

Review of Fonterra's 2015/16 Milk Price Manual: Dairy Industry Restructuring Act 2001

Final report

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Executive Summary

Purpose

- X1 This report sets out our conclusions on our statutory review of Fonterra's 2015/16 Milk Price Manual (the Manual).
- X2 This report is supported by a separate paper that provides an overview of the approach taken to our review of the Manual.¹ We recommend that this report is read together with our supporting paper.

About this review

- X3 Our review of the Manual is part of the overall programme of work we do each year under the milk price monitoring regime, which is set out in Subpart 5A of the Dairy Industry Restructuring Act 2001 (the Act).
- X4 The milk price monitoring regime is intended to promote the setting of a base milk price that provides an incentive to Fonterra to operate efficiently while providing contestability in the market for the purchase of milk from farmers.
- X5 The Manual contains the methodology used to calculate Fonterra's base milk price.² Under the Act, we are also required to review Fonterra's base milk price calculation (Review of the base milk price calculation) at the end of the dairy season.
- X6 We have focused our review on:
 - X6.1 Fonterra's amendments to the Manual;
 - X6.2 Issues arising from our 2014/15 Milk Price Calculation Review (including submissions);
 - X6.3 Issues arising from comments on the Process and Issues Paper published for this review; and
 - X6.4 Outstanding issues from previous Manual reviews.
- X7 In our report we have grouped issues by common themes and have been particularly focused on the issues that are most likely to have a material impact on the 2015/16 base milk price calculation.

¹ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual: Dairy Industry Restructuring Act 2001 - Supporting Paper #1 (15 October 2015)". This can be found on our website at <http://www.comcom.govt.nz/dmsdocument/13799>

² Section 5(1) of the Act defines the base milk price as "in relation to a season, means the price per kilogram of milk-solids that is set by new co-op for that season". Fonterra has interpreted the base milk price as meaning the farmgate milk price.

X8 Our separate supporting paper sets out:³

X8.1 our interpretation of key legislative provisions guiding the review;

X8.2 our approach to the review; and

X8.3 an overview of how Fonterra sets its base milk price.

Our conclusions

X9 We conclude that the Manual is largely consistent with the statutory purpose set out in s 150A of the Dairy Industry Restructuring Act 2001 (the Act).

X10 Most of the Manual has not changed for the 2015/16 dairy season. We have therefore relied on our previous conclusions for parts of the Manual that have not changed, unless there is new substantive information that caused us to reconsider our previous conclusions.

X11 On the whole, Fonterra's amendments to the Manual have improved its consistency with the overall purpose of the milk price monitoring regime. Nevertheless, we consider that Fonterra can further improve the Manual in some areas so that its application in the base milk price calculation is more transparent to other parties.

X12 We will follow up on how a number of rules are applied in the 2015/16 base milk price calculation, in order to consider whether any reservations we have expressed in this report need to be addressed in the 2016/17 Manual.

Key theme – transparency of information

X13 In our 2014/15 milk price calculation review, we noted that Fonterra had made good progress in the previous dairy season in increasing the level of transparency of information on how it calculates the base milk price. We also noted that Fonterra engaged with us constructively to address our suggestions in this area.

X14 Although this current review is primarily concerned with the Manual, the Manual needs to operate effectively as an integrated part of the milk price monitoring regime in order to achieve the purpose of the regime.

X15 We therefore encourage Fonterra to consider how it could improve the clarity of the rules in the Manual so interested parties can better see how Fonterra would interpret and apply them.

³ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual: Dairy Industry Restructuring Act 2001 - Supporting Paper #1" (15 October 2015)

- X16 We acknowledge that the nature of the base milk price calculation means that Fonterra needs a degree of flexibility in interpreting and applying some rules. However, we encourage Fonterra to improve its disclosures on its use of the rules.

Recommendations on substantive issues likely to have a material effect on the base milk price

- X17 A substantive issue is one that we prioritised in our analysis because it might have a material impact on the base milk price.
- X18 Fonterra has amended Rule 3 (Subsequent revisions to reference basket) to include additional criteria for determining whether a product should be added or removed from the 'reference basket' of commodity products that are produced by the notional producer. Rule 3 now states that a change to the reference basket should be made only where this is expected to result in a higher average milk price over time.
- X19 We consider that the amendments help align Rule 3 more closely with s 150C2(a)(i) of the Act, which is part of the s 150C legislative mechanism for achieving the s 150A purpose. However, we note that the rule is silent on the approach that would be adopted and the time it would take to change the notional producer's asset base and cost structure in response to changes to the reference basket.
- X20 We acknowledge that it is not feasible to anticipate the wide range of situations that may give rise to a change in the reference basket and that there needs to be some flexibility in the rules. However, we recommend that Fonterra considers codifying in the Manual a disclosure requirement for it to publicly explain the rationale and consequences of any material change to the reference basket in advance.

Other recommendations on substantive issues unlikely to have a material effect on the base milk price

- X21 Substantive issues without material effect on the milk price are issues that, although substantive in nature, are unlikely to have a material effect on the milk price.
- X22 In relation to new Rule 26 – Capacity of standard plants, we recommend that Fonterra better explains in the Manual how the capacity of non-primary standard plant is determined (i.e. AMF, butter and BMP).
- X23 We also recommend that Fonterra includes provision for winter milk premiums in the Manual and in the base milk price calculation so that it is clearly explained how Fonterra works out the notional costs provided for winter milk premiums.
- X24 Fonterra has provided interest-free loans to farmers for the current dairy season. In our view, it is likely that an efficient processor would provide similar 'support payments' (economic benefits such as favourable loans or accelerated payments) during short term stress in the industry (e.g. a milk price lower than farmers' average costs of production), with a view to a longer term commercial benefit, such as

stability and security of ongoing supply. If it is acting efficiently, Fonterra providing such support in itself suggests that an efficient processor would provide similar support payments.

- X25 Although we consider that the Manual may already provide for some support payments (for example, under new Rule 19), we recommend that Fonterra considers how the costs of such support payments should be included and clearly described in base milk price calculation.

Issues we intend to follow up in our review of the 2015/16 base milk price calculation

- X26 Although we are broadly satisfied that the remaining substantive amendments Fonterra has made to the Manual are consistent with the s 150A purpose, we intend to also review how some rules are applied in the 2015/16 base milk price calculation.

- X27 Substantive issues from this review of the Manual that we intend to follow up on in our review of the base milk price calculation review in 2015/16 are:⁴

X27.1 the practical effect of non-GDT sales on the base milk price under Rule 5 (Sales through GDT);

X27.2 how Fonterra applies the asset stranding rules (Rule 33 and Rule 44). A particular area of interest to us is how asset stranding risk is apportioned between the ex ante allowance provided by the specific risk premium and any ex post adjustments made under Rule 33 due to changes in the reference basket; and

X27.3 our suggestion to Fonterra that it considers how it could be transparent in how it applies Rule 19 (Non-recurring costs). For example, by describing the one-off costs provided for, breaking down the costs and indicating the timing basis in the milk price model and the milk price statement.

- X28 We also intend to consider the following issues in our review of the 2015/16 base milk price calculation. These issues are also substantive, but are likely to have a less material impact on the milk price than the issues listed in paragraphs X27.1 – X27.3:

X28.1 How Rule 14 (Repair and Maintenance costs) is applied in the 2015/16 base milk price calculation, to consider whether the rule should be amended to improve its level of prescription;

X28.2 How winter milk premiums are treated in the base milk price calculation; and

X28.3 How support payments to suppliers (e.g. financing costs of interest-free loans to farmers) should be treated in the base milk price calculation.

⁴ If the rules are not applied in the 2015/16 base milk price calculation, we will note them as a carry forward matter for review of their application when they are applied in a future base milk price calculation.

- X29 We will be publishing a process and issues paper for the 2015/16 base milk price calculation review shortly that outlines specific areas of focus for the calculation review.

1. Introduction

Purpose of this report

1. In this report we set out our conclusions on the extent to which Fonterra's 2015/16 Manual is consistent with the purpose of the milk price monitoring regime.
2. The purpose of the milk price monitoring regime is set out in s 150A of the Act:

150A Purpose of this subpart

- (1) The purpose of this subpart is to promote the setting of a base milk price that provides an incentive to new co-op to operate efficiently while providing for contestability in the market for the purchase of milk from farmers.
- (2) For the purposes of this subpart, the setting of a 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.

