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MONITORING FONTERRA

Preliminary

1. Before defining benchmarks and measures, we need to clarify the monitoring role of the Shareholder Council (SC): what is its purpose, what are its specific objectives and how will it achieve them?
2. These issues may be clear to you already. If so, much of the following will be redundant. However, we need to start by establishing a framework. Only then will the why, what and how of SC's role fall into place.

Core Issue

3. The essential problem that monitoring is seeking to mitigate is the separation of ownership and control in Fonterra. None of its 14,000 owners exercises control. It rests with senior management.
4. This is a classic 'agency problem', which is a feature of any large company with dispersed shareholders. Senior managers have considerable power, which could be used in a manner that is not consistent with the owners' best interests.
5. While this risk is widely viewed as a necessary cost of achieving the benefits of scale and access to professional managers, safeguards are needed to mitigate the risk.

External Safeguards

6. Years of international experience have evolved set of core mechanisms, external to the company, to mitigate the risk of agents (directors and managers) with powers of control over a company failing to act in the owners' best interests. These safeguards are summarised in the table below, which also notes whether they apply to Fonterra.

[Refer to table on next page]

External Safeguard	Fonterra
<input type="checkbox"/> Ability for owners to buy and sell shares at their discretion (ie 'vote with their feet')	<input type="checkbox"/> Very limited. Without an alternative processor, must sell farm. Also short window in year for buying and selling shares
<input type="checkbox"/> Regular value analysis and advice to investors by a wide range of financial institutions, which provides constant real feed-back on Fonterra's business decisions <input type="checkbox"/> Pressure for institutional investors (pension funds, unit trusts and so on) or major shareholder	<input type="checkbox"/> Limited to annual valuation by S&P <input type="checkbox"/> No (<i>potential for SC to play some role</i>)
<input type="checkbox"/> Potential for a partial or full takeover, which is widely recognised as a powerful discipline on managerial performance	<input type="checkbox"/> No
<input type="checkbox"/> Statutory and common law rules, including directors' duties, disclosure, minority shareholder protections, insider trading, conflicts of interest, reserve powers for shareholders and so on	<input type="checkbox"/> Companies Act, but not listing rules. Also Cooperative Companies Act, constitution and dairy legislation may 'soften' or 'blur' some rules
<input type="checkbox"/> Requirement to disclose whether comply with respected Codes of Best Practice in Corporate Governance	<input type="checkbox"/> No

Internal Safeguards

7. In addition to the external mechanisms outlined above, codes of best practice for internal corporate governance have been developed over the last 10 years in the USA, UK, Europe and Australia, by a range of public and private sector organisations. A list of the various codes is set out at the end of this paper¹.

8. It is important to note that *"[t]he object of a code of good practice is not to prescribe corporate behaviour in detail but to secure sufficient disclosure so that investors and others can assess companies' performance and governance practices and respond in an informed way"*.²

9. Under the UK 'Combined Code', every company listed on the London Stock Exchange must state in its annual report whether it has complied with the Code provisions and if it did not, why. The Code's key requirements are summarised below. How does Fonterra match up?

10. In the table that follows, 'independent director' means independent of management and free of any business or relationship that could materially interfere with exercise of their independent judgement. (Cadbury Code, paragraph 2.2).

BEST PRACTICE IN CORPORATE GOVERNANCE	
CODE OR INTERNATIONAL FINANCIAL SERVICES ASSOCIATION	FONTERRA
Directors	
Majority of board to be independent + non-executive	No
Chairperson	
Chair + CEO separate	Yes
Chair also independent + non-executive	No
Remuneration Committee	
Appointed by full board	Yes
Chaired by independent non-executive	Not known
Majority of members independent + non-executive	Not known
Remuneration package	
Disclose quantum and components for five top managers + all directors	Not full disclosure
Share options schemes to be linked to future, not past, performance	NA
LONDON COMBINED CODE	
Audit Committee Three or more non-executive directors	Not known
Director Nominations Committee Prefer non-executive directors	Not known
Directors elected every three years Provided in constitution	Yes
Executive contracts One year contracts	No
Performance-related bonuses Set upper limit	Not known
Adequate performance criteria Specified in contracts	Not known
Share based compensation Clear + adequate criteria in contracts	Not known
Long term incentive schemes Clear + adequate criteria and limits	Not known

Impact of a Traditional Supplier Co-operative

11. The safeguards outlined above relate to normal listed companies. The structure of a traditional supplier co-operative *exacerbates* the agency risk yet precludes many of the normal safeguards.

