Capital Structure Consultation

2021

Fonterra
Dairy for life

A strong Co-op benefits farmers and New Zealand

It's good to remember why we're a Co-op in the first place.

First and foremost, the role of a co-operative is to give farmers control of their own destiny. Because we own and control Fonterra, we know that our Co-op will collect our milk and work hard to ensure we receive the best possible price for it. Maximising overall wealth of our shareholders is at the core of our Co-op's purpose.

Sharing the investment in our value chain between us farmers and having confidence that our milk is going to be picked up means we can have the certainty to invest in our individual farming businesses. This is an important reason behind the efficiency and productivity that has given us some of the advantages we enjoy today – advantages that benefit all Fonterra shareholders. We believe that farmers are worse off in countries where there is no strong co-operative. Corporate processors look at milk as an input cost, and over the long run they are incentivised to reduce the price they pay for milk to maximise corporate profits.

Having a strong farmer-owned co-operative in our dairy industry is important to every New Zealand dairy farmer, and for the country as a whole.

Specific legislation enabled Fonterra to be formed so that an efficient co-operative of scale could lead New Zealand into global markets. Working together as a Co-op means we are connected to local communities around New Zealand. It enables our efficiency – from behind the farm gate through to our manufacturing operations and beyond – and supports innovation. The value we create is then returned to regional New Zealand, where it plays a strong role helping to sustain local communities and enhance their wellbeing.

For every dollar we earn as farmers, we spend almost 50 cents in our communities. 2020/21 looks set to be another season that our Co-op contributes more than $11 billion into the New Zealand economy through milk price payments.

Our milk price sets a benchmark in New Zealand, so even those who don't supply the Co-op benefit from it.

Fonterra and Tatua are the two main dairy co-operatives left here. Many other milk processing companies are, or have become, fully or substantially owned by offshore interests.

It's critical to protect and build on what we've got – for the benefit of all Fonterra shareholders. Ultimately, a strong and sustainable Fonterra leads to a stronger and more sustainable Aotearoa New Zealand.

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1. On behalf of the Board

Dear Farmer Shareholders,

I'd like to start by acknowledging that the temporary cap on the size of the Fonterra Shareholders' Fund will have come as a surprise. We did not make that decision lightly. It is necessary to keep all of our potential options for change open while we have a free and frank conversation as owners.

Over the past 24 months, our Co-op has been undergoing a cultural and strategic transformation. Change was needed. If we want Fonterra to continue supporting our families' livelihoods for another 150 years, we have to keep evolving it, while staying true to our Co-operative Principles.

Our Co-op has refocused on delivering sustainable value back to New Zealand. We do that through a strategy designed to optimise the value of our New Zealand milk, using innovation, sustainability, and efficiency to deliver products that are orientated to what our customers and consumers value.

Alongside that refreshed strategy, the Board has spent a significant amount of time reviewing our capital structure.

Both of these pieces of work are founded on our belief that New Zealand milk volumes will likely be flat or declining in the long term as a result of environmental and other regulatory changes, and alternative land uses.

Waiting for the problem to be at our feet will limit our options and likely increase the cost of addressing them, at the expense of future opportunities for us.

PETER MCBRIDE – CHAIRMAN

Our Co-op's financial performance will always be the main determinant of our share of that New Zealand milk. But we also know that our rigid compulsory capital structure makes it difficult for new farmers to join and is a key factor in farmers' decisions to leave. A more flexible capital structure that caters for the diversity and different aspirations within our Co-op would be valued by farmers and support a sustainable future milk supply.

Within that context, our review has found that our current capital structure could create challenges over time.

1. Under the current structure if milk volumes reduce, the number of dry shares will increase and could exceed the thresholds that were put in place to protect our farmer ownership and control. Our Co-op would need to take action to stay within these thresholds – such as buying back shares or units. Buy-backs could impact our Co-op's balance sheet and investment in new opportunities that increase performance. Conceivably, buying back shares or units to ensure that we retain ownership and control of the Co-op could cost shareholders up to $1.2 billion over the next ten seasons.
2. An alternative to buy-backs would be to increase the thresholds for the Fund size, to allow a greater degree of external investment.

We don't think either of these are ideal outcomes, so we have been looking at other options for change. Exactly what that change could look like is what we want to consult with you on now.

To give those conversations some structure, the Board has shared its current thinking. It is detailed in Section 3 of this booklet.

We have arrived at this point after reviewing a wide range of capital structure options from co-operatives around the world – both within and outside the dairy sector – as well as options to evolve our current structure.

Throughout the process we have focussed on addressing three key issues:

1. Maintaining financial sustainability of our Co-op
2. Protection of farmer ownership and control
3. Flexibility for farmers' invested capital that helps farmers to be part of our Co-op at every stage of the farming lifecycle and ensures we maintain a sustainable milk supply.

Having narrowed down the options, we believe the best option for our Co-op is to move to a structure that reduces the share standard so you have greater flexibility, and either removes the Fund or caps the Fund from growing further to protect our farmer ownership and control. We're referring to this as a "Reduced Share Standard" with either "No Fund" or a "Capped Fund".

Under this option, the Fund would either need to be bought back and removed from our capital structure (No Fund) or remain in the structure but with no ability to exchange shares into units so the Fund size would be capped (Capped Fund).

A key outcome of this change is that shares would be bought and sold between farmers in a farmer-only market. I want to be clear with you that we expect this change to impact the price at which shares in our Co-op are traded, and that there may not be as much liquidity in the market.

Ultimately, the price of our shares would be determined by the performance of our Co-op and trading between us farmers.

Currently our share price moves in line with the price of units in the Fund. In that sense it is influenced by unit holders, who have a different investor profile to that of us farmers – a farmer's cost of capital is typically higher.

To cater for share flexibility, some farmers would inevitably have more shares than others. We believe this is a more sustainable proposition over the longer term than the alternatives we are confronted with.

In Section 5 we detail the alternative structures that were considered and the reasons why they are not our current preferred option. We are keen to hear your views on these different variations as part of the consultation process.

We will seek to cater for the diversity within the shareholder base, but we will all need to be pragmatic if we are to find a way forward together that is in the best long-term interests of our Co-op.

Once we hear your views, and if the appetite for change remains, we will do further work to refine the preferred option(s) and have a second round of consultation. If we decide to seek a change to our capital structure, then you will have a chance to vote on that change.

As some aspects of our current capital structure are reflected in the Dairy Industry Restructuring Act, a successful vote would likely be conditional on any necessary changes to legislation being passed.

I appreciate there is a real sense of optimism in the Co-op with our improving financial performance and how we are travelling generally. But there is a sense of urgency with this review. Waiting for the problem to be at our feet will limit our options and likely increase the cost of addressing them, at the expense of future opportunities for us.

Ngā mihi
Peter

2.
Why we're proposing changes

Getting our capital structure right is critical to helping ensure the financial sustainability of our Co-op.

We've evolved our structure before, and it's important we keep evolving it as things change.

This section summarises why we believe it's time to evolve our capital structure. The issues outlined are covered in more detail in Section 4 "How we got to this point."

The environment in which we're operating has changed a lot since Trading Among Farmers (TAF) was implemented.

Our current structure was put in place in 2012 when New Zealand's milk supply was growing rapidly.

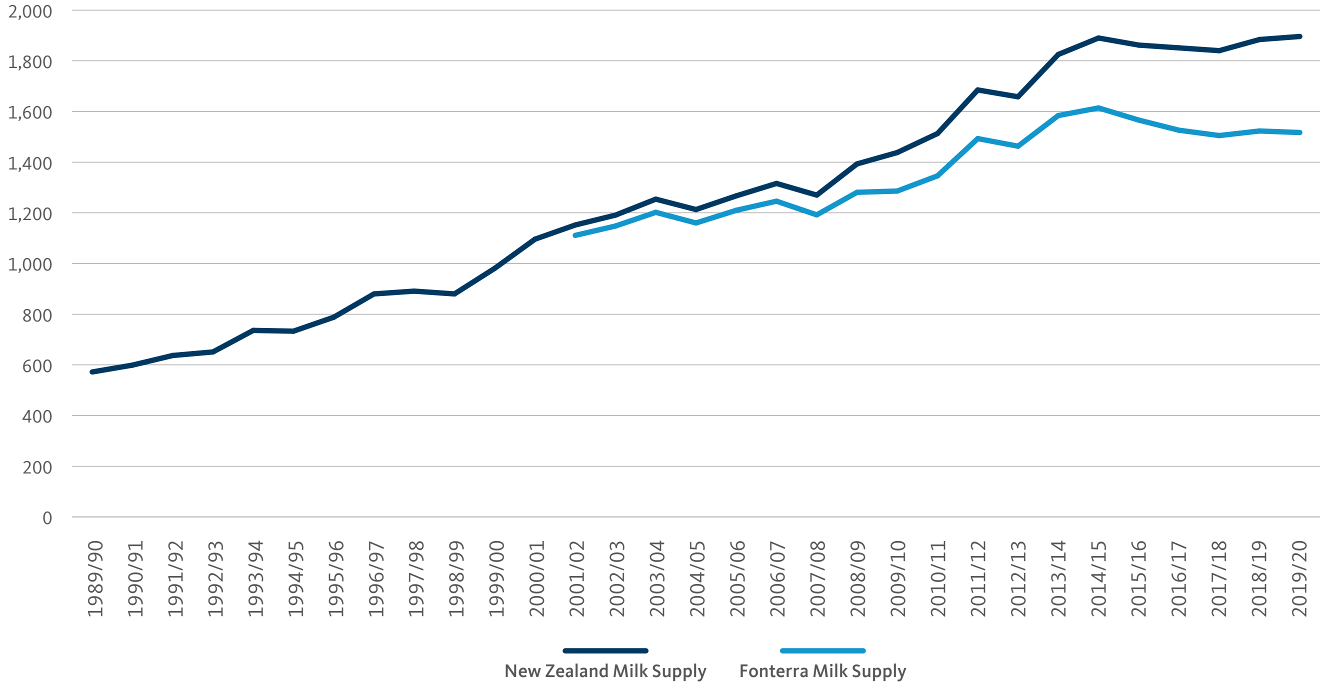
Now, we face a different reality where we need to be prepared for a flat or potentially declining milk supply environment across New Zealand in the coming years.

This is due to factors such as climate change impacts, regulatory changes and alternative land uses. These factors might not have fully impacted us yet, but we expect this to change over the next five to ten years.