Two reviews are required by the Act each dairy season

3. The Act requires us to do two separate reviews of Fonterra's base milk price setting each dairy season.
4. This report relates to the first phase: our 2015/16 review of Fonterra's Milk Price Manual. Our approach to this review, including an overview of the role of the Manual in setting the base milk price, is outlined in a separate supporting paper, available on the our website.⁵
5. In the second phase, we are required to review Fonterra's base milk price calculation at the end of the season. For example, we published our report on our 2014/15 review of the base milk price calculation in September 2015.⁶ In that report we concluded that Fonterra's 2014/15 base milk price calculation was largely consistent with the s 150A purpose.
6. We will publish a process and issues paper for our review of the 2015/16 base milk price calculation shortly. The paper will outline our proposed process, approach and key focus areas for the review.

We are fulfilling our statutory requirements

7. This report is required under ss 150H and 150I of the Act.
8. We have considered the information Fonterra provided to us under s 150L of the Act.

⁵ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual: Dairy Industry Restructuring Act 2001 - Supporting Paper #1 (15 October 2015)". This can be found on our website at <http://www.comcom.govt.nz/dmsdocument/13799>

⁶ Commerce Commission "Review of Fonterra's 2014/15 base milk price calculation" (15 September 2015).

9. We have considered the comments and further explanation Fonterra provided us after the release of the Process and Issues paper.⁷
10. We have also considered the submission Fonterra provided to us on our draft report, under s 150M(2)(a) of the Act.⁸
11. Although not required by the Act, we also sought submissions on our draft report from interested parties other than Fonterra and have considered submissions from Miraka Limited and Open Country Dairy.⁹
12. We consider that this report meets the requirements of s 150I of the Act.

How this report is structured

13. Chapter 2 covers the scope of our review.
14. Our conclusions are set out in Chapter 3 and are supported by the summary tables in Attachment A.
15. We have focused our commentary in Chapter 3 on issues that are likely to have the most material impact on the milk price calculation.
16. The other issues we have considered in the course of this review are also summarised in Attachment A. It sets out our high-level conclusions and, where appropriate, brief commentary on each issue.
17. Our separate supporting paper sets out:¹⁰
 - 17.1 our interpretation of key legislative provisions guiding the Manual review;
 - 17.2 our approach to the review; and
 - 17.3 an overview of how Fonterra sets its base milk price.
18. We intend to maintain and update the separate supporting paper for future Manual reviews.

⁷ Fonterra “‘Reasons’ Paper in support of Fonterra’s Milk Price Manual for the 2015/16 Season” (1 August 2015).

⁸ Fonterra, “Submission to the Commerce Commission on its Draft Report on Fonterra’s 2015/16 Farmgate Milk Price Manual” (15 November 2015)

⁹ Miraka “Miraka submission to the Commerce Commission: Draft report: Review of Fonterra’s 2015/16 Milk Price Manual” (5 November 2015) and Open Country “Submission on the Commerce Commission’s Draft Report – Review of Fonterra’s 2015/16 Milk Price Manual” (November 2015).

¹⁰ Commerce Commission “Supporting paper Paper #1 – Our approach to reviewing Fonterra’s Milk Price Manual” (15 October 2015).

2. Scope

19. The scope of this review of the Manual was signalled in our Process and Issues paper¹¹ and is aligned with the Act's requirements.
20. Under ss 150H and 150I of the Act, we are required to review the Manual for each dairy season and make a report on the extent to which the Manual is consistent with the purpose statement set out in s 150A of the Act.
21. The Act requires Fonterra to provide us with the following information for our review each year, and for us to consider this information in our review:
 - 21.1 Fonterra's Manual;
 - 21.2 Any recommendations by the Milk Price Panel in relation to the setting of the base milk price;
 - 21.3 Notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;
 - 21.4 Certification on the extent to which Fonterra considers that the Manual is consistent with the purpose of s 150A; and
 - 21.5 The reasons for the views expressed in Fonterra's certification.
22. Fonterra has provided the required information in the 'Reasons' Paper in support of Fonterra's Manual for the 2015/16 season (Reasons Paper). This information can be found on our website.¹²
23. Most of the Manual has not changed for the 2015/16 dairy season. We have relied on our previous conclusions for those parts of the Manual that have not changed, unless there is new information that is substantive enough for us to reconsider our previous conclusions.
24. We have therefore focused our review on:
 - 24.1 Fonterra's amendments to the Manual;
 - 24.2 Issues arising from our 2014/15 Milk Price Calculation Review (including submissions);
 - 24.3 Issues arising from comments on our Process and Issues Paper; and
 - 24.4 Outstanding issues from previous Manual reviews.

¹¹ Commerce Commission "Process and Issues Paper - Review of the Milk Price Manual for the 2015/16 dairy season" (7 September 2015).

¹² <http://www.comcom.govt.nz/regulated-industries/dairy-industry/review-of-fonterra-s-farm-gate-milk-price-and-manual/statutory-review-of-milk-price-manual/>

25. In this report, we have grouped issues by common themes and have been particularly focused on the issues that are most likely to have a material impact on the 2015/16 base milk price calculation.
26. Table 1 summarises the matters that were in and out of scope for this review.

Table 1: Matters in and out of scope

In	Out
Review of Fonterra's amendments to the Manual. The level of review for each amendment has varied on the basis of significance to the 2015/16 Milk Price Calculation review.	Policy issues regarding DIRA and the milk price monitoring regime.
Issues and themes arising from the 2014/15 Milk Price Calculation Review (including submissions) that are: <ul style="list-style-type: none"> likely to be material to the 2015/16 Milk Price Calculation Review best dealt with in the Manual Review. 	Issues with Fonterra's Manual that have been resolved in previous Manual Reviews, unless we have concerns about how a rule has been applied in the 2014/15 milk price calculation.
Outstanding issues from previous Manual reviews that are: <ul style="list-style-type: none"> likely to be material to the 2015/16 Milk Price Calculation Review best dealt with in the Manual Review. 	Review of any rules in Fonterra's Manual that were accepted in previous Manual Reviews. Exceptions to this scope exclusion would be made for the following reasons: <ul style="list-style-type: none"> rule has changed; we have concerns about how a rule has been applied in the 2014/15 milk price calculation; or new substantive and material information has come to light, including through submissions to this review, the 2014/15 Milk Price Calculation review and the Dairy Competition Review.
Considering issues arising from comments on the Process and Issues paper (this includes releasing a release of Fonterra's Manual and Reasons Paper) and submissions on our draft report. The level of consideration has varied on the basis of significance to the 2015/16 Milk Price Calculation review.	Extensive face-to-face consultation (e.g. interviews or meetings) with interested parties.
Providing commentary on: <ul style="list-style-type: none"> aspects of the Manual which interested parties do not understand; aspects of the Manual which are open to materially different interpretations; and aspects of the Manual which could be improved to increase the transparency of the Manual or how it is applied. The level of analysis and commentary has varied on the basis of significance to the 2015/16 Milk Price Calculation review.	

3. Conclusions

Introduction

27. In this chapter, we summarise our conclusions on the extent to which the 2015/16 Manual is consistent with the purpose set out in s 150A of the Act.
28. We also comment on specific aspects of the Manual where we consider it is necessary to explain our conclusions. Our commentary is grouped under the following categories:
 - 28.1 Key themes;
 - 28.2 Substantive issues;
 - 28.3 Substantive issues without a material effect on the base milk price; and
 - 28.4 Non-substantive, technical or drafting changes.

Our overall conclusion

29. Our overall conclusion is that the 2015/16 Manual is largely consistent with the s 150A purpose statement.
30. Most of the Manual has not changed for the 2015/16 season. We have relied on our previous conclusions for those parts of the Manual that have not changed, unless there is new information that is substantive enough for us to reconsider our previous conclusions.
31. On the whole, Fonterra's amendments are an improvement on the 2014/15 Manual. For example:
 - 31.1 changes to the 'consistency over time' provision in Section 2.6 of Part A of the Manual have addressed the concerns we raised in our 2014/15 Manual review and have made the provision clearer; and
 - 31.2 amendments to the asset stranding rules (Rules 33 and 44) have addressed the 'double counting' issue we raised in our Manual review last year.

