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COMMERCE COMMISSION

Decision 578

Determination in the matter of an application for determination of a dispute under the Dairy Industry Restructuring Act 2001 involving:

OPEN COUNTRY CHEESE COMPANY LIMITED

and

FONTERRA CO-OPERATIVE GROUP LIMITED

The Commission:

D F Caygill, D R Bates and P J M Taylor

Summary of Application:

Open Country Cheese Company Limited applied for a determination, under section 120 of the Dairy Industry Restructuring Act 2001, of a dispute with Fonterra Co-operative Group Limited relating to the meaning of 'new co-op retention' as defined in regulation 3(1) of the Dairy Industry Restructuring (Raw Milk) Regulations 2001.

Determination:

The Commission determines that the definition of 'new co-op retention' in the Dairy Industry Restructuring (Raw Milk) Regulations 2001 includes profits from the sale of investments and that Fonterra Co-operative Group Limited has not breached the Dairy Industry Restructuring (Raw Milk) Regulations 2001.

Date of Determination:

21 April 2006

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INTRODUCTION

1. The Commerce Commission (the Commission) has the responsibility, under the Dairy Industry Restructuring Act 2001 (the Act), to determine disputes between Fonterra Co-operative Group Limited (Fonterra) and independent processors.
2. On 4 October 2005, the Commission received an application from Open Country Cheese Company Limited (Open Country) for a determination to resolve a conflict under section 120 of the Act. On 2 November 2005, the Commission decided to determine the dispute. On 21 November 2005, the Commission issued a draft determination of the dispute.
3. Open Country is in dispute with Fonterra about the interpretation and application of the meaning of ‘new co-op retention’¹ as defined in regulation 3(1) of the Dairy Industry Restructuring (Raw Milk) Regulations 2001 (the Regulations).
4. This determination outlines the dispute, sets out the process followed in considering the matter, provides background facts about the Act and the Regulations, and sets out the Commission’s analysis in brief.
5. The Commission determines that the definition of ‘[Fonterra] retention’ in the Regulations includes profits from the sale of investments and that Fonterra has not breached the Regulations.

THE DISPUTE

6. At issue is what can be included in retention for the calculation of the default milk price. Fonterra states that it is entitled to include in retention, for the purposes of the default milk price, all after tax profits not paid to shareholding farmers, including those from the sale of its investments. Open Country disagrees, and argues that this is not the intent of the Regulations and that Fonterra’s approach distorts the purpose of the default milk price regime.
7. On 30 August 2005, Open Country received a debit memo from Fonterra, requesting payment of \$1,144,190.89 plus GST for the final end of season adjustment to the default milk price. This amount represents the additional amount payable to Fonterra as a result of its calculation of the final regulated price for raw milk. Open Country is disputing \$737,466.84 plus GST of this amount, being the portion of the price that is due to the inclusion of capital profits as part of ‘[Fonterra] retention’.
8. The bulk of the profits at issue derive from Fonterra’s sale of its shares in National Foods Limited (National Foods) in May 2005. Fonterra reported a gross gain of \$195 million from this transaction. The remainder of the profits were realised in Fonterra’s divestment of its shares in Wrightson Limited (Wrightson), which resulted in a gross gain of \$13 million.²

¹ ‘New co-op’ is hereafter referred to as [Fonterra].

² Fonterra Annual Report, 2004/2005, p6, p10.

