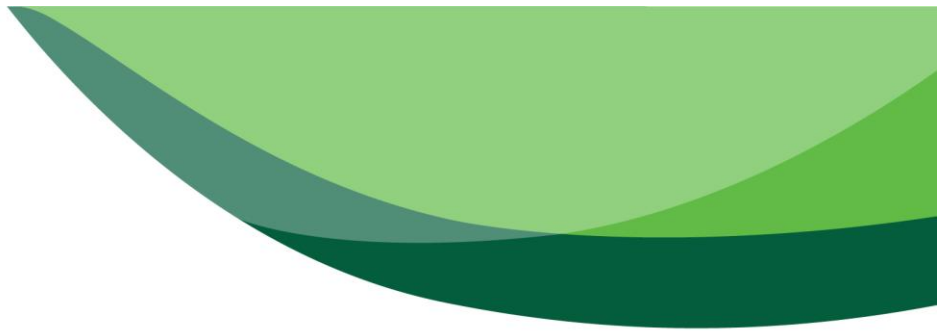




FONTERRA
CO-OPERATIVE
COUNCIL



11 October 2022

**Submission on the
Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill**

TO: Committee Secretariat
Primary Production Committee
Wellington

pp@parliament.govt.nz

FROM: Fonterra Co-operative Council

Submission on the Dairy Industry Restructuring (Fonterra Capital Restructuring) Amendment Bill

1. Introduction

- 1.1 This submission is made by the Fonterra Co-operative Council (the **Council**) on behalf of the members of Fonterra Co-operative Group. 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 Fonterra Co-operative members, elected as representatives 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 8,500 New Zealand dairy farmers. Around 70% of our milk is produced by farming families running a single farm.
- 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 Our Co-operative has evolved over more than 150 years. As food producers of a highly perishable product, we and the generations of farmers before us chose to join together under a co-operative structure to collectively use our capital to collect, process, and market and sell our milk domestically and internationally.
- 1.7 We have also collectively invested our capital to drive innovation in the uses for the numerous components of our milk and how we process milk (Fonterra's Research and Development Centre currently employs around 280 scientific and technical staff as part of our Co-operative's continuing investment in innovation), to develop new markets (geographic and product) and to build long standing and highly valued relationships with business customers and consumers around the world.
- 1.8 This has ensured the long-term sustainability of our individual farming businesses across rural New Zealand, enabling us to continue to invest on farm for efficiency gains, sustainability improvements and better environmental outcomes.
- 1.9 It has also enabled us to contribute significantly to the wider New Zealand economy, including the regional communities we live in.
- 1.10 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.
- 1.11 To ensure our industry will continue to thrive, Fonterra's shareholders strongly supported the new flexible shareholding capital structure when voting on the required Constitution changes in late 2021. Of the 83% of eligible votes that were cast, 85% were in support of the flexible shareholding structure.
- 1.12 However, Co-operative members are concerned that any changes to the Dairy Industry Restructuring Act 2001 (the **DIRA**) regulatory framework governing their Co-operative to

enable the new flexible shareholding structure are not unduly onerous, are fair across the wider industry and are workable.

- 1.13 We understood that the changes brought by the flexible shareholding structure would lead to a restricted market discount on our shareholdings. What was key to our voting decisions was ensuring that our Co-operative has the right capital structure so we don't lose the benefit of what generations of farmers have built before us - a dairy Co-operative of scale.
- 1.14 Prior to voting we debated the flexible shareholding structure extensively with Management and the Board, who clearly articulated Fonterra's strategy and its reliance on Fonterra being able to maintain a sustainable milk supply in an environment where total New Zealand milk production is considered likely to decline or remain flat at best. Board and Management also clearly set out the value that our Co-operative can generate for farmers and New Zealand over the next decade as it delivers its strategy.
- 1.15 The flexible shareholding structure recognises the differences across our Co-operative's members but that we come together as a farmer Co-operative with a common purpose:

Our Co-operative,
Empowering people
To create goodness for generations.
You, me, us together
Tātou tātou.

2. Executive Summary

- 2.1 A sustainable, high-performing Fonterra underpins a well-functioning New Zealand dairy industry, which is of significant national interest. Some of the proposed amendments set out in the Bill are unnecessary and could significantly disadvantage Fonterra with no benefit to the dairy industry or wider New Zealand.
- 2.2 The significant expansion of the current enforcement provisions is not necessary and cuts across the Commerce Commission's existing regulated function. These provisions in clause 27 of the Bill should be removed.
- 2.3 The new individual liability provisions are not appropriate in the context of the milk price oversight regime given that the Milk Price Group, the Milk Price Panel and the Board are restricted by the DIRA and Fonterra's Constitution in their roles. These provisions in clause 27 of the Bill should be removed.
- 2.4 We acknowledge the change made to the eligibility criteria for the Chair of the Milk Price Panel, and support Fonterra appointing the Chair of the Panel with the Minister's approval. To eliminate risks associated with Chair succession and transition we remain of the view that all independent Panel members should be eligible for appointment as Chair of the Panel. The new provisions set out in clause 16 of the Bill should be amended to enable this.
- 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 will be further strengthened by the proposed changes to the membership and chairing of the Milk Price Panel, and the Commission's existing oversight of Fonterra's milk pricing provides adequate safeguard for all parties involved in the raw milk market. Clause 25 of the Bill should be removed. To provide greater transparency the Commission could instead be required to quantify the materiality of any differences in opinion around inputs, assumptions and processes.
- 2.6 The proposed rotation period for the existing Milk Price Group and the proposed rotation and stand-down periods for subsequent appointments to this role in clause 17 of the Bill are unnecessary given the Milk Price Panel's robust membership. If retained they are too short, particularly in the case of the first required rotation, and could result in adverse outcomes.

