

Review of Fonterra's 2020/21 Milk Price Manual: Dairy Industry Restructuring Act 2001

Draft report

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Commerce Commission

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Executive Summary

What this report covers

- X1 This report sets out our draft conclusions on our review of Fonterra's 2020/21 Milk Price Manual (**the Manual**). The Manual contains the methodology that will be used to calculate Fonterra's base milk price for the 2020/21 season.

About this review

- X2 Our review of the Manual is required as part of the milk price monitoring regime (**monitoring regime**), which is contained in subpart 5A of the Dairy Industry Restructuring Act 2001 (**the Act**). An overview of our approach when reviewing the Manual can be found in our supporting paper "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017).¹ This framework paper should be read together with, and as part of, this report. We did not make any changes to this framework paper for the purposes of this Manual review.
- X3 Our review considers the extent to which the Manual is consistent with the purpose of subpart 5A of the Act. In particular, our review considers the 'efficiency' and 'contestability' dimensions of the s 150A purpose as required by the Act. These focus on whether the methodology used in the Manual:
- X3.1 provides an incentive for Fonterra to operate efficiently (the 'efficiency dimension'); and
 - X3.2 adopts assumptions, inputs and processes that would be practically feasible for an efficient processor (the 'contestability dimension').²
- X4 To satisfy the provisions in s 150A, our interpretation is that our statutory reviews must assess the extent to which the Manual is consistent with both dimensions. We attach equal weight to both dimensions in our reviews.

¹ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017). This paper provides an overview of the approach we have taken in reviewing the Manual. It outlines how we conduct our annual reviews of Fonterra's Milk Price Manual and each season's base milk price calculation. It includes our interpretation of key legislative provisions, our practical approach to the statutory reviews, an overview of how Fonterra sets its base milk price, assumptions of the notional processor, and internal and external controls surrounding the integrity of the milk price calculation.

² We consider the same 'efficiency' and 'contestability' dimensions when we carry out our milk price calculation review.

- X5 In reaching our draft conclusions we have focused on the amendments Fonterra has made to the Manual for the 2020/21 season.
- X6 Our Manual reviews also consider matters carried forward from previous reviews.
- X7 For those parts of the Manual that have remained unchanged we have continued to rely on our previous conclusions. We are not aware of any other new information which would warrant reconsideration of our conclusions in previous Manual reviews, but welcome submissions in that regard.

Our draft conclusions

- X8 In regard to Fonterra's amendments to the Manual since last year's review, our draft conclusions are that the following matters are not inconsistent with s 150A of the Act:
 - X8.1 replacing independent reviewer provisions with Milk Price Group (**MPG**) reviews is consistent with the contestability and efficiency dimensions of s 150A of the Act.
 - X8.2 the rule that requires the MPG, when determining the asset beta, to have regard to "any relevant requirements under DIRA" does not alter the requirements the Act places on Fonterra. We therefore do not consider that this change is relevant to our assessment of consistency with s 150A.
 - X8.3 the amendment to the receivables risk principle that actual bad or doubtful debts should generally not affect the Farmgate Milk Price is consistent with the efficiency and contestability dimension of the s 150A purpose. As the allowance is based on historical patterns, we also consider it is practically feasible.
- X9 However, there are two aspects of the Manual that we consider inconsistent with the purpose in s 150A or we would like to see more disclosure in the Manual:
 - X9.1 Fonterra's amendments to Rule 23 that allow the ability to apply the outcome of a Mid-Period Review in the year of a review; and
 - X9.2 capacity of standard plants.
- X10 Fonterra's amendments to Rule 23 is not consistent with the efficiency dimension of s 150A of the Act. Having the ability to apply the outcome of a Within-Period Review to the year in which the review is undertaken could give rise to the use of actual rather than notional inputs, potentially reducing Fonterra's incentive to operate efficiently.