THE PROCEDURES

9. Section 125 of the Act states that the Commission, in deciding whether to make a determination under section 123(a), and in making a determination under section 124, must consider the purpose of Subpart 5 of Part 2 outlined in section 70 of the Act and whether the decision or determination promotes the principles in section 71.
10. The Commission considers that the principle in section 71 of the Act most relevant to this dispute is that set out in section 71(a). Section 71(a) states that the intention of Subpart 5 of Part 2 of the Act is to promote the principle that:

Independent processors must be able to obtain raw milk, and other dairy goods and services, necessary for them to compete in dairy markets.
11. The dispute relates to the terms for supply of raw milk by Fonterra to Open Country.
12. Section 126 of the Act requires specific matters to be included in the Commission's determination.
 - (1) A determination by the Commission must—
 - (a) state the Commission's decision on the matters in dispute; and
 - (b) state clearly whether a breach of {Subpart 5 of Part 2} or any regulations has occurred; and
 - (c) include the reasons for the determination; and
 - (d) include the terms and conditions on which the determination is made; and
 - (e) specify the actions that a party to the determination must do or refrain from doing, which may include (without limitation) payment of compensation by one party to the other.
 - (2) The Commission may specify an expiry date for the determination.
13. Section 127 of the Act relates to the procedure for determinations. Section 127(a) provides that the Commission is not bound by technicalities, legal forms, or rules of evidence. Section 127(b) provides that the Commission may inform itself of any matter relevant to the determination in any way that it thinks appropriate. The Act is otherwise silent on the procedure to be followed for determinations.
14. Section 129 of the Act provides that, except in specific circumstances, the parties to a determination bear their own costs.
15. On 21 November 2005 the Commission issued a draft determination and sought written submissions on it from the parties to the dispute. The Commission received written submissions from Fonterra and Open Country on its draft determination. The Commission has had regard to those submissions in making this final determination.

THE PARTIES

Open Country Cheese Company Limited

16. Open Country commenced production on 1 October 2004. For the 2004/2005 dairy season,³ Open Country purchased approximately 50 million litres of raw milk from

³ Section 5 of the Act defines a dairy season to mean 'a period of 12 months beginning on 1 June in a year and ending on 31 May in the following year'.

Fonterra under the Regulations. This represents the maximum quantity of raw milk that Fonterra must supply to a single independent processor under the Regulations.

Fonterra Co-operative Group Limited

17. Fonterra is the company formed in 2001 by the amalgamation of New Zealand Co-operative Dairy Company Limited, Kiwi Co-operative Dairies Limited, and the New Zealand Dairy Board. Fonterra operates multiple milk processing plants in various dairying regions throughout the country. It is co-operatively owned by 13,000 New Zealand dairy farmers.⁴ Fonterra collects over 13 billion litres of milk annually and manufactures two million tonnes of dairy products. It exports 95% of its production to 140 countries.

THE LEGISLATION

18. Regulation 4(1) requires Fonterra to supply raw milk to independent processors subject to regulations 5 to 15.⁵
19. The price at which Fonterra must supply raw milk under the Regulations is determined pursuant to regulation 8, which provides:

8. Price of raw milk—

- (1) [Fonterra] and an independent processor may agree a price for the supply of raw milk.
- (2) An independent processor may, however, require [Fonterra] to supply the raw milk specified in subclause (3) or subclause (4) at the default milk price unless there is an agreement under subclause (1) about the supply of that raw milk.
- ...
20. The effect of regulations 8(1) and (2) is that an independent processor may, subject to regulations 5 to 15,⁶ require Fonterra to supply raw milk specified in regulation 8(3) and (4) at the default milk price, provided Fonterra and the independent processor have not agreed a price for the supply of raw milk under regulation 8(1).
21. The default price is set out in regulation 8(5), which provides:
- (5) The default milk price for raw milk supplied to an independent processor in a season is the wholesale milk price for that season plus,—
- (a) for raw milk except organic milk or winter milk, the reasonable cost of transporting the raw milk to the independent processor; and
- ...

⁴ Fonterra website, URL: www.fonterra.com.

⁵ Under regulation 11, the total volume of raw milk that Fonterra can be required to supply to independent processors is 400 million litres per season. The maximum volume that Fonterra can be required to supply to any one independent processor is 50 million litres per season. This does not apply to New Zealand Dairy Foods Limited, which may require up to a maximum of 250 million litres per season to be supplied to it.