Having a sustainable milk supply is critical for us continuing to deliver on our current strategy, which is all about prioritising New Zealand milk.

There are elements of our current structure that are challenging for a number of farmers now, or that may create challenges for our Co-op in a flat or declining milk supply environment. These are explained overleaf, and in more detail on pages 22-23.

NZ MILK SUPPLY (KGMS MILLIONS)



The level of investment to be part of our Co-op is challenging for a number of farmers.

We all have a lot of capital invested in the Co-op. While it's important for each of us to have skin in the game, we're hearing there's a desire for greater flexibility.

This has come through in your feedback and we've heard it from farmers who have left in recent years.

The investment that's required to supply the Co-op is making it challenging for new farmers to join and can be a key factor for existing farmers in deciding to leave so they can pay down debt or invest their capital in other things. This can be a real challenge for succession, forcing difficult decisions when farm businesses transition from one generation to the next.

At a share price of $5.00, a farmer supplying 150,000 kgMS would have $750,000 invested in our Co-op.

Strong performance only increases this investment requirement. As our earnings increase, so too should the share price, which increases the capital investment to join, and the capital for those who leave.

In short, we believe our capital structure is tilting the playing field against us when compared to other processors – the vast majority of which are corporates and don't require any capital investment from farmers who supply them.

What we're hearing is that providing more flexibility would be valued by farmers and go a long way to supporting a sustainable milk supply.

If we provide more flexibility, the Fund size could grow significantly.

Our Co-op has constitutional thresholds designed to balance the interests of farmer owners and the interests of external investors in the Fund. Exceeding those thresholds could put farmer ownership and control at risk. We know that's not something any of us want to see.

If we provide more flexibility to reduce the level of investment for farmers to be part of our Co-op, without making any other changes to our current capital structure, our thresholds could be exceeded relatively quickly.

That's because farmers would be able to hold less shares and non-farmers would be able to invest more through the Fund.

Therefore, providing more flexibility would need to be combined with making changes to the Fund in order to protect farmer ownership and control.

The Fund size could also grow if milk supply declines.

Under our current structure, when milk supply declines, the number of wet shares on issue decreases and the number of dry shares increases by a corresponding amount. Those dry shares can then be exchanged into units at any time, increasing the potential size of the Fund.

If we make no changes to our capital structure and milk supply declines, we expect current thresholds relating to the Fund size to be exceeded within a few seasons.

We have choices to make around how we could address these challenges, and we want to talk with you first.

To stay within the thresholds, our Co-op would need to take action such as buying back shares or units. This creates an uncertain demand on our capital, potentially impacting our ability to invest in strategy and growth. Under the scenarios that we've modelled, buy-backs could cost shareholders between $500 million and $1.2 billion over the next ten seasons.

We've looked at a wide range of options. No structure is perfect, and all options have trade-offs. What we're not willing to trade off is farmer ownership and control of our Co-op, which protects our interests as producers.

Exactly how our capital structure evolves is a conversation for us as owners and is what we want to consult with you on now.

3.
The preferred option and what it would mean for us

We've spent a significant amount of time looking at a wide range of alternative structures as well as options to evolve our current structure.

Our aim has been to find options that give you more flexibility when you need it but still protect ownership and control, without compromising our financial sustainability.

We prioritised a couple of structures that we thought could best meet the objectives of the review and after closer analysis, we have a preferred option – to adopt a Reduced Share Standard with either No Fund or a Capped Fund – which is explained in more detail in this section.

This indicates our current thinking, but we are open minded about adjusting that direction based on your feedback.

The other options we considered, including staying with our current structure, are outlined in Section 5, and we will discuss them during the farmer meetings. Your feedback on any or all of these is welcome.

REDUCED SHARE STANDARD WITH EITHER NO FUND OR CAPPED FUND

Our preferred option at this stage is for a Reduced Share Standard, with either No Fund or a Capped Fund. In this section we walk through how this could work, some key things to consider and why this is our preference.

This involves reducing the share standard so that the minimum requirement for farmer owners would be one share for every four kgMS supplied to the Co-operative (1:4), rather than the current share standard ratio of 1:1.

FROM (BEFORE TEMPORARY CAP)	→	**TO**
Limited flexibility: » Share standard of 1 share/1 kgMS (1:1) » Maximum shareholding of: – 2x supply; or – For shares held in excess of supply, up to 5% of the Co-operative on a look-through basis	→	Increased flexibility: » Share standard of 1 share/4 kgMS (1:4) » Maximum shareholding of: – 4x supply; or – No change
Minimum shareholding requirements based on milk supply over a rolling three-season average.	→	No change.
Dividends are discretionary and paid in respect of each share held.	→	No change.
Farmer owners have 1 vote per 1,000 kgMS supplied in the previous season to the extent the supply is backed 1:1 by shares.	→	No change, so long as you continue to hold shares on a 1:1 basis relative to your supply in the previous season. If you choose to only hold the minimum required shareholding of 1:4, you would have fewer votes than a farmer who holds 1:1. See also the scenarios on pages 10-11.
Shares traded on the Fonterra Shareholders' Market (FSM) (or a similar farmer-only market) and able to be exchanged into units in the Fund.	→	Shares traded on the FSM (or a similar farmer-only market) only. Fund bought back or capped, so no ability to exchange shares into units.
Share price set by reference to public unit market alongside the farmer-only market.	→	Share price set in a farmer-only market.
Share-Up Over Time and MyMilk contracts.	→	Share-Up Over Time and MyMilk contract supply options would be phased out (although all existing commitments would be honoured).
The Co-op can deduct, for tax purposes, dividends paid on supply-backed shares, so shareholders are paid a pre-tax dividend on those supply-backed shares. Farmer shareholders are then required to pay tax on these dividends.	→	Under current tax legislation, the amount of dividend that can be passed through to farmers pre-tax would reduce. However, the Co-op would be able to impute these dividends with income tax paid by the Co-op after tax losses are used. See further discussion on page 13.

Reducing the share standard would make it easier for new farmers to join our Co-op and give more flexibility to existing farmer owners who may want to free up capital or who are working through succession. In line with the Co-operative Principles, the financial benefits and obligations that arise from capital invested would still be allocated in proportion to shareholding. Control and voting rights would be based on share-backed supply in the same way as today. The caps on share ownership are intended to protect against significant levels of concentration of individual ownership within the farmer owner base.

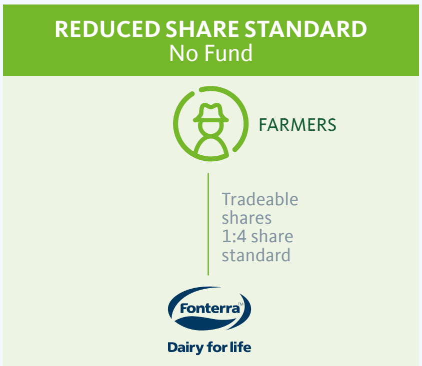
However, reducing the share standard would result in more shares that don't need to be held by farmers to supply the Co-op – or "non-compulsory" shares. If exchangeability with the Fund remained in place as in our current structure, farmer owners could sell the economic rights of these non-compulsory shares into the Fund (i.e. exchange shares into units to sell those units), causing the Fund size to grow and exceed the thresholds that protect farmer ownership and control of the Co-op.

Because of this, if we want to provide more capital flexibility, then we expect that we would need to take one of the following actions in order to protect farmer ownership and control:

» Buy back and remove the Fund (No Fund); or

» Stop the exchangeability of shares for units in the Fund and thereby cap the size of the Fund (Capped Fund).

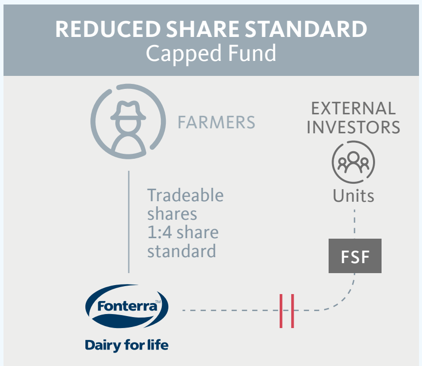
Both these options would be effective at protecting farmer ownership and control of the Co-op.



No Fund

» Removing the Fund would involve an offer by Fonterra to unit holders to buy back their units at a fixed price. The approval of at least 75% of unit holders entitled to vote and voting would be needed for the offer to be accepted.

» The offer amount would need to be acceptable to unit holders, fair to farmers and would need to make more sense to the Co-op than the Capped Fund alternative.



Capped Fund

» A Capped Fund would involve the Fund remaining part of Fonterra's capital structure and listed on the NZX/ASX, but with one key change in that farmer owners would no longer be able to sell any further economic rights of shares into the Fund. Shares would be tradeable in the FSM only.

» As at 31 March 2021, the Fund had 105 million units issued, which comprised 6.5% of total Fonterra shares. Capping the Fund would mean that it could get smaller, but it would not get bigger, other than in limited circumstances such as where a distribution reinvestment plan is offered.

» Members of the public and other investors, including farmer owners, sharemilkers, retired farmers and non-farmer investors, could continue to trade units in the NZX/ASX with units continuing to receive distributions in line with our performance. Farmer owners would also still be able to exchange any units they hold for shares in the FSM.

» This means that the size of the Fund as a proportion of our Co-op could not increase materially, but it could decrease if farmer owners exchange units they buy or hold into shares. Fonterra could also potentially buy it back in the future – partially or fully.

» There could be an ongoing price difference between the traded price of shares in the FSM and the traded price of units in the Fund, for the reasons described in the key things to consider on page 12.

HOW IT COULD WORK:

Below is our current thinking on how a Reduced Share Standard structure could work, having looked at different options for some of the features, such as the 1:4 share standard and the 4x cap on shares. We are keen to hear your views on these points over the course of the consultation process.

- New members joining the Co-op and farmers that are sharing up would need to buy shares to match 25% of their supply at a minimum.
- Shared-up farmer owners would be able to sell down to 25% of their supply. This might only be allowed in stages – potentially over several seasons.
- Any vouchers would be cancelled (as holders would not need them to count towards the Reduced Share Standard).
- Minimum shareholding requirements would be based on milk supply over a rolling three-season average (as it is today).
- Farmer owners would be able to own up to four times their supply in shares, but still subject to the existing limit on shares in excess of supply, being 5% of total shares on issue on a look-through basis.
- Shares would continue to be traded on the FSM (or a similar farmer-only market) with either No Fund or a Capped Fund. This means the implications of a farmer-only market outlined on page 12 would likely apply.
- Dividends would be discretionary and paid in respect of each share held (as they are today).
- Voting rights would remain as they are today, in that farmer owners would have 1 vote per 1,000 kgMS supplied in the previous season so long as you continue to hold shares on a 1:1 basis relative to your supply in the previous season. This means that if you only held the minimum 1:4, you would have fewer votes than if you held 1:1. See also the scenarios on pages 10-11.
- The Share-Up Over Time and MyMilk contracts would be phased out and replaced with a standard period for all farmers to share up to the Reduced Share Standard when joining, and to sell their shares when exiting. We suggest extending the share-up and sell-down periods to five seasons (up from three seasons today).
- We would continue to honour all existing Share-Up Over Time and MyMilk contractual commitments.