- 2.7 To make existing competition more effective, the Bill should not only seek to improve Fonterra's milk price transparency but also provide minimum disclosure requirements for other processors. There should be new requirements to provide standardised reporting by all processors of their milk payments.
- 2.8 Council supports the proposed changes that:
- (a) specify a market-maker in Co-operative shares to support on-going liquidity, noting this embeds in legislation what already occurs;
 - (b) require Fonterra to make independent market analysis of performance accessible to farmers and unit holders, noting there is already a level of existing analysis including analysis commissioned by Council; and
 - (c) require Fonterra to maintain and publish a dividend retentions policy, noting this embeds in legislation what Fonterra already does.
- 2.9 Council requests the opportunity to present its submission to the Select Committee in person. This request is separate to and independent of any request made by Fonterra Co-operative Group Limited.

3. Background - the Fonterra milk price

- 3.1 Milk price is one of the key determinants of on farm profitability and business sustainability for New Zealand dairy farmers.
- 3.2 Last year Fonterra delivered \$13.7 billion to the domestic economy in milk payments alone.
- 3.3 Milk payments are Fonterra's biggest input cost. The milk price used in Fonterra's milk payments is based on global market prices. The milk price calculation has strong governance and regulatory oversight – the Milk Price Panel, Fonterra's external auditors and the Commerce Commission.
- 3.4 Fonterra Co-operative members 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 for efficiency gains, sustainability improvements and better environmental outcomes.
- 3.5 It also ensures a clear benchmark above which Fonterra is incentivised to create and show value through earnings, and evidences that the calculations of the base milk price have not been artificially inflated or deflated to encourage / discourage production or supply decisions.
- 3.6 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.
- 3.7 Non-Fonterra farmers also value Fonterra's milk price setting regime as it effectively ensures they receive a global 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.
- 3.8 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.
- 3.9 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.

- 3.10 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. Under the current milk price-setting mechanism Fonterra farmers receive a price based on the global market value of their milk. 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 incorporates global market prices into the farmgate milk price.
- 3.11 A soundly based Fonterra Co-operative farmgate milk price means all New Zealand farmers receive a robust price signal to inform their business decisions, 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.
- 3.12 Alternative non co-operative processors often assert the Fonterra milk price is unfairly high but their farmers don't, as they know it reflects the global market value of their milk and provides a reference 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.
- 3.13 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

New enforcement provisions allowing a direct claim against Fonterra for an injunction or damages for breach of the Milk Price oversight provisions

- 4.1 This expansion of the current enforcement provisions was not previously consulted on and has potential for significant impact on Fonterra and therefore ultimately its farmer suppliers, and their sharemilkers and contract milkers.
- 4.2 Fonterra sets a milk price in accordance with the Milk Price Manual, and the Commerce Commission conducts reviews of both the setting of the milk price and the Manual. The new enforcement provisions would appear to cut across this review process.
- 4.3 Litigation is disruptive and distracting, invariably lengthy from onset to conclusion, and very costly. It could adversely affect Fonterra's customer and business relationships, and market access.
- 4.4 In the context of the existing, well-functioning, regulated and already tested regime (via Commerce Commission oversight for many years) this adds significant additional annual risk and cost to Fonterra's business for no clear benefit.
- 4.5 These provisions should be removed.

New individual liability provisions

- 4.6 These provisions were not previously consulted on.
- 4.7 As owners of our Co-operative we are very concerned to ensure that Fonterra can attract and retain governors, advisors and employees of the highest calibre and capability.
- 4.8 These new provisions create potential personal liability which will clearly make it less attractive to be involved in setting the milk price. The risks of getting it wrong (particularly if

the person has limited industry expertise or has had no prior involvement with Fonterra or the milk price setting process) may outweigh the benefits for them.

- 4.9 We understand that under the proposed provisions individuals could incur liability even in circumstances where there may have been no intentional wrongdoing and where due care had been taken.
- 4.10 The Commerce Commission also provides detailed oversight, and in addition the milk price is:
- (a) set by an independent third party (the Milk Price Group) which, it is now proposed, must be rotated every six seasons; and
 - (b) overseen by a Milk Price Panel of which the Chair is independent and two members are Government appointees.
- 4.11 This extended liability is unnecessary and inappropriate, and these provisions should be removed.

