Changing Fonterra's ownership model?

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Förändring av Fonterras ägarstruktur?

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Uppsala, June 2009
Charlotta Rydberg

Summary

The purpose of this thesis is to examine the reasons behind the recent capital restructure proposal in Fonterra as well as the members' rejection of this proposal. This thesis gives background information on Fonterra and a brief description of the New Zealand dairy industry and its development. During the last decade or so, a number of studies have been conducted concerning the problems of traditional co-operatives, which have become large and which have got complex business operations. The core of these studies is the notion that collective ownership creates so-called property rights problems. However, the specific attributes of Fonterra may imply that these theoretical studies do not apply to Fonterra or only limitedly so.

The theoretical part is based on a number of articles about co-operatives. These studies have a few common denominators. They all treat large co-operatives with complex business activities, working in very intense competition. In order to survive they have to grow persistently, and the increasingly large size as well as the complex nature result in heterogeneous memberships with low member involvement. As a result of this the members lose trust in management and the Board. Members become hindered in their control of the company and this leads to dissatisfaction and low involvement.

The specific attributes in Fonterra are the fair value share, the Shareholders Council, no existing congruent isomorphism and that there is still a need for a co-operative in New Zealand to keep transaction costs down. This study consists of an empirical study, the aim of which is to investigate whether these specificities of Fonterra may be the cause of the members' opposition to the Board's proposal. The main part of the empirical material was collected during a trip to New Zealand during January 2009. Interviews were carried out with representatives from the Board, the Shareholders' Council and dairy farmers from Fonterra. Two persons with co-operative insight were also interviewed.

The empirical study shows a clear distinction between the wants and needs of the members and the Board. Members are afraid of losing control over their co-operative and the Board feels that it needs to change the capital structure in order to secure the future for Fonterra's members. In this process the Shareholders' Council played an important role and members are in general very happy with its work. The fair value share causes some issues within Fonterra, members do not understand the valuation method and the high value is now starting to cause redemption. In the past decade Fonterra has been the only option for many farmers and hence there has been a need for a co-operative to lower transaction costs. New options are now emerging in New Zealand and are weakening Fonterra's position.

From the Board's side Fonterra is a typical co-operative with typical co-operative problems. However, members are not alienated and very much feel that Fonterra is their co-operative. The question whether a pure co-operative can survive in today's society remains but attributes like the Shareholders' Council to a great extent help members remain in control.

Sammanfattning

Syftet med detta examensarbete är att undersöka orsakerna till den föreslagna förändringen av Fonterras ägarstruktur. Vidare är syftet att undersöka varför medlemmarna motsade sig detta förslag. Arbetet ger bakgrundsinformation om Fonterra samt en kortfattad beskrivning av den nyzeeländska mejeriindustrin och dess utveckling. Under de senaste åren har ett antal studier gjorts om de problem som kan uppstå i traditionella kooperativa företag som växt sig stora och numera karakteriseras av komplexa affärstransaktioner. Grunden i dessa studier är att kollektivt ägande skapar så kallade äganderättsproblem. I Fonterra fall kan vissa speciella attribut leda till att dessa studier endast stämmer in till en viss grad.

Teorikapitlet är grundat på ett antal artiklar som berör kooperativt företagande. Artiklarna har ett antal gemensamma punkter, nämligen att de behandlar kooperativa företag, som har stort medlemsantal, komplex affärsverksamhet och intensiv konkurrensexponering. För att överleva krävs ständig tillväxt, vilket leder till ett stort och komplext kooperativt företag. Detta för med sig en heterogen ägarkår med oengagerade medlemmar. Som en följd av detta förlorar medlemmarna tilltron till styrelsen och ledningen. Medlemmarna hindras från att kontrollera sitt kooperativa företag, vilket leder till missnöje och lågt engagemang.

De speciella attributen i Fonterra är, ”the fair value share”, ”the Shareholders’ Council” (en skuggstyrelse), att ingen kongruent isomorfism existerar samt att det fortfarande finns ett behov av ett kooperativt företag för att hålla transaktionskostnaderna nere i Nya Zeeland. Den här studien innehåller ett empiriskt kapitel vars syfte är att undersöka om dessa speciella attribut kan vara anledningen till att medlemmarna motsade sig styrelsens förslag till ändrad ägarstruktur. Huvuddelen of det empiriska materialet samlades in under en resa till Nya Zeeland i januari 2009. Intervjuerna genomfördes med representanter från styrelsen, skuggstyrelsen, medlemmar i Fonterra samt två personer med allmän kunskap om kooperativa företag.

Den empiriska studien visar på en tydlig skillnad mellan vad medlemmarna och styrelsen anser vara viktigt. Medlemmarna är rädda för att förlora kontrollen medan styrelsen anser att förändring är nödvändig för att säkra medlemmarnas framtid. I denna process har skuggstyrelsen spelat en mycket viktig roll och medlemmarna verkar generellt vara väldigt nöjda med skuggstyrelsens arbete. ”Fair value share” skapar vissa problem i Fonterra då vissa medlemmar inte förstår hur värderingen går till. Vidare så skapar det höga värdet en inlösningsrisk. Under det senaste årtiondet har Fonterra varit det enda geografiska alternativt för många medlemmar och därför har det funnits ett behov av ett kooperativ för att sänka transaktionskostnaderna. På marknaden dyker upp nya alternativ, som försvagar Fonterras position.

Sett från styrelsens håll är Fonterra ett typiskt kooperativ med typiska problem som uppstår. Sett från medlemmarnas sida kan man ana att de inte är alienerade och fortfarande känner att Fonterra är deras kooperativa företag. Frågan om ett renodlat kooperativt företag kan överleva i dagens samhälle kvarstår, men attribut som en skuggstyrelse hjälper medlemmarna att behålla kontrollen.

Nyckelord: Ägarstruktur, förändring, Fonterra, skuggstyrelsen, fair value share, kongruent isomorfism, transaktionskostnader

Contents

1. Introduction

1.1 Background

As competition increases, it is essential for business firms to penetrate less competitive markets and to introduce new products. Both market development and product development are capital-intensive endeavours.

A prosperous company is characterized by being composed to mirror the features of the market. When a market changes, companies must change their strategy to fit the market, and to be successful with its new strategy, eventually, they need to adapt their organizational structure. In case the firm is a co-operative, the new strategy might entail problems as it is likely to demand large investments, and co-operatives normally have difficulties to raise large amounts of equity capital. Hence, the capital intensive market strategies may force co-operative firms to take on more individualised structures, involving capital from outside investors or capital that is owned individually by the farmer-members, or both.

To meet the demand of changing markets and growing customers the Board of Fonterra has recently been through a review of the existing capital structure. It planned to implement the proposal in two stages. The first stage included the establishment of a new corporate company, Fonterra. This step would also include the shareholders justifying a transfer of all assets and liabilities from the co-operative to the new corporate company. In the second stage the shareholders would authorize the corporate Fonterra's board to list the company on the Stock Exchange. The shareholders' vote was to take place in May 2010 and would give Fonterra Co-operative 65% of the shares, while 15% would be allocated to existing shareholders and the last 20% would be floating. However, before the time for the first voting, in May 2008, the members did not approve and the proposal foundered. This process is, in the light of many other co-operative conversions, remarkable, and it is well worth an investigation.

Thus, the problem addressed in this study is why present-day co-operatives feel forced to leave their original capital structure and instead finance the company with external capital, and especially why Fonterra's board was tempted to follow this route and why opposing forces showed themselves to be stronger. The problem is to be analysed in the subsequent section whereby the aim of the study is arrived at.

1.2 Problem

In agricultural markets, co-operatives account for a substantial share of business. One of the reasons co-operatives have gained popularity among farmers is that they can pool their financial resources and become more efficient compared to if they operated by themselves (Cobia, 1989).

A co-operative is by definition a "private business owned and controlled by users and operated principally to provide benefits to users" (Barton, 1989, p 1). However, in today's society focus is increasingly put on the separation of ownership and use (Fulton, 1995). As the organizational structure of co-operatives becomes increasingly complex, conflicts over residual claims and decision control sometimes become prevailing (Cook, 1995). These conflicts originate from vaguely defined property rights, which stem from members seeking short-run advantages. The complex structure of many present-day agricultural co-operatives entails large business activities and hence members become less capable of controlling the co-operatives (Cook, 1995; Bager, 1996; Harte, 1997).

As a result of aforementioned reasons, many co-operatives have changed their original capital structure to be better adapted to reigning market conditions. Some have changed their organizational structure; introducing individual ownership to the members. Others have disappeared through mergers, and a number of bankruptcies have occurred (e.g. Tri Valley Growers, Farmland Industries and Agway). Against this background it is worth noting that in Fonterra's case the majority of members did not agree with the proposed change in capital structure.

A tentative aim for the study is to explore why Fonterra's board proposed a change in the capital structure as well as the reasons why the proposal foundered. To sort out the different parts of the problem a more detailed problem analysis is needed, which follows next and which results in the statement of the final aim of the study.

1.3 Problem analysis and aim

Why co-operatives change their original capital structure is a complex issue with many explanatory factors and many dimensions. One reason for this is that they need capital for their new market strategies. Today many co-operatives find it hard to obtain a sufficient amount of equity capital from their members in order to expand their operations such they become competitive.

Even though the proposal from Fonterra's board presumably was based on considerations as to market changes, this study does not encompass any analysis of changing market conditions. It is neither possible, nor appropriate, to assess whether the Board or the members were correct in their opinions about the financial structure of the co-operative. The focus of this study is strictly on the proposal and the various processes that preceded and followed the proposal.

There are certainly numerous ways to reform the present capital structure of Fonterra – not only the one suggested by the Board. Following what is said in the preceding paragraph, all optional solutions to Fonterra's eventual capital problems are disregarded in this study.

For this study to clarify the reasons behind the Board's proposal as well as the members' rejection of this proposal, a theoretical framework is needed. During the last decade or so, a number of studies have been conducted concerning the problems of traditional co-operatives, which have become large and which have got complex business operations. These studies serve as the theoretical foundation of this study and are presented in more detail in chapter 3.

The core of these studies is the notion that collective ownership creates so-called property rights problems. By defining ownership over a resource one has the right to the residual and hence feels obliged to use it in an efficient way. The vaguely defined property rights are claimed to give rise to free-rider problems, horizon problems and portfolio problems as well as to control problems and follow-up problems. One solution can be to introduce tradable ownership rights, which may be possessed by the members, by other financiers, or by both categories.

The above-mentioned account implies that the study can be more strictly defined:

- The study concerns the proposal put forward by the Board, neither any analysis of the reasonability of the Board’s proposal, nor any discussion of optional financial solutions for Fonterra.
- The study treats the processes that preceded and followed the presentation of the Board’s proposal.
- The study’s theoretical basis is a tradition of research about agricultural co-operatives’ problems, the core being property rights problems.

This study aims at gaining a theoretical explanation to the recent reorganisation processes in Fonterra, including both the processes within the Board and the management and the processes within the membership. In order to attain this, a number of questions must be addressed, among them:

- What are the underlying factors that have led up to the proposed change in the capital structure?
- Why did the Board take the initiative to present the proposal?
- Which were the arguments that the membership had when it rejected the proposal?
- Which were the social forces within the membership?
- Do the members value something else beyond the predicted economic benefit?