COMPARING THE PREFERRED OPTION TO OUR CURRENT STRUCTURE FOR FARMERS

Every farmer's situation would be unique if we were to evolve our structure to a Reduced Share Standard with either No Fund or a Capped Fund. But the hypothetical scenarios below are designed to give you a high-level indication of how things could change at different stages of your business life cycle. Note that these are on the basis that any transition to the preferred option has been completed.

<table>
<tr><th>SCENARIO</th><th>CURRENT STRUCTURE</th><th>PREFERRED OPTION</th></tr>
<tr><td>FIRST FARM OWNER
» Planning to produce 80,000 kgMS
» Holding no shares or units</td><td>» Minimum shareholding requirement: 80,000 shares
» Maximum shareholding: 160,000 shares
» Flexibility:
– Purchase 80,000 shares over three seasons during the share-up period
– Apply for a Share-Up Over Time contract and commit to supply the Co-op for the term (e.g. 6 years), and pay a contract fee (currently 5c/kgMS) for non-share-backed supply
– Supply MyMilk under contract with no shareholding requirement, and pay contract fee on all supply (currently 5c/kgMS) for up to five seasons
– Invest further in the Co-op and hold up to 160,000 shares
» Voting: 80 votes if 80,000 or more shares held</td><td>» Minimum shareholding requirement: 20,000 shares
» Maximum shareholding: 320,000 shares
» Flexibility:
– Purchase 20,000 shares over five seasons during the share-up period
– Invest further in the Co-op and hold up to 320,000 shares
» Voting: 20 votes if 20,000 shares held; 80 votes if 80,000 or more shares held</td></tr>
<tr><td>GROWING FARM OWNER
» Average production on first farm is 80,000 kgMS
» Second farm expected to produce 80,000 kgMS
» Holding 100,000 shares</td><td>» Minimum shareholding requirement: 160,000 shares
» Maximum shareholding: 320,000 shares
» Flexibility:
– Purchase remaining 60,000 shares for second farm over three seasons during the share-up period
– Apply for a Share-Up Over Time contract for 60,000 kgMS, but would need to commit to supply for the term, and contract fee (currently 5c/kgMS) for non-share-backed supply
– Supply MyMilk from second farm under contract with no shareholding requirement, subject to contract fee (currently 5c/kgMS) and potentially sell 20,000 shares to free up capital for on farm investment
– Invest further in the Co-op and hold up to 320,000 shares
» Voting: 160 votes if 160,000 or more shares held</td><td>» Minimum shareholding requirement: 40,000 shares
» Maximum shareholding: 640,000 shares
» Flexibility:
– Sell up to 60,000 shares to free up capital, (e.g. for second farm investment)
– Invest further in the Co-op and hold up to 640,000 shares
» Voting: 40 votes if 40,000 shares held; 160 votes if 160,000 or more shares held</td></tr>
</table>

SCENARIO	CURRENT STRUCTURE	PREFERRED OPTION
ESTABLISHED FARM OWNER LOOKING TO INVEST CAPITAL » Average production is 200,000 kgMS » Holding 200,000 shares	» Minimum shareholding requirement: 200,000 shares » Maximum shareholding: 400,000 shares » Flexibility: – Invest further in the Co-op and hold up to 400,000 shares » Voting: 200 votes if 200,000 or more shares held	» Minimum shareholding requirement: 50,000 shares » Maximum shareholding: 800,000 shares » Flexibility: – Invest further in the Co-op and hold up to 800,000 shares » Voting: 50 votes if 50,000 shares held; 200 votes if 200,000 or more shares held
RETIRING FARM OWNER LOOKING TO RELEASE CAPITAL » Average production is 120,000 kgMS » Holding 150,000 shares	» Minimum shareholding requirement: 120,000 shares » Maximum shareholding: 240,000 shares » Flexibility: – Sell up to 30,000 shares to free up capital » Voting: 120 votes if 120,000 or more shares held	» Minimum shareholding requirement: 30,000 shares » Maximum shareholding: 480,000 shares » Flexibility: – Sell up to 120,000 shares to free up capital » Voting: 30 votes if 30,000 shares held; 120 votes if 120,000 or more shares held

KEY THINGS TO CONSIDER

Impacts of a farmer-only market

- If we moved to this structure, shares would be traded within a farmer-only market, either with the No Fund option or Capped Fund option.
- The biggest implication of trading in a farmer-only market is that farmers will set the price for shares through trading amongst themselves. This is likely to be different to how outside investors value units in the Fund today.
- You may hear the potential price difference in a farmer-only market referred to as a "restricted market discount". Restricted market discounts are commonly observed in any market where participation is restricted (in this case, to farmer owners). A restricted market already exists in other New Zealand agricultural companies you may be invested in.
- We can't be certain what the price difference might be, but the advice that we have received is that in normal trading the share price is likely to be in the range of 20-25% lower than if the current structure was retained. If there are times when there is stronger sell-side pressure – for example if farmers are experiencing financial pressure or otherwise need to sell shares (for example if milk supply falls) – then the discount is likely to be greater.
- In a farmer-only market there may be lower levels of trading (liquidity). While we would retain a "market maker" – the registered volume provider who is active in making bids and offers on a minimum number of shares in the FSM – the share price could move more on small volumes of trading in a farmer-only market.
- If we reduce the share standard and more farmers wish to reduce their shareholding than those looking to increase, there could be sell-side pressure, which could negatively impact the share price. This may be more apparent under certain circumstances. Examples include during transition to a reduced share standard (if many farmer owners choose to sell down), during a period of milk supply decline and farmers who are reducing their volumes or exiting sell their shares, or in times when all farmer owners may be negatively impacted by common events such as low milk prices or widespread droughts.
- The impacts of a farmer-only market could be different to what happens during the temporary cap we have implemented in order to enable consultation. This is because all compliance obligations are on hold during the temporary cap and because we are consulting on potential changes so there is a degree of uncertainty about our future capital structure. If a Reduced Share Standard structure is implemented, then that uncertainty would no longer exist – some farmer owners would be required to trade shares to at least comply with the Reduced Share Standard and some farmer owners may choose to buy shares over and above their individual minimum requirements.
- The Fund also provides a mechanism for those with connections to the Co-op such as sharemilkers, contract milkers, employees and retiring farmer owners to invest in the Co-op. With the No Fund option, this would no longer be available.

Flexibility in how this structure could work

We have put forward some of the mechanics for how a Reduced Share Standard structure could work and we hope that these will help guide our discussions during consultation. However, many variables are flexible, and we welcome your feedback.

- The Reduced Share Standard is intended to provide meaningful flexibility for farmers to reduce their shareholding while ensuring there is sufficient ability for other farmers to hold a greater number of shares without giving rise to a significant concentration of ownership. We propose that a share standard ratio of 1:4 with a 4x maximum shareholding cap (or for shares held in excess of supply, 5% on a look-through basis) strikes a good balance. A higher share standard ratio of say 1:2 might not provide enough flexibility for new and young farmers. A ratio of say 1:10 that

allowed farmers to lower their share ownership even further would mean the 4x cap would need to be higher so that there would be enough buyers in the farmer-only market. This could potentially give rise to too much concentration in ownership with a small group of farmers, or some farmers not having the level of connection to the Co-op that keeps us strong together.

- We have maintained some variables from our existing structure for simplicity and continuity, such as the three-season rolling average, and dividend and voting rights as we do not think these would need to change if we reduced the share standard.
- We do not yet have firm views on the timeframe to share-up and share-down to the new standard. We are very open to your thoughts on what you would like to see here. Our current view is that we would want to see any timeframes captured in the Constitution rather than through Share-Up Over Time contracts. At this stage, we have suggested five seasons to share-up on joining the Co-op and five seasons to share-down on exiting the Co-op.

Co-operative alignment

- A Reduced Share Standard structure allows farmer owners to have different levels of capital invested in the Co-op relative to their milk supply which might mean that farmers have different interests in the Co-op. For example, some farmers are likely to hold more shares in proportion to milk supply than other farmers.
- While all farmers would have some equity in the Co-op through the Reduced Share Standard, some may have greater equity than others. Retaining the payment of dividends on a "per share" basis and voting on a "per 1,000 kgMS backed by shares" basis, as they are today is intended to recognise this.
- When it comes to voting rights and the potential for concentration of ownership, it's important to note that because voting rights would be "per 1,000 kgMS backed by shares", a farmer who continues to hold shares on a 1:1 basis relative to their supply in the previous season will retain the same voting entitlement as today, and a farmer who holds additional shares over the 1:1 basis (up to the maximum shares at 4x kgMS supplied) would only have voting rights up to the 1:1 level, not their full shareholding.
- We welcome your views on whether there should be any other mechanisms to support greater alignment between farmers.

Timing of Transition

- We may want to transition to a Reduced Share Standard over multiple seasons by gradually reducing the share standard, rather than reducing it all at once. This would help reduce supply-side pressure in the farmer-only market. We welcome your views on this.

Tax impacts

- Currently the Co-op can deduct, for tax purposes, dividends paid on supply-backed shares and shareholders are subject to tax on these dividends.
- The number of supply-backed shares would reduce under a Reduced Share Standard, so there would be a tax impact under current tax legislation, in that the amount of dividend that can be passed through to shareholders pre-tax would reduce.
- This would have the effect of increasing the Co-op's annual tax charge, but is not expected to have a cash impact for the Co-op in the short term due to current tax losses the Co-op can use.
- Once the Co-op has used those tax losses ($1.52 billion as at 31 July 2020), the Co-op would start paying tax on earnings on behalf of shareholders, and shareholders would receive imputation credits to pass on the tax paid.
- The ability of individual farmer owners to utilise imputation credits to offset their tax expense would depend on their individual tax circumstances.