- X11 We have also carried forward our conclusion from previous reviews that disclosure in the Manual of the capacity for both primary and secondary plants would better promote the purpose in s 150A.³
- X12 Based on the information we have before us, we do not consider that either matter is sufficiently material to render this season's Manual inconsistent with the s 150A purpose as a whole.
- X13 Accordingly, our overall draft conclusion is that this season's Manual is largely consistent with the statutory purpose set out in s 150A of the Act.
- X14 We have updated our view on the disclosure of FX rates. We accept that the Manual is not the appropriate vehicle for disclosing assumed FX rates since they are assumptions that will change each season, whereas the Manual contains the overall rules that give effect to the milk price principles. Although not a matter that affects our conclusion that the Manual is largely consistent with the purpose in s 150A of the Act, we continue to consider there should be more transparency of information on the actual FX rates assumed to be achieved by the notional processor by disclosing the FX rates in quarterly milk price statements.
- X15 Although not a matter that affects our conclusion that the Manual is largely consistent with the purpose in s 150A of the Act, there is a recommendation from previous reviews that we considered would better promote the purpose in s 150A and provide greater confidence to interested parties through additional transparency. We consider that the disclosure of what constitutes a 'material change', when considering whether a change to the Manual should be made, will provide greater transparency.⁴
- X16 Although not matters affecting our conclusion that the Manual is largely consistent with the purpose in s 150A of the Act, we have updated our recommendations on the following matters as we consider that further disclosure would better promote the purpose:
- X16.1 the publication of the list of all products that constitute 'Generic product specifications' in the Manual would greatly assist clarity of what is a standard product offering;

³ Commerce Commission "Review of Fonterra's 2019/20 milk price manual: Dairy Industry Restructuring Act 2001 Final report" (12 December 2019), paragraph X9.

⁴ Commerce Commission "Review of Fonterra's 2019/20 Milk Price Manual: Dairy Industry Restructuring Act 2001 Final report" (12 December 2019), paragraph 80.

- X16.2 the conditions that apply to sales that are not considered to be transacted on freely contestable markets should be specified in more detail in Principle 2 of the Manual to clarify how this principle is to be applied; and
- X16.3 the term 'prevailing' is used in a number of rules in the Manual. We consider that defining the term 'prevailing' would provide greater clarity in respect of the inputs required to be used by these rules.

Next steps

- X17 Based on Fonterra's 2020/21 Manual amendments and our draft conclusions on this review, we have not identified any new specific focus areas for our 2020/21 milk price calculation review.
- X18 In respect of the Manual's approach to asset stranding, we intend to carry out a substantive review in our 2020/21 base milk price calculation review after Fonterra's review of the specific risk premium.⁵
- X19 We have explained how interested parties can provide input on this draft report in Chapter 2.

⁵ Commerce Commission "Review of Fonterra's 2018/19 Milk Price Manual: Dairy Industry Restructuring Act 2001 Final report" (14 December 2018).

Chapter 1 Introduction and scope of review

1. This report sets out our review of the extent to which the Manual is consistent with the purpose of the base milk price monitoring regime, which is set out in s 150A of the Act.

How this report is structured

2. This chapter introduces our review and covers the scope of our review.
3. Chapter 2 outlines how you can provide your views on our draft report.
4. Our draft conclusions of our review are set out in Chapter 3.
5. Manual amendments that we proposed to Fonterra in prior reviews, and which we consider still outstanding, have been summarised in **Attachment A**.
6. A glossary of key terms is provided in **Attachment B**.
7. As noted above, this paper should be read with the paper "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017) which we have applied in this Manual review and which forms part of this report.⁶

We are fulfilling our statutory requirements

8. 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 of subpart 5A of the Act, as set out in s 150A of the Act.⁷
9. The Act requires Fonterra to provide us with the following information for consideration in our review:⁸
 - 9.1 the Manual for the current season;

⁶ Commerce Commission "Our approach to reviewing Fonterra's Milk Price Manual and base milk price calculation" (15 August 2017).

⁷ As required under s 150H and s 150I of the Act.

⁸ Section 150L of the Act.

- 9.2 any recommendations by the Milk Price Panel (**MPP**)⁹ in relation to the setting of the base milk price;¹⁰
 - 9.3 notification of any change in the economic and business environment that, in Fonterra's view, requires a change to the Manual;
 - 9.4 certification on the extent to which Fonterra considers that the Manual is consistent with the purpose of s 150A; and
 - 9.5 reasoning behind the views expressed in Fonterra's certification.
10. The above information, where relevant, has been provided by Fonterra in the 'Reasons' Paper in support of Fonterra's Manual for the 2020/21 season and has been considered as part of our review. Fonterra's Manual and the Reasons Paper can be found on our website.¹¹

Scope of this review

- 11. We have focused our review on Fonterra's amendments to the Manual made since the 2019/20 review.
- 12. There remain recommendations from previous reviews that we considered would better promote the purpose in s 150A and provide greater confidence to interested parties through additional transparency that have not been addressed in the current Manual. For those parts of the Manual that have remained unchanged from the 2019/20 Manual we have relied on our previous conclusions. We are not aware of any other new information which would warrant reconsideration of our previous conclusions, but welcome submissions in that regard.

