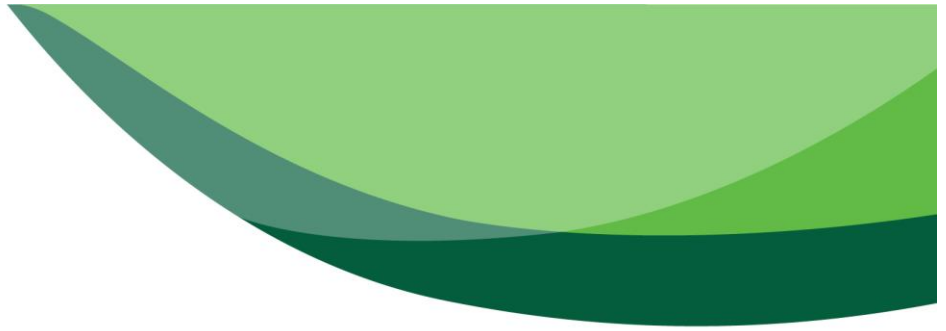




FONTERRA
CO-OPERATIVE
COUNCIL



3 June 2022

Fonterra Capital Restructuring: Proposed Government Response
Proposed amendments to the Dairy Industry Restructuring Act 2001

TO: Ministry for Primary Industries
Wellington
By email: DIRA2022@mpi.govt.nz

FROM: Fonterra Co-operative Council

CONTACT: James Barron
Chairman, Fonterra Co-operative Council
64 McNab Road
RD3 Matamata 3473

Email: 2jamesbarron@gmail.com
Ph: 027 4535 298

Submission on the

Fonterra Capital Restructuring: Proposed Government Response

Proposed amendments to the Dairy Industry Restructuring Act 2001

1. Introduction

- 1.1 This submission is made by the Fonterra Co-operative Council (the **Council**) on behalf of the Co-operative's members in response to the Ministry for Primary Industries' (**MPI**) 2022 Discussion Paper No: 2022/03. This submission is separate to and independent of the submission of Fonterra Co-operative Group Ltd (**Fonterra**).
- 1.2 The Council is a national body of 25 Co-operative members, elected by their fellow members. Council's role is to support Fonterra shareholders' democratic control of their company and to actively represent and seek to protect members' interests as owners, investors, suppliers and members of the Fonterra co-operative community.
- 1.3 Fonterra is a co-operative, owned by approximately 9,200 New Zealand dairy farmers. Around 70% of our milk is produced by farming families running a single farm. The average production per farm is around 175,000 kgMS.
- 1.4 A significant number of Fonterra supplying farms engage sharemilkers or contract milkers, whose businesses are dependent on the Fonterra milk price and who are part of the Fonterra co-operative community.
- 1.5 The Co-operative members who Council represents include Fonterra's shareholders, the sharemilkers and contract milkers of supplying shareholders, and other farmers who supply milk to Fonterra in New Zealand under its standard terms of supply.
- 1.6 Co-operative members value highly and are strongly aligned to Fonterra's co-operative structure. They see Fonterra as an extension of their farms and their balance sheets. They are very focused on the reputation, strategic direction, performance and long-term sustainability of Fonterra – their business.
- 1.7 Fonterra's shareholders strongly supported the new flexible shareholding capital structure when voting on the required Constitution changes in late 2021, understanding that it would lead to a restricted market discount on their shareholding.
- 1.8 Members have a keen interest in the proposed amendments to the Dairy Industry Restructuring Act 2001 (the **DIRA**) set out in the Discussion Paper. Council welcomes the opportunity to express the collective view of the Co-operative's members on the proposed changes.
- 1.9 The collective view of the Co-operative's members has been gathered through consultation on this submission, and small group and individual farmer discussions with Councillors.