WHY THIS IS THE PREFERRED OPTION

We prefer the Reduced Share Standard structure over the other options outlined in Section 5 for several reasons.

- Overall, we think this structure measures well against the design principles for the review while remaining aligned with our Co-operative Principles. It supports a strong Co-operative and sustainable milk supply but still requires all suppliers to become farmer owners with "skin in the game", and all farmer owners have exposure to both milk price and some earnings.
- It is preferable to a Dual Share structure (outlined in Section 5) at maintaining a strong balance sheet for our Co-op. This is a high priority for us and was also reflected in farmer feedback. This is because retaining a single share would mean that all share capital is rated as equity (which would not be the case under a Dual Share structure where one of the shares may be partially classified as debt by ratings agencies).
- We think it would be more straight forward to implement than other options.

We have also reached a preliminary view that having No Fund would be preferable to a Capped Fund because it simplifies our Co-op. However, if we cannot reach an acceptable arrangement to buy back the Fund that 75% of voting unit holders support, then a Capped Fund would also work. In other words, we would only seek to remove the Fund at a reasonable price that was acceptable to unit holders, fair to farmer owners and made sense to the Co-op compared to the Capped Fund alternative.

Capital structure is an important conversation for us as owners. We want to hear your feedback on any or all of the topics discussed in this booklet.

Do you think that there is a clear rationale for moving away from the current structure?

What do you see as the benefits and challenges with a Reduced Share Standard structure?

Do you see reducing the share standard as being effective at creating flexibility for farmers? Do you believe that this will make it easier for farmers to join and stay with the Co-op?

What are your views on moving to a farmer-only market and the potential impacts?

What do you think about the variables within this structure such as:

- the share standard ratio of 1:4
- the maximum cap on shareholding of 4x supply
- the timeframe to share-up and share-down of five seasons
- phasing out Share-Up Over Time contracts and/or MyMilk contracts
- whether we transition to a Reduced Share Standard over several seasons, or if we change all at once

What are your views on how we support alignment between farmer owners on items like voting rights? For example, should voting remain linked to share-backed supply, or should some other mechanism be considered?

Should sharemilkers and others working toward farm ownership be able to directly participate in the Fonterra Shareholders' Market?

4.
How we got to this point

A BRIEF HISTORY OF OUR CAPITAL STRUCTURE

When Fonterra was formed in 2001, Co-operative shares were issued to farmer owners in proportion to supply. Our Co-op redeemed the shares of exiting farmers and those who reduced supply for cash at a value that was set annually by an independent valuer. When a large number of farmers exited or reduced supply (e.g., during periods of drought), our Co-op had to redeem those shares and pay out the value – known as "redemption risk".

In 2012, we implemented the current Trading Among Farmers (TAF) structure, primarily to manage redemption risk. There are two key parts to TAF, which are illustrated on the right.

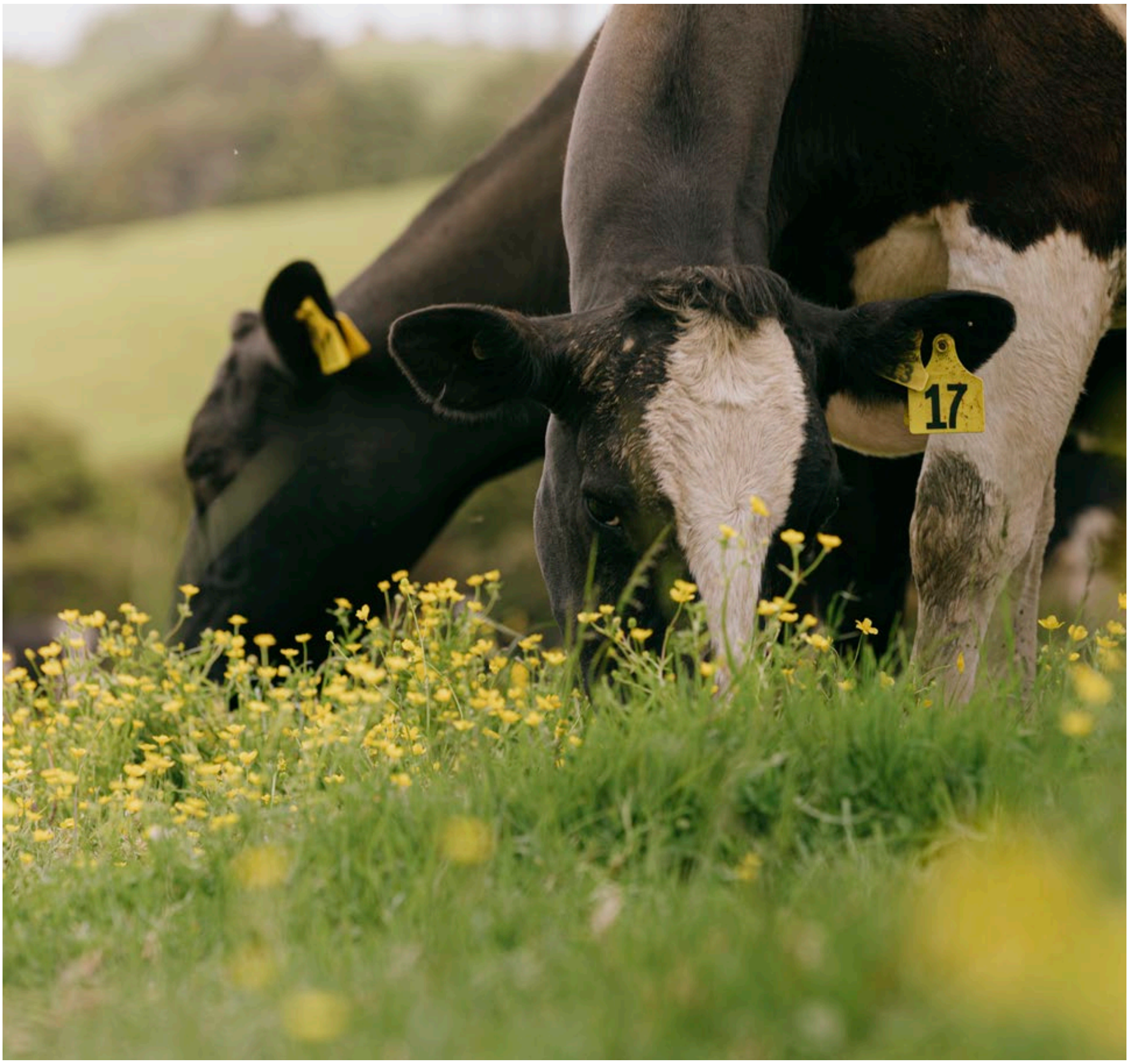
1. THE FONTERRA SHAREHOLDERS' MARKET (FSM)

This is the farmer-only market where farmers trade shares in our Co-op between themselves. The introduction of this market and the other TAF amendments in 2012 meant that our Co-op no longer had to issue and redeem shares.

2. THE FONTERRA SHAREHOLDERS' FUND (FSF OR FUND)

This is a managed investment scheme under the Financial Markets Conduct Act. It is listed on the NZX Main Board and on the ASX, and units in the FSF can be bought and sold by the public in the same way as any other listed security.

Units in the FSF give the holder access to the economic rights in a share (such as distributions or dividends). Like any member of the public, farmer owners can also trade units in the FSF.



To be part of our Co-op, the current minimum requirement is to hold one share for every kgMS supplied. This is based on a three-year rolling average supply. Farmer owners may, but are not required to, hold additional shares, up to 2x the minimum shareholding. For any farmer choosing to leave the Co-op, there's a requirement to sell shares within three seasons at a minimum rate of one third per season.

The number of shares that are matched to milk production are known informally as "wet shares" while the shares that are held in excess of the wet share requirement are known as "dry shares" – although they are in fact all the same single class of share.

Farmers can buy or sell shares on the FSM. Farmers can also sell the economic rights of shares into the Fund (except when a temporary cap is in place). In this case, the farmer-owned Custodian holds legal title to the share and a unit in the Fund is issued, which is then sold on the market. Apart from two supply offers early in the establishment of TAF, farmers have only been allowed to sell the economic benefit of dry shares, not wet shares, into the Fund. Farmers can also exchange units back into shares. In this case the unit is cancelled and the Custodian transfers title to the underlying share back to the farmer owner.

When TAF was implemented, certain protections were put in place in relation to the Fund size to help protect farmer ownership and control. These included an **Overall Limit** on the Fund size of **20%** of our total shares on issue, and an **Aggregate Threshold** of **15%** for the number of dry shares as a proportion of total shares on issue. As at 31 March 2021, the Fund size was 6.5% of our total shares on issue and the Aggregate Threshold was 14.0%. If these thresholds are exceeded, our Co-op would need to take action to get back under the thresholds again. The most likely action to achieve this under the current settings would be for our Co-op to allocate capital to buy back units or shares.

TAF helped to address some of the challenges we faced when it was implemented in 2012.

