



Fonterra submission on the  
Key Issues Paper –  
Review of Base Milk Price Calculation

19 July 2013



**Dairy for life**

## 1 Introduction

This paper sets out Fonterra's submissions on the Key Issues Paper released by the Commerce Commission (the Commission) on 5 July 2013. Most of the matters raised in the Key Issues Paper relate to the scope and process of the Commission's review of Fonterra's 2012/13 base milk price calculation, including the Commission's intended analytical approach. Fonterra has no particular comments or submissions to make on these matters.

Instead, the subject of this submission is confined to the Commission's intention to explore whether Fonterra could be limiting volumes it sells on GDT so as to realise higher on-GDT prices, at the expense of its off GDT Prices (Paragraph 38 of the Key Issues Paper). In particular, the Commission intends to:

- Compare the relative changes in volumes and prices of reference commodity products Fonterra sold on and off GDT across the last dairy season, which included a drought period; and
- Assess the reasonableness of Fonterra's underlying rationale for its decisions to place certain volumes on and off GDT, particularly during the drought period.

To assist the Commission, this submission explains:

- The impact of seasonal factors on Fonterra's production during the 2012/13 season, including a flush in late summer and autumn in the 2011/12 season, good growing conditions in the first 6 months of the 2012/13 season, and an unprecedented and unforeseen national drought from February onwards; and
- The allocation of product between Fonterra's sales channels including GDT (which accounts for about 30% of total volume of sales).

Some of the material relating to Fonterra's production and sales optimisation processes is commercially sensitive. While we have attempted to make as much of this submission as public as possible, we have also provided a confidential annex to this submission.

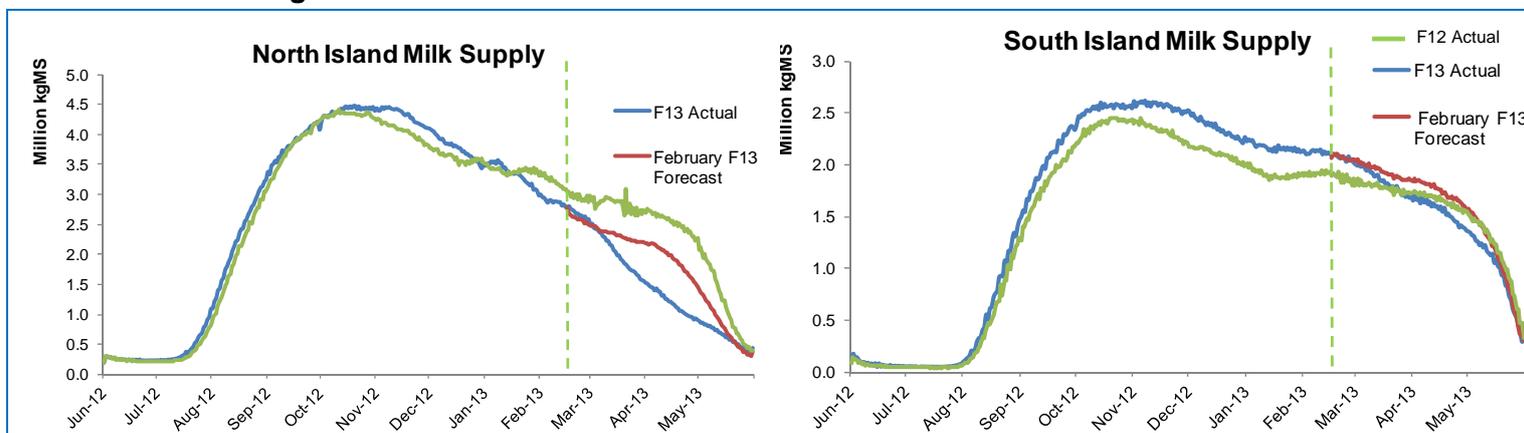
The remainder of this submission is organised as follows:

- In section 2, we describe the main production-related factors that influence Fonterra's sales phasing of volumes on and off GDT;
- In section 3, the implications of factors noted in section 2 on how Fonterra responded to the late summer drought are discussed;
- In section 4 reference commodity products offered on and off GDT are discussed; and
- Section 5 sets out conclusions.

## 2 Factors that influence Fonterra's phasing of volumes on and off GDT

The seasonal nature of Fonterra's milk supply is well known, as are the impacts of climatic factors on milk production during a year. This is illustrated in the diagrams below that show separately the milk flows for the 2011/12 season (F2012) and the 2012/13 season (F2013), together with the forecast production for 2012/13 as at February 2013.