⁹ The MPP is a committee that Fonterra is required to establish and maintain under s 150D of the Act. The MPP is required to, for each season, supervise the calculation of the base milk price; advise Fonterra on the application of the Manual; and recommend the base milk price to Fonterra. See also Fonterra "Farmgate milk price manual" (1 August 2020), page 26.

¹⁰ Fonterra provides the Commission a 'marked up' version of the Manual that shows the changes that have been made to the previous season's version of the Manual. Fonterra has stated in its Reasons Paper (page 1) that the 'marked up' version of the Milk Price Manual attached to its Reasons Paper identifies all amendments to the Manual. For the 2020/21 Manual, all the recommendations by the MPP were implemented by the Board.

¹¹ Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2020/21 season" (2020) at <https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation/milk-price-manual>

13. We have previously signalled we would review the asset beta and specific risk premium in the 2020/21 season. This aligns with Fonterra's scheduled review of its asset beta and specific risk premium. We will review these matters as part of our base milk price calculation review in 2020/21 since:
 - 13.1 the 2020/21 Manual requires the MPG to determine an updated specific risk premium and asset beta in 2020/21. The MPG has not completed its review of the calculation of these inputs in time for this draft report; and
 - 13.2 the asset beta and specific risk premium are inputs to the base milk price calculation, reflecting certain cost of capital assumptions.
14. In this report we have grouped issues in the following order:
 - 14.1 The areas of the Manual that are most likely to have an impact on the extent to which the Manual is consistent with s 150A taking account of new information and changes to the Manual (Chapter 3 focus).
 - 14.2 A summary of the Manual amendments we have proposed to Fonterra over the course of our milk price reviews which have not been adopted and which we continue to consider should be provided for. Given the ongoing nature of our reviews we consider these issues to be of continuing relevance (Attachment A).

Chapter 2 How you can provide your views

Invitation to comment

15. As required under the Act, we are consulting with Fonterra on this draft report.¹² We have also extended our consultation process to other interested parties.
16. This chapter outlines how you can provide your views on our draft report.
17. We welcome views on any aspects of this draft report that you think we should consider before finalising our conclusions. As signalled in this paper we are particularly interested in material relating to any new information that would warrant further consideration of previous conclusions.

Deadline for submissions

18. We are seeking submissions on this draft report.
19. Please make your submission via the [Milk price manual – 2020/21 season](#) page on our website, by **5pm, Monday 16 November**. The project page will direct you to a form with instructions on how to upload your submission. Your submission should be provided as an electronic file in an accessible form (eg, PDF, word or an unlocked spreadsheet).
20. The protection of confidential information is something the Commission takes seriously and in order to continue to protect confidential submissions we are trialling a new submission process. This will require you to upload your submission via the form on the project page. The process requires you to provide (if necessary) both a confidential and non-confidential version of your submission and to clearly identify the confidential and non-confidential versions.
21. When including commercially sensitive or confidential information in your submission, we offer the following guidance:
 - 21.1 Please provide a clearly labelled confidential version and public version. We intend to publish all public versions on our website.

¹² Section 150U(1) and (2) of the Act.

- 21.2 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
22. If we consider information disclosed in the confidential version to be in the public interest, we will consult with the party that provided the information before any such disclosure is made.

Chapter 3 Draft conclusions

23. This chapter summarises our draft conclusions on the extent to which the 2020/21 Manual is consistent with the s 150A purpose.