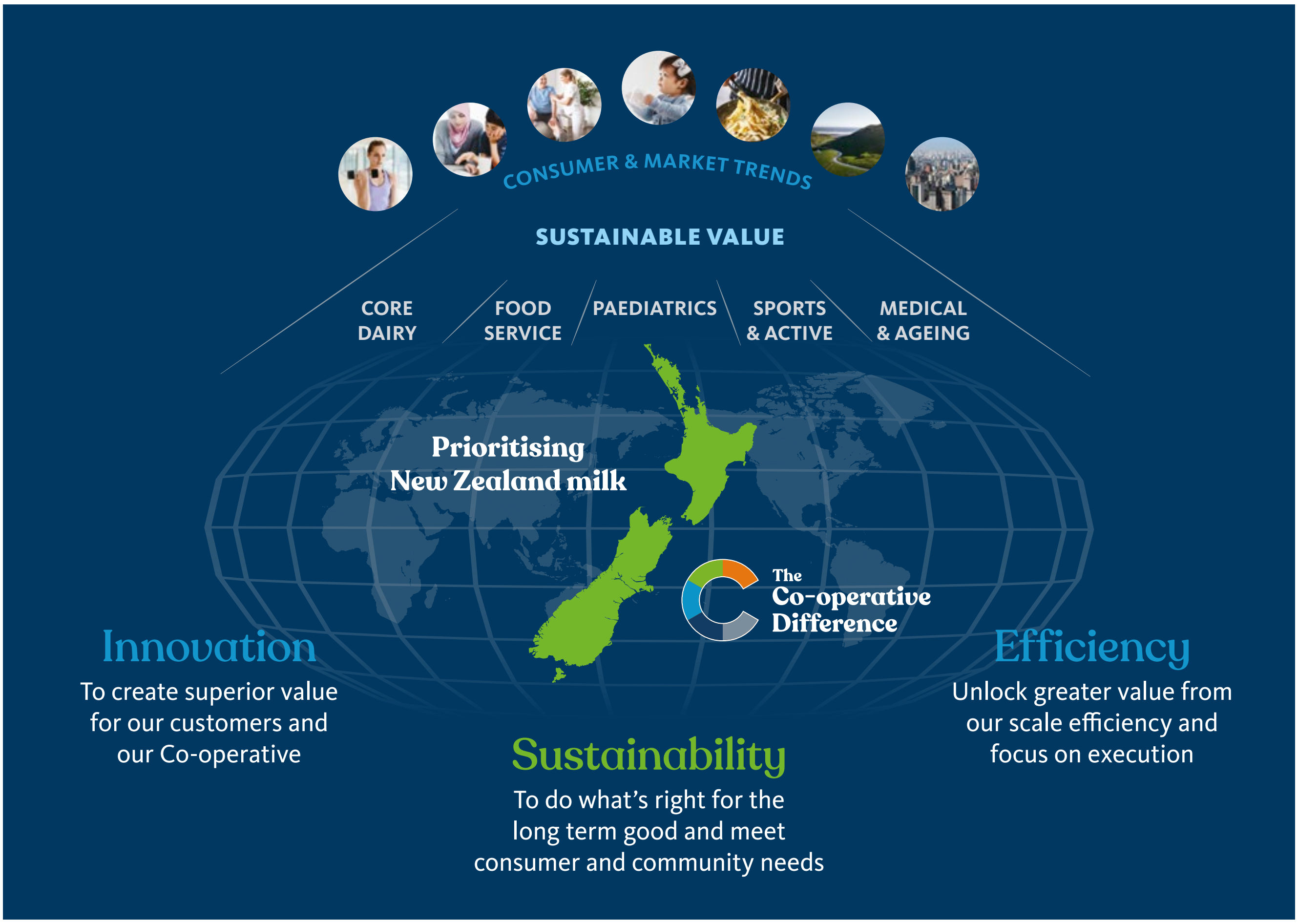
But it has been important to look at whether it will support our financial sustainability into the future based on how much has changed since then.

A RECAP OF OUR STRATEGY

Capital structure helps us execute our strategy successfully over the long-term, so it's important we're all clear on where we're headed as a Co-op before implementing any changes to our structure. Our 2019 refresh considered what we needed to do to both reset our business and achieve sustainable value over time, by responding to changing consumer, customer and market needs. We made some big decisions about the kind of Co-op we want to be.

Recap of changes made in 2019 strategy refresh

FROM	⟶	TO
Volume	⟶	Value
Global Milk Pools	⟶	Prioritise New Zealand Milk + complementary components
Maximum volume into consumer	⟶	Focus on key categories to deliver superior value
Dairy only	⟶	Supplement with non-dairy where makes sense
Partner with cash investments	⟶	Partner with IP and skills and lift R&D
Debt funded growth	⟶	Conservative balance sheet
Global giant with HQ in New Zealand	⟶	Celebrate Aotearoa New Zealand and take it to the world
Invest widely based on aggressive growth plans	⟶	Divest non-core businesses and focus where we have a competitive advantage



OUR STRATEGY PRIORITISES NEW ZEALAND MILK

Our strategy is about prioritising New Zealand milk and growing demand for it by understanding our customers, and differentiating our Co-op's milk through **innovation, sustainability and efficiency**.

We are focusing on five categories – Core Dairy (cream, butter, cheese, milk powder), Foodservice, Paediatrics, Sports & Active and Medical & Ageing.

We already have a competitive advantage in some of these five categories and in others we are drawing on our dairy know-how and innovation capabilities to strengthen our positions.

The Co-operative Difference is building on the work farmers have done over recent years to earn more premiums for our products based on their New Zealand provenance and sustainability performance.

We measure success on how we're progressing towards our three interconnected goals – Healthy People, Healthy Environment and Healthy Business.

Raising additional capital is not the purpose of this review.

Having adequate and sustainable access to capital to fund our strategy is always front of mind, and raising additional capital is not the purpose of this review. We will fund our strategy through a strong balance sheet, cashflow, and through leveraging our IP and innovation capability to partner in new products and categories where it makes sense.

This capital structure review is about prioritising New Zealand milk, protecting farmer ownership and supporting a sustainable milk supply over the longer term.

Our strategy is dynamic, and we will always be reviewing our portfolio – asking ourselves what each asset is worth to us now and into the future. We will continue to turnaround key parts of our portfolio and divest non-core businesses to support new investments as necessary. Our focus is on maintaining a strong balance sheet to support growth.

We're building good momentum and we are well positioned to make the most of future opportunities.

We have been making good progress across the Co-op, including improved business performance, a stronger balance sheet with reduced debt levels and dividend payments being resumed. Our strategic direction, combined with a diversified portfolio, has positioned us well to navigate through a period of unprecedented global uncertainty as a result of COVID-19. While there is still more work to do, we remain on track to deliver our targets.

HOW WE WENT ABOUT OUR CAPITAL STRUCTURE REVIEW

We were clear from the beginning about our objective: to have a capital structure that ensures our Co-op's financial sustainability so we can deliver value for this generation and the next.

We started by identifying what the key elements of a financially sustainable Co-operative are and developing a set of design principles. We shared these with you after our annual results in September 2020.

The wide range of alternatives that we looked at were assessed and prioritised based on how well they met the objective and design principles outlined below.

Design principles

Ownership & Control	Does the structure preserve farmer ownership and control of the Co-operative for the long term?
Sustainable Milk Supply	Does the structure support our ability to attract and retain high quality, sustainable milk and provide financial flexibility for farmers?
Protect Value	Does the structure protect value for current Co-operative members and allow farmers to transact their membership / shareholding in a way that is fair?
Align Incentives	Does the structure align incentives between shareholders, unitholders and management, to maximise value?
Build Resilience	Does the structure manage redemption risk and economic shocks in a way that makes the Co-operative resilient?
Transition Effectively	Is the transition to a potential new structure affordable, achievable and fair to unitholders and farmer shareholders?
Access Capital	Does the structure preserve balance sheet strength and provide access to capital at a reasonable cost in the future?
Simple	Is the structure simple to understand and simple to operate for both farmers and the Co-operative?

We listened to farmer views.

It was clear from the outset that consultation for this review would be more challenging than last time because both shares and units in the Fund are traded securities and we are legally required to comply with financial market continuous disclosure rules.

While we would have liked to have been out on the road discussing options with you earlier, we have gained useful insights from farmer workshops on capital flexibility that were held in 2019, the roadshows after annual results and interim results, a phone survey we did in December 2020 of a representative sample of 350 farmer owners, as well as the online survey available to all farmers from January to February 2021 where we had around 1,800 responses.

Your feedback has very much helped to shape the direction of the review so far.

WHY WE HAD TO IMPLEMENT A TEMPORARY CAP ON THE FUND

At the same time as launching this consultation process, we announced that we'd be temporarily capping the size of the Fund by suspending shares in the FSM from being exchanged into units in the FSF while we consult with you. We've done this to ensure that all options remain open to us as we have this conversation.

As we progressed the review and started looking into options that included buying back the Fund, we identified a risk that, if we started consulting on options for change without temporarily capping the Fund, the Fund size could have grown significantly and taken the option of buying back the Fund off the table before you even had a chance to consider it.

Some of the options have the potential to see differences emerge between the price at which a share trades in the FSM compared to what a unit in the Fund trades at, with units trading at a higher price than shares. If the temporary cap was not in place, anyone holding dry shares would be able to exchange them into units in the Fund. This could more than double the size of the Fund and make options that include buying back the Fund unaffordable in the context of our current balance sheet targets.

That's why we had to temporarily cap the Fund at its current size before consulting on options. This was necessary to enable full discussion with you without ruling out options that potentially buy back the Fund. It's important to note that pricing under the temporary cap may not reflect pricing of shares in a farmer-only market.

THE DETAILED FINDINGS OF THE REVIEW

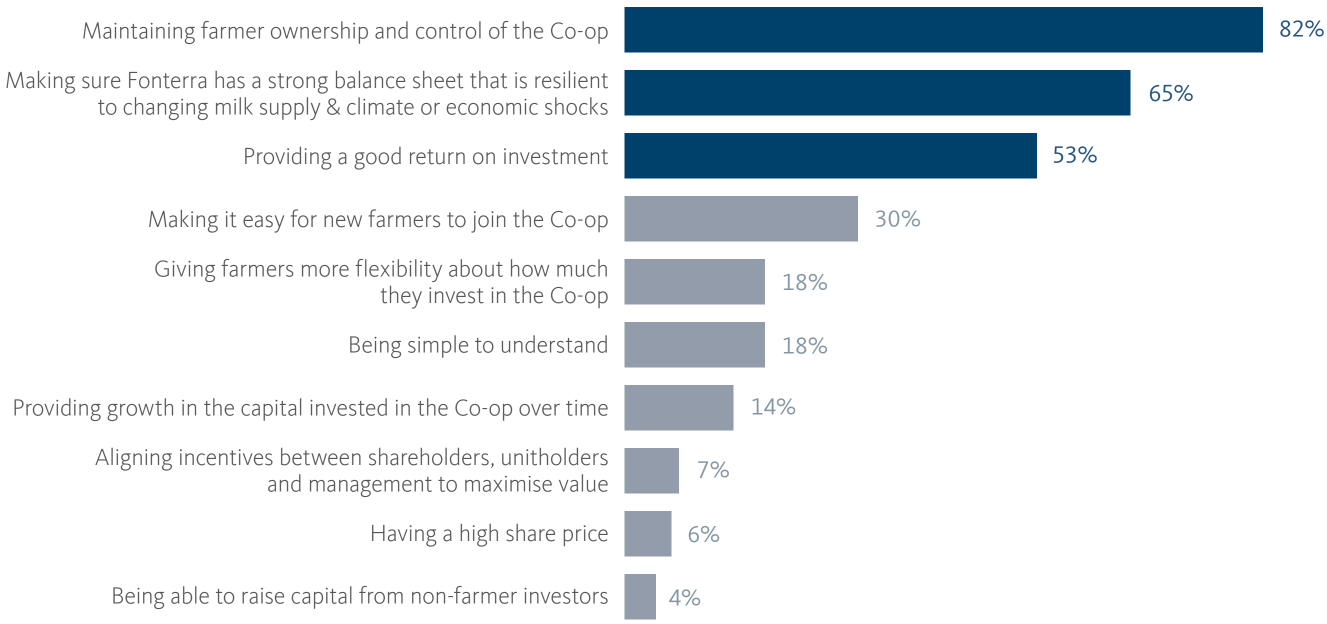
We heard what's most important to you.