1.4 Method

This thesis analyses the process undertaken in a co-operative theory perspective. The theoretical framework provides a basis for an analysis of the findings from interviews and literature.

The thesis describes the history and structure of Fonterra. Information on this was mainly gathered from various publications, financial statements and the Internet. The empirical basis, which contains the process around the capital restructure proposal, was collected during a tour to New Zealand in January 2009. A number of interviews with representatives from Fonterra (members of the Board and the Shareholders’ Council and dairy farmers) as well as other persons with insight in co-operative businesses were conducted.

1.5 Structure of the study

To provide the reader with the necessary background information Fonterra Co-operative Group Limited is described in *Chapter 2*

In *Chapter 3*, the theoretical framework of the study is presented. A number of studies have been conducted concerning the problems of traditional co-operatives, which have become very large and which have got very complex business operations. These studies serve as the theoretical framework of this study.

The approach is discussed in *Chapter 4.*

Chapter 5 contains the empirical data. The data includes four different groups and their views on the recent capital restructure proposal as well as some background information on the different stipulations that were added at the formation of Fonterra.

Chapter 6 contains the analysis of the empirical data. This is done according to the theoretical framework and primary from a property rights perspective.

In *Chapter* 7 conclusions are drawn from the empirical findings and the analysis.

2. Fonterra

2.1 The New Zealand dairy market

The first co-operative in New Zealand was formed in 1871. Numbers then rose to more than 400 by the 1930s (www, Fonterra, No 1, 2008). As numbers rose, competition grew greater and dairy co-operatives started selling their products in foreign markets. With a larger number of exporting firms, it became difficult to service these markets. In 1923 the Government established the Dairy Export Produce Control Board to control all dairy exports. The dairy Board provided farmers the power to enter new markets and earn better returns for their products. This resulted in a growing and prosperous industry.

New Zealand's small economy is heavily dependant on overseas trade (www, Fonterra, No 1, 2008). Until 1973, New Zealand exported almost all agricultural products to Great Britain. Today, Great Britain remains an important market, however, new markets like South East Asia and China are emerging, and New Zealand's agriculture and manufacturing industries have developed to suit the needs of diverse markets (www, Ministry of Agriculture and Forestry (MAF), No 1, 2008).

Within the agricultural field, the dairy industry is New Zealand's biggest exporter earner (www, MAF, No 1, 2008). With annual exports in excess of $NZ 6.3 billion, the key strengths of New Zealand's dairy industry are its efficient all-grass farming system, large-scale processing, high research and development investments and creative marketing.

2.2 Fonterra Co-operative Group Ltd

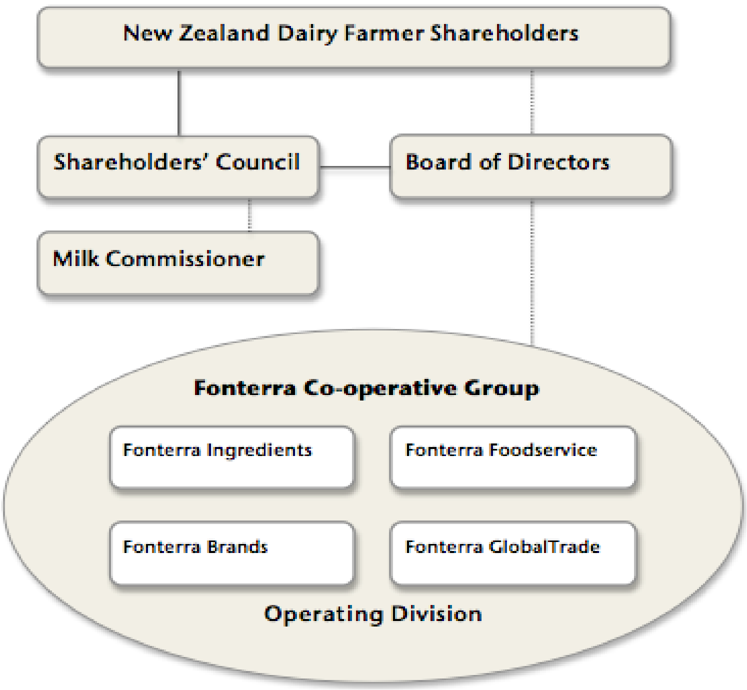
2.2.1 The history of Fonterra

The establishment of Fonterra was preceded by a numbers of mergers (van Bekkum, 2001). This was a result of market adaptation, i.e. the dairy processors wanted to compete successfully overseas (www, Fonterra, No 1, 2008). New Zealand's dairy co-operatives had to become much more efficient and the industry improved within the transportation and large-scale technologies processes. The number of co-operatives decreased from 400 in the 1930s to 180 in 1960/61 (van Bekkum, 2001). Further consolidations brought the number of co-operatives down to 19 at the beginning of the 1990s. The industry consolidated further and by 1996 there were only 12 dairy companies.

In July 2001, 84 per cent of the farmers involved voted to accept the merger of the New Zealand Dairy Board, New Zealand Dairy Group and Kiwi Co-operative Dairies (www, Fonterra, No 1, 2008). The merger was brought to completion in October of that year and a new company, Fonterra Co-operative Group Limited, was established. Fonterra now handled approximately 95 percent of New Zealand's milk production. Preceding the merger there were two options, to have Fonterra or a two-company option, which the Government of that day preferred. The result was Fonterra because it was said one co-operative could better compete on the world market. To allow for a monopsony to form it required that some strict stipulations were added. Two of these stipulations were the Shareholders' Council and the fair value share. Today Fonterra accounts for more than 30 percent of the world's trade in dairy products (www, Fonterra, No 2, 2008).

2.2.2 Corporate structure

Fonterra is owned by more than 11,000 farmers in New Zealand (www, Fonterra, No 2, 2008). Fonterra's organisational structure is shown in figure 1. The co-operative represents more than 20 percent of the total New Zealand merchandise exports and seven percent of the country's Gross Domestic Product, which makes it New Zealand's largest company. Fonterra has an annual turnover of $NZD[1]13.9 billion and assets worth $NZD12.63 billion (www, Fonterra, No 2, 2008). Fonterra collects 1246 (Million KGs) NZ Milksolids[2] or 14 billion litres per year.



Fonterra has four business segments defined by product type and geographic area, reflecting how the business is managed. The main products include milk powder, cheese, butter, and casein. The main export markets are USA, Japan, Philippines, Mexico and South East Asia. Fonterra has four sales channels, Fonterra Ingredients, Fonterra Brands, Fonterra Foodservices, and Fonterra Global Trade.

Fig. 1, Fonterra's organisational structure (www, Fonterra, No 3, 2009)

Fonterra Ingredients is the world's largest exporter of dairy ingredients, with products marketed under the NZMP brand (www, Fonterra, No 4, 2009). It was formed from the local market ingredients business of the two companies that formed Fonterra (New Zealand Dairy Group, and Kiwi Co-operative Dairies). It is represented in 140 countries and territories around the world.

Fonterra Brands is the consumer products division of Fonterra (www, Fonterra, No 5, 2009). Its primary business operations are in, sales, marketing and distribution, using a number of national and international brands for its products. Anchor, TipTop, Manland and Fernleaf are some of the brands. Fonterra Brands employ around 10,000 people in over 30 operating companies.

Fonterra Foodservice is serving customers like fast food chains, airline catering, hotels and restaurants with both dairy ingredients and branded consumer goods (www, Fonterra, No 6, 2009). The majority of sales are in the Asia Pacific region.

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[1] $NZD 1 = € 0.44
[2] One kilogram milksolids corresponds to approximately 12 kilogram of milk (LIC, 2003; van Bekkum, 2001)

Fonterra Global Trade is Fonterra's new internet-based electronic trading platform (www.globaldairytrade, 2009). Here commodity dairy products are traded all over the world. Improved price transparency and forward price information are two of the benefits offered through the service.

2.2.3 Corporate governance

On the *Board of directors* Fonterra has up to 13 directors (Annual report 06/07). Under the Fonterra Constitution nine of these are elected from the shareholder base (Elected Directors) (www, Fonterra, No 7, 2008). The remaining are appointed by the Board and approved by shareholders at the annual general meeting (Appointed Directors). There are no executive directors. Appointed directors are appointed for a term specified by the Board, subject to shareholder approval. Elected directors are appointed for a three-year period through a postal ballot.

To make sure that the needs of suppliers and shareholders are recognized by the Board the *Shareholders' Council* was established (Annual report 06/07). The Shareholders' Council operates independently of Fonterra, and is made up by 35 shareholders, each representing 35 wards all over New Zealand. The *Milk Commissioner* is appointed by the Shareholders' Council to mediate any disputes between shareholders and Fonterra (www, Fonterra, No 3, 2008).

2.2.4 Transaction – Milk Pricing Policy and Payout

When the New Zealand Dairy Board was still a part of the New Zealand dairy industry, the only visible performance measure was payout (Bayliss, 2003). Each co-operative's performance was measured on the margins they added to the Board's payout.

As a result of the mega merger, Fonterra now is the only co-operative of its size in New Zealand. Fonterra processes approximately 95 per cent of all New Zealand milk; hence there is no valid market-based price for liquid milk within New Zealand (www, Fonterra, No 8, 2008). It is neither appropriate to use prices paid in foreign markets due to the significant variances in cost structures. As a result of this, it was stated in the Dairy Restructuring Act that a benchmark price had to be calculated every season (Dairy Restructuring Act, 2001); the *Commodity Milk Price* (CMP). Up until this year it was an obligation of the Independent Valuer[3] to decide (set the CMP) at the beginning of each season. The CMP used to be defined as: "a theoretical estimate of the price an efficient commodity producer could afford to pay for your milk and still make an adequate return on capital" (www, Fonterra, No 8, 2008). To help farmers make better-informed decisions on the inputs to their farm operaitons and better assess performance of the company in managing the value added investments, Fonterra has introduced a new system to the forecasting of payout. Before payout was forecasted a single price per kilogram of milksolids but as of the 2006/07 season the payout is forcasted through a milk price and a value added component. The new breakdown also sends a clear economic signal on the real value of the milk. At present the setting of milk price is undergoing change.

At the moment the new Milk Price system is in an evolutionary stage and therefore still confidential. However, the system is in place and at the same time undergoing review as well as a great deal of scrutiny by the Shareholders Council. Instead of using a theoretical efficient

[3] The valuer for this period is Duff & Phelps

competitor like the old CMP model did, the new system uses actual costs and manufacturing capability from within Fonterra. The new milk price is subject to a "Milk Price Manual" which has five principles. The key principle is that Fonterra must return to farmers the "best and fairest" milk price.

2.2.5 Member investments – The Fair Value Share

Member investments in Fonterra equal the purchase of Fair Value Shares (www, Fonterra, No 8, 2008). Preceding the merger that formed Fonterra, no open market for trading shares in Fonterra existed. Transactions were based on a nominal share value and shareholders could therefore not assess the value of their investments. Nowadays, before the start of each season, the fair value share is decided upon. The Fair Value Share is set by the Board based on a valuation range determined by an independent valuer, who is appointed by the Shareholders' Council.

The shares represent the principle of a fair value in and a fair value out. When setting the range the valuer takes the following factors into account:

- Fonterra's likely future earnings after deducting the valuer's assessment of the commodity milk price in the future.

