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The Dairy Industry Restructuring Act 2001

Review of Fonterra's 2014/15 Milk Price Manual

Draft report

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Wellington, New Zealand

Contents

Executive Summary

X1 This report sets out our draft conclusions, and the reasons for those draft conclusions, on the extent to which Fonterra's Milk Price Manual for the 2014/15 dairy season (the 2014/15 Manual) is consistent with the purpose of the milk price monitoring regime set out in s 150A of the Dairy Industry Restructuring Act 2001 (the Act). It covers the first of two annual statutory reviews of Fonterra's base milk price setting that we are required to complete for each dairy season.

X2 Section 150A of the Act specifies that the purpose of the milk price monitoring regime is to promote the setting of a base milk price by Fonterra:

X2.1 that provides an incentive for Fonterra to operate efficiently (the efficiency dimension), while

X2.2 providing for contestability in the market for the purchase of milk from farmers (the contestability dimension).

X3 Our approach to this statutory review of the Manual, as applied in previous reviews, can be found in Attachment B, and an overview of the setting of the farm gate milk price in New Zealand, which was outlined in previous reviews, can be found in Attachment C.

X4 Our approach to considering the efficiency dimension is to assess the extent to which the provisions in the Manual are consistent with setting a base milk price that provides an incentive to Fonterra to operate efficiently, by providing for the use of notional components in the calculation of the base milk price. Our view is that setting independent notional benchmarks for the revenue and cost inputs that underpin the base milk price calculation would be expected to provide an incentive for Fonterra to operate efficiently. This is consistent with the Act, which envisages the use of notional values, and involves the assumption of a notional milk processing and collecting business (a 'notional producer').

X5 In assessing the contestability dimension, we considered the extent to which the Manual provides for the notional costs, revenues or other assumptions taken into account in calculating the base milk price to be practically feasible for Fonterra or another efficient processor.

X6 Our assessment of the 2014/15 Manual is based on our previous reviews of the Milk Price Manual and of Fonterra's 2013/14 base milk price calculation, as well as the supporting information we received from Fonterra and other interested parties for this and the previous reviews.

X7 Our conclusion is that, to the extent we are able to assess it, the 2014/15 Manual is largely consistent with the s 150A purpose statement.

X8 A number of amendments made by Fonterra to the 2014/15 Manual have primarily been made to address specific concerns we raised in our 2013/14 Manual review report.

X9 Overall, the amendments are an improvement on the 2013/14 Manual and are a step towards greater consistency with the s 150A purpose statement. However, the amendments introduce flexibility in the application of some aspects of the rules.

X10 We are therefore unable to conclude on the extent to which the following amended rules are consistent with the s 150A purpose statement. We will further review their specific application in the 2014/15 base milk price calculation.

X10.1 *The calculation of the 'repair and maintenance costs' in Rule 15.* Although the new rule is more prescriptive than the previous rule, the change introduces additional elements of discretion as to how it might be applied. This means we are unable to conclude on the extent to which the rule is consistent with calculating a base milk price that takes into account practically feasible notional costs.

X10.2 *The mechanism for providing for stranded asset risk in Rules 30 and 41.* The changes made to these rules are improvements. The stranded asset risk due to a change in the reference commodity products (RCPs) can now be provided for as an *ex ante* allowance under Rule 41. However, the changes introduce discretion as to how the rules might be applied. This means we are unable to conclude on the extent to which these rules are consistent with the s 150A purpose statement.

X11 Furthermore, the amendment made to Rule 40 addresses our concerns that the stranded asset risk is an unsystematic risk and that it should not be included in the asset beta. However, we are unable to conclude on the practical feasibility of Fonterra's asset beta estimate that would arise on application of the rule due to the information not yet being available from Fonterra.

X12 In addition, there were some outstanding issues from our review of the 2013/14 Manual not addressed by Fonterra. The most significant issue is:

X12.1 *The calculation of 'other costs, including site overheads, general overhead costs and R&D costs' in Rule 18*. During our review of Fonterra's 2012/13 base milk price calculation, Fonterra signalled its intention to introduce methodological changes to calculating these costs for the 2014/15 dairy season that would not require changes to the rule itself. Because of the apparent flexibility in the rule, we are unable to conclude on the extent to which the rule is consistent with calculating a base milk price that takes into account practically feasible notional costs.

X13 Also, in our final report on the 2013/14 base milk price calculation, we questioned whether the base milk price methodology adequately provides for costs associated with one-off or difficult to forecast events such as the 'super flush' peak milk flows in the 2013/14 dairy season.

X14 We will assess the specific application of the rules on which we are unable to conclude and consider, on the basis of the circumstance of the 2014/15 season, whether a more explicit provision for costs of a one-off or difficult to forecast nature is warranted as part of our review of Fonterra's 2014/15 base milk price calculation in 2015.

1. Introduction

1.1 In this chapter, we:

1.1.1 set out the purpose of this draft report and the scope of our review of Fonterra's 2014/15[1] Milk Price Manual (the 2014/15 Manual);

1.1.2 outline the structure of this report; and

1.1.3 set out how interested parties can contribute to our review of Fonterra's 2014/15 Manual before we finalise our conclusions.

Purpose of this report

1.2 The purpose of this draft report is to set out our draft conclusions, and the reasons for those draft conclusions, on the extent to which the 2014/15 Manual is consistent with the purpose of the milk price monitoring regime set out in the Dairy Industry Restructuring Act 2001 (the Act).

1.3 This draft report is being provided to Fonterra for comment in accordance with s 150M of the Act. In addition, we welcome feedback from other interested parties on our draft conclusions in this draft report. Any comments must be provided by 5.00pm on Monday, 17 November 2014.[2]

1.4 After considering all comments, we will finalise our conclusions and publish our final report by 15 December 2014.[3]

Scope of our review of the Manual for the 2014/15 dairy season

1.5 This draft report relates to the first of two annual statutory reviews of Fonterra's base milk price setting that we are required to undertake in each dairy season under the Act. For the 2014/15 dairy season these are:

1.5.1 this review of the 2014/15 Manual, at the start of the season; and

1.5.2 a review of the application of the 2014/15 Manual to Fonterra's 2014/15 base milk price calculation, later in the season.

1.6 This draft report relates to the review of the Milk Price Manual for the 2014/15 dairy season.

[1] The 2014/15 dairy season is the period commencing 1 June 2014 and ending on 31 May 2015.

[2] The Act requires that submissions from Fonterra are due not later than 15 November. As 15 November 2014 is a Saturday, consistent with s 35(6) of the Interpretation Act 1999, this date is extended to Monday 17 November 2014.

[3] The Act requires us to publish our final report annually by 15 December.

1.7 For this review, we have considered the provisions in the 2014/15 Manual that underpin Fonterra's methodology for setting the base milk price (ie, the principles, key assumptions, detailed rules and definitions as set out in the 2014/15 Manual), but not the application of the 2014/15 Manual to the calculation of the 2014/15 base milk price (ie, the assumptions, inputs and process that underpin the base milk price calculation).

1.8 In 2015 we will separately review the assumptions, inputs and process that underpin the calculation of the base milk price as part of our review of the 2014/15 base milk price calculation.[4] This means that our conclusions on the 2014/15 Manual could change when we see the rules in the 2014/15 Manual applied in actual practice to the 2014/15 base milk price calculation.

1.9 Section 150I of the Act requires us to report on the extent to which the provisions in the Manual are consistent with the purpose of Subpart 5A (s 150A) of the Act (the s 150A purpose). The s 150A purpose is to promote the setting of a base milk price by Fonterra:

1.9.1 that provides an incentive to Fonterra to operate efficiently (the efficiency dimension), while

1.9.2 providing for contestability in the market for the purchase of milk from farmers (the contestability dimension).

1.10 In order for us to report on this, Section 150L of the Act requires Fonterra to provide us with the following information:

1.10.1 the 2014/15 Manual;

1.10.2 any recommendations by the Milk Price Panel in relation to the setting of the base milk price;

1.10.3 notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the 2014/15 Manual;

1.10.4 certification of the extent to which Fonterra considers that the 2014/15 Manual is consistent with the purpose in s 150A; and

1.10.5 the reasons for that view expressed in Fonterra's certification.

1.11 This required information has been provided in *Fonterra's 'Reasons' paper in support of Fonterra's Milk Price Manual for the 2014/15 Season* (Reasons Paper), which we have published on our website.[5]

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4 We published our final conclusions on the 2013/14 base milk price calculation in our report *Dairy Industry Restructuring Act 2001: Review of Fonterra's 2013/14 base milk price calculation* (15 September 2014).

5 All documents cited in this report on the 2014/15 Manual are available on our website.

1.12 The Act only requires us to have regard to information provided by, and any submission made by, Fonterra. There is no requirement for us to consult more broadly with other interested parties. However, we have decided to provide an opportunity for all interested parties to comment on Fonterra's Reasons Paper, our Process Paper and our draft report.