The online survey results confirmed that there is an appetite for change, with 62% of respondents either strongly or slightly supporting a change.

The results also gave us an insight into what you consider are the main priorities when it comes to capital structure. We asked you to select up to three areas most important to you, and you can see in the graphic below the percentage of respondents who put the following factors in their top three.

Those areas in dark blue are the standouts, but we also heard that our capital structure should make it easy for new farmers to join the Co-op and for existing farmers to have more flexibility.

The survey results are similar to the feedback we've had from farmers who have left the Co-op in recent years. Essentially, the lack of flexibility in our current structure means that it's challenging for new farmers to join and can be a key factor for existing farmers in deciding to leave the Co-op.



HOW DOES OUR CURRENT STRUCTURE CONTRIBUTE TO US HAVING TO INVEST SO MUCH CAPITAL?

The features of our current capital structure that influence the level of investment include:

1. The share price is partly set by reference to the value of units traded in a public market. Investors in public markets may value shares differently than farmers. On the whole, farmers are less diversified and have competing priorities for their capital – their investments are more focussed (i.e. in farming operations) and therefore it's not possible to 'diversify away the risk' like an investor. Therefore, it is likely that farmers require a greater return from a share to make holding the share worthwhile. This means investors in the Fund may be more willing to pay a higher price for a unit than farmers would otherwise be willing to pay for a share.
2. The single class of Co-op share bundles together your right to supply the Co-op and the requirement to invest in its business, including value-added activities. This together with the current share standard means our farmer owners have little choice about the level of exposure they have to Fonterra's value-added activities, and little flexibility around the level of investment required at various stages of their business life cycle.

In addition to this, when our earnings increase, the share price should increase – so when our Co-op is doing well, our capital structure means it costs more for new suppliers to join and for existing suppliers to increase supply to our Co-op and the higher share price may also be a key factor for existing farmers to leave our Co-op.

Overall, we believe that our capital structure is tilting the playing field against us when compared to other processors – the vast majority of which are corporates who don't require any capital investment from farmers who supply them.

We found that our current capital structure could create challenges over time.

Our current capital structure was put in place when New Zealand milk supply was growing rapidly. Today, we have to be prepared for a future of flat or potentially declining milk volumes.

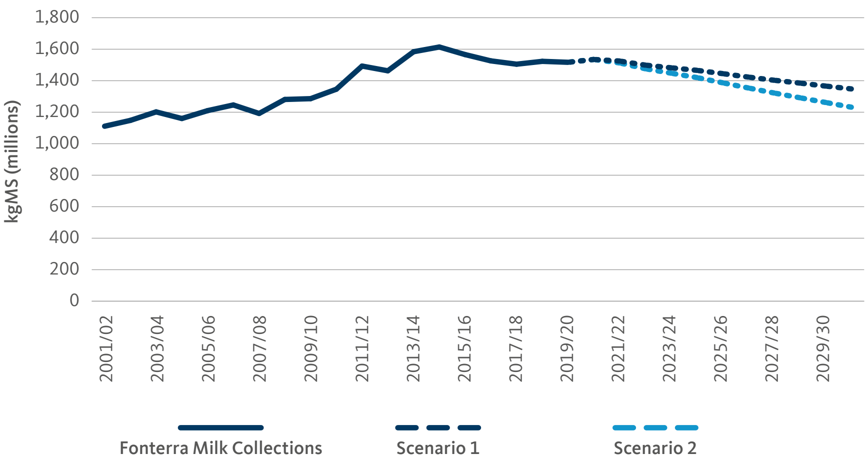
It is important to remember that under our current capital structure, when milk supply declines, the number of wet shares decreases and the number of dry shares increases by a corresponding amount.

We have tested our current structure against potential declining milk supply scenarios based on variations of the average net loss of milk we've seen over the past five seasons and the expected losses from factors such as climate change, new regulations and alternative land uses after allowing for potential productivity gains.

In the chart below:

- Scenario 1 represents environmental changes, land use changes, and changes in productivity, and assumes that our market share continues to change at half the rate of the past five seasons. This scenario could result in a decline in milksolids collected to around 1,300 million kgMS in the relevant period.
- Scenario 2 represents the same environmental changes, land use changes, and changes in productivity, but assumes that market share continues to change at the same rate as it has over the past five seasons. This scenario could result in a decline in milksolids collected to around 1,200 million kgMS in the relevant period.
- The scenarios start from the 2019/20 season's actual milk collections of 1,517m kgMS.

MILK SUPPLY SCENARIOS (KGMS MILLIONS)



Declining milk supply would reduce the number of supply backed (or "wet") shares. These shares would then become dry shares, and the economic rights to these dry shares could then be sold into the Fund. Our Constitution currently sets a threshold for dry shares of 15% of total shares (Aggregate Threshold). As at 31 March 2021, dry shares comprised 14.0% of total shares on issue.

These milk supply scenarios suggest that the thresholds that were put in place when our current structure was implemented to help protect farmer ownership and control could be exceeded within a few seasons.

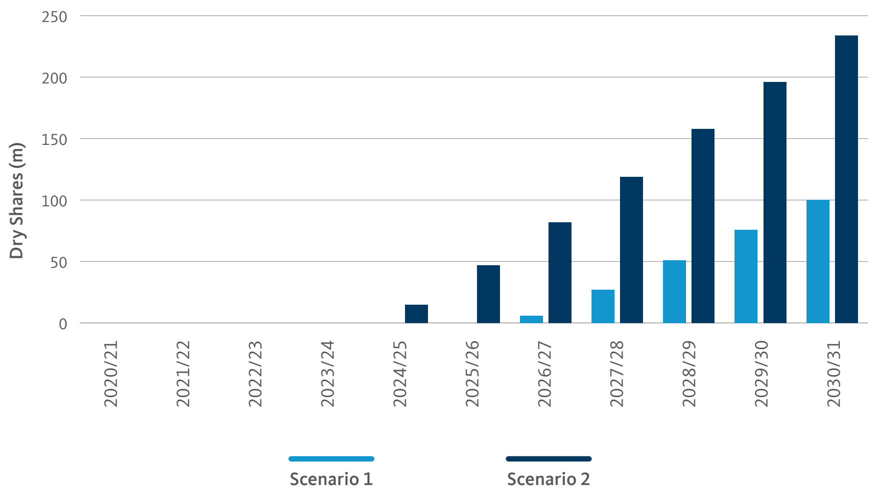
If our milk supply continues to decline to the extent suggested by the scenarios, this threshold is likely to be exceeded within the next few seasons and our Co-op would need to take action to stay within it – such as buying back shares or units. Buy-backs could impact our balance sheet and investment in other strategies that increase performance. Under these scenarios, buy-backs could potentially cost all shareholders between $500 million and $1.2 billion over the next ten seasons.

An alternative to this would be to increase the thresholds and allow a greater degree of external investment in the Co-op's performance through the Fund. However, our view is that the greater this external investment, the greater the risk to farmer ownership and control of the Co-op in the long term.

We don't think either of these outcomes are ideal, and we've reached the view that we need to have a conversation as a Co-op about the next steps for our capital structure.

Any change takes time, and if we don't start now, our options may become more limited, and the cost of addressing these challenges may increase.

CUMULATIVE DRY SHARES IN EXCESS OF AGGREGATE THRESHOLD



We found there are strong potential options for change and we now want to hear your feedback on them.

We looked at a wide range of alternatives to see which would be best at addressing the findings of the review and help ensure a financially sustainable Co-op over the long term.

To give these discussions some structure, the Board has put forward a preferred option – to adopt a Reduced Share Standard with either No Fund or a Capped Fund (see more in Section 3). This indicates our current thinking, but we remain open minded about adjusting that direction based on your feedback.

The other options we considered, including staying with our current structure, are included in Section 5. Your feedback on any or all of these is welcome.

WE HAVE RESPECTED THE CO-OPERATIVE PRINCIPLES BELOW IN CONSIDERING OPTIONS FOR CHANGE:

1. Shares in Fonterra Co-operative Group can only be acquired by persons supplying milksolids to Fonterra.
2. Fonterra supplying shareholders agree to the dual commitment to supply milk and invest capital.
3. Supplying shareholders must comply with the Co-operative Share Standard in respect of their milksolids supplied.
4. Control of Fonterra is exercised by its supplying shareholders who have voting rights in proportion to their total milksolids supplied.
5. Financial benefits and obligations that arise from selling milk are allocated to supplying shareholders in proportion to their total milksolids supplied.
6. Financial benefits and obligations that arise from invested capital are allocated to shareholders in proportion to their shareholding.

5. The other options considered during the review

Our review considered a wide range of capital structure options from co-operatives around the world – both within and outside the dairy sector. We also considered our current structure as an option, including whether there was the ability to make any adjustments within the current framework that would better support a financially sustainable Co-operative.

We then prioritised a couple of options that we thought could best meet the design principles for closer analysis and refinement. In addition to the Reduced Share Standard structure outlined in Section 3 of this booklet, we also prioritised a structure that we call Dual Share with either No Fund or a Capped Fund.

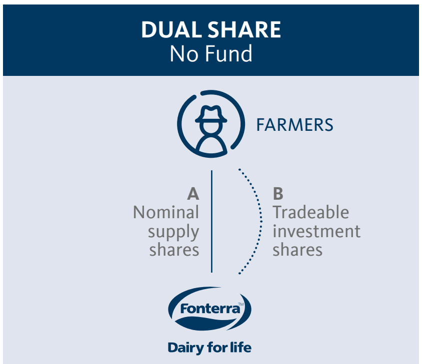
This is outlined to the right, followed by our current structure and then a summary of the other main structures that we considered earlier in the review.

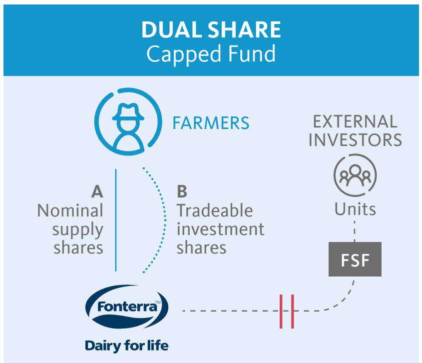
Dual Share with either No Fund or Capped Fund

This structure involves moving away from our current single Co-operative share to a structure with two classes of shares – a compulsory supply share and a separate non-compulsory investment share.

