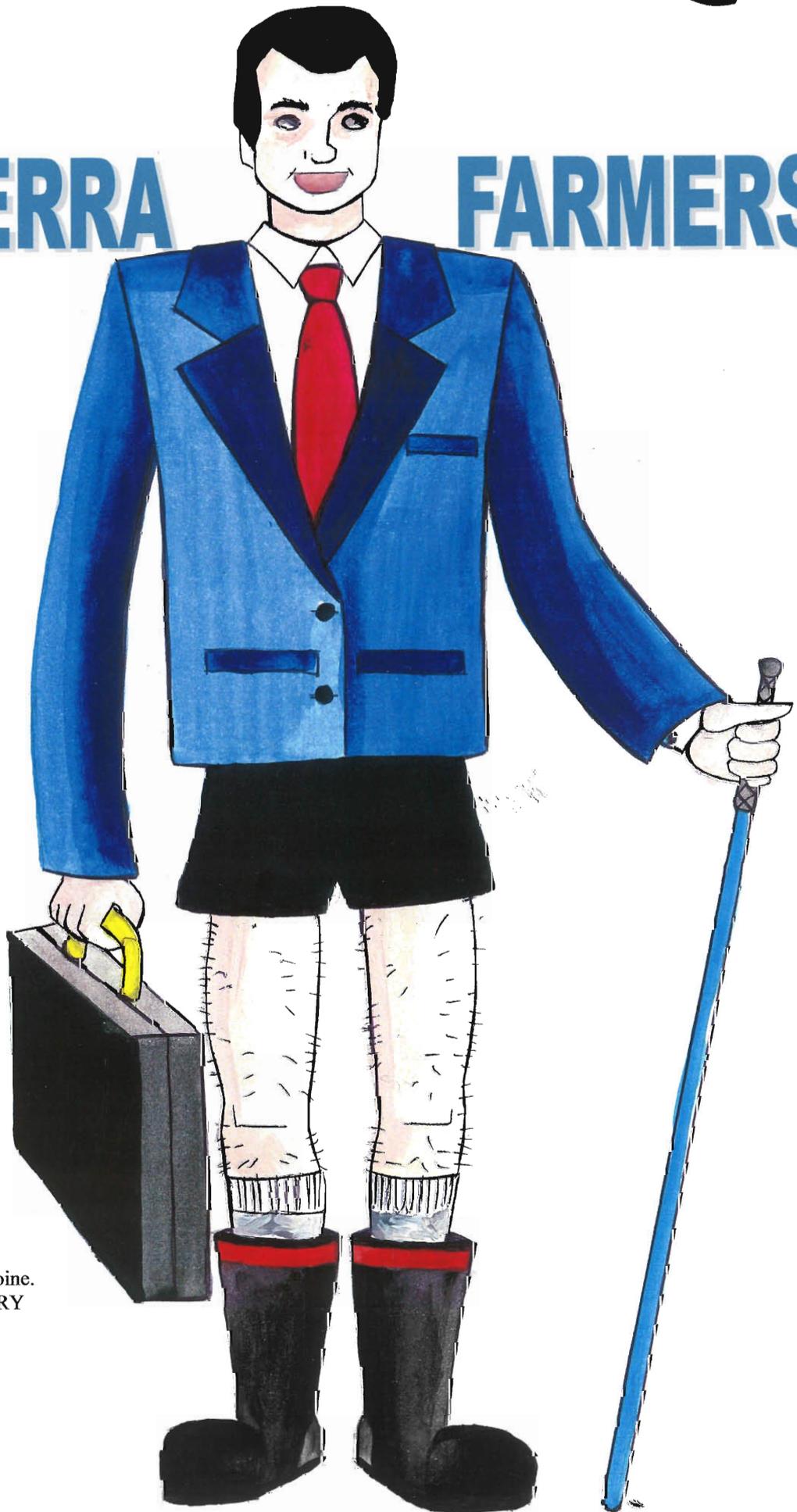


# EMPOWERING

## FONTERRA

## FARMERS



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For: PRIMARY INDUSTRY  
COUNCIL/KELLOGG  
RURAL LEADERSHIP  
PROGRAMME 2004

**“A company is designed as an association of capital, whereas the co-operative is designed as an association of people.”**

**“Enterprises run by their members, providing services for their members, for the benefit of their members.”**

**- Edgar Parnell, on co-operatives**

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The author of the report has been involved in the dairy industry as a co-operative member for the past 15 years. It is of concern to him that many current members of the Fonterra co-operative do not understand or recognise the roles or responsibilities that they have as co-operative members.

He is a current member of the Fonterra Shareholders' Council and Chair of the Learning and Development Committee.

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# 1. Introduction

## 1. Introduction

Early New Zealand dairy farmers formed co-operatives to provide some security for their farming businesses. They produced a perishable product that needed to be collected and processed daily and eventually shipped and marketed in the Northern Hemisphere. There were, and still are, significant risks associated with being a dairy farmer. The collective strength that a co-operative provides, did, and still does minimise some of those risks. My concern is that many of the Fonterra Co-operative's current farmer members lack understanding of their role and responsibilities as a co-operative member. Fonterra is often referred to as **THE** company, rather than **OUR** company.

The objective of my research is to develop a clearer understanding of a co-operative member's obligations and explore some opportunities that Fonterra could utilise in order to develop a broader participative farmer base.

The 'co-operative' business model has been formally recognised, in the western world, for at least the last 160 years.

Co-operatives have been part of primary industry in New Zealand ever since it began building its export-based economy.

Because of New Zealand's geographic isolation from most of its export markets, and the New Zealand economy's dependence on exporting primarily agricultural production, farmers very quickly recognised that forming a co-operative was likely to provide them with some collective strength and security, especially in the case of dairy farmers.

As dairy farmers are producing a highly perishable product, milk, that needs to be processed every 24 hours, the co-operative business model provides that security.

On June 18, 2001, the shareholders of the two largest remaining dairy co-operatives in New Zealand, namely the *Kiwi Dairy Cooperative* (predominately Taranaki based) and the *New Zealand Dairy Group* (predominately Waikato based), voted to merge their co-operatives to form what is now known as the *Fonterra Co-operative Group*.

The formation of Fonterra created a fully integrated manufacturing and marketing global co-operative, owned by 12,500<sup>1</sup> New Zealand dairy farmers.

While approximately 70% of the shareholders of both the legacy co-operatives voted during the merger process, this level of participation, in the now dominant Fonterra co-operative, has not been repeated.

It is essential that all stakeholders in the Fonterra Co-operative recognise the risks that the co-operative will be exposed to, if Fonterra farmers, who are the co-operative members and owners, do not participate in the activities of the co-operative from an informed position.

Many of the co-operative members do not recognise the unique differences that exist between the co-operative business model and those of an investor-driven company.

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<sup>1</sup> *Fonterra Snapshot* 2003 pg 4

The Fonterra co-operative has to take responsibility for facilitating the education process about these co-operative models and about the Fonterra co-operative model.

In return, Fonterra farmers must accept that there are some unique responsibilities that are involved in being a Fonterra co-operative member.

The purpose of this report is to highlight the need for a connection between the Fonterra co-operative and its farmer members.

In the past, the dairy industry's smaller manufacturing co-operatives provided a training ground for industry leadership. With the formation of Fonterra, that training ground has all but disappeared.

The Fonterra boardroom is no place for people to learn the art of governance.

In this report, I have attempted to discuss the high level aspects of a successful co-operative model, and where the Fonterra co-operative and its farmer members fit in that model.

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I wish to acknowledge former and current members of the industry, whose valuable information, advice and encouragement serves this report well. The following deserve mention for their time: Henry van der Heyden, Barry O'Donnell, and Sir Dryden Spring. Also, previous Kellogg scholars and the Fonterra Shareholders' Council for their support. My family are to be acknowledged for their patience and time.

I have used some initial research findings from a *Colmar Brunton* survey, commissioned by the Fonterra Shareholders council, of which I am a member. Extensive readings, regarding New Zealand and international co-operative models and behaviours, have also been used.

## 2. Executive Summary

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The co-operative business model has been in existence since 1844. It is estimated that today, at least 50% of the world's population is, in some way, affected by co-operative activity. Most of this activity is in the agricultural sector where groups of farmers have formed co-operatives. This provides them with some collective strength and security to ensure their produce is processed and marketed accordingly.

The relationship between a co-operative and its members is formalised through a set of co-operative principles that outline what responsibilities members have to the co-operative, and vice versa.

Co-operatives have certain requirements of their members, namely that members own and control the business equitably and they are the providers of capital.

While the supporting objectives of a co-operative business model and an investor-driven model are similar, the prime objectives are different. A co-operative's prime objective is to deliver benefits to members, while the investor-driven business objective is, quite simply, to deliver a return on investment of capital.

Fonterra's impact on the New Zealand economy is significant. It is New Zealand's largest company, by some margin, with turnover of \$NZ12 billion, and employs 20,500 people worldwide.

Fonterra's farmers are a diverse group of people who, as individual farmers, have differing goals and objectives. They do however, have a common requirement of their co-operative; to collect, process, and market their milk.

As New Zealand's largest business, and a co-operative, Fonterra should lead an initiative that will lift the profile of 'doing business' using the co-operative model.

The risks that Fonterra faces, as a result of commodity price fluctuations, or currency variances, are relatively small when compared to the risks that poorly informed, non-participative members could place on the co-operative.

# 3. The Early Co-operative Model

## 3. The Early Co-operative Model

Although the co-operative form of 'doing business' has been around for over 150 years, the co-operative business model is poorly understood by many people.

"Throughout history some activities have always been undertaken by groups rather than individuals, simply because this was a better and more economic way of doing things. Such activities are usually described as "informal co-operation"<sup>2</sup>. – Edgar Parnell

More formal types of co-operation, such as early co-operative societies, came to the fore during the nineteenth century, developing as a new form of economic organisation, first in Europe, and later, throughout the rest of the world.

It is recorded that the first co-operative establishment was a general-purpose store in Rochdale, England. The Rochdale co-operative began in 1844. Around the same time, a German co-operative group known as the "Raiffeisen" Co-operative were establishing themselves predominantly in the rural areas of Germany.

From this point co-operatives were often formed by groups of people, in an attempt to improve their standard of living. The formation of a collective or co-operative was seen as a means of having some control over their working conditions and ultimately their standard of living. These people often lived in poverty, hence the reason that early co-operative organisations were considered very much "working class" organisations.

Many former communist countries used the term "co-operative" to describe what were, in fact, government-run collectives that were designed to control their people and, in turn, productivity. They were referred to as "State Enterprises". This association with the communist philosophy damaged the image and reputation of the co-operative business model.

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<sup>2</sup> Parnell, Edgar *Reinventing Co-operation* – pg 1 Info Press U.K 1999

# 4. Co-operative Structures

## 4. Co-operative Structures

Edgar Parnell, in the book *Reinventing Co-operation* suggests that co-operation is based on the full acceptance of our individualism, and should not be, in any way, confused with collectivism.

This is an interesting observation, as the modern day co-operative is seen as needing the co-operation of its members to form a group in order to exercise their collective strength.

While most co-operatives have their own co-operative statements of philosophy that are unique to them, the basic co-operative structure requires that members recognise some common values/principles.