- Projected earnings of Fonterra's separate businesses, corporate overheads, research and development, and other operations,

- Forecasted volume of milk supplied to Fonterra.

The Fair Value Share reflects the value ascribed to the future return to shareholders from Fonterra's value added activities (www, Fonterra, No 8, 2008). This value represents the extra return Fonterra is able to create on top of what a business selling only basic commodity products from New Zealand creates. The value hence comes from sales of consumer and foodservice products within Brands and speciality or value added product in Ingredients.

The shareholders hold one share for each kilogram of milksolids they supply to the co-operative (www, Fonterra, No 8, 2008) except those shareholders who supply milk under a contract where a minimum of 1,000 shares is required Fonterra has to honor existing contracts but are no longer taking on new contract suppliers.

2.2.6 Fonterra's strategy

Fonterra's strategy consists of four pillars and it aims at capturing growth opportunities in both liquid fresh milk and globally traded ingredients (Annual report, 06/07). The pillars are as follows:

1. Make sure Fonterra remains one of the world's lowest costs, sustainable dairy producers.
2. By being a multi-origin supplier Fonterra shall build trusting partnerships with customers, allowing them to build more valuable relationships trough supply chain integration and innovation.
3. Leverage of Fonterra's cow-to-consumer expertise to build profitable business using locally produced milk, in high growth markets located in areas where it is not practical to use New Zealand milk.

4. Wherever Fonterra conducts business, make the products a number one choice of customers and consumers.

The core idea is to ensure that Fonterra's growth projects are not limited to growth in milk supply in New Zealand as well as ensuring that the milk gets collected, processed and sold for the most palatable price. In line with its strategy, Fonterra has four business segments, defined by product type and geographic area (www, Fonterra, No 9, 2009). Together they cover a large part of the world. The segments are:

- Commodities and Ingredients.
- ANZ – operations in New Zealand (other than those included in Commodities and Ingredients) and Australia, including Australian Milk Supply and Manufacturing.
- Asia/AME – operations in Asia, Africa and the Middle East and the San Lu investment in China.
- Latam – Soprole (Chile) and a joint venture between Dairy Partners of America in Latin America.

2.2.7 Fonterra's co-operative philosophy

A co-operative principle is a governing law of conduct (Barton, 1989). If the co-opertive abides by those, the uniqueness of the co-operative business structure should be preserved. In Fonterra this document is called the Co-operative Philosophy and it comprises Fonterra's five co-operative principles as well as how these principles are applied (Fonterra's co-operative philosophy). The Shareholders' Council wrote Fonterra's philosophy, where it sums up what the members think their co-operative stands for. The co-operative philosophy applies only to Fonterra's cornerstone activities, which are the collecting, processing, and marketing of shareholders' milk to make sure these activities remain in its true co-operative structure. The co-operative principles are as follows:

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.

2.2.8 Current capital structure and the suggested option

Today Fonterra is a traditionally organised open supplier co-operative, which is 100 per cent owned and controlled by farmers (Fonterra, 2007). According to Fonterra's co-operative philosophy Fonterra Co-operative Group is a value-adding co-operative with respect to supplying shareholders' milk (Fonterra, 2002). Fonterra is an open co-operative. No dividend is paid on shares and no phased entry exists.

In accordance with many other co-operatives Fonterra put up a suggestion for change of its original capital structure (Fonterra, 2007). The Board predicted large investment opportunities coming up in the global dairy industry and hence wanted to change the capital to be able to exploit those opportunities to follow its strategy, and preserve Fonterra's position for the next generation. According to the Board the strategy must be followed. The Board also points out the potential threat from countries with low milk production costs like South America, and Russia as a reason for change.

According to the Board of Fonterra the present capital structure was:

- "Exposing the company to unsustainable redemption risk"
- "Does not allow farmer choice "
- "Will not allow the delivery of Fonterra strategy due to insufficient capital"

The redemption risk is stemming from the appreciation in the fair value share that acts as an incentive to leave the co-operative (Fonterra, 2007). The high value also makes it difficult for young people to get into dairy. Further, according to the Board, members want choice regarding their investment portfolio. Finally, the future of Fonterra depends on its growth strategy, which requires capital. Due to this perceived situation the Board has recently been through a review of the existing capital structure where it looked at what capital structure that best would serve the strategy as well as solve the issues with redemption risk and investment choice. The Board looked at many ways to address Fonterra's capital structure pressure and came up with six options. The vote was only going to concern one of the options; the suggested option:

In this option, the supplier co-operative would remain and a second company, Fonterra, would be created (Fonterra, 2007). All the assets and liabilities in today's co-operative, including the stainless steel, the Brands and Ingredients business, would go into Fonterra. Fonterra would be listed and hence, the market would determine the value of the shares. After listing, farmers would own approximately 65 per cent through the Fonterra Farmer Co-operative and around 15 per cent through their individual shareholding in Fonterra. In legal terms Fonterra would be a subsidiary of Fonterra Farmer Co-operative. The public would hold the remaining 20 per cent.

3 Theoretical framework

3.1 A life-cycle model for agricultural co-operative development[4]

Cook (1995) suggests that agricultural co-operatives may develop according to a predetermined pattern. He operates with five stages – 1) birth, 2) early development, 3) growth and consolidation (this stage entails problems with vaguely defined property rights (VDPR), 4) problem (dealing with the VDPR problems), and 5) reorientation. The driving force behind the development is increasing competition, which implies that co-operatives towards the end of the life cycle will be characterised by increasing demand for capital, increased professionalisation and more hierarchical governance. These factors are bound to create problems in terms of vaguely defined property rights and principal-agent problems. In the first stages of the life cycle the conditions are quite different. Then co-operatives are established as a consequence of poor competition and farmers join together in order to create better functioning markets.

The reason to the issues in connection to the VDPR problems may also be put in terms of members of a co-operative. Since members do not reap benefits from all their investments they do not want to invest. They try to act as free riders, and they are not able to control management.

The five stages of Cook's life cycle for co-operatives are:

(1) Birth

When forming a co-operative there are two economic justifications. a) When excess supply creates low prices producers need institutional mechanisms to gain economic balance. b) When markets fail, producers would prefer better functioning market mechanisms to counteract their business partners acting opportunistically and hold-up situations (further explained in 3.2). Both low prices and market failures create incentives for individuals to react collectively. As a co-operative is formed to solve a problem the first step is often viewed as defensive in nature.

(2) Early development

When a co-operative is founded to create economic balance it is often short-lived and has a minor effect on members' subsistence. In contrast, when co-operatives are formed to confront market failures it often markets or delivers inputs at a more attractive price than competing IOFs (investor oriented firm). For this reason, these co-operatives tend to live through the infant stage.

(3) Consolidation

After surviving stage two, co-operatives are doing well in correcting, or at least mitigating the negative effect of market failures. As a result, the behaviour of competitors begins to modify and the price difference between IOF competitors and co-operatives decreases. Hence, members start to consider their short-run costs of transacting with the co-operative. These transaction costs emerge due to vaguely defined property rights. This will lead to conflicts

[4] The section is based on Cook (1995) unless something else is mentioned

over residual claims[5] and decision control, especially as co-operatives become larger and more complex in their structure.

The VDPR problems that are characteristic for the traditional co-operatives in a late stage of their life cycle are the free rider problem, the horizon problem, the portfolio problem, the control problem and the influence cost problem. The last two are not connected to vaguely defined property rights but to agency problems. However, all these problems are driven by conflicts over residual claims and decision control and are explained as follows.

The free rider problem emerges when property rights are not tradable, secure or assigned. In a co-operative members or non-members will use a resource without bearing the full cost of their actions or receiving the full benefit of it. *The inside free rider problem* is a more complex type. In this case new members receive the same patronage, residual control and return rights as existing members. This will create an intergenerational conflict, which will make existing members reluctant to invest in the co-operative.

The horizon problem arises when members of a co-operative society have a different time horizon for their residual claim on the net income generated by an asset compared to their horizon for the productive life of that asset. This problem arises due to a lack of a secondary market for transfer of co-operative equity shares as well as restrictions on transferability of residual claimant rights. This creates a disincentive for members to invest in their co-operative. As a result, members tend to pressure the Board to either accelerate equity redemptions at the expense of retained earnings or increase the proportion of the co-operative's cash flow devoted to present payments to members relative to investments. The horizon problem will affect the investment in long-term assets most severely, e.g. assets such as research and development, which have a very long or everlasting life span.

The portfolio problem emerges because members of a co-operative society are not able to match their co-operative's asset portfolio with their personal risk preference. This is due to lack of transferability, lack of liquidity and appreciation methods for the exchange of residual claims. As a result members will hold sub-optimal portfolios and they will try to influence management to rearrange the co-operative's investment portfolio. The case of a reduced risk may also entail lower returns.

The control problem is linked to the agency costs that appear as a co-operative tries to align the different interests of agents and principals. The problem is considered to be more severe in a co-operative due to the lack of two things: the transferability of shares between members and of management incentives. Members cannot assess the management's work, and an inefficient management might linger. In a co-operative, with a large collective capital, members do not get enough compensation for engagement and there are weak incentives to follow up on management's work. As for management incentives, a co-operative cannot use share ownership as an incentive.

When organisational decisions affect the distribution of wealth in an organisation affected members tend to influence the decisions to their benefit. This is referred to as *the influence cost problem*. Since most co-operative members do not consider exit (to leave the co-operative) an option their only option to influence is voice. Since members tend to stay rather than exit the co-operative society, co-operatives have a tendency for a higher diversity of

[5] a claim on earnings after debt obligations have been met.

economic interests than an IOF. Thus, if a co-operative is engaged in a wide range of activities members might engage in damaging influence activities. As a result of this transaction costs might increase as well as causing the wrong decisions to be made.

(4) Problem

In this stage co-operative leaders become aware of the typical property rights issues. Sunk costs, competitive yardstick (co-operatives are explained to discipline the economic system and keeping other IOFs honest[6]) reasons, and pacemaker arguments[7], all become important components of strategic decisions. At the end of stage four and after careful analyses have been carried out, co-operatives have three different options: 1) exit, 2) continuation, or 3) transition.

(5) Reorientation

Stage five consists of the choice between the strategies of exit, continuation or transition.

1. Exit. Within this option two alternatives exists: a) liquidation of the co-operative or b) to restructure as an investor-oriented firm (IOF). A low performing co-operative should liquidate or merge. A high-performing co-operative should restructure as an investor-oriented firm.

2. Continuation. In stage three members tend to under-capitalize their co-operative due to a number of property rights constraints. Co-operatives seem to follow one of the two alternatives in this stage, namely a) to seek external capital without restructuring as an IOF or b) to adopt a proportionality[8] strategy where capital is generated internally.

   When taking on the external approach the result will be joint ventures (both with co-operatives and IOFs), publicly held subsidiaries, and limited liability companies. Strategic alliances are used as strategies to seek external capital. The proportionality strategy will lead the co-operative to the completion of the principle that the financial responsibility will be shared on a proportional basis.

3. Shifting. One option is a shift to a New Generation Co-operative. This implies closed membership and hence, individual ownership. Individual ownership comes in terms of tradable shares. A non-member can purchase a share and then apply for membership.

In markets that are relatively free from externalities and are competitive the transformation of ownership from a co-operative to an IOF business form will, according to agency theory, enhance management and employee incentive and help keep track of the performance in the enterprise.

