



QUESTIONS FOR RURAL NEWS ON FONTERRA CANDIDATE INTERVIEWS

15 April 2004

By Tony Baldwin

Milk Pricing

All four candidates agree that "milk prices should better reflect market returns". They also agree this is a key issue. However, as usual, none say what it means or how to do it. Your directors have kicked it to a committee with no timeframe. So will this key problem get sorted? Your chairman can only say "it is all too early to say".

Your directors should be explaining the issues and options to you clearly, and offering their best solution. In my view, farmers should receive two payments: one for raw milk, another for Fonterra's profits.

Milk is an input cost. What counts is the profit Fonterra makes on the products it creates using milk. Some candidates say, link milk prices more closely to market returns. But the market value of many products is not related to milk. Value is determined by other factors. So paying more for milk in these cases would send the wrong signal. These returns should be paid as a dividend, separately from the milk price.

Milk contracts between suppliers and Fonterra therefore need to be more sophisticated. Fonterra should offer a menu of contracting options. Each supplier should choose the option that best suits his or her needs.

Fonterra could offer milk prices set in advance for the season, a quarter, a month or even a week. The fixed price could apply to a fixed volume during a certain period. This would allow Fonterra to better manage the volumes it wants to maximise value in the market. It would also allow suppliers to better manage their individual business risks. Farmers should also have the option of managing their own foreign exchange risk.

Another approach is to allocate 'milk supply entitlements' (MSEs) to Fonterra's suppliers. Tatua uses this mechanism. MSEs are tradable among farmers. Among other things, they help match volume of supply with processing capacity in an efficient manner.

Future of NZ Milk

Returns from NZ Milk are poor. This is caused by several factors, including problems in governance, capital and organisational structures.

Once again, all four candidates advocate growing Fonterra's value-add business rapidly. But once again, none say how this is to be achieved, even though industry leaders have been saying it since 1988.

Your directors also keep saying there is not a funding problem – that outside capital is not required to take advantage of growth opportunities. This not true. As the US Council of Farmer Cooperatives points out: "Cooperatives can't just build on debt. They are going to have to get [outside] equity". A traditional supplier cooperative structure is simply not suited to highly competitive fast-moving consumer businesses.

Your directors know this but are unwilling to front up and explain the issues and options. Once again, your chairman is ducking the problem, afraid of running against popular opinion. This is really weak leadership. I suspect Fonterra does not have as long to sort it out as your Chairman claims. Various competition and balance sheet issues, combined with the prospect of older farmers redeeming their shares, will probably crystallise the problem sooner.

The Livestock Improvement Corporation's listing on the stock exchange should give the suppliers some confidence that alternative capital structures for NZ Milk are possible, offering benefits to farmers and Fonterra.

Australian strategy

Murray Goulburn sets the benchmark for performance in dairy commodities. Fonterra is still some distance back by comparison. Can Fonterra get National Foods and Bonlac up to scratch?

Fonterra does not appear to have a coherent strategy for its interests in Australia. This is clearly a problem. None of the four candidates seem to offer any explanation or leadership in this area.

How and where in Australia can Fonterra extract value for NZ shareholders? Fonterra's inability to answer this question may be caused, in part, by lack of clarity in its NZ corporate strategy.

Powdergate

All four candidates want Fonterra's role in Powdergate firmly consigned to the past. I agree with this approach, except it is important that Fonterra learn any relevant lessons.

It is reasonably clear that, when Powdergate surfaced, some of Fonterra's directors did not want it to derail the merger, with the result that the internal investigation was probably not as rigorous as it should have been.

Too many dairy directors in the past have adopted an arrogant, 'we know best', 'we make the rules' attitude. The problem with this approach is that it blinds the company to new and better ways of growing wealth. This attitude has been a part of the industry for too long, to the detriment of NZ suppliers. The question is whether Fonterra has changed its culture.

General

If a significant number of suppliers decide to cash-up over the next few years, Fonterra's capital structure could come under pressure. For now, suppliers can only go to Fonterra to withdraw their equity. This makes no sense, especially when better options are available that also preserve farmer control and avoid the need for highly artificial 'fair value' and redemption processes.

It is disappointing that your industry leaders are still reluctant to lead. It is telling that your Chairman says in his interview above: "We can't run too far ahead [of popular opinion]". I heard Helen Clarke make the same comment last week on TV. This is fine in the context of a political party campaigning to stay in Government. But such reluctance to lead has no place in running a business.

Henry van der Heyden has been Chairman for nearly two years. Now is the time he should be showing what leadership he has to address the fundamental issues facing Fonterra.

Tony Baldwin
Producer Board Project Team 1999