It is interesting to compare the original “**Rochdale**” **Rules**, that applied to the society in 1860, (see A. below), with the International Co-operative Alliance “**Statement on Cooperative Identity**” adopted in 1995. (see B. below)

### **(A). A Summary of the Original Rochdale Rules of Co-operation, 1860.**<sup>3</sup>

1. Capital should be self-provided and bear a fixed rate of interest.
2. Only the purest provisions procurable should be supplied.
3. Full weight and measure should always be given.
4. Market prices should be charged and no credit asked or given.
5. Profits should be divided pro-rata based on the total value of members' purchases.
6. The principle of one member/one vote should prevail in government and there should be equality of the sexes in membership.
7. The management is to be in the hand of officers and committee elected periodically
8. A definite percentage of profits shall be allocated to education.

### **(B.) Statement on the Co-operative Identity (adopted 1995).**<sup>4</sup>

#### **Definition**

A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspiration through a jointly owned and democratically controlled enterprise.

#### **Values**

Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility and caring for others.

#### **Principles**

The co-operative principles are guidelines by which co-operatives put their values into practice.

<sup>3</sup> Parnell, Edgar – *Reinventing Co-operation* pg 60

<sup>4</sup> *International Co-operative Alliance* supplied by New Zealand Co-operatives Association Inc.

### ***1st Principle: Voluntary and Open Membership***

Co-operatives are voluntary organisations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.

### ***2nd Principle: Democratic Member Control***

Co-operatives are democratic organisations controlled by their members, who actively participate in setting their policies and making decisions. Men and women, serving as elected representatives, are accountable to the membership. In primary co-operatives, members have equal voting rights, (one member, one vote), and co-operatives at other levels are also organised in a democratic manner.

### ***3rd Principle: Member Economic Participation***

Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership.

### ***4th Principle: Autonomy and Independence***

Co-operatives are autonomous, self-help organisations controlled by their members. If they enter into agreements with other organisations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members, and maintain their co-operative autonomy.

### ***5th Principle: Education, Training and Information***

Co-operatives provide education and training for their managers, elected representatives, members and employees, so they can contribute effectively to the development of their co-operatives. They inform the general public - particularly young people and opinion leaders - about the nature and benefits of co-operation.

### ***6th Principle: Co-operation among Co-operatives***

Co-operatives serve their members most effectively, and strengthen the co-operative movement by working together through local, regional, national and international structures.

### ***7th Principle: Concern for Community***

Co-operatives work for the sustainable development of their communities through policies approved by their members.

One can notice that, despite the fact that these principles were adopted 135 years apart, they are easily comparable, and somewhat synonymous.

For example, the following similarities are particularly evident:

- how members contribute capital - members will, if required, contribute nominal amounts of capital, usually in proportion to their usage of the services that the co-operative provides.
- how profits are distributed
- the need for a democratic election process
- one member - one vote
- the need to provide for the education and training of members

The benefits of being a member of a co-operative are there for members, while they transact business through the co-operative, using its collective strength.

Members receive the majority of the benefits of being a co-operative member while they are involved in the co-operatives' activities.

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Co-operatives like the Fonterra co-operative, sometimes referred to as "new generation co-operatives", still adhere to a set of co-operative principles (see Appendix).

The contribution of capital is clearly still a member responsibility; this issue has become more complicated for members of the Fonterra co-operative, with the move away from a nominal share concept, to what is referred to as the "Fair Value Share" (F.V.S.).

The F.V.S. is a capital instrument that members are required to hold, in proportion to usage, or in this case, supply of milk to the co-operative. It is an indication of the value of the co-operative that is independently assessed on an annual basis.

As the value of this co-operative share rises over time, it will place some different tensions on the co-operative. There could be a temptation for members to exit, taking their capital as they go, or, it could also serve as a constraint, as far as growth is concerned.

A 'publicly listed' company or 'investor company's' first priority is to deliver a return on capital invested by the shareholders, not to provide a service to its members who may or may not also be investors.

Co-operatives, as they are known, operate world-wide and range from very small enterprises, involving a small group of members seeking a common objective, to larger groups involved in large businesses, where turnover is measured in billions of dollars, but whose members seek similar outcomes.

# 5. Co-operative Membership

## 5. Co-operative Membership

A co-operative is a distinct form of business, recognised as part of our private enterprise system, but as already mentioned, not understood well by many people. The users, who receive benefits in proportion to use, own a co-operative. Users are known as members, and can be individuals, businesses or other organisations. They are drawn together with a mutual interest - for example, having their milk processed and marketed – and joining a co-operative enterprise can easily fulfill this interest. A co-operative publishes a set of legal requirements known as by-laws; these outline the legal obligations that a member must meet.

A co-operative's basic purpose is to fulfil the needs of its members, as they are the owners. The members need to 'instruct' the co-operative, and communicate what needs must be fulfilled, and if those needs change.

Members provide capital so that the co-operative can supply those demands. They make certain, through an electoral process, that the right people are in place to govern the business, and to represent members' views.

The governors in turn, must ensure that the right management is in place, and that facilities are present and sufficient to enable the co-operative to operate efficiently.

Finally, members must do the most important thing for the co-operative to achieve its purpose – use it.

In summary, members make co-operatives work by exercising their responsibilities of ownership and control, and by providing finance and patronage.

## 6. Co-operative Ownership

### 6. Co-operative Ownership

Many co-operative members fail to recognise the user relationship that they have with their co-operative. They lack understanding of their owner relationship and the responsibilities that are associated with ownership. As previously mentioned, members must behave as owners and vote when required as well as provide capital and actually use the co-operative.

These responsibilities are far greater than owning shares in an investor-orientated business, where the primary function of that business is to earn a return on some capital that has been invested.

Co-operatives are created by members, and for members, to serve their needs. Figs 6.1 and 6.2 outline the supporting objectives of an investor-driven company compared with a co-operative. They show that, while the supporting objectives are similar between the two groups, the prime objective is different.

Fig 6.1 OBJECTIVES OF AN INVESTOR-DRIVEN COMPANY

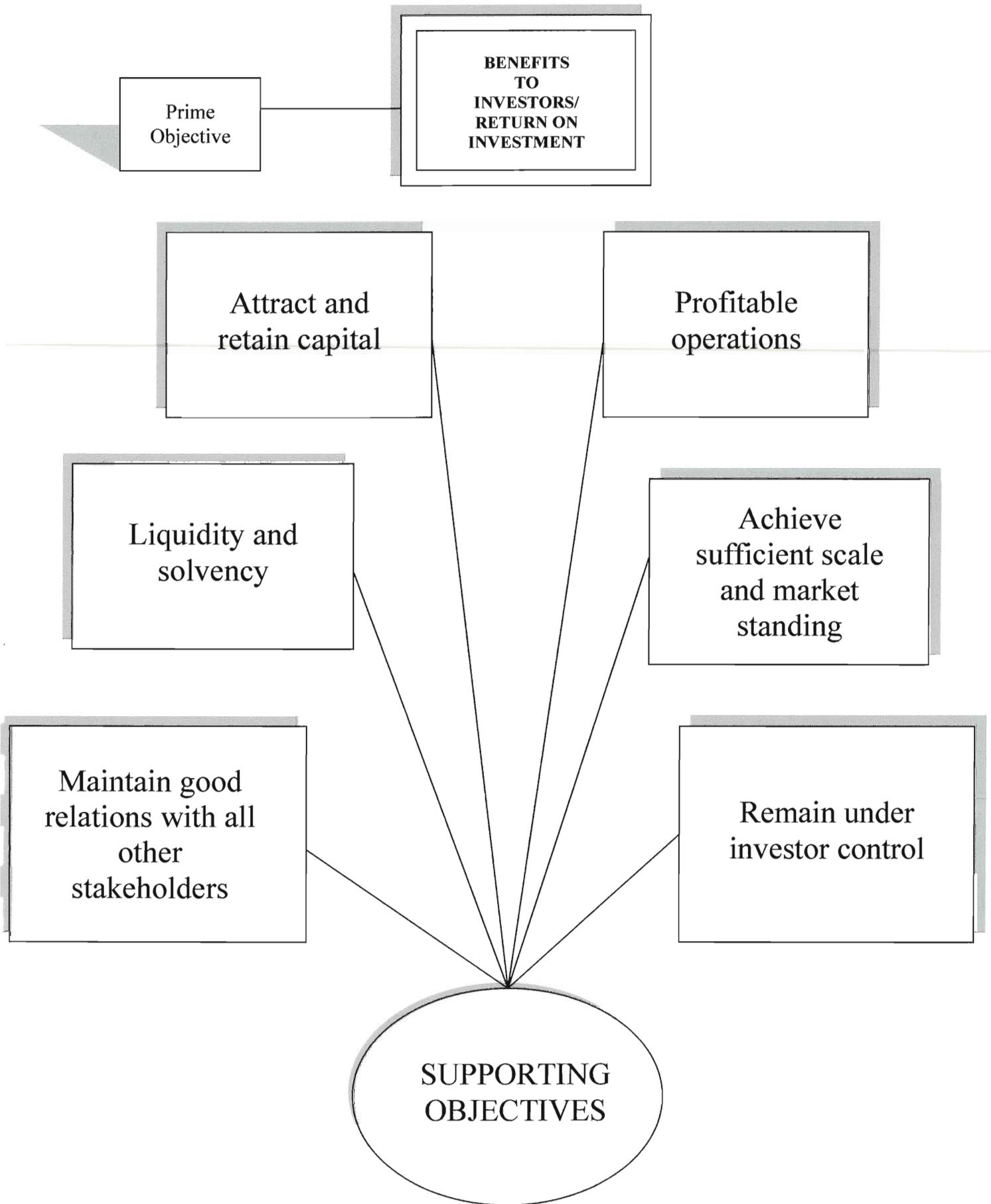
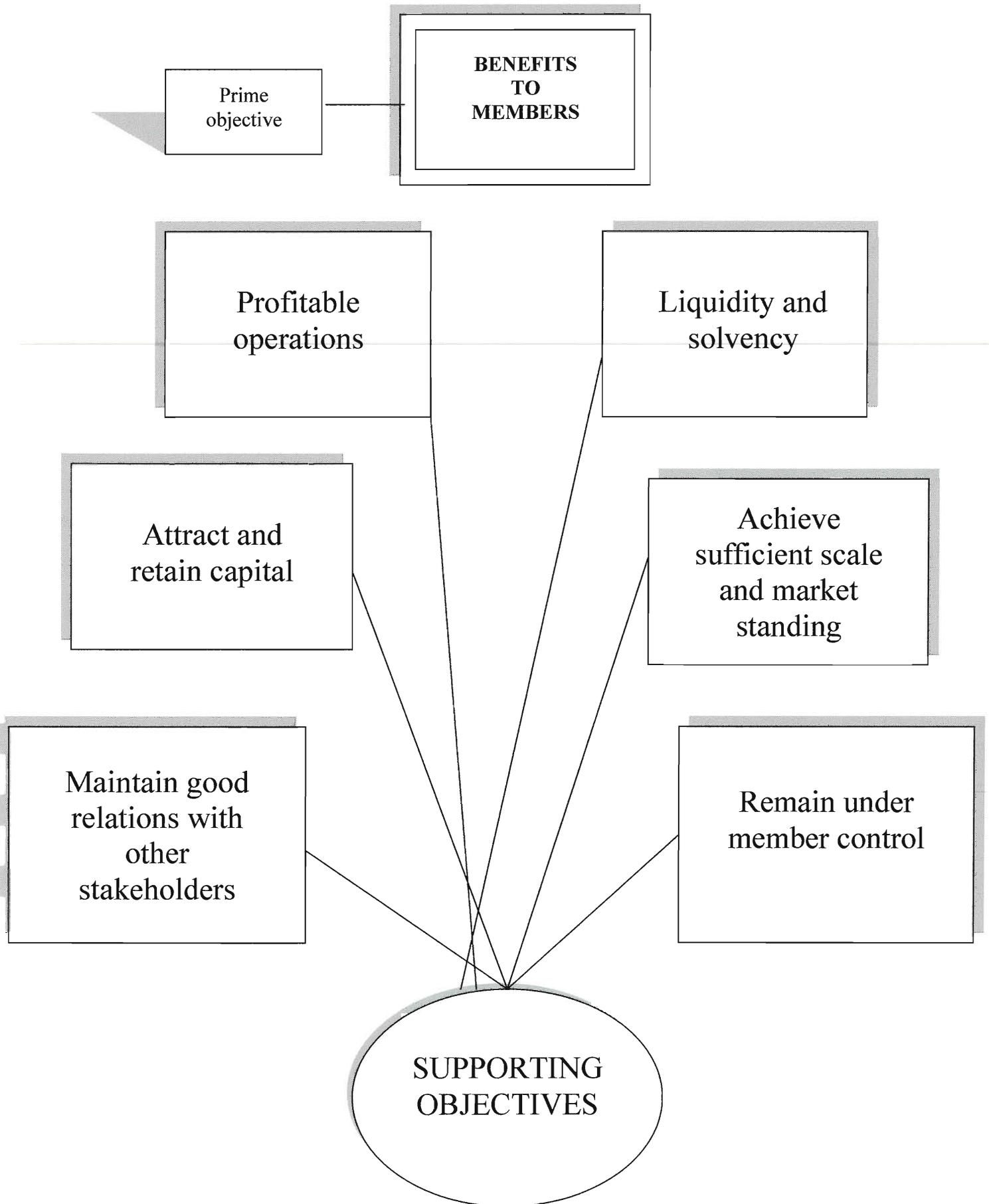


