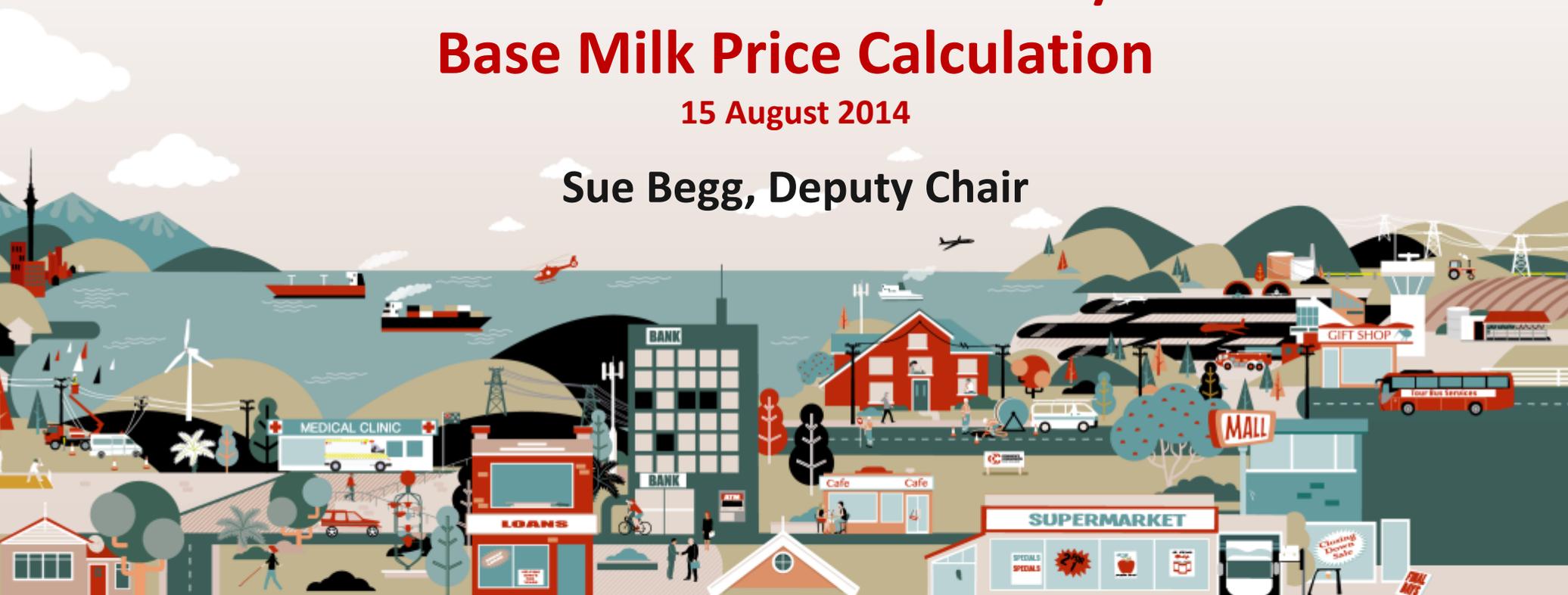


Commerce Commission

Review of Fonterra's 2013/14 Base Milk Price Calculation

15 August 2014

Sue Begg, Deputy Chair



Overview

- Summary of draft conclusions
- Milk price monitoring regime
- Fonterra's calculation of base milk price
- Adjustment amount
- Our draft conclusions
- Longer term implications
- Our process and next steps



Summary of draft conclusions

- Together, the assumptions, inputs and process used to calculate 2013/14 base milk price are **not** consistent with regime's purpose
- Fonterra has **not** calculated the 2013/14 base milk price consistent with the efficiency dimension of the regime's purpose
 - Key issue is the way the Adjustment Amount has been determined and implemented
- Fonterra has calculated a base milk price consistent with the contestability dimension of the regime's purpose
 - This year's downward adjustment to the Manual-consistent price is sufficiently large to ensure practical feasibility for an efficient processor

