Andrew Ferrier at the New Hemisphere Speaker Series: “Unlike a corporate, whose relationship with shareholders is based purely on capital, the co-operative has complex, and multi-dimensional relationships with our farmers”.
Opportunities and Challenges of the Co-operative Model

by Andrew Ferrier

At the top of New Zealand’s list of top 200 companies are two very different organisations. At one is Fonterra, with $12.5 billion in revenues in 2003. At two is Telecom, with $5.1 billion in revenues in the same year. The first is a co-operative, the second a corporate. We share many similarities. Both Fonterra and Telecom are the products of change. Telecom was born out of the old New Zealand Post Office in the days when the government was withdrawing from the business of business, privatising its commercial assets and exposing them to deregulation. Fonterra too was created through deregulation, but it was deregulation that was threatened by Government, and ultimately brought about by farmers themselves with the Government’s co-operation. We are alike, but we also have fundamental differences. Telecom’s website, for example, lists 12 broking houses with analysts dedicated to studying and commenting on its operations for the benefit of shareholders. Its shareholders can be anyone with capital willing to invest voluntarily in the company. They enter and exit at will, simply by trading their shares on the market. Fonterra, by contrast, has one formal mechanism for studying and commenting on our performance – and that is a self-created mechanism through our Shareholders’ Council. Our shareholders must be dairy farmers. To supply us, they must make compulsory capital investments and these are invariably for the long term.

It is not surprising then, that I believe Fonterra is not well understood as New Zealand’s largest company. Much of this stems from the lack of understanding about the traditional and the modern co-operative model. In today’s session, I want to close this information gap by examining why the co-operative model survived as a cornerstone for the New Zealand dairy industry – and indeed the economy. I want to trace the evolution of this model from one exhibiting some very real disadvantages, to one which combines traditional co-operative values with modern corporate standards in terms of governance and performance measurement.

Finally, having put the co-operative into a clear context, I want to examine what challenges the co-operative model poses for manage-
ment, and how these challenges have unique solutions. Before doing so, I want to place on record the contribution of co-operatives to the New Zealand economy. The figures may surprise you. The total revenue from New Zealand’s top 200 companies is some $101 billion per annum. Of that, over $53 billion is generated by the top 20 companies. Of those top 20 companies, the top six co-operatives, including Fonterra at number one, generated over $20 billion of revenue – or more than 39% of the revenue from those top 20 companies. All up, trading co-operatives contribute over $23 billion per annum to the New Zealand economy. Yet there is this lingering notion that co-operatives are an anachronism, riddled with problems like lack of performance transparency, capital constraints and cumbersome decision-making processes. Despite this, they have survived. In today’s session, we will return to history to consider why that is and to learn why they are so tightly woven into the fabric of the dairy industry, that any alternative seems impossible.

The Historical Perspective
Dairy co-ops have been part of New Zealand’s history since 1871 when the country’s first cheese company was created on Otago Peninsula. Like co-operatives all over the world, they were established to create the power that comes from pooling resources. By the 1930s, more than 400 separate dairy co-operative companies were operating throughout the country. They were export focused, and had their own international marketing arm in the Dairy Export Produce Control Board. From the 1930s to the 1960s, we saw the beginnings of the industry consolidation which ultimately led to Fonterra. As technologies in transport and refrigeration improved – for example, cooling of milk on-farm was introduced 1955 – co-ops began joining forces to become more efficient. By the 1960s, 400 co-ops had become 168. From today’s perspective, the industry of the 1960s was fragmented, high-cost and inefficient. In the 168 manufacturing companies the average herd size was just over 60 (it’s 285 today) and the overwhelming bulk of earnings came from the sales of butter and cheese to the United Kingdom. Nonetheless, the foundations for the modern co-operative were laid back then. In the 1960s the menace of dumping in the international market place was already a reality worrying New Zealand’s farmers.