**Figure 1: Milk Production in North and South Islands F2012 and F2013.**



Source: Fonterra

The above figure highlights significant variances in the pattern of milk collections in the last two seasons. The late summer/autumn 'flush' of milk due to favourable climatic decisions is apparent in F2012, particularly in the North Island, which accounts for about 65% of national milk collections. Milk production in F2013 started well throughout New Zealand, partly due to favourable conditions at the end of the previous season, but also due to climatic factors, with milk production well up on the previous year by the end of January. However, the marked drop in production from mid-late summer compared to the previous season (and compared to production forecasts at the start of February) is clearly shown on the charts.

The seasonal nature of milk collections is reflected in the seasonal nature of sales to differing extents, depending on the sales channel. In particular:

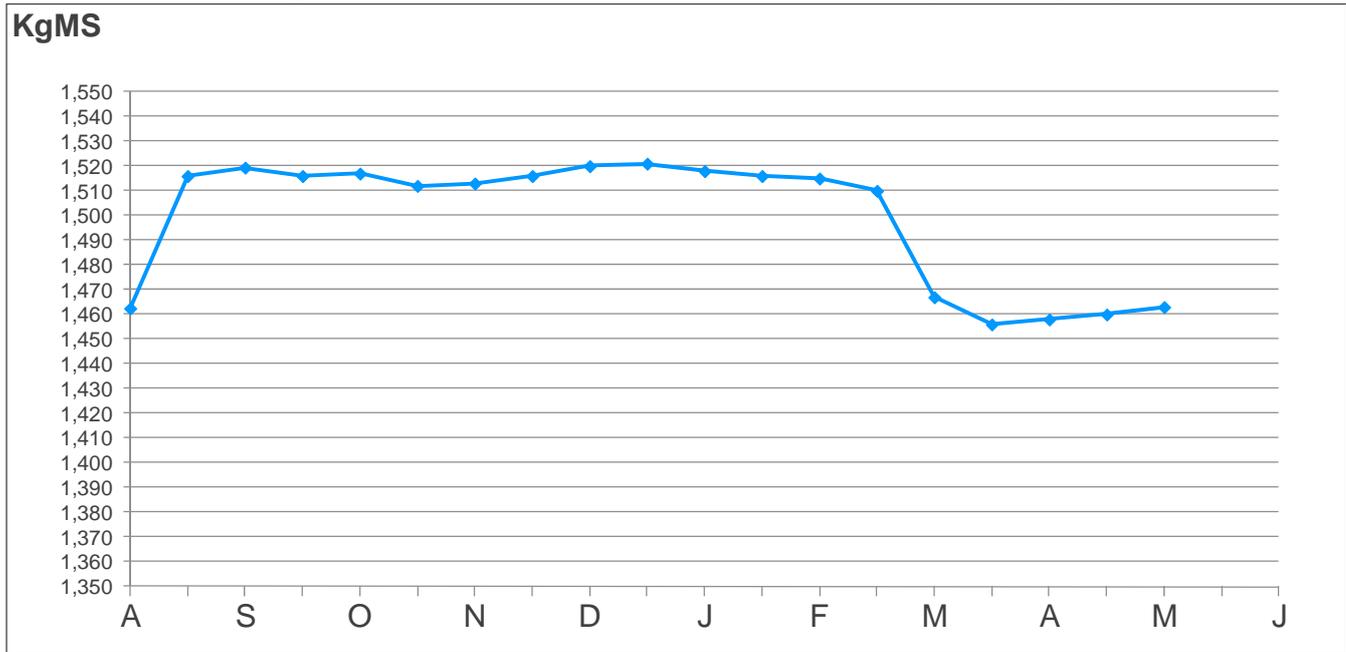
- Fonterra supports its own downstream consumer and foodservice businesses in New Zealand and elsewhere with fairly even volumes during the course of a season.
- Fonterra also enters into General Supply Agreements (GSAs) with major customers under which they are provided with committed volumes during a season under long-term agreements. Products are generally priced at a premium to GDT reflecting the commitment to prioritised volume under these agreements.
- The other two major channels are 'General Trade' and GDT. Volumes through these two channels are much more variable between seasons (and within a season) in response to both the seasonal nature of milk production, and to fluctuations in annual milk volumes. In this context:
  - 'General Trade' volumes tend to be spread more evenly across a season than GDT, because the channel covers significant volumes of government tenders that occur each year (and that generally attract a premium to prevailing GDT prices). General Trade also tends to be less flexible than GDT in managing short-term changes in milk volumes because the channel involves a large number of individual transactions that require intensive sales activity. In contrast, GDT is a much a less complex channel. Customers on GDT often actively switch between products and contracts on GDT, which increases its flexibility, and also between GDT and product from other suppliers.
  - Accordingly, GDT tends to exhibit the highest variability in its monthly sales volumes of all Fonterra's sales channels.

