



## Process and issues paper - review of 2014/15 base milk price calculation

7 April 2015

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### Purpose

1. This paper invites submissions on our 2014/15 base milk price calculation review from interested parties on:
  - 1.1 the key areas that we intend to focus on;
  - 1.2 our approach; and
  - 1.3 our process for the review.
2. Details on how you can provide your views can be found in paragraphs 30 and 31.
3. Submissions are due to us no later than **5pm, Tuesday 28 April 2015**.

### How interested parties can contribute

4. Before preparing this paper, we met with Fonterra and with representatives of some of the independent processors (Synlait Milk Limited, Miraka Limited and Open Country Dairy Limited) to better understand their issues and concerns and to help us select the focus areas and decide the approach to our review.
5. We are particularly interested in any comments from interested parties on:
  - 5.1 any suggested additional areas of focus;
  - 5.2 suggested alternative approaches in analysing our focus areas; and
  - 5.3 any additional supporting evidence that can be provided that may assist us in our reviewing these areas of Fonterra's base milk price calculation.
6. We have separately made available on our website a breakdown of the categories of the base milk price calculation as per Fonterra's Milk Price Model.<sup>1</sup> This is to assist interested parties in providing us with input on the base milk price calculation or on individual revenue or cost components. We appreciate there may be potential issues of confidentiality in providing us with such information and we set out later in this paper how we would treat such information.

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<sup>1</sup> <http://www.comcom.govt.nz/review-of-milk-price-calculation-201415-season/>

### Scope of our review

7. The scope of our review is confined to Fonterra's base milk price calculation. We will consider the extent to which the assumptions adopted, and the inputs and processes used, provide an incentive to Fonterra to operate efficiently, while providing for contestability in the market for the purchase of milk from farmers.<sup>2</sup>

### Our approach in reviewing the 2014/15 base milk price calculation

8. This is the second of two reviews we are required to undertake under the Dairy Industry Restructuring Act 2001 (the Act) on the base milk price each milk season. The first review this season, of Fonterra's 2014/15 Milk Price Manual which describes the rules used to calculate the base milk price was completed in December 2014.<sup>3</sup>
9. In our past reviews of the base milk price calculation we reviewed each revenue or cost component making up the base milk price. We also carried out an aggregate cross-check of the assumptions, inputs, and processes for the components.
10. This year we intend to build on this aggregate assessment to provide an improved reasonableness check of the practical feasibility of the notional producer as a whole.
11. We will continue to review each component, but put a greater level of emphasis on certain areas of focus, and review all other components on whether they are each fit for purpose in the base milk price calculation.

### Legal framework

12. We are not proposing to substantively change our legal framework (eg. our interpretation of 'efficient processor'). However, we will review the framework to make sure the way we have described it remains accurate within the context of our 2014/15 base milk price calculation review. The legal framework can be found in Attachment B of our 2013/14 base milk price calculation review final report.<sup>4</sup>

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<sup>2</sup> These are the statutory tests in s 150A of the *Dairy Industry Restructuring Act 2001* (as amended on 26 July 2012).

<sup>3</sup> Commerce Commission "Review of Fonterra's 2014/15 Milk Price Manual: Final Report" (15 December 2014).

<sup>4</sup> Commerce Commission "Review of Fonterra's 2013/14 base milk price calculation: Final Report" (15 September 2014).

### **Focus areas of our review**

13. We have identified the focus areas for the 2014/15 calculation review from:
  - 13.1 components where we were unable to conclude on their practical feasibility in our 2013/14 calculation review and our 2014/15 Manual review;
  - 13.2 concerns raised in submissions from our 2014/15 Manual review that relate to the 2014/15 base milk price calculation review; and
  - 13.3 our meetings with Fonterra and independent processors.
14. The focus areas for this year's review are:
  - 14.1 Aggregate assessment of the notional producer;
  - 14.2 Pricing;
  - 14.3 Yields;
  - 14.4 Certain cash costs (energy, repairs and maintenance, administration and site overheads); and
  - 14.5 Capital charge on fixed assets (WACC rate, capital cost estimates, impact of peak flows of milk, depreciation, company tax and capital charge on net working capital).