As with the Reduced Share Standard structure, the Dual Share option would give more flexibility to farmers but also has the potential for the existing constitutional thresholds to be exceeded if we took no action in relation to the Fund, as the investment shares could move into the Fund over time. That's why we would need to combine the Dual Share option with either one of the following actions:

- Buy back and remove the Fund (No Fund); or
- Stop the exchangeability of shares for units in the Fund and capping the size of the Fund (Capped Fund).





HOW IT COULD WORK:

Below is how we think the features of a Dual Share structure could work, but as with the Reduced Share Standard structure and other options, these mechanics could be changed.

- The supply share would have a nominal value of $1. The Co-op would issue and redeem supply shares to you based on your kgMS supplied. This would be similar to the arrangements before TAF, but at $1 per supply share, rather than a share price being set each year by a valuer.
- The share standard would be one supply share for each kgMS supplied based on a rolling three-season average, but there could also be a buffer of +/- 5% to allow for fluctuations between seasons.
- The supply share would be:
  - Issued for cash (although this could be payable over a share-up period or out of your milk payments); and
  - Redeemed with an equivalent value of investment shares, or another instrument such as a capital note, or, after an initial five-year period, for cash.
- The investment share would be optional and traded on the FSM (or a similar farmer-only market), with either No Fund, or a Capped Fund where each unit represents the economic benefit in an investment share.
- This means that new members joining the Co-op would only need to buy $1 nominal value supply shares to match their supply, and if you are already a fully-shared farmer owner you would be able to sell down your investment shares if you wanted.
- Farmer owners would be able to hold the lower of up to four times their supply in investment shares, or investment shares in excess of supply representing 5% of the investment shares on a look-through basis.
- Dividends would be discretionary and paid on both supply shares and investment shares. The dividend on supply shares would be capped at a fixed level that is reflective of the risk on those supply shares. Any surplus dividend would be paid on the investment shares only.
- Supply shares and investment shares held by a farmer owner would both carry potential votes:
  - 1 vote per 1,000 kgMS supplied in the previous season to the extent backed by supply shares; and
  - An additional 1 vote per 1,000 kgMS supplied in the previous season, to the extent backed by investment shares. This means that if you hold one investment share for every supply share you will get 2x votes, but if you hold two, three or four investment shares for every supply share you would not get any additional votes.
- The Share-Up Over Time contracts and MyMilk contracts would be phased out and replaced with a standard period for all farmers to pay for the supply shares they would be issued in their first season (of say five seasons). The Co-operative would redeem all supply shares once the farmer has stopped supplying (by exchanging them for investment shares or other instruments as described above). Exiting farmers would have a longer period to sell their investment shares, such as five seasons.

NO FUND – *see pg. 8*
CAPPED FUND – *see pg. 8*

KEY THINGS TO CONSIDER

Some considerations for the Dual Share option are similar to those for the Reduced Share Standard structure.

» This option gives farmers the ability to choose whether or not to invest in the Co-operative beyond milk supply and the associated compulsory supply shares.

» Because the supply share would carry a nominal price, this price would not fluctuate over time. This means that those farmer owners that choose to hold only supply shares would not carry any risk of movements in the Co-operative share price over time.

» Farmer owners would not be required to hold any investment shares and could therefore choose to remove most of their exposure to earnings performance.

» Features such as the nominal value for the supply share and the cap on investment shares could be changed over time. In addition, the dividend on supply shares, voting rights and the timeframes for sharing up and selling shares on exit could be set differently.

» The impacts of a farmer-only market and the regulatory impacts outlined on page 12 under the Reduced Share Standard structure would also apply to this Dual Share option.

The key reasons why this is not our preferred option are:

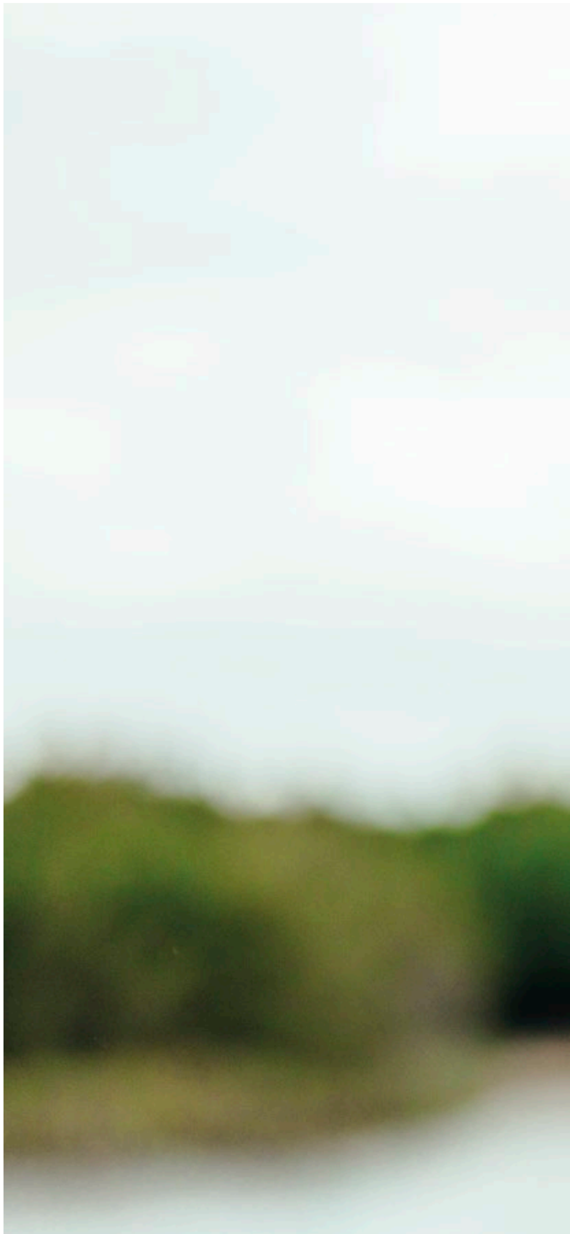
» The supply share is likely to be treated as a half debt and half equity ("hybrid") instrument by the rating agencies that review Fonterra's financial strength, and as debt for accounting purposes. This means that it would reduce the Co-operative's balance sheet capacity by around $750 million (or potentially $1.5 billion if it is rated as all debt), which could limit our financial flexibility over time.

» A Dual Share structure could result in less alignment among the Co-operative's farmer owners than a Reduced Share Standard structure. Farmer owners that choose to only hold supply shares may be more interested in investment in activities that are milk price focussed with less interest in value-adding strategies and investments. On the other hand, those farmer owners with a large proportion of investment shares may be more aligned with business decisions that drive earnings.

» As there would be no requirement for farmer owners to hold investment shares, there may be less liquidity in a farmer-only market than under a Reduced Share Standard.

» A Dual Share structure is likely to be more complex to transition to and operate over time.

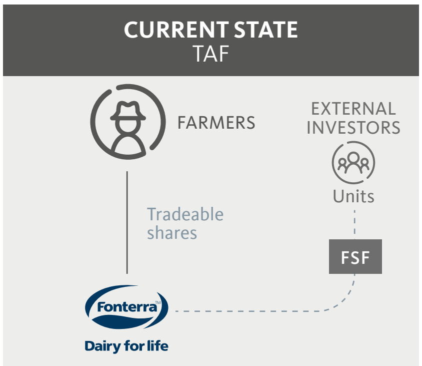
We welcome your thoughts on the features of this option and the relative risks and benefits.



CURRENT STRUCTURE

The key features of our current structure are outlined in Section 4.

Under our current structure, if milk supply declines to the extent suggested by the scenarios, Fund size limits would likely be exceeded. This would mean that the Co-op would need to take action such as an ongoing programme of share buy-backs to maintain the Fund within the thresholds set out in our Constitution. Buy-backs mean that we would have an uncertain demand on our capital, which compromises our ability to invest in strategic initiatives to grow value for shareholders. If we didn't buy back shares, we may need to increase the Fund size limits, which could put farmer ownership and control of our Co-op at risk.



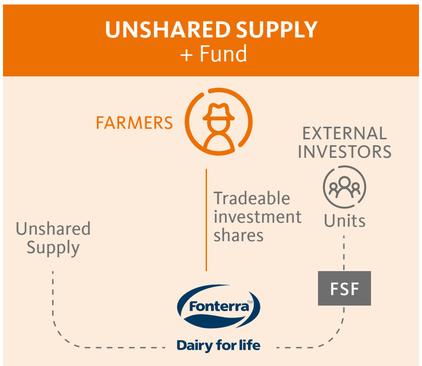
If we do not have enough farmer owner support for change, we can continue with our current structure for a period of time, but the challenges identified will ultimately need to be addressed if milk supply declines to the extent suggested by the scenarios. This is why it is so important that we hear your feedback on the options.

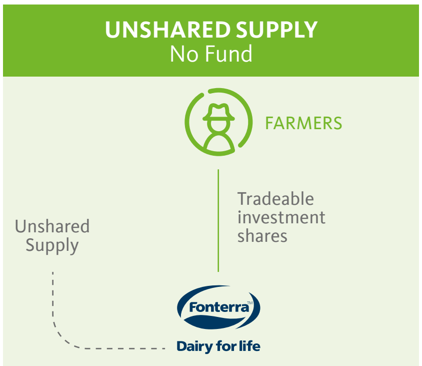
What are your views on the Dual Share structure?

What are your views on retaining our current structure?

OTHER OPTIONS CONSIDERED, BUT NOT PRIORITISED

A number of other options were considered in the review but not prioritised. The main ones are summarised here, but again there are variations within each:



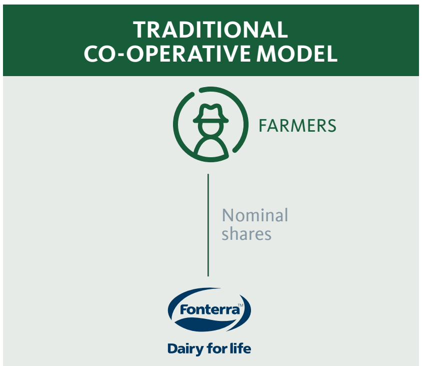


Options that allow Unshared Supply

We considered allowing a greater proportion of unshared supply in the Co-op. Unshared supply means that milk could be supplied to the Co-op without any capital investment.

