

Farmgate Milk Price Statement

FOR THE SEASON ENDED 31 MAY 2021

**Good
Together**
from one generation
to the next





IMAGE:
Dave, Darryl & Gareth, Taranaki

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COVER IMAGE:
Dave & Gareth, Taranaki

2021 Season Farmgate Milk Price

The primary purpose of this Statement is to help Fonterra farmer shareholders, unitholders in the Fonterra Shareholders' Fund and other interested parties better understand the Farmgate Milk Price.

The Farmgate Milk Price is the average price paid by Fonterra for each kilogram of milk solids (kgMS) supplied by Fonterra's farmer shareholders under Fonterra's standard terms of supply¹. It is calculated in accordance with the Farmgate Milk Price Manual. The Manual is maintained by the Fonterra Board in accordance with the Dairy Industry Restructuring Act (DIRA) and the Fonterra Constitution.

The 2021 season Farmgate Milk Price of **\$7.54** per kgMS is:

- The Aggregate Farmgate Milk Price of **\$11.611** billion; *divided by*
- New Zealand milk supplied to Fonterra in the 2021 season of **1.539** billion kgMS.

The Aggregate Farmgate Milk Price is calculated as revenue less costs. Revenue assumes:

- The entire volume of milk collected is processed into commodity specifications of the five Reference Commodity Products (RCPs) which are Whole Milk Powder (WMP) and Skim Milk Powder (SMP), and their by-products Butter, Anhydrous Milk Fat (AMF) and Buttermilk Powder (BMP).²
- The RCPs are sold in USD on and off GDT.
- USD sales revenue is converted into NZD at exchange rates achieved by Fonterra.

Costs comprise:

- **Cash Costs:** costs of collecting raw milk, efficiently manufacturing the five RCPs, delivering finished product to New Zealand export ports, and selling and administration expenses.
- **Capital Costs:** depreciation of fixed assets, an appropriate return on investment including on working capital, and corporate tax.
- **Additional Commodity Milk Payments and Standard Supply Adjustments³:** adjustments for milk quality issues and additional payments or deductions for milk not supplied on standard terms, to the extent these would apply to the Farmgate Milk Price business.

Numbers in this Statement have been rounded and, as a result, some tables may not exactly total or sum to 100%.

2021 Season Farmgate Milk Price

\$7.54 per kgMS

Changes in revenue drive most of the movements in the Farmgate Milk Price between seasons. Figure 1 shows this.

Figure 1: Changes in the Farmgate Milk Price between seasons

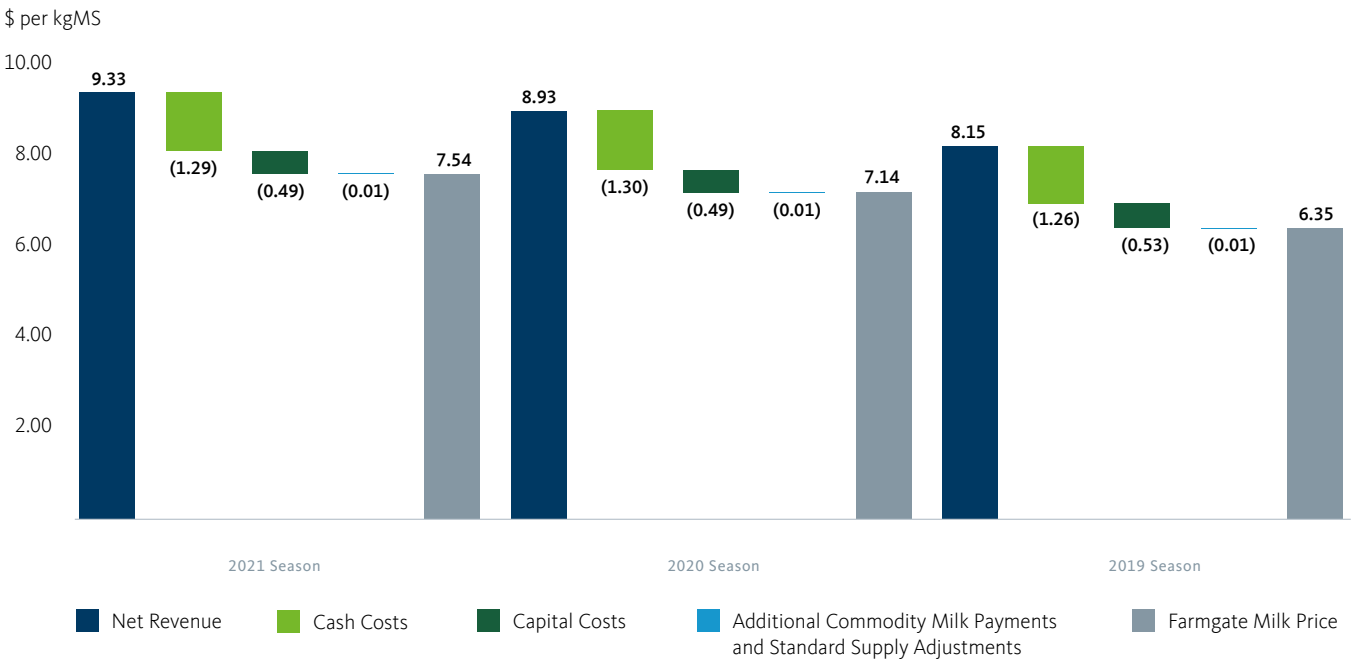


Table 1 shows the summary Farmgate Milk Price calculation for the last three seasons.

Table 1: Farmgate Milk Price Summary

SEASON	2021 \$ MILLION	2020 \$ MILLION	2019 \$ MILLION
Farmgate Milk Price Revenue	15,014	14,061	12,831
Lactose	(648)	(508)	(423)
Net Revenue	14,366	13,553	12,408
Farmgate Milk Price Cash Costs	(1,986)	(1,968)	(1,915)
Farmgate Milk Price Capital Costs	(754)	(746)	(803)
Additional Commodity Milk Payments and Standard Supply Adjustments	(15)	(11)	(14)
Aggregate Farmgate Milk Price	11,611	10,829	9,676
Million kgMS	1,539	1,517	1,523
Farmgate Milk Price calculated under the Manual (\$ per kgMS)	7.54	7.14	6.35

The following sections provide more detail on revenue, costs and drivers of change between seasons.

1 This price may differ from the “farm gate milk price” published in accordance with the Dairy Industry Restructuring (Raw Milk) Regulations 2012 due to the way “farm gate milk price” is defined in those Regulations and the impact of Fonterra’s fixed milk price offers.

2 Almost all the increase in milk supplied over the past decade in New Zealand to Fonterra and its competitors has been used to manufacture milk powders. As returns from the sale of milk powders and their by-products represent the marginal returns that would drive the price of milk in a competitive market in New Zealand, the Farmgate Milk Price is based on these products.