#### *Aggregate assessment of the notional producer*

15. Independent processors have raised the concern that the notional producer is not practically feasible in aggregate, citing material differences between an efficient processor and the performance of the notional producer. We therefore intend this year to place a greater emphasis on an aggregate assessment of the practical feasibility of the notional producer.
16. Independent processors have cited a lack of transparency of the notional cost details used in the calculation of the base milk price published in the annual Milk Price Statement. In particular, they note the lack of details on the notional producer's cost category breakdown.
17. This has resulted in independent processors saying they are unable to pinpoint areas where material differences may lie between the actual costs of an efficient processor and the notional costs of the notional producer. Accordingly, this constrains their ability to provide appropriately-presented comparable information for our aggregate review.

18. We have discussed with Fonterra how it might provide greater guidance to interested persons on the breakdown of the notional cost components. As a first step, we have prepared a supporting breakdown that includes the assumptions, inputs, and process for each component from our 2013/14 review of the base milk price calculation.<sup>5</sup> We have grouped those descriptions by the main cost categories that are forecast to apply to the 2014/15 base milk price calculation.
19. We are encouraging Fonterra to provide a more granular breakdown of the notional values comprising the base milk price calculation this year in its reasons paper than it has previously provided in its Milk Price Statement, to the extent that the notional values are not dependent on disclosing actual Fonterra values.
20. The steps we will use to assess the aggregate practical feasibility of the notional producer in the base milk price calculation model are:
  - 20.1 A 'top-down' analysis of the financial aspects of the notional producer to review the overall consistency of the individual revenue and cost components of the milk price calculation.
  - 20.2 Compare the aggregate financial result between Fonterra's notional and actual performance. We will compare the performance of Fonterra's NZ Milk Products (NZMP) dairy ingredients business with the notional producer's modelled performance.<sup>6</sup>
  - 20.3 Review what the investment markets are saying about the performance of NZMP and the impact of the base milk price (calculated on a notional basis) on the ability to forecast NZMP's (and Fonterra's) actual earnings.
  - 20.4 To assist with our review, we invite independent processors to provide cash cost information based on the categories outlined in our separate breakdown of the categories in the milk price model.

### *Pricing*

21. We will review the pricing inputs to the calculation of the notional revenue in the milk price calculation model. In particular, we will look at whether the GDT pricing used in the milk price model is consistent with the modelled notional volumes. We will also consider how Fonterra has dealt with cross-period billing and review the reasonableness of the treatment of non-GDT sales in the milk price calculation model.

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<sup>5</sup> <http://www.comcom.govt.nz/review-of-milk-price-calculation-201415-season/>

<sup>6</sup> NZMP is the closest Fonterra business that resembles the notional producer. NZMP ingredients products include the reference commodity products and other milk ingredients. Attachment A outlines how the farm gate milk price is used in calculating NZMP's earnings before interest, tax, depreciation and amortisation (EBITDA).

### *Yields*

22. We will review whether or not the assumed losses for the notional producer are practically feasible for a full season. We will take into consideration the assumed mix of old and new plants in the milk price model and the commercial realities of operating plants.
23. We propose to further review the mass balance reconciliation calculation between assumed volumes in the milk price calculation model and the milk collected for production.

### *Certain cash costs*

24. We will review the following components and the overall consistency of the charges with other related components:
  - 24.1 Energy costs (variable and fixed). We have previously been unable to conclude on the practical feasibility of energy costs and the related 'on product time' (OPT) assumption. We have engaged an independent energy expert to assist us in determining the practical feasibility of the assumed energy costs for a full dairy season. We have determined that to improve the chances of reaching a conclusion a 'top-down' review type approach is required rather than the previous 'bottom-up' empirical re-performance approach.
  - 24.2 Repairs and Maintenance. We could not previously conclude on the contestability dimension of Rule 15: Repairs and Maintenance of the Milk Price Manual. We will review the consistency of application in the 2014/15 base milk price calculation with Rule 15 in Fonterra's 2014/15 Milk Price Manual. We will also assess the practical feasibility of this component alongside the costs of fixed assets for the notional producer.
  - 24.3 Administration costs and site overhead costs. We will review the reasonableness of continuing to use Fonterra's 2012 budgeted numbers, increased yearly by inflation, for cash costs in the 2014/15 dairy season. The key question is whether this approach adequately addresses the issues of scalability of costs to the size of the notional processor.