1.13 In our Process Paper on the review of the 2014/15 Manual we invited comments from interested persons on the process we proposed to undertake for our review and on the information provided by Fonterra.[6]

1.14 We have had regard to information provided in Fonterra's Reasons Paper and a submission we received on our Process Paper.[7]

How we present our analysis and draft conclusions

1.15 For this review, we have relied on our conclusions from previous reviews of the Milk Price Manual for the provisions that have not changed. We set out the detail of those aspects of the 2014/15 Manual where we consider there is a need for particular comment.

1.16 We outline our draft conclusions, and the reasons why we have reached them, in Chapter 2 of this report. Our draft conclusions reflect our assessment of the extent to which the 2014/15 Manual is consistent with the purpose in s 150A of the Act.

1.17 We set out our interpretation of the key legislative provisions and our approach to the review of the 2014/15 Manual in Attachment B of this report. It explains the key questions and concepts that have guided our assessment of the 2014/15 Manual and our rationale behind them.

1.18 We provide an overview of Fonterra's methodology for setting the base milk price in Attachment C. The content of this attachment was included in our previous reports on Fonterra's base milk price setting.

How you can contribute to our analysis

1.19 In addition to the statutory requirement under s 150M for us to consult with Fonterra on our draft report, we are providing an opportunity for all interested parties to comment on this draft report.

1.20 We welcome your views on any aspects of this draft report or any other issue that you think we should consider before finalising our conclusions.

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[6] Commerce Commission, *Process Paper – Review of the Milk Price Manual for the 2014/15 dairy season*, 29 August 2014.

[7] *Miraka submission to the Commerce Commission: Process Paper (29 August 2014) - Review of the Milk Price Manual for the 2014/15 Dairy Season*, 15 September 2014.

Deadline for your submission

1.21 To allow us time to consider your views, your submission must be provided to us by no later than 5:00 pm on Monday 17 November 2014. We will consider submissions and publish our final report on 15 December 2014.

Format of your submission

1.22 All submissions must be provided electronically in a format suitable for word processing. You should address your response to Patricia Jennings at regulation.branch@comcom.govt.nz.

1.23 We intend to publish all submissions on our website. If you would like the published electronic copy to be 'locked' then we ask that you provide multiple versions of your comments. At least one version should be provided in a file format suitable for word processing, rather than a locked PDF file format.

Preserving confidentiality of your submission

1.24 While we discourage requests for non-disclosure of information you provide to us, we recognise that there may be cases where parties wish to provide information in confidence. We offer the following guidance:

1.24.1 If it is necessary to include confidential information in your submission, the information should be clearly marked.

1.24.2 Both confidential and public versions of your submission should be provided.

1.24.3 The responsibility for ensuring that confidential information is not included in a public version rests entirely with the party providing the submission.

1.25 Parties can also request that we make orders under s 100 of the Commerce Act 1986 (s 100 order) in respect of information that should not be made public. Any request for a s 100 order must be made when the relevant 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. A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. 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.

2. Draft conclusions from our review of the 2014/15 Manual

2.1 In this chapter we summarise our draft conclusions, and the reasons for those draft conclusions, on the extent to which the 2014/15 Manual is consistent with the purpose in s 150A of the Act.

2.2 To the extent we are able to assess it, our draft conclusion is that the 2014/15 Manual is largely consistent with the s 150A purpose.

2.3 The changes made by Fonterra to its 2014/15 Manual have primarily been made to address specific concerns we raised in our 2013/14 Manual review report.[8]

2.4 Overall, the changes are an improvement on the 2013/14 Manual and are a step towards greater consistency with the s 150A purpose statement.

2.5 We have relied on our conclusions from previous Milk Price Manual reviews for the provisions that have not changed.

2.6 We set out the detail of those aspects of the 2014/15 Manual where we consider there is a need for particular comment. These fall into the following categories:

2.6.1 amendments to the 2014/15 Manual since our review of the 2013/14 Manual;

2.6.2 outstanding issues from our 2013/14 Manual review not addressed by Fonterra in its changes or Reasons Paper; and

2.6.3 an issue raised in our 2013/14 base milk price calculation review that should be considered for inclusion in the 2015/16 Manual.

2.7 In its certification on the consistency of the 2014/15 Manual with the s 150A purpose, Fonterra has requested that in respects other than the current year changes, the 2014/15 Reasons Paper be read in conjunction with its 2012/13 and 2013/14 Reasons Papers.[9]

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[8] Commerce Commission, *Final Report on Review of Fonterra's 2013/14 Milk Price Manual*, 16 December 2013.

[9] Fonterra, *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2014/15 Seas*on, (1 August 2014), page 4: see Fonterra, *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2013/14 Seas*on, (1 August 2013), and *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2012/13 Seas*on, (31 August 2012).

2.8 Therefore, as well as the 2014/15 Reasons Paper, our assessment takes into account Fonterra's 2013/14 Reasons Paper and our conclusions based on those reasons, updated by our review of the 2013/14 base milk price calculation.[10] Our draft conclusions on the extent to which the 2014/15 Manual is consistent with the s 150A purpose is based on our reviews of these taken together.

2.9 We do not consider that any of the changes made to the 2014/15 Manual would affect our previous conclusions on the Milk Price Manual at an aggregate assessment level.

Amendments to the 2014/15 Manual since our review of the 2013/14 Manual

2.10 Fonterra has made four substantive changes to address our specific concerns in the 2013/14 Manual review:

2.10.1 a new section (section 2.6 of the 2014/15 Manual: Consistency over time) has been included to recognise the importance of the consistency of application of the Milk Price Manual across dairy seasons;

2.10.2 the revision of the rule for calculating repairs and maintenance costs (Rule 15);

2.10.3 the revision of the rule for adjustments to the asset base for amendments to reference commodity products (RCPs) (Rule 30); and

2.10.4 the revision of the rule for calculating the asset beta used in the weighted average cost of capital (WACC) (Rule 40), and addition of a new rule to establish the inclusion of a specific risk premium in the WACC (Rule 41).

2.11 Fonterra has explained the reasons for these amendments in its Reasons Paper.

2.12 We note that the lack of clear prescription in some of the changes made to the 2014/15 Manual means that we are unable to conclude on the extent to which the resulting amended rules are consistent with the s 150A purpose. We will further review the specific application of those parts of the 2014/15 Manual in the calculation of the base milk price for the 2014/15 season.

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[10] Commerce Commission, *Final Report on Review of Fonterra's base milk price calculation*, 15 September 2014.

Consistency over time (section 2.6)

Amendment and Fonterra's reasons

2.13 In our review of the 2013/14 Manual we had concerns that the descriptions of the provisions in the Milk Price Manual leave discretion for Fonterra to make year-on-year methodological changes that could lead to year-on-year changes to the base milk price which would be due to methodological choices rather than the underlying performance factors. We recognised that in some instances methodological improvements in the base milk price calculation would be beneficial (eg, where more or better evidence becomes available over time) but any improvements should be signalled through transparent changes to the documented methodology.

2.14 In response to our concerns, Fonterra has introduced a new section (2.6) into the 2014/15 Manual that recognises the importance of consistency of application of Manual across years. Section 2.6 of the 2014/15 Manual states:

> Although not a Principle, Fonterra recognises that consistency of application of the Manual across years is important. Consequently, it is intended that:
>
> In normal circumstances, the Milk Price, and inputs into its calculation, will evolve in a manner that could be achieved by a 'real world' dairy processor that is operated in a manner that satisfies the requirements of Principle 2;
>
> Where more than one approach to applying a rule is available, Fonterra will disclose any change in approach that results in a materially different value of an input used to calculate the Farmgate Milk Price, and provide an explanation of the rationale for the change in the Farmgate Milk Price Statement.11

2.15 The justification for the new section is described in Fonterra's Reasons Paper as follows:

> The amendment is intended to:
>
> - Provide increased assurance to stakeholders that the approach taken to applying the Manual will not be changed arbitrarily between years, by codifying in the Manual the approach that has in fact been applied since the introduction of the current Milk Price methodology in 2008/09.
> - At least partially address the "general concern" expressed by the Commission in its 2013 Final Report about the flexibility of interpretation of the Manual. (Other amendments also address the Commission's concern).

Our assessment of the amendment

2.16 We welcome this recognition in the 2014/15 Manual that consistency of the application of the Milk Price Manual across years is important. If actioned in practice, this would help to ensure that the Milk Price Manual reflects a set of stable and prescriptive rules that provide transparent benchmarks for Fonterra management to

[11] Fonterra, *Farmgate Milk Price Manual for the 2014/15 Season*, (1 August 2014), page 11.

beat and for external stakeholders to monitor Fonterra's performance against. This is consistent with the efficiency dimension of the purpose statement.