Property rights theory, transaction cost theory and incomplete contract theory indicates the existence of collective action when for example high-frequency transactions exist in an uncertain environment. If vaguely defined property rights constraints are mitigated producers

[6] Hoegland (2006)
[7] Co-operatives linger where their existence disciplines competitors
[8] A co-operative as a proportional enterprise with respect to voting control, equity capital investments, and profit distribution (Barton, 1989)

are more likely to invest in co-operatives. Hence co-operatives that attend to these issues have a better chance of surviving. In the subsequent sections these issues are further investigated.

The five aforementioned problems that are characteristic for the traditional co-operative organisational model tend to occur more frequently in large and complex organisations. Agency problems appear in co-operatives because management and risk bearing are separated. In cases where co-operatives fail to align residual control with residual returns the set of property rights constraints appear. The free-rider problem occurs for example when the upfront equity investment is small.

3.2 Creeping privatisation of Irish co-operatives[9]

The markets for agricultural products and farm inputs have become more transparent, more liberalised and larger. Market failures also appear less frequently in modern agriculture. Harte (1997) suggests that the transformation of some leading Irish co-operatives (e.g. Kerry) into public companies with farmers' co-operatives as controlling shareholders is a result of that farmers no longer need co-operatives to lower their transaction costs.

Vertical integration can be defined as when two or more stages in the production and marketing of a good are carried out in the same firm. A co-operative can be said to be a partially vertically integrated firm. Vertical integration is more likely to occur in situations characterised by a market failure and where transaction costs are high. *Transaction costs* occur when property rights are vaguely defined, when contracts are incomplete and the trading partner acts opportunistically and is the cost of negotiating and carrying out transactions. These costs include search and information costs, bargaining and decision costs, and policing and enforcements costs.

In transaction cost theory, transactions can be described by three attributes. First, many transactions are characterised by uncertainty. When the uncertainty is unevenly distributed between the partners in the transaction information asymmetry arises. Second, how often a transaction takes place will affect the way people choose to do business with each other. Finally, there are a number of transactions where the asset is specific to the transaction. For example temporal asset specificity (hold up situations), where a perishable product loses value shortly after the actual production, e.g. milk. A co-operative can be seen as a partially vertical integrated firm. Forming a co-operative will remove the threat of a hold-up situation. In an uncertain environment the number of costly contract renegotiations increases. Co-operatives will mitigate the uncertainty. When negative externalities exist in nearby markets farmers may form co-operatives to comprise those externalities.

Today market failures occur less frequently and internal organisation costs are high in large partially integrated vertical systems. Further co-operative enterprises involve higher transaction costs regarding the horizon, portfolio and control problems. Fully integrated vertical systems can achieve lower *agency cost*[10] because it is easier to create a means by which management performance can be monitored and rewarded. Hence the conversion of some Irish co-operatives into IOFs has benefited the farmers.

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[9] This section is based on Harte (1997), unless something else is mentioned.
[10] The cost for the principal associated with mitigating the issues with using an agent to run the business

3.3 The future of Canadian agricultural co-operatives

Property rights of individuals over assets can be defined as "the right, or the powers, to consume, obtain income from, and alienate these assets" (Barzel, 1989, cited in Fulton, 1995, p 1145). The basic assertion of this approach is that ownership accompanied by secure property rights is the most effective institution for providing co-operative members with an incentive to create, maintain and improve co-operative assets. Hence it is important for the owners to control the assets at their benefit. Co-operative ownership can be questioned since members cannot control the assets individually. Property rights become vaguely defined which creates inefficiency. Since traditional co-operatives are composed in a way that property rights belong to members collectively, the rights are not transferable, and dividends are given in proportion to patronage, vaguely defined property rights exist, which among other things lead to disincentives in investments.

Fulton (1995) applies property rights theory in a way where he is questioning whether co-operative enterprises can survive in a society with intensive competition and in a more internationalised capital- and knowledge-demanding food industry. Fulton states that the strongest actor will be the one controlling the most critical part of the production process.

During the past century the most critical part of the production process has been to produce large quantities of high quality products, which explains why co-operatives have prospered. Co-operatives are also more likely to emerge and be successful in situations where the input provided by the members is subject to unpredictable variability.

Within agriculture, in industries like dairy and poultry, co-operatives have been prominent in the industrialisation. Today, the production of high quality products is, however, not the most critical part for a prosperous manufacturing industry. Hence, the production can be separated from ownership and large enterprises can run farm production. Consequently, the arguments for co-operative business fail.

Instead investor owned multinational genetic companies, food manufacturing, and food retailing will dominate. If co-operatives can gain a strong position in these markets their probability of survival increases. Another possibility is that they can produce at low cost and sell to less price-sensitive markets. Cases of closed-membership co-operatives (based on the farmer's role as an investor) as well as co-operatives with external co-owners (run together with multinational companies) will increase the probability of co-operative survival.

3.4 The economic culture of U.S. agricultural co-operatives[11]

Hogeland traces how the co-operative philosophies initiated in the early 20th century created contradictions for later co-operative development. She explains the development in terms of economic cultures within the farmer communities. Co-operatives changed norms to facilitate their response to the economic incentives of industrialisation and globalisation, for example by expanding. As this preceded the culture that is supportive for traditionally organised co-operatives became threatened. "Farmers wanted to use co-operatives to protect their economic independence, but co-operatives needed farmers to be economically dependent on them." (Hogeland, 2005, p. 67-68).

[11] This section is based on Hogeland (2006)

The California plan can be seen as market-driven co-operatives. The yardstick model, on the other hand, sent the message that farmers should stand alone, trusting no one but themselves. Co-operatives and proprietary firms were seen as enemies and farmers believed customers were driving down food prices. Competition compels co-operatives to expand and hence to make larger investments. Larger investments entail stricter member control.

When industrialisation changed agricultural production and decreased the importance of the individual farmer and as the concept of vertical integration was established, the first step towards co-operatives as organisations with goals and identities separate from farmer-members was taken. When expanding in size membership becomes more heterogeneous and thus “multiple, sometimes conflicting, social or economic objectives” (ibid.: p.68) exists. Along with industrialisation and growing management control co-operatives were creating a new culture that allowed them to become more similar to their investor-owned competitors. In this farmers became alienated in relation to the co-operative and trust and identity disappeared from the memberships.

3.5 The social side of agricultural co-operatives[12]

Within neo-institutional theory there is a focus on homogenisation on organisations within the same organisational field. Part of this homogenisation is a result of institutional isomorphism. Three types of institutional isomorphism exist: *coercive isomorphism, mimetic isomorphism* and *normative isomorphism*. Common educational backgrounds and informal business networks leading to employees with an increasing professionalisation can explain the latter. Other social groups that are involved in the organisation, for example members of a co-operative, may further explain normative isomorphism. Mimetic isomorphism stems from uncertainty on goals etc. This may force organisations to adopt other organisations’ goals. Isomorphism can work in a congruent and a non-congruent way. Congruent pressures will work in a way that corresponds well with the organisational form.

Members of a co-operative will infuse their values, norms and culture into the co-operative. More over as a co-operative society grows it tends to become more heterogeneous. This entails complexity and uncertainty of goal setting and decision-making. Hence co-operatives tend to be exposed to mimetic isomorphism to a greater extent than non-co-operative firms, particularly since large co-operatives have a tendency to copy the behaviour of large for-profit companies in the same sector.

In the early stages of co-operatives, the numbers were large and they formed a closely connected group. Mimetic isomorphism occurred, which shaped the co-operatives even more alike each other. Today, techno-economic and institutional changes result in large and complex co-operatives operating internationally. Thus co-operatives are subject to non-congruent isomorphism, gradually adopting the practices of IOFs. Not only the co-operative firm is subject to this kind of isomorphism; also the farmers have social networks with others except farmers and farmers who are members of a co-operative.

[12] This section is based on Bager (1996)

3.6 Future of co-operatives: a corporate perspective[13]

The theory of the firm has gained much attention lately. However, it is important not to forget the role of non-corporate forms of organisations. Holmström (1999) compares corporate governance of traditional co-operatives to that of IOFs. He also points at challenges that co-operative firms may experience in the near future.

The capital markets, which have become more liberalised and characterised by innovativeness, are one challenge since co-operatives are locked out from them. Neither members nor financial analysts scrutinise co-operatives' shares since these are non-tradable. This entails investment portfolios that are sub-optimal. As a further consequence, no stock prices will signal when change is needed, and no investors will enforce a restructuring of the organisation. Deregulation may be an external source of change. A major dilemma here is that change is likely to create resistance within the organisation. Change will upset well-established decision mechanisms and it will also cause disagreement between preferences.

Collective decision-making in co-operatives also leads to less efficient portfolios. Democratic processes are particularly slow and costly. Especially in unstable times, conflicts between members will hinder valuable investments. A way of influencing decision-making and also to protect interests of concerned individuals is either by giving people *exit* options or by giving them *voice* (a kind of direct governance mechanism). One must be careful though not to give voice to a very heterogeneous group since it will have difficulties in using it. Homogeneity is, in part, achieved by narrowing the co-operative's line of business. When exit options are plentiful there is no need for alternative options of voice. However, when exit options are poor, there is an opening for co-operatives.

3.7 Interpretation

All theoretical work is based on a number of theoretical assumptions, together comprising a specific paradigm. Hence, this is true also for the five studies, presented above. They have implicit theoretical assumptions, saying that co-operatives have dominantly unallocated capital, are professionalised and complex to such an extent that the members have no longer much to say, are subject to fierce competition by IOFs, and have a large number of alienated members. In the remainder of this study, these assumptions are challenged. It is not necessarily so that the same assumptions apply also in the case of Fonterra. The fact that the Fonterra board suggested a restructuring of the co-operative while the membership was opposed to that plan may indicate that different paradigms may be used when observing the recent development in Fonterra.

It may be hypothesised that the Board was influenced by ideas like those presented above, when it put forward its claims: (1) Due to insufficient capital Fonterra would not be able to deliver its strategy properly. (2) The present capital structure does not allow farmer choice. (3) The present capital structure is exposing the company to unsustainable redemption risk. A solution to these problems would, according to the Board, be reached with the help of a certain degree of demutualisation, implying that external capital should be invited. Fonterra would in this way be able to adapt better to the ever-increasing competition worldwide.

[13] This section is based on Holmström (1999)

As the membership seems to have another opinion, it may be that another set of assumptions existed among members. It may also be claimed that Fonterra in an objective sense deviates from most other large agricultural co-operatives in a number of respects, which means that the aforementioned studies should not be uncritically applied to the Fonterra case. These studies have a few common denominators. They all treat large co-operatives with complex business activities, working in intense competition. In order to survive they have to grow persistently, and the increasingly large size as well as the complex nature result in heterogeneous memberships with low member involvement. As a result the members lose trust in management and the Board. Members become hindered in their control of the company and this leads to dissatisfaction and low involvement.

The specific attributes of Fonterra may imply that the theoretical discussions in the preceding sections do not apply to Fonterra or only limitedly so.

1. Firstly, to mitigate the free rider problem (Cook, 1995) Fonterra has the fair value shares. Since the shares represent the value ascribed to future returns to shareholders from value added activities as well as future earnings from investments and joint ventures, they allow the members to have a better idea of the value of Fonterra.

