Fonterra Farmers' 2nd Vote on TAF: A Second Opinion

Report Commissioned by "Our Co-op" Group of Fonterra Farmers to:

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Terms of reference

Write a report addressing the following questions:

- Based on cooperative principles and international cooperative experience, is TAF likely to stand the test of securing 100% ownership and control for farmers, both in the near future and longer term?
- If not, what are the potential risks that farmers may face?
- Are there better alternatives to realize the goal of guaranteeing a stable and growing capital base?

About the author
Dr. Onno van Bekkum (1969) is a cooperative expert resident in the Netherlands. He has researched and consulted cooperatives for 17 years, looking particularly at ownership issues. His research database covers over 700 agribusiness cooperatives in about 40 countries worldwide. After 15 years with Rabobank Nederland and cooperative institute NICE at Nyenrode Business University, he started his own company called "CO-OP Champions" in January 2010. Onno lectures cooperative case studies (including Fonterra) in three modules of the Executive MBA in Food & Finance at Nyenrode Business Universiteit.

Earlier Fonterra assignments

- Presentation to Board members, Councillors and Federated Farmers representatives in Springfield, Missouri, USA, August 2004
- Preparation of a series of mini case studies on capital structures of Friesland Foods, Campina, Kerry Group, Glanbia, Dairygold, Warrnambool, Murray Goulburn and Land O'Lakes in July 2007
- Video conference presentation to a Shareholders Council delegation, August 2009
- Independent advisory paper on TAF, invited by CEO Theo Spierings, October 2011

Context of the Report and Disclaimer

Fonterra has recently published its ‘Strategy Refresh’. That strategy needs a stable capital base, with room for growth. Since 2006, Fonterra has discussed changes in the capital structure it has inherited from the 2001 merger. That structure, based on up-front, fair value shares redeemed by the cooperative, has proven unstable. In 2007 the Board proposed a partial stock listing that met with opposition from the farmers. In 2009 a new proposal was presented, called “Trading Among Farmers” (TAF). In June 10, with 90% of those voting in favour, the Board received a strong mandate to further elaborate plans. Now, in June 2012 farmers are asked to cast their final vote. It should be acknowledged that there has been an enormous amount of corporate and private time, energy and cash gone into the proposal as it is today.

As in any vote, there are two possible outcomes: “yes” (in this case: at least 50% in favour) or “no” (less than that). The Board has indicated it wants to proceed with TAF only if there is a “unifying vote”. It is not clear exactly what this means, but probably something closer to 75% rather than 50%. Actually, one would hope a similar percentage as the 90% of 2010. As in any vote, the outcome is known only when the votes are counted. In case of a unifying vote, the Board wishes to implement TAF by November 2012.

In case of a “no” – then what? What does this mean looking back? Was all that time, energy and cash for nothing? What would that mean in terms of staff motivation? Would that outcome impact on current governance and leadership? How long would it take to prepare another proposal and obtain member support for any Constitutional changes that might be required? And how much would it demand from government once again to create a new, appropriate enabling environment, should any changes in the law be required? Should all that mean a “no” vote jeopardizes Fonterra’s (refreshed) strategy and sound business development, that would be a very heavy price to pay.

This report was commissioned by a group of concerned Fonterra farmers. The report doesn’t say farmers should vote either “no” or “yes”. This report discusses the capital structure problem of Fonterra and TAF as a proposed solution. Deliberately, this report is presented as a critical examination. Farmers must vote with their eyes open. This means realizing the possible consequences of voting “yes” as well as of “no”. The benefits and strengths of TAF are being measured out widely by Fonterra. There is no need for repetitions. The report also mentions elements of alternative solutions to the capital structure problem.

There is no doubt economics students will write their PhD’s and historians their books about the early history of Fonterra and its capital structure debate. This report was written under a fair bit of time pressure and therefore it doesn’t do justice to all the ins and outs of the proposal. We will content ourselves with a summary of apparent highlights. Moreover, it was written by a non-English native speaker on the other side of the globe. It is inevitable that the views expressed in this report wouldn’t fully synchronize with those of a well-informed local observer. There will be unconscious, non-deliberate misrepresentations (for which the author apologizes). The reader should keep this in mind.

Having said that...

I. Ten Years Fonterra: The World's No.1 Dairy Co-op

I.1 Fonterra in the World

Fonterra isn't just a cooperative. It isn't just big in New Zealand. As the world dairy cooperative ranking (see below) shows, it's the world's no.1 dairy cooperative. Fonterra sets a world standard. Whatever Fonterra does affects the evolution of cooperatives worldwide. In terms of business development as well as in terms of capital structure. It is a business that New Zealand dairy farmers may rightfully be proud of.

COOP CHAMPIONS DATABASE

World Dairy Co-ops
Update: 22May12

Dairy#	W#	Company name	Country	Date	NZD m Revenues	Δ	Net profit	Profit/ Reven	10yr growth
D1	W3	Fonterra	NZ	Jul11	19871	19%	900	4.5%	43%
D2	W8	Dairy Farmers of America	USA	Dec11	16796	32%	52	0.3%	37%
D3	W7	Land O'Lakes	USA	Dec11	16601	14%	237	1.4%	49%
D4	W4	FrieslandCampina	NL	Dec11	16105	4%	361	2.2%	71%
D5	W9	Arla Foods	DK	Dec11	12354	9%	295	2.4%	11%
D6	W22	DMK	DE	Dec10	7197	-17%	4	0.1%	57%
D7	W24	Sodiaal	FR	Dec10	6932	43%	40	0.6%	84%
D8	W31	Glanbia	IR	Dec11	4575	22%	201	4.4%	-1%
D9	W36	Agropur	CA	Oct11	4484	5%	53	1.2%	85%
D10	W33	Tine	NO	Dec11	4175	0%	202	4.8%	12%
D11	W40	California Dairies	USA	Dec10	3855	13%			8%
D12	W39	Emmi	CH	Dec11	3741	1%	114	3.0%	96%
D13	W44	Irish Dairy Board	IR	Dec11	3315	1%	30	0.9%	-12%
D14	W46	Valio	FI	Dec11	3228	3%	90	2.8%	1%
D15	W56	Murray Goulburn	AU	Jun11	2965	8%	47	1.6%	27%
D16	W59	Amul	IN	Mar11	2835	13%			?
D17	W60	Darigold / Westfarm Foods/	USA	Mar11	2725	17%	67	2.5%	-7%
D18	W68	AMPI	USA	Dec11	2584	16%	3	0.1%	38%
D19	W65	Maitres Laitiers du Cotentin	FR	Mar11	2413	-2%	26	1.1%	?
D20	W74	Hochwald	DE	Dec10	1979	-4%	3	0.1%	61%

Notes:
- For some cooperatives 2011 data haven't been released yet. Sometimes profit figures couldn't be obtained.
- A number of cooperatives have merged during the past decade. For the 10 year growth figures, the merged entity is compared with its biggest predecessor, e.g. FrieslandCampina with Friesland Foods.
- For Kerry Co-op Creameries revenues and profit of Kerry Group were multiplied with 17.1%; 31.1% for 10 yrs ago).

I.2 Fonterra's First Decade: Achievements and Challenges

The Table below summarizes key capital structure related data for Fonterra over the past decade, compiled from various annual reports.

