

# **The Dairy Industry Restructuring Act 2001**

## **Review of Fonterra's 2014/15 Milk Price Manual**

### **Final report**

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Regulation Branch  
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## Executive Summary

- X1 This report sets out our conclusions, and the reasons for those 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). The report 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. For instance, 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.
- X10 However, a number of the amendments have also introduced flexibility in the application of some aspects of the rules, and therefore we are 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. This *ex ante* allowance provides for shareholders to bear the risk of asset stranding, given they are best placed to manage that risk, while being appropriately compensated for doing so. However, the changes, combined with the existing provisions, still provide Fonterra with the discretion to allocate stranding risks to suppliers of raw milk. This means we are unable to conclude on the extent to which these rules are consistent with the s 150A purpose statement.
- X11 In addition, there were some outstanding issues from our review of the 2013/14 Manual not addressed by Fonterra. The most significant issue is:
- X11.1 *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 still unable to conclude on the extent to which the rule is consistent with the s 150A purpose statement.
- X12 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. Fonterra's Milk Price Panel has determined to further consider whether a cost allowance to take account of one-off or difficult-to-forecast events should be introduced if similar circumstances persist beyond the 2013/14 dairy season. We will consider whether a more explicit provision for these costs is warranted as part of our review of the 2014/15 base milk price calculation.

- X13 We will assess the specific application of the rules on which we are unable to conclude as part of our review of Fonterra's 2014/15 base milk price calculation in 2015. We will consider, on the basis of the circumstances of the 2014/15 season, whether a more explicit provision for costs of a one-off or difficult-to-forecast nature is warranted.

## 1. Introduction

1.1 In this chapter, we:

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

1.1.2 outline the structure of the report.

### Purpose of this report

1.2 The purpose of this report is to set out our conclusions, and the reasons for those 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 We are required under the Act to publish our report on the 2014/15 Manual not later than 15 December 2014.

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

1.4 This 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:

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

1.4.2 a review of the application of the 2014/15 Manual to Fonterra's 2014/15 base milk price calculation, later in the season.<sup>1</sup>

1.5 This report relates to the review of the Milk Price Manual that applies for the 2014/15 dairy season.

1.6 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).

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<sup>1</sup> The New Zealand dairy season runs from 1 June each year to the following 31 May. The 2014/15 dairy season runs from 1 June 2014 to 31 May 2015.

- 1.7 In 2015 we will review the application of the 2014/15 Manual in our separate review of 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.<sup>2</sup> 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.
- 1.8 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:
- 1.8.1 that provides an incentive to Fonterra to operate efficiently (the efficiency dimension), while
  - 1.8.2 providing for contestability in the market for the purchase of milk from farmers (the contestability dimension).
- 1.9 In order for us to report on this, Section 150L of the Act requires Fonterra to provide us with the following information:
- 1.9.1 the 2014/15 Manual;
  - 1.9.2 any recommendations by the Milk Price Panel in relation to the setting of the base milk price;
  - 1.9.3 notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the 2014/15 Manual;
  - 1.9.4 certification of the extent to which Fonterra considers that the 2014/15 Manual is consistent with the purpose in s 150A; and
  - 1.9.5 the reasons for that view expressed in Fonterra's certification.
- 1.10 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).<sup>3</sup>
- 1.11 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 decided to provide an opportunity for all interested parties to comment on Fonterra's Reasons Paper, our Process Paper and our draft report.

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<sup>2</sup> 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).

<sup>3</sup> Fonterra "'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2014/15 Season" (1 August 2014).

- 1.12 We have had regard to information provided in Fonterra’s Reasons Paper and submissions we received on our Process Paper and draft report.<sup>4</sup>
- 1.13 In our Process Paper we invited interested parties to comment on the information provided to us by Fonterra. In particular, we invited comments on:
- 1.13.1 the reasons Fonterra has provided for why the 2014/15 Manual is consistent with the purpose in s150A of the Act; and
- 1.13.2 any other information we should consider in our review of the 2014/15 Manual.<sup>5</sup>
- 1.14 We received a submission from Miraka Limited (Miraka) on our Process Paper.<sup>6</sup>
- 1.15 We provided our draft report to Fonterra on 15 October 2014 for comment in accordance with s 150M of the Act.<sup>7</sup> Fonterra sent us a submission on our draft report.<sup>8</sup>
- 1.16 We also sought comment from other interested parties on our draft report. We received a submission from Open Country Dairy Limited (Open Country). However, some matters raised by Open Country in its submission on our draft report could not be assessed directly in the context of this review of the Manual. A number of those points appear to us to be relevant to our 2015 review of Fonterra’s 2014/15 actual milk price calculation and will be considered further at that time. This is because they relate more to the application of the calculation methodology in the milk price calculation than to the specification of the methodology in the Manual.<sup>9</sup>
- 1.17 We have formed our conclusions for this report after considering the comments from Fonterra and Open Country on our draft report.