### 3 Implications of the late summer drought in F2013

The effect of the climatic factors discussed in relation to Figure 1 became apparent in February 2013. This is highlighted in the figure below that charts the trends in Fonterra’s milk collection forecasts throughout F2013.

Reflecting trends in production early in F2013, the milk collection forecast was raised to above 1,510m kgMS by August and remained at about that level until revised in late February down to 1,468m kgMS (some 54m kgMS below the forecast in December).

**Figure 2: Milk Collection Forecast Track F2013 (million kgMS)**

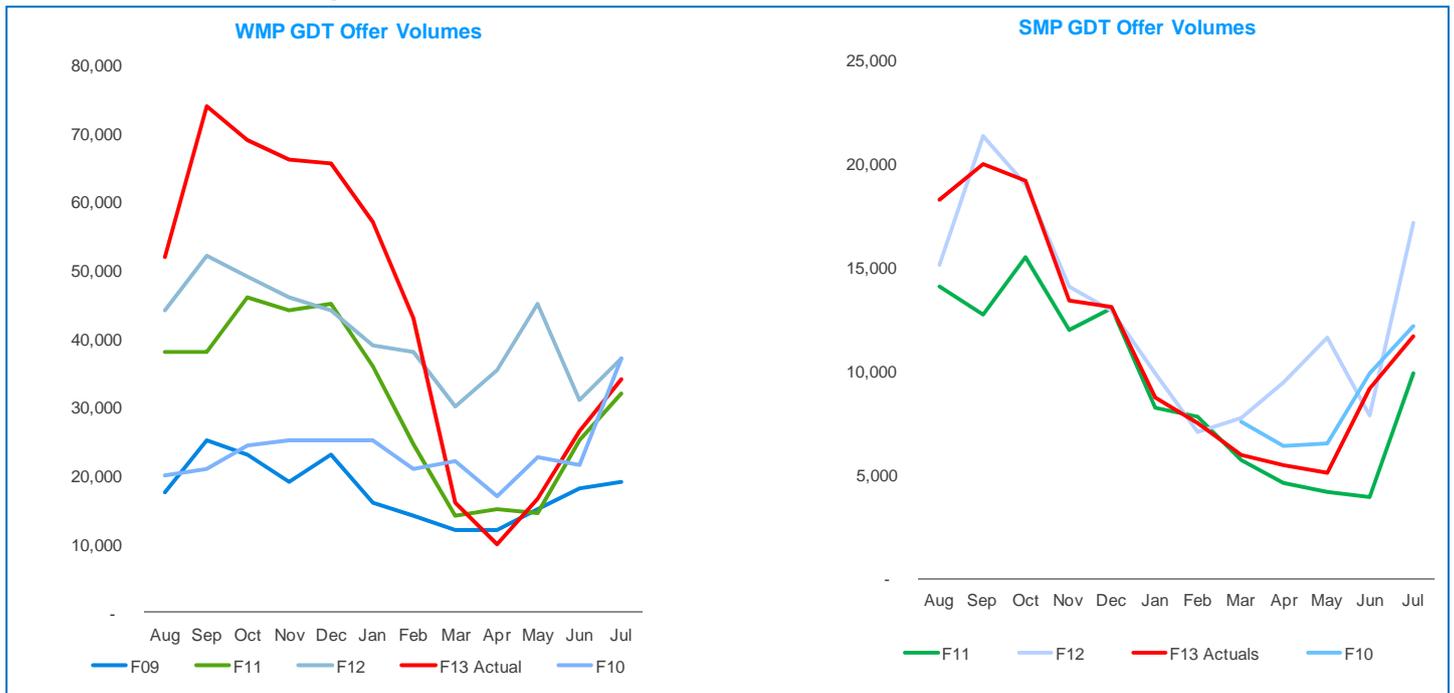


Source: Fonterra

Fonterra reviewed its internal milk production forecast in late February. Until that time, NIWA had continued to forecast relatively benign climatic conditions. While Fonterra has regard to other indicators, significant regard is given to NIWA’s forecasts.