2.17 However, given Fonterra has noted that it is not a principle nor a rule, it is not clear how prescriptively it should be interpreted. It is also not clear in how this section of the Manual would be applied in practice.

2.18 Fonterra has not defined 'material differences' in the context of the provision in the 2014/15 Manual. However, we note that Fonterra in its Reasons Paper outlined that it is intended that materiality would be determined in an audit context (ie, by around 2 cents per kgMS or more).

2.19 The new section also states that the material difference of any change would be determined by the value of the input used in the calculation of the farm gate milk price.[12]

2.20 In its submission to our Process Paper, Miraka notes that this new section of the 2014/15 Manual does not define 'normal circumstances' and leaves considerable flexibility for Fonterra.[13] We therefore recommend that Fonterra considers clarifying 'normal circumstances' in this context for the 2015/16 Manual.

2.21 Fonterra proposes that it would disclose any material changes through the Farmgate Milk Price Statement. However, we would expect to see any changes in the approach clearly disclosed in not only the Farmgate Milk Price Statement but also in Fonterra's Reasons Paper for the base milk price calculation required to be provided to the Commission by 1 July of each year. This would require Fonterra to comment on how the process, inputs and assumptions used pursuant to the changes in approach meet the efficiency and contestability dimensions set out in the Act.

2.22 We note that in previous Reasons Papers for the base milk price calculation, changes in approach in applying a particular rule have not always been clear. It would be helpful to the Commission and other external stakeholders if these changes in approach are clearly described and disclosed.

Repairs and maintenance costs (Rule 15)

Amendment and Fonterra's reasons

2.23 In our report on the 2013/14 Manual, we had concerns that the Repairs and Maintenance Rule was less prescriptive than the previous rule and provided additional flexibility for interpretation.

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[12] We note that the audit materiality disclosed in the Farmgate Milk Price Statement is output-based.

[13] Miraka, *Miraka submission to the Commerce Commission: Process Paper (29 August 2014) - Review of the Milk Price Manual for the 2014/15 Dairy Season*, 15 September 2014, page 7.

2.24 In response to our concerns, Fonterra has amended Rule 15 (Rule 16 in the 2013/14 Manual). The previous version of this rule stated:[14]

In calculating the Farmgate Milk Price a reasonable provision for Repairs and Maintenance Costs shall be deducted, calculated by reference to:

- Fonterra's average expenditure on repairs and maintenance with respect to assets comparable to those assumed in the Farmgate Milk Price Fixed Asset Base, relative to the assessed replacement cost, age, and any other relevant characteristics of those assets;

- The relevant characteristics of the assets included in the Farmgate Milk Price Fixed Asset Base, including the assumed age and economic lives of the assets; and

- Any other matters relevant to the assessment of a commercially reasonable provision for Repairs and Maintenance Costs.

2.25 Revised Rule 15 states:[15]

In calculating the Farmgate Milk Price a reasonable provision for Repairs and Maintenance Costs shall be deducted, calculated as follows:

- For the costs that are largely fixed in nature, such as the costs of maintaining on-site engineering departments, and where sufficiently accurate information on Fonterra's actual costs is available, a provision calculated by reference to Fonterra's actual prior-year costs, adjusted where appropriate for inflation and differences in the characteristics of Fonterra's fixed assets and the Farmgate Milk Price Fixed Asset Base;

- For other costs, the amount

A x B

A. is the ratio of Fonterra's average expenditure over the preceding four years on repairs and maintenance with respect to the fixed assets on manufacturing sites that have fixed assets that are broadly comparable to those assumed in the Farmgate Milk Price Fixed Asset Base to the average assessed replacement of those assets; and

B. is the current-year assessed replacement cost of the Farmgate Milk Price Fixed Asset Base.

This Rule does not apply to repairs and maintenance costs associated with milk collection fixed assets, which are to be calculated under Rule 16 (Milk Collection Costs), or dry store fixed assets, which are calculated under Rule 19 (Supply Chain).

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14 Fonterra, *Farmgate Milk Price Manual for 2013/14 Season, Marked up* , (1 August 2013), page 41.

15 Fonterra, *Farmgate Milk Price Manual for 2014/15 Season*, 1 August 2014, page 40-41.

2.26 The justification for the change is described in Fonterra's Reasons Paper as follows:[16]

> The amended provision is more prescriptive than the provision in the F14 Manual, and is similar to the Rule which applied from F09-F13, which specified that the R&M allowance was to be reset at four yearly intervals (in each review year), by reference to Fonterra's actual R&M spend relative to the replacement costs of relevant Fonterra assets over the preceding four years, with adjustments for inflation and changes in capacity of the NMPB asset base over the intervening period. The primary differences between the new rule and the F09-13 rule are:
>
> - Under the new rule, the ratio of R&M costs to replacement costs will be reset annually, rather than once every four years. Fonterra's experience has been that this ratio has not been constant across time, and an annual reset will therefore increase the likelihood that the R&M provision satisfies the Commission's 'practically feasible' test.
>
> - The new rule allows for costs which are largely fixed in nature to be separately modelled. Again, this refinement increases the likelihood that the resulting R&M provision will satisfy the Commission's 'practically feasible' test.
>
> - The new rule allows for use R&M costs for a sample of Fonterra sites that are most similar to the notional sites assumed to be used by the NMPB (as compared to all Fonterra sites under the F09-F13 rule), again increasing the likelihood that the R&M provision reflects the costs that would actually be incurred by the NMPB.
>
> Consistent with the approach applied to date, the amended rule the R&M provision will not draw on Fonterra's current year costs, and is therefore consistent with the efficiency dimension of section 150A.

Our assessment of the amendment

2.27 As noted by Fonterra, the amended rule is more prescriptive than the rule in the 2013/14 Manual and is more closely aligned to the previous Repairs and Maintenance Rule in the Manual for the 2008/09 to 2012/13 dairy seasons.

2.28 In being more prescriptive, the new rule appears to provide for greater transparency on how it is to be applied. However, the lack of some definitions introduces greater flexibility on how it is to be applied.

2.29 The rule clearly states that costs will be based on Fonterra's prior year actual costs and so are effectively notional costs for the current year. As discussed in Attachment B, we consider that using a notional benchmark set independently of Fonterra's current year performance provides a stronger incentive to Fonterra to operate efficiently than the use of actual costs for the current year.

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[16] Fonterra, *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2014/15 Seas*on, (1 August 2014), pages 6-7.

2.30 We agree that, under this rule, it is reasonable to exclude milk collection costs and dry stores costs from the calculations under this rule, given the use of actual costs for those inputs. As discussed in Attachment B, we consider that there are instances where it is reasonable to use actual data in setting the base milk price. We outline the reasonableness of using actual data for these costs in Attachments J and R of our review of the 2013/14 base milk calculation final report.[17]

2.31 The separate treatment of fixed costs more accurately reflects the mixed nature of repairs and maintenance costs and is therefore more likely to give rise to overall costs that are practically feasible.

2.32 The use of Fonterra sites that are most similar to the notional sites assumed to be used by the notional producer further aligns the costs of the notional producer to those that would be faced by a potential entrant considering production of a similar mix of commodity products.

2.33 Notwithstanding the greater level of prescription provided by these changes, the new rule still allows for a large degree of discretion as to its application. In particular:

2.33.1 the determination of the fixed cost component is largely discretionary;

2.33.2 for costs that are not largely fixed in nature, it is unclear from the rule how the average assessed replacement costs are to be calculated or how Fonterra will determine the fixed assets that are 'broadly comparable' to those fixed assets in the farm gate milk price asset base. We note that the previous 2013/14 rule listed the criteria to be considered, although similarly it did not specify how the assessment should be made; and

2.33.3 it does not specify that collection and dry store assets should be removed from the replacement costs asset base used in the ratio calculation, to be consistent with the exclusion of these costs from average expenditure on repairs and maintenance.

2.34 Whether this rule in actual application is practically feasible will depend heavily on the practical feasibility of the current-year replacement cost of the farm gate milk price asset base.

2.35 Our view is that, in absence of seeing the rule applied in the base milk price calculation, and given the remaining degree of discretion available under the rule, and taking into account the existing questions around the practically feasibility of the asset base of the notional producer, we are unable to conclude on the extent to which the rule is consistent with calculating a base milk price that takes into account notional costs that are practically feasible.

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[17] Commerce Commission, *Review of Fonterra's 2013/14 base milk price calculation*, Final report, 15 September 2014, Attachment J: Collection costs, page 106 and Attachment R: Storage costs, page 140.

Adjustments for stranded assets (Rule 30)

Amendment and Fonterra's reasons

2.36 In our report on the 2012/13 Manual, we highlighted the difference in the treatment of assets stranded due to a change in the RCP basket, which is dealt with by an *ex post* adjustment, and the treatment of assets stranded due to a shortfall in milk supply, which is dealt with by an *ex ante* allowance in the cost of capital.