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<sup>4</sup> 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); Fonterra “Submission to the Commerce Commission on its Draft Report on Fonterra’s 2014/15 Farmgate Milk Price Manual” (17 November 2014); and Open Country “Submission on the Commerce Commission’s Draft Report – Review of Fonterra’s Milk Price Manual” (17 November 2014).

<sup>5</sup> Commerce Commission “Process Paper – Review of the Milk Price Manual for the 2014/15 dairy season” (29 August 2014).

<sup>6</sup> 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).

<sup>7</sup> Commerce Commission “The Dairy Industry Restructuring Act 2001: Review of Fonterra’s 2014/15 Milk Price Manual – Draft report” (15 October 2014).

<sup>8</sup> Fonterra “Submission to the Commerce Commission on its Draft Report on Fonterra’s 2014/15 Farmgate Milk Price Manual” (17 November 2014).

<sup>9</sup> Open Country “Submission on the Commerce Commission’s Draft Report – Review of Fonterra’s 2014/15 Milk Price Manual” (17 November 2014).

- 1.18 All of our published documents and the submissions received from Fonterra, Miraka and Open Country are available on our website.<sup>10</sup>

### **How we present our analysis and conclusions**

- 1.19 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.
- 1.20 We outline our conclusions, and the reasons why we have reached them, in Chapter 2 of this report. Our conclusions reflect our assessment of the extent to which the 2014/15 Manual is consistent with the purpose in s 150A of the Act.
- 1.21 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.
- 1.22 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.

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<sup>10</sup> <http://www.comcom.govt.nz/statutory-review-of-milk-price-manual/201415-season>

## 2. Conclusions from our review of the 2014/15 Manual

- 2.1 In this chapter we summarise our conclusions, and the reasons for those 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 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.<sup>11</sup>
- 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.<sup>12</sup>

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<sup>11</sup> Commerce Commission “Final Report on Review of Fonterra’s 2013/14 Milk Price Manual” (16 December 2013).

<sup>12</sup> Fonterra “Reasons’ Paper in support of Fonterra’s Milk Price Manual for the 2014/15 Season” (1 August 2014), page 4; “Reasons’ Paper in support of Fonterra’s Milk Price Manual for the 2013/14 Season” (1 August 2013); and “Reasons’ Paper in support of Fonterra’s Milk Price Manual for the 2012/13 Season” (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.<sup>13</sup> Our conclusions on the extent to which the 2014/15 Manual is consistent with the s 150A purpose are 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 has been included to recognise the importance of the consistency of application of the Milk Price Manual across dairy seasons (section 2.6 of the 2014/15 Manual: Consistency over time);
  - 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 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); and
  - 2.10.4 the revision of the rule for adjustments to the asset base for amendments to reference commodity products (RCPs)<sup>14</sup> (Rule 30).
- 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.<sup>15</sup> 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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<sup>13</sup> Commerce Commission "Final Report on Review of Fonterra's base milk price calculation" (15 September 2014).

<sup>14</sup> Reference commodity products are the commodity products used to calculate the Farmgate Milk Price, which comprises of whole milk powder, skim milk powder, buttermilk powder, anhydrous milk fat and butter.

<sup>15</sup> Open Country, in its submission on our draft report, raised general concerns that Fonterra has too much discretion in certain areas of the Manual. These areas are: cash costs of overheads and plant labour; the point of determination for the notional producer's capital costs; how the level of buffer capacity has been set; the level of flexibility Fonterra has to choose the characteristics of the plant producing each RCP; and winter milk not provided for in the Manual. See Open Country "Submission on the Commerce Commission's Draft Report – Review of Fonterra's Milk Price Manual" (17 November 2014), page 6.