Fig 6.2 OBJECTIVES OF A CO-OPERATIVE



# 7. Co-operative Control

## 7. Co-operative Control

The most important aspect of member control is in the education of the governors of the co-operative. The board of directors, in a modern-day co-operative, will typically be made up of owner representatives and possibly some 'outside directors', who can assist with particular areas of governance that the member directors may be deficient in.

There is a trend, within some large global co-operatives, to separate the governance and representation aspects of the role, to allow board directors to concentrate on governance, and therefore enabling the best decisions to be made in the interests of the whole co-operative. This is discussed in more detail in Section 10 of this report.

The representation focus sometimes means that directors can lose focus, meaning that decisions are made for a small group of members rather than for the whole entity.

Members usually elect their leaders democratically using the one member – one vote process. This, however, is not always seen as fair and equitable, where there are large variations, between members, of usage or capital held in the co-operative.

To try to address this, some modern day co-operatives, such as Fonterra, have introduced a proportional voting system, based on usage or capital held, which are linked. As a safeguard against large groups taking a controlling interest, a maximum vote can be specified in the by-laws.

In effect, members are delegating some of the control of the co-operative to the board of directors, whose chief role is to appoint the Chief Executive Officer – C.E.O.

The board and C.E.O should develop strategy jointly, and the C.E.O establishes a management team who will deliver results based on this strategy.

This does not mean members should abdicate all responsibility they have as owners. They must still participate through taking an interest, and voting when required.

This is the fundamental difference between a co-operative and an investor-driven business. An investor-driven business must deliver a Return On Investment (ROI) and the participation of investors or owners is not paramount to its success.

While a co-operative needs to also deliver ROI, this is only part of the package.

# 8. Co-operatives of Today

## 8. Co-operatives of Today

It is estimated that today, at least 50% of the world's population<sup>5</sup> is in some way involved or affected by co-operative economic activity. A significant proportion of this activity is groups of individual farmers, who form co-operatives to process and market their produce.

Today, co-operative activity also covers a wide range of businesses, such as standard retailing and wholesaling, as well as insurance, healthcare and housing. One of the most widely recognised forms of co-operative activity, outside of the farming arena, is the finance sector, through banking and community credit unions.

The size and scale of some of these co-operative groups is well illustrated in the United States agricultural sector:<sup>6</sup>

- United States dairy production is currently estimated at 71 billion kilograms of milk solids, 86% of this milk is processed through co-operatives. (NZ total milk production 2002-2003 season = 1.1 billion kilograms of milk solids)<sup>7</sup>
- Fruit and Vegetable co-operatives in the United States total 212, and have a total membership of 32,500 people.
- There are 66 livestock co-operatives in the United States, with 94,000 members, which process 56% of all the United States beef, pork, and poultry – which equates to 12.2 million kilograms of meat.
- There are 769 grain and oilseed co-operatives in the United States that have a total membership of 542,470 members.

Within the New Zealand economy, most people associate co-operatives with agricultural business.

New Zealand co-operatives are estimated to generate revenue of approximately \$NZ24 billion per annum, which equates to a massive 22% of New Zealand's Gross Domestic Product.<sup>8</sup>

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<sup>5</sup> Parnell, Edgar *Reinventing Co-operation* pg 293

<sup>6</sup> Nilsson, Jerker *Strategic Choices for Agribusiness Co-ops* Presentation 30/10/04

<sup>7</sup> Fox, Andrea *Cracking Co-operatives* Unlimited Magazine 01/07/04

<sup>8</sup> Fox, Andrea *Cracking Co-operatives* Unlimited Magazine 01/07/04

There are a number of relatively well-known 'household names' in the rural co-operative sector.

- Fertiliser co-operatives, such as *Ravensdown* and *Ballance* - revenues of \$NZ469 million and \$NZ350 million respectively.
- Kiwifruit and avocado co-operative *Satara*
- Livestock genetics and cattle breeding co-operative *Livestock Improvement Corporation* (annual revenue \$NZ92 million)
- Meat processing company *PPCS* (annual revenue of \$NZ1.4 billion)
- the three remaining dairy farmer co-operatives: –
- *Tatua Co-operative Dairy Company* (revenue \$NZ115 million),
- *Westland Co-operative Dairy Company* (revenue \$NZ180 million)
- *Fonterra Dairy Co-operative Group* (revenue \$NZ12.46 billion).<sup>9</sup>

These, and many other large agricultural co-operatives, have been established to serve New Zealand's, largely export-driven, agricultural economy.

There are many other co-operatives, in cities, also serving New Zealand's domestic economy. These include *Interflora*, *PlumbingWorld*, *PSIS*, *Motor Trade Finance*, and *Sportsworld*. *Foodstuffs*, the grocery business synonymous with stores such as *Pak 'N Save*, *New World*, and *4Square*, is the largest domestic co-operative in New Zealand.

The New Zealand Co-operative Association has 46 co-operative member organisations, ranging from small producer co-operatives, to the previously mentioned dairy giant, *Fonterra*.

The New Zealand economy is considered, internationally, as predominantly export-driven. In fact, as far as dairy is concerned, 96% of the milk produced by New Zealand dairy farmers is processed and then exported. The reverse occurs in many of the world's large growing economies such as Europe, United States of America, and China, where most of the milk production is consumed within their domestic economy as liquid milk or fresh dairy produce.

Most of the co-operatives mentioned have clear guiding principles, and were founded by people with a common purpose. Over time, a lot of the basic co-operative intent tends to be overshadowed by what individual members believe they are entitled too.

Co-operatives of today do not spend enough time educating their members about their co-operative and the responsibilities that they have as members. In fact, it is critical that members understand the original intent, or purpose, of establishing their co-operative.

"The real difference between the co-operative model, and any other form of business, lies in the fact that the co-operatives' prime objective is to provide benefits which the members will share as a group. These benefits cannot be achieved in isolation."<sup>10</sup>

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<sup>9</sup> Fox, Andrea *Cracking Co-operatives* Unlimited Magazine 01/07/04

<sup>10</sup> Parnell, Edgar *Reinventing Co-operation* Chapter 2

# 9. The Merger Process

## 9. The Merger Process

### The New Zealand Dairy Industry

The *Fonterra Co-operative Group* was established, and presented to the shareholders of New Zealand, on October 16, 2001.

In reality, the concept, of most New Zealand dairy farmers being members of a global co-operative, had been developing for the past one hundred years.

The dairy industry in New Zealand emerged as a pastoral industry, following World War I, and began to take shape as an exporter of dairy products, namely butter and cheese, in the 1920s.

By 1920, 255 dairy proprietaries and co-operatives were processing mostly cream, and selling cheese and butter to the United Kingdom.

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Over the next 80 years, significant rationalisation occurred within the industry to the point where, by the year 2001, there were only three dairy co-operatives remaining in NZ:

- *Fonterra Co-operative Group*
- *Tatua Co-operative Dairy Company*
- *Westland Co-operative Company*

The organisation, known by dairy farmers as *The New Zealand Dairy Board*, was conceived out of legislation that government passed in 1936, known as the “Single Seller” legislation.<sup>11</sup> The Government at the time stated this would give New Zealand dairy farmers “critical mass”.

The dairy board, during those years, had a number of functions regarding milk quality on farms, and product quality during manufacture. However, its most important function, in the eyes of the dairy farmer, was to provide a single marketing desk for New Zealand product into the United Kingdom.

In 1908, New Zealand agribusiness pioneer William Goodfellow, a Hamilton merchant, had persuaded government that there was a need to appoint a representative in London, to act on behalf of the New Zealand dairy co-operatives.

William Goodfellow saw New Zealand dairy product being sold by traders, on behalf of many small New Zealand co-operatives, at Tooley Street in London. Most of the traded dairy production in the United Kingdom was handled at Tooley Street and he witnessed soft selling and, in his view, large trader margins that were not in the best interests of New Zealand dairy farmers.

Although he was not a farmer, he managed to convince the majority of the dairy industry, that by that stage consisted of mostly co-operative processors, to form a

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<sup>11</sup> Government legislation passed in 1936

single marketing organisation and seek government support. This entity was known as "Empire Dairies".<sup>12</sup>

The New Zealand Dairy Board, as most farmers know it, was established in 1961, and, along with some quite bureaucratic rules, marketed 99% of New Zealand dairy produce abroad. There were some exemptions to the rules, for example, anyone could sell colostrum-based product.

Government legislation that allowed the Dairy Board to exist was very prescriptive, and through the 1980-90s, a lot of debate occurred within the remaining co-operatives, with regards to who should control the Dairy Board – dairy farmers through their co-operative, or the Government, on behalf of the people of New Zealand.

The Dairy Board, over a period of time, developed some very successful product brands, that became very valuable, yet the ownership of these assets, (the brands), was not clearly defined. This situation of a lack of clearly defined ownership of the Dairy Board, and the fact that the government imposed legislation, seemed to be stifling innovation and led to a period of quite dramatic change for the industry through the 1990s. Several legislative changes placed the New Zealand Dairy Board assets with the participating co-operatives, who held these assets on behalf of their farmer members.