32. Despite our overall conclusion, we consider that:
- 32.1 Fonterra should continue to improve the transparency of information in the Manual;
 - 32.2 Fonterra should consider including a disclosure requirement in the Manual so that it is required to explain publicly the rationale and consequences of any material change to the reference basket in advance;
 - 32.3 the Manual should better explain how the capacity of non-primary standard plant is determined (i.e. AMF, butter and BMP);
 - 32.4 Fonterra should include provision for winter milk premiums in the Manual and in the base milk price calculation so that it is clearly explained how Fonterra works out the notional costs provided for winter milk premiums; and
 - 32.5 Fonterra should consider how the costs of support payments to suppliers (for example, the financing costs of interest-free loans to farmers) should be included and clearly described when calculating the base milk price.
33. Although we are broadly satisfied that the other substantive amendments Fonterra has made to the Manual are consistent with the s 150A purpose, for the workability of the rules we intend to review how some rules are applied in the base milk price calculation:
- 33.1 the practical effect of non-GDT sales on the base milk price under Rule 5 (Sales through GDT);
 - 33.2 if applicable, how Fonterra applies the asset stranding rules (Rule 33 and Rule 44);
 - 33.3 if relevant, how Fonterra has applied Rule 19 (non-recurring costs). We suggest for example, that Fonterra should describe and provide a breakdown of the one-off costs provided for, and indicate the timing basis (i.e. whether costs have been provided for ex ante or ex post) in the milk price model and the milk price statement; and
 - 33.4 how Rule 14 (Repair and Maintenance costs) is applied in the 2015/16 base milk price calculation, to consider whether the rule should be amended to improve its level of prescription.
34. A full list of all the issues considered in this review of the Manual is provided in Attachment A.

Key theme – transparency of information

35. The explanatory note to the Dairy Industry Restructuring Amendment Bill 11-1 (27 March 2012), which introduced the milk price monitoring regime, said the Bill:

...introduces a new milk price regime to bolster the existing incentives for Fonterra to operate in accordance with DIRA's contestability standard. It does so through provisions promoting –
 - greater transparency of Fonterra's farm gate milk price setting processes; and
 - greater confidence in the consistency of Fonterra's farm gate milk price with contestable outcomes.
36. Transparency of information is an issue we have highlighted in previous reviews carried out under the milk price monitoring regime and is noted in submissions to those reviews.
37. The transparency of application of the Manual continues to be of interest to us. The information published by Fonterra in support of the Manual and the base milk price calculation is an important mechanism that allows us and other interested parties to assess whether the base milk price provides incentives for Fonterra to operate efficiently, while still providing for contestability in the market for the purchase of milk from farmers.
38. We note that many of the amendments made by Fonterra this year have improved the clarity, and therefore transparency, of the Manual. We also acknowledge that the nature of the base milk price calculation means that Fonterra does sometimes require a degree of flexibility in some rules. For example, Rule 19, which deals with one-off or difficult-to-forecast events.
39. However, we encourage Fonterra to consider how it could improve the clarity of the connections between the higher level provisions (rules and principles) in the Manual and the mechanics of the base milk price calculation reflected in the milk price model. In our view, Fonterra should aim to continue to make more explicit how it has interpreted and applied the Manual provisions. Improved transparency would help improve interested parties' confidence in the calculation used by Fonterra (i.e. the inputs, process and assumptions applied in the milk price calculation).

40. For example, Fonterra could better explain how it interprets and applies the Manual with particular regard to the below (or, [if this information is already in the public domain, Fonterra could better improve the way it is presented](#)):
- 40.1 where actual Fonterra data is being used in the base milk price calculation in order to meet the rules in the Manual;
 - 40.2 the process of transforming actual data into the data used in the base milk price calculation (e.g. the losses and offset specifications used in the yields calculation); and
 - 40.3 the matters that an independent expert would take into account in reviewing the methodology and inputs in any aspect of the base milk price calculation (e.g. production yields).
41. In our 2014/15 milk price calculation review, we noted that Fonterra had made particular progress in increasing the level of transparency in calculating the base milk price.¹³ We also noted that Fonterra engaged with us constructively to address our suggestions in this area. We are keen that Fonterra continues to make further progress in the quality of its Manual and base milk price calculation disclosures.

Substantive issues

42. Substantive issues are issues that we have prioritised in our analysis because they may have a material impact on the base milk price. These include:
- 42.1 the transparency of selling prices achieved other than on GDT;
 - 42.2 how the notional producer deals with asset stranding;
 - 42.3 the addition of a new rule to cover non-recurring costs (Rule 19);
 - 42.4 the addition or removal of manufacturing sites;
 - 42.5 the application of the WACC risk free rate; and
 - 42.6 changes to the reference basket.

Transparency of selling prices achieved other than on GDT

43. For 2015/16, Fonterra has made some amendments to Section 4.3 and Rule 5 of the Manual, which together describe the circumstances where Fonterra may choose to reference off-GDT sales.
44. Our view is that that the changes improve the clarity of the Manual and have no substantive impact on how these provisions are applied in practice. We do not think that the amendments have any implications for consistency with the s 150A purpose.

¹³ For example, refer to: Commerce Commission “Review of Fonterra's 2014/15 base milk price calculation: Final report” (15 September 2015), paragraphs X11-X13.

45. Section 4.3 and Rule 5 are consistent with the efficiency dimension of the section 150A purpose. This is because the Manual describes how it would establish a notional benchmark for selling prices.
46. We do not have any reason to consider that the contestability dimension of the section 150A purpose has not been satisfied. However, we note that reviewing how Rule 5 is applied in a milk price calculation is necessary in order to be able to understand whether the rule is practically feasible for an efficient producer.
47. We do not think Fonterra needs to provide more clarity regarding selling prices achieved off-GDT within the Manual. However, we encourage continued disclosure and clarity by Fonterra as to its reliance on-GDT and off-GDT sales in its milk price statement and Reasons Paper supporting its base milk price calculation.
48. Rule 5 is one of the detailed rules underpinning the definition of the Farmgate Milk Price Commodity Business. When read together with Section 4.3 of the Manual, these provisions may appear to provide Fonterra with a high level of discretion regarding on- and off-GDT sales. For example, Rule 5 states that:

In determining whether it is appropriate to place sole reliance on Benchmark Selling Prices achieved on GDT in respect of a particular Reference Commodity Product, the Board will have regard to:

- The volume of the Reference Commodity Product traded on GDT relative to the total volume of the Reference Commodity Product sold by Fonterra.
 - Any factors relevant to determining whether the prices achieved on GDT can be considered to be materially representative of the prices Fonterra (and its competitors) should generally be able to achieve for Qualifying Materials traded on terms comparable to those typically provided by sellers of those products.
49. However, the reference to Benchmark Selling Prices connects Rule 5 with Rule 8, which is one of the detailed rules underpinning the calculation of Farmgate Milk Price Revenue. The practical effect of Rule 8 and the definition of Qualifying Reference Sales in Part C of the Manual is that the selling prices for WMP, SMP and AMF are those achieved from on-GDT sales. In the 2014/15 season, these products made up around 90% of the notional producer's total product mix.

50. We therefore consider that the prices achieved from off-GDT sales make up a relatively small proportion of the notional producer's revenue mix, so the impact of any such sales on the base milk price would appear to be small. However, this is an issue that could be considered again as part of our 2015/16 calculation review.
51. Also, our interpretation of the Manual is that if Fonterra were to move to including off-GDT sales for WMP, SMP or AMF, it would have to amend the definition of Qualifying Reference Sales in Part C. This would need to be accompanied by an explanation of the rationale for the change in its Manual Reasons Paper for the year in which the change is made. In this way, Fonterra's discretion regarding this aspect of the Manual is substantially constrained.¹⁴

How the notional producer deals with asset stranding

52. Fonterra has amended Rule 33,¹⁵ which covers the treatment of asset stranding due to a change in the reference basket and Rule 44,¹⁶ which covers the specific risk premium.
53. The amendments respond to a concern about possible 'double counting' that we expressed in our 2014/15 review of the Manual. We had noted that asset stranding risk is both:
 - 53.1 implicitly provided for in the specific risk premium as an ex ante allowance in Rule 44; and
 - 53.2 explicitly adjusted by an ex post adjustment under Rule 33.
54. Fonterra states in its Reasons Paper¹⁷ that the amendments provide that compensation for costs associated with removal of a reference asset from the asset base can only be recovered once – either on an ex post basis at the time of removal or on an ex ante basis through the specific risk premium.
55. We agree that the amendments address the 'double counting' issue we raised in our review last year.
56. As we were unable to conclude on the practical feasibility of the specific risk premium in our 2014/15 Manual review and in our 2015/16 calculation review,¹⁸ we will continue to monitor how Fonterra applies the asset stranding rules, if they are applicable, in the 2015/16 base milk price calculation review.