Require the Milk Price Panel Chair to be independent of Fonterra

- 4.12 This change could negatively affect the strength and integrity of the governance structure around the setting of the Fonterra farm gate milk price as it creates new risks associated with effective Chair succession, transition and induction, all of which will be borne by Fonterra.
- 4.13 The Milk Price 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 Milk Price Manual and makes a recommendation on it to the Fonterra Board;
 - (b) provides recommendations on any changes to the Manual; and
 - (c) provides the required assurances that the milk price has been calculated in accordance with the Manual.
- 4.14 In order to chair effectively, the Chair of the Milk Price 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.
- 4.15 There are no compelling reasons why the Chair of the Milk Price Panel should not be selected from all the independent Panel members - the independent Council appointee and the Fonterra independent director members should also be eligible for appointment as Chair of the Panel. All appointees to the Panel have been selected by their nominator (whether the Council, the Board or the Minister) 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.
- 4.16 The restrictions on the eligibility of the independent Council appointee and the Fonterra independent Director members should be removed.

Giving the Commerce Commission directive power

- 4.17 Council does not support the proposed changes.
- 4.18 The setting of the milk price is already robust, going through many layers with independence of Fonterra:
- (a) a governance panel (the Milk Price Panel) with proposed 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.

- 4.19 Giving the Commission powers of direction will require significant capability and knowledge retention within the Commission.
- 4.20 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 one of the key determinants 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.
- 4.21 That risk would be borne by farmers, with presumably no accountability for the Commission.
- 4.22 It is unnecessary to both increase the independence of the Milk Price Panel and give new powers to the Commission.
- 4.23 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.
- 4.24 The extra governmental appointee to the Milk Price Panel coupled with the requirement for the Minister's approval of the Panel Chair appointment and 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.
- 4.25 The proposed process would result in unnecessary duplication of existing Fonterra functions, is costly and overly bureaucratic.
- 4.26 These provisions should be removed.
- 4.27 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 farm businesses, would be of concern to farmers. Therefore the Bill should be amended to regulate that directions could only apply to future seasons and that there could be no impact on current or prior seasons' milk payments.

Greater transparency and reporting

- 4.28 The Bill should instead require greater transparency and reporting.
- 4.29 Recognising that the Fonterra Board would retain the discretion to determine the amount to be paid by Fonterra for milk supplied to it, to provide greater transparency the Commission could instead be required to quantify the materiality of any differences in opinion around inputs, assumptions and processes.
- 4.30 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.
- 4.31 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.

- 4.32 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.
- 4.33 Rather than striving to pay a sustainably maximised price, corporate processors seek to minimise their input costs, the greatest of which is for milk.
- 4.34 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

- 4.35 In Cabinet papers it was reported that the financial implications of the proposed changes include an estimated additional \$1.5 million per annum in Commission costs.
- 4.36 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 Fonterra to contract out the day-to-day administration of the base milk price calculation to an external party, who must be replaced every six seasons and the incumbent must be replaced after two seasons

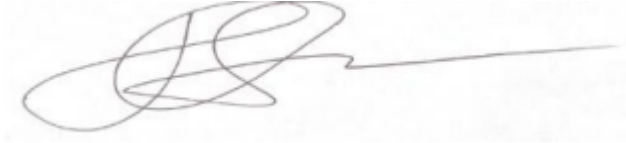
- 4.37 If the Milk Price Panel's membership is robust, then it is not necessary to prescribe the contracting out of the day-to-day administration of the base milk price calculation or a rotation period. The Panel should be empowered to carry out its role, which includes appointing the independent Milk Price Group and governing its functions.
- 4.38 If this is regulated then a requirement for external parties to change every six seasons 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.
- 4.39 Requiring the incumbent to be replaced within two seasons is too tight to allow a thorough and effective search, selection and handover process. This requirement brings significant risk to the effectiveness of the Milk Price Group in the 2025/26 season.
- 4.40 Council has strong concerns regarding the suggested frequency of rotation in terms of the capability and capacity within other New Zealand 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.
- 4.41 These provisions should be removed.

5. Conclusion

- 5.1 We acknowledge the risks that the DIRA manages, and which theoretically arise from Fonterra's size in New Zealand dairy markets.
- 5.2 However, we believe that the perceived risks arising from the new flexible shareholding structure do not require all the changes proposed by the Bill.
- 5.3 To ensure our industry will continue to thrive, the final changes should not be onerous on Fonterra or its members who choose to come together as a Co-operative and should be fair across the wider industry.

5.4 This will ensure Fonterra can continue to contribute to the benefit of all New Zealand dairy farmers, rural communities and the wider New Zealand economy.

Yours sincerely,



James Barron
Chairman, Fonterra Co-operative Council