There had been some concern that government may decide to nationalize the Dairy Board assets so to finally define ownership was a relief for the dairy industry.

During discussions around the Dairy Board ownership issues, especially during the 1990s, the idea of merging all, or most, of the manufacturing co-operatives, and then merging this entity with the industry marketing-arm, the Dairy Board, was floated.

Initially, farmers saw this as creating a non-transparent cumbersome monopoly but over a period of time, and as the industry became more of a global player on the international dairy scene, farmers became more receptive of the idea.

There were also some quite significant developments on the international dairy scene that made New Zealand farmers realise that they were in a unique position.

In 1994, the Gatt Uruguay round was finally signed; this brought agricultural trade under an international trade umbrella for the first time. It highlighted to farmers issues such as the impact of trade tariffs and agricultural subsidies on the international trading environment that New Zealand dairy farmers relied on. The New Zealand dairy industry had always faced unique challenges through restricted access to markets and geographic isolation from the market, not to mention the fact that the industry was nearly totally reliant on exports.

Highlighting these issues made many farmers begin to realise that the industries' real competition was in the international market place, not within New Zealand where manufacturing co-operatives were competing over the price of raw milk and, consequently, supply.

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<sup>12</sup> Established early 1900s.

Given that in 1990 there were still eighteen manufacturing co-operatives, and their subsidiaries, operating right across New Zealand, there was a lot of merger activity during the period 1990 – 2000 (see Appendix)

Fig 9.1 Number of New Zealand Dairy Companies

	June 1970	June 1980	June 1990	June 1993	June 1994
<b>Total</b>	<b>95</b>	<b>42</b>	<b>18</b>	<b>15</b>	<b>15</b>
<b>North Island</b>	<b>59</b>	<b>29</b>	<b>10</b>	<b>7</b>	<b>7</b>
<b>South Island</b>	<b>36</b>	<b>13</b>	<b>8</b>	<b>8</b>	<b>8</b>

Source: Dairy Facts and Figures 1999/2000<sup>13</sup>

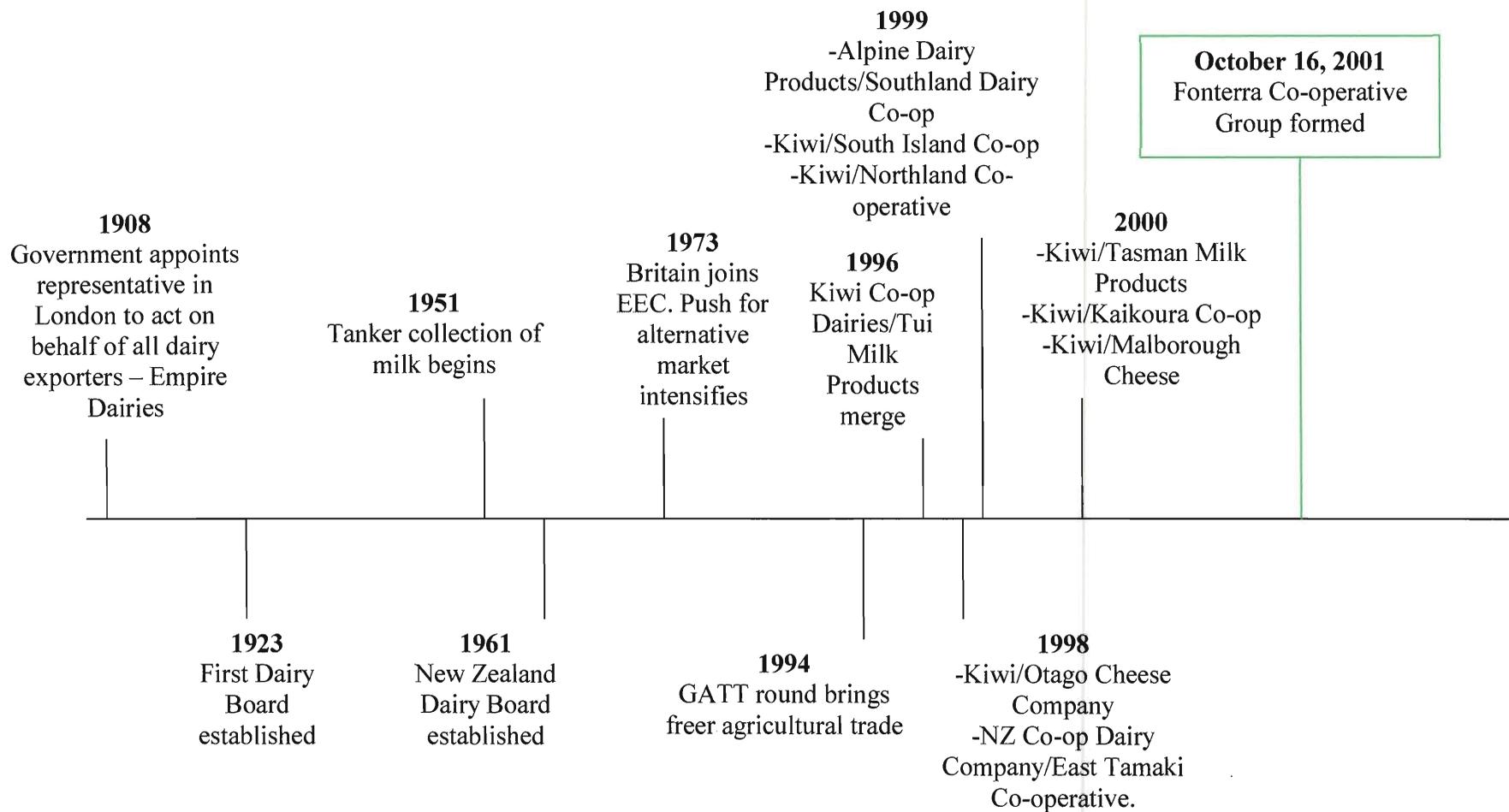
On December 21<sup>st</sup> 2000, the Taranaki-based Kiwi co-operative and the Waikato-based New Zealand Dairy Group, announced they would be signing an agreement to integrate the operations of the New Zealand Dairy Board into a newly formed company to be known as, “Global Dairy Company”

From this point, it was only a matter of some eighteen months before dairy farmer members of the “Kiwi” and “Dairy Group” co-operatives voted to form, what is now known as, the “*Fonterra Cooperative Group*”.

Fig 9.2 shows a timeline of events contributing to the merger process.

<sup>13</sup> *Fonterra Snapshot 2003*, pg 23

**Fig 9.2 Timeline showing major events in the Dairy Industry and specific dairy mergers of the 1990s**



# 10. The Fonterra Co-operative

## 10. The Fonterra Co-operative

Dairy farmers voting, to create a fully integrated manufacturing and marketing co-operative, was only part of what was required to form Fonterra.

Due to the size of company, and the possibility of the monopoly-type influence it was likely to have in New Zealand, the government first of all, allowed the merger process to bypass the Commerce Commission, but at the same time, it wrote the “Dairy Industry Restructuring Act” legislation which sets out how the co-operative must treat it’s members and what obligations members have to the co-operative. The support from the government in forming Fonterra has created a platform for the majority of New Zealand dairy farmers to be part of the largest trader of dairy product in the world and the second largest dairy co-operative in the world,<sup>14</sup> after the *Dairy Farmers of America*, see Fig 10.1.

This places the Fonterra Co-operative, and its owner members, in a unique position to have some real influence on the international dairy scene, over the next twenty years.

Fonterra is responsible for generating over 10% of New Zealand’s Gross Domestic Product. Its turnover for the 2002/03 financial year was \$NZ12 billion. It is New Zealand’s largest company, by some margin, considering Telecom, the next largest company, had an annual turnover in the 2002/03 financial year of \$NZ5.4 billion. Fonterra employs 20,500 people worldwide<sup>15</sup>. Fonterra farmers have a large responsibility, not only as co-operative members, but also as New Zealanders.

While the size of Fonterra, and its ability to influence the international dairy scene may sound impressive, the risks and responsibilities that co-operative members must accept as part of this, are large.

Co-operative members are the providers of capital, and that always carries an element of risk. As members, they also need to take some responsibility and be involved in the decision-making processes with an informed point of view.

The risks that Fonterra faces, as a result of commodity price fluctuations, or currency variances, are relatively small when compared to the risks that poorly informed, non-participative members could place on the co-operative.

It is imperative that farmer members understand the long-term strategic direction that the Fonterra co-operative is likely to take, and balance this with the shorter-term focus of a milk price.

### Leadership

“Co-operatives, more than any other form of economic enterprise, rely on the existence of high-quality leadership for their survival and successful development.”  
Edgar Parnell<sup>16</sup>

As dairy farmers, we have moved very quickly, from a situation where people in leadership positions within the industry were readily accessible, as was the case when the industry comprised of many small manufacturing co-operatives.

<sup>14</sup> *Fonterra Snapshot* 2003, pg 2

<sup>15</sup> *Fonterra Snapshot* 2003, pg 2

<sup>16</sup> Parnell, Edgar *Reinventing Co-operation* pg 119

This type of structure provided leadership development within the co-operative boardrooms.

With all the merger activity and the creation of a fully integrated dairy co-operative (Fonterra) this training ground no longer exists.

It is not only the dairy industry that is affected by this issue but there is no doubt that in the past the dairy co-operative board rooms provided leadership development that was utilised right across the rural sector, from local government through to fertilizer co-operatives and a myriad of other industry bodies.

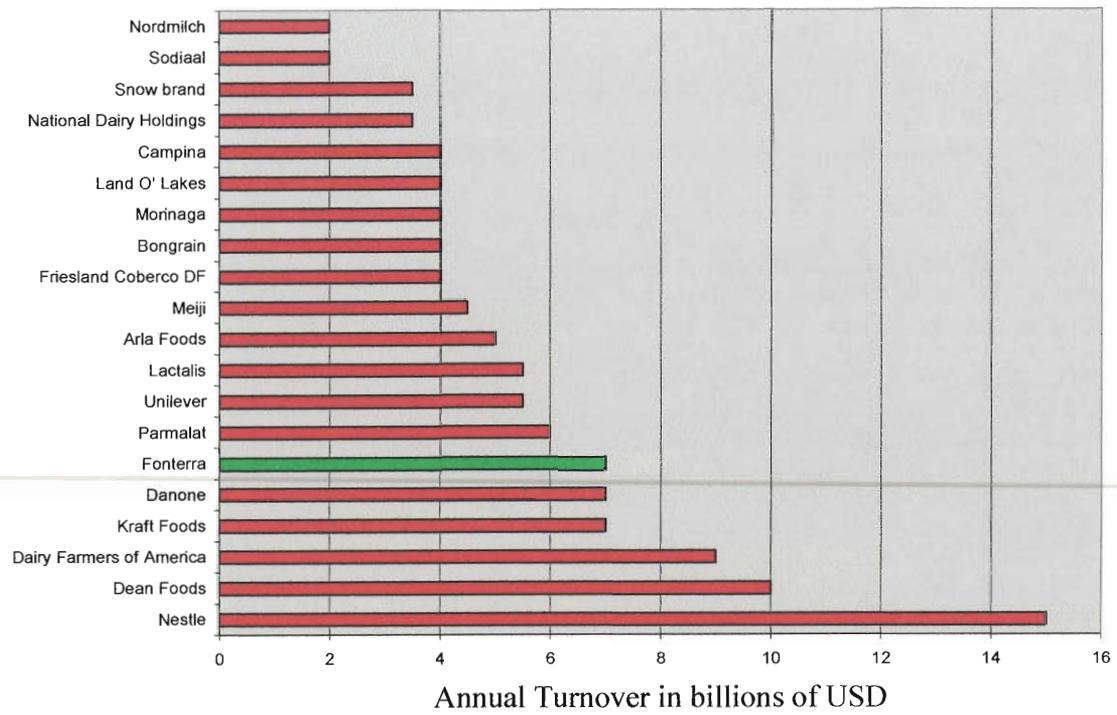
The most significant issue is that probably the most effective training ground for the future governors of Fonterra has disappeared.