Our draft conclusions

24. Regarding Fonterra's amendments to the Manual since last year's review, our draft conclusions are that the following matters are not inconsistent with s 150A of the Act:
- 24.1 replacing independent reviewer provisions with MPG reviews is consistent with the contestability and efficiency dimensions of s 150A of the Act.
 - 24.2 the rule that requires the MPG, when determining the asset beta, to have regard to "any relevant requirements under DIRA" does not alter the requirements the Act places on Fonterra. We therefore do not consider that this change is relevant to our assessment of consistency with s 150A.
 - 24.3 the amendment to the receivables risk principle that actual bad or doubtful debts should generally not affect the Farmgate Milk Price is consistent with the efficiency and contestability dimension of the s150A purpose. As the allowance is based on historical patterns we also consider it is practically feasible.
25. However, there are two aspects of the Manual that we consider inconsistent with the purpose in s 150A or we would like to see more disclosure in the Manual:
- 25.1 Fonterra's amendments to Rule 23 that allow the ability to apply the outcome of a Mid-Period Review in the year of a review; and
 - 25.2 capacity of standard plants.
26. Fonterra's amendments to Rule 23 is not consistent with the efficiency dimension of s 150A of the Act. Having the ability to apply the outcome of a Within-Period Review to the year in which the review is undertaken could give rise to the use of actual rather than notional inputs, potentially reducing Fonterra's incentive to operate efficiently.

27. We have also carried forward our conclusion from previous reviews that disclosure in the Manual of the capacity for both primary and secondary plants would better promote the purpose in s 150A.¹³
28. Fonterra does not consider the Manual is the appropriate vehicle for these disclosures. Fonterra states that they put this information into the public domain in its base milk price calculation reasons papers.¹⁴
29. We consider that the disclosure of plant capacity in the Milk Price Calculation reasons paper is too late to enable interested parties to assess the practical feasibility of the assumed production volumes. We therefore maintain and adopt the conclusion in our previous Manual reviews on this matter.
30. Based on the information we have before us, we do not consider that either matter is sufficiently material to render this season's Manual inconsistent with the s 150A purpose as a whole.
31. Accordingly, our overall draft conclusion is that this season's Manual is largely consistent with the statutory purpose set out in s 150A of the Act.
32. Fonterra does not consider the Manual is the appropriate vehicle for the disclosure of FX rates. Fonterra states that they routinely disclose the information suggested by the Commission with respect to both the prior season average FX conversion rate and the forecast rate for the current season in the Milk Price Statement, released each September.¹⁵
33. We accept that the Manual is not the appropriate vehicle for disclosing assumed FX rates since they are assumptions that will change each season, whereas the Manual contains the overall rules that gives effect to the milk price principles. However, although not a matter that affects our conclusion that the Manual is largely consistent with the purpose in s 150A of the Act, we continue to consider there should be more transparency of information on the actual FX rates assumed to be

¹³ Commerce Commission "Review of Fonterra's 2019/21 milk price manual: Dairy Industry Restructuring Act 2001 Final report" (12 December 2020), paragraph X9.

¹⁴ Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2020/21 season" (2020), page 4.

¹⁵ Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2020/21 season" (2020), page 4.

achieved by the notional processor by disclosing the FX rates in *quarterly* milk price statements, not just each September.

34. Although not a matter that affects our conclusion that the Manual is largely consistent with the purpose in s 150A of the Act, there is a recommendation from previous reviews that we considered would better promote the purpose in s 150A and provide greater confidence to interested parties through additional transparency.
35. We concluded in our 2016/17 Manual review, that disclosure of what constitutes a 'material change' in this context will provide greater transparency. Fonterra considers that a 'bright line' materiality threshold is likely to lead to less disclosure.¹⁶
36. We continue to consider that the disclosure of what constitutes a 'material change', when considering whether a change to the Manual should be made, will provide greater transparency.¹⁷
37. In the base milk price calculation review 2019/20, we asked Fonterra to provide a detailed description of 'Standard Product Offering', 'tender and formulaic sales', 'freely contestable markets' and 'prevailing prices' as we made recommendations in regards to these matters in our 2019/20 Manual review.¹⁸ In our view, Fonterra's explanations of these terms provide greater transparency regarding how the relevant rules are applied.¹⁹ Although not matters affecting our conclusion that the Manual is largely consistent with the purpose in s 150A of the Act, we consider that further disclosure of the following matters would better promote the purpose:
 - 37.1 the publication of the list of all products that constitute 'Generic product specifications' in the Manual would greatly assist clarity of what is a standard product offering;

¹⁶ Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2020/21 season" (2020), page 4.

¹⁷ Commerce Commission "Review of Fonterra's 2019/20 Milk Price Manual: Dairy Industry Restructuring Act 2001 Final report" (12 December 2019), paragraph 80.

¹⁸ Commerce Commission "Review of Fonterra's 2019/20 Milk Price Manual: Dairy Industry Restructuring Act 2001 Final report" (12 December 2019), paragraph X10.