⁶ Dairy Industry Restructuring (Raw Milk) Regulations 2001, regulation 4(2).

22. The formula for calculating the wholesale milk price (WMP) is set out in regulation 8(6):

(6) The wholesale milk price for a season is the price per kilogram of milksolids calculated using the following formula:

$$\frac{(\text{total payout} + [\text{Fonterra}] \text{ retention} - \text{annualised share value})}{\text{kilograms of milksolids}}$$

23. Definitions of the components in the WMP formula are set out in regulation 3(1):

“**total payout**” means the total payment made by [Fonterra] and interconnected bodies corporate of [Fonterra] to shareholding farmers for raw milk supplied by them in that capacity in a season, minus the total winter milk premium for that season

“**[Fonterra] retention**”—

(a) means the after-tax profit of [Fonterra] for a season that is retained by [Fonterra] and not paid to shareholding farmers; but

(b) does not include retentions for abnormal or extraordinary asset revaluations or write-offs

“**annualised share value**”, in relation to a season, is the amount of a perpetual annuity that has a net present value equal to the sum of—

(a) the price of a co-operative share as at 1 June in the season multiplied by the total number of co-operative shares as at that date; and

(b) the peak note price multiplied by the total number of peak notes as at 1 June in the season

“**kilograms of milksolids**” is the number of kilograms of milksolids supplied to [Fonterra] in a season by shareholding farmers in that capacity.

24. The payment for milk made by Fonterra to shareholders is further defined in Fonterra’s constitution, which was authorised by the Act. The constitution states that the ‘payment for milk supplied’ is determined by deducting Fonterra’s costs from Fonterra’s income from all activities.⁷ Fonterra’s payment to its shareholders for milk supplied therefore contains elements of all aspects of Fonterra’s business.
25. The purpose of the formula in regulation 8(6) is to unbundle the returns to supplier shareholders for the two inputs they supply: raw milk and capital. The formula identifies the total return for the two inputs as ‘total payout’ plus ‘retention’. It then deducts from this the annualised share value (ASV), which is intended to represent the return for capital supplied. The balance should then be the (implicit) raw milk price that is available to Fonterra to either pay to its supplier shareholders or retain.

PAYMENT ARRANGEMENTS

26. Open Country and Fonterra did not agree a price for the supply of raw milk pursuant to regulation 8(1) of the Regulations. Open Country required Fonterra to supply raw milk at the default milk price pursuant to regulation 8(2) of the Regulations.

⁷ Dairy Industry Restructuring Act 2001, Schedule 1, clause 10.1.

27. Open Country and Fonterra entered into a contract for the supply of milk at the default milk price, the Raw Milk Supply Contract (Regulated Price) – OCCC 0405 (the Raw Milk Supply Contract). The Raw Milk Supply Contract sets out the terms and conditions upon which Fonterra agrees to sell, and Open Country agrees to purchase raw milk. Open Country was billed monthly by Fonterra for Open Country's raw milk purchases during the 2004/2005 season.
28. The price for default milk on each monthly summary invoice uses the default milk price formula, with the forecast value made for that quarter for the payout replacing the 'total payout' in the calculation. Fonterra re-forecasts the payout four times during the season. Following each re-forecast, there is a wash-up for the difference in price on milk purchased in the earlier quarters.
29. By 20 May 2005, Open Country had paid for all the milk purchased during the 2004/2005 season based on Fonterra's forecast of the payout as at 31 March 2005. Any remaining payment or refund would be the final wash-up when Fonterra announced the final payout.
30. Fonterra publishes, as per its obligation under regulation 16, forecasts, in each season, of the total payout and retention.⁸ These forecasts must be made as soon as practicable after 1 June, 1 September, 15 December and 1 March.⁹ Fonterra also must publish the actual total payout and the retention for the season as soon as practicable after the end of the season to which the information relates.¹⁰
31. In a notice on 29 August 2005, Fonterra published *Fonterra's Actuals For Season Ending 31 May 2005* showing Fonterra's total payout at \$5,321.4 million and retention at \$191 million for the 2004/2005 season.
32. As a result of the actuals, on 30 August 2005, Fonterra set out the final regulated price for raw milk for the 2004/2005 season. Open Country subsequently received a debit memo from Fonterra for the wash-up payment for default milk purchased during the 2004/2005 season, as detailed in paragraph 7.