3 Additional Commodity Milk Payments are payments for milk supplied other than on standard terms of supply where it would be appropriate for the Notional Milk Price Business to source that milk for conversion into RCPs. Examples of these payments include the portion of Winter Milk premiums that would be payable by the Notional Milk Price Business and discounts for contract milk. Standard Supply Adjustments arise from adjustments to payments for milk supplied under Fonterra’s standard terms of supply, such as where milk quality demerits have been applied.

Farmgate Milk Price Revenue

Farmgate Milk Price Revenue uses a combination of actual Fonterra results and key assumptions:

- 1.539 billion kgMS of milk actually supplied to Fonterra during the 2021 season.
- All milk supplied is converted into the five RCPs based on Fonterra’s actual mix of those products.
- Sales volumes are assumed to reflect Fonterra’s actual shipments of RCPs.
- Selling prices reflect relevant prices achieved by Fonterra for RCPs on and off GDT.

Milk Supply, Production and Sales Volumes

Figure 2 shows the relationship between:

- Milk collected during a season (the light blue line). This shows very little milk is supplied in June and July and that supply peaks in late October / early November.
- Volume of products manufactured from that milk (the dark blue line).
- When that product is sold (the green line). There is typically a lag of between one to three months between when milk is collected and manufactured into RCPs and when those RCPs are sold.

Sales of product manufactured in a season do not normally start until August and are normally complete by October of the following year.

Revenue is recognised when sales are invoiced, which is at the time of shipment. Sales prices are always struck before the month of shipment. Figure 3 shows the average lag between when prices are struck and when products are shipped. This lag matches Fonterra’s actual average lag for relevant sales.

Figure 2: Timing of Supply, Production and Sales Volumes

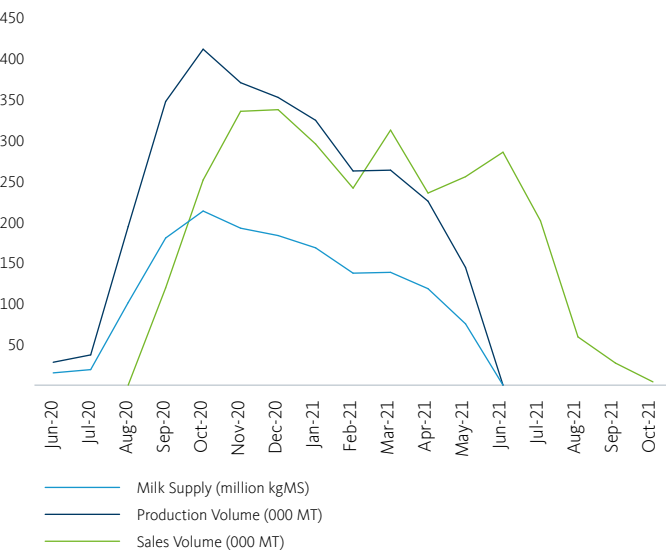
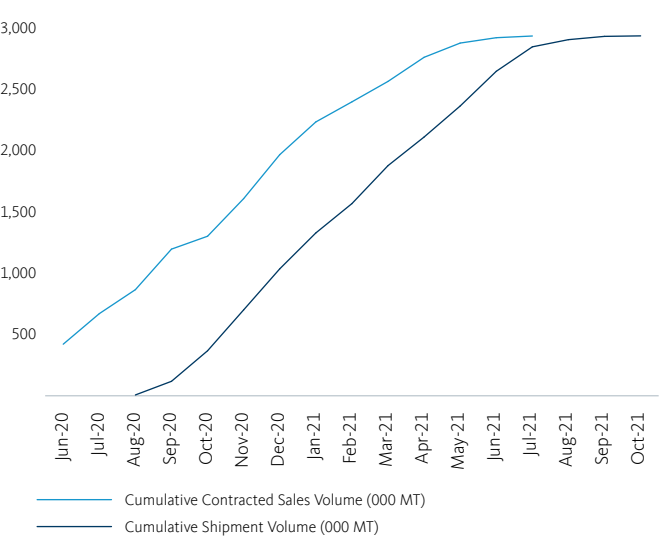


Figure 3: Average Lag between when prices were Struck and Shipment



Prices

The Farmgate Milk Price uses weighted average monthly prices achieved by Fonterra on relevant sales of RCPs on and off GDT.

The Manual outlines the criteria which Fonterra’s sales must meet to inform the Farmgate Milk Price which include:

- Only arm’s length sales at current market prices to customers in freely contestable global markets can be included. Sales to Fonterra subsidiaries are excluded.
- Only sales contracted by Fonterra between one and five months before shipment are included.
- Off GDT sales are only included when they are of commodity products with similar specifications to products sold on GDT.

Between the 2012 and 2016 seasons, GDT was the sole source of prices for WMP, SMP and AMF whereas both on and off GDT prices were used for Butter and BMP. Since the 2017 season, certain off GDT sales of all RCPs inform the Farmgate Milk Price. In the 2021 season, the inclusion of these off GDT sales of WMP, SMP and AMF in the Farmgate Milk Price resulted in an increase of 10 cents per kgMS relative to not including these off GDT sales.

Table 2 shows weighted average selling prices for each RCP for the last three seasons. It shows that weighted average USD selling prices per metric tonne (MT) were 5.7% higher for the 2021 season than last season.

Impact of NZD/USD Foreign Exchange Rate Movements

As RCPs are sold in USD, Fonterra enters into foreign exchange hedge contracts to reduce volatility and exposure to movements in NZD/USD rates, thereby providing a degree of certainty over the resulting NZD revenue. The average rates Fonterra achieves through its hedging programme are used to convert Farmgate Milk Price USD receipts to NZD.⁴

Fonterra’s hedging programme resulted in an average NZD/USD conversion rate for the 2021 season of 0.6677, against an average spot rate of 0.7067. Table 3 shows this across the last three seasons.

Lactose

Lactose is contained in the raw milk supplied and used as an ingredient in the production of WMP, SMP and BMP. The Farmgate Milk Price has further lactose requirements to achieve a standard product composition in line with internationally recognised standards.

The Farmgate Milk Price assumes this further lactose is purchased on global markets. Lactose is shown in Table 1 as a deduction from Farmgate Milk Price Revenue.

Table 4 shows volume and average purchase prices of lactose over the past three seasons.