COOP CHAMPIONS DATABASE **Fonterra**

NZDm, unless indicated otherwise	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Year End	5	5	5	5	5	5	7	7	7	7
Assets tot	11,800	10,746	11,112	11,812	13,080	12,631	14,439	14,117	14,169	15,530
Equity tot	4,485	4,665	4,795	4,911	5,145	5,016	4,269	4,805	5,667	6,541
Equity/Assets %	38%	43%	43%	42%	39%	40%	30%	34%	40%	42%
Equity coop	4,166	4,515	4,613	4,728	5,017	4,880	4,226	4,765	5,631	6,503
Reserves	-50	45	74	166	170	-166	18	26	547	943
Co-op shares	3,229	3,348	3,538	3,334	3,569	4,897	4,297	4,557	4,764	4,965
Dry shares									252	296
Peak notes	1,177	1,164	1,160	1,137	1,149					
Share red. rights	67	188	151	338	285					
Shares issued	403	549	552	495	634	1,644	1,142	750	617	404
Shares redeemed	189	322	403	535	440	1,750	1,425	506	158	159
Share price $	3.00	3.85	4.38	4.69	5.44	6.56	6.79	5.57	4.52	4.52
Share volume #	1,110	1,144	1,200	1,158	1,208	1,280	1,200	1,251	1,353	1,377
Milk mem (MS m)	1,111	1,148	1,201	1,160	1,210	1,243	1,183	1,227	1,256	1,320
Revenues	13,924	12,474	11,830	12,323	13,001	13,882	19,512	16,035	16,726	19,871
Milk price $	5.06	3.16	3.77	4.14	3.85	3.87	7.35	4.72	6.10	7.60
Value add return $	0.22	0.47	0.48	0.45	0.25	0.59	0.31	0.49	0.00	0.00
Dividend/share $									0.27	0.30
Retention/share $							0.24	0.01	0.33	0.35
R&D	81	68	32	44	99	95	100	86	98	90
Net profit	-31	284	16	219	12	165	294	433	800	900
Coop profit	-50	257	7	191	0	165	244	422	788	889
>Share dividend									348	402
>Retained	-50	257	7	191	0	165	235	19	438	487
>ToOthers	19	27	9	28	12	0	50	11	12	11
Cash flow oper	354	534	779	228	-232	1,322	1,310	1,594	1,479	1,184
Cash inv	-947	-403	-402	-646	-713	-612	-795	-756	-354	-488
Cash fin	360	-137	-303	366	912	-598	-25	-929	-1,154	-433
Cash net	-233	-6	74	-52	-33	112	490	-91	-29	263
Cash closing	37	20	94	37	22	115	614	542	534	762
Milk tot (L)	13,133	13,429	14,016	13,503	14,051	14,340	13,862	14,764	14,746	15,427
Mem indiv #	13,057	12,562	12,144	11,680	11,286	10,921	10,724	10,573	10,463	10,485
Staff fte avg #	20,000	19,800	19,600	18,600	17,400	16,400	15,900	15,600	15,800	16,800
Staff fte int #			8,500	7,000	6,400	6,400	6,400	6,100	6,000	6,000

Notes:
- 2008 book year change from May to July, i.e. 14 months. For 12 months revenues approximated $16,700m.
- Dry shares 2011: own estimate

Based on the table a number of observations may be made:

- The **second half** of the decade has been considerably better than the first half. For example, the total revenues figure (finally) grew and cash flows were much better.
- The **volume** of member milk (milk solids) has grown at a rate of less than 2% per year between 2002 and 2011, and it has fluctuated a bit. The NZ milk boom won't last

forever (though growth figures for the current season are highly impressive, once again!). For Fonterra, to base a capital growth strategy on the growth of milk solids would seem not to be a very good idea.

- The **value add return** (now more or less translated into dividend paid out on shares) hasn't really been growing during the decade. The average percentage of R&D to revenues (0.53% over ten years and not growing) probably reflects Fonterra's ambitions in this respect. Milk price would seem to be much more important than value add returns (or share dividends as it is now reported). Fonterra looks like a milk & commodity business - and does well in that. This gives rise to a question though: would a commodity business require external capital backing?

- During this past decade value add returns compared to less than 9% of the farm-gate milk price. The relative **value of 'milk'** is very high. This relative importance of milk price highlights the importance to members of being 'in there' in the long run. An investor wishes to maximize (short-term) returns at Fonterra level; a member-producer seeks to maximize long-term returns on the aggregate of Fonterra+Farm levels (even including such things as land value). Hence he arrives at very different decisions. A low milk price year after year (due to poor management or attention away from investments in dairy processing) costs members much more than Fonterra missing out on a few good investment opportunities every now and then.

- The **share price** more than doubled from 2002 to 2008. It is difficult to explain this growth from the other data reported in the table. There must have been inspiring visions of future profits, much beyond those realized during the past two years. For the 2012-13 season the valuer arrived a mid-point of $4.38, i.e. up 20c from $4.18 the year before, which was down 9c from $4.27 for 2010-11. The point is: with all the achievements of the past few years, the share value changed hardly at all, whereas it grew very rapidly before when there wasn't much reason for it - that is when looking at figures such as those in the table. Is Grant Samuel different and perhaps more realistic than Standard & Poor's and Duff & Phelps? In any case, the recent valuations don't put pressure on the current $4.52 fix of the share price.

- <u>During the decade, members contributed the phenomenal amount of $7.2bn to equity.</u> Who now dares say cooperatives are inherently '**constrained**' in terms of their ability to raise (member) capital? (It is an amount that completely dwarfs the $500m+ proposed to be placed in the Shareholders Fund.) During the same period the cooperative has had to surrender shares with a total value of $5.9bn. An amazing speed of capital rotation! Thus there has been a **net contribution** of $1.3bn. The growth in share price clearly played a role. Had the share price remained unchanged at $3, 'only' $4.2bn would have been raised, and $3.2bn would have been surrendered, i.e. a net contribution of $1.0bn. <u>In other words the net effect of share value increase in terms of capital raised has been 'only' $300 million!</u>

- This $300m of capital thus being raised, however, came at a tremendous cost: a rapidly rising, total outstanding **'redemption claim'** (number of outstanding shares × share price). In 2002 with a share price of $3, the outstanding redemption claim amounted to $3.3bn. With a total book value of 'cooperative equity' (i.e. minority shareholders in group entities excluded) of $4.2bn, one would say 'no problem'. However in 2008, when the share price had risen to $6.79, the total outstanding redemption claim had risen to $8bn. Fonterra (or its valuers) had 'created' $4.7bn of wealth for shareholders

(8.0-3.3=4.7) that was never actually 'paid' for. Phrased differently: in order to raise $300m extra capital, it built up an outstanding claim on its equity of $4.7bn. Based on this analysis, there is only one possible conclusion: this share valuation policy is completely irresponsible. If TAF is about solving the redemption problem, it should be clear that it is a solution that doesn't fundamentally solve its underlying problem (the 'mirage' of 4.7bn that was created, though not in real terms: cooperative equity in the books of 2008 was virtually the same as in 2002). TAF may be a way out, but it doesn't solve the problem. Solving the problem requires a different share valuation process all by itself, making TAF unnecessary.

- The net contribution of $1.3bn includes the share capital loss of $400 million during the 'transition' years 2007 (conversion of peak notes and redemption rights into shares) and 2008 (change of book year). In 2008, the net $300m redemption was due to the 'mistake' in the (application of the) share redemption rules. The 14 months book years perhaps also played a role here. The years 2007 & 2008 were very good in terms of operating cash flows, though, and also the share price peaked. At the same time, the cooperative's equity received a major blow (down to 30% of total assets from 40% in 2007). Perhaps a milk price of $7.35 was somewhat over the top. The two years 2005 and 2006 stand out for their high net borrowings. After this four year period (i.e. 2005 - 2008), it seems the situation improved significantly. That share price increase from $3 to $6.79, however, almost got the cooperative listed on the stock exchange and then rightfully fueled fears of redemption risk.