ANALYSIS

33. Open Country submits that the Commission's draft determination defeats the purpose of the default milk scheme. Fonterra agrees with the overall result in the Commission's Draft Determination.

Principles of the Act and the Wholesale Milk Price

34. Open Country submits that the approach taken by Fonterra does not reflect the intent and purpose of the Act. It argues that the inclusion of profits from the sale of investments in National Foods and Wrightson as retention, which Open Country has termed 'capital profits', distorts the default milk regime by requiring independent processors to pay a price for raw milk that does not enable them to compete in dairy markets.

⁸ Dairy Industry Restructuring (Raw Milk) Regulations 2001, regulations 16(1)(a) and (b).

⁹ Dairy Industry Restructuring (Raw Milk) Regulations 2001, regulation 16(3).

¹⁰ Dairy Industry Restructuring (Raw Milk) Regulations 2001, regulation 16(6).

35. Open Country suggests that, in principle, the default milk price should be based on normal operating performance, excluding abnormal and extraordinary items. It suggests that if the Commission is of the view that the Regulations ‘cannot be read in any of the ways suggested to give effect to the statutory purpose, then it likely follows that the Regulations must be ultra vires’.¹¹
36. Fonterra submits that the meaning of the Regulations is clear and unambiguous. Fonterra states that there is no suggestion in regulation 3(1) of the Regulations (definition of ‘[Fonterra] retention’) that after tax profit be limited by the exclusion of capital profits as defined by Open Country. Fonterra further submits that the only items excluded from the definition are abnormal or extraordinary asset revaluations or write-offs. Profits realised from the sale of investments clearly do not fall into these categories.¹²
37. Fonterra disagrees with Open Country’s principal suggestions that the default milk price should be based on a narrow accounting definition of operating profits only and should not include capital, abnormal and extraordinary items. It disagrees with Open Country’s assertion that the inclusion of what Open Country refers to as ‘capital profits’ in the calculation of retentions distorts the purpose of the default milk regime.
38. The Commission has considered the scheme and purpose of the Act and the Regulations as they inform the interpretation of regulation 8(6). The Act and the Regulations contemplate that contestability and the efficient operation of dairy markets are to be achieved by enabling access to raw milk at a price that allows independent processors to compete.
39. The Commission is of the view that profits realised from the sale of shares in Wrightson and National Foods, if retained by Fonterra, would fall within the first limb of the definition of retentions set out in regulation 3(1)(a). As discussed further below, the Commission is also of the view that these profits would not be excluded by the second limb of the definition as they are not retentions for abnormal or extraordinary asset revaluations or write-offs.
40. Alternatively, if these profits had been paid out to shareholding farmers they would clearly fall within the definition of ‘payout’ stipulated in the regulations. This point is discussed further below.
41. As a consequence it is clear that these profits should be included in the calculation of the WMP. They will appear on the left hand side of the WMP formula (total payout + retentions). It is the role of the ASV to then unbundle the total return to shareholding farmers and determine the implicit milk price.

Profits

42. As discussed above, regulation 3(1) sets out the definition of “new co-op retentions” which is to be included in the WMP formula. Part (a) of the definition states that “new co-op retention” means the after tax profit of new co-op for a season that is retained by new co-op and not paid to shareholding farmers.
43. Open Country submits that profits from the sales of Fonterra’s investments are not funds that result from Fonterra’s normal trading activities and so ‘would not fall

¹¹ Submission of Open Country Cheese Company Limited, 4 December 2005, p11.