Table 2: Weighted Average USD Contract Price⁵

WEIGHTED AVERAGE PRICE (USD) PER MT	2021	2020	2019	2021/2020 % CHANGE	2020/2019 % CHANGE
WMP	3,323	3,110	2,907	6.9%	7.0%
SMP	3,012	2,755	2,216	9.3%	24.3%
Butter	4,117	4,140	4,448	(0.6)%	(6.9)%
AMF	4,792	4,891	5,540	(2.0)%	(11.7)%
BMP	3,194	2,833	3,032	12.8%	(6.6)%
				5.7%	5.7%

Table 3: Impact on the Farmgate Milk Price of Fonterra’s Hedging, Relative to Not Hedging

SEASON	2021	2020	2019
Average Hedged Rate (NZD/USD)	0.6677	0.6638	0.6905
Average Spot Rate (NZD/USD)	0.7067	0.6375	0.6697
Impact on Milk Price of hedging, relative to not hedging (\$ per kgMS)	0.53	(0.38)	(0.26)

Table 4: Purchased Lactose and Price

SEASON	2021	2020	2019	2021/2020 % CHANGE	2020/2019 % CHANGE
Purchased Lactose (000 MT)	369	361	348	2.1%	3.7%
Average Price (USD per MT)	1,154	946	851	21.9%	11.2%
Total Lactose Purchases (USD m)	425	342	296	24.4%	15.3%

⁴ Fonterra’s hedging policies are outlined in Fonterra’s Financial Statements for the year ended 31 July 2021.

⁵ Average shipment prices include an allowance for lower prices received for downgrade product. These are products that do not meet standard manufacturing specifications, some of which may only be suitable for stock feed.

Farmgate Milk Price Cash Costs

Farmgate Milk Price Cash Costs reflect:

- Fonterra’s actual collection costs, and supply chain costs determined by reference to Fonterra’s actual costs.
- Costs of operating modern plants capable of processing the same volume of milk Fonterra collects, but only manufacturing the five RCPs. These assume plant operating parameters consistent with manufacturers’ specifications, Fonterra’s per unit costs, and include the full range of overhead costs associated with running these plants.
- Overhead and selling costs that would be incurred by a business selling the five RCPs from New Zealand. These are determined by reference to Fonterra’s actual costs for undertaking those activities.

Figure 4 and Table 5 summarise the major categories of cash costs and movements between the 2020 and 2021 Seasons.⁶

Figure 4: Sources of Movements in Average Cash Costs

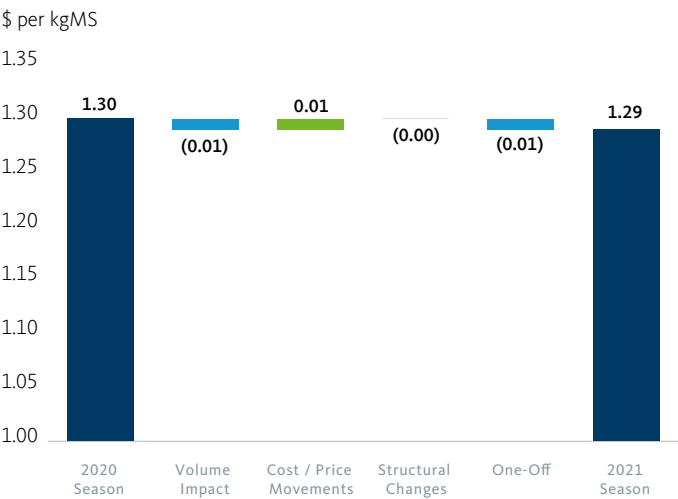


Table 5: Summary of Movements in Cash Costs

\$ MILLION	2020	VOLUME	COST/PRICE	STRUCTURAL	ONE-OFF	2021	% CHANGE COST/PRICE	TOTAL % CHANGE
Sales costs	130	0	2	–	–	132	1.2%	1.5%
Variable manufacturing and supply chain costs	705	1	16	(4)	–	718	2.2%	1.7%
Fixed manufacturing (including repairs and maintenance)/site overheads and supply chain costs	424	–	9	–	–	433	2.1%	2.1%
Collection costs	367	4	(12)	–	–	359	(3.2)%	(2.1)%
Other costs	342	8	4	–	(9)	344	1.1%	0.6%
Total cash costs	1,968	13	18	(4)	(9)	1,986	0.9%	0.9%
% movement		0.7%	0.9%	(0.2)%	(0.5)%			

Movements between the 2020 and 2021 season were due to:

- \$13m of volume-related costs due to an increase in milk collected to 1.539 billion kgMS from 1.517 billion kgMS.
- Increases in the cost of inputs primarily due to the impacts of inflation and foreign exchange.
- Structural changes in the 2021 arising from the adoption of Fonterra’s average actual carbon credit cost compared to the use of benchmark data in previous years.
- One-off costs were \$9m lower in the 2021 season than in the prior season, with the only material item in this category relating to COVID-19 related savings.

6 Average cash costs for 2020 have been restated from \$1.29 per kgMS in Figure 4 of the 2020 Farmgate Milk Price Statement.

Farmgate Milk Price Capital Costs

Farmgate Milk Price Capital Costs provide for:

- Depreciation of manufacturing and other assets.
- A return at a benchmark Weighted Average Cost of Capital (WACC) on the book value of those assets.
- A WACC return on net working capital balances from the sale and manufacture of the RCPs and on the phasing of milk payments to suppliers.
- Corporate income tax.

The Milk Price business manufactures RCPs in modern plants with current industry-standard technology. These plants have manufacturing capacity that approximates the average of Fonterra’s RCP plants. The average daily processing capacity of the standard WMP and SMP plants installed prior to the 2013 season is approximately 1.9 million litres. Incremental and replacement WMP and SMP plants incorporated in the asset base since 2013 have an average daily processing capacity of approximately 2.5 million litres, equivalent to plants installed by Fonterra at Darfield in 2011 and Pahiatua in 2015. The Milk Price business ensures there is always sufficient capacity to process all milk collected by Fonterra and it does so by maintaining or adding incremental plants where necessary.

Table 6 shows capital costs and total book value of the Milk Price business fixed asset base and average net working capital for the last three seasons.

The WACC has been declining since 2012. This is primarily because it incorporates a rolling five-year average of the five-year New Zealand Government bond rates, which have declined from an average of 5% over the five-year period to June 2012 to 2% over the five-year period to June 2021. An amendment to DIRA passed into law in July 2020 mandates a change to the methodology used to determine the asset beta, a key input into the WACC, for the F22 season. Fonterra has determined the revised DIRA methodology will be applied to the F21 season WACC, and in consequence has increased the asset beta from 0.38 to 0.45 and has also reduced the specific risk premium in the cost of equity from 0.22% to nil, which has the effect of reducing the WACC by 0.15 percentage points on average. The net impact of these changes is a WACC of 4.9%, compared to a WACC of 4.6% if the asset beta and specific risk premium remained unchanged from their previous values. The WACC will be 4.8% for the F22 season, reflecting a further reduction in the rolling five-year average risk-free rate, partially offset by an increase in the Post Tax Market Risk Premium from 7.0% to 7.5%.

For the 2021 season the lower WACC, in isolation, resulted in:

- A decrease of \$6 million in the capital charge on fixed assets.
- A decrease of \$0.5 million in the capital charge on net working capital.
- A decrease of \$3 million in the provision for corporate tax.
- Higher depreciation of \$2 million.