## 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. This 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.
- 2.14 We recognised that methodological improvements in the base milk price calculation would be beneficial (eg, where more or better evidence becomes available over time) in some instances. But, any improvements should be signalled through transparent changes to the documented methodology.
- 2.15 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.<sup>16</sup>

- 2.16 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).

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<sup>16</sup> Fonterra "Farmgate Milk Price Manual for the 2014/15 Season" (1 August 2014), page 11.

*Our assessment of the amendment*

- 2.17 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 beat and for external stakeholders to monitor Fonterra's performance against. This is consistent with the efficiency dimension of the purpose statement.
- 2.18 However, given Fonterra has noted that it is neither 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.
- 2.19 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).
- 2.20 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.<sup>17</sup>
- 2.21 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.<sup>18</sup>
- 2.22 Fonterra, in its submission on our draft report, notes that it will consider the practicality of defining 'normal circumstances' for the 2015/16 Manual. Fonterra will also consider the merits of substituting an alternative term that better signals its intent that the methodology would only be allowed to evolve other than "in a manner that could be achieved by a 'real world' dairy producer" in highly unusual circumstances.<sup>19</sup>

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<sup>17</sup> We note that the audit materiality disclosed in the Farmgate Milk Price Statement is output-based.

<sup>18</sup> 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.

<sup>19</sup> Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2014/15 Farmgate Milk Price Manual" (17 November 2014), page 7.

- 2.23 Fonterra proposes that it would disclose any material changes through the Farmgate Milk Price Statement.<sup>20</sup> 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.
- 2.24 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*

- 2.25 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.
- 2.26 In response to our concerns, Fonterra has amended Rule 15 (Rule 16 in the 2013/14 Manual). The previous version of this rule stated:<sup>21</sup>

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.

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<sup>20</sup> Open Country notes that where Fonterra must make judgment calls, the approach taken to those judgment calls should be shared with the Commission and the wider industry. See Open Country "Submission on the Commerce Commission's Draft Report – Review of Fonterra's Milk Price Manual" (17 November 2014), page 6.

<sup>21</sup> Fonterra "Farmgate Milk Price Manual for 2013/14 Season, Marked up" (1 August 2013), page 41.

## 2.27 Revised Rule 15 states:<sup>22</sup>

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).

## 2.28 The justification for the change is described in Fonterra's Reasons Paper as follows:<sup>23</sup>

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.

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<sup>22</sup> Fonterra "Farmgate Milk Price Manual for 2014/15 Season" (1 August 2014), pages 40-41.

<sup>23</sup> Fonterra "'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2014/15 Season" (1 August 2014), pages 6-7.

- 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*

- 2.29 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.
- 2.30 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.
- 2.31 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.
- 2.32 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.<sup>24</sup>
- 2.33 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.
- 2.34 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.

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<sup>24</sup> 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.

- 2.35 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:
- 2.35.1 the determination of the fixed cost component is largely discretionary;<sup>25</sup>
  - 2.35.2 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<sup>26</sup> 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
  - 2.35.3 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.<sup>27</sup>
- 2.36 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.
- 2.37 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 practical 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.

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

#### *Amendment and Fonterra's reasons*

- 2.38 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.

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<sup>25</sup> As Fonterra notes in its submission: "Whether or not the provision established under this Rule complies with these criteria is primarily a factual matter which can be tested in the course of the base milk price review." See Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2014/15 Farmgate Milk Price Manual" (17 November 2014), page 5.

<sup>26</sup> Fonterra confirmed that the approach taken to establishing the replacement cost of Fonterra's fixed assets is fully consistent with the replacement with the approach taken to establishing the replacement cost of the notional producer's fixed assets and will consider making this explicit in the 2015/16 Manual. See Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2014/15 Farmgate Milk Price Manual" (17 November 2014), page 5.

<sup>27</sup> Fonterra will consider making the 2015/16 Manual explicit that milk collection and dry store fixed assets are excluded when determining the replacement cost of the notional producer's fixed assets. See Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2014/15 Farmgate Milk Price Manual" (17 November 2014), page 5.

2.39 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.

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

2.41 New Rule 41 states:<sup>28</sup>

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.