¹⁴ See Fonterra, "Submission to the Commerce Commission on its Draft Report on Fonterra's 2015/16 Farmgate Milk Price Manual" (15 November 2015), p.5.

¹⁵ Rule 30 in Fonterra's 2014/15 Milk Price Manual

¹⁶ Rule 41 in Fonterra's 2015/16 Milk Price Manual

¹⁷ Fonterra "Reasons Paper in Support of Fonterra's Manual for the 2015/16 Season" (1 August 2015), p.3.

¹⁸ Commerce Commission "Review of Fonterra's 2014/15 base milk price calculation" (15 September 2015), pp.59-60.

57. Particular areas of interest to us are:
- 57.1 how asset stranding risk is apportioned between the ex ante allowance provided by the specific risk premium and any ex post adjustments made under Rule 33 due to changes in the reference basket; and
 - 57.2 how the notional producer deals with the regional aspects of asset stranding.
58. Although it is appropriate for the Manual to provide some flexibility between methods, we note that ex ante provisions may be preferred from a contestability perspective. This is because they give a more predictable treatment of the potential costs of stranded assets.
59. Currently, the milk price model appears to assume that the oldest plant would be stranded first. However, this does not seem to be consistent with the converse situation of how plant is added in response to regional needs in that model.
60. In its submission on our draft report, Fonterra noted that Rule 34 relates to an excess of capacity within a region and that it is therefore intended that it is the oldest plant(s) *in the region* that would be removed if there were excess capacity in that region. Fonterra will consider adding the words “in the region” to the penultimate paragraph in Rule 34 to make the treatment more explicit.¹⁹

New Rule 19 – Non-recurring costs

61. Fonterra has introduced new Rule 19 (Non-recurring costs), which deals with one-off and difficult-to-forecast events.
62. The new rule responds to a suggestion in our 2014/15 Manual review that Fonterra should consider including an allowance for one-off or difficult-to-forecast events in the 2014/15 Manual. An example of a ‘one-off’ event discussed in our 2014/15 review was the ‘super flush’ of peak milk flows during the 2013/14 dairy season.
63. In its Reasons Paper, Fonterra has explained that the Manual did not have a specific provision for ‘super flush’ or certain other non-recurring costs, but that it makes appropriate provision for various costs falling into this category.
64. New Rule 19 is therefore a transparency measure. It is intended to be a ‘catch-all’ provision for non-recurring costs incurred by the notional producer that are not otherwise provided for in the base milk price calculation methodology. The rule provides two examples of such costs – ‘super flush’ related costs and costs resulting from a natural disaster.
65. Fonterra notes that the new rule codifies what has been its practice to date, so it believes that the amendment will not have any impact on the base milk price.

¹⁹ Fonterra, “Submission to the Commerce Commission on its Draft Report on Fonterra’s 2015/16 Farmgate Milk Price Manual” (15 November 2015), p.5.

66. Based on the intention of the rule, as evidenced by the examples provided by Fonterra on when it might use the rule, Rule 19 is not inconsistent with the contestability dimension of the s 150A purpose. However, we intend to review how the rule is applied in calculating the base milk price to understand whether it is practically feasible for the notional producer at the time the rule is applied.
67. Fonterra explains in its Reasons Paper that, where its actual costs are used as a “starting point” for the milk price model, adjustments are made for differences between Fonterra and the notional producer. As the rule provides Fonterra with the ability to make ex ante provisions for potential one-off costs based on what could be reasonably expected for the notional producer, the rule is not inconsistent with the efficiency dimension of the s 150A purpose.
68. However, as the rule provides Fonterra with a high degree of flexibility, we may need to monitor its application to ensure it remains consistent with the s 150A purpose.
69. We acknowledge that the nature of the costs covered in this rule mean that the rule needs to give Fonterra a degree of flexibility. We suggest that, when Fonterra applies this rule in a base milk price calculation, it should be transparent about how it has been applied. For example, Fonterra could describe the one-off costs provided for in the rule. It could also break down the costs and indicate the timing basis (i.e. ex ante or ex post) in the milk price model and the milk price statement.²⁰
70. If applicable, we intend to review how Fonterra applies Rule 19 in our review of the 2015/16 base milk price calculation.

Addition or removal of manufacturing sites

71. Amendments to Rule 36 (Site Footprint) have been made to show the consequences of adding or removing a manufacturing site from the milk price model.
72. Fonterra states in its Reasons Paper that the amendments codify an approach outlined in Fonterra’s submission on our draft report on the 2014/15 Manual and which were used when the Darfield and Studholme sites were added to the milk price model and the Plains site was removed.

²⁰ Fonterra noted in its submission on our draft report that it has consistently disclosed the quantum and nature of one-off costs (now) covered under New Rule 19 in the annual Milk Price Statements, starting with the first Statement produced in 2011.

73. Fonterra states that the amendment is consistent with the s 150A practical feasibility requirement because it requires that appropriate provision is made for both the land and fixed assets associated with a new site. Fonterra's view is that the amendment appropriately incentivises it to make efficient decisions when acquiring land and otherwise establishing new manufacturing sites. This is because the rule allows for a choice between market value and cost in establishing land values (and otherwise assumes notional fixed asset costs).²¹
74. Fonterra has also noted to us that, when removing notional plants from the footprint, small plants are most likely to be affected first. It considers that the difference between the remaining notional value of those plants and their market values is unlikely to be material. That is, the difference would be able to be absorbed within one season's milk price and there is unlikely to be a shock effect on the milk price from removal of plants.
75. The materiality of this effect to the base milk price is likely to be greater if it arises from a change to the composition of the reference basket. We comment on this separately in the context of the changes to Rule 3 below.
76. We consider the amendments to the rule satisfy the efficiency and contestability dimensions of the s 150A purpose. This is on the basis of the explanation provided by Fonterra and on the results of our review of the approach to notional plant additions during our review of the 2014/15 base milk price calculation.

WACC - risk free rate

77. In a letter to the Commission during the 2014/15 season, Castalia, on behalf of Open Country Dairy, raised a concern about the practical feasibility of Fonterra's use of a 5 year rolling average risk free rate, rather than a current risk free rate.
78. In our 2014/15 milk price calculation review Final Report, we proposed to consider Castalia's concern in our 2015/16 Manual and base milk price calculation reviews.

²¹ Fonterra "'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2015/16 Season" (1 August 2015), p.8.

79. When Fonterra's use of a five-year rolling average generates a value above the current rate, it is practically feasible for an efficient processor. But when it results in a value below the current spot rate, it is possible that the average may not be practically feasible for a new entrant or for an existing processor seeking to expand.
80. In its submission on our draft report, Fonterra states that, unless interest rates increase very rapidly, the impact of the spot rate being higher than the rolling average rate "would not be material, given the relevant timeframes (in excess of 30 years for most forms of new manufacturing plant)".^{22 23}
81. We will revisit this issue when we consider the milk price calculation (i.e. when the actual average and current spot rate are known). At that time, our view may also be informed by work that the Commission is undertaking for its review of Input Methodologies for other regulated sectors relating to WACC.²⁴ The outcome of our further review will determine whether we suggest that Fonterra considers the issue for its Manual review.

WACC – practical feasibility and Milk Price Calculation review issues

82. Open Country Dairy and Miraka Limited made submissions to our draft report on several WACC issues:
 - 82.1 Open Country Dairy stated that we need to "maintain pressure on Fonterra to urgently improve the practical feasibility of the capital charge".
 - 82.2 Miraka's submission raised some issues relating to our base milk price calculation review, including requests that we confirm our work programme for the 2015/16 base milk price calculation review will include a more comprehensive review of the WACC used to determine the base milk price, in particular, the asset beta.
83. Having considered the submissions, we will be publishing a process and issues paper for the 2015/16 base milk price calculation review shortly that outlines specific areas of focus for the calculation review, including the WACC used in the base milk price calculation.

²² Fonterra, "Submission to the Commerce Commission on its Draft Report on Fonterra's 2015/16 Farmgate Milk Price Manual" (15 November 2015), pp. 5-6.