- In 2010 and 2011 for the first time, a total of $925m **retentions** were made. Compared to the $1.3 billion ten year margin of share issues over share redemptions, this is a very significant amount. Until 2010, profits were fully distributed as milk price premiums. Only in exceptional circumstances of profits emerging from divestments, e.g. in 2003 and 2005, were retentions made. And in response to the global financial crisis, a one-time retention was agreed in 2008. A deliberate retention policy, however, was decided only two years ago.

- The **milk price** has been markedly higher during the later five years of the decade than the previous five, and it could have been higher even without retentions. The capacity of farmers to invest in Fonterra during these peak milk price years hasn't been utilized to further strengthen the balance sheet. This offers wonderful opportunities!

II. What is Fonterra's problem?[1]

The above review of Fonterra's development over the past ten years highlighted Fonterra has a problem: its 'fair' share valuation isn't sustainable. It is very important to realize, because this precisely is what TAF seeks to address.

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1 This report section has been reviewed by three cooperative 'heavy weights' in the Netherlands, Ireland and Sweden. They support the argumentation and conclusion.

II.1 A Pyramid Game, an Iceberg, a Bubble a Dog Biting its Tail

Why is it that Fonterra's fair value share isn't sustainable? And why is it that TAF doesn't solve this problem, but replaces it with something even more undesirable from a cooperative point of view?

- Normally, upon entry members of a cooperative purchase shares proportional to their expected milk deliveries. Normally, they pay nominal value. It is obligatory: all must contribute. It's part of the production decision on-farm.
- Upon growth members purchase additional shares. Nominal value. Again obligatory.
- Perhaps annual contributions are made by members into personalized accounts. Hard cash.
- Upon exit shares are redeemed plus any capital 'waiting' in personalized accounts. It's hard cash. Nominal value.
- The system is in balance: capital contributed upon entry+growth equals capital redeemed upon exit. Hard cash.

- **In the case of Fonterra the situation is different:** Contributions and redemption takes place at so-called 'fair' value. From 2002-2008 the share price increased from $3 to $6.79.
- Entrants and growers paid the increased price hard cash. They are what we call the 'tip of the iceberg'.
- Stable suppliers and exiting members represent the 'iceberg under water'. Their share price has increased in value too. No hard cash was ever paid for that growth.
- The system is not in balance: every share that is redeemed to an exiting member, effectively by a new or growing member (through the cooperative), leaves a growing outstanding claim behind (in the cooperative). The bubble expands.
- It only works if 1) you are able to tap into a fresh source of income and 2) so long as the volume of milk solids is at least stable over time.
  - *Value growth* can't be that source, because that only and exactly aggravates the problem. It would be a dog biting its tail.
  - What other source do you have other than retentions and/or reinvesting dividends?
  - When there is a sudden exodus of farmers/milk, the bubble breaks.
- Fonterra has used the system of fair value shares not just to redeem exits but also to *raise* capital. (It had no alternative source for capital raising.) In doing so, it *created* a huge outstanding claim. Virtual cash; very hard upon redemption. That is the problem.
- As the above calculation showed, net capital raised (2002-2008) that may be ascribed to the higher share price amounted to $300m. However the size of iceberg 'under water' grew $4.7bn. There was no balance.
- To make it worse: the fresh source of income (annual net results) were paid out in cash as a milk price supplement.
- The milk price supplement fueled extra production, which 'raised' more capital on the surface, but aggravated the problem 'under water': the dog was running faster and faster.
- (To make it even worse: there was a mistake in the structural design, as a result of which members could step out and in when the next season's share price was valued lower.)
- It is a pyramid game: who will pay the last generation?

II.2 Does TAF Solve the 'Pyramid-Iceberg-Bubble-Dog' Problem?

- TAF breaks the iceberg in two: net growth of milk solids (entrants+growers-exits) will lead to extra shares. The tip of the iceberg it keeps to itself. Very intelligent.
- The iceberg 'under water' is transferred to farmers: 'trading among farmers'. Conscious or not, farmers will be accepting a massive outstanding redemption claim.
- The creditworthiness of Fonterra receives a major boost.
- The creditworthiness of farmers - yes, what will happen to that?
- How do banks look at the old shares (hard cash; obligatory: production decision) vs. the tradable shares (uncertain cash; mixed: obligatory+voluntary; mixed: production +investment decision)?
- Let's suppose: all the TAF protections work well; no limits will be breached. (But we'll come back to that in the next chapter.) Farmers will be trading Fonterra shares forever. The share price will go up and down. Fonterra will buy back and resell some units. It all works fine.

- But wait a minute: where did the promise to redeem the outstanding claim of $6bn go? We had agreed on a collective buffer and we called it "a cooperative". Our joint fund would be there to pay when any one of us left. Where did it go?
- The "Co-operative share" under TAF is no longer a "cooperative share". It has become a derivative of a cooperative share. It is a repackaged loan with a note saying I can ask someone else instead to repay me this loan. With uncertain conditions even. This is how banks create a financial crisis!
- It has every characteristic of a normal company's share: buying, selling, share price, dividend... (some restrictions, which make it a bit of an odd share). Perhaps it *is* a normal company's share - it's not a cooperative share any more.
- This is an escape, but not a cooperative solution. That is: it is a solution for Fonterra as a business. But for the farmers' *collective* it marks the end of the pyramid game: under TAF, Fonterra is *sold* ('privatized') to *individual* farmers. In return for assuming the outstanding redemption claim.
- The waiting is for this last generation to cash in. Would probably be bonanza day for that generation. And signal the end of farmer influence on their production and marketing chain.
- That sounds harsh. It does. This is our conclusion: TAF drives Fonterra from a cooperative to a farmer-owned business (FOB). A heavily protected FOB, but in essence an FOB. TAF is the privatization project of Fonterra the cooperative.
    - Characteristic of an FOB is that it has an independent profit objective. It behaves differently from a cooperative. Its objective is not to pay the highest sustainable milk price as such. Its purpose is to provide farmers access to market on sound commercial terms.
    - There is a hybrid element in this FOB in that a majority of its shares have a delivery right attached to them. To be more precise: it is a hybrid FOB-NGC (New Generation Cooperative).
    - In the NGC-model at least there was a rock-hard linkage between the delivery right and the share. Which is loosened under TAF. Most NGC's appeared short-lived: shares accrued too much value and after one generation members decided to cash them in.
    - Fonterra would be an FOB. Milk supplies would be seen as a 'cost'. Under TAF milk farming isn't the source of value creation anymore, with dairy processing as an extension of the farm. NZ milk processing investments would be evaluated based on returns on investment.

- It would seem odd why farmers would accept the so-called ‘Co-operative share’ not just as not delivery right but also as delivery obligation. That involves a risk. Removing that obligation, however, further breaks down a cooperative terms.
- If you look at Fonterra as an FOB, the “100% farmer ownership and control” gets a different meaning. Fund-unit investors would have ‘ownership without control’. Doesn’t this ‘financial ownership’ compromise “100% farmer ownership”?

• We are aware that under TAF, Fonterra is foreseen to act as a buyer in the Shareholder Fund, but deliberately so only to a very limited extent. Equivalent probably to the ‘tip’ of the iceberg. That’s not enough. That’s not what we mean.