2.42 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 borne 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”.

2.43 Open Country agreed, but submitted that the risk of a shortfall in milk supply could more transparently be included in the Manual through a separate cash line item rather than through an uplift in the WACC.<sup>29</sup>

#### *Our assessment of the amendment*

2.44 We agree with Fonterra 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.

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<sup>28</sup> Fonterra “Farmgate Milk Price Manual for 2014/15 Season” (1 August 2014), page 52.

<sup>29</sup> Open Country “Submission on the Commerce Commission’s Draft Report – Review of Fonterra’s 2014/15 Milk Price Manual” (17 November 2014), pages 2-3.

*Feasibility of the asset beta estimate recommended by the Independent Reviewer under Rule 40*

- 2.45 Fonterra has advised us that it has received an asset beta recommendation from an Independent Reviewer. However, we consider this estimate reflects the application of Rule 40 rather than the setting of the rule. Therefore we do not conclude at this time on the practical feasibility of Fonterra's asset beta estimate under Rule 40. We will review Fonterra's information on the asset beta in the context of the WACC rate applied in our overall review of Fonterra's 2014/15 base milk price calculation.

**Adjustments for stranded assets (Rule 30)**

*Amendment and Fonterra's reasons*

- 2.46 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.
- 2.47 Fonterra acknowledged that the Milk Price Manual at that time arguably did not provide for the treatment of stranded assets that may occur from major structural, rather than minor incremental, changes in the RCP basket. For example, when a new product is substituted into the basket, and assets used to manufacture the product(s) it replaces are no longer needed.<sup>30</sup> Fonterra stated that in such a situation, it may not be feasible (or appropriate under the risk sharing principles described in section 2.4 of the Manual) to pass the stranded asset costs onto suppliers while still paying a competitive milk price. Fonterra stated that, in its opinion, the risk of such major changes occurring should be borne by shareholders. As stated in our 2013/14 report, we consider that if stranded asset risk is borne by shareholders, then shareholders should be compensated *ex ante* for bearing this risk.<sup>31</sup>
- 2.48 Fonterra has amended Rule 30, which covers the treatment of asset stranding due to a change in the RCP basket.
- 2.49 The revised rule covering asset stranding states:<sup>32</sup>

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.

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<sup>30</sup> Fonterra "Clarification of Fonterra's submission on the Commerce Commission's draft report on the Review of the Manual for the 2013/14 dairy season" (26 November 2013).

<sup>31</sup> Commerce Commission "Review of Fonterra's 2013/14 Milk Price Manual – Final Report" (15 December 2013), page 13.

<sup>32</sup> Fonterra "Farmgate Milk Price Manual for 2014/15 Season" (1 August 2014), page 48-49.

## 2.50 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.

### *Our assessment of the amendment*

2.51 The amended Rule 30 requires Fonterra to treat the costs arising from asset stranding (such as the financial effect of removal of the reference asset from the notional plant) as a reduction in the milk price in the year of stranding, 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.

2.52 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.<sup>33</sup> 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.<sup>34</sup>

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<sup>33</sup> Also mentioned by Miraka. See 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).

<sup>34</sup> Fonterra, in its submission on our draft report, notes that, in its view, it does not consider it possible to anticipate the full range of circumstances under which the ‘significantly less’ provision might be triggered and is therefore reluctant to include a prescriptive definition in the Manual. However Fonterra considers it unlikely that the provision would be triggered unless the gap between Fonterra’s milk price and the price other processors were able to be pay was materially more than 10 cents per KgMS or more and notes that this would only occur if in excess of 30 percent of notional fixed assets were stranded. See Fonterra “Submission to the Commerce Commission on its Draft Report on Fonterra’s 2014/15 Farmgate Milk Price Manual” (17 November 2014), page 6.

- 2.53 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”. Miraka considers that this is contradictory to the key assumptions of the Milk Price Manual itself and to the underlying purpose of Subpart 5A of the Act.<sup>35</sup> We note that Miraka is making a comparison to the actual price. However “the price able to be paid” implies a notional assessment.
- 2.54 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.<sup>36</sup> 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.
- 2.55 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.
- 2.56 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.<sup>37</sup>

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<sup>35</sup> 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).

<sup>36</sup> 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), pages 2-4.