Of note, Fonterra had collected nearly 75% of its forecast milk volumes when it substantially reduced its full-year milk forecast in late February. GDT and uncommitted volumes through Fonterra’s General Trade off-GDT sales channels were the most flexible channels to deal with the changed volume outlook, for reasons discussed earlier. This is illustrated in the volumes on GDT (across all GDT contract periods) for key reference commodity products shown in the Figures 3 and 4 below for F2013 compared to earlier seasons.

**Figure 3: Offer Volumes on GDT F2009-F2013: WMP & SMP**



Source: Fonterra

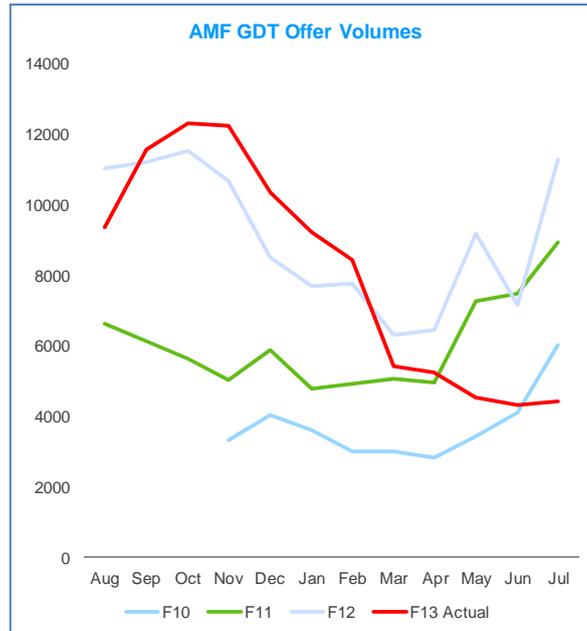
The decline in WMP volumes on GDT from December to April in F2013 reflected the seasonal decline of earlier years, but was more pronounced. This partly reflected the significant ramp up of WMP production prior to December due to the substantial increase in milk volumes in the South Island (but also the North Island to some extent) illustrated in Figure 1. This additional milk was largely manufactured into WMP – in the South Island using recently acquired and built WMP capacity in Studholme and Darfield, as well as existing WMP capacity at Edendale and Clandeboye.

Although volumes of WMP offered on GDT dropped significantly compared to earlier in the season, volumes in the February to May period, which were most affected by the drought, were broadly comparable to the same period in F2009, F2010 and F2011 (but were significantly less than the same period in F2012 due to additional volumes on GDT reflecting the late summer flush illustrated in Figure 1).

SMP volumes on GDT in F2013 reflected the same seasonal pattern, but with a less variance from earlier years.

The information shown in Figure 3 for WMP and SMP is repeated for AMF in the figure below (historical comparisons are not possible for butter, which debuted on GDT in February 2013). In the case of AMF, volumes fell away in February due to the drought, but scarce milk was thereafter allocated to higher priority streams which resulted in volumes being lower late in F2013 compared to earlier seasons.