2.37 Fonterra acknowledged that the Milk Price Manual was not clear on the treatment of stranded assets that may occur from structural, rather than incremental, changes in the RCP basket (eg, when a new product is substituted into the basket, and assets used to manufacture the product(s) it replaces are no longer needed).[18] Fonterra stated that, in its opinion, the risk of such changes occurring should be borne by the shareholders.

2.38 To clarify and to address our concerns, Fonterra has amended Rule 30, which covers the treatment of asset stranding due to a change in the RCP basket.

2.39 The revised rule covering asset stranding states:[19]

> The financial implications of removing a Reference Asset, under this Rule, being either the remaining stream of annuities or an annual amount or amounts with the same present value, will be deducted in calculating the Farmgate Milk Price, other than where this would result in the Farmgate Milk Price being significantly less than the milk price Fonterra's competitors for milk in New Zealand are able to pay while still earning a reasonable risk-adjusted return on their invested capital.

2.40 The justification for the change is described in Fonterra's Reasons Paper:

> We have amended Rule 30 to provide that costs associated with assets stranded due to a change in the reference basket will be borne by shareholders in circumstances where those costs are "significant". We have not attempted to quantify the term 'significant', as we consider it likely that whether or not a particular shortfall in Fonterra's milk price is sufficiently large to significantly influence farmers' decisions about whether to continue to supply Fonterra will vary with a range of factors which cannot be fully anticipated in a prescriptive rule.
>
> The amended provision is in our view consistent with the purpose of subpart 5A of DIRA:
>
> - The allocation of costs associated with stranded assets between the milk price (suppliers) and earnings (shareholders) is intended to mimic, at least approximately, the allocation that would likely prevail in a competitive market, and is therefore practically feasible.
>
> - Because the residual costs arising from a significant value of stranded assets fall on earnings, the provision should incentivise efficient capital investment decisions, and is therefore consistent with the efficiency dimension.

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18 Fonterra, *Fonterra's clarification of the Rule 31 in the Manual*, 26 November 2013.

19 Fonterra, *Farmgate Milk Price Manual for 2014/15 Season*, 1 August 2014, page 48-49.

Our assessment of the amendment

2.41 The amended Rule 30 requires Fonterra to treat the costs associated with asset stranding in this circumstance as an *ex post* adjustment to the milk price, where the costs would not result in the farm gate milk price being 'significantly less' than the milk price Fonterra's competitors for milk are able to pay.

2.42 We are not clear how this rule will be applied in practice, due to the discretion Fonterra has in dealing with any asset stranding arising from a change in the RCP basket.[20] Fonterra has not attempted to quantify what a 'significantly less' amount would be in determining whether the shareholders, or the suppliers through the milk price, would bear the costs.

2.43 Miraka submits that the choice to either include or exclude costs of the stranded assets in the milk price is determined by a comparison with the milk price "able to be paid by Fonterra's competitors" and this is contradictory to the key assumptions of the Milk Price Manual itself and to the underlying purpose of subpart 5A of the Act.[21] We note that Miraka is making a comparison to the actual price. However "the price able to be paid" implies a notional assessment.

2.44 Miraka also argues that the range of products in the commodity basket used in the base milk price calculation is unrealistic and the basket of commodities should reflect the full range of Fonterra's dairy commodities.[22] However, under s 150C Fonterra is required to determine the portfolio of commodities for the notional producer by the mix of the commodities that are likely to be the most profitable over a period not exceeding 5 years.

2.45 The new rule provides for the costs of asset stranding from a change in RCPs to be treated as both an *ex ante* allowance and an *ex post* adjustment. The introduction of a specific risk premium under Rule 41 (ie, an *ex ante* allowance) provides that an independent reviewer is to have regard to Fonterra's exposure to earning risk as a consequence of assets being removed from the notional producer's asset base due to an adjustment to the RCP basket.

2.46 We have a concern about possible double counting where the asset stranding risk is both implicitly provided for in the specific risk premium as an *ex ante* allowance under Rule 41 and also explicitly adjusted by any *ex post* adjustment under Rule 30.

2.47 We recommend that Fonterra considers clarifying in Rule 30 that any asset stranding costs incurred that are estimated to have been previously provided for in the risk premium be excluded from any *ex post* adjustment.

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20 Also mentioned by Miraka. Miraka, *Submission to the Commerce Commission: Process Paper (29 September 2014) – Review of the Milk Price Manual for the 2014/15 Dairy Season*, 15 September 2014.

21 Miraka, *Submission to the Commerce Commission: Process Paper (29 September 2014) – Review of the Milk Price Manual for the 2014/15 Dairy Season*, 15 September 2014.

22 Miraka, *Submission to the Commerce Commission: Process Paper (29 September 2014) – Review of the Milk Price Manual for the 2014/15 Dairy Season*, 15 September 2014, pages 2-4.

2.48 Our view is that even with this change, without seeing the application of the Rule though the calculation of the specific risk premium,[23] we are unable to conclude on the extent to which the new Rule 30 is consistent with the s 150A purpose statement.

2.49 We note that, for completeness, Fonterra should amend Rule 30: WACC specification to include the specific risk premium as per the definition of cost of equity as defined in section 1.4 of the Manual.

Asset beta (Rule 40) and Specific Risk Premium (Rule 41)

Amendment and Fonterra's reasons

2.50 In our 2013/14 Manual review final report, we expressed our view that it is methodologically unsound to conflate the unsystematic risk represented by asset stranding with the systematic risk represented by the asset beta.

2.51 In response to our concern, Fonterra has amended Rule 40 by removing the stranded asset risk and incorporating a specific risk premium in a new Rule 41.

2.52 Fonterra has also amended the cost of equity definition to incorporate the specific risk premium.

2.53 New Rule 41 states:[24]

> An independent Reviewer will recommend a Specific Risk Premium in a Review Year. In calculating the Specific Risk Premium, the Independent Reviewer is required to have regard to:
>
> - Fonterra's exposure to earnings risk as a consequence of assets being removed from the Farmgate Milk Price Business asset base due either to a shortfall in milk supply or an adjustment to the Reference Basket; and
>
> - Any other factors which in the Independent Reviewer's opinion would result in investors in the Farmgate Milk Price Commodity Business requiring additional compensation for risk and which have not otherwise been provided for in the Farmgate Milk Price calculation methodology.

2.54 The justification for the change is described in Fonterra's Reasons Paper:

> These amendments are intended to address the Commission's objection to the incorporation of stranded asset risk in the definition and calculation of the asset beta, while still enabling an appropriate provision for the ex ante cost of stranded asset risk to be included in the milk price calculation. Our revisions are consistent with the Commission's comments in its 2013 Final report: "We agree that if stranded asset risk is bone by shareholders, then shareholders should be compensated ex ante for bearing this risk. This could be implemented through an increment to the weighted average cost of capital. We consider that an amendment should be made to the Manual to clarify this".

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[23] Any *ex post* adjustment would only be seen in the event of asset stranding actually occurring.

[24] Fonterra, *Farmgate Milk Price Manual for 2014/15 Season*, 1 August 2014, page 52.

Our assessment of the amendment

2.55 We agree that removing asset stranding risk from the asset beta addresses our view that the asset stranding risk is an unsystematic risk which should not be included in the calculation of the asset beta.

Feasibility of the asset beta estimate in Rule 40

2.56 We are unable to conclude on the practical feasibility of Fonterra's asset beta estimate in Rule 40 due to the information not yet being available from Fonterra at this point in time. We will review Fonterra's information on the asset beta as part of our review of Fonterra's 2014/15 base milk price calculation.

Technical amendments

2.57 Along with the substantive amendments mentioned in paragraph 2.10, Fonterra has made the following technical amendments to the 2014/15 Manual to address our concerns about the level of flexibility of approach by the 2013/14 Manual:

2.57.1 definition of 'Farmgate Milk Price Tax Depreciation';

2.57.2 definition of 'Review Year';

2.57.3 definition of 'Benchmark Selling Price'; and

2.57.4 new Rule 33: Site footprint.

2.58 These amendments are either technical corrections or provide clarification and consistency. We provide our brief comments on these amendments below.

Definition of 'Farmgate Milk Price Tax Depreciation'

2.59 In our final report for the 2013/14 Manual review and our final report for the 2013/14 base milk price calculation, we commented that the lack of a requirement in the Milk Price Manual to adhere to a particular tax methodology over time means that changes could be introduced from time to time to raise or lower the milk price, in a way that would not be practically feasible, given Inland Revenue tax rules.[25] Fonterra has amended the definition of Farmgate Milk Price Tax Depreciation in Part C of the 2014/15 Manual to address this concern. The definition has been amended for tax depreciation for the notional producer, which is to be calculated using the relevant tax depreciation rates and tax depreciation methodology used by Fonterra to calculate its New Zealand income tax liability. The amendment made fully addresses our concern.