• There is a ‘(half)way out’ perhaps, should one want to preserve TAF. If Cooperative Fonterra would guarantee/ underwrite to pay any farmer exiting (as a ‘good leaver’ or at least as a leaver ‘for good’) at any time a price of, say, $4.52 or $3.00 or whatever – then it would be quite different. Then the collective buffer would still be there as a collective buffer (safety-net), preserving a cooperative heart.
  - This ‘(half)way out’ would require amending the current proposal, but possibly not of the Constitution. This at least would be a relevant question to ask. Prior to the vote.

• With TAF, Fonterra replaces an inherently deficient ‘fair’ value share with something that is, in terms of cooperative sustainability, even worse.

• **A truly cooperative solution is possible. That would require a real value share – one that is directly linked to value being added to milk. It would be recommended then to generate capital on *all* milk – not just on the net *growth* of milk. Such a structure is possible, but not under TAF.**

• One might argue: “it all doesn’t matter given that there are plenty of protections built into the system and if after all it doesn’t work, we can stop within two years and buy the Fund out.” Recreating a genuine cooperative (at that stage) will be extremely difficult.

This marks the conclusion of the report.

All that follows – to feed the discussions – is a series of arguments and views with varying degrees of uncertainty: would TAF – as is – actually work and what would be its possible risks and negative side-effects? That discussion weighs heavily on the problems emerging from delinking (a minority of) shares, which hasn’t even been mentioned in the preceding line of argumentation. There is a degree of logic in the stories that follow and a degree of speculation. We can debate the arguments and we may all have varying degrees of optimism about the future. In the end: nobody knows for sure. Still, farmers will have to make up their minds.

The review begins with an introduction on the difference between cooperative and stock market principles. Then various considerations are listed, grouped under five thematic headings:

1. Shift in Mindset: From Producer to Investor interests
2. Milk Price Related Concerns
3. Managing the Size of the Shareholders Fund
4. Redemption Problem & the Fair Value Share (deepening/revisited)
5. Miscellaneous Items

III. Trading Among Farmers: A Critical Examination

Introduction: Cooperative vs. Stock Market Principles

TAF creates a hybrid structure. The table below shows two competing sets of institutional principles: those regulating the stock market and those governing cooperatives. As it appears, these are mutually exclusive: it would seem difficult to preserve their essential characteristics and merge them in a single system. One has given rise to a major global financial crisis; the other largely evolves publicly unnoticed.

Two sets of conflicting principles. The table below summarizes some characteristics of the stock market and compares those with the cooperative. As it appears, these two sets are quite opposite. TAF introduces stock exchange thinking into the internal Fonterra Shareholders Market. It also imports stock market effects into the internal market through the linking with the Shareholders Fund. Both parallel markets are designed as much as possible along the same lines, as the blueprint also explains. The question is whether these two sets of principles may coexist in a cooperative. Or whether at the Board table one really has to choose between the one and the other. That is a bit difficult to say. It is possible to conceive a stock-listed company with somewhat more cooperative characteristics. The world would probably be a better place if most Plc's did. One would think the opposite would then be possible too, i.e. a cooperative that has integrated stock market principles. That's the question.

	Stock market	Cooperative
Stakeholder orientation	Investors	Users/producers
Organizational goal	Maximize returns on invested capital: share price, dividends	Maximize returns on production: on-farm & cooperative investments
Values	Individualism, personal gain, greed, scrutiny, opportunism	Solidarity, mutual gain, sharing, trust, commitment
Supplier relations	Minimize costs; quality secured	Maximize long-term pay-out; invest in quality
Investment horizon	Short term	Intergenerational transfer
Strategic basis	Foot-loose	Locally rooted
Access to capital	'Unrestricted' (though there is global competition for capital market resources)	'Constrained' by willingness of members to reinvest profits from the production chain
Destination of benefits	Extraction of wealth from the production chain ('the rich get richer')	Reinvestments in the production chain and rural communities ('develop human resources')
Shareholder interaction	Largely anonymous, institutionalized	Personal engagement as much as possible/workable

	Stock market	Cooperative
Board engagement	Professional, distant	Directly affected
Control mechanisms	Share price signals; stock analysts; shareholder activism; market for corporate control; professional non-executives	High Board member engagement; democratic voting; member influence; professional non-executives (optional); social control
Shareholder communication	Highly regulated; quarterly	Open internally; at least annual
Corporate social responsibility	Integrated in the marketing concept	Intrinsically motivated due to long-term rooting in local communities

From the integration of the stock market set of principles into the cooperative structure, a number of issues emerge. Below these have been grouped under several headings.

III.1 Shift in Mindset: From Producer to Investor interests

The difference between 'shareholders' and 'members'? At Fonterra one talks about "shareholders", not "members". What's in a name? Still, in an international cooperative perspective this sounds a bit strange. True, Fonterra is a cooperative based on shares (as opposed to e.g. in the Netherlands, where most cooperatives are based on plain membership) and therefore members are shareholders. But the cooperative as a business form precisely isn't about shareholding - it's about 'use'. The primary role of the member with his cooperative is the 'use' or 'transaction' relationship. The other member relationships (i.e. governance, investment and community) are very important – no cooperative can live without them – but they are important to a certain degree only. And that is: only to the extent that they serve the primary relationship: the transaction relationship. They are subservient. That's the whole point of setting up a cooperative. Without milk no dairy cooperative, plain and simple. So why then refer to the producers of this milk as 'shareholders'? As if they are the owners of an ordinary shareholder company? As if the membership is about shareholding: value creation, share price, dividends, etc. Sure, a cooperative that doesn't generate value for its members isn't worth very much. But that value should be seen from a perspective of members in their capacity as producers and not for members as shareholders/investors (let alone for non-members as investors).

Capital intensity and member investment incentives. As the capital intensity (expressed as dollars equity per kg milk solids) increases, the member's investor role tends to become relatively more important. Capital intensity typically increases due to value added investments, or because non-member milk activities become important, for example due to offshore activities. The theory is that, as capital intensity increases, members must receive stronger investment incentives to preserve their willingness to invest. Fair enough: that's why cooperative capital structures evolve over time and there is a broad range of cooperative capital instruments that you may choose from. In the case of Fonterra, capital intensity has remained virtually unchanged at $4 from 2002 to 2009. Only during the last two years it moved to $4.50 and $5.00. One would doubt about the need of *stronger* investment incentives in Fonterra.

TAF breaks chain of self-sufficiency. There is nothing wrong with a high capital intensity provided one condition is met: that there is no significant capital drain from the system. So long as the cooperative performs and the proceeds are reinvested in the system, at member level and/or cooperative level, there is no problem. The chain is self-sufficient: it perpetuates. When proceeds are extracted from the system (e.g. due to external investor interests), capital intensity may rise to levels where they become too much of a burden for members. So long as the investment role keeps subservient to the transaction function there is no fundamental problem. TAF introduces a capital drain from the sector: moneys that will be extracted by external investors in the Shareholders Fund.

TAF encourages free riding. As producers, member interests are all -more or less- equal. They have a collective interest. As shareholders/investors, interests are individual. The logic of shareholding is being opportunistic: moving in and out before others do. This may be positive (forward thinking) or negative (speculation). Farmers are not immune from opportunistic behavior, as the 2008 washing out and in has demonstrated. In the literature, this is being described as ‘free riding’ behaviour (of which there are many different forms). People are not born ‘cooperative’ - that requires some education. Protection against opportunism helps temporarily, but isn’t sufficient: you want to change underlying incentive structures. Individually, all members decide at different moments, in different settings. Each little step hardly being noticed the aggregate outcome may be unstoppable movement in a direction that, collectively, you never might have wanted. That’s why in a cooperative where milk price and investments are strongly linked, individual and collective interests are aligned. Under TAF, with de-linked dry shares this logic is interrupted. Given the opportunistic shown in 2008, don’t expect the outcome of individual farmers’ investment decisions under TAF to lead to collectively desired outcomes.