**Figure 4: Offer Volumes on GDT F2010-F2013: AMF**

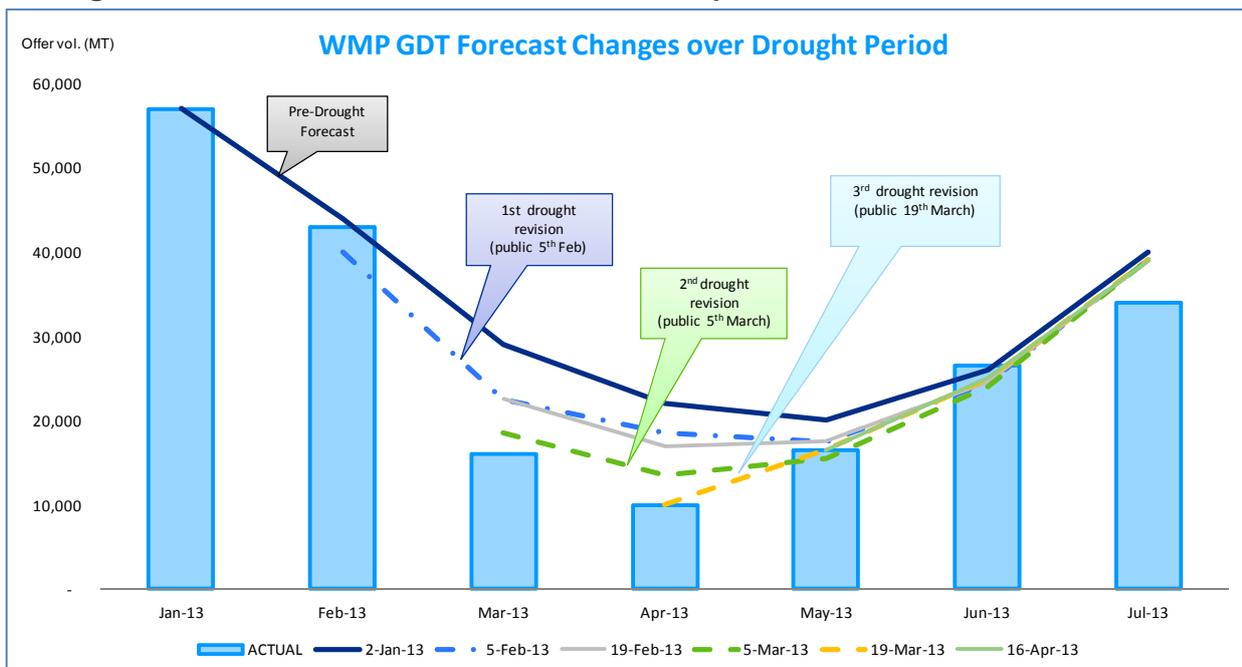


Source: Fonterra

Fonterra operates strong internal protocols in respect of providing forecast volumes on GDT, as well as complying with rules set by GDT to which all sellers on the platform are subject.

As soon as Fonterra became aware of volume risks, its optimisation team undertook a detailed review of product allocations and disclosed their implications for forecast volumes to GDT bidders, as they were best understood at the time. The progression of forecast monthly offer volumes on GDT compared to actual volumes is shown in the figure below for WMP. As shown, these forecasts were updated regularly from 5 February.

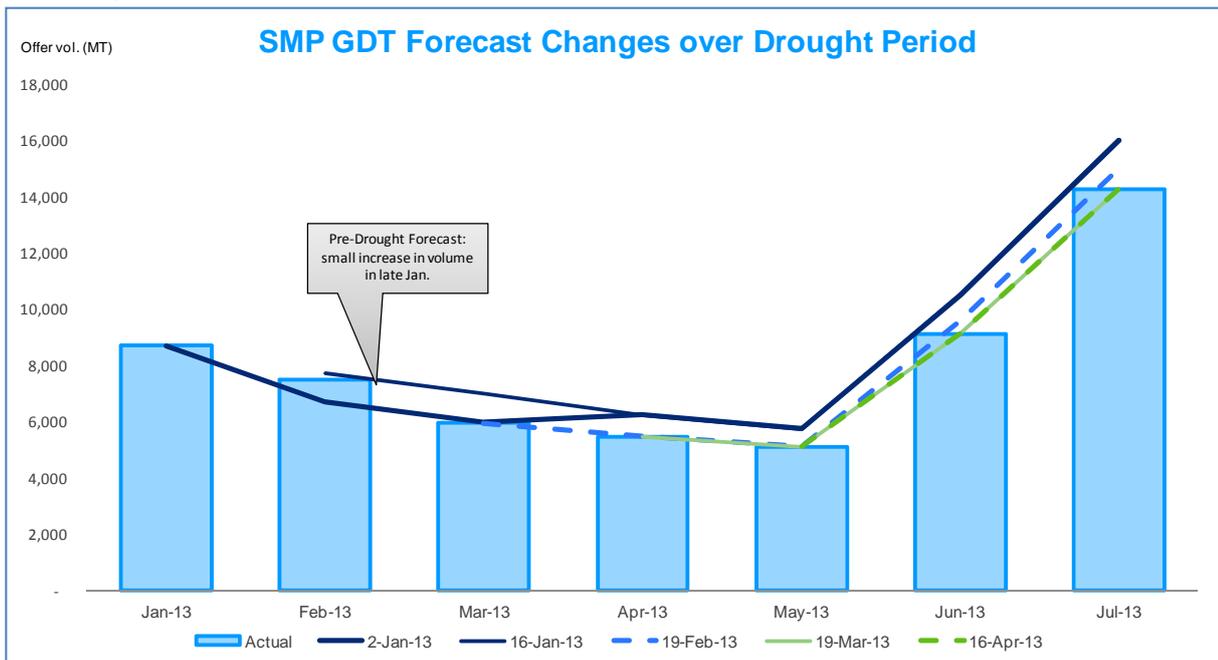
**Figure 5: Forecast WMP Volumes on GDT compared to Actual: Jan 2013-Jul 2013**