[25] Commerce Commission, *Final Report on the Review of Fonterra's 2013/14 Milk Price Manual*, 16 December 2013, Page 20.

Definition of 'review year'

2.60 In our final report for the 2013/14 Manual review, we commented on the lack of clarity around what constitutes a 'review year', when particular assumptions must be subjected to 'review year' verification by independent experts. Fonterra has amended the definition to clarify when a review year occurs for the individual assumptions of the farm gate milk price business.

2.61 We note that the definition of review year does not include all assumptions that are subject to verification by independent experts. The omitted assumptions include yields, the post-tax market risk premium in the WACC specification and the specific risk premium.

2.62 We recommend that Fonterra considers adding these omitted assumptions to the scope of the definition for the 2015/16 Manual.

Definition of 'Benchmark Selling Price'

2.63 Fonterra has amended the formula for the benchmark selling price to make it more prescriptive, by making it explicit that sales contracted up to the fixed value of 5 (rather than defined as 'N') months prior to shipment are included in the calculation of average shipment prices.

2.64 We note that removing the explanation of the term 'N' from the formula has arguably made its operation in the formula less clear.

New Rule 33: Site Footprint

2.65 Fonterra has added a new Rule 33 to make it explicit that the milk price site footprint (ie, the site locations) is aligned to Fonterra's actual commodity manufacturing site footprint.

2.66 We note that the rule makes it clear that milk collection costs, freight costs, site overheads, ancillary assets and dry stores capital are to be calculated by reference to the site footprint, which is consistent with Fonterra's previous approach.

Other amendments

2.67 Table A1 in Attachment A to this report sets out drafting corrections that Fonterra has made to the 2014/15 Manual and the reasons Fonterra has given for these amendments in its Reasons Paper. We provide our brief comments on these amendments in Attachment A.

2.68 There are also changes to the 2014/15 Manual that were not explicitly addressed in Fonterra's Reasons Paper. We have not sought explanation of the rationale for these amendments from Fonterra, as these could be classified as cosmetic changes that do not affect any provisions or rules in the 2014/15 Manual. We list these changes in Table A2 in Attachment A to this report.

Outstanding issues from our 2013/14 Manual review not addressed by Fonterra in its amendments or Reasons Paper

Rule 23: Standard plants and other reference plants

2.69 In our review of the 2013/14 Manual we noted a concern that a correction of Rule 24: Standard plants and other reference assets (now Rule 23) resulted in the removal of the requirement to determine the market value of land required for the production of the RCPs at each of Fonterra's manufacturing sites.

2.70 Fonterra, in its submission on our 2013/14 Manual draft report, acknowledged that the Milk Price Manual does not contain any provision specifying how the initial value of the land required for a new manufacturing site is to be determined. Fonterra confirmed that its approach has been to use independent market valuations to set the initial land values from 2008.

2.71 We recommend that Fonterra addresses this issue for the 2015/16 Manual.

Rule 18: Other costs, including site overheads, general overhead costs and R&D costs

2.72 In our review of the 2013/14 Manual we noted that Fonterra stated that its review of the costs in Rule 19 (now Rule 18) will "generate a new set of administrative and other overhead costs for implementation in 2014/15".[26] Given the lack of prescription of this rule, it would appear that no change is necessary to accommodate methodological changes to calculating these costs, as long as it results in a 'reasonable provision'. Our view is that if significant methodological changes are possible without changing the rules in the Milk Price Manual (irrespective of which season to which these rules apply), the rules are not sufficiently prescriptive to enable our assessment of those rules in isolation against the legislative purpose. We therefore are unable to conclude on the extent to which Rule 18 is consistent with the legislative purpose. We will further review its specific application in the 2014/15 base milk price calculation review.

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[26] Fonterra, *Submission to the Commerce Commission on its Draft Report on its review of the F13 base milk price*, 30 August 2013, page 11. Available at http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-calculation/

An issue raised in our 2013/14 base milk price calculation review that should be considered in the 2015/16 Manual

Allowance for costs arising from one-off or difficult to forecast events

2.73 In our final report on the 2013/14 base milk price calculation we questioned whether the base milk price methodology adequately provides for costs associated with one-off or difficult to forecast events such as the 'super flush'[27] peak milk flows in the 2013/14 dairy season.

2.74 We consider that Fonterra should assess whether the notional milk price model should include an allowance for such events and whether it is possible to do so within the existing rules in the 2014/15 Manual. We do note that Rule 41 requires an independent reviewer to assess whether any other factors would result in investors in the farm gate milk price commodity business requiring additional compensation for risk which have not otherwise been provided for in the farm gate milk price calculation methodology.[28]

2.75 Fonterra's current approach, given the nature of these costs that are one-off or difficult to forecast, is to provide for them through a combination of *ex ante* allowances and *ex post* adjustments applied to the base milk price.[29]

2.76 Fonterra acknowledges that the current approach for providing for costs of a one-off or difficult to forecast nature is not explicitly set out in the Milk Price Manual, and will consider amending the Milk Price Manual for the 2015/16 season to make its approach more explicit.[30]

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27 'Super flush' is the term used by Fonterra to describe the event relating to the peak milk supply that exceeded milk processing capacity which occurred in the 2013/14 season.

28 Fonterra, *Farmgate Milk Price Manual for 2014/15 season*, 1 August 2014, Rule 41, page 52.

29 Fonterra, *Submission to the Commerce Commission on its draft report on Fonterra's base milk price for the 2013/14 season (public version)*, 1 September 2014, page 13.

30 Fonterra, *Submission to the Commerce Commission on its draft report on Fonterra's base milk price for the 2013/14 season (public version)*, 1 September 2014, page 14.

2.77 We note that Fonterra has concluded that the circumstances in the 2013/14 season which gave rise to Fonterra's decision to pay a base milk price lower than the milk price calculated under the 2013/14 Manual (which includes the costs of the 'super flush' peak flows) reflect factors specific to Fonterra, and that it does not imply any change is required to the Milk Price Manual. [31] We further note that Fonterra's Milk Price Panel has determined to further consider this issue if similar circumstances persist beyond the 2013/14 dairy season.[32]

2.78 We will consider, on the basis of the circumstance of the 2014/15 season, whether a more explicit provision for costs of a one-off or difficult to forecast nature is warranted as part of our review of Fonterra's 2014/15 base milk price calculation in 2015.

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31 Fonterra, *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2014/15 Season*, 1 August 2014, page 10. Miraka argues that there are many factors "specific to Fonterra" which are deeply embedded in the Milk Price Manual that should be considered such as Fonterra's actual cost rates and the use of Fonterra's USD/NZD currency conversion rate. Miraka, *Submission to the Commerce Commission: Process Paper (29 September 2014) – Review of the Milk Price Manual for the 2014/15 Dairy Season*, 15 September 2014. As noted in paragraph 2.74 above, we consider that Fonterra should assess whether a cost allowance is needed in the base milk price model for one-off costs such as the 'super flush' peak flow costs that occurred in the 2013/14 season. Our review of the 2013/14 base milk price calculation suggests that a cost allowance could potentially factor in a combination of plant optimisation (additional ancillary plant fixed assets and additional plant labour) and network optimisation (additional collection costs and revised yields). However an allowance may not necessitate a change in the Manual if the allowance can be included within the existing rules. We note that some of the examples given by Miraka (eg, the use of Fonterra's USD/NZD currency conversion rate) are sheltered under the 'safe harbour' provision under s 150B.

32 Fonterra, *Milk Price Panel Paper – Amendments to Milk Price Manual for F15* attached to *'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2014/15 Season*, 1 August 2014, page 3.

Attachment A: Review of technical changes to the Manual

A1 Table A1 below sets out drafting changes Fonterra has made to the 2014/15 Manual and the reasons Fonterra has given for these changes in its Reasons Paper.

A2 Table A2 below sets out changes to the 2014/15 Manual that are not explicitly addressed in Fonterra's Reasons Paper. We have not sought explanation of the rationale for these amendments from Fonterra as these could be classified as cosmetic changes that do not affect any provisions or rules in the 2014/15 Manual.

Table A1: Review of drafting changes to the 2014/15 Manual, as set out in Fonterra's Reasons Paper

Reference	Change	Fonterra Comment	Commission Comment
p.39, Rule 13. Also Rule 21	Replacement of 'Standard Factory' with 'Standard Plant' and related changes.	Alignment of terminology and editing for clarity.	Clarification amendment only. No implications for consistency with purpose statement.
p.49, Rule 31	Replacement of 'Fonterra' with 'Farmgate Milk Price Commodity Business'.	Aligns provision with intent and application to date, which is to ensure that the processing capacity assumed in the Milk Price asset base, rather than Fonterra's, is aligned to milk supply.	Clarification amendment only. No implications for consistency with purpose statement.