Stress testing: free riding behaviour. Suppose the share price is very high, as you would want it to be. For a growing supplier currently shared up to full 100% and with little spare cash, the solution is easy: buy shares and immediately convert them into vouchers. This allows up to 50% growth (the ceiling is set at 33%: 33%×(100+50)=50) without any investment obligation. This works so long as the market hasn’t reached its 15% limit. Obviously, the member would miss his dividend on shares. That would be an ordinary shareholder decision. Sure the members has attachments to the notion of a cooperative, but when he decides he is free to decides. He may decide to free-ride on other members investing in the cooperative. The more others members invest, the better for the free rider.

Investor interests induce a strategic shift? Once investor interests (in the sense of rights to performance-based returns) are delinked from producer interests, a strategic shift becomes very logical. The focus will be on investment decisions that generate the highest dividends. It doesn’t matter whether the investors are formally voting or non-voting, whether they own 1% or 51%, or whether they are members or public investors. Investors have legal rights that you can’t ignore. As a plain business or a cooperative, just the same, you can’t consciously take decisions that deliberately trade-off investor interests with those of producers. The Notice of Meeting summary already refers to the rights the Fund has should farmer shareholders take action targeted at the economic rights of co-op shares purchased by the Fund. I’m not a legal specialist, much less acquainted with New Zealand law, but no doubt your Securities Act protects the rights of shareholders and owners of share-like instruments. I wonder: could the Board freely decide e.g. on milk-related investments that would be important for producers but that would threaten the profitability and hence shareholder returns?

Executive incentives under TAF. There would be another driver: even though the dry shares and units may formally be non-voting, the leadership will continuously be watching the effects of their decisions on share price movements. And hence they will take decisions that will take these possible movements into account - i.e. so as to strengthen the share price, for the benefit of all shareholders. And there may be an additional reason: management incentives. Although the word doesn't appear in the various documents, it would seem reasonable to expect performance bonuses to be based also on share price. If so, that would have an important effect on strategy and execution. The combined effect would be a strategic focus in favour of shareholder interests. This may not fully align with producer interests.

III.2 Milk Price Related Concerns

'Boring' milk price under TAF. Under TAF the fun part is in investing, rather than milk price. Back in 2009-10, the wording "maximum sustainable milk price" appeared in the documentation a number of times. Since then, it appears changes have been made and now the milk price has become highly regulated by the Milk Price Manual. The milk price will become quite 'boring': performance of the business will be reflected in the dividend, rather than in the milk price. There is a theoretical argument favouring a milk price reflecting the value of milk, as opposed to being cross-subsidized by the value of capital investments. You like to transfer proper incentives, both to produce and to invest. So that your dairy farmers can make a good evaluation between investing in extra milk (on-farm) or in extra dairy processing (off-farm). A 'neutral' milk price achieves that. So long as milk price and investment returns are linked, members and cooperative will still understand each other: 'returns on dairy'. The farmer will receive two signals: milk price and dividend from cooperative value adding activities. But it will all be expressed in dollars per kg milk solids. That members' logic disappears under TAF.

Rewarding milk or investments? It is a fundamental question: if the cooperative performs well, do you want to reward milk or do you want to reward investment? As an investor-owned company one thinks the latter (suppliers of investment), as a cooperative it is natural to think: the former (suppliers of milk). Under TAF the tendency is towards rewarding the investor. So long as dry shares are restricted to 15% of total shares and Fund size at 20% of total shares one would think on aggregate, milk (through the wet shares) still accrues the predominant share of dividends. But in individual cases, even of equally sized suppliers, the ratio of dividends to milk may differ quite strongly. One farmer may have sold economic rights up to 33% of his wet shares, whereas the second one may have shared up fully at +100% of dry shares (and have investments directly in the Fund). In this example the second farmer accrues (at least) three times much in dividends as the first farmer. And there may equally be farmers supplying milk on contract with no investments at all. Fair enough: it was their own choice to invest more or less. But it will create tensions that you don't really want in a cooperative. We've seen that at Friesland Foods in the Netherlands. It also gives rise to free-riding behaviour that will make life difficult e.g. in the case of capital raising.

Producer investment incentives. There is another element to a 'neutral' milk price, which has to do with the investment incentives of the farmer. In the past, through his investments in the cooperative, the member (believed he) could influence his milk price. Under TAF, the farmers' investment only influences his return on investment. In the minds of farmers, investing will get a different meaning. As producers, farmers will look at investing in their farms.
There is another dimension to this: back in 2009, a distinction was made between the milk price of fully-backed shares and the price for unshared milk. This would have created some producer incentive to invest in Fonterra. In the current Blueprint and the Notice of meeting summary, this concept isn't mentioned any longer. Has it disappeared? Is it in the Milk Manual?

High share price violates producer interests. The effect of the Fund will be to raise the share price, seemingly being synonymous with 'free exit'. You don't want to make capital too expensive. A high share price taxes production growth, discourages new entrants and encourages current farmers to leave and cash, particularly those under financial stress. The market behaviour of external investors will influence the pace at which NZ dairy farmers can grow their farms and their supplies to Fonterra.

Milk price and credit rating. There is another dimension to milk price. The cooperative, residual milk price calculation offers flexibility to the cooperative: in a difficult year a cooperative may suffer less than an investor company because it has more room to adjust the milk price. This is not unimportant. To demonstrate that: in Nov 2007, when the public listing proposal was announced, it was reported Standard & Poor's "cut its outlook on Fonterra Cooperative Group Ltd to negative from stable after the company suggested it might opt for a capital restructuring. The agency said while a restructuring would improve the New Zealand-based dairy group's access to equity capital, it could diminish the creditor protection afforded by the company's flexible price setting and subordination of milk payments." (AFP, 15 Nov 2007). This is a downside to the milk protection mechanisms under TAF and the focus on payment of dividends based on investments, rather than milk. This is another implication of the different strategic focus of the cooperative.

III.3 Managing the Size of the Shareholders Fund

Size management instruments. The Board will have a policy to keep the size of the Shareholders Fund within a range of 7-15% (including dry shares that may find their way to the Fund) with several instruments envisaged in the "Proposed Risk Management Policy".
On the **downside**, it seems a bit odd that there would be a required *minimum* of the Shareholders Fund. From a farmers' perspective, why would you need a minimum? If farmers don't need to use the Fund because there demand for shares on the internal market exceeds supply (i.e. when liquidity is demonstrably there), why force a Fund that drains dividends on $500m worth of shares (and that members have been prepared to invest)? What logic underpins the $500m minimum? If the answer is 'government': what was/is the government's logic? Why $500m?
On the **upside**, the Board will have several instruments at its disposal to *reduce* Fund size, should farmers sell too many (economic rights of) shares to the Fund:

- **Buying back Units.** Buying back Units sounds a bit like redemption under the 'old' Constitution, in terms of the costs one would incur. It depends a lot on what budget the Board has in store for this. If that is limited, as it is likely to be (why otherwise give up redemption?), that would define the range within which this instrument may be effective. It may give farmers a bit of a strange feeling that under TAF, in this situation, external investors would be the ones to be 'redeemed'.
- **Introducing a Dividend Reinvestment Plan**. Wonderful plan! Could have been introduced ten years ago. Why does it need TAF?
- **Reducing the FSF Transfer Limit,** i.e. lowering the proportion of wet shares that farmers are are able to sell the economic rights to. This would effectively require a group of individual farmers to buy back a portion of their shares 'sold' to (the custodian of) the Fund. While it would seem to address the problem with the right persons, this may be quite a drastic measure in practice, for example when the cash obtained from selling (rights of) shares has already been spent.
- **Issuing shares**, to farmers, presumably. Nice, but if it means farmers are called in to solve the problem, that may be a bit of an 'easy' solution perhaps. Will 'loyal' farmers be paying for the free-riding behaviour of their more investor-minded colleagues? Or would it all be (dry) share bonus issues? Does 'issuing shares' mean the +100% limit on Dry shares may be raised to e.g. +150%?