2. Executive Summary

- 2.1 We support strengthening confidence in the milk price setting regime, but this should not be at the expense of eroding farmer confidence in it.
- 2.2 Whilst a sustainable, high-performing Fonterra underpins a well-functioning NZ dairy industry, which is of significant national interest, achieving this does not require all the proposed amendments.
- 2.3 The risks outlined in the consultation document can be addressed by:

- (a) one further Ministerial appointment to the Milk Price Panel (the **Panel**) and prescribing the size of the Panel at a minimum of five and maximum of seven members;
 - (b) prescribing that the Chair of the Panel must be one of the independent members of the Panel (which includes the Fonterra independent directors, Council's independent appointee, and the two ministerial nominees), appointed by the Fonterra Board with the Minister's approval;
 - (c) measured requirements in relation to the market-maker function;
 - (d) requiring easy farmer access to independent financial markets research and analysis of Fonterra's performance; and
 - (e) Fonterra publishing its dividend and retentions policy.
- 2.4 By setting Panel membership optimally, given the Panel appoints the Milk Price Group and governs its functions, it is not necessary to prescribe for Fonterra to externally contract out the day-to-day administration of the base milk price calculation or a rotation period. The Panel should be empowered to carry out its role.
- 2.5 The Commerce Commission does not require, and should not have, the power to make its review findings binding. The setting of the milk price is already robust, and the Commission's existing oversight of Fonterra's milk pricing provides adequate safeguard for all parties involved in the raw milk market.
- 2.6 Any changes to the setting of the milk price that would reduce the sensitivity and timeliness of price signals, which are critical to the operation of farm businesses, would be of concern to farmers.
- 2.7 To make existing competition more effective, there should be new requirements to provide standardised reporting by all processors of their milk payments.
- 2.8 Council would be happy to discuss any aspect of this submission and requests the opportunity to provide further input as the process progresses.
- 2.9 Council requests the opportunity to present its submission to any Select Committee in person. This request is separate to and independent of any similar request made by Fonterra Co-operative Group Limited.

3. Background - the base milk price calculation

- 3.1 Milk price is the key determinant of on farm profitability and business sustainability for New Zealand dairy farmers.
- 3.2 Fonterra Co-operative members therefore highly value the transparent calculation of the value of their New Zealand milk which is delivered by the current milk price regime. It provides farming businesses with the confidence to make long term investments in milk production and to continue investing in efficiency gains and sustainability improvements for better environmental outcomes.
- 3.3 It also ensures that members have a clear benchmark above which Fonterra is incentivized to create value through earnings. Members have confidence that the calculations of the base milk price have not been artificially inflated or deflated to encourage / discourage production or supply decisions.
- 3.4 A robust milk price methodology is especially important to sharemilkers and lower-order sharemilkers, our next generation of dairy farmers. They are heavily reliant on milk payments, usually do not hold shares or units and most do not have the asset backing of farm owners for additional security in tough times.
- 3.5 Non-Fonterra farmers also value Fonterra's milk price setting regime as it effectively ensures they receive a market price for their milk. It is notable that Fonterra's competitors generally do

not offer a transparent milk pricing regime independent of the Fonterra milk price regime to evidence the value of the milk supplied to them. Some instead specify a milk payment directly linked to Fonterra's farmgate milk price.

- 3.6 Fonterra's Constitution, the milk price regime and Fonterra's co-operative structure all require Fonterra to pay the maximum sustainable price for members' milk.
- 3.7 Deviations between the Milk Price Manual determined base milk price and the farmgate milk price paid to members have been the result of exceptional circumstances, are made public and have been closely monitored by Council, the Commerce Commission and our Co-operative's members.
- 3.8 The historical gap between the milk price received by New Zealand farmers compared to the milk price received by farmers in the European and US markets has now closed. This can in part be attributed to:
 - (a) the introduction of Global Dairy Trade which has provided a transparent global market price for commodity milk products; and
 - (b) the robust, consistent and transparent milk price methodology which translates this global market price back to a farmgate milk price.
- 3.9 A strong Fonterra Co-operative farmgate milk price means all processors pay a strong milk price, ensures more of the total value of milk produced in New Zealand is retained in New Zealand and provides greater ability for New Zealand dairy farmers to invest in their farms (including in environmental sustainability) and communities.
- 3.10 Alternative non co-operative processors assert the Fonterra milk price is too high but their farmers don't, as they know it sets the base for the price they will be paid. Fonterra's milk price setting mechanism drives accountability for suppliers of alternative processors, ensuring that their processors pay a fair milk price.
- 3.11 A milk price that is not sustainably maximised could distort investment decisions in milk processing assets by artificially inflating their economic returns. Given the New Zealand dairy industry is facing flat or potentially declining milk production, additional investment in milk processing assets will ultimately result in asset stranding and plant closures with negative flow on effects for the work force, regional communities and wider New Zealand. The consequences of surplus processing capacity can be clearly seen in the Australian dairy industry.