12. External measurement of performance is limited given the absence of non-supplier share capital and the strict linking of supply and shares, which in turn precludes any trading of shares.

13. Returns from different businesses units are bundled together as a payment for purchasing shareholders' supplies, even if the performance of a business unit is not related to the volume or value of those supplies. This makes it extremely difficult to measure performance effectively.

14. It is harder to align managers' incentives with shareholders' interests, as managers are not able to receive incentive payments in the form of shares as part of their remuneration package.

15. Owners' objectives for management are often poorly defined and mixed, as reflected in various statements of cooperative principles³. As a leading expert on corporate governance has noted, mixed objectives "*politicise a company and leave its managers empowered to exercise their own preferences in spending the firm's resources*"⁴.

16. Supplier directors tend to be driven by member payouts and production issues rather than market demand, and many find it difficult to scrutinise the analysis of professional managers.

17. Decision-making processes tend to be less efficient, given the expectation of many stakeholder groups of having an opportunity to contribute.

18. These problems have been identified by *proponents* of cooperatives. It is *not* to say that traditional supply co-operatives are inappropriate structures. For suppliers, they avoid the need to contract with an independent processor.

19. However, traditional supplier co-operatives are likely to be most effective when the business is relatively simple, members are close and products manufactured are very close in nature to goods purchased from suppliers⁵.

17. As its business becomes more complex, its capital requirements increase and its product range diversifies beyond suppliers' goods, a traditional supplier co-operative starts to become strained, particularly in controlling managers and new investment decisions.

18. The bonds of a shared commitment among suppliers to a common philosophy are not sufficient to ensure effective accountability and sound governance.

19. In passing, note that co-operatives like Foodstuffs, Combined Rural Traders, Ravensdown, PSIS and Rabobank are not traditional supplier co-ops.

Summary of Safeguards relating to Fonterra

External safeguards

20. Of the six external safeguards outlined above, only *one* is in place now: namely, statutory and common law rules, though even here there is some 'blurring' from the interaction of different rules under the Companies Act, the Co-operatives Companies Act, Fonterra's constitution and the recent dairy reform legislation.

21. None of the other five external safeguards is in place.

22. Under Fonterra's current structure, only *one* of these - disclosure compliance with guidelines for good corporate governance - could be applied in a real-world sense.

23. An ability for shareholders to trade their shares and the threat of take over, which are among the most important of safeguards, are precluded by Fonterra's constitution.

24. The other two - regular market analysis and active pressure from institutional or large shareholders - are not available in a real-world sense. As discussed below, the SC could play some role, however, in developing proxies for this normal market dynamic.

Internal safeguards

25. Of the 16 internal safeguards outlined above (relating to good corporate governance), all but two are available to Fonterra at present. However, it is not clear if Fonterra complies with these 14 guidelines.

26. The other two could be made available if Fonterra changed its constitution, but for now they have been precluded.

27. Of all the internal safeguards, the most important is to have a majority of independent directors. Fonterra's move to increase the number of independents from three to four is positive, but not sufficient. Further change is required. The problem of attracting the highest calibre independent directors also needs to be addressed.

SC's Role and Purpose

28. Which of the weaknesses in Fonterra outlined above can the SC effectively remedy or mitigate? The answer to this question defines the SC's role and purpose.

29. Under Fonterra's current constitutional structure:

- ❑ *With respect to missing external safeguards*, the SC could try to put in place processes that proxy normal market analysis and institutional pressures; and
- ❑ *With respect to internal safeguards*, the SC could require half-yearly disclosure by Fonterra of whether it meets the London and ISFA codes of corporate governance, together with reasons for any departures.