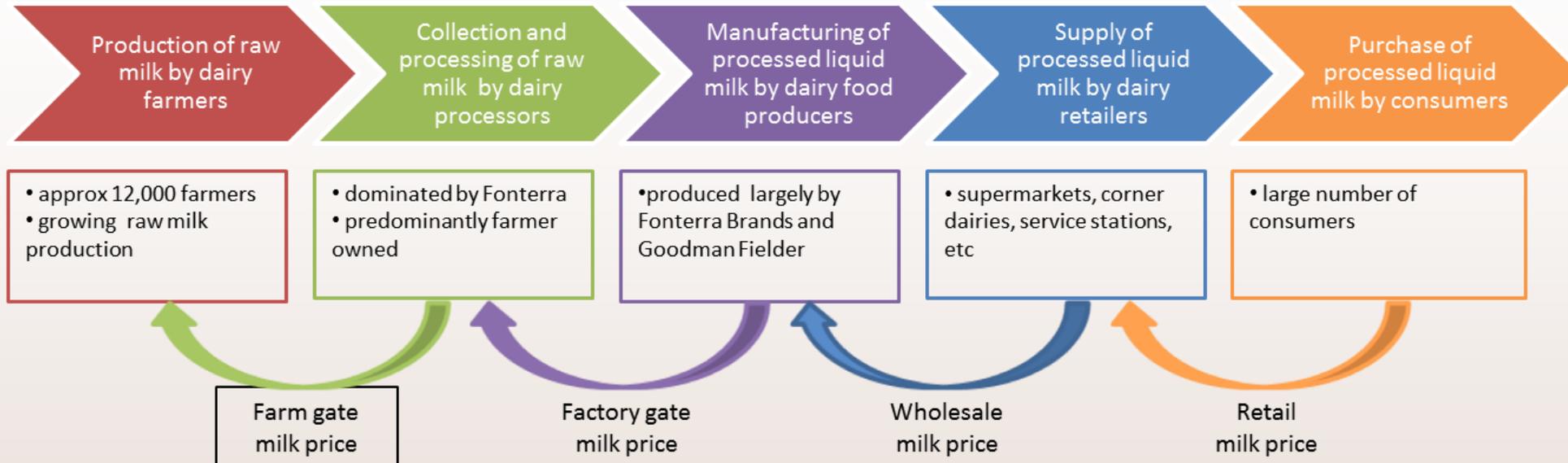


DIRA's milk price monitoring regime

- Dairy Industry Restructuring Act 2001 (DIRA) milk price monitoring regime introduced in 2012
- Regime intended to provide greater transparency in the way Fonterra sets the 'base milk price'
- This is a *monitoring* regime – largely disclosure obligations
- Legislation does not constrain how Fonterra actually calculates the base milk price



Base milk price



- ‘Base milk price’ is the term in DIRA for Fonterra’s farm gate milk price
- Monitoring regime *not* about price for processed milk



Monitoring regime's purpose

- To promote the setting of a base milk price that provides an incentive to Fonterra to **operate efficiently** while providing for **contestability** in the market for the purchase of milk from farmers
- Contestability is considered to be provided for if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are **practically feasible** for an efficient processor



Legislative requirements

- Fonterra is required to provide us with:
 - Milk Price Manual setting out how the base milk price is to be calculated for the coming season
 - Assumptions adopted, and inputs and process used, in calculating the base milk price for the preceding season
- Each year we review Fonterra's Manual and base milk price calculation
 - We report on the extent to which the assumptions adopted, and the inputs and process used by Fonterra are consistent with the purpose of the regime
 - We must not state the base milk price according to own calculations