Source: Fonterra

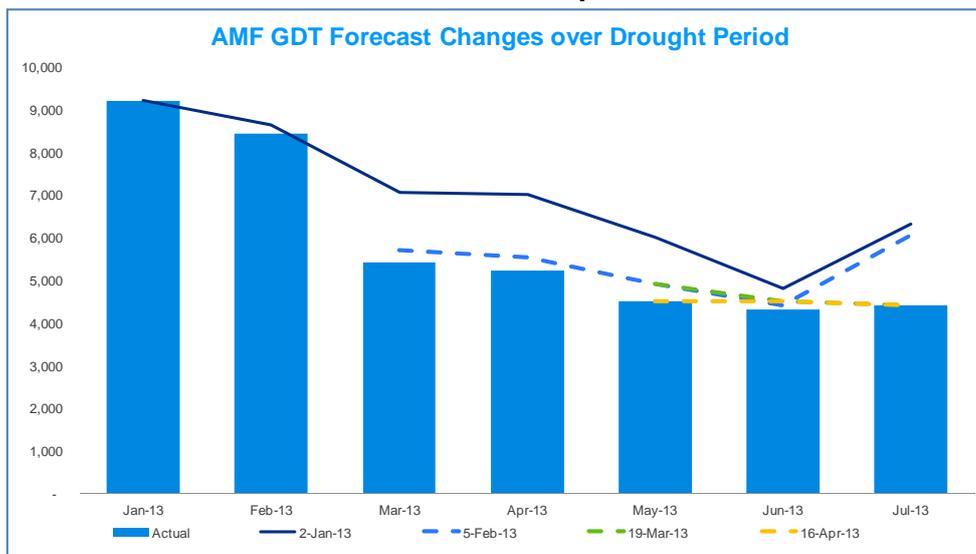
Figures 6 and 7 provide the same information on forecasts compared to actual for volumes of SMP and AMF on GDT.

**Figure 6: Forecast SMP Volumes on GDT compared to Actual: Jan 2013-Jul 2013**



Source: Fonterra

**Figure 7: Forecast AMF Volumes on GDT compared to Actual: Jan 2013-Jul 2013**



Source: Fonterra

The above discussion highlights that revised allocations of volume to GDT once the severity of the drought became known during February affected GDT events most significantly in March to May. These allocations to GDT, and to off-GDT sales, reflected a full review of all year-to-go production and sales plans in March undertaken by the New Zealand Milk Products (NZMP) business. NZMP reviewed its forecast production and sales plan for the remainder of the year having regard to:

- stock on hand at the start of April;
- projected new production from reduced milk volumes as a result of lowered forecasts;
- planned year-to-go sales; and
- projected closing stock.

Production and sales plans confirmed early in April were significantly affected by sales contracts and longer-term supply commitments already entered into by Fonterra in respect of off-GDT products. In respect of planned production from April:

- Around a quarter of planned production from expected milk collection was devoted to the manufacture of products already sold, or planned to be sold, on GDT.
- More than half of planned production was devoted to the manufacture of products to meet long-term contractual commitments, infant formula/nutritional customers or to serve Fonterra's downstream consumer and foodservice customers.
- Between 10-15% of planned production was devoted to the supply of liquid milk to the domestic market in New Zealand, of which 8% of total planned production was to supply milk to Independent Processors under DIRA.
- The plan therefore left only a very small proportion of expected production to meet uncommitted spot contracts.

The early April sales plan drew from stock on hand and expected additional production:

- Of planned new sales nearly 90% reflected volumes committed under GSAs, sales already in the process of being sold bilaterally by NZMP, committed nutritional/foodservice sales and volume requirements of Fonterra's own consumer business.
- Much of these committed volumes would have been sold at prices struck earlier in the year (in the case of GSAs and sales/shipments relating to contracts resulting from earlier GDT events).
- A little over 10% of expected new sales was therefore available for GDT and 'spot' contracts. The largest share (~62%) of this uncommitted additional volume was allocated to GDT for the remaining events to July.