30. The problems of establishing these functions in a manner that makes them likely to be effective should not be underestimated.

31. The SC could also take an active role in developing constitutional changes, to put in place the missing shareholder safeguards. This is discussed further below.

32. It is important to note that these proposed SC functions would not cut across the proper functions of the Fonterra board.

Key issues

33. Fourteen key issues need to be resolved to define properly the SC roles proposed above:

- ❑ The SC's assumed shareholding interest;
- ❑ Whether the SC has a short, medium or long term perspective;
- ❑ The SC's approach: is it 'active' or 'passive'?
- ❑ What services to shareholders the SC should provide;
- ❑ What resources and capacity the SC needs to put in place;
- ❑ Important assumptions about the working relationship between the SC and Fonterra;
- ❑ How performance goals and benchmarks are set for Fonterra;
- ❑ How the SC should interact with Fonterra's board and senior management;
- ❑ How Fonterra's disclosure obligations are created;
- ❑ How the obligations are enforced;
- ❑ What Fonterra discloses;
- ❑ The frequency and mode of disclosure;
- ❑ How the SC responds where disclosure and analysis indicates issues of material concern; and finally -
- ❑ The SC's capacity to play a useful role in relation to strategic policy issues which impact on shareholders.

34. Some may argue this detail is not necessary - the SC will sort it out as it goes along. Quite possibly, this is how it will work in practice. However, given the relatively limited experience and expertise of the SC, as a body, in systematic monitoring, and given the diversity of perspectives within the SC and the risks of industry-political behaviour, a detailed prescription on each issue outlined above is essential if the SC is to be effective in its monitoring.

Assumed Shareholding Interest

35. Disclosure by a company depends on the size of a person's shareholding. Larger holdings tend to receive higher levels of disclosure and have a greater strategic influence. The key shareholding thresholds (in ascending order) are roughly:

- ❑ A single small shareholder, who receives only statutory disclosures and has no direct influence. They rely on advice from brokers and have three options in responding to a company's performance - buy, sell or hold;
- ❑ An institutional investor with a portfolio holding (say 5%), which receives the above *plus* regular briefings and more detailed explanations from senior management;
- ❑ A cornerstone shareholder with effective control (say 25%), which receives the all of the above *plus* (if they wish) key strategic board papers (through their appointed directors);
- ❑ A majority shareholder with over 50%, which can receive *all* board papers and control the board;
- ❑ A majority shareholder with over 75%, which can receive all of the above *plus* control any changes to the constitution; and
- ❑ Obviously, a 100% shareholder, which can receive and control everything.

Recommendation

36. The question is, what size holding should the SC assume it has for the purposes of monitoring? In my view, the SC should either assume:

- ❑ The level of typical institutional investors with about 5%; or
- ❑ A 100% owner operating within certain defined constraints, analogous to the Crown owning 100% of its SOEs but operating within the limits set out in the SOE Act 1986. This approach is discussed further below.

Period of Investment

37. A shareholder's approach to key company decisions will obviously depend on their investment horizon. Short term investors tend to respond by buying or selling shares. Longer term investors with a strategic stake tend to respond by seeking to influence the company's direction.

Recommendation

38. What investment horizon should the SC adopt? I would suggest it should act as a long term investor.

Active or Passive Approach

39. Many institutional investors monitor in a passive manner: analysing information,, meeting with senior management, generating forecasts and reviewing their portfolio, but not seeking to influence a company's strategic direction or board composition. Sometimes, institutional investors even abstain from voting on shareholder resolutions.

40. Others adopt a more active approach by seeking to influence board membership and strategic direction, often in collusion with other strategic shareholders.

41. Institutions seek to make independent judgements about companies, applying one key criterion: what is the likely impact on shareholder value?

Recommendation

42. Which approach should the SC adopt? I would suggest the active, independent approach. It is extremely important for the SC Performance Committee to operate as if it were independent of Fonterra, like an arms-length institutional investor.