Table A2: Review of drafting changes to the 2014/15 Manual, not mentioned in Fonterra's Reasons Paper

Reference	Change	Commission Comment
p.40-49	Drafting change: changes to the numbering of Rules 14-32 as 2013/14 Manual had no Rule 14.	Re-ordering amendment only. No implications for consistency with purpose statement.
p.81	Drafting change: 'panel' moved to be consistent with alphabetical ordering of glossary.	Re-ordering amendment only. No implications for consistency with purpose statement.

Attachment B: Our approach to this statutory review of the Manual

B1 In this attachment, we:

B1.1 summarise our interpretation of the key provisions in the Act relevant to the review of the Manual for the 2014/15 dairy season; and

B1.2 explain our practical approach to this review.

Our interpretation of key legislative provisions guiding our review

Our review and report – section 150H, 150I and 150J

B2 Section 150H of the Act requires us to review the Manual for each dairy season.

B3 Sections 150I and 150J of the Act require us to make and publish a report on the extent to which the Manual is consistent with the purpose set out in s 150A of the Act.

The purpose statement – section 150A

B4 Section 150A(1) states that the purpose of Subpart 5A of the Act is to promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently (the 'efficiency dimension') while providing for contestability in the market for the purchase of milk from farmers (the 'contestability dimension').

B5 Section 150A(2) specifies that the setting of the base milk price provides for contestability in the market for the purchase of milk from farmers if any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor.

B6 We consider that the efficiency and contestability dimensions within s 150A are interlinked and that together, they require consideration of:

B6.1 What is meant by 'efficiency'?

B6.2 What is meant by 'contestability'?

B6.3 How do the dimensions of efficiency and contestability inter-relate?

Our interpretation of efficiency

B7 Section 150A refers to incentives to Fonterra to 'operate efficiently'. There are many factors which can, and do, provide efficiency incentives to Fonterra. Our review of the Manual against the efficiency dimension requires us to focus on only one of these possible factors (ie, the extent to which the Manual is consistent with promoting the setting of a base milk price that provides an incentive to Fonterra to operate efficiently).

B8 We have interpreted the primary focus of the efficiency dimension to be providing incentives for Fonterra to drive cost efficiencies (ie, productive and dynamic efficiency).[33]

Our interpretation of contestability

B9 While the Act does not define contestability, practical guidance on what is required to provide for contestability in the market for the purchase of milk from farmers is provided by s 150A(2).

B10 Section 150A(2) states that the setting of a base milk price will provide for contestability if "any notional costs, revenues, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor". Therefore, our interpretation of s 150A is that if the Manual provides for the assumptions used in setting the base milk price to be practically feasible, individually and in aggregate, the contestability dimension is satisfied.

How are the two dimensions reconciled?

B11 It is our interpretation that to satisfy s 150A the Manual must be consistent with both dimensions, independently.

Section 150B – 'safe harbours'

B12 Section 150B lists certain assumptions that, if used in the base milk price calculation, are considered to not detract from the achievement of the purpose set out in s 150A.

B13 We interpret s 150B as being intended to create 'safe harbours' where Fonterra sets the base milk price using any of the assumptions listed in subparagraphs (a) to (d). Section 150B prevents the use of any of those assumptions from having the effect of detracting from the achievement of the purpose set out in s 150A where the use of any such assumption might otherwise have had that effect.

Section 150C – 'mandatory assumptions'

B14 We interpret s 150C of the Act as setting out certain assumptions that Fonterra is required to make in setting the base milk price if the setting of that price is to be consistent with s 150A. In particular, the revenues and costs taken into account by Fonterra in calculating the base milk price must be determined from the prices of a portfolio of 'RCPs (ie, the portfolio of commodities referred to in s 150C(2)) and must include the costs of processing milk into the same portfolio of RCPs).

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[33] Productive efficiency is present when producers use inputs in such a manner as to minimise costs, subject to technological constraints. Dynamic efficiency relates to decisions made over time which result in improvements in productive efficiency. We are primarily concerned with productive and dynamic efficiencies when reviewing Fonterra's costs. For revenue items (such as the selection of reference commodity products and sales prices), where productive efficiency is not relevant, we necessarily focus on allocative efficiency. Allocative efficiency occurs when there is an optimal distribution of goods and services, and involves taking into account consumers' preferences.

B15 We interpret s 150C as setting out certain assumptions that Fonterra is required to make in setting the base milk price.[34] Our review of the assumptions in s 150C is therefore limited to examining whether the Manual contains those assumptions.

Our practical approach to the review of the Manual

Our approach to the efficiency dimension – how Fonterra is provided with incentives

Fonterra has incentives to improve efficiency to maximise its profits

B16 We consider that Fonterra has an incentive to maximise its overall payments to farmers and to shareholders, including unit holders in the publicly listed Fonterra Shareholders Fund created as part of the trading among farmers (TAF) regime. Improvements in efficiency may be passed through into a higher base milk price or a higher dividend (ie, profit).

B17 We consider Fonterra's management has a stronger incentive to maximise profits (which benefits both farmers and shareholders, including unit holders in the publicly listed Fonterra Shareholders Fund) relative to its incentive to increase the base milk price.[35] This incentive is reinforced by the transparency associated with the listing on the stock exchange of the non-voting units, and the importance to Fonterra of ensuring that its TAF regime works.

The use of notional inputs in the base milk price provides incentives for efficiency

B18 There are many factors which can, and do, provide efficiency incentives for Fonterra. Our review of the Manual against the efficiency dimension requires us to focus on only *one* of these possible factors—ie, the extent to which the Manual is consistent with promoting the setting of a base milk price that provides an incentive to Fonterra to operate efficiently.

B19 The efficiency incentive provided by setting the base milk price works as a result of the effect it has on Fonterra's actual profitability. Fonterra will have a stronger incentive to operate efficiently where the base milk price is set independently of Fonterra's actual performance (ie, it uses notional data). This is because, for a given level of revenue, any improvements in cost efficiency will result in higher profits.

B20 Using notional data also provides Fonterra with a benchmark to beat, and increases transparency to shareholders about whether Fonterra is achieving efficiency gains relative to using data on Fonterra's actual performance to set the base milk price. The Manual requires, in some cases, that the notional data used in the base milk price calculation should be based on Fonterra's actual data in a previous year.

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34 We have not received any supporting information from Fonterra to show that the current RCP mix is still the most profitable mix. We note that under s 150C, Fonterra must complete a review of the current RCP mix by the end of the 2014/15 dairy season. Arguably, Fonterra should be reviewing the profitability of the RCP mix yearly.

35 The use of the term 'profits' throughout this report refers to the difference between Fonterra's revenues and costs (including the cost of raw milk) and includes dividends paid to shareholders (including farmers and unit holders in the publicly listed Fonterra Shareholders Fund).

Therefore, efficiency savings achieved in one year (which result in a reduction in actual costs) may lead to a higher base milk price in a later year.

B21 Subpart 5A of Act is consistent with this view. It envisages the use of notional values and involves the assumption of a notional milk processing and collecting business (a 'notional producer').

B22 Our view is that setting any independent benchmark for the costs that underpin the base milk price calculation would provide an incentive for Fonterra's management to improve efficiency.[36] There is no unique price that needs to be ascertained to provide incentives for Fonterra to improve its efficiency. Setting any independent benchmark provides a target and would mean that any improvements in efficiencies will always result in higher profits, all things being equal.[37]

It may be reasonable to use some actual data in setting in the base milk price

B23 Notwithstanding the efficiency dimension of the s 150A purpose, there are instances where it is still reasonable to use actual data in setting the base milk price. These particularly include where:

B23.1 there is insufficient information to know what an appropriate notional value would be, or it would be unreasonably costly to obtain this information; or

B23.2 Fonterra has very limited control over the actual costs used for the benchmark.

B24 Where the Manual requires the use of actual data, we have assessed whether the use of this data distorts or weakens incentives to operate efficiently. For example, whether it provides Fonterra with an opportunity to earn higher profits without achieving efficiencies.[38]

B25 Our approach to considering the efficiency dimension is to therefore assess the extent to which the provisions in the Manual are consistent with setting a base milk price that provides an incentive to Fonterra to operate efficiently, by providing for the use of notional components in the calculation of the base milk price. As discussed above, there may be instances where it is reasonable to use actual data. Where the provisions in the Manual require the use of actual values, we have explored whether notional data could reasonably have been used instead, and whether the use of actual data distorts or weakens incentives for Fonterra to operate efficiently.

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36 Ideally the benchmark should be stable over time in order to provide an incentive to operate efficiently over time and to provide transparency to shareholders on efficiency gains achieved.

37 This means that using a notional cost assumption that is less than the average across all of Fonterra's plants is still consistent with the efficiency dimension.