<sup>37</sup> Fonterra notes that it will consider addressing our concern on double counting by amending both Rule 30 and Rule 41 in the 2015/16 Manual to provide that allowances for actual stranded asset costs (under Rule 30) or the risk that assets may be stranded (under Rule 41) should only be deducted to the extent that compensation has not otherwise been provided to providers of capital. See Fonterra “Submission to the Commerce Commission on its Draft Report on Fonterra’s 2014/15 Farmgate Milk Price Manual” (17 November 2014), page 6.

- 2.57 Furthermore, Open Country, in its submission on our draft report, notes that it disagrees with Fonterra's Rule 30 amendments, and submits that the Manual could be improved by allocating all asset stranding risks on the shareholders as they are the parties that have the best information, abilities and incentives to manage the risks.<sup>38</sup> Open Country further notes that compensation to the shareholders for bearing those risks should be through an *ex ante* allowance. We agree with Open Country. We consider that providing just an *ex ante* allowance for all asset stranding risks (ie. both incremental and structural changes) would remove the possibility of double counting and address our concerns over the amount of discretion Fonterra has.
- 2.58 The amendments raise further questions on how Rules 30 and 41 would apply in practice. We recommend that Fonterra should further justify the difference in the treatment of risk allocation for stranded assets and consider amending the Manual for the 2015/16 season.
- 2.59 Our view is that even if rules were put in place to avoid double counting, without seeing the application of the Rule through the calculation of the specific risk premium,<sup>39</sup> we are unable to conclude on the extent to which the new Rule 30 is consistent with the s 150A purpose statement.
- 2.60 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.

### Technical amendments

- 2.61 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:
- 2.61.1 definition of 'Farmgate Milk Price Tax Depreciation';
  - 2.61.2 definition of 'Review Year';
  - 2.61.3 definition of 'Benchmark Selling Price'; and
  - 2.61.4 new Rule 33: Site footprint.
- 2.62 These amendments are either technical corrections or provide clarification and consistency. We provide our brief comments on these amendments below.

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<sup>38</sup> Open Country "Submission on the Commerce Commission's Draft Report – Review of Fonterra's Milk Price Manual" (17 November 2014), page 5.

<sup>39</sup> Any *ex post* adjustment would only be seen in the event of asset stranding actually occurring.

*Definition of 'Farmgate Milk Price Tax Depreciation'*

2.63 In our final report for the 2013/14 Manual review and our final report for the 2013/14 base milk price calculation, we commented on the lack of a requirement in the Milk Price Manual to adhere to a particular tax methodology over time. This 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.<sup>40</sup> 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.

*Definition of 'review year'*

2.64 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.

2.65 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.<sup>41</sup>

*Definition of 'Benchmark Selling Price'*

2.66 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.

2.67 We note that removing the explanation of the term 'N' from the formula has arguably made its operation in the formula less clear.<sup>42</sup>

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<sup>40</sup> Commerce Commission "Final Report on the Review of Fonterra's 2013/14 Milk Price Manual" (16 December 2013), page 20.

<sup>41</sup> Fonterra, in its submission on our draft report, confirmed that these omissions were in error and will amend the 2015/16 Manual to include references to Rule 8 (Product Yields), Rule 39 (WACC specification), and Rule 41 (Specific risk premium). See Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2014/15 Farmgate Milk Price Manual" (17 November 2014), page 7.

<sup>42</sup> Fonterra, in its submission on our draft report, notes that the removal of the principle governing the selection of the maximum number of months between contract and shipment of sales included in the Milk Price revenue calculation was an unintended consequence of its attempt to simplify the provision and make its application more transparent. Fonterra will consider reinstating the previous language in the 2015/16 Manual. See Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2014/15 Farmgate Milk Price Manual" (17 November 2014), page 7.

*New Rule 33: Site Footprint*

- 2.68 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.
- 2.69 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**

- 2.70 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.
- 2.71 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*

- 2.72 In our review of the 2013/14 Manual we noted a concern about a correction to Rule 24 (now Rule 23) regarding standard plants and other reference assets (now Rule 23). This 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.
- 2.73 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.