Services to Shareholders

43. Market institutions provide a range of services to client investors, for example:

- ❑ Regular appraisals of market and sector trends;
- ❑ Detailed reports on a particular company, its prospects and strategies;
- ❑ 'Broker' bulletins, with buying and selling recommendations;
- ❑ Advice on how to vote on shareholder resolutions at a company's general meetings (board elections, auditor appointments, special distributions, director fees, constitutional changes and so on). Leading organisations in this area include CalPERS* and the Institutional Shareholder Services (ISS), both of the US; and
- ❑ Advice on key strategic and corporate issues. A range of NZ and international firms provide services in these areas.

45. What services should the SC provide or commission for Fonterra shareholders? SC members will argue that the SC must be seen to be 'neutral', to maintain the confidence of Fonterra and shareholders. Some may also argue it should avoid any public tension or conflict with Fonterra.

46. In my view, the SC has a responsibility to express views in an independent and forthright manner. In a sense, owners have 'sovereignty' over their company: Fonterra's culture should be to serve and advance the interests of shareholders, just as shop owners seek to serve customers.

47. The SC's main responsibility is to ensure that owners are informed in an independent and neutral manner, even if it is strongly critical of Fonterra.

* California Public Employees Retirement System, which is the largest public employees' retirement funds manager in the US, which actively monitors corporate governance.

Recommendation

48. The SC should arrange *all* of the reporting and advisory services outlined above. It could generate this material in its own name, or it could distribute work prepared by independent analysts with the SC taking no ownership of the material.

Resources and capacity

49. The SC needs, at least, a full time co-ordinator to manage the proposed monitoring process. The substantive work of preparing the various reports and advice should be carried out by contracted experts who are fully independent of Fonterra.

50. The SC Performance Committee would act like a board, commissioning the contractors and reviewing their work. As noted above, the SC would remain neutral and express no view on the contractors' conclusions or recommendations.

51. It would be preferable for the SC's funding in this area to be independent of Fonterra, however this is probably not practical at this stage. However, an effective mechanism is needed to ensure that Fonterra is not able to mute the SC's monitoring work by contesting or reducing the SC's funding.

Recommendation

52. The SC should out-source the required analytical and reporting skills to experts who are fully independent of Fonterra.

53. The SC should also commission two or three different analysts to prepare regular 'broking' reports, to ensure that shareholders have the benefit of alternative opinions as occurs in a normal capital market.

Important Working Assumptions

54. Under the proposed SC role, occasional tension and conflict between the SC and Fonterra is inevitable. However, the SC would certainly *not* be protecting shareholders' interests if it deferred to direct or indirect pressure from Fonterra. A clear sense of independence and objectivity is essential. Healthy analytical scepticism is also important on the SC's side if it is to make a meaningful difference to the structural weaknesses outline earlier in this paper.

55. For its part, the SC would need to understand clearly the boundaries between its role in representing shareholders' ownership interests and the board's role in governing the company. Nothing in the proposed monitoring role breaches that boundary.

56. Lack of independence and objectivity from the SC is likely to render it of limited value and importance. The SC would become a relatively meaningless industry body largely managed by Fonterra.

Recommendation

57. The SC and Fonterra need to be clear about the independence of the SC's monitoring role.

Interaction with Fonterra

58. The SC should seek to replicate the same manner and level of interaction that occurs between institutional investors and a listed company.

59. In monitoring listed companies, institutional investors and analysts:

- ❑ Regularly gather information (often in quite an aggressive manner) about the company's investment policy, capital budget, capital allocation and financial performance, and seek explanation from the company about its performance and goals;
- ❑ Meeting senior managers one-on-one, in conferences arranged by the company or the institution, and by conference calls.

57. Senior managers of listed companies often invest considerable time and effort into reducing friction with important institutional investors and analysts.

Recommendation

58. The SC's interaction with Fonterra in relation to monitoring must be professional, objective and systematic.

Performance Goals and Benchmarks

59. Under clause 16.1(d) of Fonterra's constitution[†], the SC is to review a 'statement of intentions' (SOI) by the board relating to the performance and operations of the company for each season. Apart from informal comment, the SC has no *formal* active role under the constitution in relation to the SOI.