Changes in the average age of the asset base do not result in material season on season movements in the capital charge. This is because the capital charge is calculated so that growth each season is approximately in line with capital goods inflation as long as the WACC does not change. This methodology means that a decrease in the WACC will, other things being equal, result in an increase in depreciation.

Table 6: Capital Costs, Book Value of Fixed Asset Base and Average Net Working Capital

NZD \$ MILLION	2021	2020	2019
WACC % (post-tax)	4.90%	5.00%	5.30%
Depreciation	278	269	260
WACC Charge – Fixed Assets	316	330	358
WACC Charge – Net Working Capital	43	31	47
Tax	117	116	138
Total Capital Costs	754	746	803
Total Fixed Assets (Book Value)	6,532	6,684	6,832
Average Net Working Capital	622	635	791

Appendix 1: Independent
Reasonable Assurance Report
TO THE DIRECTORS OF FONTERRA CO-OPERATIVE GROUP LIMITED



Opinion

Our reasonable assurance opinion has been formed on the basis of the matters outlined in this report.

In our opinion, the Farmgate Milk Price has been calculated, in all material respects, in accordance with the Farmgate Milk Price Manual for the season ended 31 May 2021.

In our opinion, the information presented in the Farmgate Milk Price Statement is materially consistent with the data in the calculation of the Farmgate Milk Price.

Information subject to assurance

We have performed an engagement to provide reasonable assurance in relation to the Fonterra Co-operative Group Limited (Fonterra) Farmgate Milk Price and Farmgate Milk Price Statement for the season ended 31 May 2021.

Criteria

The Farmgate Milk Price Calculation and the Farmgate Milk Price Statement are assessed against the requirements of the Farmgate Milk Price Manual for the season ended 31 May 2021, dated 1 August 2020.

Key Assurance Matters

Key assurance matters are those matters that, in our professional judgement, were of most significance in our reasonable assurance engagement in relation to the Farmgate Milk Price and the Farmgate Milk Price Statement for the season ended 31 May 2021. We summarise below those matters and our key procedures to address those matters in order that the Directors may better understand the process by which we arrived at our opinion. Our procedures were undertaken in the context of and solely for the purposes of our opinion on the Farmgate Milk Price and the Farmgate Milk Price Statement as a whole and we do not express discrete opinions on separate elements of the Farmgate Milk Price and the Farmgate Milk Price Statement.

Net Sales

We consider the calculation of Net Sales to be a key assurance matter due to the nature and detail of the policies and judgements included in the Principles and Rules of the Farmgate Milk Price Manual. In respect of Net Sales there is complexity relating to (a) determining and calculating Benchmark Selling Prices from underlying Fonterra sales data, that are applied to notionally derived Referenced Commodity Product volumes and (b) the judgement in determining the phasing of sales volumes relating to actual Fonterra collections.

The procedures we performed to evaluate Net Sales included:

- examining the processes, judgements and models used to extract sales data from underlying Fonterra systems, considering whether there is manipulation of the transactional price and quantity data that forms the basis of the statutory financial statements of the Co-operative. We also examined the bespoke IT program that extracts the data;
- evaluating these assumptions and judgements used in the models that calculate Net Sales. This involved challenging management and the Milk Price Group regarding the basis for each assumption; and
- assessing whether the requirements of the Fonterra Farmgate Milk Price Manual had been correctly applied in the models used to calculate Net Sales.

We did not identify any instances where the models and the judgements and assumptions therein, used to calculate Net Sales were inconsistent with the requirements of the Farmgate Milk Price Manual.

Capital Charge

The Farmgate Milk Price Manual requires that the Milk Price Group (MPG) calculate asset beta having regard to the requirements of the Farmgate Milk Price Manual and DIRA (in light of the recent changes to DIRA legislation).

We consider the calculation of the WACC, used to calculate the capital charge and depreciation, to be a key assurance matter. This is due to the complexity and judgement employed by the MPG in determining the asset beta and specific risk premium included in the WACC calculation.

The procedures we performed to evaluate Overheads included:

- understanding the requirements set out in the Farmgate Milk Price Manual regarding the timing, frequency and elements to be considered in the asset beta and specific risk premium.
- examining the process and judgements used by the MPG to update the asset beta and specific risk premium included in the updated WACC. This included using our Corporate Finance Specialists.
- examining the capital models used by the MPG to apply the WACC in calculating the depreciation and capital charge.

Applying the requirements of the Farmgate Milk Price Manual can give rise to a range of possible outcomes for the WACC – we did not identify any instances where the models and the judgements and assumptions therein, used to calculate depreciation and capital charge, were inconsistent with the requirements of the Farmgate Milk Price Manual. We consider the WACC could be in the range of 4.9% to 5.6% (which amounts to approximately 3 cents/kgMS).

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Standards we followed

We conducted our reasonable assurance engagement in accordance with International Standard on Assurance Engagements (New Zealand) 3000 (Revised) Assurance Engagements other than audits or reviews of historical financial information and Standard on Assurance Engagements SAE 3100 (Revised) Assurance Engagements on Compliance. We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion. In accordance with those standards we have:

- used our professional judgement to assess the risk of material misstatement and plan and perform the engagement to obtain reasonable assurance that the Farmgate Milk Price and Farmgate Milk Price Statement are free from material misstatement, whether due to fraud or error;
- considered relevant internal controls when designing our assurance procedures, however we do not express an opinion on the effectiveness of these controls; and
- ensured that the engagement team possesses the appropriate knowledge, skills and professional competencies.

How to interpret reasonable assurance and material misstatement

Reasonable assurance is a high level of assurance, but is not a guarantee that it will always detect a material misstatement when it exists.

Misstatements, including omissions, within the Farmgate Milk Price and Farmgate Milk Price Statement are considered material if, individually or in aggregate, they could reasonably be expected to influence the relevant decisions of the intended users taken on the basis of the Farmgate Milk Price and Farmgate Milk Price Statement.

Use of this assurance Report

Our report should not be regarded as suitable to be used or relied on by any parties other than the Directors for any purpose or in any context. Any party other than the Directors who obtains access to our report or a copy thereof and chooses to rely on our report (or any part thereof) will do so at its own risk.

To the fullest extent permitted by law, we accept or assume no responsibility and deny any liability to any party other than the Milk Price Panel and Directors of Fonterra for our work, for this independent reasonable assurance report, or for the opinions we have reached.

Our report is released to Fonterra Co-operative Group Limited on the basis that it shall not be copied, referred to or disclosed, in whole (save for Fonterra's own internal purposes or in the Farmgate Milk Price Statement) or in part, without our prior written consent.

Milk Price Group’s responsibility for the Farmgate Milk Price and Farmgate Milk Price Statement

The Milk Price Group of Fonterra are responsible for the preparation and fair presentation of the Farmgate Milk Price and Farmgate Milk Price Statement in accordance with the Farmgate Milk Price Manual. This responsibility includes such internal control as the Milk Price Group determine is necessary to enable the preparation of the Farmgate Milk Price and Farmgate Milk Price Statement that are free from material misstatement whether due to fraud or error.