Dealing with Fund size breaches. Whether or not the Board will actually employ these instruments is defined by a 'thresholds table'. In the 'worst case' scenario, i.e. if the Potential Fund Size breaches 20% for at least a majority in 30 days, then it will take various actions within 90 days. That might be a long time! It would then suspend the conversion of shares into vouchers+units and call for a Special Meeting of shareholders to consider and recommend a preferred option. Obviously, this is a hypothetical situation and we can only speculate. Yet this is what stress-testing is all about: looking at sustainability of the structure under extreme circumstances. I'm curious as to whether this would involve only a combination of the above-listed instruments or whether it might also be contemplated to increase the size of the Fund as well. I get the impression it might be. Why otherwise would a Special Meeting need to provide the Board with a mandate e.g. to buy back units?

Stress testing: The 15% Fund size. How many farmers would it require to buy dry shares and convert them into vouchers to stagnate the market? Under the proposal farmers can exchange 33% of their wet shares for vouchers and stock up 100% of production in dry shares and exchange for vouchers. In effect they may buy 200% extra over wet shares (133% vouchers over 66% wet shares). A shareholder fund maximized at 15% of total shares would thus require (less than) 5% of wet shareholdings, i.e. some 68 million kg of milk solids. Board members Colin Armer and Jim van der Poel between themselves hold 24 million shares, to put things into perspective...

Stress testing: milk surge. A good case for immediate TAF stress testing is the current season's 11% milk surge. How would farmers respond under TAF in terms of getting their required shareholdings in place? An 11% share increase costs farmers some $600-700m. That is a lot of money! Under TAF they may decide to contribute 50% in cash and buy-and-sell the other 50% with moneys from the Fund. That would make sense probably: you contribute one part and let 'the market' contribute the other half. That's $300m then into the Fund, added to the started package of $500m. The Actual Fund Size would probably already breach the 12% and call for a "strategy to address the underlying causes” of this expansion trigger consultations with the Shareholders’ Council. In this case the underlying cause is a normal response of farmers to an ‘exceptional’ inflow of milk than will be there on the table for at least one season. Since this is a fairly ‘stable’ underlying cause, it would probably make sense to just widen the Target Range and wait to see what happens. Very difficult actually, to “address” an 11% milk surge. Whereas before, farmers could tell their banks they simply *had* to invest in Fonterra shares, that bank may now be telling farmers: “no, 50% is quite enough given your current financial situation”. What can you say? First year breach, what will happen next?

Stress testing: Milk drop. Also the reverse situation would be significant to look at. What would happen e.g. in a scenario of a structural 20% drop in supply (or just 11% if the current season’s milk surge appeared to be a once-only peak)? In that case there would be a flood of wet shares. The dry share cap would need to be lifted, which would probably be followed by an increase of the percentage of shares ‘sold’ to the Fund. That, again, would breach Fund size. Would be difficult to solve without Fonterra buying back units. So then you’re back at redemption again.

Stagnated market or slippery slope? There are many protection mechanisms built into the system and the creativity of the team must be applauded for that. Government apparently will also play a role, embedding Fund size into the law. Protections, however, don’t eradicate underlying forces in the system the protection mechanisms seek to safeguard the cooperative from. You can actively protect for a while until at some stage you’ll find out the market begins to stagnate. The 15% limit on dry shares and the 20% limit on the Fund, large as they may still be, may prove to be quite restrictive. What happens when these limits have reached their max? The reasons that caused the breach don’t disappear. The system won’t work anymore: investors will complain liquidity is too limited, shares and units will be trading at a discount, exiting farmers won’t succeed to exit at ‘fair’ value. For some time the “proposed risk management policy” may work, but not forever. It may become too costly to Fonterra and individual farmers. There will be pressures building up from within and from outside to relax controls, to find out that was only a temporary solution. Each incremental change will further hasten the next.

Perspective changes over time. From the current perspective, it would seem quite unlikely that farmers would ever want to vote 75% in favour of relaxation of current limits and controls. However, a future vote would be taken, not from the perspective of today but from a yet unknown perspective. One that has been influenced by experiences gained in the meantime and shifts in interests from producer to investors interests. Farmers thinking individually as investors 10 years from now may take a very different stand than farmers collectively thinking as producers today. It is very difficult to protect against that. Much better to prevent dynamics that would lead to such a change of perspective.
Compare with Kerry Group: it listed with only a 20% external interest; today 17% is cooperatively owned. Views of member voters clearly changed on the way.

III.4 Redemption Problem & the Fair Value Share

Redemption problem in three dimensions. First of all: redemption in cooperatives is normal. The difference with Fonterra lies in that the ‘fair’ valuation of its shares bears no or limited relationship to the current financial status of the cooperative. That may cause some problems. The ‘redemption’ problem has at least three dimensions:

- Firstly, **generational succession**. As in any cooperative, there is the perpetual cycle of capital contributions and redemptions through which the cooperative is passed on from one generation to the next. Normally, this is calculable and therefore manageable. It depends on securing funds equal to the long-term average number of shares that require redemption. In the case of Fonterra, the rapid growth of the share price created an enormous problem, as was identified in the 10 year growth table. The current book value of cooperative equity ($6.5bn) exceeds the redemption value of shares ($6.0bn) - it's very tight, but with a carefully designed retention and member capital raising programme this dimension of redemption risk should be manageable. As it was noted before, though, the total outstanding redemption claim was was in excess of book value back in 2008. So yes, there is significant potential problem. But share value is really the trigger. Not redemption as such.

- Secondly, **'seasonal redemption risk'**. This refers to the opportunistic behaviour of members "washing out and in" shares following temporary declines in milk deliveries (e.g. due to droughts). The fix of the end of season share transactions arrangement seems excellent. The Constitution (article 5.7) already allows for a halt on cash redemption in case of a 5% annual outflow if such would "materially and adversely affect the implementation of the business plan". In such case (as in 2008), the Board could (have) issue(d) redeemable preference to exiting members. Does this dimension of redemption risk require anything more? Perhaps not.

- Thirdly, **'exodus redemption risk'**. This is the redemption that must take place should for whatever reason, 20% or so of the members suddenly decide to leave. This is the real issue. The only structural solution is good strategy and solid performance. And, certainly, the higher share price, the most costly redemption becomes.

Redemption: a $1bn problem? The Board ciphers the potential cost to cover the redemption problem possibly as much as $1bn. Probably this refers to the third dimension of redemption, perhaps in combination with the second. Supposing that figure is correct, that is an enormous amount of money. It is money that probably would need to be kept on the balance sheet, but that can't really be used for long-term investing or lending purposes. In any way not the same as permanent capital would be. That is very unfortunate. However, how insurmountable would this be? In the long history of Fonterra yet to come, it's an amount that equals just the past two years' retention. If that's all it takes to 'solve' the problem of redemption risk once and for all, perhaps farmers and the cooperative should just accept that. It is double the amount of the initial Shareholder Fund; it's not all that much. Does avoiding that $1bn justify all the fuss?