¹⁹ Commerce Commission "Review of Fonterra's 2019/20 base milk price calculation: Dairy Industry Restructuring Act 2001 Final report" (15 September 2020), paragraph 2.59.

- 37.2 the conditions that apply to sales that are not considered to be transacted on freely contestable markets should be specified in more detail in Principle 2 of the Manual to clarify how this principle is to be applied; and
- 37.3 the term 'prevailing' is used in a number of rules in the Manual. We consider that defining the term 'prevailing' would provide greater clarity in respect of the inputs required to be used by these rules.

Fonterra's amendments to the 2020/21 Manual

38. Fonterra has made amendments to the 2020/21 Manual to assign explicit responsibility for various independent reviews to the MPG. The specific rules affected are set out in Fonterra's Reasons Paper:²⁰
- 38.1 Rule 23 has been amended to provide that in exceptional circumstances when a Within-Period Review may be initiated, the outcomes of the Within-Period Review will apply, where warranted by circumstances, to the year in which the review is undertaken.
- 38.2 Rule 42 has been amended to require that, when calculating the Asset Beta, the MPG will also have regard to any requirements under the Act.

Assigning responsibility for reviews to the Milk Price Group

39. Our draft conclusion is that we consider the change to assign responsibility for various reviews from the Independent Reviewer to the MPG does not detract from the consistency of the Manual with the s 150A purpose.
40. The definition of "independent reviewer" previously in the Manual was "a valuer or other expert appointed to perform a review or function with respect to the Manual." The Manual did not contain any specific independence requirements.
41. Fonterra has explained that the introduction of an independent review was a temporary measure, designed to ensure that key inputs were provided by or reviewed by parties independent of Fonterra when the responsibilities initially carried out by the MPG were transferred to Fonterra management. Fonterra also

²⁰ Fonterra "'Reasons' Paper in Support of Fonterra's Milk Price Manual for the 2020/21 Season", found [here](#).

explains that that transfer of responsibilities has not eventuated, so the additional layer of independence is not required.²¹

42. The governance structure around the milk price is set out in Fonterra’s 2020 Farmgate Milk Price Statement.²² The key features of the governance structure include a statutory committee known as the MPP whose terms of reference must include the following functions:
 - 42.1 supervise the calculation of the base milk price;
 - 42.2 advise Fonterra as necessary on the application of the milk price manual;
 - 42.3 recommend to Fonterra the base milk price; and
 - 42.4 make recommendations to Fonterra in respect of the milk price manual, including a recommendation that it should be amended and a recommendation that a proposed amendment should not be made.²³
43. Section 150E(2) of the Act requires that at all times the Chair and a majority of members (including the Chair) of the MPP must be independent.
44. Fonterra’s Farmgate Milk Price Statement explains that the MPP oversees the governance of the Farmgate Milk Price and the Manual, including changes to the Manual and verification by independent external experts of key parameters (such as resource usage rates, product yields and fixed manufacturing costs).
45. The governance structure also includes the MPG, which is a working group established by Fonterra. The Head of the MPG is independent of Fonterra’s management and reports directly to the Chair of the MPP. The role of the MPG includes:²⁴

²¹ Fonterra, ‘Reasons’ Paper in Support of Fonterra’s Milk Price Manual for the 2020/21 Season Public Version 1 August 2020, page 2.

²² This can be downloaded from <https://www.fonterra.com/nz/en/investors/farmgate-milk-prices/milk-price-methodology.html>

²³ Sections 150D(3) and (4) of the Act

²⁴ Fonterra “Farmgate Milk Price Statement – for the season ended 31 May 2020”, page 11. Found [here](#).

- 45.1 ensuring that the base milk price is calculated in accordance with the Manual and making recommendations in respect of the Farmgate Milk Price to the MPP;
 - 45.2 considering any proposed amendments to the Manual, including those the MPG itself considers are appropriate, and ensuring they are in accordance with the Milk Price Principles in Fonterra's Constitution;
 - 45.3 providing assurance to the Fonterra Board over the calculation of the forecast of the base milk price; and
 - 45.4 managing engagement with external reviewers.
46. The functions of the MPG are contracted out to EY and other technical experts who are not employees of Fonterra.
47. The Manual requires that "In order to enhance the independence of the MPG, the MPG Head will report to the Panel in relation to all matters, including matters relating to, or arising from, the administration, operation and application of the Manual and the performance of the MPG Head and the MPG, and to the MPG Head's appointment."
48. Fonterra also explained that the independence of the MPG is further assured by a requirement imposed by the MPP that the core members of the MPG team are prohibited from investing both in Fonterra (and other NZ dairy processors) and in dairy farms.²⁵
49. The relationship between the milk price governance structure and the Manual and base milk price is explained in Fonterra's Reasons Paper supporting the 2019/20 base milk price calculation:

As noted above, we interpret the term 'process' in section 150T to cover both the processes used by Fonterra to generate and aggregate the various inputs into the base milk price, and the processes and controls implemented by Fonterra to ensure individual inputs and the overall milk price accurately reflect the underlying data and rules. In addition, Fonterra has put in place a number of mechanisms

²⁵ 'Reasons' Paper in Support of Fonterra's Milk Price Manual for the 2020/21 Season Public Version 1 August 2020, page 2.

to provide assurance that the Milk Price is consistent with the Milk Price Principles set out in both the Milk Price Manual and in Fonterra's constitution.²⁶

50. These assurance mechanisms comprise the Fonterra Board, the MPP, the MPG, external audit, internal audit and the Milk Price Steering Committee, which provides Fonterra management input to the work of the MPG.
51. Given the degree of independence that exists between Fonterra and the MPP and MPG, we do not consider that the absence of any additional independence provided by the independent reviews detracts from the s 150A purpose. The verification of the input of external reviewers will continue to be overseen by the MPP.
52. Therefore, we do not consider the change significantly alters the quality of assurance processes associated with the inputs to the base milk price calculation and its consistency with the rules and principles set out in the Manual.

Within-Period Reviews

53. Our draft conclusion is that we do not consider the introduction of the requirement to apply the outcome of a Within-Period Review to the year in which the review is undertaken is consistent with the efficiency dimension of the s150A purpose.
54. The Within-Period Review is only able to be conducted under exceptional circumstances, which are set out in Rule 23.²⁷
55. In its reasons paper Fonterra explains that the intent of the amendments is threefold:²⁸
 - 55.1 To assign to the MPG responsibility for undertaking Within Period Reviews, for the reasons discussed in the "Independent review provisions" section above.
 - 55.2 To clarify, where necessary, the outcome of a review to be implemented in the year in which the review was undertaken, rather in the following year.

²⁶ Fonterra "Reasons' Paper in Support of Fonterra's Base Milk Price for the 2019/20 Season – Public Version" (1 July 2020), page 5.

²⁷ Fonterra "Farmgate Milk Price Manual" (1 August 2020), page 46.

²⁸ Fonterra "Reasons' Paper in Support of Fonterra's Base Milk Price for the 2019/20 Season – Public Version" (1 July 2020)

The necessity of this amendment became apparent in the context of the 2019 review of overhead costs, where it became evident that it was necessary to implement a portion of the review's outcome immediately, in the 2018/19 season, rather than as scheduled in the 2019/20 season, to ensure the practical feasibility of the provision for overhead costs for the 2018/19 season.

- 55.3 To extend the ability to undertake a Within Period Review with respect to all inputs established on a four-yearly basis, rather than just cost inputs. (Other inputs established on a four yearly basis include, for example, resource usages and certain capital inputs.)
56. The first of these reasons is dealt with in our conclusion on assigning responsibility for independent reviews to the MPG above.
57. We consider the change in respect of the third bulleted reason reflects the fact that costs may only be one of a number of relevant inputs and is consistent with the "notional costs, revenues, or other assumptions" language of the s 150A purpose.
58. In respect of the second change, we consider that earlier revision of an input where the input is no longer considered to be practically feasible for an efficient notional processor is consistent with the contestability leg of the s 150A purpose. In applying Rule 23 to initiate a Within-period review we would expect that Fonterra would compare the value of existing inputs with the value of inputs faced by an efficient notional processor.
59. However, we consider this change could give rise to the potential replacement of benchmark notional inputs, with current actual inputs in the year of review, thereby removing an incentive for Fonterra to beat those inputs in the year of review.
60. We therefore consider that this change is not consistent with the efficiency leg of the s 150A purpose.
61. We observe, however, that the efficiency incentive impact of a review year change in an input or assumption may have less weight where the 'exceptional circumstances' trigger for the Within-period review is exercised in circumstances that are truly exceptional. As the term 'exceptional circumstances' is not defined, there may be a wide range of circumstances in which a Within-period Review can be triggered.
62. After a Within-period Review is triggered, the wording that prescribes when the outcomes of a Within-Period Review may be applied in the year in which the review is undertaken ("where warranted by circumstances") is overly discretionary and

vague, and Fonterra should consider amending the wording to provide greater certainty and objectivity.