Our responsibility

Our responsibility is to express an opinion to the Directors on:

- whether the Farmgate Milk Price has been calculated, in all material respects, in accordance with the Farmgate Milk Price Manual, and
- whether the information presented in the Farmgate Milk Price Statement is materially consistent with the data in the calculation of the Farmgate Milk Price.

Our independence and quality control

We have complied with the independence and other ethical requirements of Professional and Ethical Standard 1 (Revised) issued by the New Zealand Auditing and Assurance Standards Board, which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

The firm applies Professional and Ethical Standard 3 (Amended) and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Our firm has also provided other services to the Fonterra Co-operative Group Limited in relation to the statutory audit of the financial statements and other assurance services. The firm has no other relationship with, or interest in, the Fonterra Co-operative Group Limited.

KPMG.

KPMG
Auckland
22 September 2021

Appendix 2: Updates to the Farmgate Milk Price Manual and Calculation

Minor refinements to address practical issues in a timely and efficient way have regularly been made to the Manual since it was introduced in the 2009 season. These refinements play an important part in ensuring the Farmgate Milk Price methodology continues to be robust. Refinements to the Manual must be consistent with the Milk Price Principles.

Adjustments can be made to a number of parameters and inputs without any change being required to the Manual. An example is the rule that allows for new RCPs to be added if certain criteria are met. The Manual also provides for reviews of important aspects to be carried out at least every four years, and the Board or Milk Price Panel may initiate additional reviews if circumstances warrant.

Farmgate Milk Price Manual Updates

The Fonterra Board approved a number of amendments to the Manual for the 2022 season, all intended to address minor matters raised by the Commerce Commission in its Final Report on the F21 Manual, and none of which are expected to have any impact on the calculation methodology or quantum of the Farmgate Milk Price. A summary and explanation of these changes is provided in the 'reasons paper' provided by Fonterra to the Commerce Commission in support of the 2021/22 Manual, located at:

https://comcom.govt.nz/__data/assets/pdf_file/0031/262867/Fonterra-Reasons-paper-in-support-of-FonterraE28099s-Base-Milk-Price-Manual-for-the-2021-22-season-30-July-2021.pdf

The Manual for the 2022 season is available at:

https://www.fonterra.com/content/dam/fonterra-public-website/fonterra-new-zealand/documents/pdf/milk-prices/2021/Fonterra%27s_Farmgate_Milk_Price_Manual_Final_2021-22.pdf

As part of its oversight role, the Commerce Commission reviews and reports annually on whether the Manual is consistent with ensuring Fonterra is operating efficiently, and whether it allows for competition in the market for farmers' milk. The Commerce Commission's final report on the 2020/21 Manual was released on 15 December 2020. That report can be found at:

https://comcom.govt.nz/__data/assets/pdf_file/0014/230270/Final-report-Review-of-Fonterras-Milk-Price-Manual-15-December-2020.pdf

Changes in approach to the calculation of the Farmgate Milk Price

There were three changes in the application of the Manual for the 2021 season that resulted in materially different values of inputs into the Farmgate Milk Price calculation.

An amendment to DIRA passed into law in July 2020 mandates a change to the methodology used to determine the asset beta, a key input into the WACC, for the F22 season. As advised in last year's Farmgate Milk Price Statement, Fonterra determined in F20 that the revised DIRA methodology would be used to determine the F21 season asset beta. The application of the revised methodology by the Milk Price Group resulted in an increase in the asset beta, from 0.38 to 0.45, and the removal of the specific risk premium. The net impact of these updates was a WACC of 4.9%, compared to a WACC of 4.6% had the previous inputs been used.

In addition, and as noted on page five, the methodology used to determine the average surrender value of carbon credits, an input into Farmgate Milk Price energy costs, was revised this season to incorporate the use of the average cost of credits surrendered by Fonterra in the current season. In previous seasons an external benchmark was used.

Appendix 3: Farmgate Milk Price Overview

Rationale for Farmgate Milk Price

Fonterra currently collects around 80% of New Zealand's milk production. Because Fonterra purchases such a large proportion of New Zealand's total milk, there is no market price for milk that is independent of the price paid by Fonterra. As a result, since its formation in 2001, Fonterra has calculated a Farmgate Milk Price that enables total returns to be allocated between payments for milk and returns on the capital invested by Fonterra farmer shareholders and by unit holders in the Fonterra Shareholders' Fund.

The Aggregate Farmgate Milk Price is different from the cost of New Zealand sourced milk disclosed in Fonterra's financial statements due to:

- The financial statements report the cost of milk for the 12 months ending 31 July whereas the Aggregate Farmgate Milk Price relates to milk supplied in the 12 months of the season ending 31 May;
- Differences between what Fonterra is willing to pay in premiums for value-added products such as organic milk which a commodity-only processor would not pay;
- The higher premium that Fonterra pays for Winter Milk compared to the premium that would be paid by a commodity-only processor;
- The amount of Additional Commodity Milk Payments and Standard Supply Adjustments.

Rationale for Reference Commodity Products

Manufacture of the RCPs comprised approximately 70% of Fonterra's total New Zealand ingredients production in the 2021 season.

Almost all the increase in milk supplied over the past decade in New Zealand to Fonterra and its competitors has been used to make milk powders.

As returns from the sale of milk powders and their by-products represent the marginal returns that would drive the price of milk in a competitive market in New Zealand, the Farmgate Milk Price is based on these products. Returns from non-powder commodities, such as cheese and casein, have largely been irrelevant in driving investment in the dairy industry over the past 10 years and are therefore not taken into account in determining the Farmgate Milk Price.

The Farmgate Milk Price approach does not include any returns earned by Fonterra from non-commodity or specialised ingredients and consumer branded products. These types of products earn premiums over the returns to standard commodity ingredients. It is therefore appropriate that these premiums are recognised in Fonterra's earnings rather than in the Farmgate Milk Price.

Basis for the WACC Calculation

The WACC used to determine the Fixed Asset Capital Charge and the Net Working Capital Charge is calculated using the simplified Brennan Lally methodology employed by the Commerce Commission.⁷

Since the 2012 season, the methodology has been based on rolling five year averages of market interest rates, including the five year New Zealand Government stock rate, resulting in a reduction in the WACC from 7.7% for the 2012 season to 6.8% for the 2014 season.

In the 2015 season, the WACC methodology was changed to incorporate a specific risk premium of 0.15% and a reduction in the asset beta from 0.45 to 0.38, on the basis of a review by an independent expert, Associate Professor Alastair Marsden of the University of Auckland. As noted in Appendix 2, the WACC methodology was further updated this season to incorporate an increase in the asset beta to 0.45 and a reduction in the specific risk premium to nil.