The Fonterra boardroom is no place to learn the art of governance.

As mentioned in Section 7, the removal of the representation function from the boardroom allows the board of directors to focus solely on governance issues. When a director is making decisions in the best interests of the whole co-operative, representing a group of members can often become a constraint on best practice governance.

Co-operative members need to recognise that there are distinct differences in the competencies required to govern Fonterra as is the function of the “Board of Directors” as opposed to those that are required to represent the Fonterra co-operative members as is the function of the “Shareholders Council” (See appendix) Fonterra co-operative members not only need to fulfil their responsibilities as owners and vote during the director and councillor election process, they also need to research the candidates competencies and compare them to the required competencies in order to make an informed decision.

Fig 10.1 The World's Top 20 Dairy Companies 2002



**Fig 10.2 FONTERRA'S CO-OPERATIVE PHILOSOPHY**  
**- The foundation that the Co-operative is built on.**

**It applies to Fonterra's 'cornerstone' activities.**

Fonterra's 'cornerstone' activities are the collection, processing and marketing of supplying shareholders' milk and the activities that have a strong link to selling or adding value to supplying shareholders' milk.

**Co-operative Principles**

1.	Shares in Fonterra Co-operative Group can only be held by supplying shareholders.
2.	Fonterra-supplying shareholders agree to the dual commitment to supply milk and invest capital.
3.	Supplying-shareholders will be issued and must hold co-operative shares, in proportion to their total milksolids supplied.
4.	Control of Fonterra is exercised by its supplying shareholders who have voting rights in proportion to their total milksolids supplied.
5.	Financial benefits and obligations that arise from cornerstone activities are allocated to supplying shareholders in proportion to their total milksolids supplied.

**How these Principles are applied**

<b>MAINTAIN CO-OPERATIVE CULTURE</b>	<ul style="list-style-type: none"> <li>• Fonterra exists for the mutual benefit and sustainability of its supplying shareholders.</li> <li>• Fonterra is committed to co-operative ownership of cornerstone activities.</li> <li>• Transactions between Fonterra and its supplying shareholders must be transparent and fair.</li> <li>• Supplying shareholders acknowledge that Fonterra must act in the collective good of all supplying shareholders.</li> </ul>
<b>ACCEPT ALL SHARE-HOLDERS' MILK</b>	<ul style="list-style-type: none"> <li>• Fonterra will collect all supplying shareholders milk that meets the Terms and Conditions of Supply.</li> <li>• Fonterra must provide supplying shareholders with timely, transparent and economic signals as to the value of their milk.</li> <li>• Fonterra will provide supplying shareholders with timely, relevant information and services to help manage their businesses.</li> </ul>
<b>MAXIMISE SUSTAINABLE RETURNS</b>	<ul style="list-style-type: none"> <li>• Supplying shareholders invest in the collection, processing and marketing of their milk to enhance its value.</li> <li>• Fonterra's principle purpose and priority focus is to maximise the sustainable value of supplying shareholders' milk.</li> <li>• Payout is of primary importance to meeting supplying shareholder needs.</li> <li>• Economic sustainability is fundamental to ensuring the Co-operative's longevity.</li> </ul>
<b>INFORM, EDUCATE AND CONSULT</b>	<ul style="list-style-type: none"> <li>• Fonterra will keep supplying shareholders well informed in a timely, transparent and balanced manner consistent with their status as owners of the company.</li> <li>• Fonterra will consult fully with supplying shareholders before implementing any significant changes that impact upon shareholders.</li> <li>• Well informed supplying shareholders can and should participate actively in their Co-operative.</li> <li>• The commitment to inform, educate and promote the benefits of the Co-operative extends to all stakeholders.</li> </ul>

# 11. Fonterra Farmers - Who are they?

## 11. Fonterra Farmers - Who are they?

In April and May 2004, Colmar Brunton research company were commissioned by the *Fonterra Shareholders' Council* to enquire how they might use research, to better understand and represent shareholders' views, and to communicate more effectively with them.

It was decided to survey a small sample group of farmers in order to gain some understanding of what a 'Fonterra Farmer' was. The findings were used to develop a more comprehensive survey of Fonterra farmers. This was circulated in September-October 2004.

The Shareholders' Council identified the key objectives of the survey:<sup>17</sup>

- Needing to understand who Fonterra shareholders are, and their needs.
- Identify how shareholders perceive Fonterra Co-operative Group as an organisation
- Understand how best to communicate with shareholders

Some initial observations identified the following key issues for farmers:

1. The formation, and transition to the formation, of Fonterra has created different challenges for different farmers, i.e. all farmers are challenged, but in different ways.
2. There is growing pressure on the dairy industry from competing land uses. This varies from region to region, but is most prevalent around the main centres in New Zealand.
3. The cost of entering the dairy industry is becoming prohibitive. This was identified in terms of the capital requirements for the purchase of co-operative shares and also applied to farmers attempting to grow their existing business.
4. Increasing internal scrutiny of on-farm practices especially in the area of animal welfare. Concerns were raised regarding how much influence "life-stylers" were beginning to have on what were once viewed as acceptable farming practices. Practices such as –
  - On/off grazing systems
  - Zero grazing/stand off pads
  - Effluent disposalAnd also some animal welfare issues such as –
  - The use of calving inductions
  - Tail docking of animals
  - Disposal of dead stock
  - Bobby calf pick-ups
5. A greater global influence on New Zealand farming platforms. This is closely linked to the previous concerns, but are the opinions of the international market, that are their perceptions of the industry farming practices.

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<sup>17</sup> Colmar Brunton survey, April-May 2004, 50 farmers

6. Probably viewed as the most positive observation - the formation of Fonterra has established the New Zealand dairy industry as a global player. Farmers felt this was minimising risk, in that their returns from milk products were not so reliant on one or two markets.

It was found that farmers could be categorised and from their research, Colmar Brunton has generalised farmers into four hypothetical groups:

- 11.1 Strategic Opportunists
- 11.2 Progressive Acquirers
- 11.3 Embattled Investors
- 11.4 Traditional Toilers<sup>18</sup>

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<sup>18</sup> These titles are used in accordance with the Colmar Brunton survey findings, as generalisations. They are, in no way, a diagnosis of the diversity of the farming community.

## 11.1 STRATEGIC OPPORTUNISTS<sup>19</sup>

Typically, these people are entrepreneurial and innovative. They have a strategic focus and are risk-averse. They use specialist people to help them with key business issues and discussions.

### Attitude to Farming

“This is a business”.

They have little or no emotive connection to the land. Their focus is always on the bottom line, and for now, that just happens to be generated from dairy farming. They would take their capital out of the industry and invest elsewhere if their current investment did not stack up. They are probably focused on their own successes, rather than those around them, or the community.

### Communication

These people will actively search for information, constantly use the internet. Prefer brief factual information from Fonterra, quick, easy to digest. Use professionals for advice.

### Future Strategy

They would exit the industry if they felt the returns to them were not sustainable, and if they could see a better return from alternative land use.

### Attitude to Fonterra

They see some synergies between Fonterra and themselves – they are both going places. They see that Fonterra has size and is able to influence. Farmers are beginning to see the benefits of the formation of Fonterra. Joint-venture partnerships are having a global influence in the market. Despite the fact the Fonterra is a near-monopoly, the company can still be held accountable by its shareholders through the Shareholders' Council.

### Concerns

The need for ongoing accountability can easily make a large organisation, ‘fat and lazy’. There is a need for discussion around what sort of structure, co-operative or publicly-listed company, Fonterra will be in the next 10-20 years. They are also concerned about what farmers think is a sustainable return via payout, and what Fonterra will deliver.

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<sup>19</sup> Colmar Brunton survey

## 11.2 PROGRESSIVE ACQUIRERS<sup>20</sup>

Typically, members of this group have grown up as part of a farming family, and they have literally learnt on the job. They may have a tertiary farming qualification. They have made the most of any opportunities that have come their way to expand their business, usually land, that has become available. They have moved from traditional smaller farms to large agri-business type operations. They are very comfortable with debt, if it is part of expansion. They are involved in the day-to-day running of the farm, but will employ staff for specific roles. They are of no particular age or stage of life, but do possess a certain mindset.

### Attitude to Farming

They are connected to the land through heritage, but would relocate if competing land uses prevented expansion in their area. They would like to see their own actions, and those of the dairy industry as having a positive effect on their rural community. They have a developmental mindset and believe they must expand their business to remain ahead of the game and be successful. They know they have to grow in order to stay in business. Generally pragmatic people, they regard fluctuating returns as inevitable and take a long-term view of the industry. Farming is a business they are passionate about, and they take pride in **their** business through good farm practices.

### Communication

This group prefer some personal contact from Fonterra. They will use technology as a tool in their business. They use the Internet usually for day-to-day management issues such as milk quality etc. Being hands-on, they attend seminars, field days etc and they regularly read industry-related magazines and newspapers.

### Future Strategy

They want to ensure their business is sustainable through to the next generation.

### Attitude to Fonterra

They can see the benefits of the global business side of Fonterra flowing through. It makes sense to them to have integration from “cow to customer”.

They use new technology to reduce costs; they can see that this will drive the returns to farmers, higher.

They see the teething problems, associated with forming Fonterra, as being more or less sorted.

Generally, they support new on farm compliance issues as part of being accountable as farmers, for the land and stock.

### Concerns

Keeping Fonterra accountable to the farmers is a major concern for this group. They also want to avoid bureaucracy. They believe the clean, green image of New Zealand must be guarded, as they see it as the key point of difference. They are also concerned over biosecurity and what the use of biotechnology will mean to the industry.

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<sup>20</sup> Colmar Brunton survey

### 11.3 TRADITIONAL TOILERS<sup>21</sup>

This group usually have spent a lifetime in farming. They are possibly nearing the end of their farming career. They are probably an owner/operator, husband and wife team, or at least, they rely on a large amount of family involvement. Due to their longevity in the industry, they generally have low debt levels.

#### Attitude to Farming

They believe they have a 'calling', and the land is their life – it is in their blood. They want to get on with farming and not be bombarded with regulations and paperwork. They do what is required with regards to compliance, but nothing more. They could be classed as resistant to change. They are suspicious of new rules and regulations; 'why change things when it used to function fine?' is their catch-cry. They find compliance issues very difficult and can sometimes feel consumed by them. They possibly feel inadequate in what is a rapidly changing environment. They do only what is necessary to comply.