We did not prioritise unshared supply options because they are less aligned to our Co-operative Principles, and they set up incentives for farmers to become unshared suppliers in order to free up capital. We feel it is important that our capital structure should be on the basis that all suppliers to the Co-op have some capital commitment or "skin in the game".

While unshared supply options could be implemented with or without the Fund, if the Fund was retained and a large proportion of farmer owners wished to transition to unshared supply, it could grow significantly and we would likely need to move to a Capped Fund. If a significant number of farmers chose to become unshared, this could also have implications for concentration of ownership amongst a small group of farmers.

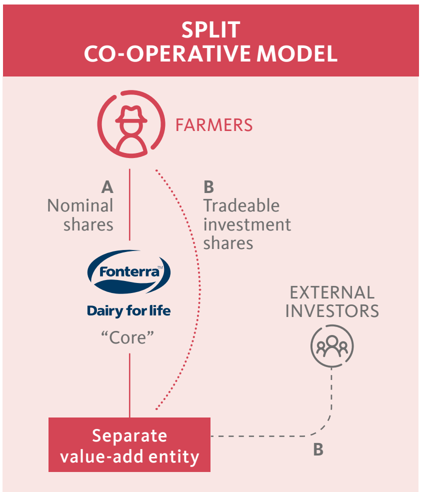


Traditional "nominal share" options

This option would require us to return to a nominal share only structure, similar to a traditional co-op model. This would mean that farmer owners would only need to hold a nominal share (e.g. $1) for every kgMS supplied.

While this would significantly reduce the barriers to entry and incentives to leave for all farmer owners, we did not prioritise this because transitioning to a nominal $1 share would require all current shares on issue to be bought back. This would require significant capital to be returned to farmer owners, which would be unaffordable. We also do not think this would be achievable under the current regulatory environment in New Zealand.

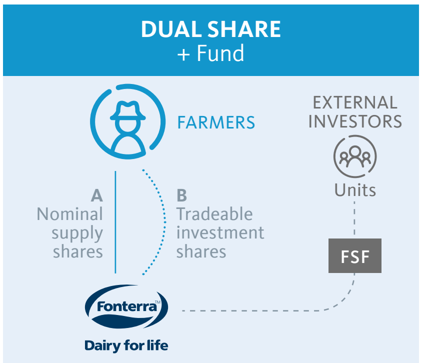
Are there any other options or alternatives that you think should have been considered?

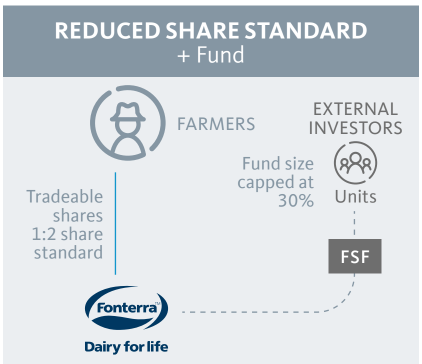


Options that split the Co-operative

This option would see the Co-op split into core processing assets that farmers would continue to wholly own, and a separate "value-add" entity that external investors could invest in. Only farmer owners would hold shares in the core processing assets which could have a nominal value (noting this may not be achievable under the current regulatory environment). Farmer owners and external investors could hold shares in the separate value-add entity.

We removed this option from further consideration because of the operational and transitional complexity it would introduce, and because of the potential for misalignment between external equity and farmer interests, and pressure to sell down the farmer stake in the value-add entity over the long-term.





Options that provide flexibility and retain the Fund

Earlier in the process we considered options that created more flexibility but retained the Fund.

These options were a Dual Share structure with Fund and a Reduced Share Standard structure with a larger Fund.

These options were discounted on the basis that the non-compulsory investment shares would likely be sold into the Fund over time, and the Fund size would grow significantly, risking farmer ownership and control.

We also explored a 1:2 share standard, but this was considered unlikely to provide the level of flexibility required by farmers and would also likely result in the Fund size growing significantly, risking farmer ownership and control.

6.
Where to from here

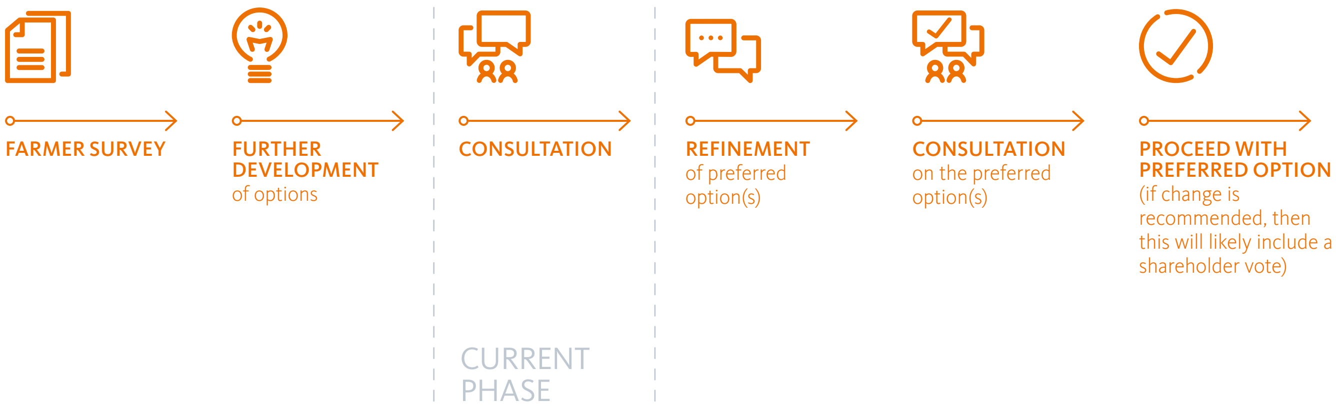
THE CONSULTATION PROCESS AND TIMELINE OF NEXT STEPS

We want to hear your feedback. All of the key information about our review is set out in this booklet which is being emailed and delivered to each supplying farm. You can find further information and questions and answers at www.fonterra.com/capitalstructure.

There will be a series of initial meetings in your regions to discuss this further, with your Directors and management representatives leading those discussions. After that, there will be further opportunities for discussion and feedback in your regions – check the Farm Source website for dates and locations. We intend to share initial farmer feedback in July.

Your feedback will inform the next steps of the review. On the basis it remains clear that there's an appetite for change, the idea is that we'll do further work to refine the preferred option(s) and have a second round of consultation. If we decide to seek a change to our capital structure, then you will have a chance to vote on that change and you will receive a document with all the detail prior to your vote. We would likely aim to seek your vote on direction for change at or around the annual meeting in November.

As some aspects of our current capital structure are reflected in the DIRA, any vote is likely to be conditional on any necessary changes to legislation being passed.



1 FIND OUT ABOUT THE REVIEW

This booklet provides you with all the key information you need to know about the review. You can also find this information via fonterra.com/capitalstructure

- **Come along to a Director meeting** near you or join an online webinar. The webinars will be recorded and made available via the Farm Source website. You can find dates, times and locations via nzfarmsource.co.nz/meetings

2 GET INVOLVED

After the initial Director meetings, we will be running local meetings and discussion groups. There will be online options as well. These meetings will be an opportunity to discuss this booklet, what capital structure means for us, what works, what doesn't and an opportunity to ask questions and provide your feedback.

- **Come along to a local meeting.** You can find dates, times and locations via nzfarmsource.co.nz/meetings
- Join the **online conversation** with fellow farmers on the Farm Source community discussion group on the Farm Source website via nzfarmsource.co.nz/community

3 PROVIDE YOUR FEEDBACK

Share your views via the online form at fonterra.com/csfeedback

Alternatively, you can also provide your feedback via any of the following channels.

1. At a farmer meeting
2. Contact your Area Manager or service team on 0800 65 65 68
3. Email us on cs_feedback@fonterra.com

HOW TO CONTACT US

If you have any questions about Fonterra's capital structure, contact your Area Manager or service team on 0800 65 65 68, or email us at cs_feedback@fonterra.com

Directors are also available if you have any questions. Contact details can be found in the back of any Farm Source Magazine.

FOR MORE INFORMATION VISIT *FONTERRA.COM/CAPITALSTRUCTURE*

7. Glossary

IN THIS BOOKLET:

Aggregate Threshold	means the threshold set out in the Constitution for dry shares as a proportion of total shares on issue, being 15%
Board	means the board of directors of Fonterra
Constitution	means Fonterra's constitution, as amended from time to time
Co-op, Co-operative or Fonterra	means Fonterra Co-operative Group Limited
Custodian	means Fonterra Farmer Custodian Limited
DIRA	means the Dairy Industry Restructuring Act 2001
Dry share	means a share held by a farmer owner in excess of the number of shares determined in accordance with the Share Standard for the season
Economic rights	means the rights to receive dividends and other economic benefits derived from a share held by the Custodian for the benefit of the trustee of the Fund
Farmer owner	means a shareholder in the Co-op
FSF or Fund	means the Fonterra Shareholders' Fund
FSM	means the Fonterra Shareholders' Market
kgMS	means kilogram of milksolids
Market maker	means the registered volume provider who is active in making bids and offers on a minimum number of shares in the FSM
MyMilk contract	means the current contract supply option without any requirement to purchase shares, available to farmers who meet the relevant criteria
Overall Limit	means the limit set out in the Constitution on the size of the Fund, being 20% of the total shares on issue
Non-compulsory share	means any share that is not required to be held to meet the relevant Share Standard
Share	means a co-operative share in Fonterra
Share standard	means the number of shares a farmer owner is required from time to time to hold as determined in accordance with clause 3.4 of the Constitution
Share-Up Over Time	means the contract options to supply Fonterra on the basis that shares are purchased over time, including strike price contract options
TAF	means Trading Among Farmers
Temporary Cap	means the temporary cap on the size of the Fund that has been put in place in order to consult as set out in this booklet by suspending the ability for the economic rights of dry shares to be sold into the FSF
Wet share	means a share held by a farmer owner which is required to be held in accordance with the Share Standard for the season
Unit	means a unit issued by the FSF
Voucher	means a certificate referred to in clause 3.4 of the Constitution that was provided to a farmer owner on the transfer of the economic rights of a wet share to the Fund under the 2012 and 2013 supply offers to farmer owners, and that can be used by the farmer owner together with shares, to meet the Share Standard.

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