60. The SOI is to be set by the Board, then provided to the SC for review. No minimum content requirements are prescribed by the constitution. Nor is the board required to take into account any of the SC's comments. In short, Fonterra sets its own specific goals and expresses them in the form it wishes.

61. This SOI mechanism is, no doubt, based on the 'statement of corporate intentions' (SCI) mechanism used by shareholding Ministers in relation to State Owned Enterprises (such as NZ Post, Transpower and Meridian).

62. However, there are some key differences in between the SOI and SCI processes. In particular, under the SCI process:

- ❑ The period of operations to be covered is specified;
- ❑ The range of companies in the group is specified;
- ❑ The items of information to be provided are specified. This is summarised in Annex 1 below;
- ❑ The period for consultation with shareholders is specified;

[†] Of the only readily available on-line version, which is dated March 2001

- ❑ The company is required to take into account the shareholders' comments;
- ❑ The shareholders have a reserve power, after consulting with the board, to direct changes to key parts of a company's SCI; and
- ❑ The company can only change its SCI following prior consultation with the shareholders.

63. None of these features operate under Fonterra's SOI system. In short, the SC has no meaningful legal role in formulating the SOI. By contrast, the SCI process provides a balance of power between the board and shareholders.

64. While the SC has a power of approval over Fonterra's 'mission statement' and 'statement of values', these documents tend to be vague and are not of major importance in serious performance monitoring.

Recommendation

65. Add the SCI elements outlined above to the SOI process, except for the reserve power of direction which may be problematic given the size of the SC's membership.

Creation of Disclosure Obligations

66. This is likely to be one of the hardest elements to be put in place.

67. For monitoring to be effective, enforceable disclosure rules are required. Relying on personal relationships and 'individual integrity' is not a sound basis for monitoring a large company, the ownership of which is fragmented and comparatively 'captured'.

68. Fonterra has weak incentives to disclose adverse information in a timely and full manner. Experience and recent research[‡] shows that companies seek to avoid, delay or minimise the release of adverse information.

69. Some groups in the US are exploring ways of structuring senior managers' remuneration to provide stronger incentives for them to cooperate with external monitors.⁶

70. Given Fonterra's culture and structure, rules combined with a menu of countervailing powers are required to ensure full and timely disclosure by Fonterra to the SC or its contractors.

71. Under the current constitution, the SC's powers are *extremely* limited. It can only:

- ❑ Make recommendations to shareholders and the board to commission a special report, but the SC cannot commission reports itself; or
- ❑ Call a special meeting of shareholders, but only if 75% of SC members agree.

[‡]References to recent research in the US on companies' compliance with disclosure rules under different share value conditions are available if required.

72. The proposed rules need to set out what is to be disclosed, when, how and to whom, together with sanctions for non-compliance.

73. The rules must be enforceable and could be set out in either:

- A contract between the SC and Fonterra; or
- Government regulations. (Disclosure regulations are in place for electricity lines companies, Telecom and other monopoly businesses).

74. Neither Fonterra nor the SC is likely to favour regulation. However, the *threat* of regulation by the Government has provided a powerful focus in the past for private parties to agree on rules by contract.

75. The 'threat' approach has been used successfully in several similar situations; for example, in establishing the New Zealand Electricity Market Rules, which is a multilateral contract with rules of disclosure and enforcement.

76. Proper processes are required to ensure confidentiality of commercially sensitive information. This is not an issue as standard procedures are available which have been used successfully by the industry in the past.

Enforcement of Disclosure Obligations

77. A joint enforcement body is probably required, to resolve disputes between Fonterra and the SC in relation to disclosure. The joint body should comprise independent people with skills in dispute resolution, enforcement and financial issues.

78. Many useful models are available, for example the Electricity Market Surveillance Panel, whose members have top legal, economic and market experience. It is headed by a retired Court of Appeal judge and operates under the authority of a contract between parties. It has range of enforcement powers.