#### Communication

This group relies on personal contact for information. They would like to see more company personnel, especially directors, at farmer-level – how it used to be. They will sometimes attend discussion group but are resistant to change. Any dairy industry correspondence is mostly through the Fonterra monthly publication, *Farmlink*.

#### Future Strategy

The main goal is to sell the farm and retire. They will redeem their co-operative shares to pay off debt, or to change their farming practice to a less intensive system. They would welcome small niche dairy companies that may provide other options to Fonterra.

#### Attitude to Fonterra

They view Fonterra as largely remote and impersonal. They see it as moving away from being a co-operative and losing connection with its farmers. They think Fonterra imposes a lot of rules and regulations, which they feel is not their job – "it should be the job of Regional Councils." They believe that some of the rules and regulations are not even necessary and are certainly not market-driven. They also feel that the only measure they have of Fonterra is through payout.

#### Concerns

They are concerned about the lack of new blood in the industry and a loss of pathways for young people to come on board, e.g. the sharemilking system is breaking down. They feel that Fonterra is involving itself in non-core businesses, e.g. policing compliance issues that are local authority issues. They also feel that Fonterra does not want small operators.

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<sup>21</sup> Colmar Brunton survey

## 11.4 EMBATTLED INVESTORS<sup>22</sup>

Typically this group are smaller farmers whose farm would be a stepping-stone or an investment. They are usually reliant on some form of off-farm income as part of the financial equation. Their survival relies on careful planning and management; they are usually finely balanced, financially. Occasionally, they have come through the sharemilking system or are from a small family farm background. They usually are a “jack-of-all-trades” and do everything themselves. They are also information “junkies” who absorb information via the Internet.

### Attitude to Farming

This group likes the mix of lifestyle and business. They have a careful, planned approach to farming and also a strong attention to detail. They need to feel in control of their business and like to deal with a local entity.

### Communication

This group use the Internet a great deal – you could call them information junkies. They like to absorb new information. They would use a farm consultant and would attend discussion groups and seminars. They are more focused on meeting their needs. They do attend important company meetings.

### Future Strategy

They would look at exiting the industry, maybe subdividing their land. They hope for an emergence of local niche processors to provide options for them to supply in the future.

### Attitude to Fonterra

This group also feels Fonterra is too large and remote. They feel it is trying to be too many things for too many people. It is seen as promoting larger units through aggregation that will not be sustainable in the long term. They are concerned that larger corporate-style farms are not worried about succession planning. This group feels disenfranchised from Fonterra. They have concerns around the voting system, especially around patronage voting. They would prefer a one-man/one vote system. They also feel swamped by the size of the Fonterra business and larger farms. They would like more personal, face-to-face contact from Fonterra to allay their anxieties.

### Concerns

This group have concerns around succession planning. They see land aggregation and agribusiness-type operations as moving away from traditional co-operative models. They are concerned regarding the recruitment of new share capital. They see it as inflexible – the debt burden too high for entry-level farmers.

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<sup>22</sup> Colmar Brunton survey

It can be seen, from the feedback received by Colmar Brunton, that these four groups within the co-operative, are a diverse range of shareholders who all have varying requirements of the co-operative.

In reality, they all require the co-operative to collect and process a highly perishable raw product that they, the farmers, produce – milk.

They require the co-operative to return them a milk price, and grow the value of the capital that they, as shareholders, contribute.

In return, the co-operative must retain members. This can be achieved through paying a competitive milk price and growing shareholders wealth.

Most importantly, the co-operative must connect with each of these farmer groups, or it is possible that its worst fear will be realised – a run-on capital will ensue. A large number of shareholders redeeming their co-operative shares, and taking their milk elsewhere, maybe to a competing milk processor, or changing the land use of their respective farms. This is a very real threat for Fonterra.

The different groups of farmers that have been discussed, need to acknowledge that, while it may appear that they, as individuals, have differing expectations of the co-operative, in actual fact, they all require some level of certainty for their respective businesses.

The Fonterra Co-operative will adapt to the global environment it now operates in, and its farmer members will need to adapt as well. Some will find this process easier than others.

# 12. Co-operatives of Tomorrow

## 12. Co-operatives of Tomorrow

For the co-operative structure, or business model, to be a preferred option in the twenty-first century, a number of fundamental issues need to be addressed.

Co-operatives are sometimes considered mysterious, 'closed shops', which shut out new ideas and investment capital.

Members, with an interest in ensuring that the co-operative form of business enterprise will prosper in the twenty-first century, need to consider the following:

- Does their co-operative have a clear direction? Is that direction and focus clear to the members?
- Are the benefits (probably profit) sustainable?
- Does the co-operative have ready access to resources? Most importantly, people and capital to drive and fund growth.
- Is the co-operative customer/market focused and responsive to the market?
- Is the co-operative flexible, responsive to change, able to make quick decisions?
- Is the co-operative innovative? Can the co-operative embrace change, particularly in the area of new technology?
- Is there a common purpose among members, and from within the leadership group, as well as management and all the stakeholder groups?
- Does the co-operative have strong focused leadership that can take the members from today to tomorrow?

While very few co-operatives in New Zealand access, or allow outside capital, at this point in time, that may well change as they strive to grow and deliver long-term benefits to their members. The fundamental issue here is that if the co-operative moves away from being focused on its members' needs, and starts to focus on attracting capital, then it will very quickly cease to be a co-operative.

Research has shown that if the strategy and direction of the co-operative is well articulated to the members, then accessing capital through the members, or the co-operatives balance sheet, is rarely a problem.

# 13. Empowering Fonterra Farmers

## 13. Empowering Fonterra Farmers

The slogan, “Big in the World, Small at Home”, is the Fonterra Co-operative’s vision for connecting with farmers. In essence, this is attempting to portray that in the world of trading dairy products, Fonterra, as a co-operative, is big, but at home where the farmer shareholders are relied on to supply premium raw product and capital, it is small enough to care for farmers as individuals.

As has been discussed earlier in this paper, for a co-operative to be successful, it needs to be able to communicate effectively with its members.

As Fonterra continues to grow, the level and type of communication will become more critical.

While the advent of new technology, e.g. Broadband, will certainly improve the cost-effectiveness and level of communication with some groups of farmers, Fonterra will need to devote resources towards lifting the level of uptake, by farmers, of information, via new technology. However, some farmers will, for some considerable time yet, require more personal, face-to-face communication which is, of course, more costly.

Co-operatives are probably most seriously disadvantaged through the lack of education and training options within most western economies.

The curriculum of most educational institutions has a focus on one form of private enterprise – the ‘investor-driven’ company. This naturally means that teachers and lecturers simply pass their lack of knowledge, of the co-operative business model, on to their students.

People throughout the education and training sector need more information about the co-operative model and the unique impact that a co-operative can have on local communities and a nation’s economy.

Co-operatives, and in this case, Fonterra, can, for the better of the company, and the community, make inroads into this problem by developing closer ties with education institutions so that people begin to take interest in the co-operative business model, and understand it.

As an initiative, to encourage member participation, Fonterra should consider an induction programme for new co-operative member/owners; just as new staff members or participants in any business or organisation would be part of a familiarisation programme.

As in all co-operatives, encouraging member participation is an issue, this is especially important when making constitutional changes (which require 75% of voting shareholders to endorse change) and of course when electing leaders. Voting within the Fonterra Co-operative is based on the capital held by way of co-operative shares or in simple terms on a usage basis.

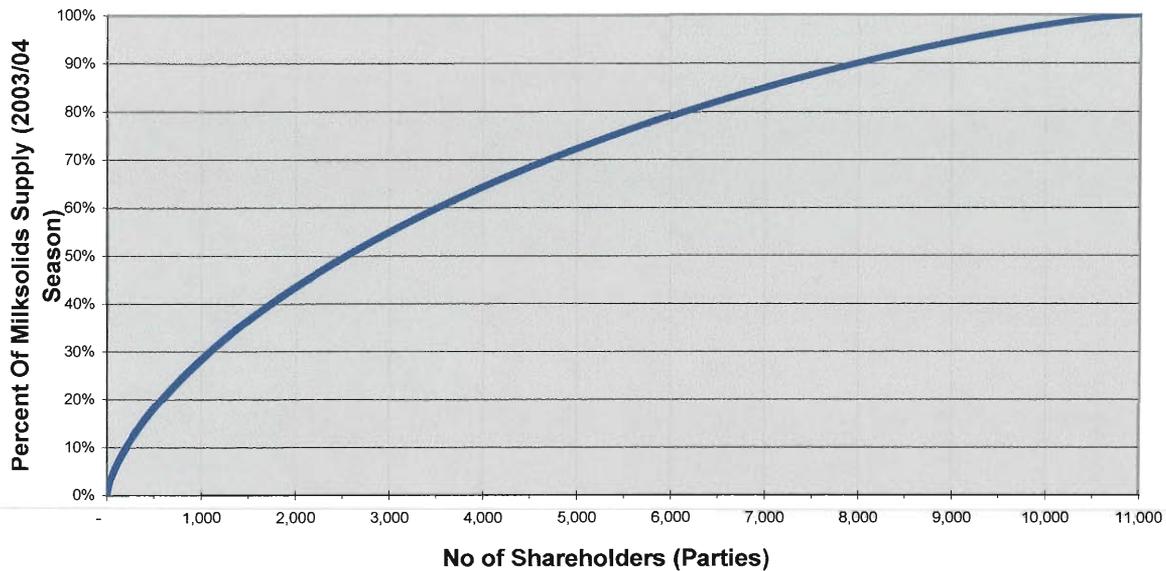
Of significant concern to the co-operative is the widely held view amongst smaller farmer shareholders that their vote does not count as the larger farmers voting power easily cancel it out.

As shown in Fig 13.1<sup>23</sup>, approximately six hundred larger farmers hold 20% of the voting entitlement within the Fonterra Co-operative. If all the smaller farmer shareholders exercised their voting rights then they would most certainly have real influence on any outcomes.

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<sup>23</sup> Fonterra Shareholders’ Council *Annual Report 2003/04*

**Fig 13.1 Voting rights based on Milksolids supplied - 2003/04 season**



Pride is a very real factor in the empowerment of Fonterra farmers. Being part of a successful co-operative does and will continue to instil pride within the membership of the co-operative.

The vision of the Fonterra Shareholders Council of which I am a member is “Proud Fonterra Farmers”. There are many ways of bringing the vision to life with some simple messages and opportunities.

The Fonterra Shareholders’ Council has developed a number of learning opportunities, designed to lift the level of understanding, amongst farmers, about the Fonterra co-operative. The ‘Strategic Priority’ for these programmes is to “lead the development of a knowledgeable and participative farmer base”.<sup>24</sup>

These learning opportunities are available to all Fonterra farmers and cover most aspects of the co-operatives business activities around the world. The programmes also cover the responsibilities that co-operative members have to their co-operative. For many of the attendees, this will be the beginning of them, as Fonterra farmers, taking more of an active part in the co-operative.

It is a concern that, for many Fonterra farmers, these programmes are the first opportunity they have had to gain some understanding of how a co-operative business model works.