38 For example, through a combination of using actual and notional values in the base milk price calculation.

Our approach to the contestability dimension – what is practically feasible

Our interpretation of efficient processor in s 150A

B26 Section 150A(2) states that “for the purposes of this subpart, the setting of the base milk price provides for contestability in the market for the purchase of milk from farmers if any notional costs, revenue, or other assumptions taken into account in calculating the base milk price are practically feasible for an efficient processor”.

B27 The term ‘efficient processor’ is not defined in the Act. It is our interpretation, within the context of the Act, including s 150A, that the term means a processor that is able to operate at least cost over time. This is consistent with our view that the primary focus of the efficiency dimension is on improving incentives for Fonterra to drive cost efficiencies over time (ie, productive and dynamic efficiency).

B28 We consider that expansion by an existing processor or entry by a new processor would be most likely to achieve least cost operation over time. That is because a newly built (ie, 'incremental') plant would be able to take advantage of the latest technology, and could be built at a capacity to take the best possible advantage of cost efficiencies in not only processing, but in associated activities as well (such as the collection of milk).

B29 Therefore, conceptually, we consider the Manual is consistent with the contestability dimension in s 150A of the Act if the Manual provides for the notional costs, revenues, and other assumptions taken into account in calculating the base milk price to be practically feasible for Fonterra or another processor that is efficiently building an incremental plant.

B30 In its submission on Fonterra’s Reasons Paper for the 2013/14 base milk price calculation, Synlait noted that it has previously argued against our interpretation of ‘efficient processor’ because, in its view, the only feasible processor of Fonterra’s scale in the New Zealand market is Fonterra itself.[39] Miraka also disagrees with our interpretation of ‘efficient processor’.[40] However, we do not agree that the only interpretation of ‘efficient processor’ is to mean Fonterra itself. Had Parliament intended s 150A(2) to mean ‘practically feasible for Fonterra’ then it could have used the term ‘new co-op’ rather than ‘efficient processor’.

B31 In our first review of the Manual, which we undertook for the 2012/13 dairy season, we assessed whether the provisions in the Manual are practically feasible by making both an individual and an aggregate assessment (described in paragraphs B32 to B35 below). For our review of the 2014/15 Manual, we have relied on our conclusions from the review of the previous season for the provisions that have not changed, considered any issues that were outstanding from the previous review, and assessed

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[39] Synlait, *Submission on Fonterra’s ‘Reasons’ Paper in relation to the 2013/14 base milk price*, 15 July 2014, paragraph 14.

[40] Miraka, *Submission to the Commerce Commission: Process Paper (29 August 2014) – Review of the Milk Price Manual for the 2014/15 Dairy Season*, 15 September 2014.

the provisions of the Manual that have changed for the 2014/15 Manual in accordance with our practical approach.

We have assessed whether the Manual provides for assumptions that are individually practically feasible for Fonterra

B32 The Manual provides, for the most part, for the use of performance parameters based on the average across all relevant (RCP) Fonterra notional plants, rather than on a single recently built Fonterra plant. Doing so is consistent with assuming that there is a national network of facilities for the collection and processing of milk (ie, the safe harbour provision in s 150B(a)). In addition, the notional plants provided for in the Manual approximate the average capacity of Fonterra's actual plants, consistent with the safe harbour provision in s 150B(b).

B33 Our practical approach examines whether the Manual provides for the notional costs, revenues, and other assumptions taken into account in calculating the base milk price to be practically feasible for Fonterra. This approach is appropriate because, more often than not, the Manual provides for the use of parameters reflective of Fonterra's 'average' plant rather than its most cost efficient plant(s), and therefore an efficient processor (building an incremental plant) should be able to achieve lower costs.

B34 In reaching our draft conclusion we have also considered whether the Manual provides for the assumptions taken into account in calculating the base milk price to be practically feasible for Fonterra due to features unique to Fonterra, which do not relate to Fonterra acting efficiently. In that case, any such notional costs, revenues, or other assumptions may not be practically feasible for another efficient processor. We therefore included a cross-check to identify whether our assessment is being affected by unique features which are not subject to 'safe harbour' provisions.

Cross-checks to ensure the Manual provides for assumptions that are practically feasible in aggregate

B35 Our aggregate cross-checks included:

B35.1 checking that the provisions in the Manual are internally consistent with each other. We have been largely guided by submissions to identify areas where there are potential inconsistencies between the provisions in the Manual, and have reviewed these areas in our analysis; and

B35.2 considering the overall impact on the Manual of the provisions which may not be individually practically feasible or that we are unable to conclude on at this stage.

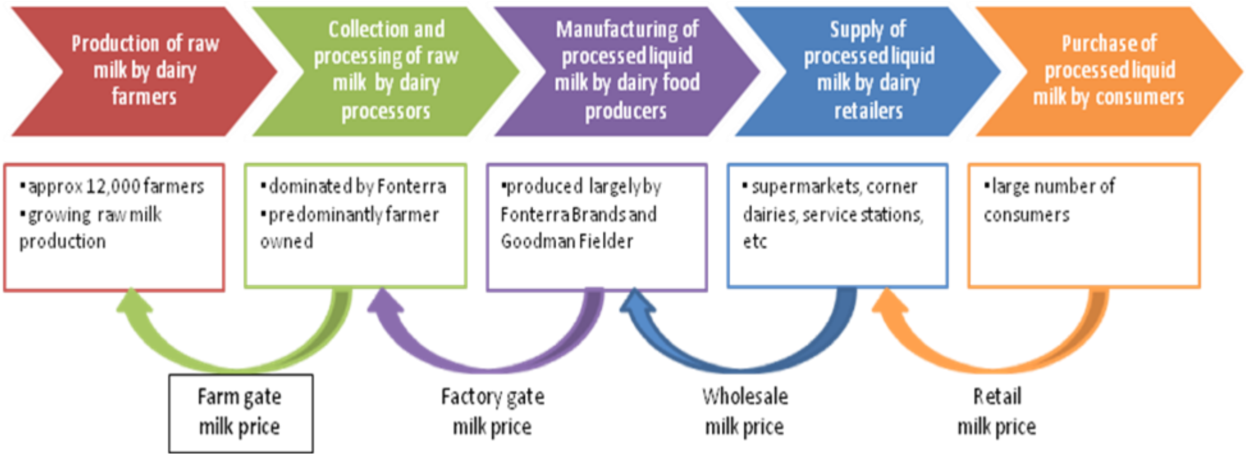
Attachment C: The setting of the farm gate milk price in New Zealand

C1 This attachment outlines the different milk prices within the milk supply chain and explains the unique nature of the farm gate milk market in New Zealand. It also provides an overview of our understanding of Fonterra's rationale for calculating its farm gate milk price and the methodology Fonterra uses to calculate its farm gate milk price. The Act uses the term "base milk price" and all references here to the farm gate milk price should be read as meaning the same.

Milk prices in New Zealand

C2 The phrase "milk price" can have different meanings depending on which component of the milk supply chain is being considered. Figure C1 describes the milk supply chain in New Zealand and shows the different components of the "milk price" as generated by different milk markets within the supply chain.

Figure C1: Milk supply chain in New Zealand



C3 As Figure C1 shows, the "milk price" in New Zealand is made up of the following four components:

C3.1 **Farm gate milk price** is the price paid by dairy processors (eg, Fonterra) to dairy farmers for raw milk;

C3.2 **Factory gate milk price** is the price paid by dairy processors (eg, Synlait, and dairy food and beverage producers, eg, Goodman Fielder) to other dairy processors (eg, Fonterra) for either raw milk or dairy ingredients;

C3.3 **Wholesale milk price** is the price paid by dairy retailers (eg, supermarkets) to dairy food and beverage producers (eg, Fonterra Brands and Goodman Fielder) for processed milk; and

C3.4 **Retail milk price** is the price paid by dairy consumers to dairy retailers (eg, supermarkets) for processed milk.

C4 Given that approximately 95% of the total raw milk produced in New Zealand is exported, all four components of the “milk price” are influenced by the demand and supply characteristics of the international dairy markets and by foreign exchange fluctuations.

C5 The focus of our review is solely on the **farm gate milk price** and not any other milk price within the milk supply chain. The farm gate milk price accounts for between one quarter and one third of the retail milk price.[41]

Farm gate milk market in New Zealand

C6 In a workably competitive farm gate milk market, the level of the farm gate milk price would be determined both through the process of competition between suppliers of raw milk (ie, farmers) to processors, and through those processors competing in both the purchase of raw milk and its onward sale after processing.

C7 In New Zealand, the majority of farmers are also the owners of the majority of processing capacity (ie, Fonterra, which collects approximately 89% of total raw milk supply in New Zealand). In this situation there is not a workably competitive market process to derive a farm gate milk price and it is determined by Fonterra using an administrative methodology.