4. Proposed amendments to strengthen the base milk price setting regime

Increase the number of Ministerial nominees on the Milk Price Panel from one to two and prescribe a maximum (seven) and minimum (five) number of Panel members

- 4.1 If it will strengthen confidence in the milk price setting regime Council accepts this proposal, but we question if it is required.
- 4.2 The current composition of the Panel provides strong independence. Of the six members:
 - (a) two are Fonterra farmers and four are non-farmers;
 - (b) three are Fonterra Directors and three are not Fonterra Directors; and
 - (c) a majority are required, under clause 10.3(c)(ii) of the Constitution, to be 'independent' members.

In addition, both the Ministerial nominee and one of the Council appointees are required to be independent of Fonterra.

- 4.3 Also requiring the Panel Chair to be independent of Fonterra (see comments below) would distort the balance between farmer and non-farmer Panel members, as there would be either five or six non-farmer members (the Chair, two Ministerial nominees, one or two Fonterra independent directors, and one Council appointee) and only one or two farmer members (the

Council appointee and a Fonterra farmer director if there is only one Fonterra independent director). This imbalance would erode farmer confidence in the Panel.

Require the Panel Chair to be independent of Fonterra, appointed by the Board with the Ministers' approval and additional to the two Ministerial nominees on the Panel

- 4.4 There are strong concerns with this proposal among Co-op members.
- 4.5 In reality, it means that the Minister has the ability to control the appointment of three members of the Panel, including the Chair. This creates the perception that the Fonterra milk price, and therefore wider NZ dairy industry milk pricing (noting the comments in paragraph 3.5 above), will be Government controlled.
- 4.6 As noted in paragraph 4.3, it distorts the balance between farmer and non-farmer members of the Panel, which would erode farmer confidence.
- 4.7 It could negatively affect the strength and integrity of the governance structure around the setting of the Fonterra farm gate milk price. The Panel's governance structure must be robust. The Chair appointment must be functional and the appointed Chair must be able to chair the Panel well given the Panel:
- (a) supervises the calculation of the milk price under the Manual and makes a recommendation on it to the Fonterra Board;
 - (b) provides recommendations on any changes to the Milk Price Manual; and
 - (c) provides the required assurances that the milk price has been calculated in accordance with the Manual.
- 4.8 In order to chair effectively, the Chair of the Panel must not only be experienced and have strong governance skills and acumen, but should also have a specific skill set - an extensive knowledge of the Fonterra milk price regime and core knowledge of Fonterra's business.
- 4.9 Requiring an additional person to be appointed to the Panel as Chair, and for that person to be independent of Fonterra and additional to the two Ministerial nominees to the Panel, creates new risks associated with effective Chair succession, transition and induction, all of which will be borne by Fonterra.
- 4.10 There are no compelling reasons why the Chair of the Panel should not be selected from the independent Panel members - the independent Council appointee, the Fonterra independent director members and the Ministerial nominees should all be eligible for appointment as Panel Chair. An additional independent appointment is not required. All appointees to the Panel have been selected by their nominator (whether the Minister, the Board or Council) for their governance capability and skills. Key considerations include the appointee's ability to contribute and articulate views to Panel discussions and deliberations, and ensure their voice is equal to the voices of other Panel members.

Require Fonterra to contract out the day-to-day administration of the base milk price calculation to an external party, who must be replaced every 4-6 years

- 4.11 If the Panel's membership is robust, then it is not necessary to prescribe the contracting out of the day-to-day administration of the base milk price calculation or a rotation period. The Panel should be empowered to carry out its role, which includes appointing the independent Milk Price Group and governing its functions.
- 4.12 If this is regulated then a requirement for external parties to change every 4-6 years seems unduly onerous, recognising the time that would likely be required to develop a deep knowledge of Fonterra's business, and the unique milk pricing regime and methodology.
- 4.13 Council also questions the suggested frequency of rotation in terms of the capability and capacity within other NZ firms to undertake this work, and potential conflicts given Fonterra already engages the services of a number (if not all) of the large accounting firms.

4.14 The effective date would also need careful consideration to minimise disruption and allow a reasonable period for search and selection. A new Chair appointment and change of external provider overlapping during any 18 - 24 month period should be avoided.