The walls of agricultural protectionism were being built and the use of production subsidies by the developed economies was widespread. It became increasingly clear that in order to compete, New Zealand’s dairy co-operatives were going to have to become much more efficient. Driven by technology and cost efficiencies, the processing industry began to consolidate and by 1995 had shrunk to 13 dairy companies. In contrast to this consolidation at home, internationally the industry’s marketing operations were expanding – and for good reason. The 1960s threat of Britain joining the EU sent the Dairy Board into a diversification drive. Milk recombining plants were established in South East Asia and contracts established for the supply of milk powder and milk fat to other countries. The industry’s marketing arm also started down the value-added road, establishing what we now know as New Zealand Milk, to improve returns to farmers. Brands and a consumer marketing infrastructure were built, products developed and people trained and recruited. By the 1980s, the Dairy Board had 19 subsidiaries and associated companies around the world. By 1990 it had 40 and by 1995, 80. In a little over 10 years, the New Zealand Dairy Board became the world’s largest dedicated dairy marketing network. Talk to any industry leader and they will tell you that the UK’s move into the EU represented a watershed for the industry. The diversification I have just described took place at home as well as in our markets. Co-operatives began to expand their manufacturing capabilities, shifting from butter and cheese – the mainstay of our UK exports – to begin investing in the infrastructure to manufacture the milk powders which are an important part of today’s product mix. You can see a pattern forming here. Co-operatives moved with the times, but kept to the traditional model because it made sense. There was no need to change. The system worked. Farmers kept control of assets built up over generations and the whole business of marketing products was efficiently taken care of by a separate, monopolistic marketing arm.

The Question of Disconnection
But it is fair to say there was a curious disconnection between manufacturing and marketing – even though both were supposed to be working for the farmers’ good. This may go to partly explain the exasperation the business world had with dairy co-operatives in terms of efficiency and performance transparency. How did this disconnection come about? A lot of it was due to ownership structures. When Government legislation created the Dairy Board in 1961, it created an entity where capital and assets were provided by the co-operatives, but the primary accountability was not to the industry, but to the Government. Legal ownership of the Board was never clearly defined under the 1961 establishing act. It is probable that at the time, Parliament did not envisage the Board becoming a multi-billion dollar global enterprise with net assets of US$1.2 billion – an enterprise in which co-operatives had millions of dollars invested. This lack of clarity led to two things. The industry did not behave as owners and the Board did not treat them as such. The one measure of performance for the Board was payout. Payout forecasts were made three times a year and there was no long-term reporting of performance.

This tended to shift the focus onto the co-operatives, who added the cream on the top of payout with their margins. A co-operative’s success was always measured by its margin and so there was fierce competition between New Zealand’s co-operatives to beat their neighbours. How did this disconnection manifest itself? Industry veterans talk about the Board working the market to secure contracts for milk powder, while co-operatives were going their own way and producing cheese because they thought it had more value. In other words, the Board had no real influence over what co-operatives could, or would, produce. The co-ops, hell bent on beat-
ing their neighbours, had little interest in the shifts of market demand. It’s fair to say farmers were also disconnected from the global markets that bought their products. For most, the world ended at their co-operative and they had little understanding, or interest, in the key factors influencing payout.

It was not until 1996 that this disconnection started to be resolved. It was then that the Dairy Board Amendment Act transferred ownership of the Dairy Board’s assets to New Zealand’s 12 dairy co-operatives. Even then, the transformation was not instant. A year after the transfer of the assets, it was apparent that the co-operatives still hadn’t come to grips with what this meant. In a speech to co-operative chairmen, John Storey, then Chairman of New Zealand Dairy Group, tried to argue for a charter of owners to set down some performance parameters. “The Board’s assets are now on our balance sheets”, he said. “We can no longer sit back - as we have sometimes done in the past - and leave the Board to carry all the responsibility for its performance. There’s not much point in paying lip service to principles like transparency and accountability unless we’re prepared to put down on paper how we want these principles observed”. He also forecast that the industry had to take ownership very seriously because, and I quote, “all the signs point to a future which may see the Board lose its statutory support”. This threat of deregulation, which became a reality, is the pivotal point in the development of the modern dairy co-operative. It forced the industry to really consider the future, and what changes were needed to move into a future without a single desk export monopoly. It also forced competing co-operatives to work together, to counter the threat of forced deregulation with a proposal to manage the transition themselves. But the single, integrated co-operative that we have today was not their immediate solution.