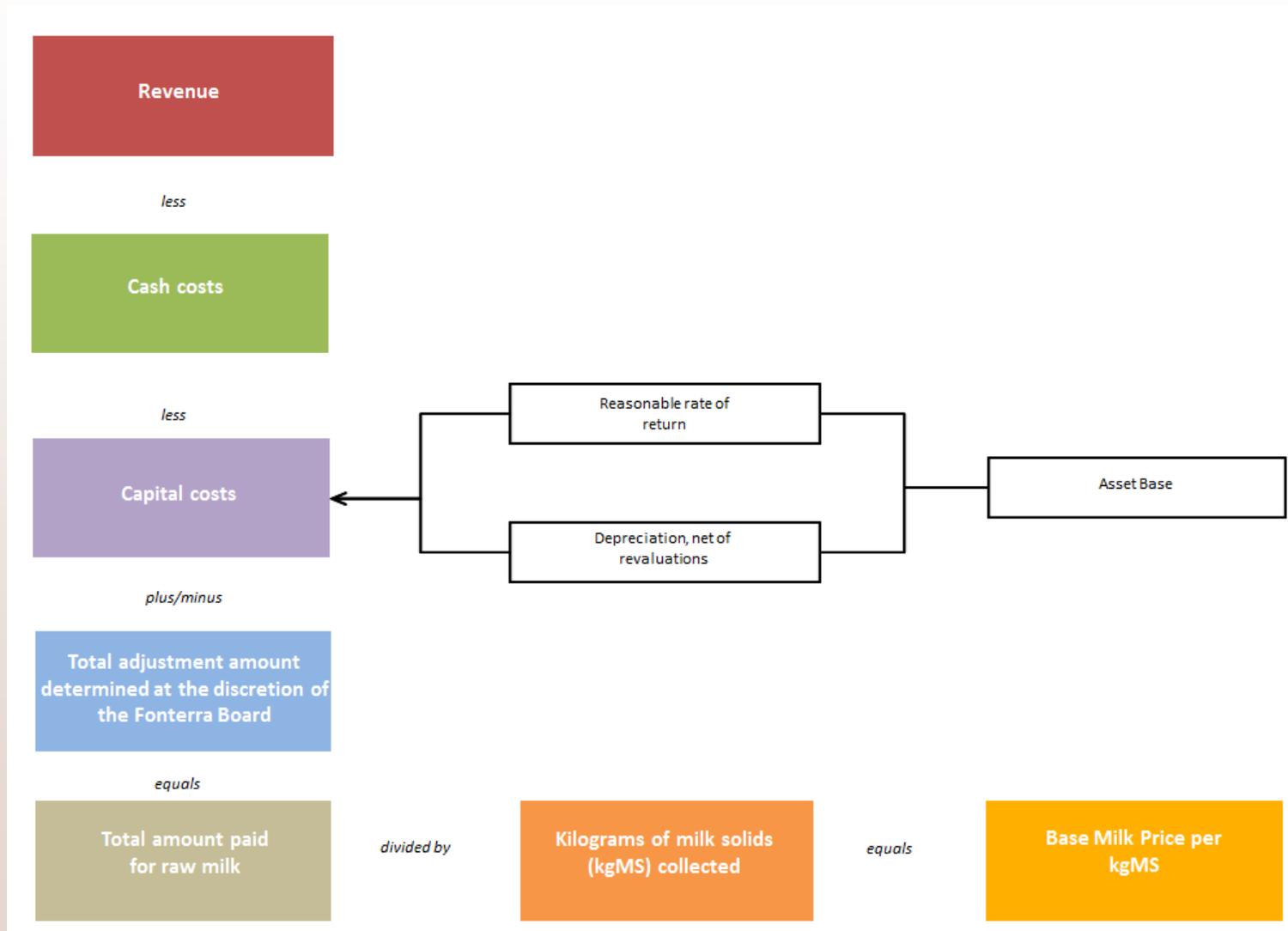


Calculation is based on notionals

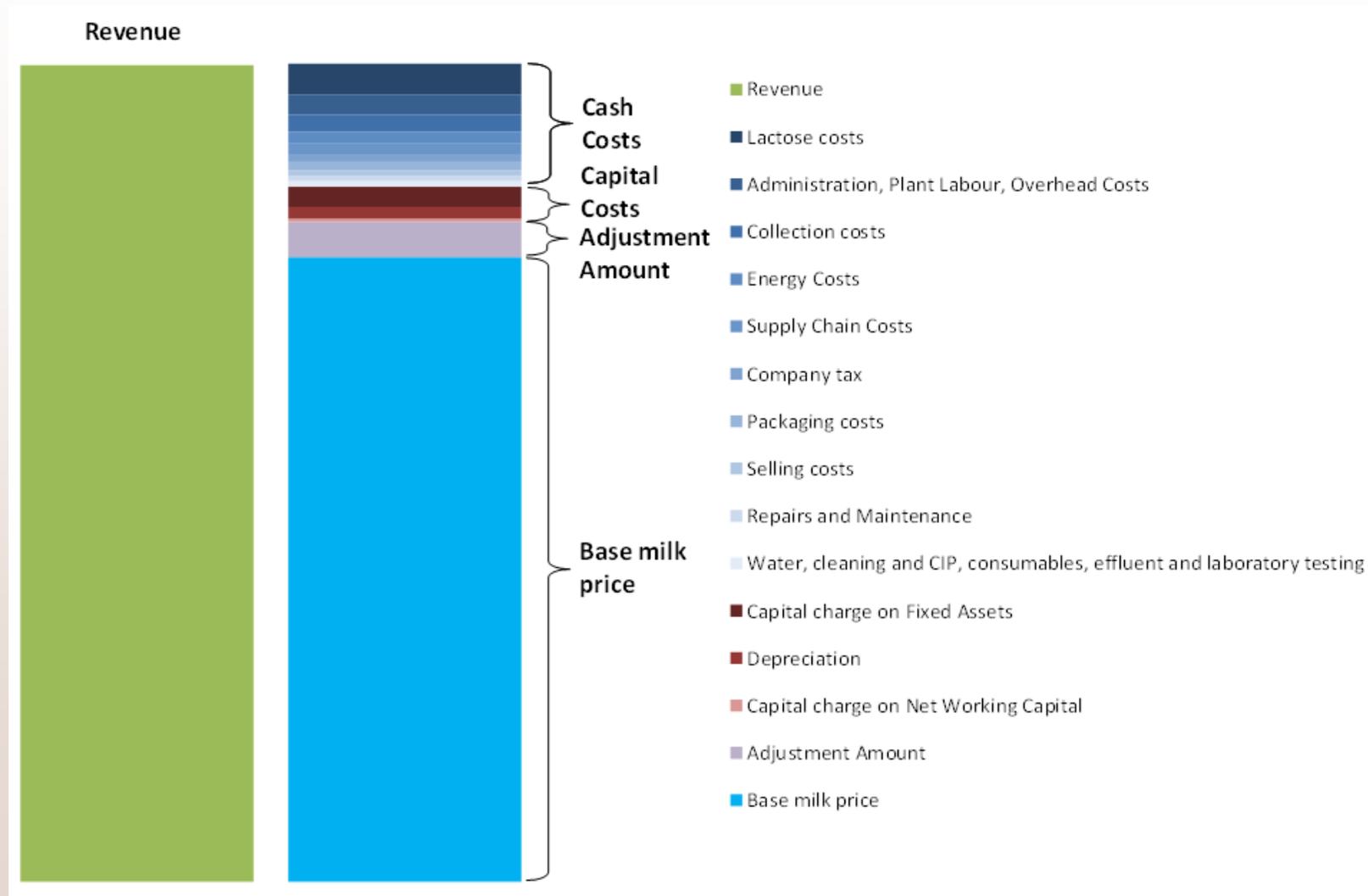
- Under DIRA, Fonterra is expected to calculate the base milk price using the revenues and costs of a **notional** milk processing business
- Notional revenues based on sale of **reference commodity products**
 - Reference commodity products are: whole milk powder, skim milk powder, butter, anhydrous milk fat and butter milk powder
- Notional costs based on costs of collecting, processing, transporting and selling reference commodity products



How Fonterra sets the milk price



Significance of each component



How we review the calculation

- We review each of the components that go into the base milk price calculation and ask these questions
- Efficiency: is the component notional or actual?
 - When the base milk price is calculated using notional data, Fonterra's own efficiency performance will affect its profits
 - The scope to improve profits provides Fonterra with incentives to improve efficiency
- Contestability: is the component practically feasible individually, and also with others in aggregate?



2013/14 Adjustment Amount

- In previous years, Fonterra has paid a base milk price consistent with its Milk Price Manual
- For 2013/14, Fonterra intends to adjust the Manual-consistent milk price down by an Adjustment Amount
 - \$8.95/kgMS Manual-consistent price, 55c/kgMS Adjustment Amount, \$8.40/kgMS base milk price
- Fonterra's 2013/14 Adjustment Amount is a new component, which is the most significant in this year's review
- Final base milk price not set until September – after our final report



2013/14 Adjustment Amount

- Reference commodity products were much more profitable than products Fonterra was actually able to make
 - Its actual asset footprint meant it was unable to produce the same mix of high return products
- Fonterra faced high costs dealing with milk flows at season peak
 - Limits on physical processing capacity resulted in extra transport costs, inefficient product specification
- Fonterra intends to use the Adjustment Amount to reverse out these adverse effects on its earnings by lowering milk price