2. Secondly, in Ireland the transaction costs have diminished because there are plenty of other options for farmers (Harte, 1997). Fonterra is the only co-operative of its size in New Zealand and for most farmers the only firm they can deliver their milk to. Thus, transaction costs would occur if Fonterra did not exist, so there is a need for vertical integration to lessen issues with rising transaction costs.

3. Another consequence of Fonterra being the only co-operative of its size in New Zealand is that no congruent isomorphism will arise and hence the co-operative culture will be strong within the membership as well as within the co-operative society (Bager, 1996). This effect will be countervailed by the fact that there might be non-congruent isomorphism between Fonterra and other international enterprises of the same magnitude.

4. The Shareholders' Council might have solved the issue with management getting much power over the co-operative. The Shareholders' Council will make sure the needs of supplier shareholders are recognised by the Board. The "watchdog" role of the Shareholders' Council may further have the effect of reducing the agency problems (Cook, 1995) within the co-operative, i.e. the power balance between the members and the management will be to the former group's advantage, and The Shareholders' Council will see to it that no unnecessary bureaucracy costs will exist.

The remainder of this study consists of an empirical study, the aim of which is to investigate whether these specificities of Fonterra may be the cause of the members' opposition to the Board's proposal. Hence, the following section specifies what data is needed for this empirical investigation.

3.8 Propositions

On the basis of the account above a number of propositions could be stated:

1. The work of the Shareholders' Council implies that the members feel more involvement in Fonterra.
2. The work of the Shareholders' Council increases the members' degree of trust in Fonterra.
3. The members think that the Shareholders' Council functions well to balance the power of the Board of Directors.
4. Members perceive themselves as owners of Fonterra.
5. The fact that the Fair Value Shares are appreciable is highly valued by the members.
6. If the members consider that there are new business opportunities for Fonterra they would be willing to invest more money in the co-operative, provided that their investments had clearly identifiable property rights.
7. The membership is fairly homogeneous as concerns the interests that Fonterra is to promote for the members.
8. There are relatively few conflicts within the membership as to the business policies of Fonterra.
9. The members feel that their transaction costs when selling their milk would increase if the capital structure was to be changed.
10. Fonterra is not influenced by the way IOFs conduct their raw material procurement.
11. Fonterra is such a large firm in the New Zealand business life that it is Fonterra itself that sets the agenda for the country' dairy industry.
12. The fair value share is considered to be a better valuation tool than the stock exchange.

These propositions are used as a base for the questionnaire for the semi structured interviews. The complete questionnaire is found in Appendix 1. The following two chapters present the investigation and the results of it.

4 Approach

4.1 Visit to New Zealand

The lion's share of the data used in this study was collected during a trip to New Zealand in January 2009. Interviews were carried out all over New Zealand, both on the north and the south island.

Since New Zealand is on the other side of the world the trip was essential for collecting empirical data. Telephone or e-mail interviews would not have provided the same quality of data. It would also have been difficult to achieve the same contact between interviewer and interviewees. The visit was also important for the understanding of the New Zealand dairy industry. To fully understand the industry it takes an insight in New Zealand's economy and the importance of agricultural production. Apart from this insight is was also instrumental to visit farms and speak to farmers about their situation. Even information gained through other sources becomes easier to interpret after the visit.

4.2 Selection of interviewees

At first interviewees were suggested by Ramsey Margolis, Executive Director of the New Zealand Co-operative Association. He was approached with a preliminary project proposal and kindly sent a list of suitable interviewees in Fonterra as well as people outside Fonterra. These people were contacted with the same project proposal and asked for an interview. The final selection of interviewees was thus a result of the initial suggestion made by Ramsey Margolis, my own judgement of the different perspective each interviewee could provide and the possibility to carry out the interview. Often one interviewee told me about another person worth interviewing. Time and geographical distance were the major constraints. A number of interviews were carried out with representatives from different groups in Fonterra as well as other people with insight in the co-operative field. The interviewees are listed in table 1.

Table 1 List of interviewees

NAME	POSITION	ORGANISATION
Blue Read	Chairman	Shareholders' Council, Fonterra
Campbell Shearer	Shareholders' Council	Fonterra
Ramsey Margolis	Executive director	New Zealand Co-operative Association
Earl Rattray	Former Board Member	Fonterra
Catherine Bull	Dairy farmer, supplier	Fonterra
Doug Bull	Former dairy farmer	Fonterra
Tom Mason	Dairy farmer, supplier	Fonterra
Jim van der Poel	Board member	Fonterra
Keith Holmes	Dairy farmer, supplier	Fonterra
John Luxton	Dairy farmer, supplier	Fonterra
Mark Cessnay	Share milker[14]	Fonterra
Alan Robb	Independent financial commentator and Adjunct Professor	Saint Mary's University

[14] 50/50 share milking is a system in New Zealand where a young person buys a herd and then sharemilks on a farm. The owner provides land, milking machinery and housing. They each get 50 % of the cheque.

The interviewees are mainly connected to Fonterra in different positions; the Board, the Shareholders' Council and dairy farmers. Two interviewees are people with co-operative insight outside Fonterra. The interviews focused on the recent capital restructure proposal in Fonterra. The different positions of the interviewees gave a broad perspective of the current process in Fonterra.

4.3 The interviews

All interviews were carried out with a structured question guide. The original question guide for the interviews is found in Appendix 1. Depending on the interviewee some questions were not asked in all interviews. The questions were open and in some interviews lead to further questions.

The interviews lasted for about an hour each and were carried out in different environments, some in the office of the interviewee, some in cafés and some in the homes of the interviewee. The interviewees were located all over New Zealand, both in cities and on the countryside. On permission of the interviewees the interview were recorded and to a great extent transcribed. Interviewees were informed about the aim with the thesis before the interview and most of them had received a copy of the project proposal beforehand. In one case the questions were sent to the interviewees in advance due to the time limit of the interview. Some additional questions have been sent by email to clarify uncertainties.

5 Empirical Findings

5.1 Introduction

This chapter is roughly structured like the question guide and describes the different perspectives of the four interviewed groups gathered during the interviews. A focus has been on the course of event for the recent capital restructure proposal. Further the chapter contains some explanations, gained through the interviews, to the certain stipulations that were put in at the formation of Fonterra. The interviewees are divided in four groups, namely the Board, the Shareholders' Council, dairy farmers and persons with co-operative insight. Hence the different perspectives of the four interview groups influence the views and descriptions in this chapter. The problem background of the study is described in Chapter 1.

5.2 Views of the Board

At the establishment of Fonterra there were two options. One was to have two companies and the other was to create one large company. The Government of that day preferred the two-company option but admitted that it was in the interest of most New Zealand dairy farmers to form a major co-operative like Fonterra. This decision allowed for essentially a monopsony to form but the Government of that day required that some stipulations were added. When Fonterra was formed it included 95% of the New Zealand dairy and the commerce commission of New Zealand required a transparent valuation method before it would sign off the formation of Fonterra as an open co-operative. As a result of this the fair value share was established. A second stipulation that was part of the deal was the Shareholders' Council.

The Shareholders' Council has the purpose of separating the concept of regional representation from the concept of commercial governance of the company. In Fonterra all shareholders elect the directors, whereas wards (regions) elect the councillors. Altogether there are 35 wards that make up the Shareholders' Council.

"This is quite good because even though you get elected through an election process you never want to mix up your roles between representation and governance. As a governor it is your obligation to run the business in the best interest of all shareholders. The Shareholders' Council pays the representative role and should also help inform the Board of issues faced by the farmer shareholders"(pers. comm. van der Poel).

With only nine farmer directors on the Board it is difficult to talk to all farmers. One of the Shareholders' Council's functions is to talk to farmers and help them understand what is going on in Fonterra. Since each ward has one shareholders councillor who also has a number of people working under him or her, a network is created. The shareholders turn to the Shareholders' Council as a group of their representative with elevated knowledge to give them some guidance on difficult matters.

"Most farmers just want to be dairy farmers and do not take an interest in what happens at the Board level. Because the councillors are living in the district they represent and people generally know them they can help to understand the process of what is happening in Fonterra" (pers. comm. van der Poel).

Beside the representative role of the Shareholders' Council another role is to monitor the Board. The Board makes the final decisions but the Shareholders' Council has plenty of responsibility, yet it has not got the authority to make decisions around the governance of the business. However, the Shareholders' Council has quite strong powers and when it does not like what the Board is doing it can call a special meeting to try and solve the inequality in views. The relationship between the Board and the Shareholders' Council can sometimes get a little bit strained and media is sometimes accusing the Shareholders' Council of being lapdogs instead of watchdogs if it supports the Board too much. According to the interviewees from the Board the most powerful way to criticise is behind closed doors, but generally the process functions well.

In Fonterra's history the Shareholders' Council has always given an opinion on constitutional matters and the Board has never gone to the farmers with a proposal that the Shareholders' Council did not support in advance. However, as the Board was forming its view regarding the capital restructure proposal the Shareholders' Council was awaiting the voice of the farmers before revealing its view. A possible reason for this is that the Shareholders' Council thought the proposal was "too hot to handle" (pers. comm. Rattray). If the Shareholders' Council had formed a negative view on the proposal the Board probably would not have taken the proposal to the members.

"The lesson for Fonterra here is that you cannot go to a vote if you do not have the Shareholders' Council s support. You also cannot put a proposal in front of the members if you do not have the Shareholders' Council's support" (pers. comm. Rattray).

Another stipulation formed at the foundation of Fonterra was the fair value share. It was first put in place in order to make sure that those exiting or entering the co-operative are coming in and leaving at a fair value. If the co-operative has grown it has done so with the help of members' capital hence when they leave they are entitled to some of the growth. The negative side of the fair value share is that most co-operatives have to redeem when members want to leave and the co-operative has to find the funds for paying the exiting member. The co-operative is responsible for those who stay. Therefore it cannot have people leaving with more than what they are entitled to and expose the remaining members to risk.

Part of the reason the fair value share was introduced is that it was considered there was still some growth in New Zealand. In Europe there are quotas on dairy production and if somebody wants to expand he or she has to buy quotas from someone else. This is how European farmers reflect the value in their business. Due to the lack of Government support there are no quotas in New Zealand. To find a way for farmers to reflect the value in their business and to make sure that people coming in also paid a fair share price the fair value share was introduced.

What happens in New Zealand is that if farmers are growing their businesses some are buying sheep farms and converting them to dairy farms. They work out the price of the dairy farm, what it would cost them to convert the sheep farm, what the share price is, and how much they can afford to pay for the sheep farm. In this scenario, if the share price is low, they pay more for the sheep farm. This happens at the expense of people that had been shareholders for a long time. The latter group has to subsidise the establishment of new dairy factories.

The value of the fair value share is set by an independent valuer hence it is not the market that sets the value. The valuer looks at Fonterra's ten-year business plans and projections, and then comes up with a value based on that. Then this value is discounted and you get today's value of the co-operative. The valuation is done in March or April and the value is announced in May. If you want to leave the co-operative you have to notify the co-operative before the 28th of February.

Some members might not understand the function of the fair value share and their worry at the moment is that the share price has dropped. One of the main reasons for that is that the environment is different; the markets are taking a hiding because people no longer believe in growth stories because of the recession.