Deregulation as a spur to change
The industry examined no fewer than 32 different options, some which tinkered with the idea of opening up the dairy industry to external investment. To the corporate world, this may have seemed a very sensible model indeed, but to the co-operative world, it was an anathema. The co-operative principles of farmer ownership and control are not lightly relinquished. After considering 32 options, the industry determined that the single integrated company looked the best. Farmers understood the relationship between the ownership of the value chain and capturing in payout their share of the value created beyond the farm gate. They saw, in the integrated model, the opportunity to create a new co-operative that would extend from the farm gate out into the world, do away with the disconnection between manufacturing and marketing and introduce some really tough and transparent performance measures. But it’s a measure of corporate scepticism about co-operatives that their new found vision looked very flawed to many commentators. One, for example, cautioned farmers there was a “real threat of an unaccountable, bloated primary manufacturing business soaking up the benefits, with the farmer-owner little better off”. Many commentators doubted the industry would ever make the change – especially as the merger discussions to create this one company looked more like two parties arguing over a hostile takeover. What these commentators failed to see was that co-operatives, by their nature, can only move forward by consensus. While this is a slow and sometimes painful process, it is important to recognise what an historic consensus was being reached here.

It was pan industry agreement that we needed a new co-operative model – one that integrated marketing and manufacturing and addressed the major issues such as fair entry and exit and governance, which I will deal with shortly. Despite these improvements, there were still critics who felt the industry lost an opportunity to do away with the co-operative model altogether. Comments by John Roadley, founding Chairman of Fonterra, sum up why this option was never seriously considered. “We are organised as a co-operative not because we espouse a sort of vague collectivism. It is firstly because this suits the long-term nature of our dairy farming business and secondly, most importantly, because it gives us market power. Market power has always been exercised by those who have it over those who do not. By having market power, Fonterra gives the farmers the only viable means by which they can move more of their milk towards the higher end of the value chain and utilize the value creation potential of the business itself”.

Market Power
The industry voted for just that, market power. If you are one of our 12,634 shareholders, you have that. What you own is the largest dairy ingredients company in the world. What you own ranks at six in the world’s top dairy companies and is responsible for 40% of global dairy trade. What you own is 25 ingredients manufacturing sites in New Zealand and a further 37 sites in New Zealand and around the world that produce consumer dairy products. What you own is a consumer brand portfolio that includes household names in New Zealand like MeadowFresh, Mainland, Tip Top, Kiwi and Hutton, and internationally, like Fernleaf, Anchor, Soprole, Anlene and Annum. What you own is a share of nearly $11 billion in assets. And speaking of market power, Fonterra generates 23% percent of New Zealand’s export receipts by value and dairy is our leading export industry. No wonder our shareholders have faith in the co-operative model.

This faith is not based purely on history. It is based on their determination that in creating Fonterra, they would create a modern co-operative which is far superior in terms of governance, performance transparency and efficiency. I should make these points with a flourish. While there are many things Fonterra could do better, it serves as an example of what a cooperative could do better. The key driving force was the need to convince the regulators, whose co-operation was needed, that this virtual monopoly could, and would behave in line with modern standards of governance and performance transparency. The new co-operative model needed to abide by new rules, captured under the heading New Economics, that would allow the empowering legislators to take the leap of faith to create Fonterra. The
new co-operative model addressed all the problems of the old, including fair exit and entry, governance and clear pricing signals, while maintaining the commitment to co-operative principles. Let me explain how these issues were resolved.

**Fair Exit and Entry**

Fonterra’s adoption of fair exit and entry values represented a significant shift in co-operative thinking. Shares in a dairy co-op used to be something you bought at a nominal price in order to supply milk. You sold them at the same price, probably many years later, when you ceased to supply. On exit, you would almost certainly leave a co-operative that had enjoyed significant growth in its assets. The farmers coming in to replace you would immediately benefit from those assets without paying more for the privilege. Today, the value of our shareholders’ investment in us is not only far more transparent, but is also bankable. The rules are the same. Our shareholders must buy shares based on the volume of their supply. But those shares are now independently valued by Standard & Poor’s.

It is an annual process that takes into account the likely future earnings of Fonterra by looking at our added value businesses, corporate overhead, R&D, and other operations, as well as the forecasted volume of milk supplied to Fonterra, expected exchange rates, commodity prices, and the number of shares. From a valuation range given by S&P, the Board selects the share value for each season. Two weeks ago, our Board set the value for 04/05 season at $4.69, an increase of 31 cents, or 7%. This compares with $4.38 in 03/04 and $3.85 in the 02/03 season. Our new shareholders buy into Fonterra at a price that reflects the full value of the co-operative. Those leaving, exit at a price that reflects any increase in our value. Exiting farmers are paid out immediately, in full, in the form of Fonterra capital notes, which are freely traded. This mechanism also prevents the possibility of a run on the company’s shares. Because any major outflow of capital would be serious for the company, we have a brake mechanism within the Fonterra Constitution so the Board can buy time and protect our viability if more than 5% of shareholders decide to leave at one time. This contrasts with earlier co-operative models which allowed co-ops to retain a farmers’ processing capital for up to five years.