²³ Fonterra also states that a new investor or an existing processor that is expanding will enjoy tax benefits that are not taken into account in the calculation of the base milk price and that the present value of this benefit would exceed any costs arising from a difference between the spot and five year average risk free rates. In our view, the tax benefits referred to by Fonterra are not relevant to this issue, as they would occur regardless of whether a spot rate or rolling average is used for the risk free rate.

²⁴ Castalia "Review of Fonterra's 2014/15 milk price calculation and supporting analysis - Report to Open Country Dairy" (August 2015) p.5 notes that, "For the cost of debt, the Commission uses a spot rate for all other regulated businesses in New Zealand, although there are theoretical reasons why a rolling average might be preferred". The cost of capital is currently within the scope of the Commission's review of Input Methodologies for other regulated sectors.

Changes to the reference basket

84. Fonterra has amended Rule 3 (Subsequent revisions to reference basket) to include additional criteria for determining whether a product should be added or removed from the reference basket, so that a change should be made only where this is expected to result in a higher average milk price over time.
85. The additional criterion for when a Reference Commodity Product (RCP) can be *removed* from the reference basket is:

Removal of the product is expected to result in a higher Milk Price on average over the remaining economic life of any associated assets that would be removed from the Farmgate Milk Price Fixed Asset Base, having regard to any adjustments required under Rule 30.
86. The additional criterion for when a RCP can be *added* to the reference basket is:

Addition of the product is expected to result in a higher Milk Price on average over the economic life of any additional assets required to manufacture the product.
87. Fonterra's Reasons Paper states that the amendment is intended to:
 - 87.1 Provide greater clarity over the circumstances under which the reference basket might be amended;
 - 87.2 Create better alignment between Rule 3 and the corresponding provision in s 150C2(a)(ii);²⁵ and
 - 87.3 Codify a key consideration actually applied in evaluations to date of the merits of any change to the reference basket.
88. A further comment, in Fonterra's marked-up version of its 2015/16 Manual (attached to the Reasons Paper), says that the intent of the amendment is to:
 - (a) Get closer, albeit not perfect, alignment with the DIRA test, and
 - (b) Add the more (most) relevant factors that should drive changes to reference basket, being the impact on the milk price²⁶

²⁵ This section reference appears to be a typographical error, as the amendments appear to be aimed at aligning the Rule more closely with s 150C2(a)(i) of the Act.

²⁶ Fonterra "Farmgate Milk Price Manual 2015/16" (1 August 2015), p.35 (marked up version attached to the Reasons Paper)

89. We consider that the amendments do help to align Rule 3 more closely to the requirements of s 150C2(a)(i) of the Act, which is part of the s 150C legislative mechanism for achieving the s 150A purpose. However, we note that:
- 89.1 the time horizon set out in s 150C2(a)(i) is for no more than five years, whereas the timeframe for the 'profitability' test in the Manual relates to the expected economic life or remaining economic life of assets that would be added or removed from the notional producer's asset base; and
 - 89.2 the amendments refer to a higher 'Milk Price', which we assume to have the same meaning as the defined term, 'Farmgate Milk Price'.
90. We also note that the rule is silent on the timing effects of changes to the reference basket on the notional producer's asset base and cost structure.
91. For our draft report, Fonterra provided us with preliminary comments on this timing issue. Fonterra noted:
- 91.1 As it has not made any changes to the reference basket to date, the optimal transition path for any particular change to the reference basket could vary significantly depending on circumstances at the time. It therefore does not want to make the Manual unnecessarily prescriptive;
 - 91.2 The Section 2.6 undertaking that the base milk price should evolve in a manner consistent with a real world dairy processor implies that a change in the reference basket that required significantly different assets would ordinarily be well signalled, to allow for probably a one to two year period for notional construction and commissioning of a new notional plant, and that the objective of maximising the milk price over time (subject to the various relevant constraints) would imply that, other than in circumstances where there was a very significant difference in relative returns to the new RCP and current RCPs, any new capacity would be introduced gradually over time;
 - 91.3 Not all new RCPs would require whole new plants. For example, Milk Protein Concentrates or nutritional milk powders could be manufactured using the existing powder dryers with some relatively minor additional capital spend, implying a more rapid transition; and
 - 91.4 On changes to the notional site footprint as a result of a change to the mix of the reference basket, Rule 33 already provides that the footprint is to be aligned to Fonterra's actual site footprint. Changes to this will normally be well signalled by Fonterra, though the timeframes will vary with circumstances. For example, the new Darfield site would have been publicly announced around two or more years prior to the building and commissioning of the first powder plant, whereas the addition of the Studholme site occurred as a consequence of Fonterra's acquisition of New Zealand Dairies Limited (NZDL), which occurred at relatively short notice.

92. We acknowledge Fonterra's submission on our draft report²⁷ that it is not feasible to anticipate the wide range of situations that might give rise to a change in the reference basket. There is a need to leave some flexibility in the rules for varying future circumstances.
93. We agree with Fonterra that it would be necessary for it to publicly explain the rationale and consequences of any change in advance of a change to the reference basket and note that Fonterra has undertaken to do this. However, we recommend that Fonterra considers codifying this undertaking as a disclosure requirement in the Manual.
94. We consider the minor drafting change to the rule (removal of the phrase 'at all times') to be inconsequential to the s 150A purpose.

Substantive issues without material effect on the base milk price

95. Some issues that have arisen in our review are substantive, but may not have a material effect on the base milk price.²⁸ We have provided commentary on these issues only where we think this is necessary. They concern the following aspects of the Manual:
 - 95.1 Part A, Section 2.6 – Consistency over time;
 - 95.2 Rule 14 – Repair and maintenance costs;
 - 95.3 New Rule 26 – Capacity of standard plants;
 - 95.4 Winter milk costs; and
 - 95.5 Financing costs of interest-free loans to farmers.

Part A, Section 2.6 – Consistency over time

96. Fonterra has amended Section 2.6 in the Manual to respond to an outstanding issue from our review of the 2014/15 Manual.²⁹ We noted that the meaning of "normal circumstances" was not defined and stated our expectation to see any changes in approach in Fonterra's Reasons Paper supporting its base milk price calculation. We consider that the amendments have made the provision clearer and more transparent.

²⁷ Fonterra, "Submission to the Commerce Commission on its Draft Report on Fonterra's 2015/16 Farmgate Milk Price Manual" (15 November 2015), p.6.

²⁸ We acknowledge Open Country Dairy's submission on our draft report, which states that we should not pre-judge the materiality of amendments to DIRA or their significance for competition. We note that our categorisation of issues for this paper relates to our current broad understanding of the materiality of issues in terms of their relative potential impact on the milk price and that, as the factors influencing the milk price are dynamic, these relativities can also change.

²⁹ Fonterra "'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2015/16 Season" (1 August 2015), p.6.

97. We have previously noted that this section was neither a Principle nor a Rule.³⁰ However, we consider that this is not a significant issue, due to the expectation created by the provision that Fonterra would disclose and explain a material change in its approach.

Rule 14 - Repair and maintenance costs

98. Fonterra amended Rule 14 (Rule 15 in the 2014/15 Manual). In our review of the 2014/15 Manual, we expressed concerns that:
- 98.1 the rule still allowed for a large degree of discretion in its application, particularly in relation to the determination of fixed costs;
 - 98.2 it was unclear from the rule how average assessed replacement costs would be calculated or how Fonterra would determine the fixed assets that are 'broadly comparable' to those fixed assets in the farm gate milk price asset base; and
 - 98.3 the rule did not specify that collection and dry stores assets were to be removed from the replacement costs used in the ratio calculation.
99. Fonterra has amended the rule to make explicit that:
- 99.1 Milk collection and dry stores fixed assets are to be excluded from the ratio calculation; and
 - 99.2 Consistent methods and assumptions are to be used in determining the replacement costs of the relevant Fonterra and notional producer's fixed assets.
100. The above amendments have made the rule more prescriptive. However, the determination of the fixed component remains largely discretionary.³¹
101. We noted in our 2014/15 Final Report of the calculation review that the calculation of Repairs and Maintenance did not distinguish between the separate fixed costs.³² Fonterra has stated in its Reasons Paper that it has not further codified an approach to calculating fixed costs in the absence of appropriate data, but will reconsider the matter in 2015/16.

³⁰ Commerce Commission "Review of Fonterra's 2014/15 Milk Price Manual" (15 December 2014), paragraph 2.18.