Reduce Fonterra's discretion in setting the base milk price by giving the Commerce Commission the power to make its review findings binding on Fonterra's inputs, assumptions, and the processes in the base milk price Manual and the calculation

4.15 Council does not support this proposed change.

4.16 The setting of the milk price is already robust, going through many layers with independence of Fonterra:

- (a) a governance Panel with recently enhanced (and proposed to be further enhanced), independence;
- (b) an externally contracted working group (the Milk Price Group);
- (c) external advisors and reviewers, on inputs and financial models;
- (d) an external auditor; and
- (e) Commerce Commission annual statutory reviews, of both the Milk Price Manual and the milk price calculation.

4.17 Giving the Commission powers of direction will require significant capability and knowledge retention within the Commission.

4.18 Of significant concern is the risk of a negative impact on the profitability and sustainability of the businesses of virtually all New Zealand dairy farmers if the Commission makes a direction that later proves to be flawed or simply wrong (irrespective of any consultation with Fonterra as part of the process). Milk price is the key determinant of on farm profitability and business sustainability, and the Fonterra milk price informs the milk price paid to the vast majority of dairy farmers in New Zealand.

4.19 That risk would be borne by farmers, with presumably no accountability for the Commission.

4.20 This proposal also brings into question the purpose of the proposal to increase the independence of the Panel. It is unnecessary to both increase the independence of the Panel and give new powers to the Commission.

4.21 Giving the Commission the power to make its review findings binding in effect asserts that the independence, expertise, capability and judgement of the Milk Price Panel and the Milk Price Group (regular replacement of which is also proposed to be regulated) is insufficient. This brings into question the purpose of increasing the independence of the Panel.

4.22 The extra governmental appointees to the Milk Price Panel coupled with the increased influence of the Commission through its ability to make binding recommendations gives the calculation of the base milk price a quasi-regulated flavour. While farmers fully support a transparent and robust milk price methodology for determining the market value of the milk they produce, they do not favour changes which introduce characteristics of a regulated milk price.

4.23 If this proposal is progressed, any changes that would reduce the sensitivity and timeliness of the price signals derived from the milk price, which are critical to the operation of their farm businesses, would be of concern to farmers. It would be imperative to regulate that any directions could only apply to future seasons and that there could be no impact on current or prior seasons' milk payments.

4.24 The proposed process would result in unnecessary duplication of existing Fonterra functions, is costly and overly bureaucratic.

Greater transparency and reporting

- 4.25 The concerns that this proposal seeks to address can and should instead be managed through greater transparency and reporting.
- 4.26 Recognising that the Fonterra Board would retain the discretion to determine the amount to be paid by Fonterra for milk supplied to it, Fonterra and the Commission should instead be required to quantify any differences in opinion around inputs, assumptions and processes.
- 4.27 In addition, and to more effectively ensure contestability for farmers' milk supply, there should be better transparency of milk prices paid by other processors so farmers can assess Fonterra's and other dairy processors' milk price offers. This will help ensure existing competition is more effective.
- 4.28 Dairy farmers want clear price signals on where to send their milk. It is imperative, in the interests of fair competition and an informed and efficient industry, for greater transparency around milk prices paid by all processors so that comparisons can be fairly made, milk can be directed to the most efficient processor and better-informed decisions made by farmers about the highest alternative use of their milk.
- 4.29 Currently there's an imbalance of information available to farmers compared to some processors. This means it can be difficult for farmers to understand the actual milk price they would be paid if they supplied another processor. Standardised reporting of milk payments could correct this imbalance.
- 4.30 Corporate processors (that are not co-operatives) will not pay any more than they have to in order to secure milk. As noted above, other non-cooperative processors set their milk price based on what Fonterra pays, rather than their own view of a maximum sustainable price.
- 4.31 Supporting this submission for greater transparency and reporting, it is noted that in its recent inquiry into the Australian dairy industry the Australian Competition and Consumer Commission (**ACCC**) determined:
- (a) there's an imbalance of information available to farmers compared to the processor; and
 - (b) a processor (recognising there are no co-operatives in Australia) will not pay any more than it has to in order to secure milk.
- 4.32 The ACCC recommended:
- Contracts between farmers and processors must set out either:*
- *a clear price or schedule of prices that will apply to that farmer (based on elements such as volume, quality and composition), and/or a clear pricing mechanism (such as a formula); and/or*
 - *a price notification process (the process by which the processor notifies the farmer of the price.*
- Such that at any given point in time, a farmer can be certain of the base milk price that will be paid for the milk produced.*
- 4.33 Council submits that all processors should be required to publish:
- (a) total milksolids collected;
 - (b) the farm gate milk price for the season, being the average amount paid for milk from farmer suppliers excluding any premiums; and
 - (c) average premiums paid for milk.