- 2.74 In our draft report, we recommended that Fonterra address this issue for the 2015/16 Manual. Fonterra, in its submission on our draft report, notes the addition of Site footprint (Rule 33) to the 2014/15 Manual. This was intended to deal with the lack of any explicit provision specifying the consequences for the milk price of Fonterra adding or closing commodity manufacturing sites. Alignment of the milk price footprint with Fonterra's will be maintained by adding or removing sites from the milk price model. The population of a new site with the requisite manufacturing assets, together with a provision of an allowance for the acquisition of land, is in its view then required under Rule 23 (Standard plants and other reference assets).<sup>43</sup>
- 2.75 We accept Fonterra's explanation, but consider that the Manual could be more explicit, ie, along the lines of that explanation.

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

- 2.76 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".<sup>44</sup> 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'.
- 2.77 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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<sup>43</sup> Fonterra further accepts that it would assist readers if an explicit statement was made on the consequences for the asset base of adding an additional site to the Milk Price Model, and it will consider this for the 2015/16 Manual. See Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2014/15 Farmgate Milk Price Manual" (17 November 2014), page 8.

<sup>44</sup> 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

- 2.78 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’<sup>45</sup> peak milk flows in the 2013/14 dairy season.<sup>46</sup>
- 2.79 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.<sup>47</sup>
- 2.80 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.<sup>48</sup>
- 2.81 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.<sup>49</sup>
- 2.82 Miraka has argued 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. As noted 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.

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<sup>45</sup> ‘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.

<sup>46</sup> Open Country submits that a cost allowance to take account of the cost effects of over-supply or under-supply of milk should be introduced. Open Country further suggests an approach to address the issue of under and over supply of milk. See Open Country “Submission on the Commerce Commission’s Draft Report – Review of Fonterra’s Milk Price Manual” (17 November), page 4.

<sup>47</sup> Fonterra “Farmgate Milk Price Manual for 2014/15 season” (1 August 2014), Rule 41, page 52.

<sup>48</sup> 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.

<sup>49</sup> 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.

- 2.83 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.<sup>50</sup>
- 2.84 We note that Fonterra has also 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.<sup>51</sup> 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.<sup>52</sup>
- 2.85 We will consider, on the basis of the actual circumstances 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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<sup>50</sup> 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).

<sup>51</sup> Fonterra "'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2014/15 Season" (1 August 2014), page 10.

<sup>52</sup> 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).<sup>53</sup>

*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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<sup>53</sup> 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.<sup>54</sup> 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.<sup>55</sup> 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.

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<sup>54</sup> 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.

<sup>55</sup> 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).

- 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. 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.<sup>56</sup> 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.<sup>57</sup>

*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.<sup>58</sup>

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<sup>56</sup> 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.

<sup>57</sup> 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.

<sup>58</sup> For example, through a combination of using actual and notional values in the base milk price calculation.

- 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.

### **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.<sup>59</sup> Miraka also disagrees with our interpretation of ‘efficient processor’.<sup>60</sup> 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 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.

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<sup>59</sup> Synlait “Submission on Fonterra’s ‘Reasons’ Paper in relation to the 2013/14 base milk price” (15 July 2014), paragraph 14.

<sup>60</sup> 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).

B34 In reaching our 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:

