



Submission to the Commerce Commission
on 'Process Paper – Review of base milk
price calculation' issued on 3 May 2013

17 May 2013



Dairy for life

1 Introduction

This submission sets out Fonterra's views on the Commission's *Process Paper – Review of the base milk price calculation*, dated 3 May 2013. It has been reviewed and is supported by the Milk Price Panel.

The *Process Paper* invites submissions on the best approach the Commission could take to assessing the eight specific issues summarised in Tables 2 and 3 of the *Process paper*, including submissions on:

- Methods of conducting the assessment of the base milk price calculation, and
- Where use of industry data and experts may be of assistance.

The appropriateness of alternative methods of assessment of the base milk price depends at least in part on the interpretation of section 150P of the Dairy Industry Restructuring Act (DIRA). We therefore comment briefly in Section 2 on this matter.

We then provide brief comments in Section 3 on the subject matter of the two bullet points above, and in Section 4 on the specific matters summarised in Tables 2 and 3 of the *Process Paper*.

2 Interpretation of section 150P

Section 150P provides that the Commission's report must consider "the extent to which the assumptions adopted and the inputs and process used by [Fonterra] are consistent with the purpose of this subpart." We comment briefly in this section on:

- The interpretation of section 150A, which sets out the purpose of subpart 5A of DIRA.
- The interpretation of the phrase "assumptions adopted and the inputs and process used by Fonterra".

Section 150A

Section 150A(1) provides that "the purpose of this subpart is to promote the setting of a base milk price that provides an incentive to [Fonterra] to operate efficiently while providing for contestability in the market for the purchase of milk from farmers. Section 150A(2) further provides that the 'contestability' test is satisfied if 'any' "notional costs, revenues or other assumptions ... are practically feasible for an efficient processor."

The Commission has set out its interpretation of s150A in both its 'dry run' report¹ and its report on its review of Fonterra's 2012/2013 Milk Price Manual.² In brief, the Commission's view is that:

- "The primary focus of the efficiency dimension [is on] ... improving incentives for Fonterra to drive cost efficiencies (ie, productive efficiency)."³
- "If the assumptions used in setting the base milk price are practically feasible, the contestability dimension is satisfied."⁴

¹ *Report on the dry run review of Fonterra's farm gate Milk Price Manual*, 27 August 2012 (the 'Dry Run Report').

² *The Dairy Industry Restructuring Act 2001 – Review of Fonterra's 2012/13 Milk Price Manual*, 14 December 2012 (the 'Manual Report').

³ The Manual Report, p.30.

⁴ The Manual Report, p.31.

We comment further below on our understanding of the Commission’s proposed practical approach to testing the base milk price against the ‘efficiency’ and ‘contestability’ dimensions, and note that:

- As documented in our submission of 5 September 2012 on the 2012/13 Milk Price Manual, we broadly agree with the Commission’s interpretation of section 150A.
- We note, however, that aspects of efficiency other than productive efficiency are also relevant in considering whether the base milk price appropriately incentivises Fonterra to operate efficiently. In particular, the milk price methodology is intended to create appropriate incentives for Fonterra to make efficient and innovative investment decisions, and the absolute level of the milk price (in addition to considering whether it is based on notional or actual inputs) is relevant in this context.

Section 150P

As noted above, section 150P provides that the Commission’s report must consider “the extent to which the **assumptions adopted and the inputs and process used** by [Fonterra] are consistent with the purpose of this subpart.” We comment briefly in this section on the interpretation of the highlighted phrase we propose applying in our report to be provided under section 150T.

In particular, we propose interpreting:

- ‘Inputs’ to mean the specific values used in calculating the base milk price for the 2012/13 year. Depending on context, these values could be expressed either as a quantum (‘NZD 2.3 million’), in descriptive terms (‘volume-weighted average price achieved for all NZ-sourced WMP sold on GlobalDairyTrade and shipped in the relevant month’), or both.
- ‘Assumptions’ to mean the rationale underpinning the approach used to calculate each input, including the rationale for use of notional or actual values.
- ‘Processes’ to mean both:
 - the approach used to (a) generate each input and (b) aggregate those inputs to produce the base milk price, and
 - the processes and controls implemented by Fonterra to ensure individual inputs and the overall milk price accurately reflect the underlying data and rules.

We note for completeness that our proposed interpretation of ‘assumptions’ is not consistent with the usage of that term in section 150A(2) to refer to notional inputs (“notional costs, revenues, or other assumptions”), but do not consider this to be of any particular significance.

3 The Commission’s approach to conducting its assessment

The Efficiency Dimension

The Commission explains in para B26 of the Manual Report that its practical approach assessing the extent to which the base milk price incentivises Fonterra to operate efficiently is to ask the following questions:

1. Have actual or notional values been used?
2. Where actual values are used:
 - a. Are they consistent with the assumed product mix?
 - b. Why were actual values used?
 - c. Could the use of notional data instead provide a better incentive for Fonterra to operate efficiently?
3. Where notional data is used, is it exogenously determined, or is it adjusted for Fonterra’s actual results?