In Fonterra you see a broad range of members but they all have one thing in common, namely the collective control that gives them some market power. The interviewees mention that the directors feel that members of Fonterra quite often distance themselves from the company and do not take much interest outside their own farm business. Many do not show up at meetings.

"*Most farmers just want to be farmers – they want to get up and milk their cows and make sure the tank is coming and that the cheque comes in the mail every 20th of the month. They want to be confident that they have an outlet for their milk and that they get a fair milkprice."(pers. comm. van der Poel).*

According to the interviewees from the Board members see themselves as owners although, in some cases, they are a little too possessive about their ownership in Fonterra. The membership is also quite heterogeneous. Due to the large-scale structure in New Zealand dairy a number of members operate several farms of considerable size where they no longer run the farm themselves. The large milk quantity also entails a large number of shares. Some of the members with a large number of shares still understand the value of the co-operative but there is a growing disconnect between them and farmers with fewer shares.

In 2007 Fonterra went through a capital restructure process resulting in the preferred option mentioned in more detail in Chapter 2. Today all operating functions are still in the co-operative but in the proposal the Board wanted to take the operating functions out and float it, to create a listed subsidiary of Fonterra. Farmers feared they would lose control but according to the Board the purpose of it was to keep the control while having all the commercial benefits of being a listed company.

Part of the reason was that there is a belief that by giving farmers more choice, the gap between the subgroups may be decreased. However, if farmers are allowed to contribute with capital above their milk supply, there will be a need for some kind of trading mechanism and there is a risk of a discount if you restrict the trading to farmers only. The Board is aware that for lots of farmers the co-operative is an extension of their farm but also thinks that if an element of control can be secured there is no need for farmers to be scared of external capital.

Further reasons for the capital restructure were about finding ways to bring in more equity to the company. The Board feels that if Fonterra would start a new growth strategy there would be a need to address redemption risk and capital for growth. At the moment the only ways the company can get (equity) capital is either to retain earnings or subscribe new shares from members. 2008 was the first year Fonterra took retained earnings. This year farmers got a pretty good payout but the year before 70% of New Zealand farmers made cash lost. The difficulty with taking retentions from payout is that it will make the co-operative uncompetitive. By taking retentions Fonterra will give a disadvantage to those who just became members and those who are leaving. Some farmers will argue, and it is likely to stand for about 60% of them, that Fonterra can retain their earnings and invest in the future. When a company like Fonterra is pursuing an investment strategy it cannot afford to pay out 40% of the members. The other reason why retentions have not been taken up until now is that Fonterra has had constant growth. A worry with subscription of new shares a worry is that New Zealand will not increase its dairy production much more because it loses land to alternative use like wine, kiwifruit or life style blocks. Another worry is that farmers now have other options; with new IOFs emerging farmers no longer depend on supplying Fonterra.

In the preferred option the Board said that it believes that there is value in keeping the core business integrated. The benefits of having a strong supply chain will be fully realised only if the business is integrated. If you separate ownership you might not get the same level of benefits. It is also believed that the only way of dealing with redemption risk is by cutting the business long ways meaning the business stays one but allowing external investors to contribute equity to other parts of the business. This will bring in capital and farmers will still own the core business. The Boards sees the key critical factor in that there will always be tension if you have any outside investors or even farmers themselves disproportional to their milk supply and expect a dividend return if you have any doubt about the value of milk. If the milk price is set transparently there will not be a tension.

Farmers pushed back on the preferred option quite a bit because they were afraid of losing control and they realised the risk in having to take their product to the world. The investments in their farms rely on their product being collected, paid a good price for and taken to the market. They see Fonterra or at least the manufacturing part of Fonterra as an extension of their farm.

The Board has its duty to protect the company and align interests between shareholders and the company. If the Board is going to ultimately secure Fonterra’s business with its customers it has to do more than simply collect members’ milk. It has to continue to grow with its customers and to supply them globally. Ten customers around the world take half of Fonterra’s production and to keep these customers Fonterra needs to be able to supply from all over the world to avoid stops in production due to for example foot and mouth disease or drought. The Board’s view is that in order to protect one has to have change.

”No one likes change but change is the only thing that gives you progress” (pers.com. Rattray).

If Fonterra was a simple business one could argue for a nominal share without need for growth. But when it goes beyond being a simple business, the nature of the capital requirements in the business will change. Particularly in a business as large as Fonterra it would be impossible to be relevant in a generation’s time if it didn’t continue make new investments.

“Many of the shareholders do not know the scope of the business that they are in” (pers. comm. van der Poel).

When Fonterra looks at how well it is performing it uses a benchmark against other companies. The Board and the Shareholders’ Council set up a list of what companies to compare with and at the end of the year they compare for example returns. When it comes to things like milk price Fonterra has 95% of the industry and other companies look at it as the benchmark.

5.3 Views of Fonterra farmers

Preceding Fonterra there used to be plenty of co-operatives in New Zealand and if one co-operative disappeared there was always another co-operative not too far away. But as the number of co-operatives decreased the farmer got more dependent on the remaining co-operatives since the options had diminished.

"As companies get bigger the Board becomes less concerned with shareholder issues and more with business management. Hence there was a need for an organisation to truly speak on behalf of the shareholders" (pers. comm. Holmes).

The idea of the Shareholders' Council came up when a team was sent to Europe and America to come up with a solution to the issue with managers getting too much power. Today, Fonterra is not the only co-operative with a Shareholders' Council. Other large dairy co-operatives like Friesland Campina and Dairy Farmers of America have some sort of council.

The Shareholders' Council was established as a performance monitor of Fonterra. Today the Shareholders' Council also functions as a representative body that makes sure farmers are represented in the Board. All councillors represent a certain ward in New Zealand, and they will convey viewpoints of its farmers to the Board.

"The Shareholders' Council has become a little bit of a watchdog, a challenge to the Board" (pers. comm. Luxton).

Compared to in the past, when all members were at the same meeting, an annual general meeting is today done by videoconference, which gives the chairman the opportunity to cut people off. A person who wants to change something has to do it before the meeting. Because the Shareholders' Council represents the members in the Board it also creates a less direct involvement to what it used to be when people went to the meetings.

There used to be a more open communication between the directors and members but today less people will ring up their local director and complain. Nowadays some members feel that going to the meeting is a waste of time. When you are one of 11,000 shareholders you do not have a great say. This is exemplified by one of the interviewees who mentioned that 200 of the largest connected individuals control 50 percent of the milk in Fonterra.

"*25 years ago when I was farming in Taranaki and supplying milk to Kiwi, if there was a dairy meeting (we were sort of on the main road) everyone would pass us to go to the meeting. And farmers were a lot more involved when the company was smaller and they could relate to it better. There is certainly not that involvement now" (pers. comm. Mason).*

Fonterra's head office is in Auckland and members rarely see the executives. Parts of senior management are not familiar with the notion of a co-operative as a financial organisation. There is a worry among farmers that the Board and executives do not understand farming and what farmers' business is about. A further worry is that some directors will not be challenged by potential new directors in the co-operative and will hold power at any cost rather than looking at the health of the co-operative.

Fonterra has become so large and complex that most members do not know in detail what Fonterra is doing internationally or how it performs. The Shareholders' Council has to make sure that the information given to the shareholders is an accurate reflection on what is happening in the company. The Shareholders' Council also mitigates the tension between the members and the Board and does the debating that is normally done in a village hall or at an annual general meeting. A problem mentioned by one member is that it is difficult to find a category of people for the Shareholders' Council who have the ability to be independent thinkers.

"Fonterra has become big and complex; hence the issues have become difficult to grapple with. As a result there has been a certain amount of passing the buck to the Shareholders' Council" (pers. comm. Holmes).

During the capital restructure process the Shareholders Council did not make a decision itself, instead it waited for a response from the members. The response from telephone surveys showed that approximately 85% of the members did not like the proposal and shortly after the Board postponed the vote. However, members believe that the Board still wants to change the capital structure of the co-operative. Thus members feel that Fonterra is not always honest with them and listening to their views and the communication from the Board is not always sufficient. Due to this members have not got much confidence in the Board and its policies.

"The next thing in the media is that the proposal is off the agenda because the shareholders do not want it. Then you read in the paper that the chairman of the Board is saying it is back on the agenda, which means he has ignored the voice of the shareholders" (pers. comm. C. Bull).

From the farmers there is also an element of mistrust in the Shareholders' Council. Some members feel that the Shareholders' Council listens too much to the Board and members feel powerless.

"Instead of being a watchdog on behalf of the shareholders, the Shareholders' Council becomes a puppet for the Board" (pers. comm. C. Bull).

In general farmers think that the Shareholders' Council is a good model to protect the shareholders and it seems like when Fonterra is in trouble it realises that it has got a real job to do. In 2008 one member of the Board did not get re-elected, which is a way for the members of having a say. To make any significant change the Board has to get 75% of the votes from the members and that is how members can stop it from changing. A concern expressed by one member is that it is hard to get competent people to the Board because New Zealand is at the end of the world.

Regarding the proposal farmers fear they would lose control and that if they let go it will be the same as listing the co-operative. Some do not think a co-operative can stay partially demutualised and hence those made it very clear that they were not happy with the proposal. To some extent it is the same debate that went on at the inception of Fonterra about whether to demutualise or not. Some farmers agree with the Board that members have to be given choice if they want to take place in the business outside the core functions or not. Further they think that the core functions have to remain a co-operative. Farmers want to own the processing plants and the infrastructure to get their product to the market. A worry expressed by one farmer is that New Zealand is too far away from other co-operatives in e.g. Europe that have gone down the same road. Hence farmers in New Zealand cannot see the result of what a new capital structure would entail.

A further reason for having the fair value share was that New Zealand Dairy Group drove the process of the fair value share and it was trying to address the risk of a corporate takeover if having an undervalued share. Another view from the members is that the fair value share was introduced as a result of a report from McKenzie where it was stated that more capital was needed to grow Fonterra's brands internationally.

The valuation process is quite complex but it is a reasonable measure of the performance of the business. At one stage the fair value share almost reached seven dollars. A high value makes it very hard for young farmers to enter the co-operative and the ones who still managed to enter made a huge loss when the share started to go down. A high value of the fair value share also becomes an incentive for people to redeem their shares and find another partner. However, members feel that if only Fonterra were treating them as owners and perform better than other companies they would have no obvious reason to leave. A further issue with the fair value share is that it entails investing a large amount of money in one company. The part of Fonterra that farmers need is the part that gets the milk picked up, processed, marketed and being paid on the 20th each month.

"A very important issue is that we are not in it for the investment nor for a return on our shares. We are in it for a return on our milk" (pers. comm. D. Bull).

An additional stipulation from the foundation of Fonterra, which is a peculiarity for New Zealand, was that a proportion of the milk Fonterra collects should be sold at the cost of the milk to enable competing dairy companies to start up. This is still going on and is now becoming a major worry for Fonterra since new IOFs are starting to form in New Zealand.

A further dimension to this issue is that since Fonterra has the same transfer cost right across the country (in wintertime the ones far away from the factory has to pay more) the IOFs base themselves in dairy concentrated areas and say that they will collect milk within a certain distance. Hence they are able to pay more than Fonterra. According to one of the interviewees the Board has looked at having some kind of transport differential. Another, and possibly greater, redemption risk is drought Because of the most recent drought Fonterra changed the rules and said that if farmers left their shares in the co-operative Fonterra would pay them the difference in price of the share between the year before and the year of the drought. In this way Fonterra did not have to redeem the shares that farmers no longer needed because of a drop in production.