Recommendation

79. The SC and Fonterra should agree to establish a three-member panel with rules and enforcement powers to resolve disputes relating to disclosure.

What is to be disclosed?

80. My initial recommendations are set out in Annex 2. However, this is an area requiring more detailed advice from an expert financial analyst. (Mr Chas Cable, based in Auckland, previously with Ord Minnett, is a highly expert and independent person I would recommend for this purpose).

81. As noted in Annex 2 below, I would also suggest that Fonterra covenant, in a written and enforceable manner, that it will disclose to the SC *as if* its shares were listed on the NZ Stock Exchange.

82. While Fonterra's capital notes are listed, many parts of the NZSE Listing Rules do not apply as the capital notes are not equities.

Recommendation

83. Engage an independent expert in company monitoring to help specify the particular items to be disclosed by Fonterra. Annex 2 below sets out my initial suggestions.

84. Fonterra should also undertake in an enforceable manner to comply with the NZSE Listing Rules, as if its shares were listed.

Frequency and Mode of Disclosure

85. A mix of modes will be necessary.

Recommendation

86. The key written documents from Fonterra would include:

- The Statement of Intentions, discussed above;
- Statutory disclosures, including annual and half-yearly financial reports under the Financial Reporting Act; and
- Quarterly reports to the SC covering the items set out in Annex 2;
- Other disclosures required *as if* the NZSE Listing Rules applied to Fonterra's shares.

87. Further information would be provided using the normal range methods (mentioned in paragraph 59 above) as if the SC was an institutional shareholder with a strategic holding of say 5%.

Response to Performance Concerns

88. Disclosure and monitoring is useful only to the extent that it disciplines Fonterra's behaviour. The acid question is then, what will the SC or its Performance Committee do:

- If Fonterra fails to disclose fully or in a timely manner; or
- If analysis of the disclosures gives rise to material concerns about Fonterra's performance?

89. Disclosure by Fonterra in exchange for strict undertakings of confidentiality and restraint by the SC would be net *loss*, not a net gain, for shareholders. It would neuter the possibility of effective pressure from shareholders.

90. If the SC operates exclusively on an in-house basis, Fonterra can, after rounds of polite consultation, *not* act on the SC's advice. This can easily be done in a manner that placates grievances in the SC. Industry leaders are well practised at appealing to farmers' sense of loyalty and gently pointing out their dependence on Fonterra.

91. Relying on voting for three directors every year is a blunt and untimely substituted. Monitoring only works if it enables shareholders to respond to poor decisions close to when they are made.

92. So what can the SC do when monitoring shows poor performance or a failure to disclose adequately?

93. This is when the SC needs to have the confidence, professionalism and independence to act strongly, even if it creates tension and conflict within Fonterra.

94. The SC's only current remedy under the constitution is call a special shareholders' meeting. This is such a large 'cliff-face', it is not likely to be a meaningful threat.

95. Quiet 'inside' counselling by senior SC members with Fonterra directors may 'shave off the odd rough edge' in Fonterra's behaviour. However, when the issues are more significant (but short of a crisis), what options does the SC have if Fonterra takes no notice?

Recommendation

96. The SC should seek to replicate the dynamics that occur between shareholders, analysts and listed companies.

97. Rather than become a hostage to adverse information, the SC should commission a range of different analysts to provide shareholders with regular appraisal on Fonterra. The SC would co-ordinate the process, managing relationships with Fonterra, supervising contract issues with analysts and ensuring that information flows are efficient.

98. As discussed above, the SC need not take a position on the views expressed by the independent analysts. The aim is simply to create wider and more informed accountability.

Capacity for Strategic Policy

99. If Fonterra is serious about achieving its growth targets (increasing revenues from \$10b to \$40b in 10 years), its current capital and legal structures are likely to change within five years.

100. Many high level industry reviews have concluded that activities in which returns are not related to milk supply are more efficiently carried out in a corporate structure with ownership delinked from supply, tradable shares, independent directors and (in time) external equity.