Asset beta

63. Fonterra has made an amendment to Rule 42, that requires that in calculating the asset beta the MPG will have regard to any relevant requirements under the Act.
64. We note that Fonterra must comply with the requirements of the Act (including any amendments made to the Act, once they come into force) irrespective of the contents of the Manual. For this reason, we do not consider that this change is relevant to our assessment of consistency with s 150A.
65. We will carry out a review of the asset beta calculation in our 2020/21 base milk price calculation review.

Table 2.1: Receivables risk

66. Fonterra has made an amendment to the receivables risk principle in Table 2.1 of the Manual. This amendment provides that actual bad or doubtful debts should generally not affect the Farmgate Milk Price. This amendment is not included in Fonterra's list of substantive amendments.
67. In its Reasons Paper Fonterra has explained that this amendment is intended to avoid the inference that the Milk Price calculation should not include any allowance for bad debts, or that it is appropriate in all circumstances to provide a notional ex ante allowance. It also better aligns the table to the approach actually taken to bad debts in the Milk Price calculation.
68. Fonterra further explained that the practice since the introduction of the Farmgate Milk Price has been to set a notional allowance (under Rule 18) to provide for an 'in the normal course of business' allowance for bad debts based on historic patterns. There has been one instance in the past 10 years in which Fonterra incurred a significant bad debt in circumstances which could reasonably be expected to be faced by an efficient processor, and where the MPG concluded the appropriate solution was to provide an additional ex post allowance under Rule 19, Non-recurring costs.
69. We consider the clarification of this rule better describes the assumptions and inputs used in calculating the base milk price. The general use of a notional ex ante allowance is consistent with the efficiency leg of the s150A purpose. As the allowance is based on historical patterns, we also consider it is practically feasible.

Attachment A Outstanding amendments proposed earlier to Fonterra

- A1 This Attachment provides a summary of the amendments that we have proposed to Fonterra through both the Manual and calculation reviews, which have not been adopted. We have updated the recommendations relating to the Manual that were raised during the base milk price calculation review 2019/20. We consider this to be a valuable summary for all interested parties.
- A2 We consider that these outstanding amendments would:
- A2.1 better promote the purpose of the Act; and
 - A2.2 provide greater confidence to interested parties through additional transparency.
- A3 Table A1 outlines these outstanding Manual amendments, Fonterra's reasons and our brief comments.

Table A1 Summary of amendments proposed earlier to Fonterra

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion ²⁹	Conclusion in this review
Part A, Section 2.6	Fonterra considers that a 'bright line' materiality threshold is likely to lead to less disclosure. ³⁰	Materiality	2016/17 Manual review	The Manual does not define a 'material change' when considering a change to the Manual and the timeframe for making such a change. Disclosure if what constitutes a 'material change' will provide greater transparency.	No change to our previous position.
Part B, Rule 26	Fonterra does not consider the Manual is the appropriate vehicle for these disclosures. Fonterra states that they put this information into the public domain in our base milk price calculation reasons papers. ³¹	Capacity of standard plants	2016/17 Manual review	We recommend Fonterra considers disclosing its plant capacity for both primary and secondary plants early in each season to provide certainty of the notional processors' assumed capacity for the related season. We consider this would improve the ability of interested parties to assess the practical feasibility of the assumed production volumes.	No change to our previous position. We consider that the plant capacity disclosure should be made earlier in the season than in the base milk price calculation reasons paper. We consider that the disclosure of plant capacity in the Milk Price Calculation reasons paper is too late to enable interested parties to assess the practical feasibility of the assumed production volumes.

²⁹ Previous conclusions in these areas from prior reviews. These reports can be found at <https://comcom.govt.nz/regulated-industries/dairy/milk-price-manual-and-calculation>

³⁰ Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2020/21 season" (2020), page 4.

³¹ Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2020/21 season" (2020), page 4.