Traditionally in New Zealand there has been a strong support for the co-operative movement. This entailed a rather homogeneous membership. Earlier with several co-operatives in New Zealand a "we against them" feeling was created. Nowadays, competition is off shore and dairy farmers no longer see the competition and feel the "we against them". In recent time there has been a lot of outside investment coming into the dairy industry, among them large corporate farmers who have a more commercial view of the world than the traditional small-scale dairy farmers. Farmers range from milking 150 cows (the average herd is 350 cows) to controlling over 10 000 cows in the largest dairy holding. Concerning attitudes among

Fonterra’s members, there is quite a regional difference. In some regions you find a much more business-focused attitude, implying that farmers want the co-operative as long as they get paid and the milk is being processed. In other regions people are more historically emotional and look to the social aspects of co-operatives. The dairy industry is also more diverse than it was 25 years ago.

The one thing all Fonterra farmers have in common is that they all produce milk and supply capital to get their milk processed. Apart from that they all have a different approach to farming; herd size, level of debt and also an individual picture of what a dairy co-operative’s raison d’être is. It is hard for a co-operative to be all things to all people.

“What I want from Fonterra can be quite different to what someone else wants” (pers. comm. Mason).

Some farmers say the idea with a co-operative is about meeting the collective need of its supplying shareholders, which in Fonterra’s case is adding value to members’ milk. Some members think that it makes sense for Fonterra to extend the supply lines and enter new markets, because the closer you can get to your consumer the higher margins you will get long term.

At the moment ownership in Fonterra entails guaranteed milk collection. Some farmers believe that if Fonterra stopped existing it would be the death of the dairy industry in New Zealand. Compared to the forest industry, dairy farmers cannot wait another year before they cut down the tree; they depend on having their milk picked up every day. If Fonterra broke down it is believed by some farmers that within half a generation another co-operative would start forming.

“Perhaps it is part of the evolution for a co-operative to form, grow and dissolve” (pers. com. C.Bull).

A few members believe that the co-operative structure is out of date. If there is a marketplace with many options it doesn’t matter if a co-operative or an IOF owns the processing plant because there will be a competitive market. However, the IOF is going to pay only what it has to in order to fill the factory in order to maximise its profit. Initially this will entail a premium price for the farmer, but in the long term the IOF will try to lower that price.

Fonterra is benchmarking with other similar dairy operators in the world especially in its consumer business. In some cases Fonterra also compares with other New Zealand co-operatives and tries to explain why Fonterra’s payout is less than others. With a lower pay out and no fee for the share an IOF becomes attractive to some members. Fonterra offered farmers contract milk where farmers could deliver milk on a contract without becoming members of Fonterra. With a weak balance sheet a co-operative cannot afford members to leave and capital becomes critical, hence Fonterra no longer takes on farmers on contract. So farmers benchmark against other farmers from different companies, both co-operatives and IOFs.

5.4 Views of the Shareholders' Council

The role of the Shareholders' Council is written in the constitution and is to make sure farmers are represented in the Board and that the Board and the company are performing well. It is also responsible for making sure that Fonterra follows the constitution. The interviewees from the Shareholders' Council think that it is important to constantly remind the Shareholders' Council about its obligations. If the Shareholders' Council is able to follow its duties the interviewees think that trust from the members will evolve.

The councillors think that it is a privilege for the farmers to have a group of people who have access to more information than the average member receives. However, due to the fact that the Shareholders' Council will represent farmers in the Board there is a certain degree of less involvement from members than what would perhaps have been the case without a council.

"A lot of the farmers abdicate the responsibility of involvement in Fonterra to the Shareholders' Council or council member" (pers. comm. Read).

During the capital restructure process the councillors attended meetings that the company held and formed opinions about the new direction the Board was suggesting. The Shareholders' Council took a neutral stand to it until they had gathered enough information from the members by formal surveys and discussion groups. From this gathered information the Shareholders' Council then knew that neither the members nor the Shareholders' Council were happy with the proposal.

"We were not promoting or negating the proposal but we were making sure that people understood the particular new parts of the proposal" (pers. comm. Shaerer).

When dealing with complex matters like capital restructure the Board and the Shareholders' Council do a lot of debating behind closed doors. The Shareholders' Council will later inform the farmers about the situation as well as tell the Board about members' opinions. From time to time this process becomes destructive. This will damage the trust members have in the Board and in the Shareholders' Council. Members' confidence in the company has been tested in the past year due to the capital restructure process.

The interviewed councillors also point out that if there were no council to convey the information to the members so called ginger groups would emerge (there are some in Fonterra at the moment). These are self-appointed people with a special interest that will congregate together. They gather information and try to make change in their own interest. According to the councillors they do more harm than good to the company in many situations.

The traditional view of a co-operative has been the intergenerational, a dollar in, a dollar out. The interviewees think that the majority of the Shareholders' Council is sharing this view. However, not all of the councillors agree on it. The Shareholders' Council therefore puts a lot of effort on defining what Fonterra as a co-operative is and the intention is to strive for that set of values and understanding.

"A lot of people tend to forget that the company exists for the shareholders and the shareholders do not exist for the company" (pers. comm. Read).

The interviewees from the Shareholders' Council think that members' views on why the co-operative exists are quite diverse. New Zealand has a long history in co-operatives in dairy; some people were brought up with the co-operative mentality and therefore understand the benefits. However, some people are just buying farms to have it as their lifestyle and some people have it purely for business. All members have one thing in common and that is being farmers. Apart from that there are huge differences within the membership. Farmers depend on having their milk being picked up every day because the product will go bad after 15 minutes. At the moment there is a generation of farmers in New Zealand who has not had to live through hardship and thus do not realise the strength of a strong co-operative. Fonterra has a tough year ahead, which might lead to an increased insight for this generation.

Today part of the valuation of the fair value share is based on the cash value where most of it comes from the value added part of the business. The valuation also includes the market multiples where the valuer compares with other international firms. An issue, according to the interviewees is that the way the fair value share is calculated can cause members leaving with a value that is too high. A further issue according to the interviewees is that some of the small farmers get disenfranchised with the existing voting system where shares are in proportion to the farmer's milksolids.

"A fear today, and it is not far for Fonterra, is where the shares are in the hands of too few" (pers. comm. Shearer).

Until recently the fair value share has appreciated and as a result of the high value small farms has not rationalised in time. As been shown lately the fair value share is not only appreciable, it is also depreciable. The interviewees say that some members seem to be confused with the valuation going up and down and there is a lack in understanding of the methodology that is employed for the valuation of the fair value share. When people who do not know farming make decisions about matters concerning farmers one risk is having a faulty decision made and a personal view from the Shareholders' Council is that the valuation methodology was a mistake.

"I do not think farmer wanted the fair value share at all because 90% of the value is represented in your farm and the facilities that the factories have. Not in the value added parts of the business" (pers. comm. Read).

The situation at the moment in New Zealand is that people are farming on marginal land. Lately land and stock prices have been astronomical and anybody that became a member in the last couple of years is finding that they are in deep trouble because they paid a large amount for the land as well as that fair value shares. These people are probably more willing to leave Fonterra and invest elsewhere.

The fact that recent members have made large investments and also lost value from the fair value share will differentiate farmers as a body concerning their capability to invest in things outside the core business. Close to two and a half billion dollars has evaporated from the balance sheet after the two past valuations. At the moment there has been no opportunity for farmers to contribute with capital for a specific purpose investment and farmers have been asking for a chance to contribute. In February or March (2009) Fonterra will issue a bond, which will be open to the public. At the time of the interview no system of doing it had yet been set.

In an IOF profit generates performance among members. Co-operatives are not trying to maximise profit and hence profit cannot be used to generate performance in co-operatives. Another aspect for New Zealand in particular is that all profit is heavily affected by exchange rate and commodity prices over which the employees have little control. Here the fair value share and the structure of the milk price have an advantage since it allows creating some sort of stable recognition of profit.

Fonterra has procured milk in a more commercial way in Australia and according to the interviewed councillors there would be a 15 % higher cost in procurement if the business was not integrated. If you change the structure to a more corporate structure like in an IOF the tension would rise on milk price and there would be a discreet incentive to minimize the milk price. To avoid the tension the milk price has to be set transparently and therefore Fonterra is working on a new milk price process. If you cut the business horizontally (the business stays one but external investors contribute equity to other parts of the business) the tension would also abate. But it is not until the new milk price process is put in that an eventual difference will show. According to the interviewees one reason that the proposal foundered is because there is a desire to recognize the entire value in the co-operative and have a tradable share.

Fonterra's future path will be about evolution and seizing opportunities and deciding whether to stay as a vertically integrated business. The core business is the most important and Fonterra needs to give farmers choice if they want to be part of the added value side of business. The view from the interviewees is that there is a lack of understanding what co-operatives are and that co-operatives are absolutely necessary to preserve the substance of the farm. Fonterra has competition coming up, from IOFs within New Zealand as well as from low cost producers all over the world.

"The issue that will always challenge co-operatives is how to continue to provide a motivation force for growth for its members" (pers. comm. Shearer).

5.5 Views of people with co-operative insight

When Fonterra was formed it was through the merger between Kiwi Co-operative Dairies, the New Zealand Dairy Group and the New Zealand Dairy Board. The argument was that with totally free markets and specializing in one area New Zealand and Fonterra could dominate the international dairy industry and initially the merger was given the code name global dairy. Tatua and Westland were invited to join but they both wanted to stay out of it.

During the capital restructure process the Shareholders' Council commissioned a report about what farmers thought about the proposal. The response was overwhelmingly negative, which the Shareholders' Council then conveyed to the Board. The report made the Board realise that it could not get away with what it wanted, than the Board realised the proposal was not as good as management had been saying. At one stage tension between management and the Board got so bad that the Board brought in a mediator to try to restore the relationship between the management and the Board.

According to one of the interviewees, reports from the Shareholders' Council have been informative compared to reports from the directors. The Shareholders' Council has been very good at communicating with members and they have told the farmers about issues or concerns within the co-operative. There is a worry that the Shareholders' Council will be intimidated and told by the Board that it is not good for the co-operative if it makes public statements.

"The Shareholders' Council is a wonderful voice for farmers to make their views known to the Board, and it is inevitable that members are more involved because of the Shareholders' Council and if it was not there Fonterra would probably have been demutualised by now"(pers. comm. Robb).

The fair value share was established to make Fonterra function like a public company where members could exit by easily selling their shares. The idea was to have a "fair" value, but whether it is fair or not really depends on how you calculate it. Today, the valuation is based on an expectation of earnings and not the assets in the business. This means that farmers who are leaving today are taking out a greater share of the business than the remaining farmers could possibly get if the business was liquidated and members were all paid out proportionally. The fair value share thus provides the opportunity for some members to enrich themselves at the expense of others. The fair value share also increases redemption risk in Fonterra.

"The fair value share becomes an investment with an expected increase in value. Whereas with a nominal share the invested amount is seen as a contribution to capital needs" (pers. comm. Robb).