Farmgate Milk Price Governance

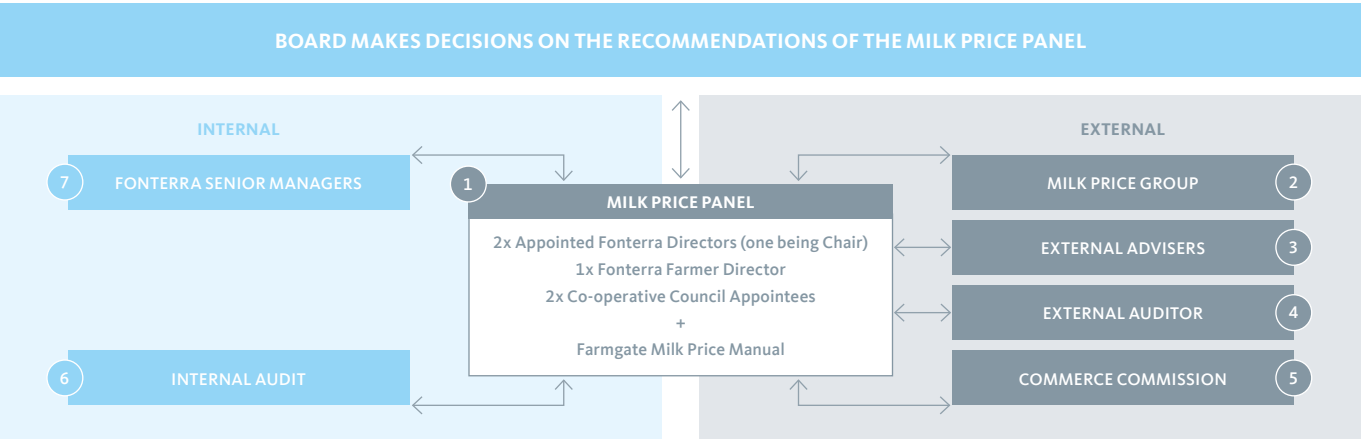
The Fonterra Board sets the total amount to be paid by Fonterra for all milk supplied to it in New Zealand in each season.

Both Fonterra's Constitution and DIRA require Fonterra to maintain the Manual, which sets out Fonterra's policies and methodology for determining the Farmgate Milk Price. The Manual must reflect the Milk Price Principles set out in Fonterra's Constitution. The Farmgate Milk Price has been calculated in accordance with the Manual since the start of the 2009 season.

The Fonterra Board has established a robust governance structure to oversee the setting of the Farmgate Milk Price, which comprises the elements illustrated in the diagram on page 12.

⁷ For example, <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/cost-of-capital-im-review/>

Appendix 3: Farmgate Milk Price Overview (CONTINUED)



1. Milk Price Panel

The Milk Price Panel plays a key role in overseeing the integrity of the Farmgate Milk Price. It currently has five members: two are Fonterra appointed directors (one of whom is the Chair); one is a Fonterra farmer-elected director; and two are appropriately qualified nominees of the Fonterra Co-operative Council. With effect from 1 June 2021, the responsible Minister under DIRA (currently the Minister of Agriculture) has the right to nominate one member of the Panel.

The current members of the Panel are: Scott St John (Chair) and Bruce Hassall, who are appointed Fonterra directors; Brent Goldsack, who is a farmer-elected Fonterra director; and Andrew Wallace and Bill Donaldson, who are nominees of the Fonterra Co-operative Council.

The Panel 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).

The Panel is responsible for:

- Overseeing the calculation of the Farmgate Milk Price and making a recommendation on it to the Fonterra Board.
- Providing recommendations to the Fonterra Board on changes to the Manual.
- Providing assurance to the Fonterra Board that the Farmgate Milk Price has been calculated in accordance with the Manual.

The Fonterra Board is responsible for the forecast of the annual Farmgate Milk Price.

2. Milk Price Group

The Milk Price Group is a working group established by Fonterra. The Head of the Milk Price Group is independent of Fonterra’s management and reports directly to the Chair of the Milk Price Panel. The role of the Milk Price Group includes:

- Ensuring that the Farmgate Milk Price is calculated in accordance with the Manual and making recommendations in respect of the Farmgate Milk Price to the Panel.
- Considering any proposed amendments to the Manual, including those the Milk Price Group itself considers are appropriate, and ensuring they are in accordance with the Milk Price Principles in Fonterra’s Constitution.
- Providing assurance to the Fonterra Board over the calculation of the forecast of the Farmgate Milk Price.
- Managing engagement with external reviewers.

- Engaging with the Commerce Commission, including to ensure full disclosure of all material aspects of the Farmgate Milk Price derivation each year.

The functions of the Milk Price Group are contracted out to EY and other technical experts who are not employees of Fonterra.

3. External Reviewers

External advisors may provide expert advice on various inputs, as well as assurance over the accuracy of financial models. In addition, they participate in reviews of key parameters of the Farmgate Milk Price at regular intervals (which can be up to four years).

4. External Auditor

The external auditor examines the Farmgate Milk Price each year and provides assurance that the Farmgate Milk Price has been determined in accordance with the Milk Price Principles, Methodologies and Detailed Rules of the Farmgate Milk Price Manual. Fonterra’s external auditor is KPMG.

5. Commerce Commission

Subpart 5A of DIRA, which was passed into law in July 2012, gives the Commerce Commission an oversight role with respect to Fonterra’s Farmgate Milk Price.

The purpose of Subpart 5A is to promote the setting of a Farmgate Milk Price that provides an incentive to Fonterra to operate efficiently, while providing for contestability in the market for the purchase of milk from farmers (section 150A). Each year the Commission is required to review and report on the extent to which the Manual and Fonterra’s actual Farmgate Milk Price are consistent with this purpose.

6. Internal Audit

Fonterra’s internal audit team provides assurance over the processes and controls relating to Fonterra data used in the calculation of the Farmgate Milk Price.

7. Fonterra Senior Managers

Fonterra senior managers provide internal oversight of the calculation of the actual and forecast Farmgate Milk Price in accordance with the Manual and detailed models and procedures. Fonterra management is also responsible for engagement with the Commerce Commission.