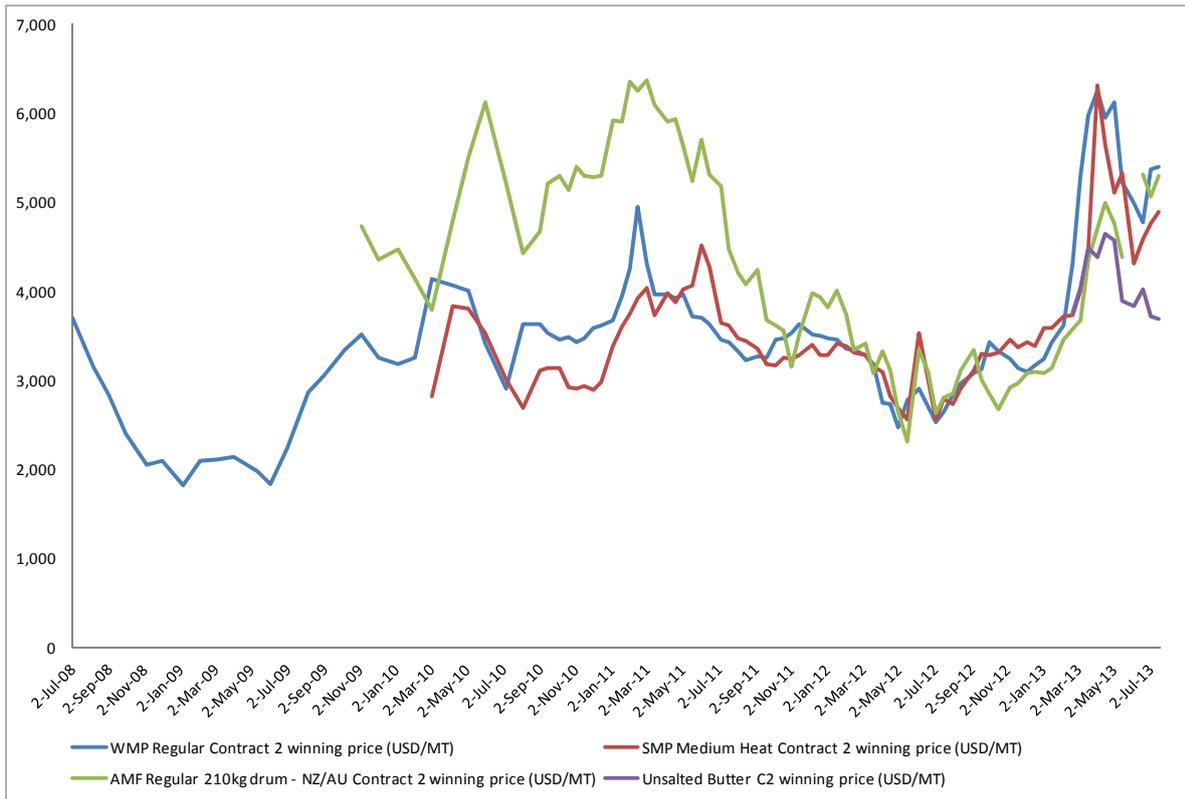
This plan resulted in Fonterra facing significant unfilled demand from many of its most significant customers.

## 4 Prices for Products offered on-GDT and off-GDT

Volumes of product sold on and off GDT, and factors that influenced their seasonal pattern (including the drought), are described in section 2. Prices that Fonterra received for off GDT sales of reference commodity products throughout F2013 were generally in-line with or above GDT benchmarks, as they were in earlier seasons.

It is notable that the increase in pricing on GDT in March and April of 2013 affected all reference commodity products, including SMP and AMF that exhibited much lower variance in offer volumes from earlier forecasts.