Higher share price reduces investment capacity. The issue of capital raising may also be approached from a different angle: farmers buying into Fonterra. A higher share price will make it more expensive for current members to grow, and for future farmers to enter Fonterra. As a result, their capacity to contribute fresh capital to Fonterra diminishes. The more they need to pay just to maintain their current combined ownership level ('intergenerational transfer of the cooperative'), the less they are able to provide fresh capital into Fonterra. If the new generation spent less to retire the old generation, they keep more to invest in Fonterra's capital growth. A higher share price, due to the Fund, hampers the growth of Fonterra as a farmer-owned business. And hence drive the transition to non-farmer ownership. TAF, with the Shareholder Fund, appears to be focused on freedom to exit, more than on freedom of entry. Exit is attractive for the current generation, but what is the perspective for the next generation? Who are you there for?

Dealing with the historic value of the Dairy Board. There is yet another dimension to valuation and redemption: the merger with the Dairy Board. Ten years ago when Fonterra was formed, the value of the NZ Dairy Board accrued for the largest part to Fonterra. The rest of the industry was allocated their share of the Board's value. But the idea was that individual farmers should have the rights to that value. So that if farmers decided to leave, they would take out this value and invest it in their next dairy venture. This 'privatization' of the Board into the hands of farmers was a wonderful gift to the farmer community. It wouldn't seem proper to allow the current generation of farmers to cash this value. The historical legacy of the Dairy Board belongs as much to the next generation(s) of farmers as it does to the current generation. The fair value share was introduced to make sure Fonterra wouldn't retain that value at the loss of exiting farmers. Whether they wanted to join a different dairy company, start a new dairy processing venture, or exit the industry. We are now ten years down the road. How much of Fonterra's current value *changes* may still be ascribed to the Dairy Board? Why do you still need to value the Board of ten years ago at 'fair' value today? For how long should the historical value of the Dairy Board continue to play such an important role, to the extent that the design parameters of *all* of Fonterra's capital structure are still regulated by it? Fair valuation has become a millstone around the cooperative neck of Fonterra. Hasn't the time come to redress this historical factor?

III.5 Miscellaneous Items

Stress testing: capital raising. Capital raising doesn't seem to be a feature of TAF any more. Farmers appear not to like TAF to be associated with it, and (hence) the Board is quite clear TAF isn't about capital raising. To the extent that farmers will be encouraged to cash $500m shares to create the Fund. However, there will come a day when Fonterra wants to raise fresh capital. How would they do it? What will happen as a result? The mindset will be such that an increase of the share standard, obvious in the past, probably won't be contemplated any more. Probably, as already contemplated back in 2009, hopes are set on dry shares. But with a cap on dry shares equal to 15% of total shares, that room is quite limited. So, would that call for a 75% vote to raise the limit on dry shares back from 15% back to 25%, as already voted for back in 2010. How would you avoid a subsequent breach of the 20% Fund limit?

Stress testing: takeover bid. Suppose public market demand in the Fund is low (financial crisis or so) and at the same the financial situation of farmers is under pressure (the Global Dairy Trade auction price has been really depressed for a long time, and hence farmers receive low milk prices, and at the same time have to make major investments e.g. due to new environmental regulations, or whatever). No surprise: the share price is low. A gentle, Asian-looking man with two briefcases knocks the door in Auckland, says he likes to meet the Chairman of the Board and offers five or ten times the market price. It's very clear that this is an amazing proposal; there is no way the Board can 'create' more value than this. Does the Board have the legal right to say "no"?

TAF complicates international cooperative consolidation. Arla Foods has recently announced a merger with Milk Link in the UK. Similarly, it merged with Hansa Milch in

Germany and is preparing a merger with Milchunion Hocheifel. It cost Arla next to nothing to grow over $2bn turnover and consolidate in the German and British markets. That may be a very clever move. With a fairly straightforward capital structure, where individual members don't capture a significant share of the cooperative's value, cooperative mergers are relatively easy. The ability of cooperatives to merge, without doubt, has been the main contributor to cooperative growth during the past 100 years. TAF, given its complexity and involvement of outside capital owners, will make it a lot more difficult and costly for foreign cooperatives to align with Fonterra.

IV. Do Farmers Really Need TAF?

TAF impact summary. To summarize some of the arguments presented in the previous section, TAF:

- Is complex, both in concept and in language;
- Integrates into a single system two set of conflicting organizational principles: those of the cooperative and stock market models;
- Shifts the Board mindset towards satisfying market demands of internal and external investors;
- Shifts the strategic focus from producer interests (return on milk) to return on investments;
- Shifts management focus on driving profits, should incentive payments be linked to the share market price;
- Looks at milk as a 'cost' factor rather than as a source of wealth creation;
- Reduces the ability of Fonterra to cushion the effect of shocks on its financial stability through adapting the milk price;
- Erodes the milk linkage between milk supply and investments;
- Shifts the members' focus from producer interests to investor interests (dividend, share price) and hence alienates producers from their 'cooperative' (or FOB as argued before);
- Creates tensions between member groups with different investment profiles;
- Induces a higher share price, taxing milk growth and entry, and hence creating an incentive for members to sell the (economic rights of their) shares;
- Encourages free riding in terms of individual member investment decisions (positively phrased: 'adds flexibility') that will not sustain collective producer interests;
- Keeps members locked in Fonterra to supply their milk under the delivery obligation attached to the shares they own, even after selling their financial ownership;
- Causes money earned in the dairy chain to flow out of the dairy system (i.e. dividends to unit owners) rather than being reinvested;
- Includes various protection mechanisms that will restrict the working of its markets, compromising its intended outcomes;
- Creates dynamics that may quickly cause breaches of various limits set (e.g. %dry shares and %Fund size), even without major events such as a milk drop, which:
    - Would test the budget Fonterra is prepared to allocate to buying back units (redemption at the other end of the market).
    - Pressure member-investors to vote for going down the slippery slope of relaxing these restrictions and eventually other protections;
- Generates capital for Fonterra with every new peak in milk supply, but which subsequently creates Fund limits tensions should volume 'normalize';

- Makes it difficult for Fonterra, given the restrictions on %dry shares, to raise additional fresh capital (in fact it cuts member financial ownership with $500m right at the start);
- May cause a difficult situation when an external investor with deep pockets shows up: would the Board have a legal right to say “no” on terms of producer interests?
- Includes a number of beneficial instruments that may be introduced without TAF just the same (e.g. three year buy-in and pay-out periods and a dividend reinvestment plan);
- Embeds Fonterra even deeper in the law and increases public scrutiny, reducing the freedom of the company to act and adapt;
- Complicates international cooperative mergers;
- Is cumbersome and costly to reverse.

Are TAF ‘farmer benefits’ convincing? The level of detail of the TAF proposal is impressive. A number of bright minds have really worked hard on this and deserve a big compliment. But what’s the bigger picture? Do farmers, and does the cooperative really need TAF? That would seem to be a strange question after many years of capital structure debate and proposal development. Let’s take a look at the “What you need to know” booklet dated Apr12 to see how TAF is ‘sold’ to farmers. The booklet lists a number of TAF benefits as considered from a farmers’ perspective. Is the list convincing?