Appendix 4: Milk Supplied and Production Volumes

2021 SEASON	MILK SUPPLIED (MILLION KGMS)	PRODUCTION (000 MT) OF FINISHED PRODUCT					
		WMP	SMP	BUTTER	AMF	BMP	TOTAL
JUN 20 TO AUG 20	135	179	46	13	16	5	259
SEP 20 TO NOV 20	585	772	201	87	47	20	1,127
DEC 20 TO FEB 21	488	626	174	84	36	18	938
MAR 21 TO MAY 21	332	504	58	39	21	11	633
TOTAL	1,539	2,080	479	223	121	53	2,957

2020 SEASON	MILK SUPPLIED (MILLION KGMS)	PRODUCTION (000 MT) OF FINISHED PRODUCT					
		WMP	SMP	BUTTER	AMF	BMP	TOTAL
JUN 19 TO AUG 19	130	151	61	11	23	6	250
SEP 19 TO NOV 19	595	760	222	87	55	21	1,145
DEC 19 TO FEB 20	488	609	182	82	42	19	934
MAR 20 TO MAY 20	304	401	96	41	30	13	581
TOTAL	1,517	1,921	561	221	150	58	2,911

2019 SEASON	MILK SUPPLIED (MILLION KGMS)	PRODUCTION (000 MT) OF FINISHED PRODUCT					
		WMP	SMP	BUTTER	AMF	BMP	TOTAL
JUN 18 TO AUG 18	128	195	26	11	10	3	246
SEP 18 TO NOV 18	601	756	229	89	59	22	1,154
DEC 18 TO FEB 19	487	578	202	91	44	20	935
MAR 19 TO MAY 19	308	337	140	49	43	16	585
TOTAL	1,523	1,867	597	239	155	61	2,920

Appendix 5: Sales Volumes

2021 SEASON						
SHIPMENTS (000 MT) OF FINISHED PRODUCT						
	WMP	SMP	BUTTER	AMF	BMP	TOTAL SALES
AUG 20 TO OCT 20	269	61	19	16	6	370
NOV 20 TO JAN 21	667	168	84	36	12	967
FEB 21 TO APR 21	569	114	58	33	15	788
MAY 21 TO JUL 21	530	122	43	31	15	741
AUG 21 TO OCT 21	45	15	20	5	4	90
TOTAL	2,080	479	223	121	53	2,957

2020 SEASON						
SHIPMENTS (000 MT) OF FINISHED PRODUCT						
	WMP	SMP	BUTTER	AMF	BMP	TOTAL SALES
AUG 19 TO OCT 19	251	83	22	20	3	379
NOV 19 TO JAN 20	662	203	94	38	17	1,014
FEB 20 TO APR 20	514	146	52	43	19	774
MAY 20 TO JUL 20	434	115	35	44	17	644
AUG 20 TO OCT 20	60	14	19	5	3	100
TOTAL	1,921	561	221	150	58	2,911

2019 SEASON						
SHIPMENTS (000 MT) OF FINISHED PRODUCT						
	WMP	SMP	BUTTER	AMF	BMP	TOTAL SALES
AUG 18 TO OCT 18	163	61	18	20	6	268
NOV 18 TO JAN 19	731	234	69	50	22	1,106
FEB 19 TO APR 19	526	157	85	40	17	825
MAY 19 TO JUL 19	394	137	49	40	11	631
AUG 19 TO OCT 19	53	8	19	5	5	90
TOTAL	1,867	597	239	155	61	2,920

Appendix 6: Average Number of Months Prior to Shipment that Prices were Struck

2021 SEASON					
AVERAGE NUMBER OF MONTHS PRIOR TO SHIPMENT					
	WMP	SMP	BUTTER	AMF	BMP
AUG 20 TO OCT 20	3.1	3.1	2.4	2.7	2.5
NOV 20 TO JAN 21	3.2	3.3	3.2	3.0	2.6
FEB 21 TO APR 21	3.2	3.1	3.6	2.9	2.7
MAY 21 TO JUL 21	2.8	2.9	2.9	2.8	2.7
AUG 21 TO OCT 21	2.8	3.2	2.8	3.3	2.4
	3.1	3.1	3.1	2.9	2.6

2020 SEASON					
AVERAGE NUMBER OF MONTHS PRIOR TO SHIPMENT					
	WMP	SMP	BUTTER	AMF	BMP
AUG 19 TO OCT 19	2.6	2.9	2.9	2.2	1.8
NOV 19 TO JAN 20	2.8	3.1	2.8	2.7	2.9
FEB 20 TO APR 20	2.8	2.9	3.3	3.0	2.6
MAY 20 TO JUL 20	2.6	2.9	2.6	2.6	2.4
AUG 20 TO OCT 20	2.7	2.9	2.7	2.8	2.3
	2.7	3.0	2.9	2.7	2.6

2019 SEASON					
AVERAGE NUMBER OF MONTHS PRIOR TO SHIPMENT					
	WMP	SMP	BUTTER	AMF	BMP
AUG 18 TO OCT 18	2.5	3.0	2.3	2.7	2.7
NOV 18 TO JAN 19	2.5	3.2	2.7	3.2	2.9
FEB 19 TO APR 19	2.8	3.1	3.0	3.4	3.0
MAY 19 TO JUL 19	2.9	2.5	3.0	2.6	2.5
AUG 19 TO OCT 19	3.2	3.7	2.8	3.2	3.0
	2.7	3.0	2.8	3.0	2.8

Appendix 7: Average % of Sales Contracted in Each Month Prior to Shipment

2021 SEASON		AVERAGE PERCENTAGE OF SALES CONTRACTED IN EACH OF MONTHS 1-5 PRIOR TO SHIPMENT				
		WMP	SMP	BUTTER	AMF	BMP
1		8%	6%	8%	7%	13%
2		30%	32%	25%	33%	39%
3		27%	24%	29%	31%	26%
4		19%	22%	22%	19%	15%
5		17%	17%	16%	10%	7%

2020 SEASON		AVERAGE PERCENTAGE OF SALES CONTRACTED IN EACH OF MONTHS 1-5 PRIOR TO SHIPMENT				
		WMP	SMP	BUTTER	AMF	BMP
1		10%	6%	13%	12%	20%
2		39%	35%	31%	39%	38%
3		28%	27%	24%	24%	23%
4		14%	19%	22%	14%	10%
5		9%	13%	11%	10%	9%

2019 SEASON		AVERAGE PERCENTAGE OF SALES CONTRACTED IN EACH OF MONTHS 1-5 PRIOR TO SHIPMENT				
		WMP	SMP	BUTTER	AMF	BMP
1		14%	8%	7%	10%	13%
2		38%	32%	42%	29%	33%
3		22%	27%	25%	27%	25%
4		16%	18%	18%	18%	16%
5		10%	15%	9%	16%	13%

Appendix 8: Average USD Prices

2021 SEASON		USD PER MT OF FINISHED PRODUCT				
SHIPMENT PERIOD		WMP	SMP	BUTTER	AMF	BMP
AUG 20 TO OCT 20		2,974	2,699	3,568	4,010	2,612
NOV 20 TO JAN 21		3,020	2,797	3,552	4,095	2,754
FEB 21 TO APR 21		3,247	3,045	4,102	4,729	2,962
MAY 21 TO JUL 21		3,899	3,383	5,183	5,891	3,771
AUG 21 TO OCT 21		4,077	3,412	4,757	5,873	4,066
		3,323	3,012	4,117	4,792	3,194
Full season GDT-only prices		3,288	2,966	4,039	4,726	3,141