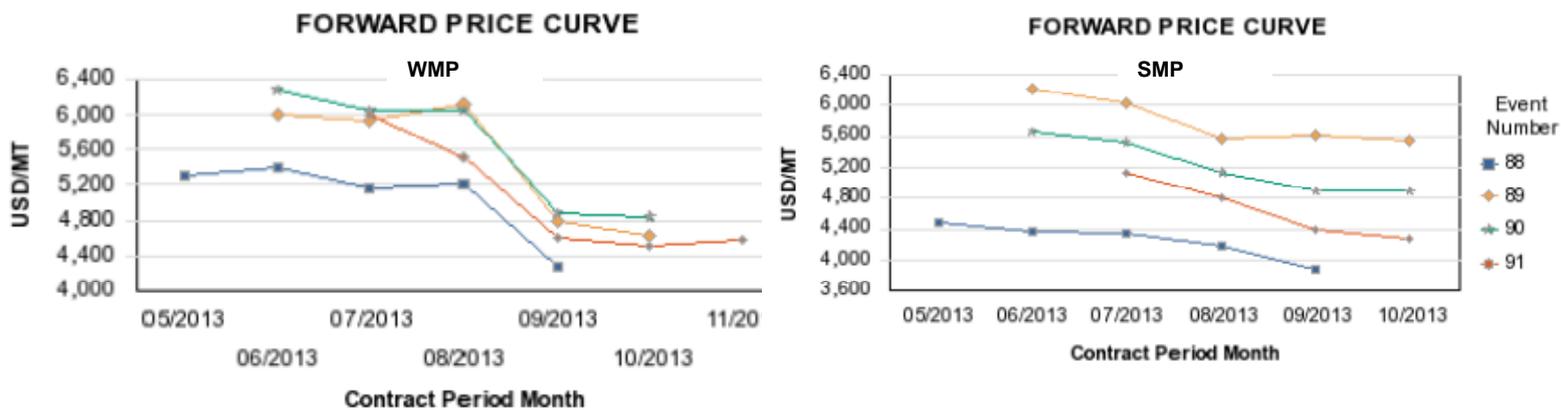
**Figure 8: Weighted Average GDT Prices (USD/tonne) for Reference Commodity Products 2 July 2008-2 July 2013**



Source: Fonterra

Moreover, GDT events in March and April evidenced forward pricing curves with a steep downwards slope for longer-dated contracts (refer to the forward pricing chart for WMP and SMP for four GDT events from 20 March to 2 May 2013 illustrated in Figure 8 below). By March, the depth of the nationwide drought and its implications were widely known. It is therefore reasonable to assume that this forward pricing profile reflected market expectations throughout this period that the drought would have only a short-term effect on pricing, with lower prices being paid for products manufactured from new season F2014 milk. In the event, current GDT WMP prices are above prices contracted in the GDT contracts shown in Figure 8 below (with the average WMP price on the 17 July GDT event being USD5,062/tonne for WMP and USD4,830/tonne for SMP)

**Figure 8: Average Forward Prices for WMP and SMP for GDT events 88-91 (20/03-02/05)<sup>1</sup>**



<sup>1</sup> This chart shows, for both SMP and WMP, the forward contracting profile of each GDT event from 20 March 2013 (Event 88) to 2 May 2013 (Event 91). The chart shows for each month, and each GDT event, the forward contracted prices for the contract periods offered.

## 5 Conclusion

Section 2 outlined the general production- and marketing-related factors that influence Fonterra's volume allocation decisions across its main channels. The section highlighted that Fonterra's GDT channel provided the most flexibility to respond to short-term changes in milk volumes.

The underlying rationale for Fonterra's decisions to place volumes on and off GDT was discussed in more detail in section 3. The primary drivers of volumes offered on GDT in F2013 were:

- the significant uplift in year-to-date milk production in F2013 through to January, at which point milk production was significantly above production to the same time in the previous (record-breaking) production season. For the reasons noted, much of this incremental milk was manufactured into WMP through newly acquired and built processing capacity in the South Island;
- this period of strong production being followed by an unprecedented (and unforeseen) national drought from mid to late summer.

These contrasting conditions during the season amplified the usual seasonal reduction in GDT offer volumes from December to March, particularly for WMP.

For the reasons noted in section 3, volumes were prioritised to meeting existing contractual and supply arrangements, which left limited additional sales volumes available for WMP (with a lesser volume impact for SMP and butter due to inventory held from production across the peak).

It is also clear from observed bidder behaviour on GDT that the market anticipated that the pricing impact of the (by then widely-known) drought would be temporary. Evidence of Fonterra's bilateral sales indicates that these were selling at or above GDT benchmarks in almost all instances, but with relatively low volumes late in the year due to the drought.

With new season's production now being sold, and increased volumes being offered on GDT, current prices observed on GDT are, in the case of WMP, higher than those contracted on GDT at the time of the drought (and are at broadly equivalent levels for SMP). This outcome, despite higher volumes now on GDT, supports the commentary in the Commission's Issues Paper that switching volumes between alternative sales channels (i.e., on and off GDT) should not, all other things being equal, result in material price changes over the medium term.

Instead, pricing on GDT is far more dependent on a variety of other exogenous factors, only some of which can be surmised.