³¹ Fonterra has noted in its submission on our 2014/15 draft report that "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 calculation review. Fonterra "Submission to the Commerce Commission on its Draft Report on Fonterra's 2014/15 Farmgate Milk Price Manual" (17 November 2014), p.5.

³² Commerce Commission "Review of Fonterra's 2014/15 base milk price calculation: Dairy Industry Restructuring Act 2001", paragraph 6.83.

102. We consider that the amendments to Rule 14 are an improvement and that the rule is not inconsistent with the contestability dimension of the s 150A purpose statement. However, we will consider whether Rule 14 should be amended to exclude the separate fixed cost approach to improve the prescriptiveness of Rule 14 after reviewing the application in the 2015/16 calculation review.

New Rule 26, Capacity of standard plants

103. Fonterra has amended Rule 26 (Rule 25 in the 2014/15 Manual) to align the average capacity of standard plants used in the Milk Price Model with Fonterra's WMP and SMP plants (i.e. the notional producer's primary product plants).
104. Fonterra's reasoning for the amendment is that its investments in new AMF and Butter processing capacity plants are very irregular. Fonterra notes that the weighted average capacity of its existing assets will therefore not necessarily be aligned to the capacity of new plants typically installed by equipment suppliers.³³
105. We consider that the alignment of the average capacity of the standard plants with Fonterra's WMP and SMP plants is consistent with the safe harbour provision in s 150B(b) of the Act.³⁴
106. However, the Manual does not state how capacities for the non-primary (AMF, butter, BMP) standard plants (and any incremental plants) are determined. We understand that the capacities for the AMF, butter and BMP for the standard plants currently in the model are based on Manufacturer's specification. We recommend that Fonterra explicitly states the treatment of capacity for non-primary product standard plants in the Manual.
107. We note that Fonterra stated in its submission on our draft report that it will consider our recommendation in the course of reviewing the Manual for 2016/17.³⁵

Winter milk costs

108. Open Country Dairy has suggested that Fonterra's approach to winter milk is not practically feasible and that winter milk premiums should be included as a cost in the base milk price model.³⁶ In our 2014/15 milk price calculation review, we proposed considering the issue in the 2015/16 Manual review.

³³ Fonterra "'Reasons' Paper in support of Fonterra's Milk Price Manual for the 2015/16 Season" (1 August 2015), p.8.

³⁴ S 150B(b) of the Act states that the size of new co-op's (Fonterra) assumed units of processing capacity approximates to the average size of new co-op's actual units of processing capacity.

³⁵ Fonterra, "Submission to the Commerce Commission on its Draft Report on Fonterra's 2015/16 Farmgate Milk Price Manual" (15 November 2015), p.7.

³⁶ Open Country, "Submission on the Commerce Commission's Process and Issues Paper – Review of Fonterra's 2015/16 Milk Price Manual and "Submission on the Commerce Commission's Draft Report – Review of Fonterra's 2014/15 milk price calculation (31 August 2015)", p.4.

109. The milk price model includes assumptions on winter milk supply, but assumes that the notional producer pays no premium for it. There is no specific provision for winter milk premiums in the Manual.
110. The case made by Open Country Dairy in its submission on our 2014/15 milk price calculation review was that Fonterra's approach to winter milk is not practically feasible because the notional processor receives milk for which it does not pay the full cost. The issue for determining practical feasibility is that a real world processor can either choose to buy winter milk and pay winter milk premiums or not buy the milk at all. Although Open Country Dairy agrees with Fonterra that the notional producer is unlikely to buy winter milk, for the purposes of practical feasibility, that would mean that the notional producer would therefore need to:
- 110.1 exclude winter milk from the calculation (this would mean that the 'safe harbour' provided by s 150B(d) would then no longer be available); or
- 110.2 include winter milk supply as well as winter milk premiums.
111. Open Country Dairy is of the view that winter milk premiums and winter milk supply volumes are material. Open Country Dairy states that:³⁷
- 111.1 Around 5% of Fonterra's total supply in the 2013/14 season was winter milk; and
- 111.2 Fonterra's March forecast for winter milk premiums for 2014/15 was \$0.61 per kgMS in the North Island and \$1.64 per kgMS in the South Island.
112. Fonterra has clarified that only a portion of the winter milk premiums are excluded from the base milk price calculation.³⁸ For the purposes of the base milk price calculation Fonterra says it does provide for a notional 'cost' of 75 cents per kgMS of milk supplied to Fonterra under winter milk contracts. This 'cost' is effectively deducted from the amount available to pay for non-winter milk.³⁹
113. Fonterra has also noted that the Manual does not include an explicit provision covering winter milk premiums as the Manual and the terms of reference of the Milk Price Panel are focused on determining the aggregate amount Fonterra should pay for milk supplied to it. Fonterra has further explained in its submission on our draft report that the allocation of payments is the role of Fonterra's Board, and in its view, it would not be appropriate to amend the Manual to make explicit the treatment of either winter milk premiums or any of the other mechanisms used by Fonterra to allocate payments for milk to suppliers.

³⁷ "Submission on the Commerce Commission's Draft Report – Review of Fonterra's 2014/15 milk price calculation (31 August 2015)", p.4.

³⁸ Fonterra "Farmgate Milk Price Statement 2014", p.2. We note that Footnote 1 could be clearer that only a portion of winter milk premiums are not included in the calculation, however, the text appears to be clear that a portion of winter milk premiums is included in the base milk price.

³⁹ We note that Open Country and Fonterra may have different views about the materiality of winter milk premiums on the base milk price calculation.

114. Our statutory reviews are focused on the extent to which the Manual and the base milk price calculation meet the purpose of the milk price monitoring regime set out under s 150A of the Act. Therefore, we are less concerned with how winter milk fits in with Fonterra's constitutional arrangements and more concerned with whether the treatment of winter milk in the Manual and the base milk price calculation is both practically feasible for the notional producer and transparently disclosed by Fonterra for other interested parties.
115. We welcome the commitment made by Fonterra to considering how it can refine the explanation of the treatment of winter milk premiums that is provided annually in the milk price statement to make it more explicit that a portion of winter milk premiums are treated 'as if' they were a cost when determining the annual prices per kilogram of milkfat and protein supplied to Fonterra.⁴⁰
116. We consider that the treatment of winter milk is relevant to the practical feasibility of the Manual and that Fonterra should increase its level of transparency on the level of winter milk premiums included in the base milk price calculation. We recommend that the Manual includes a rule that covers winter milk premiums in the Manual so that it is clearly explained how Fonterra works out the notional costs for winter milk premiums and that these costs are included in the base milk price calculation.
117. We intend to look more closely at how winter milk premiums are calculated and presented during our review of the 2015/16 base milk price calculation.

Financing costs of interest-free loans made to farmers

118. On 1 September 2015, Fonterra announced that farmer shareholders can apply for an interest-free loan of 50 cents for every kilogram of share-backed milk solids produced from 1 June to 31 December 2015. The loan would be interest-free until 31 May 2017, after which Fonterra may charge interest. Farmers can repay all or part of the loan at any time and no security is required over their shares or any other assets.
119. Open Country Dairy is of the view that the cost of the interest-free loans that Fonterra is making to its farmers should be included in the base milk price model and that the Manual should be capable of addressing this.⁴¹

⁴⁰ Fonterra, "Submission to the Commerce Commission on its Draft Report on Fonterra's 2015/16 Farmgate Milk Price Manual" (15 November 2015), p.7.

⁴¹ Open Country Dairy "Submission on the Commerce Commission's Process and Issues Paper – Review of Fonterra's 2015/16 Milk Price Manual" (submitted 21 September 2015)

120. Castalia's report to Open Country Dairy on the 2014/15 milk price calculation⁴² states that, if an efficient notional producer would make the same loans as Fonterra has, then for practical feasibility the financing costs of the loans should be included in the milk price model. Open Country has a "firm belief"⁴³ that an efficient notional processor "would have done what Fonterra has done—support its farmers through difficult times".
121. Fonterra has expressed its view to us that, as the costs associated with the interest-free loan will be funded from earnings (and more specifically from working capital savings), it will not be making any provisions or adjustments in the base milk price calculation.
122. At a high level, we consider that, regardless of how the loan scheme is funded, it raises a potential issue for practical feasibility of the Manual (and by extension, the connected base milk price calculation) because:
- 122.1 An economic benefit is provided by Fonterra to farmer suppliers;
 - 122.2 A key reason for the economic benefit is to support suppliers through difficult circumstances in the short term for a longer term benefit and to ensure stability and security of supply;
 - 122.3 The benefit therefore appears to be linked to the amount of milk supplied;
 - 122.4 It appears rational for an efficient processor to behave and incur costs similarly; and
 - 122.5 We understand that other processors have used mechanisms such as accelerated payments and loans to suppliers for similar reasons to Fonterra.
123. We note Fonterra's submission that the loan scheme is provided to Fonterra shareholders and not as consideration for milk.⁴⁴ Notwithstanding this difference of view, we suggest that Fonterra should consider how the costs of support payments to suppliers, such as the financing costs of interest-free loans to farmers, should be included and clearly described in the base milk price calculation.