¹² Fonterra Co-operative Group Limited, Comments on the application, 20 October 2005, p2

within the natural understanding of retentions for the purpose of the regulatory price formula'.¹³

44. Fonterra submits that the allocation of total profits between payout and retentions is a matter for its Directors. Fonterra submits that it is entitled to pay out what Open Country refers to as 'capital profits' and retain 'operating profits'. It states that the WMP formula adjusts for this by including both retentions and payout without regard for whether the profits are from capital or from operations.¹⁴
45. Fonterra suggests that, by including the profits from the sale of investments as retention, it is complying with the Regulations. Were it not to include them it would be in breach of the Regulations and face a justified complaint from its shareholders.
46. Fonterra also submits that 'capital profits', as defined by Open Country, is not a term that exists under generally accepted accounting practice (GAAP). Even if it were a defined term, Fonterra submits that it is not clear why 'capital' profits should not be included in retentions or total payout. Fonterra submits that all of its assets, including investments, are part of its business and profits on disposal of those assets should be included in the calculation of the WMP.¹⁵
47. The Commission considers that a distinction between normal operating profits and other profits is not open to it on a plain reading of the definition in regulation 3(1)(a). It seems clear that if the gains on disposal had been paid out to supplier shareholders, they would be included in 'total payout'. It also seems clear that, in circumstances where such gains are retained, they are captured by regulation 3(1)(a). The Regulations do not distinguish between profits earned as the result of the sale of milk and profits earned as a result of the sale of an investment.
48. Nor does the Commission see any economic reason why, for the purposes of calculating the WMP, as set out by the Act, capital profits and operating profits ought to be treated differently from one another. Both operating profits and capital profits represent gains to shareholders, so it would not be sensible to omit one in favour of the other if the objective is to determine total returns to shareholders.

Revaluations

49. Open Country submits that profits from the sale of a considerable investment such as National Foods does amount to an 'abnormal or extraordinary asset revaluation' and should therefore be expressly excluded from the definition of retentions. Open Country also submits that the sale of an asset at a significant profit above the valuation in the company's accounts could be described as in the nature of an asset revaluation following an investment transaction.¹⁶ Open Country also notes that the Commission appears to limit the meaning of 'abnormal or extraordinary asset revaluations or write-offs' to non-cash transactions.
50. Fonterra submitted that the Commission was in error in its assertions in paragraph 45 of its draft determination. It submits that the Commission's statement that any revaluation of shares in National Foods would be an extraordinary asset revaluation is incorrect: it would not meet the accounting definition of 'extraordinary'. It also

¹³ Submission of Open Country Cheese Company Limited, 4 December 2005, p9.

¹⁴ Submission of Fonterra Co-operative Group Limited, 5 December 2005, p3.

¹⁵ Submission of Fonterra Co-operative Group Limited, 5 December 2005, p4.

¹⁶ Submission of Open Country Cheese Company Limited, 4 December 2005, p9.

submits that it is incorrect that no capital profit would have been made on the sale of investments if those investments had previously been revalued¹⁷.

51. The Commission is now of the understanding that unless an entity trades as part of its day to day activities in investments, where such investments would be revalued frequently, then GAAP requires that investments be carried in the financial statements at the lower of their cost and net realisable value. As such, it would not be in line with GAAP for a company such as Fonterra, whose core business is not the trading of investments, to revalue an asset on its books prior to selling it. Therefore a move by Fonterra to revalue an asset, and keep it on its books, would not be in line with GAAP.
52. This means that the gains in question are not, and should not be, excluded by regulation 3(1)(b), as they do not relate to ‘abnormal or extraordinary asset revaluations or write-offs’.