101. Evolution in this direction is likely. Current owners need to be in a position to positively contribute to these issues *before* they arise. Shareholders need to anticipate them, rather than react to management proposals.

102. Before the Fonterra merger, senior industry people developed work on a range of options in this direction. Fonterra's strategy groups are likely to work on these issues in the coming year.

Recommendation

103. After the SC has established its monitoring processes, it needs to develop an independent capacity to address strategic issues and options relating to Fonterra's future direction and structure.

104. If it remains passive, the SC is likely to find itself 'snowballed', with a limited capacity to contribute in an informed and meaningful way.

CCMAU Case Study

105. The Crown's ownership monitoring of SOEs may have some useful lessons for the SC. The three main challenges in relation to SOEs were to:

- ❑ Prevent political interference in management decisions;
- ❑ Ensure effective accountability by the board to the owners (shareholding Ministers); and
- ❑ Provide clear strategic goals and guidelines from the owners to the board in relation to scope of business, capital structure, dividend policy and performance targets.

106. Shareholding Ministers set up the Crown Company Monitoring Unit (CCMAU) to co-ordinate and manage the owners' interests. CCMAU now contract analysts in various private institutions to carry out routine monitoring. CCMAU also contracts specialists to advise owners on key strategic issues.

107. The SC should adopt a similar approach using formal and enforceable mechanisms.

Conclusion

108. Without a framework, the SC's monitoring role is likely to be ineffective over time. The approach proposed in this paper may appear at first to be overly detailed and formal. However, the alternative of using informal mechanisms and personal relationships will fail.

109. The purpose of monitoring is to discipline the way in which managers' exercise their real-world powers of control.

110. Managers unaccustomed to normal shareholder safeguards (which is the case in Fonterra) will be *extremely* reluctant to relinquish any measure of control.

111. Under the current arrangements, Fonterra has effective control over the nature and extent of the SC's monitoring and governance supervision. The proposals outlined in this paper significantly alter the balance in favour of shareholders. Fonterra are likely to see this as a threat and represent it as inappropriate. By contrast, listed companies see it as absolutely normal.

112. A major shift in culture is required. Without strong leadership, the SC is likely become a vehicle for Fonterra to manage its shareholders.

113. The SC has a major task. I wish you and your colleagues well in carrying it out.

Tony Baldwin
Motueka
10 May 2002

Note:

- ❑ It is curious that Standard & Poors are acting as valuers of 'Fair Value' *and* providing credit rating services to Fonterra. It raises conflict of interest questions.
- ❑ The agency acting as valuer must be fully independent of Fonterra; that is, not carrying out or seeking other work from Fonterra.
- ❑ Valuation is also a highly specialised art. It is not clear that S&P are the best people for this job. It is *not* the same as assessing credit risk on capital.

ANNEX 1:
'STATEMENT OF INTENTION'

The SOI should relate to Fonterra and its subsidiaries (the group). It should cover the financial year in which it is delivered and each of the immediately following two financial years and set out:

- ❑ The objectives of the group
- ❑ The nature and scope of the activities to be undertaken
- ❑ The ratio of consolidated shareholders' funds to total assets, and definitions of those terms
- ❑ The accounting policies
- ❑ The performance targets and other measures by which the performance of the group may be judged in relation to its objectives
- ❑ An estimate of the amount or proportion of accumulated profits and capital reserves that is intended to be distributed to shareholders
- ❑ The kind of information to be provided to the Shareholders Council during the course of those financial years, including the information to be included in quarterly and half-yearly reports
- ❑ The procedures to be followed before any member of the group subscribes for, purchases, or otherwise acquires shares in any company or other organisation
- ❑ Any activities for which the board seeks compensation from the Crown (whether or not the Crown has agreed to provide such compensation)
- ❑ The board's estimate of the commercial value of the Crown's investment in the group and the manner in which, and the times at which, this value is to be reassessed
- ❑ Other matters agreed by the Shareholders Council and the board.