In addition to the Fair Value Share, our farmers have other means of scrutinising our performance, and hence the value of their investment. One is by comparing their Actual Milk Return with the Commodity Milk Price, also set independently by Standard and Poor’s. The CMP is the highest theoretical price that an efficient competitor could afford to pay for New Zealand’s milk, while making an adequate return on capital. It optimises product mix, and minimises capital investment and other costs, to set out what is an extremely challenging benchmark. Our challenge is to reduce the gap between the CMP and what we actually pay farmers. Our shareholders also have the performance measure of Total Shareholder Return. TSR is our total return to shareholders, before tax, divided by the value of their total equity invested at the beginning of the year. Our TSR, excluding foreign exchange hedging related to the Commodity Milk Price, was 10.2% last season and 16.7% including hedging.

**World Class Governance**

Poor governance is constantly being cited as a problem with old-style co-operatives. Some of that criticism is justified. Many boards were very large and decision-making was often slow, even by co-operative standards.

This stemmed from a tradition of local, rather than national representation on Boards. Co-operative shareholders were accustomed to ringing their local director and believed he represented their interests. This is despite the Companies Act stating clearly that directors must always act in the best interest of the company. In other words – of all shareholders. Fonterra, by contrast, began life with an already lean governance model of nine elected farmer directors and four appointed outside directors. Our shareholders, every year, have the opportunity to pass judgement on their performance, as three farmer directors must retire by rotation and contest an election. The appointed directors, as well, must be ratified by a shareholder vote. These annual elections mean the Board’s performance is under constant scrutiny, as is the performance of individual directors.

Fonterra’s performance is also subject to a further layer of scrutiny which is unheard of in the corporate world. We have a Shareholders’ Council, with 46 councillors elected in geographic wards. It came about because farmers were worried that with the merger they would lose the traditional direct access to Directors that they enjoyed in small companies. The Council works with the Fonterra Board to advance the company’s co-operative philosophy and it also formally monitors and reports on our performance. It is no lapdog. In the corporate world you have to deal with large institutional investors or controlling shareholders who scrutinise the performance of the board in much more detail than the average shareholder. In Fonterra, through the Shareholders’ Council, our shareholders have a unique independent body mandated to evaluate the Board’s performance in governing Fonterra.

**Clear Pricing Signals**

Another constant criticism of co-operatives is that they did not give their members the clear pricing signals needed for those members to make decisions on increasing or reducing production. Fonterra addressed this issue with a mechanism called Peak Notes. Our shareholders hold one Fonterra share for every kilogram of milk solids they supply, but we also take into account the fact that shareholders may exceed their average seasonal supply patterns in any given season. Peak Notes, which cost $30 each, are the mechanism through which shareholders contribute extra capital to cover the processing of this extra milk. The overall aim is to ensure that price signals are transmitted as directly as possible to farmers, and that farmers are able to make the most informed decisions about their investments and production. I have to say that farmers are not the world’s most enthusiastic supporters of
Peak Notes, which they regard as complex. We continue to grapple with how we might simplify the system. We also need to grapple more effectively with how we ensure farmers know the underlying value of their milk. The industry attracted fair criticism for its past practice of bundling returns. This lack of transparency encouraged farmers into inefficient over-production.

Today in payout, we separate the underlying value of our suppliers’ milk, which we call the Actual Milk Return, from Fonterra’s “profit”, or the return on our value-added activities. This is because there is a need for strong signals about the value of a bucket of milk at the farm gate. Let me explain why. New Zealand farmers are among the world’s most cost efficient. They have enjoyed no subsidies since the mid-1980s, so they have had good incentives to keep their production costs as lean as possible. They drive hard to bring production up, using everything available from selective breeding to the management of their pastures to do this without increasing their costs. As a result, they have generally profited from their production, even at times of low commodity prices. Currently, the bulk of their earnings come from commodity sales. Our expected payout this year includes around 12% of value-added returns. But with all the long-term trends pointing to a lessening in commodity prices – Fonterra is strongly pursuing value-add strategies to increase our payouts to farmers. As we push value-added earnings up, it’s important our suppliers are clear about the underlying value of their milk. We want them to increase production, but only of profitable milk. So it will become increasingly important for them to differentiate clearly between commodity and value-added returns so they can make the right judgements on production increases.