⁴² Castalia "Review of Fonterra's 2014/15 milk price calculation and supporting analysis - Report to Open Country Dairy" (August 2015)

⁴³ Open Country Dairy "Submission on the Commerce Commission's Process and Issues Paper – Review of Fonterra's 2015/16 Milk Price Manual" (submitted 21 September 2015)

⁴⁴ Fonterra, "Submission to the Commerce Commission on its Draft Report on Fonterra's 2015/16 Farmgate Milk Price Manual" (15 November 2015), pp.7-8.

124. We acknowledge Fonterra's submission that, if the costs of the loans were to be funded from the aggregate amount payable for milk calculated under the Manual,⁴⁵ it would not be necessary to amend the Manual as the costs could be provided for under new Rule 19 (non-recurring costs). We agree that a change to the Manual may not be necessary due to the coverage of Rule 19.⁴⁶
125. In our view, recipients of the interest-free loan will receive an economic benefit in the foregone financing costs of the loan⁴⁷ and (in future) if any portion of the loan that is written off. Whether the funding costs of providing this benefit should be included in the milk price model depends on whether an efficient producer would similarly incur costs to support its suppliers.
126. In our draft report, we considered that it is possible that an efficient processor would make similar support payments, as Fonterra has done through interest-free loans.
127. Fonterra considers that the "mere possibility" that an efficient processor would make similar loans is too low a threshold for it to then follow that it should consider including the financing costs in the milk price. In our view, we now consider that it is likely for an efficient processor to make support payments to suppliers at times of stress and that, although a change to the Manual may not be necessary, the treatment of these payments should be included and clearly described in the base milk price calculation:
- 127.1 It appears rational for an efficient processor to incur shorter term costs through accelerated payments or loans to support its suppliers at times of commercial stress in return for the longer term benefit of ongoing security and stability of supply;
- 127.2 If Fonterra is acting efficiently, it would appear that Fonterra providing interest-free loans is in itself evidence that an efficient processor would provide similar support payments;⁴⁸ and
- 127.3 We understand that other processors have provided accelerated payments or loans to assist their supplier farmers in the current dairy season and in previous dairy seasons, albeit not on the same scale as Fonterra's scheme.

⁴⁵ Fonterra reiterates in its submission that the financing costs will be funding from Fonterra's earnings and not the milk price.

⁴⁶ Assuming the costs meet the criteria of the rule, e.g. are non-recurring.

⁴⁷ We note that Castalia proposed a methodology for quantifying this cost in its report to Open Country Dairy on Fonterra's 2014/15 milk price calculation. For the purposes of this review, we do not offer a view on how the funding cost should be quantified.

⁴⁸ For example, comments made by Fonterra's Chief Financial Officer reported in the media suggest that Fonterra is acting in the overall interests of the firm – see <http://www.stuff.co.nz/business/71032479/Fonterra-fights-flak-over-430-million-of-interest-free-loans-to-farmers>.

128. The reasoning for our view as set out in our draft report⁴⁹ is related to the question of whether the loan benefits received by Fonterra farmers is closely linked to milk supply or a merely a benefit provided to shareholders in their capacity as shareholders. On balance, we think that the loan benefits are closely linked to milk supply:
- 128.1 Along with being a shareholder, supplying milk to Fonterra is an eligibility criterion (the scheme is not available to non-supplier shareholders);
 - 128.2 The amount that a farmer can borrow is linked to the volume of milk supplied (50 cents per kgMS);
 - 128.3 Automatic loan repayments are linked to the milk price (when the Total Advance Rate Payments exceed \$6) and volume of milk supplied;
 - 128.4 Provisions that require a farmer to repay part or all of a loan immediately are triggered by (among other things) a drop in a farmer's milk production or a reduction of milk supply;
 - 128.5 Fonterra can deduct loan repayment amounts owed by a farmer from milk payments to the farmer.
129. Fonterra also noted in its submission that its "contract suppliers" would be left in a worse position than suppliers to independent processors if the financing costs of interest-free loans were deducted as a cost when calculating the milk price.⁵⁰ We consider this to be an allocation issue for Fonterra, rather being relevant to the extent to which the Manual is consistent with the purpose of the milk price monitoring regime set out in the Act.
130. We intend to give further consideration to this issue in our review of the 2015/16 milk price calculation.
131. We will be addressing the competitive aspects of Fonterra's loan scheme separately, in our Report to the Minister on the state of competition in the New Zealand Dairy Industry.⁵¹

⁴⁹ Commerce Commission "Draft report - Review of Fonterra's 2015/16 Milk Price Manual: Dairy Industry Restructuring Act 2001" (15 October 2015), paragraph 126.

⁵⁰ Fonterra, "Submission to the Commerce Commission on its Draft Report on Fonterra's 2015/16 Farmgate Milk Price Manual" (15 November 2015), p.8.

⁵¹ Our Final Report - Review of the state of competition in the New Zealand Dairy Industry will be published on 29 February 2016.

Non-substantive, technical or drafting changes

132. Fonterra has made a number of non-substantive drafting or technical changes to the Manual.⁵² We do not consider any of these to be consequential.
133. For completeness, we have listed all of the drafting or technical changes assessed in this review in Attachment A.

⁵² See Attachment A, Table A3

Attachment A: Summary of all issues considered in this review**Purpose of this attachment**

- A1. This attachment provides a summary of all issues considered in this review, which have been categorised as follows:
 - A1.1 Table A1 – Summary of substantive issues;
 - A1.2 Table A2 – Summary of substantive issues without a material effect on the base milk price; and
 - A1.3 Table A3 - Summary of non-substantive, technical or drafting change issues.

Table A1: Summary of substantive issues

Manual reference	Issue category	Description of issue	Fonterra reasons	Commission comment
Part A, Section 4.3 and Part B, Rule 5	Fonterra Manual amendment	Amendments that describe the circumstances where Fonterra may choose to reference sales off the GDT platform.	Introductory words no longer required, as all RCPs are now sold on GDT. Additional language is to get better alignment to Rule 5.	See paragraphs 43-51
Part B, Rule 3	Fonterra Manual amendment	Addition / removal of RCPs from the reference basket so that a change should only be made where expected result is a higher average milk price over time.	Amendment provides greater clarity over the circumstances under which the reference basket might be amended, creates better alignment between Rule 3 and the corresponding provision in s 150C2(a)(ii), and codifies a key consideration actually applied in evaluations to date of the merits of any change to the reference basket.	See paragraphs 84-94
Part B, Rule 19	Fonterra Manual amendment	New Rule 19 established to cover any non-recurring costs which could reasonably be expected to have been incurred by the notional producer and not otherwise provided for in the calculation methodology.	Submission on 2014/15 Manual review draft report acknowledged that the Manual did not explicitly provide for various one-off costs.	See paragraphs 61-70
Part B, Rule 33	Fonterra Manual amendment	Drafting changes to address Commission's double counting point in 2014/15 review regarding adjustments for stranded assets.	Addition of provisions providing that compensation for costs associated with removal of a reference asset from the asset base can only be recovered once.	See paragraphs 52-60

Manual reference	Issue category	Description of issue	Fonterra reasons	Commission comment
Part B, Rule 36	Fonterra Manual amendment	Amendments to Rule 36 to show consequences of adding or removing a manufacturing site from milk price model.	Addition of provision which makes explicit the approach actually applied in practice (e.g. on addition of Darfield and Studholme sites, and on removal from the model of the Plains site).	See paragraphs 71-76
Part B, Rule 42	From 2014/15 milk price calculation review	Whether the risk free rate for WACC should be based on spot rate or 5-year average.	Submission on 2014/15 calculation review draft report acknowledged that additional support is required for the values of the asset beta and specific risk premium, and will be addressed in the course of the 2015/16 season.	See paragraphs 77-81
Part B, Rule 44	Fonterra Manual amendment	Drafting changes to address Commission's double counting point in 2014/15 review regarding adjustments for stranded assets.	Addition of provisions providing that compensation for costs associated with removal of a reference asset from the asset base can only be recovered once.	See paragraphs 52-60