ANNEX 2:**KEY DISCLOSURE ITEMS**

(This is an initial outline. It requires further work by people more expert in financial monitoring)

- ❑ Coverage of coming year and the two following years
- ❑ Broken down by business units (*very important*)
- ❑ Accounting policies
- ❑ Projected capital structure
- ❑ Capital expenditure plans
- ❑ Business plan
- ❑ Projected revenue and cost streams (as for all other key indicators, these revenue and costs streams must be disclosed by business units)
- ❑ Normal financial performance measures, including accounting return on total assets, accounting return on equity and accounting rate of profit
- ❑ Operating systems performance targets, including for key plant and machinery
- ❑ Organisation quality targets, including staff turnover
- ❑ Payout policies and targets, with the payout broken into raw milk price, return on manufacturing, return on value-added, returns from quota premiums and other returns).
- ❑ Dividend policies and targets
- ❑ EVA
- ❑ Relevant ratios, for example EV/sales, EV/EBITDA, EV/EBIT, P/NAV, Gross Margin, EV/(NAV + DEBT)
- ❑ Benchmarks using same measures from competitors
- ❑ Transfer pricing policies between business units
- ❑ Details of performance incentives for senior managers (what results have they been encouraged to deliver in their remuneration package?)
(This is very important)
- ❑ Whether Fonterra satisfies the ISFA and London Combine Codes on Corporate Governance, with reasons for any departures
- ❑ Compliance with the NZSE Listing Rules *as if* Fonterra's shares were listed.

Note

Monopoly business are often encouraged to disclose their WAAC as well. This may or may not be appropriate between Fonterra and the SC. Items that could be disclosed include:

- Weighted cost of capital (WACC), which equals the rate of return multiplied by the proportion of equity plus the after tax cost of debt multiplied by the proportion of debt.
- The assumptions and parameters underlying the WACC, including risk free rate, corporate tax rate, asset beta, post tax market premium, interest tax parameter, dividend imputation adjustment, cost of equity, debt margin and cost of debt.

This requires further consideration.

END NOTES

¹ Principles and Codes of Best Practice in Corporate Governance:

- ❑ Investment and Financial Services Association (IFSA) - representing all significant institutional investors in Aus - *Corporate Governance: A Guide for Investment Managers and Corporations (IFSA Guidance Note No.2, IFSA, Sydney 1999)* - wide support among Australian institutional investors
- ❑ Australian Institute of Company Directors - Working Group, Bosch Committee, *Corporate Practices and Conduct, 1995*
- ❑ UK - Committee on Financial Aspects of Corporate Governance (Sir Adrian Cadbury, chair), Report 1992. Cadbury Code of Best Practice, 1992
- ❑ UK - Study Group on Directors' Remuneration, Greenbury Committee, UK 1995 - Code of Best Practice, 1995 - Greenbury Code
- ❑ UK - Committee on Corporate Governance, Sir Ronald Hampel, chair, report 1998 - among other things, reviewed Cadbury and Greenbury. Statement of principles and code of best practice.

Note: Each of these three UK committees were sponsored or supported by a cross section organisations from the British commercial sector

- ❑ UK - London Stock Exchange, Combined Code - based on Hampel report, 1998, which integrated Cadbury (1992) and Greenbury (1995)
- ❑ USA - National Association of Corporate Directors (NACD), *Blue Ribbon Commission of Report on Director Professionalism, 1996*
- ❑ Western nations - OCED, *OECD Principles on Corporate Governance, 1996*

² Hampel Committee Report, paragraph 1.25

³ See the ICA Co-operative Principles 1995, for example

⁴ Prof Michael Jensen, Harvard Business School, *"Value Maximisation, Stakeholder Theory and the Corporate Objective Function"*, Journal of Applied Corporate Finance, Vol 14, No. 3, Fall 2001 at p10.

⁵ Leading international advocates of co-operatives have noted that traditional co-operatives are likely to be most effective when:

INSERT 12 CONDITIONS

⁶ N.K.Chidambaran and Kose John, *"Managerial Compensation and the Efficiency of Large Shareholder Monitoring"*, March 1999 - New York Centre for Law and Business