The Commission also notes that its view is that the use of actual data is reasonable where:

1. There is insufficient information to know what an appropriate notional value would be, or
2. Fonterra has very limited control over the actual costs used for the benchmark.

We are comfortable with the Commission's proposed approach. (We note, however, that there are some circumstances in which it is appropriate to apply a modified version of 2(c), along the lines of "Could the use of notional data instead provide a **worse** incentive for Fonterra to operate efficiently?" For example, our view is that use of notional sales phasings could potentially incentivise inefficient behaviour by Fonterra.)

The Contestability Dimension

The Commission's proposed approach to assessing the base milk price against the contestability dimension of s150A is set out in paras B27 – B37 of the Manual Report. In brief, the Commission explains that:

- The primary test is whether the assumptions are practically feasible for an efficient processor.
- The Commission's main test in assessing whether an assumption is 'practically feasible' is to determine whether the assumption is practically feasible for Fonterra in particular.
- The Commission recognises that it is "possible that assumption is practically feasible for Fonterra due to features unique to Fonterra, which do not relate to Fonterra acting efficiently [in which] case the assumption may not be practically feasible for another efficient processor."⁵ The Commission notes that in these instances it will consider what further review is necessary on a case-specific basis.

While the Commission's comments in para B32 apply specifically to its review of the Manual, we assume they will be applied in the following manner in the Commission's review of the base milk price:

- The Commission will consider whether there is consistency amongst the inputs / assumptions used to calculate the base milk price, and
- This assessment will inform the Commission's determination of "the extent to which ... the assumptions adopted and the inputs and processes used" to calculate the base milk price are consistent with the contestability dimension of s150A.

With respect to the latter point we assume, consistent with s150A(2), that so long as the Commission finds that the inputs, assumptions and processes used would in combination be practically achievable by a single efficient processor, the Commission will conclude that those inputs, assumptions and processes are fully consistent with s150A.

We also note, and agree with, the Commission's comments in para B29 of the Manual Report, in which it notes that the reasons for focusing primarily on whether an assumption is practically feasible for Fonterra comprise both the practical matter that the majority of the data available to the Commission is Fonterra's, and the confirmation in section 150P(3)(a) that the Commission is not required to model the costs of an independent processor. If the Commission were to test our assumptions against data made available by other processors, it would be important that the Commission have an equivalent level of access to those processors' data as it has to Fonterra's, and that the Commission apply an equivalent level of analysis of those processors' data as to Fonterra's.

⁵ Para B30, p.34, Manual Report.

4 Assessment of specific matters raised in Process Paper

We provide brief comments in the table below on our views on the appropriate approach to assessing the specific matters raised in Tables 2 and 3 of the Process Paper.

Issue	Fonterra views on best approach to assessment
Asset stranding	This matter is best considered in the course of the Commission’s assessment of the appropriateness of the asset beta. (We also note that clarification of the matters the Commission considers uncertain, per para 3.30 of the Manual Report, will assist in this assessment.)
Milk collection costs	Direct collection costs are primarily a function of (a) kilometres travelled by the Fonterra collection fleet and (b) Fonterra’s average cost per kilometre. It is very difficult to independently assess whether (a) is inefficiently ‘too high’, other than by determining whether there are any shortcomings in Fonterra’s approach to scheduling milk collection. Benchmark data is however available on (b), and it is in our view appropriate to test Fonterra’s average costs against this data.
Operating costs – use of actual resource usage and unit rates	Application of the practical tests set out under the ‘Efficiency Dimension’ above is appropriate.
[Potential] Over-optimisation of notional assets	Detailed consideration of the points raised by Fonterra in its submission on the Manual Review, and summarised in para 3.39 of the Manual Report, constitutes an appropriate approach to assessment of this issue.
Yields	Have appropriately qualified experts review the detailed build-up of milk price yield assumptions, and support for same.
Practical feasibility of notional producer	While the Commission “is not required to calculate the costs of an independent processor” (s150P(3)(a)), it may nonetheless be useful to test the range of milk prices that ‘representative’ notional producers with various characteristics different to Fonterra’s could potentially pay for milk, relative to the base milk price, given a common set of relevant base assumptions. (We emphasise that we do not consider this exercise to be a necessary element of the s150O process. We do, however, consider that such an exercise could cast useful light on the claims by some third parties that the base milk price is ‘over’ or ‘fully’ optimised.)
Pricing: <ul style="list-style-type: none"> • Impact on GDT prices of using notional yields • Discretion to use off GDT prices 	Compare actual composition (fat, protein, moisture content) of product sold on GDT against milk price yield assumptions to determine whether any material difference in assumed yields. For off-GDT prices, determine circumstances in which these are used and how they are selected (eg by reference to criteria determined ex ante or ex post) and whether there is any systematic bias (high or low) in prices achieved on selected sales vs those not selected.

Jonathan Mason
Chief Financial Officer