### *Capital charge on fixed assets*

25. We will review the individual parts of the capital charge and the overall consistency of the charge with other related components:

- 25.1 WACC rate (asset beta assumption and specific risk premium). We could not previously conclude on the asset beta assumption and specific risk premium. We propose to review the asset beta report from Fonterra's independent reviewer and conclude on the WACC rate overall. The Commission will be working with Fonterra to publicly release the asset beta report before our Draft report.
- 25.2 Capital cost estimates. We could not previously conclude on the practical feasibility of the plant capital cost estimates. We raised the issue whether additional cash costs would arise from capacity issues at the times of peak milk flows. We intend to further review the capital cost estimates on a 'top down' basis using cost information from Fonterra's actual plant commissioning. To do this we will test how the assumptions on the notional commissioning of plant are developed from the forecast milk volumes.
- 25.3 Impact of peak flows of milk. We will test how the notional commissioning of plants lines up with the assumptions on cash costs at the time of peak flows of milk (ie, whether there is sufficient assumed capital capacity in the milk price model to deal with peak flows) and will consider what is likely to happen to cash costs if there is not sufficient capacity at any stage.
- 25.4 Depreciation (tilted annuity method) and company tax. We will review the consistency of the tax depreciation calculation with the assumed economic lives in the tilted annuity formula.
- 25.5 Capital charge on net working capital. We will review the assumptions in the model on this cost component with the setting of the advance milk price.

### **Review of other components**

26. For all other components not part of the areas of focus we will undertake a fit for purpose review. This will involve an analytical verification of the component against our previous reviews of the component and resolution of carried forward issues. It will also include a review of the consistency of the component with the other components. If this review identifies inconsistencies with our previous analyses or with other components of the model, we will consider whether a more substantive analysis is required.

### Indicative timeline for our review

27. A summary of our review process and indicative timings for stages in our review is set out in Table 1.

**Table 1: Indicative timeline**

Process step	Indicative timing
This Process and issues paper released	Tuesday 7 April 2015
Submissions on Process and issues paper due	Tuesday 28 April 2015
Fonterra provides Commission with information required under section 150T of the Act	Wednesday 1 July 2015
Draft report on base milk price calculation released	Monday 17 August 2015 <sup>7</sup>
Submissions on Draft report due	Tuesday 1 September 2015
Final Report on base milk price calculation released	Tuesday 15 September 2015

28. The Act requires us to consult with Fonterra on our Draft report. However, we also intend to provide an opportunity for other interested parties to comment throughout our review process, as outlined above.
29. We will communicate any updates to this process as they arise.

### How you can provide your views

30. We invite you to provide your written submissions on this paper no later than **5pm, Tuesday 28 April 2015**.
31. Submissions on this paper should be addressed to:

Brett Woods

Senior Analyst, Regulation Branch

c/o [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

<sup>7</sup> The Act requires us to publish our draft report annually by 15 August. 15 August 2015 falls on a Saturday. Consistent with s 35(6) of the Interpretation Act 1999, we will publish our report the following business day, which is Monday 17 August 2015.

*Preserving confidentiality of your submission or other information provided*

32. We encourage full disclosure of submissions so that all information can be tested in an open and transparent manner. However, we offer the following guidance where you wish to provide information in confidence:
  - 32.1 If you include confidential information in your submission, the information should be clearly marked.
  - 32.2 Both confidential and public versions of your submission should be provided.
  - 32.3 The responsibility for ensuring that confidential information is not included in a public version rests entirely with the party providing the submission.
33. Under s 145 of the Act, parties providing us with information can also request us to make orders under s 100 of the Commerce Act in respect of information that should not be made public.
34. Any request for a s 100 order must be made when the information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on s 100 orders if requested by parties.
35. Any s 100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.

**Attachment A: NZ Milk Products**