**Commitment to Co-operative Principles**

The one thing that remains the same in the old co-operative model and the new is the total commitment to co-operative principles. At their heart is the commitment to accept, process and sell all milk supplied by shareholders. Whatever direction we take as a company will always start from this point. Sustainability of the co-operative is an important value held by all our shareholders.

**The Unique Management Challenges & Opportunities**

Having explained the new co-operative model, the new rules that govern it and how the new model is a vast improvement on the old, I will now move to the unique management challenges and opportunities this model presents. These challenges come under three main headings; communications, internal competition and capital. The opportunities include the ability to think long term and the truly global potential of Fonterra. Let’s consider the challenges first, beginning with communication.

**Communications** Unlike a corporate, whose relationship with shareholders is based purely on capital, the co-operative has complex, and multi-dimensional relationship with our farmers. They are our shareholders. They are also our suppliers and they are the beneficiaries of services and support. Like shareholders in a corporate, they run the full gamut from the institutions down to the Mum and Dad shareholders. Farming corporates, with sophisticated organisational structures and intensely professional planning disciplines are becoming increasingly common. They run more than 1600 cows and supply, on average, half a million kg/MS a year. The biggest provides almost one million kg/MS. At the other end of the scale are the smaller operators, with a typical herd size of around 234 cows and average supply of 71,000 kg/MS. Large or small, they have invested heavily in their businesses. Our shareholders’ average capital investment in their farms exceeds $2.2 million, or $25,000 per hectare. Last financial year, the average shareholders’ investment in Fonterra, including the capacity funding instrument of peak notes, was $5.39/kg/MS – or close to half a million dollars.

These are substantial investments and because the future of their business is intrinsically linked with their co-operative’s performance, our shareholders need to understand our business in its totality. For this reason, a substantial amount of my management time is spent in direct communication with our shareholders – all 12,634 of them. When I talk to corporate leaders about the time I spend on the road talking to shareholders, I can hear them thinking this is excessive – or indeed obsessive. But let me share a story. Last year, our shareholders experienced our usual round of communications. This included:

- Regular Field Rep briefings
- a monthly magazine
- a website dedicated to farmer needs which they can access daily for their own on-farm production statistics
- letters from the Chairman updating them on any important issue
- briefings around our half year and annual accounts
- director roadshows on initiatives around the environment and milk pricing
- an AGM televised over nine venues, and
- regular district meetings with Shareholders Council

You might think our shareholders were communicated out. In fact, what I was hearing is that despite all this effort, they still felt we were too remote, too inaccessible and were not giving them all the information they wanted about their co-operative. They were right and they were wrong. There was nothing wrong with the amount of information we were providing, or the level of detail. What our farmers wanted, however, was to hear it face to face and in small groups. I cannot imagine a single corporate that would be able to recruit hundreds of volunteers to form a network designed to talk to shareholders. We’ve done just that. The Fonterra Farmer Community Network is a team of farmer volunteers who are going out there, in their communities, sharing the news about Fonterra.

They’re working on a ratio of one network member to every 20 of our shareholders. They will augment the work we already do in shareholders communications, and of course
the onus is on us to ensure they are fully informed about the company. The initiative comes under a programme we called “Big in the World, Small at Home”. This sums up the communications task we have with our shareholders. “Big in the World” means we are building their understanding of what they own and what we are doing with it. “Small at Home” addresses the concern our shareholders had that the big, new Fonterra was too removed from them and, in growing so large, had become remote. It encapsulates everything we are doing to connect with our farmers. Shareholder communications is undoubtedly one of the biggest differences between managing a corporate and a co-operative. In the corporate world, you can afford to map out a strategy and pursue it without too much dialogue with your shareholders. In the co-operative, you have to take your shareholders every step of the way. You must constantly invest in ensuring they understand the major issues facing the business because, time and again, they will be required to support the initiatives needed to address those issues. When those initiatives involve major change, the level of understanding among shareholders must be such that 75% are prepared to commit to this change when it is put to the vote.

**Internal Competition** Investing in the level of communications needed to keep shareholders engaged and informed makes good commercial sense. Engaged shareholders are also loyal shareholders and therefore less likely to take their capital – and their supply – to a competitor.