What is not happening fast enough is the education of co-operative members about the strategy and direction of the Fonterra co-operative. This goes well beyond the original rationale for our dairy industry forebears adopting the co-operative business model.

There is no doubt that in order to **Empower Fonterra Farmers** to be active members of their co-operative there needs to be a combination of **Communication** and **Education** that will instil **Pride** within the membership and lift the level of member participation.

The risks of not spending considerable time and money on these factors are significant.

<sup>24</sup> Fonterra Shareholders’ Council Programme Objectives 2004

I would like to think that the dairy farmer-owned and controlled co-operative, that I am a member of, and which provides me and my family with 95% of its income, could be defined in quite simple terms:

**I believe that the Fonterra Co-operative Group,**

**“Will achieve for me, as a dairy farmer, commercial advantage that I would not be able to achieve if I acted as an individual.”**

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## 15. References and Acknowledgement

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# Appendices

## Appendices

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# Governance Competencies

## Fonterra Shareholder Elected Director Key Capabilities

### Governance

- Sets high standards of ethical behaviour and acts with integrity at all times
- Understands the role of a Director and is clear about Directors' regulatory, financial and legal responsibilities.
- Publicly commits to Board decisions and works through challenges and differences in opinion.
- Considers overall Fonterra risk exposure and asks probing questions of management.

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### Strategic Vision/Business Knowledge/Judgement

- Sees ahead clearly, and can anticipate future consequences and needs accurately.
- Seeks to create and maximize value for shareholders.
- Has a good understanding of business financial information and can critically evaluate board papers to recognise gaps, issues and opportunities.
- Has sound judgement and makes good decisions based on analysis, wisdom, and experience.

### Understands Co-operative Structure/Teamwork

- Promotes the values and ethics of Fonterra Co-operative Group.
- Has a passion for the industry and understanding of shareholder needs and long term objectives.
- Actively encourages co-operation amongst fellow Directors.

### Leadership/Interpersonal Skills

- Has credibility and respect amongst peers and in the wider dairy industry.
- Provides a clear sense of direction and communicates this with others in a clear and concise manner.
- Assertively communicates own point of view and will take an unpopular stand if necessary.
- Listens well, and uses tact and diplomacy to defuse tense situations.

# Representation Competencies

## Fonterra Shareholder Councillor Key Capabilities

### Business Understanding

- Understands the business of farming, the dairy industry and the Fonterra operating environment.
- Is clear about how value is created for shareholders.
- Focuses on and expresses key business issues affecting the shareholder base.
- Makes the effort to understand the reasons behind key policies, practices and procedures.

### Communication and Interpersonal Skills

- Develops appropriate networks including shareholders.
- Is easy to approach, takes time to hear people out, and is willing to be a sounding board.
- Communicates complex issues and relevant points of view in a clear and concise manner.
- Admits mistakes and fronts up to them.
- Appropriately adapts their own style to a situation.

### Representation and Advocacy

- Is ethical, widely trusted, and seen as a person of integrity who will make sure that farmers' views are represented.
- Understands and respects the role and boundaries of a Shareholder Councillor, and adheres to Council protocol and procedures.
- Acknowledges and faces tough challenges and will take an unpopular stand if necessary to encourage direct and tough debate around key issues.
- Critically evaluates information, recognises gaps, and identifies issues and opportunities.
- Ensures shareholder value by monitoring and reviewing Fonterra performance against.

### Teamwork

- Promotes the values and role of the Shareholders' Council within the cooperative.
- Gets things done and focuses on areas of priority.
- Has a willingness to debate issues and appropriately provide feedback on behalf of shareholders.
- Publicly commits to agreed Shareholders' Council decisions without compromising confidentiality.

**Interviews:**

- Henry van der Heyden, Chairman of Fonterra Cooperative Group – 28/09/04
- Sir Dryden Spring, former Chairman New Zealand Dairy Board – 16/09/04

Guidelines for some discussion around the following issues:

Why did Dairy Farmers form co-operatives? Are these reasons still relevant?

**Communication**

How should the co-op communicate with its farmers?

What is the most effective means of communication? Why?

What is the least effective means of communication? Why?

**Education**

Is it important for the company to educate farmers about the activities of the co-op? Why?

Assuming that this is important, how does it do this?

Should the co-operative have an education programme for its members?

**Participation**

Is participation in a cooperative by its members important? How important?

Are certain areas of participation more important than others? Eg. AGM voting, Director election voting, meeting attendance etc.

A transcript of the interview with: **Mr. Henry Van der Hayden, Chairman of the Fonterra Cooperative Group.**

**David** -Thankyou for your time today Henry.

Basically the question is “Why did NZ dairy farmers form co operatives?”

You wanted to expand on that - “What do NZ dairy farmers want from cooperatives?”

**Henry** - Basically, we have a lot more strength banding together. For N.Z the dynamics of Fonterra the co operative are different from some of the key things round those cooperatives offshore because 95% of our revenue is actually obtained from overseas. It’s about us having strength in the global marketplace.

If you go back 5years, or even 20years, there was only one thing farmers wanted from their cooperative, which was milk price. Payout, payout, payout. Where we are now I think the dynamics have actually shifted. There are two things, the emphasis is now on wealth creation. What are farmers really working towards, looking at cows for the rest of their lives and an outdoor lifestyle?

Really we buy our land for capital gain - 99.9% of farmers would acknowledge they we buy land to generate wealth. If all that was wanted by farmers was payout, the board of Fonterra would actually be going down an altogether different track.

We wouldn’t be going down the value added track, just running a commodity business.

As a farmer what I want from a cooperative is a sustainable payout, and wealth creation and Fonterra has to deliver these two things for me. It is no different to what all the co ops in the world are actually facing.

Those co-ops that are simply focussed round a milk price or a kg of meat have not actually survived. Co-ops. have had to go down this dual route.

**David** - The security around having your perishable product collected, that was the fundamental way back.

**Henry** - I look at that as a given. It’s about us working together so that we have some market power or influence, but for the dairy farmer knowing he will get paid on the 20th - that’s critical too.

**David** - You are generalising when you talk about the reasons for wanting or forming co-operatives. But in my experience there is a wide range of views. There are some very, very focussed operators out there who have invested heavily in the industry, and if it doesn’t perform will go elsewhere tomorrow. Then there are the rest, the bulk of us, who sit in the gap in the middle where we are farming for all those reasons we have discussed.

**Henry** - We haven’t got a shareholder base where all things are the same, in fact things are becoming more divergent. The bigger farmers are getting bigger and the smaller ones are happy where they are, that gap gets larger and larger. That creates challenges for the coop. and communication plays a key part. I think that communication channels will evolve as the coop. evolves.

**David** - So if you look at all those things - communication, education, participation - you are actually trying to cater for a whole range of reasons for farmers being there?

**Henry** – Yes, that is coming into communication. It's a very good question David, "how should a co-op communicate with its farmers, what is the most effective means of communication and why"? Can I break this down into a couple of things?

Ultimately, co-ops will survive or die because of two things.

One, performance and that is a given: payout in a sense.

Co-ops will actually fail unless the glue is there to actually keep the farmers connected and feel proud of their co operative.

Performance alone does not deliver you a sustainable co-op, how can we make farmers actually feel part of it. From the co-ops view first, we need to communicate through Farmlink (company monthly newsletter) and through personalised letters. We get to the stage where farmers think we are just filling up the letterbox with junk. The big guys want it, the smaller ones don't. For well over 50% of farmers, what they want is eyeball-to-eyeball, voice-to-voice communication.

This is where the Shareholders Council plays such a key role. So many farmers can't actually see outside their boundary fence. Management don't always talk in their language, but those who can need to come and lean up against the strainer post and chat. We need to strengthen that - that's where the Council and representation play such a key role.

**David** - Governance and representation in a co-op director's role cannot be completely separated. The governors of a business are actually setting the strategic direction and need to be linked a bit to the representation?

**Henry** - Hey, that's a fair question to ask, but I want to be linked to the representation through the Council, not actually the farmers.

To my mind this is actually working. How many calls do you think I get from farmers in a year? You can count them on the fingers of, at the most, two hands. All my effort and energy is going into interfacing with the Council. That's why we are here talking; it's my responsibility to convince the representation body that our strategic direction is right. I have to actually be able to articulate it when asked at a shareholder meeting, but it is not my responsibility to lean up against the fencepost.

**David** – Yes, I accept that.

**Henry** - So we have to do the print stuff, the stuff the big boys want. We do still have over 50% of farmers though who don't want it.

**David** - So that empowerment bit, the bit about empowering the Fonterra farmers, does it come through the representation body?

**Henry** - We have never had a discussion within Fonterra about who is actually responsible for the education. I think the Board's role is to educate and make themselves available to educate Councillors, but ultimately it is up to Council and the field representatives to actually educate the farmers.

**David** - As we discussed before, the Management (shareholder services in particular) and Council should be attached at the hip on some of these issues.

**Henry** - Because the farmers at that level want voice to voice, eyeball to eyeball communication. The Board's responsibility is to see that you are actually armed with all the information, and understand the issues.

**David** - Just to digress a wee bit. It is the Board's role to communicate the company's performance and direction and so on down - as that becomes more and more sophisticated; it's more and more difficult.

**Henry** - The gap between the Board and the shareholder base will become wider and wider.

**David** - It's inevitable.

**Henry** - It's not positive, but ultimately if we are going to succeed as a co-op in a global marketplace, that is what is going to happen and I am focussing the directors on the commercial outcomes and out of the market and not looking over their shoulders back at the shareholder base. We still have to run an AGM and furnish a set of annual accounts.

The real interface is actually with Council, the representational body.

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**David** - Education. From what I read, there are not many co-ops that have a structured education programme about their cooperative. DFA for instance, it seems that they haven't a structured programme for their members about their cooperative. In your experience, is that pretty common throughout the world? Is the "Understanding your Cooperative" programme we are doing unique?

**Henry** - It's new. We are leading the cooperative world in these areas. There are a lot interested in our model, but none willing to take the risk to go down there yet. We are being watched to see whether we are successful or not. We are the ones breaking the frontier here. More and more, different entities, for instance the Australian Wheat Board are interested. We are leading in some of this stuff.

**David** - Do you accept then, that it is important for the Company to educate farmers about the activities of their cooperative?

**Henry** - Yes it is, but it should be in the informal way, voice-to-voice, eyeball-to-eyeball - it is actually the way you do it.

**David** - Think back to Grandfather, in my view they formed co ops to give them some power. So they could do collectively what they couldn't do individually. You are saying that people are probably far more focussed on the bottom line and the milk price and if they thought about it, capital gain, as opposed to the fact that they are members of a cooperative.

**Henry** - Yes, but communication and education is this glue, which is what I am talking about, that is where we will be different to an independent processor like "Open Country Cheese" or whatever.

I'll give you an example here: one of the executives in Dairy Farming NZ, now supplying an independent processor said he went there looking for a better milk price. When he had explained to him what Fonterra was all about, he said his "culture was a lot closer to that of Fonterra than where he is now" he was looking at milk price, but he now says "I'm actually a farmer and I'm looking for capital gain, I have just chopped off that option".

He wondered if we would be prepared to take him back. I said yes. This is where the place of education, communication and the role that councillors play is such a key role, getting that message out there.