2020 SEASON		USD PER MT OF FINISHED PRODUCT				
SHIPMENT PERIOD		WMP	SMP	BUTTER	AMF	BMP
AUG 19 TO OCT 19		3,129	2,549	4,420	5,408	2,820
NOV 19 TO JAN 20		3,184	2,680	4,257	5,210	2,794
FEB 20 TO APR 20		3,203	2,980	4,128	4,954	3,033
MAY 20 TO JUL 20		2,916	2,761	3,883	4,394	2,691
AUG 20 TO OCT 20		2,825	2,673	3,732	4,198	2,561
		3,110	2,755	4,140	4,891	2,833
Full season GDT-only prices		3,069	2,719	4,108	4,835	2,758

2019 SEASON		USD PER MT OF FINISHED PRODUCT				
SHIPMENT PERIOD		WMP	SMP	BUTTER	AMF	BMP
AUG 18 TO OCT 18		3,011	2,056	4,938	5,886	2,483
NOV 18 TO JAN 19		2,811	2,051	4,336	5,418	2,707
FEB 19 TO APR 19		2,788	2,214	4,085	5,200	3,131
MAY 19 TO JUL 19		3,163	2,553	4,882	5,821	3,630
AUG 19 TO OCT 19		3,198	2,541	4,902	5,851	3,388
		2,907	2,216	4,448	5,540	3,032
Full season GDT-only prices		2,870	2,164	4,355	5,507	2,959

Appendix 9: Average NZD/USD Conversion and Spot Rates

	FONTERRA'S AVERAGE CONVERSION RATE	SPOT EXCHANGE RATE
2021 SEASON		
AUG 20 TO OCT 20	0.6477	0.6746
NOV 20 TO JAN 21	0.6570	0.7134
FEB 21 TO APR 21	0.6637	0.7159
MAY 21 TO JUL 21	0.6889	0.7055
AUG 21 TO OCT 21	0.6825	0.7010 ⁸
Revenue-weighted annual average	0.6677	0.7067
2020 SEASON		
	FONTERRA'S AVERAGE CONVERSION RATE	SPOT EXCHANGE RATE ⁹
AUG 19 TO OCT 19	0.6651	0.6366
NOV 19 TO JAN 20	0.6693	0.6541
FEB 20 TO APR 20	0.6627	0.6079
MAY 20 TO JUL 20	0.6565	0.6477
AUG 20 TO OCT 20	0.6568	0.6647
Revenue-weighted annual average	0.6638	0.6375
2019 SEASON		
	FONTERRA'S AVERAGE CONVERSION RATE	SPOT EXCHANGE RATE
AUG 18 TO OCT 18	0.6919	0.6676
NOV 18 TO JAN 19	0.6982	0.6805
FEB 19 TO APR 19	0.6895	0.6726
MAY 19 TO JUL 19	0.6813	0.6573
AUG 19 TO OCT 19	0.6809	0.6354
Revenue-weighted annual average	0.6905	0.6697

As at 31 July 2021, Fonterra had hedged approximately 71% of the forecast cash flows related to the 2022 season Farmgate Milk Price. If the remaining 29% of the forecast cash flows were to be hedged at the 31 July spot rate, the average NZD/USD conversion rate would be around 70 cents.

Glossary

In this Statement the following terms have the meanings as set out below:

Additional Commodity Milk Payments as defined in the Manual for the 2021 season.

Aggregate Farmgate Milk Price as defined in the Manual for the 2021 season.

AMF means anhydrous milk fat.

BMP means buttermilk powder.

Detailed Rules means the detailed rules for calculating the Farmgate Milk Price as set out in the Manual.

DIRA means the Dairy Industry Restructuring Act 2001, which authorised Fonterra's formation and regulates its activities.

Farmgate Milk Price means Fonterra's Farmgate Milk Price as determined under the Manual for the 2021 season.

Farmgate Milk Price Capital Costs as defined in the Manual for the 2021 season.

Farmgate Milk Price Cash Costs as defined in the Manual for the 2021 season.

Farmgate Milk Price Manual or **Manual** means Fonterra's Farmgate Milk Price Manual which is available on www.fonterra.com.

Farmgate Milk Price Revenue as defined in the Manual for the 2021 season.

Financial year means Fonterra's financial year, which runs from 1 August to the following 31 July.

Fixed Asset Capital Charges as defined in the Manual for the 2021 season.

Fonterra means Fonterra Co-operative Group Limited.

Global Dairy Trade or **GDT** means the electronic auction platform that is used to sell commodity dairy products.

kgMS means kilograms of milk solids.

Methodology means the methodology for calculating the Farmgate Milk Price as set out in the Manual.

Milk Price Principles or **Principles** means the Milk Price Principles set out in Fonterra's Constitution.

MT means metric tonnes.

Net Working Capital Charges as defined in the Manual for the 2021 season.

NZD means New Zealand dollars.

Reference Commodity Products or **RCP** means the commodity products used to calculate the Farmgate Milk Price, comprising WMP, SMP, BMP, AMF and butter.

Season means the 12-month period from 1 June to the following 31 May.

SMP means skim milk powder.

Standard Supply Adjustments as defined in the Manual for the 2021 season.

USD means United States dollars.

Winter Milk means milk supplied by farmers in the months of May, June and July.

WMP means whole milk powder.

⁸ This Milk Price Statement presents the spot exchange rate for August to October 21 as the spot rate at 9am on 31 July 2021, which is the last day of Fonterra's financial year.

⁹ Certain average spot exchange rate figures for the 2020 season differ from those disclosed in the 2020 Farmgate Milk Price Statement, as forecast exchange rates have been replaced with actual exchange rates.



Our 2021 Suite of Reports

Our Annual Review is a concise summary of our environmental, social and economic activities and performance. It is supported by a suite of supplementary reports where stakeholders can find more detailed information most relevant to them. This represents another step on our journey towards more integrated reporting.



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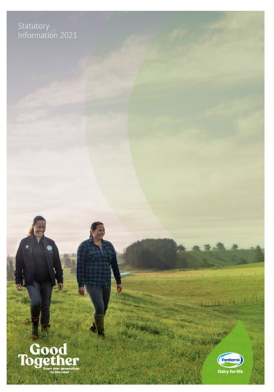
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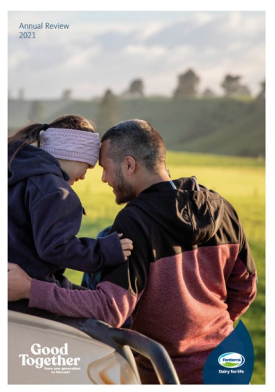
Corporate Governance
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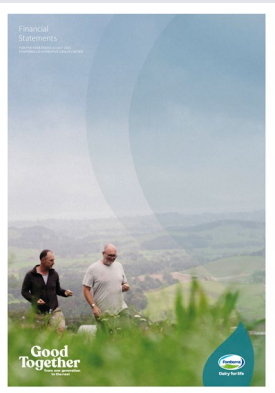
Statutory Information
2021



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