- **“You’re in the driver’s seat”** because under TAF the farmer doesn’t need to make share investment decisions many months in advance. “Driver’s seat” sounds nice, but farmers were already in the driver’s seat, weren’t they? This doesn’t seem to be a very serious argument. Sure it’s helpful it you can buy shares any time, but what’s the problem deciding a few months before the end of the season, particularly if a longer buy-in period is accepted?
- **“Easier to manage your cash flow”** through the three season rolling average share standard. Additional is a longer, six months compliance period. And a three year buying in and selling period. Makes sense; sounds good! But do these require TAF? No, not at all.
- **“Easier to use”:** Fencepost share trading is supposedly easier than current share forms. That would seem very strange: Would it require TAF to get rid of an overly difficult share form? One might even argue that farmers weren’t waiting for a system to be able to trade shares 24/7 365, with all that it takes to intelligently buy and sell in two parallel markets. TAF may well demand more from farmers than the present system.
- **“The share price will be set by what farmer shareholders trade at”** rather than by an external valuer. No, it won’t. The share price will effectively be set by the public market for the units. That was the whole point of introducing an external market. The Shareholders Market’s pay-off “buying and selling from each other” is only part of the full story. And why does the Board suddenly suggest that share valuation by an external valuer apparently wasn’t desirable? And, if so, of what (“safeguard”) value, then, would the view of a valuer be that will continue to do its work? Let’s suppose what they really mean is “a share price that is set in a deep and liquid market with every likelihood of a high price”. But as already argued, as a milk supplier you might not really desire a high share price.
- **“A stronger cooperative”** - that is a cooperative with a stronger capital base. What is meant is a business with a stronger capital base. This may not necessarily be the same as a stronger cooperative as such. But if TAF creates a stable capital base by solving the redemption problem, this must be accepted as a valid argument.
- **“Flexibility”** to manage farm cash flows basically is a repetition of the second argument.

First time farmer control. There was another remarkable selling point in the booklet: "TAF will entrench for the first time 100% farmer control and ownership of our Co-operative". Sounds really wonderful, but what is this supposed to mean? Same point is reiterated when referring to the restricted value share: TAF "recognized that shares are only owned by Fonterra farmers". That doesn't really make sense. Right from the beginning, Section 2 in Fonterra's original Constitution (22 March 2001) was already entitled "Shareholders to be suppliers". So what is really entrenched for the first time?

Capital structure problem: times have changed. The capital structure debate has been influenced by the realities that are summarized in the ten year history table. The debate was rooted in the immediate years after the merger. Today the situation is very different and hence the issues should be looked at quite differently today. The problem back then was: could external capital play a role in getting Fonterra off the ground? It was the flag of Kerry Group waving before the eyes of many. Kerry farmers became highly prosperous from the stock-listing of the company in 1986 – and the excellent performance since then. It seems at Fonterra, access to capital was seen as the solution, though access to capital probably wasn't the problem. More likely, performance was the problem. Fonterra has had a few very good years. Fonterra today is much stronger than it was before. Fonterra is well on track. External capital is no longer seen as a goal of TAF. Redemption is still mentioned, but it seems with the overheated share price having been frozen and retentions made, it's not so much a presently burning issue. It seems, though, that the 'idea' that somehow external capital is needed as a 'solution' to make Fonterra 'work' has lingered on. TAF is the product of that.

A better alternative? The cooperative's leadership has been quite persistent in going forward with TAF. It was the single option presented in 2009. Farmers weren't given a lot of choice options, so to say. And they were relieved a public share listing was definitely off the table. Since then, TAF and TAF only has been further elaborated. It seems hardly imaginable, but TAF isn't actually the only possible solution for Fonterra. There are some uncertainties about TAF. It has some complexities. It changes the nature of the cooperative. It looks like a second best option. Of course there are alternatives. There are hundreds of thousands of cooperatives. None of them are anything like Fonterra: Fonterra is the world's no. 1 dairy cooperative. Which doesn't mean you can't learn more from the rest out there. It would be a surprise, actually, if the cooperative model wouldn't have another, cooperative solution for Fonterra. Who knows an opportunity arises for that report to be written some other day...

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Epilogue: Fonterra in 2050

Fonterra's revenues have transgressed the 100bn $barrier. Much less than a quarter is still generated from NZ milk. The remainder is from overseas, processing local milk and dairy inputs worldwide. Global headquarters are still in Auckland and Fonterra still has a NZ stamp on it. But clearly, it has become a fully-fledged, multinational corporation.

In 2050, who are the owners of Fonterra? Things got way too big for the relatively 'small band' of NZ farmers to shoulder. Did farmers succumb and let external investors in? Did they gradually lose majority ownership and control? Or did they manage to keep it all in farmers' hands? It did get "way too big" for NZ farmers AND they managed to "keep it in farmers' hands". That seemed like a contradiction at the time. What happened?

In the 2010s NZ farmers decided the route ahead was investing in solidarity with farmers worldwide. They realized inviting external farmers was a better deal than opening up to external investors. Two proposals involving public (non-voting) share trading were voted down during a five year period. Farmers rallied behind the strategy refresh though and vowed to deliver a stable capital base. Gradually, a different mindset took on. It made more sense to align with farmers internationally, as mutual interests appeared very much akin. Not just with farmers with similar grazing systems such as in Australia and Ireland, but subsequently with the Danes, the Dutch, the Americans, and those in other countries as well. There was sufficient growth to share and more market demand than NZ farmers could handle anyway.

Overseas farmers co-invested with NZ farmers to make growth possible. Fonterra became a global cooperative platform with multi-local roots. Each fueling growth at a national level. And each benefiting and participating in the global network as well. Global brands owned by the network and licensed to local units worldwide. The worldwide valorization and distribution system being accessible for an attractive fee. Production standards being raised and monitored internationally. Efficiency of processing benchmarked within the system and upgraded continuously.

Fonterra managed to export its cooperative model worldwide. And farmers and their cooperatives eagerly embraced it across the planet. Wherever needed, the Fonterra network contributed to local cooperative development. Fiercely competitive in the first stages of dairy processing, the big multinational players, both listed and family owned, gradually moved away to branding only. And even there, the global Fonterra cooperative system became a strong player. With a local farmer identity everywhere, under a trusted global banner.

A few big steps were made during the preceding decades. One of the milestones was the launch of the global dairy trade auction system. That enabled Fonterra to befriend participating cooperatives. It started to discuss a 'cooperative solution' to the benefit of all. Under a warmly welcomed NZ leadership that could be trusted by all. Because it became a cooperative game, each sharing according to its contributions. It solved Fonterra's capital growth requirements. Fonterra's capital notes are now 'traded among farmers' worldwide. The investor community is satisfied now with the listed permanent bonds. The annual interest payment is decent, but more importantly, highly credible.

The first decade of the century was seemingly lost to an endless debate about ‘redemption’ but the cooperative came out united. In the end, it was agreed to introduce a ‘valve’: Annual redemption of ‘wet’ shares couldn’t ever exceed annual equity contributions anymore. It did happen a couple of times: more farmers retired than the system permitted. They had to wait a few years until all their shares could be redeemed. Production growth and retained earnings were stable over longer periods. And hence each could receive his own fair share. Government officials recognized this was in tune with the spirit of the original DIRA. The initial rigid structure of annual ‘fair share’ valuations was allowed to preserve dairy farmer ownership. The fair value share, vital to make the 2001 merger happen, just wasn’t needed and sustainable anymore and both farmers and government officials recognized that before it was too late.

But that’s all long history now. Farmers in NZ and across the planet are earning a healthy share of consumer dairy spend. Fonterra Global has grown to become a wonderful example of democracy in international business, operating with impressive efficiency. Transparent for the public but rightfully in farmers’ hands.