One of the misconceptions about Fonterra is that we have no real domestic competition, given there are only two other dairy co-operatives in New Zealand. One, Tatua, is closed to new supply. The other, Westland, is geographically limited in what new supply it can accept. New ventures, like the Open Country Cheese Co, are looking for supply, but their needs are modest. So why worry? In a word, deregulation. The Dairy Industry Restructuring Act 2001 opened up the industry, creating opportunities for setting up new domestic and export dairy companies to enhance competition. It removed the export monopoly enjoyed by the Dairy Board, and through them, the dairy industry. It specifically restricts Fonterra from entering into long term contracts that lock down total supply in any geographic area – a third must always be open to competition. Our shareholders have the right to allocate 20% of their production to another processor. If they are dissatisfied with our performance, they can leave the co-operative and take their investment with them. Fonterra is also compelled to sell up to 400 million litres of milk, effectively at cost, every year to any potential buyers.

The absence of an immediate threat does not mean there are no threats. Performance is our best defence. As long as we continue to produce a high quality product at competitive prices and to form strong partnerships with important customers, such as Nestlé, we will lessen the incentive for a competitor to set up in New Zealand. At the same time, delivering sustainable and increasing returns to our shareholders lessens the incentive for them to supply a competitor. Of course, given Fonterra’s size and scope, we really view any real competitors from a global, rather than a New Zealand-centric perspective.

**Capital** One of the principal challenges I face stems from the heart of co-operative principles. As a co-operative with capital linked to supply, we have fundamental tensions to deal with that other commercial entities do not. First is the extent to which supplier shareholders are prepared to accept compulsory funding of opportunities that can create value. Second is the unique role of our shareholders, who are also our suppliers and have the right, in our deregulated market, to take supply and capital elsewhere. Finally, Fonterra, as a co-operative, has the commitment to process all milk from our suppliers. Fonterra sought to resolve these tensions by defining those activities that clearly fit under the compulsory shareholder investment umbrella. We call these our cornerstones. They are the activities where there is a strong link to selling or adding value to shareholders’ milk. They include all commodity activities, plus a sub-set of value-added activities that clearly fit within the realm of compulsory shareholder investments. What this means is that Fonterra should only own value-added activities beyond the production and sale of basic commodities when they have strong commercial merit, when they use Fonterra’s distinct capabilities and when they support the selling of shareholders’ milk. One of the defining characteristics of a cornerstone is that Fonterra is the natural owner because the activities are more valuable to us than to any other owner. If an activity has more value to another owner, it would be in shareholders’ interests to sell it and use the funds elsewhere in the business. The cornerstones are designed to provide a focus for the business, but it is important to recognise that in defining them, we are not locking in an inflexible view of the business. A critical component of our long term strategy is in defining the cornerstones sufficiently to truly unleash the potential of our co-operative.

Our Strategic Plan takes into account the long-term implications in defining the cornerstones. It recognises our evolution from the Dairy Board with a mandate to export New Zealand milk products, to the pre-eminent global dairy products company that we are today. For example, Fonterra not only sells products made from our shareholders’ milk, but also products made from milk sourced from third parties. At first glance, this would appear to work against the interests of our shareholders, since these third parties are not providers of capital. However, one of the real benefits of Fonterra is that this third party supply has the ability to create better long-term returns for our shareholders. Why? For two reasons. Firstly milk supply in New Zealand is seasonal, but the demand from major food manufacturers for commodity ingredients is not. Secondly, the major players in the market seek security of supply and they see supply from any single country as a risk. Our presence in the market is such that we can offer our customers security by sourcing supply from third parties, thereby reducing perceived risks and offsetting seasonality. This allows us to take more significant positions with major multinationals and has the effect of stabilising
our sales portfolio somewhat. This brings greater certainty to
our sales, something that is very much in our shareholders’
interests. Similarly, Fonterra owns a portfolio of global con-
sumer brands that generates value for our shareholders, even
though the products sold under these brand names may not
always include New Zealand-sourced milk solids.