Table A2: Summary of substantive issues without a material effect on the base milk price

Manual reference	Issue category	Description of issue	Fonterra reasons	Commission comment
Part A, Section 2.6	Fonterra Manual amendment	Amendments to 'consistency over time' provision in response to 2014/15 Manual review.	Commission raised the lack of clarity in the term 'normal circumstances' in its draft report on the 2014/15 Manual, amendments are to make it clearer that this undertaking would hold in anything other than 'highly unusual circumstances'.	See paragraphs 96-97.
Part B, Rule 14	Fonterra Manual amendment	Amendments to R&M costs rules to address 2014/15 Manual review comments about clarity.	Response to an issue raised by Commission in the 2014/15 Manual review to make explicit actual practice.	See paragraphs 98-102.
Part B, Rule 18	Outstanding issue from previous Manual review	Fonterra in our 2012/13 calculation review signalled methodological changes for "other costs", including site overheads, general overheads and R&D without Manual rule change.	No comment made by Fonterra.	We have yet to see any methodological changes to the valuation of associated costs. Therefore, we cannot comment further at this time. We will be reviewing this in the 2015/16 milk price calculation review.

Manual reference	Issue category	Description of issue	Fonterra reasons	Commission comment
Part B, Rule 24 Part B, Rule 25 Part B, Rule 26	Fonterra Manual amendment	New rules and amendments that separate material previously contained in a single rule into 3 rules, to make establishment / evolution of asset base clearer and to include milk collection assets.	Drafting only, intent is to split out the provision describing the composition of the asset base from the rule describing how asset values are to be established.	No expectation of consistency issues for drafting changes. See paragraphs 102-106 for discussion of new Rule 26.
Part B, Rule 26	Fonterra Manual amendment	New Rule 26 amended so that average model plant capacity will be aligned to Fonterra's capacity just for 'primary' RCPs (WMP & SMP).	Amended to provide that requirement to equate average milk price plant capacity to Fonterra's average capacity only applies to WMP and SMP. Previous language was ambiguous.	See paragraphs 103-107.
N/A	From 2014/15 milk price calculation review Submission from interested party	Whether the notional producer should take increased costs of winter milk into account.	N/A.	See paragraphs 108-117.

Manual reference	Issue category	Description of issue	Fonterra comment	Commission comment
N/A	From 2014/15 milk price calculation review Submission from interested party	Financing costs of interest-free loans.	N/A	See paragraphs 118-131

Table A3: Summary of non-substantive, technical or drafting change issues

Manual reference	Issue category	Description of issue	Fonterra comment	Commission comment
Part A, Section 4.5	New for 2015/16 Manual Review	Depreciation is not explicitly mentioned in the section regarding capital costs.	N/A.	No expectation of consistency issues; lack of explicit mention regarding depreciation does not seem to have resulted in any application issues previously, as the application of depreciation in the model is implied.
Part A, Section 5	New for 2015/16 Manual review	Impact of current restructuring of Fonterra's head office management on organisational arrangements, described in this section of the Manual.	N/A.	We do not expect that there would be consistency issues, but suggest that Fonterra clarifies whether the restructuring impacts on any organisational arrangements for the governance and administration of the Manual and the calculations of projected and actual base milk prices.

Manual reference	Issue category	Description of issue	Fonterra comment	Commission comment
Part B, Section 2	Fonterra Manual amendment	Inconsistency of column headings in Section 2 with other sections – change from “Rule” and “Application” to “Objective” and “Rule”.	Change to column headings consistent with contents and approach taken in practice to applying the Manual.	No consistency issues, but note that the drafting change may not accurately describe the nature of the actual content in each column.
Part B, Rule 3	Fonterra Manual amendment	Deletion of words “at all times”.	Phrase is redundant.	No consistency issues; “must” is sufficient wording.
Part B, Rule 6	Fonterra Manual amendment	Sales cost provision moved from "Farmgate Milk Price Commodity Business" section of Part B to Cash Costs section (now Rule 17).	Moved per Commission suggestion. Note that this brings sales costs within the ambit of the 4 yearly Reset Year review requirement (as also suggested by Commission), which is how we have treated them in any case to date.	No consistency issues; the change responds to an issue previously raised by the Commission.
Part B, Rule 17	Fonterra Manual amendment	Replacement of “standard specification commodity products” with “Qualifying Materials”.	The term ‘standard specification’ refers solely to a single base specification (e.g. Regular WMP) whereas the intent is that this test applies to the broader range of commodity products included in the Milk Price revenue calculation. Amendment will not have any practical consequences.	No consistency issues; the change improves drafting accuracy.

Manual reference	Issue category	Description of issue	Fonterra comment	Commission comment
Part B, Rule 18	Fonterra Manual amendment	Deletion of reference to “costs of a ‘one-off’ nature”.	‘One-off costs’ now covered by new Rule 19.	No consistency issues; the change reflects that a new rule that has been added (Rule 19 has been included in substantive part of review).
Part B, Rule 27	Fonterra Manual amendment	Replacement of “reasonable” with “commercially supportable”.	Intent is to make drafting more precise - will not have any substantive impact.	Cannot conclude whether any consistency issues arise as a result of the change – without specifying what “commercially supportable” actually means in practice, vagueness of terminology remains.
Part B, Rule 38	Fonterra Manual amendment	Replacement of “Review Year” with “Year” for periodic revisions of annuity calculations.	These calculations are updated every year, not just at 4 yearly intervals. This does not result in any change to approach actually applied.	No consistency issues; the change responds to a point raised by the Commission in the 2014/15 Manual review.
Part C	Fonterra Manual amendment	Addition of definition of ‘Standard Specification Product’.	Remedies accidental omission.	No consistency issues; the change adds a defined term to the Manual's glossary.
Part C	Fonterra Manual amendment	Replacement of “Reference Commodity Product” with “Standard Specification Product”.	Corrects a drafting error.	No consistency issues; the change improves drafting accuracy.

Manual reference	Issue category	Description of issue	Fonterra comment	Commission comment
Part C	Fonterra Manual amendment	Reinstatement of explanation of test to be applied in selecting maximum contract tenor of 5 months prior to month of shipment in the definition of "Benchmark Selling Price".	Reinstate previous language for transparency purposes per Commission Manual report. Not a substantive change.	No consistency issues; the change responds to an issue raised previously by the Commission and aids transparency.
Part C	Fonterra Manual amendment	Definition of "Review Year" amended to include references to Rule 17 (Sales costs), Rule 7 (Product yields), Rule 41 (WACC specification) and Rule 43 (Specific Risk Premium).	Apart from Rule 17, the references were accidentally omitted when the new provision was introduced last year. Does not result in any change in practice.	No consistency issues; the change responds to an issue previously raised by the Commission.

Attachment B: Glossary

Term/Abbreviation	Definition
The Act, or DIRA	Dairy Industry Restructuring Act 2001
AMF	Anhydrous milk fat
Base milk price	Farm gate milk price expressed per kilogram of milk solids
BMP	Butter milk powder
Calculation review	Review of Fonterra's base milk price calculation, generally referred to by the review relating to each dairy season (eg, 2014/15 calculation review)
Dairy season	1 June to 31 May
Manual review	Review of Fonterra's Milk Price Manual, generally referred to by the review relating to each dairy season (eg, 2015/16 Manual review)
Milk Price Manual or the Manual	Fonterra's Farm Gate Milk Price Manual, generally referred to by the version relating to each dairy season (eg, 2015/16 Manual)
GDT	Global dairy trade, Fonterra's online auction
kgMS	Kilogram of milk solids
Notional producer	The notional commodity business that is used to calculate the base milk price
R&M	Repairs and maintenance
RCP	Reference Commodity Product, being WMP, SMP, BMP, butter, AMF
Reasons Paper	Fonterra's Reasons Paper, which is provided alongside the Manual for each dairy season (Fonterra also provides a 'Reasons Paper' when it discloses its base milk price calculation at the end of each dairy season)
SMP	Skim milk powder
TAF	Trading Among Farmers
WACC	Weighted average cost of capital
WMP	Whole milk powder