**Henry** - All this stuff that is glue, as the Board gets further and further away from the farmer base, that glue is going to need to be stronger and stronger. That is why communication and education, David, is actually the key.

**David** -Is there is any one area of participation that is more important than another?

**Henry** - No there is not. But I do know that in Council you are very precious about Director election voting. Voting for leaders is very important, but once a farmer has a sense of responsibility about participation in the co op I think you will find that whatever it is for, voting is all just the same. We just have to be a lot more dynamic in this area. Participation is a hot button for me.

**Participation is the measurement.**

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**David** - That is a very good comment to finish off with, Henry, thankyou very much for your time today.

A transcript of the Interview with: Sir Dryden Spring, former Chair New Zealand Dairy Board.

**David-** Thankyou very much for your time today.

Why did the Dairy Farmers form cooperatives?

**Dryden** - There are two reasons. Particularly in the early days in NZ it was the only way they could farm. There had to be someone who could actually process and sell the milk particularly in new districts there had to be someone to take it. So they formed cooperatives in order to actually start farming.

**David** - So it was a protection thing as well?

**Dryden** - Well it was a combination and very often cooperatives around the world started because the service, that was processing milk, was simply not available. That's a very common reason. Another reason is that producers always felt that they were being ripped off. You go to the Supermarket and see a can of milk powder, you do your sums and it is 3,4 or 5 times the price you are being paid as a producer so you think you are being ripped off. Farmers don't actually understand how much money it costs to get a product to the market and the market being what it is, if there isn't an alternative market you will get ripped off.

Then there is another reason about cooperatives generally. This is my definition of a cooperative:

"A cooperative company is a grouping of people with common business interests for commercial advantage which will achieve for the members commercial advantage which they would not achieve acting individually".

Getting our milk processed and sold by grouping our business interests together we would have a commercial advantage over those acting individually. Acting individually we have absolutely no commercial muscle.

**David** - When you say 'services' are you talking about services from manufacturing, processing, do you have to buy those services otherwise?

**Dryden** - Well the service is that you have to take your raw milk, which has no value, and turn it into a form that is marketable. The service is processing and marketing.

**David** - The research that I have done around why people form cooperatives, Parnell and others write in fairly general terms.

**Dryden** – I once met the Chairman of Dairy Farmers of America, Ivan Strickler an elderly gentleman since retired and one morning the collection on his farm didn't take place, they had nowhere to send their milk. A neighbouring coop at considerable inconvenience and expense came to the rescue. Strickler says he has devoted his life to coops since that day. That's an example of the primary purpose of a coop, to give a service to people. Other types of companies can say sorry, we're doing OK without you.

**David** - apart from telling farmers that that is the case, very few farmers in NZ would understand that reality, the reality of being in business in other parts of the world.

**Dryden** - That's true.

**David** - Can we just look at Communication, Education, and Participation. Do you have some views around communication? How should the coop communicate with its farmers? Is this important?

**Dryden** - I think you should use all the tools that you have got. Use written communication systems. Internet was not available in my day. Be prepared to use mass means. Radio I found a very good medium, directed at farmers, a reasonable proportion listening at that time. TV is much more difficult, big stars as interviewers, confrontational interviews, only really interested in a crisis or something spectacular.

What never must be set aside and it's a bigger problem with a single company is face-to-face communication.

**David** - Do you think that in your time as a director when you look back at NZ Dairy Group and other coops, has the need to communicate changed?

**Dryden** - I think the nature of it has changed - the need hasn't. It's got more difficult; you've got fewer people but more tools available.

**David** - The message is the same?

**Dryden** - Absolutely, when farmers whole livelihood is at stake they must be able to know and understand what you are trying to do. Hugely supportive if they think you are on the right track.

**David** - As opposed to your experience as a corporate director, you have investors to deal with.

**Dryden** - It's short term. There must be a high level of communication, in a publicly listed company. You spend a lot of time communicating. The difference is you don't have to go and talk to thousands of them. You go and talk to the fund managers and analysts. Getting them to know and understand, in order to invest in the company. Otherwise a languishing share price. A problem here, unlike farmers and coops, the company doesn't actually matter to them. They can do well out of their investment even if the company is doing badly, depending when they buy and sell.

**David** - Speculators?

**Dryden** - To a degree. There is one message; you cannot overlook fronting up to the farmer. You do have to have a number of formal meetings, probably less these days and more informal, cowshed style.

**David** - Education. Just from my point of view, in the past farmers were well informed. Sixty directors in the Waikato, farmers were engaged. Looking around the

world at say DFA, they do what they do very well, they seem to rely more on breed societies, Young Farmers Clubs etc to talk about what the coop does.

**Dryden** - You have two types of communication and education. First the cooperative concept tends to be taken for granted. There is a need for education about the principles of coops. Why the cooperative concepts make sense and you don't want to start diluting them and ending up somewhere where you don't want to be. We haven't done enough, on the concept side of things. You are right; the overseas examples are not very good. The reality is that with a limited number of exceptions, the coops overseas make the point that our critics make; they are not innovative, or on the cutting edge, not entrepreneurial. Generally speaking, most of the U.S. co ops are not much more than milk brokers, selling their product to someone else to process. The Dutch are an example of doing really well adding added value, and the Danish cooperatives as well.

**David** - To summarise, should cooperatives have an education programme for their members?

**Dryden** –Yes, but don't overlook the first part - we didn't spend a lot of time on the first part - we took it for granted. My grandfather was chairman of a co-op. The farms were carved out of the bush; something had to be done with the milk. They got together and formed a co-op. My father's generation knew that without a co-op there would be no dairy industry, I knew that, but the next generation doesn't understand.

**David** - And that is probably because at the end of the day Fonterra has a monopoly. I guess the last area is participation. As far as members participating, is there any area of participation that is more important than the others. When you consider AGM voting, directorship voting is there any area that is more important than another.

**Dryden** -No I don't think there is. But what I feel is terribly important is that farmers are given that opportunity to participate and if they are not you need to find new ways to give them that opportunity. If they fail to get involved you don't want to get too uptight. If they are unhappy they will start participating. You cannot take non-participation as yes, but benign or comfortable, apathetic. The majority of people will be in this category. Giving them the opportunity is terribly important, whether they avail themselves of this opportunity or not.

**David** - Most of the people in my ward area are small shareholders. They have this view that there are these huge shareholders who control a massive amount of the company. In actual fact, if you look at the numbers, if all these smaller farmers voted the big farmers vote would be less effective. That's a message that's hard to get across. I think that something like 200 farmers control in total 12% of the company. The other 88% of the vote is in the hands of the average farmer.

**Dryden** - In most publicly listed companies, the top 20 shareholders control between 60 - 85% of the company.

**David** – Thankyou Dryden very much for your time.

**Interview:**

- Barry O'Donnell, Director Shareholder Services, Fonterra Cooperative Group.  
– 20/08/04

Barry, the following is an outline of the issues that I wish to cover in my interview:

**Communication**

Does the Fonterra co-op differentiate between shareholders and suppliers/farmers in its communications? Why?

Does the company have a communication strategy regarding communication with/for farmers?

What is it?

How does the company communicate with its farmers?

How does the company communicate with its shareholders?

What is the most effective means of communication? Why?

What is the least effective means of communication? Why?

What forms of communication have worked/not worked?

**Education**

Does the company have an Education strategy for its shareholders/farmers?

What is it?

Is it important for the company to educate its farmers about the activities of the company? Why?

Assuming that this is important, how does it do this?

**Participation**

Is participation in a co-operative by its members important? How important?

From a management point of view is participation by co-op members important? Why?

Does the company measure/monitor the level of participation by shareholders/farmers?

Why does it do this?

Are certain areas of participation more important than others? Eg. A.G.M voting, director election voting, meeting attendance?

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A transcript of the interview with: Barry O'Donnell, Director of Shareholder Services Fonterra Cooperative Group.

**David**- Can we please discuss the way that the cooperative communicates with cooperative members being Fonterra farmers?

**Barry** - Getting the Fonterra field representative much more up to speed, fetch and carry guys at farmer level, relationship guys at management level.

**David** - The field rep. role is very much more like retail banking. Relationship development.

**Barry** - I don't want to have the field rep. as the guy who brings round the milk quality results. That can be done another way, not that we don't want it done, but working at a higher level. Relationship guys.

I also want the offshore staff to come back and start talking to these farmers. Not using power point but actually telling farmers what they actually do in their job off shore.

We've had the treasury guys go out and tell them what they actually do on a day-to-day basis. We assume that when we put up all these graphs and things that there is a high level of understanding amongst farmers. But there's not. Farmers won't ask questions, they are scared that the others will think they are dumb.

**David** - And that comes right back to identifying who are the owners of the business, what makes this coop tick? People are all at different levels, aren't they?

**Barry** - You can talk to a large operator about all this, Forex for example, he's right into it. But the guy running the 100-cow farm or even the guy doing 80,000 kgs. of milk solids may not have that understanding because he hasn't been exposed to it. So that's really where we are actually trying to lift the level of understanding. I'd like to get our Marketing and Innovation people out there, show these people what we are trying to do in Research and Development, some examples of that. At the farmers' homes, small meetings. The overseas guys all want to do it again; there is such a high level of interest from farmers. Once farmers feel comfortable they are not intimidated by asking questions and our guys just got an avalanche of questions, mostly just day to day stuff but once you get that level of understanding going you can build on that with the more complex stuff.

**David** - People are often interested in the little bits of really interesting information about the coop. that instils pride, too. That is so important for participation.

**Barry** - Chairman Henry said at the Shareholder Council meeting, this is a three-legged stool here. There's management, there's the Board and the Council, and if you haven't got it all lined up the thing will fall over. You can have management driving the company, if that is what you want, but if it isn't driving in the direction that you want, well the stool will fall over, as soon as management captures the company.

**David** - There has to be some balance in there.

**Barry** - I'm a very strong believer that you have to have the shareholders at first base.

**David** - On the topic of education. Council has the view at the moment that it's role and responsibility is to deliver education around understanding the cooperative. And that is sensible, but is there any reason why management can't do it?

**Barry** - To me it is Council who is the most suited to do it, and the understanding the company thing is probably best done by Council because they understand best what it is that shareholders want to know. Management could do it but would need guidance from Council about where to pitch the message - a perspective thing.

**David** - Does the company measure/monitor the level of participation by the shareholders/farmers.

**Barry** - We do at our level. We keep records of contacts; do surveys of levels of satisfaction. We really believe that we have to monitor that; we really want to do that more. We can do that well.

**David** – Looking to the future, does management have a view regarding moving away from the way that farmers currently exercise their vote. The small farmers that I represent can't for the life of them understand why the operator with half a million kgs. of milk solids has so many votes when in comparison he has so few. Is there any feeling that we should alter the way we as farmers vote?

**Barry** - One guy one vote?

**David** - Not necessarily, but a capped vote situation.

**Barry** - Not that I have heard. I've heard the issue raised regarding one share one vote but not a capping situation. To be effective the cap would have to be very small. Where would you put the cap?

Our data shows that the largest 100 shareholders have interests in about 550 dairy farms - averaging 5.5 farms each. Combined production about 150 million kgs. of solids, 12% of total supply.

We try to identify what influences are at play. At a strategy level what influences this groups thinking. We need to talk to these people.

Thanks for your time Barry.