You can see we have a degree of flexibility in terms of our
cornerstone activities and it is likely we will need more. Some
of this flexibility may need to come from our shareholders
themselves. While Fonterra can fund the immediate needs
of the cornerstone activities and current options within our
existing balance sheet, as the business evolves this may not
always be the case. A change of capital structure could pro-
vide Fonterra with access to new pools of capital either from
shareholders or, in some cases, from external investors. Is
this on the agenda? Our capital structure has been identified
as an issue by a number of shareholders. Any inability to
access sufficient equity could undermine our ability to realise
the full potential of our value-add operations. That in turn
could prevent us from increasing the long-term wealth of
our farmers; a challenge in itself given that commodity pric-
ing long term is on a downhill slide. Yet any change to the
fundamental principles of how farmers provide capital to the
coop-operative will require 75% of them to be absolutely con-
vinced that any alternative is better. This is not to say farmers
are so conservative that they will not countenance change.
They will accept change if they reach the consensus view that
it is in their best interests. But reaching consensus can be a
lengthy process. One does not go out to challenge a funda-
mental principle of co-operative ownership without prepar-
ing a compelling argument.

Opportunities Having dealt with the challenges, I now move
to the opportunities. First, the luxury of the long-term view,
and second, the truly global potential of Fonterra. Fonter-
ra’s balance sheet is secured by more than 12,000 sharehold-
ers who are in the dairy industry for the long haul. They
are not opportunistic providers of capital. The corollary of
this is that they think I too can take the long-term view. I
do run into the realities of the moment, but generally it is a
long term view that I take. Let me give you an example. We
have confidence that China is a market offering considerable
long-term opportunities for Fonterra. It is a market where
milk consumption is low – around 8 litres per person per
year compared with around 30 litres elsewhere in Asia – but
where consumption is forecast to grow. One of the drivers
here is Government policies to encourage milk consumption
and not only because of the health benefits. Their view is that
higher demand for milk will transfer wealth to local dairy
farmers. Higher demand is being actively promoted through
programmes such as agricultural subsidies, milk in schools
and the setting of per capita consumption targets. China
is investing in increasing domestic production, but since it
has only 6% of the world’s arable land, it will always require
dairy imports. We have taken a long-term view of this re-
ality. Our starting point is the established base we already
have in China. Our consumer dairy products company and
our Ingredients business achieved combined sales of US$188
million last year. From this well-established base we are look-
ing to build industry partnerships, and our discussions with
the San Lu dairy company are well known. We believe it is
important to work collaboratively in China, working with
the local industry to grow the consumption that will benefit
both the domestic producers and exporters like ourselves.
As just one example, Fonterra worked with the Ministry of
Agriculture in its Milk in Schools Programme, sharing our
expertise in food safety, technology and quality management
with providers of the programme. Trust is important in do-
ing business in China, so our focus is as much on building
relationships as building sales.

Our shareholders are accustomed to our industry building
on a market reputation to achieve incremental growth. They
will give us time to deliver. Contrast this to corporates from
New Zealand and elsewhere who have made the decision to
invest in China and have quickly gone under the blowtorch
from shareholders impatient for quick returns. Fonterra’s
truly global presence provides our second opportunity. We
sell dairy products in 140 countries and our top eight mar-

kets span the Pacific Rim. The United States is our largest
single market by revenue and Asia is our largest export re-

gion. We have forged partnerships with some of the indus-
try’s most important players. With Nestlé, for example, we
have our Dairy Partners Americas alliance with joint ven-
tures in several South American countries. Our partnership
with Dairy Farmers America, the United States’ largest co-
operative, enables us to participate in the North American
market and contributes to Fonterra being the largest exporter
of skim milk powder from the United States. Our portfolio of
brands includes international household names like Anchor,
and our heritage includes New Zealand’s outstanding reputa-
tion for the quality of its milk. Our farmers are world-class
and our milk supply is growing, as demand for dairy prod-

cuts is growing in global markets. We have a truly valuable
presence in the market place. We also have, in Fonterra, a co-
operative that has avoided the worst dysfunctions of the
traditional model, while retaining all that is strong about col-
lective partnerships. We have a massive opportunity to build
on our industry’s competitiveness and low-cost position long
term to build strong relationships with the world’s major food
companies. We also have the massive opportunity to realise
the full potential of our value-adding activities, making full
use of our considerable assets, infrastructure, institutional
capacity and intellectual property.

This will require finding the right solutions to the issue
of how we can best fund these activities so that we provide
our farmers with returns that reflect more value-add earn-
ings and less dependence on commodities. My challenge is to
see that potential unleashed in a way that ensures long term
growth in their wealth, including the optimal mix of com-
modity-based and value-added earnings, while maintaining
the sustainability they look to us to provide them as long-
term investors in the dairy industry.