Forecasts

53. Open Country submits that Fonterra has failed to fulfil its obligation to forecast retention by not forecasting that it would retain profits from the sale of its investment in Wrightson.
54. Provided profits are adequately forecast, the WMP will be unaffected if profits are included in the forecast payout or the forecast retention. In either instance, those profits are listed on the left hand side (total payout + retentions) of the WMP formula, and will have the same overall effect on the final WMP.
55. The Commission is of the view that Fonterra should make efforts to accurately forecast its payout and retention. However, Fonterra’s directors should have the freedom to make decisions that may differ from what had previously been forecast.

Consultation Process

56. Open Country submits that the Commission’s process fails to give due account to the importance of this issue for the dairy industry reform by choosing ‘an unreasonably truncated consultation process, both in time and range of submissions’.
57. The Commission contacted Fonterra and Open Country, informing them of the release of the Draft Determination and the closing date for submissions of 5 December 2005. In addition, the Commission issued a press release, which noted the closing date for submissions. The Commission has not heard from any other industry participants. The Commission considers this process gave all interested parties the opportunity to be heard on the matter.

Interest

58. Fonterra submits that the correct rate of interest Open Country should pay to Fonterra is set out in the ‘Default Interest’ clause in the agreement between Open Country and Fonterra for the provision of milk at the default milk price. The interest rate specified in the contract is ‘the rate per annum equivalent to 1% above the average buying rate for 90 day bank bills published on Reuters page BKBM, or any successor of it, on the due date for payment’.¹⁸

¹⁷ Submission of Fonterra Co-operative Group Limited, 5 December 2005, p5.

¹⁸ Raw Milk Supply Contract (Regulated Price) – OCCC 0405, clause 10.5, p10.

59. The Commission considers that Open Country is in default of the contract and therefore the contractual interest rate for such default should apply in these circumstances.
60. The Commission, in making its draft determination, was of the understanding that the rate of interest payable by Open Country to Fonterra for default of its contractual agreement was 18% per annum. The Commission now understands that the applicable rate is as set out in paragraph 58.

Conclusion

61. It is the Commission's final determination that to consider that profits from the sale of investments and other non-current assets should not be included in retention would be to clearly contradict the words in the interpretation of '[Fonterra] retention' in regulation 3(1). Profits from the divestiture of investments and other non-current assets are entitled to be included in Fonterra's retention and/or 'total payout'.

DETERMINATION

Decision on the Matters in Dispute

62. Section 126(1)(a) of the Act requires the Commission to state its decision on the matters in dispute.
63. The Commission's determination is that the definition of '[Fonterra] retention' in the Regulations includes profits from the sale of investments.

Has a Breach Occurred?

64. Section 126(1)(b) of the Act requires the Commission to state clearly whether a breach of Subpart 5 of Part 2 of the Act or any regulations made under section 115 has occurred.
65. The Commission notes that Fonterra is currently supplying raw milk to Open Country and is requiring payment of \$737,466.84 plus GST as the outstanding portion of the end of season adjustment to the price payable for regulatory milk under regulation 8(5).
66. The Commission's determination is that Fonterra is not in breach of the Regulations by requiring payment from Open Country of the amount set out in paragraph 65.

The Commission's Reasons

67. Section 126(1)(c) of the Act requires the Commission to include the reasons for the determination. This determination sets out the Commission's reasons.

Terms and Conditions and Compensation

68. Section 126(1)(d) of the Act requires the Commission to include the terms and conditions on which the determination is made and section 126(1)(e) states that the Commission must specify the actions that a party to a determination must do or refrain from doing, which may include (without limitation) payment of compensation by one party to the other.
69. The Commission orders Open Country to meet its commitments, in light of the Commission's determination in paragraph 63, under the Raw Milk Supply Contract.

Expiry Date

70. The Commission does not propose to specify an expiry date for its determination pursuant to section 126(2).

Costs

71. Pursuant to section 129 of the Act, it is the Commission's view that the parties should bear their own costs, as neither party contributed unreasonably to costs or delays.

Dated this 21st day of April 2006

D F Caygill

Deputy Chair

Commerce Commission