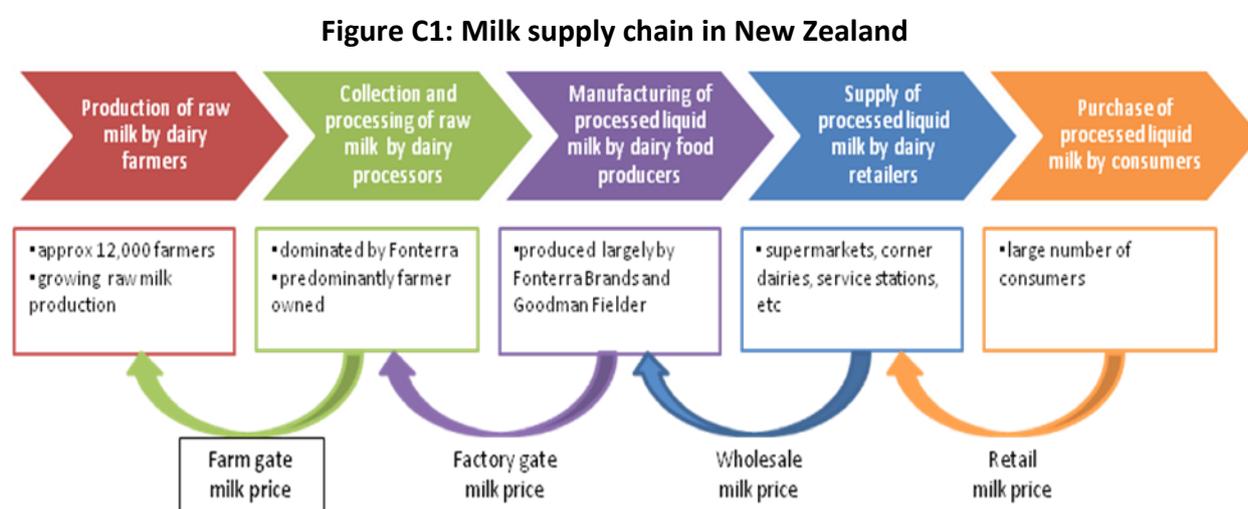
- B35.1 checking that the provisions in the Manual are internally consistent with each other. We have been largely guided by submissions to identify areas where there are potential inconsistencies between the provisions in the Manual, and have reviewed these areas in our analysis; and
- B35.2 considering 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.



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.<sup>61</sup>

### **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.<sup>62</sup> 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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<sup>61</sup> 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.

<sup>62</sup> 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:<sup>63</sup>

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<sup>64</sup> 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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<sup>63</sup> Source: <http://www.fonterra.com/global/en/Financial/Trading+Among+Farmers>

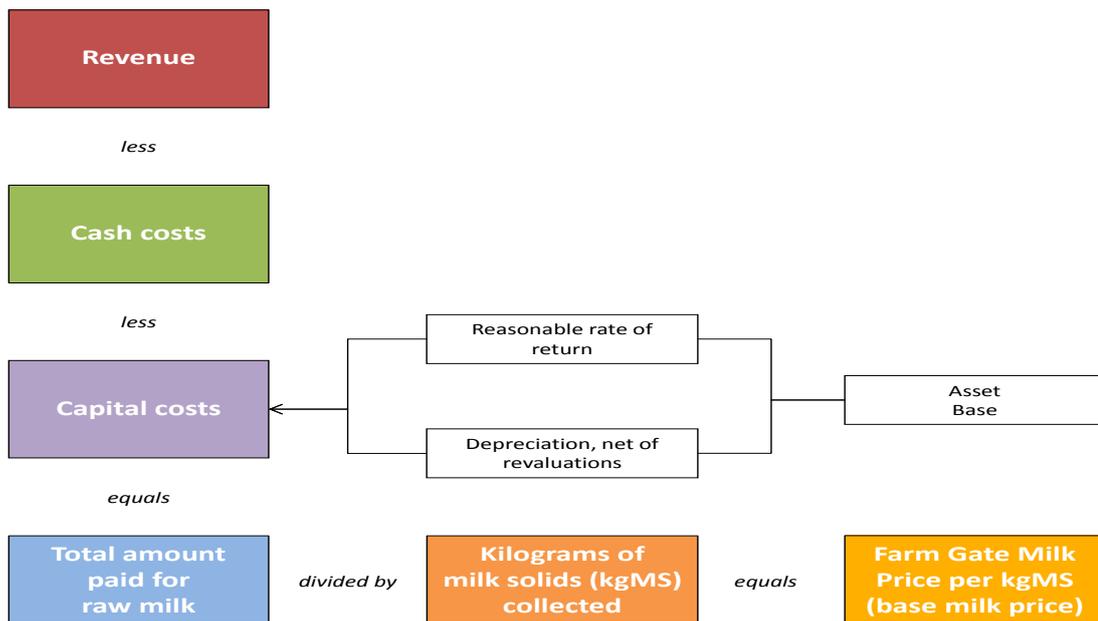
<sup>64</sup> There is a market maker (known as the Registered Volume Provider or RVP) who is continuously active in offering to buy and sell Shares on the Fonterra Shareholders' Market during the periods of operation of the Fonterra Shareholders' Market (other than in the case of a temporary halt in, 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<sup>65</sup>**



- 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

<sup>65</sup> 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**