Fonterra’s approach to calculating its farm gate milk price

C8 Since its formation and until 2009, Fonterra’s payment to dairy farmers for their raw milk was bundled together with the returns to dairy farmers for their shareholding in Fonterra. During that time, Fonterra’s farm gate milk price was calculated only for the purposes of estimating Fonterra’s long-run earnings for share valuation purposes.

C9 Shareholding dairy farmers have had two separate but related interests in Fonterra and have been recompensed through two revenue streams: payment for the raw milk they supplied and the dividend payments for the share capital they held in the cooperative.[42] As a result, it is the total return on raw milk and share capital invested in the cooperative that supplier-shareholders have tended to be interested in, rather than its individual components.

C10 In 2009, Fonterra unbundled its total return to farmers into a farm gate milk price paid for raw milk and returns on share capital. With the unbundling came the need to set the farm gate milk price independently of Fonterra’s share valuation processes.

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41 The actual proportion of the farm gate milk price to the total combined milk price is difficult to estimate as each of the milk price components (particularly the retail milk price) varies among retailers.

42 To supply raw milk to Fonterra, dairy farmers are required to hold one share for every kilogram of milk solids they wish to supply the cooperative. We understand that an average Fonterra supplier holds approximately half a million dollars in Fonterra shares at the current share valuation. There are a small number of dairy farmers who supply Fonterra with raw milk on a contract supply basis and do not hold shares.

C11 In 2010, Fonterra shareholders voted to change Fonterra's capital structure to implement TAF. TAF replaces the Fonterra share purchase and sale process, where the Shares were issued and redeemed by Fonterra. TAF was endorsed by Fonterra shareholders in June 2012. Live trading of Shares commenced on 30 November 2012.

C12 As explained by Fonterra, there are two components to TAF:[43]

> Fonterra Shareholders' Market. This is a private market on which Farmer Shareholders can now buy and sell Shares among themselves, not with Fonterra. It is a private market because only Farmer Shareholders, Fonterra, and a specially appointed market maker will be allowed to trade Shares.
>
> The Fonterra Shareholders' Fund. The Fund is intended to:
>
> − supplement liquidity in the Fonterra Shareholders' Market through a liquid market for Units which can effectively be "exchanged" for Fonterra Shares (by Farmer Shareholders, Fonterra and the market maker) and vice versa;
>
> − provide additional financial flexibility for Farmer Shareholders, who will have the opportunity to sell Economic Rights of Shares to the Fund; and
>
> − permit a broader range of investors to buy a security (a Unit in the Fonterra Shareholders' Fund) that essentially passes through the Economic Rights.
>
> Although the markets are separate, they have been designed to work together. Farmer Shareholders, Fonterra and the RVP[44] can buy or sell Shares in the Fonterra Shareholders' Market, and buy or sell Units on the NZX Main Board or ASX (Australian Stock Exchange). They can effectively exchange Shares for Units and vice versa and therefore can shift between the two markets. Other investors will not be able to transact in the Fonterra Shareholders' Market and exchange Units for Shares.
>
> The Economic Rights of a Share are the rights to receive dividends and other economic benefits derived from a Share, as well as other rights derived from owning a Share. However, these rights do not include the right to hold legal title to the Share (i.e. to become registered as the holder of the Share), or to exercise voting rights, except in very limited circumstances.

C13 Under TAF, the economic interests of external (non-farmer) investors will be to maximise the share price and the return on share capital invested in Fonterra, rather than the return on raw milk.

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43 Source: http://www.fonterra.com/global/en/Financial/Trading+Among+Farmers

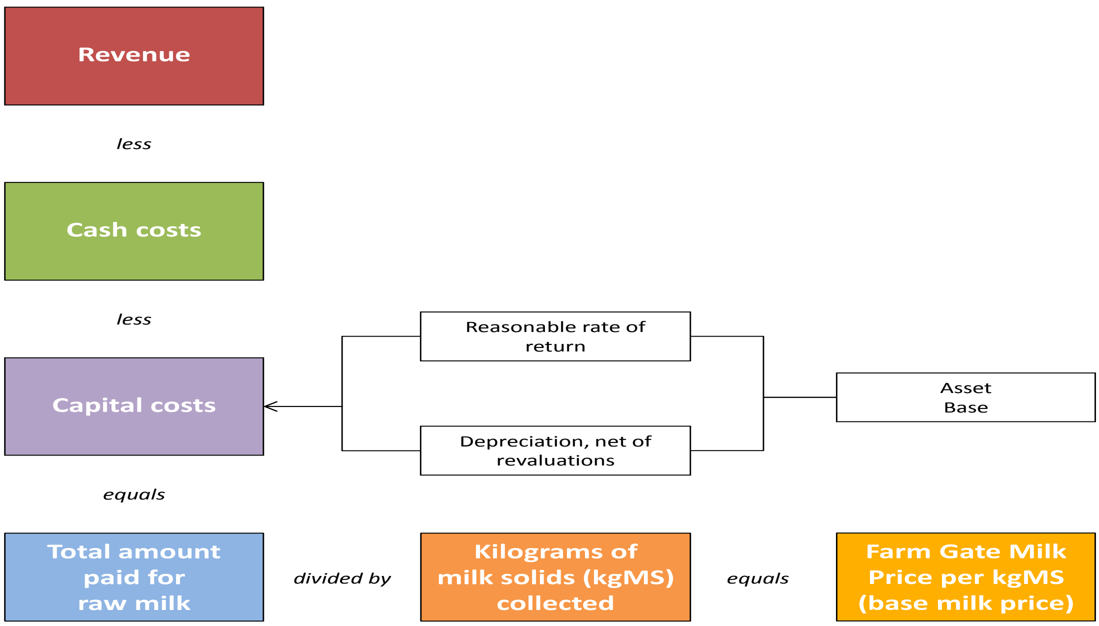
44 There is a market maker (known as the Registered Volume Provider or RVP) who is continuously active in offering to buy and sell Shares on the Fonterra Shareholders' Market during the periods of operation of the Fonterra Shareholders' Market (other than in the case of a temporary halt in, or suspension of, trading in Shares). This is intended to assist the liquidity of trading on the Fonterra Shareholders' Market to make it easier for Farmer Shareholders to buy or sell Shares on that market.

C14 The Fonterra Board sets the farm gate milk price for each dairy season. The Board is advised by a Milk Price Panel, whose role is to oversee the governance of Fonterra's Manual. The Milk Price Panel has five members, with the majority and the chair of the panel being independent of farmer interests. All panel members are appointed by the Fonterra Board and ratified by Fonterra Farmer Shareholders.

Fonterra's methodology for setting its farm gate milk price

C15 Fonterra's methodology for calculating its farm gate milk price is guided by a set of principles set out in Fonterra's constitution and outlined in Fonterra's Manual. Figure C2 provides a visual representation of Fonterra's methodology.

Figure C2: Fonterra's Farm Gate Milk Price methodology[45]



C16 Fonterra calculates the farm gate milk price from the total pool of money available for payment to farmers for their raw milk supply to Fonterra in a season, which is determined by:

C16.1 the **revenue** Fonterra would earn in NZ dollars if the equivalent of all the raw milk supplied to Fonterra in New Zealand was converted into a chosen product mix, and sold on international dairy markets; less

C16.2 the '**cash' costs** (or operating costs) of collecting raw milk from farms, processing it into the chosen product mix and then transporting this product mix to the point of export from New Zealand, along with the costs of selling the finished product, administration/overhead and tax expenses; less

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45 For the 2013/14 dairy season, Fonterra made an adjustment to the milk price calculated under the Manual which was determined at the discretion of Fonterra's Board. Fonterra's Farm gate milk price methodology for the 2013/14 dairy season can be found in figure 1.2 in our final report on review of Fonterra's 2013/14 base milk price calculation.

C16.3 the **capital costs**, which provide for depreciation on fixed assets, return on and of capital investment, and working capital.

C17 The farm gate milk price is expressed in terms of dollars per kilograms of milk solids (kgMS) supplied to Fonterra. Payments to individual farmers for their milk are, however, adjusted for the composition of milk supplied (in terms of the fat and protein components) and the timing of supply (eg, milk supplied during the winter period attracts certain premiums).

C18 Although Fonterra makes a number of payments to farmers for raw milk during the dairy season (based on its forecast farm gate milk price), its current policy is to confirm the final farm gate milk price for the season a few months after the end of that season. The dairy season runs from 1 June to 31 May. Fonterra's final farm gate milk price is typically set in September after the end of the relevant season. This results in end of year 'wash-up' payments to farmers.

C19 Fonterra's current policy is that its Manual is subject to comprehensive review every four years. However, changes to the Manual can be made in the interim on a prospective basis. Any changes to the Manual take effect in the financial year after the year in which the changes are made (Fonterra's financial year is from 1 August to 31 July). Figure C3 shows a timeline of Fonterra's decisions in each dairy season and how it fits with our statutory review processes.

Figure C3: Timeline for Fonterra's FGMP setting processes and statutory review process