2013/14 Adjustment Amount

- DIRA allows for Fonterra to set a base milk price different from the Manual-consistent price
- If so, Fonterra must make its reasons publicly available
- Reasons included in Fonterra's 2013/14 'Reasons paper' – its report to us on assumptions, inputs and process used in this year's base milk price calculation



Our overall draft conclusions

- Together, the assumptions, inputs and process used to calculate 2013/14 base milk price are **not** consistent with regime's purpose
- Fonterra has **not** calculated the 2013/14 base milk price consistent with the efficiency dimension of the regime's purpose
- Fonterra has calculated a base milk price that **is** consistent with the contestability dimension of the regime's purpose
- Inconsistency with either the efficiency or contestability dimension is sufficient for us to conclude the base milk price has not been set consistent with the purpose



Draft conclusions – efficiency

- Fonterra has **not** set the 2013/14 base milk price consistent with the efficiency dimension of the regime's purpose
- Efficiency incentive provided when Fonterra's profitability depends on whether it is more or less efficient than notional producer
- Adjustment Amount reverses out adverse effects on Fonterra's earnings this year due to processing constraints
- Adjustment undermines incentive by removing profitability impact of Fonterra's less efficient performance
- But other factors provide Fonterra with incentives for efficiency



Draft conclusions – contestability

- Fonterra has set a base milk price consistent with the contestability dimension of the regime's purpose
- This year's downward adjustment to the Manual-consistent price is sufficiently large (55 cents/kgMS) that the assumptions, inputs and process used should, in aggregate, be practically feasible for an efficient processor



Draft conclusions – if no adjustment

- We also present our draft conclusions for the 2013/14 base milk price calculation **without** the milk price adjustment
- *Efficiency*: use of mostly notional data to set the Manual-consistent price would be consistent with providing incentives for Fonterra to operate efficiently
- *Contestability*: it is probable the assumptions, inputs and process used to set the Manual-consistent price would, in aggregate, **not** be practically feasible for an efficient processor



Draft conclusions – if no adjustment

- Conclusion on contestability dimension if no adjustment
 - One component of the base milk price, energy costs, is not practically feasible
 - We are unable to reach a conclusion for fixed asset values and asset beta
 - No cost allowance appears to be made for the risk that peak milk flows exceed the capacity of the notional processor
 - These factors act in the same direction, and are of sufficient size to imply the Manual-consistent price may be ‘too high’



Longer term implications

- The milk price monitoring regime provides a ‘snapshot’ of a single year’s base milk price against the regime’s purpose
- Further work is planned to resolve outstanding issues from this year’s review for our 2014/15 review
- We have suggested Fonterra consider making an allowance for peak flows in its future base milk price calculation



Longer term implications

- A single year's negative finding on the efficiency dimension might not be a significant concern because many other factors provide incentives for Fonterra to operate efficiently
- Fonterra is allowed to adjust the base milk price but doing so might reduce predictability for farmers, investors, or other processors
- Material discounts to the base milk price could be a concern if they persisted over time
 - They might reduce Fonterra's incentives to operate efficiently and promote inefficient entry rather than contestability



Our process and next steps

Process paper released	9 June 2014
Comments on process paper received	20 June 2014
Receipt of Fonterra's Reasons paper	1 July 2014
Submissions received on Reasons paper	15 July 2014
Draft report released	15 August 2014
Submissions on draft report due	1 September 2014
Final report released	15 September 2014



Any questions?



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Additional background: our interpretation of the efficiency and contestability dimensions



Our interpretation of the purpose

- We have interpreted the primary focus of the **efficiency dimension** of the regime's purpose to be on improving incentives for Fonterra to drive cost efficiencies (ie, productive and dynamic efficiency)
 - Fonterra will have a greater incentive to operate efficiently where the base milk price is set independently of Fonterra's actual performance (ie, where the calculation of the base milk price relies on notional data)
 - For a given level of revenue, cost efficiency improvements will result in higher profits for Fonterra
 - Incentives for efficiency from the setting of the base milk price will depend on the extent to which the base milk price bears the risk that actual performance might fall below forecast performance



Our interpretation of the purpose

- We have interpreted the **contestability dimension** of the regime's purpose to be satisfied if the assumptions adopted, and inputs and process used in setting the base milk price are practically feasible for Fonterra or another processor that is efficiently building an incremental plant