Figures should exclude milk purchased / sold at the factory gate (that is, milk transferred between processors).

Commission costs

- 4.34 The financial implications of this proposal set out in the Cabinet paper at paragraph 72 (an estimated additional \$1.5 million per annum) are noted.
- 4.35 These costs would arise from an unnecessary duplication of existing Fonterra functions. Fonterra already incurs significant costs setting its milk price, separate to the Dairy Industry (Levy Process) Regulations.

Require a market maker to maintain a range of minimum bid / ask spreads in the market including a scaled obligation to participate as liquidity changes, an obligation to hold a minimum amount of inventory, and the ability to hold additional inventory for long periods of time to facilitate liquidity in the market

- 4.36 Council and Co-op members are comfortable with this proposal, but question whether it needs to be prescribed.
- 4.37 If it is prescribed, it is vital:
- (a) Co-op members are not buying and selling at 'extremes' driven by lack of liquidity;
 - (b) the respective interests of exiting, remaining and new shareholders are balanced;
 - (c) the respective interests of all shareholders and the Co-op are balanced;
 - (d) any rules are broad and not prescriptive to ensure the market maker function is not constrained, undermined or less effective; and
 - (e) Fonterra has the commercial flexibility it needs to sustainably run its own business and to evolve the market maker function over time as we learn more about how the 'new' FSM and FCG markets work and to adapt to any changing circumstances.

Require Fonterra to ensure independent financial markets research and analysis of Fonterra's performance are easily accessible to farmers

- 4.38 Council and Co-op members are comfortable with this proposal, but question whether it needs to be prescribed.
- 4.39 The price set in the FCG farmer only market will reflect the value that farmers see in Fonterra shares. This will be guided by strategy information from Fonterra, analyst reports and also the external reference point provided by the FSF. Also, as shareholding and supply decisions will be made separately, Fonterra will likely have a stronger focus on informing the ownership (shareholding) decisions of farmers.
- 4.40 Council's role and functions prescribed in the Constitution include its accountability questioning and reporting, and representing members' expectations to the Board through the delivery of an annual Letter of Members' Expectations. In addition, under the Constitution it has the power to call a special meeting of shareholders if has serious concerns about the achievement of key performance measures, or the alignment of strategy or those performance measures to members' expectations.
- 4.41 Council commissions independent analysis of Fonterra's results for each quarter and communicates that analysis to all Co-op members quarterly, as well as including an extensive independent analysis of the full year's performance and operations in its Annual Report each year which is available to all members.

Require Fonterra to maintain and publish a dividend and retentions policy

- 4.42 This proposal embeds in legislation what Fonterra already does.
- 4.43 Council and the wider Co-op member base expect Fonterra to maintain and publish a dividend and retentions policy, and to clearly explain the rationale for any changes to or deviations from it.

- 4.44 Council's representation functions include representing, to the Board, member views on the policy and ensuring accountability for it, in terms of clear articulation by the Board of the policy and clear explanation by the Board of any changes to or deviations from it.
- 4.45 The proposed Flexible Shareholding structure will provide even greater motivation for shareholders to understand Fonterra's earnings outlook and forecast dividends and retentions, as this will influence shareholding decisions.
- 4.46 Clause 16.14 of the Fonterra Constitution requires the Board to provide certain information to Council and to consult with Council on various matters, including the Risk Management Policy that will operate in relation to the new Flexible Shareholding structure. That Policy is intended to manage the alignment risks that are created by offering flexibility for shareholders. It will include thresholds, and a reporting framework, that monitor alignment of share ownership and milk supply, and the distribution of ownership of the Co-operative. The Board is required to consult with Council before approving any changes to that Policy.

5. Conclusion

- 5.1 For the reasons noted above Council submits that the risks outlined in the consultation document can be addressed by fewer changes than those proposed, as summarised in section 2 above.

Council would be happy to discuss any aspect of this submission and intends to provide further input to the Select Committee as the process progresses.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'James Barron', with a long horizontal line extending to the right.

James Barron
Chairman, Fonterra Co-operative Council