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion ²⁹	Conclusion in this review
N/A	Fonterra does not consider the Manual is the appropriate vehicle for these disclosures. Fonterra states that they routinely disclose the information suggested by the Commission with respect to both the prior season average FX conversion rate and the forecast rate for the current season in the Milk Price Statement, released each September. ³²	Actual FX rates assumed	2016/17 Manual review	We suggest there should be more transparency of information on the actual FXD rates assumed to be achieved by the notional processor.	We accept that the Manual is not the appropriate vehicle for disclosing assumed FX rates since they are assumptions that will change each season, whereas the Manual contains the overall rules that gives effect to the milk price principles. However, we continue to encourage greater transparency by disclosing in the <i>quarterly</i> milk price statements, not just each September.

³² Fonterra "Fonterra's Reasons Paper in support of Milk Price Manual for the 2020/21 season" (2020), page 4.

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion ²⁹	Conclusion in this review
N/A	The application of this rule forms part of the process that filters off-GDT sales. Not specifically addressed in 2019/2020 base milk price calculation	Standard Product Offering	2019/2020 Manual review	We suggest there should be a clearer specification in the Manual of what is a 'Standard Product Offering' (SPO).	We consider the publication of the list of all products that constitute 'Generic product specifications' in the Manual would greatly assist clarity of what is a standard product offering.
N/A	The application of this rule forms part of the process that filters off-GDT sales. Fonterra provided further explanation in the 2019/2020 base milk price calculation.	Tender and Formulaic sales	2019/2020 Manual review	Consistent with our 2016/17 review, we do not consider that there are strong arguments as to why tender sales should inform milk price revenues. We consider that tender sales do not meet the "globally contested markets" requirement in the Act, to be considered a commodity.	Given that the circumstances of tender sales may change, we consider the conditions that apply to sales that are not considered to be transacted on freely contestable markets should be specified in more detail in Principle 2 of the Manual to clarify how this principle is to be applied.

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion ²⁹	Conclusion in this review
N/A	The application of this rule forms part of the process that filters off-GDT sales. Fonterra provided further explanation in the 2019/2020 base milk price calculation.	Sales not transacted on freely contestable markets	2019/2020 Manual review	We suggest further clarifications regarding conditions applying to sales not transacted on freely contestable markets	We consider the conditions that apply to sales that are not considered to be transacted on freely contestable markets should be specified in more detail in Principle 2 of the Manual to clarify how this principle is to be applied.

Manual reference	Detail	Category	First raised by the Commission	Previous Commission conclusion ²⁹	Conclusion in this review
N/A	The application of this rule forms part of the process that filters off-GDT sales. Fonterra provided further explanation in the 2019/2020 base milk price calculation.	Prevailing prices	2019/2020 Manual review	We consider Fonterra's explanation of 'prevailing prices' is clear, that "prevailing prices" means the relevant market spot price for the product unless it is outside policy, is a formulaic sale or a long-term sale agreement. We do not read Fonterra's reference to a target margin to mean a margin above the market spot price. We do not agree that a prevailing price benchmark should be limited to GDT standard specification products. We consider there may be good reasons why higher prices may be achievable off-GDT.	The term 'prevailing' is used in a number of rules in the Manual. We consider that defining this term would provide greater clarity in respect of the inputs required to be used by these rules.

Attachment B Glossary

Term/Abbreviation	Definition
AMF	Anhydrous milk fat
The Act	Dairy Industry Restructuring Act 2001
Base milk price	Farm gate milk price expressed per kilogram of milk solids
Calculation review	Review of Fonterra's base milk price calculation for the prior season
Dairy season	1 June to 31 May annually
FX	Foreign exchange
GDT	GlobalDairyTrade, Fonterra's online auction platform used to sell commodity products
kgMS	Kilogram of milk solids
Manual review	Review of Fonterra's Milk Price Manual for the current season
MPG	Milk Price Group
Milk Price Manual or the Manual	Fonterra's Milk Price Manual
MPP	Milk Price Panel
Notional processor	The notional commodity business that is used to calculate the base milk price (in its Reasons paper Fonterra uses the term notional producer).
QRS	Qualifying Reference Sale
QOS	Qualifying Outlier Sale
RCP	Reference Commodity Product
R&M	Repairs and maintenance
Reasons paper	Fonterra's Reasons paper which is provided alongside the Manual for each dairy season (this is also provided when Fonterra discloses its base milk price calculation at the end of each dairy season)
SMP	Skim milk powder
WMP	Whole milk powder