Lots of non-elected directors have no knowledge of work in co-operatives, which becomes an issue if you get these people on your board. There is a worry that some Fonterra directors are not committed to keep Fonterra as a co-operative. Instead, it is argued, Fonterra should be bringing in external directors with more knowledge about co-operatives such as people from boards of other co-operatives. According to one of the interviewees, business advisors also seem to be lacking knowledge about co-operatives. These people might also have financial interests to bring about mergers and growing companies as well as co-operatives since they have fees for doing it.

According to one of the interviewees, farmers today are more business aware then they were a generation ago. Compared to 20 years ago when everything was sold through the Dairy Board they probably take more interest today. In Fonterra, you find both family farmers and corporate farmers. The latter will pose a real tension for Fonterra since corporate farmers want things only on economically rational grounds whereas the other side will also look at it from a community point of view. Family farmers have often been on the farm for generations and they know what happens when there is a downturn. The corporate farmers on the other hand are more likely to sell off an operation and move into something else because they are more concerned about capital growth. The Shareholders' Council plays a very important role in protecting the smaller farmers.

Even though farmers of today are more business aware, most dairy farmers in New Zealand have to borrow from the bank or someone else in order to set up their business. They might appear to be rich, but a lot of it is debt. People get into dairy farming knowing that they will be in it for the rest of their life (almost). Hence, it is difficult for most farmers to come up with more capital for the co-operative. One alternative for members of a co-operative is to bring in investor shares. New Zealand law allows for a co-operative to bring in up to 40% investor shares. Four co-operatives in New Zealand have done this but not all have been very successful. Non-transacting shareholders want to maximise their return on capital, which can be achieved by reducing the payout on milk.

"One of the executives of one of these co-operatives says it is a complete nightmare, because you get conflicting interests. The growers want the best return for their produce and the investors want the best return for their investments" (pers. comm. Margolis).

As mentioned by one of the interviewees, one large accounting firm did a review on co-operatives in New Zealand. Through a literature search, it came to the conclusion that there is never reported any evidence that co-operatives have difficulties in raising capital. It seems to be a story used by those who want to demutualise a co-operative. One option to raise equity capital, for instance, could be to let farmers subscribe for shares and pay them off over a five-year period.

What generally is happening in New Zealand is that when a dairy farmer sells his farm, the buyer will also deliver to Fonterra. Now, however, a number of investor owned companies are entering the market, setting up milk processing plants. Since Fonterra is the price setter, the new companies will offer a higher price. If the farmer follows a short-term view he or she will go with the better-paying IOF. If the farmer is in it for the long term, it will be better to go with the co-operative because there will be benefits from being an owner. The IOF might be able to perform better at the start but later they will try and lower the payout because that is where they make profit. Since Fonterra has high fixed costs, the IOFs pose a threat when they take away volume for Fonterra. Another challenge for Fonterra is that New Zealand has a long way to transport its products. As consumers are starting to count air miles involved in the products and want local products, distance becomes a real challenge. In the initial scenario where the argument was that New Zealand could dominate the world in dairy, transport was seen as a negligible cost. Perhaps this is now showing to be false.

6. Analysis and discussion

6.1 Introduction

The aim of the empirical study is to investigate whether the specificities of Fonterra may be the cause of the members' opposition to the Board's proposal. This chapter tries to give an answer to this question in theoretical terms, presenting an analysis of the four specificities denoting Fonterra; the fair value share, isomorphism, transaction costs and The Shareholders' Council using the theoretical concepts presented in Chapter 3.

6.2 Fair Value Share

The merger of two co-operatives and the New Zealand Dairy Board created Fonterra. This was from the start already a large and complex co-operative. Therefore the first stages in Cook's (1995) life-cycle model are not relevant for Fonterra. Some of the issues stemming from vaguely defined property rights already existed before the merger, which corresponds to stage three in Cook's model. Eight years after the formation the Board and management have reached stage five (reorientation) and choose the second option in the model, continuation, by seeking external capital through a publicly held subsidiary. However, by rejecting the proposal for external capital it seems like members are not ready for reorientation. At least they are not ready for the type of reorientation proposed by the board. An alternative explanation is, according to Holmström, that change will create resistance. This is in line with a suggestion made by one member of the Board that change is not popular among members.

At the formation of Fonterra the fair value share was established as a way of mitigating the free rider problem when people are entering a co-operative with a large collective capital. Today, the inside free rider problem is said to create an intergenerational conflict that results in existing members being reluctant to invest (Cook, 1995). Added to this, co-operatives are said to have difficulties in convincing members to invest. However, from this study it is clear that current members do not seem to be reluctant to invest in Fonterra, at least if it is for processing members' milk, which is in accordance with proposition number six. Further proof for this is that a study of co-operatives was mentioned in one interview and according to this study it has not been proved that co-operative enterprises should have any difficulties in raising capital (pers. comm. Robb).

Members of Fonterra have not so far been asked for capital for investment. The fact that Fonterra has had constant growth in milk supply and thereby growing assets, might explain why members have not yet been asked. Considering investments regarding processing non-members' milk, members do not seem to be interested in contributing capital. Fonterra's strategy of supplying customers all over the world and therefore the need to process non-members' milk has created a tension between members and the Board. Membership seems to be fairly homogeneous concerning which interests it wants Fonterra to promote for it, namely adding value to members' milk. Concerning Fonterra's business policies the membership seem to agree that some of Fonterra's policies are not in accordance with what the members want.

The fair value share will also cause a free rider issue in adjacent industries. It was mentioned by one of the interviewees that farmers in for example lamb or beef industry can act as free riders, because when the share price is low they get a higher price for their land. The sheep farmer has contributed nothing but he or she sells the land to a dairy farmer and receives more money.

The appreciation of the fair value share has entailed a high entry fee. Due to this people will consider before they buy shares in Fonterra. But, if potential members find other options more attractive, the high value of the share instead creates an incentive to supply IOFs, where no entry fee is required. This can be compared to stage three in Cook's model where members scrutinise their costs of transacting with the co-operative. Some members in Fonterra came to the conclusion that this cost was too high and decided to deliver on a contract without buying shares. The fair value share was brought in to solve the free rider problem but the problem now is redemption risk and the fact that people see the value as an entry barrier and an incentive to leave. This redemption risk was one of the issues that the Board was trying to address with the recent capital restructure proposal.

Moreover, by this new system, a person that leaves the co-operative gets his or her fair share of the value that has been created during the time in the co-operative. This system is therefore a way of dealing with vaguely defined property rights in a co-operative.

According to Fulton (1995) a problem in co-operatives is that members cannot access the value they have participated in creating. The fair value share system can be seen as a way of dealing with this. An issue with the valuation of the fair value share is that the value members get when leaving the co-operative is more than what all members would get if the co-operative were to be liquidated and the value evenly distributed among members (pers. comm. Robb). This means that the share is contributing to a form of asset stripping and will not be sustainable in the long run

Compared to a nominal share with a lower value the fair value share does to a greater extent contribute to the portfolio problem (Cook, 1995). Right from the start members have to make a large payment. Hence, if the Board takes on a risk preference that does not match the individual; the dissatisfaction can be expected to be even bigger. When supplying large quantities of milk the farmer has to buy a lot of shares and membership becomes a pretty risky investment strategy (pers. comm. Mason). But to some extent the fair value share can also be said to mitigate the *portfolio problem* because it holds an appreciation (as well as depreciation) method. However, since the valuation method is not clearly understood the question is to what extent this is actually happening?

Most members of Fonterra are in the co-operative for the benefits of being member of a strong co-operative. When they have to invest large sums in the fair value share Fonterra becomes almost like an investment co-operative. This is something most members are not interested in being part of. The issue for some farmers does not seem to be raising capital for growth but rather aligning farmers' interests with the interests of the Board and management.

Co-operatives enterprises lack a stock price that can signal when change is needed, which Holmström (1999) points out. In Fonterra the decrease in the fair value share probably signals that some kind of change has to take place. So, the fair value share has had some effects that are of help. The problem is that, so far, proposed change has met resistance. This might be because there is no mutual way of defining the signal and what kind of change that is needed. A subsequent problem caused by this lack of mutual interpretation is that members will probably be even more reluctant to accept change, because the trust in the Board and management is at an all time low. When the fair value share appreciates members seem to be happy about it but when the value goes down the fair value system and the high value is subject to dispute.

Since the fair value share is in proportion to the milk quantity it enables members who run large-scale operations to empower themselves on behalf of smaller members. Therefore the fair value share system amplifies the growing disconnect between the needs of the different groups within Fonterra.

To sum up, for members who understand the valuation method of the fair value share it may help them to have a better idea about the value of the co-operative. However, since many members do not fully understand the method the share does not fulfil the purpose entirely and thus cannot be seen as a better valuation tool than the stock market. Further the fair value share solves some but also causes new free rider problem and portfolio problem. Members of Fonterra do not seem to perceive identifiable property rights as a problem. As long as Fonterra wants to invest in relevant objects, members seem to be willing to supply capital.

6.3 Transaction Costs

If Fonterra allowed external capital, new owners would be brought in. For a start it would be hard for farmers to know the new owners' intentions. Most members perceive a coming conflict between different interests on the milk price. The level of uncertainty and therefore also transaction costs would rise. If the transaction has to take place every day, like in dairy, the seller cannot accept deceitfulness to a great extent. The probability of transaction costs and thereby also vertical integration increases when an actor has made high transaction specific investments (Harte, 1997). To enter dairy one has to make large transaction specific investments. If the company is aware of that this is the only option for the farmer, the company can use this to lower the price paid for the milk. The farmer depends on the milk being picked up every day, hence dairy farmers risk finding themselves in a classic hold-up situation. By transacting through Fonterra farmers will remove the threat of a hold-up situation, as long as Fonterra stays a well functioning co-operative.

In New Zealand the number of co-operatives has gone from around 400 in 1935 to four in 2001. This development has diminished farmers' options radically as well as increased the transaction cost. Most members in Fonterra are not interested in leaving the co-operative and instead some of them are trying to use their voice to change what is happening. According to Harte (1995) one must be careful before giving voice to a heterogeneous group because they might not be able to use it in the right way. In Fonterra certain ginger groups are emerging, striving for personal interests. This can be interpreted as a result of the influence cost problem (Cook, 1995) or if members are unhappy with the co-operative's asset portfolio a case of the portfolio problem.

In New Zealand a number of IOFs in dairy are starting up. From the interviews it is clear that Fonterra still is the only geographical option for most farmers. In Ireland dairy farmers have plenty of options and hence the conversion of some Irish co-operatives to public companies with co-operatives as controlling shareholders has benefited farmers (Harte, 1997). However, what has happened in Ireland, where the appearance of more options has lowered the need for a co-operative, is not yet happening in New Zealand. There are farmers with more options than Fonterra and if the share continues to depreciate some farmer might be willing to start up their own business.

According to Cook (1995) farmers start to scrutinise their short time cost of transacting with the co-operative, as the price difference with other IOFs becomes smaller. By taking milk on contract Fonterra took one step towards the way IOFs procure their raw material. Farmers in the process of scrutinising their costs were also provided an easy option to test the IOF alternative. Farmers who delivered some quantities on contract got closer to the option of delivering all their milk to an IOF (pers. comm. Mason). Some farmers would benefit from delivering to an IOF. However, these realise that they would benefit if Fonterra would still be there to keep the IOFs honest.

In today’s society it can be claimed that better technology in transportation would decrease the need for a co-operative (Fulton, 1995). Although some dairy farms in New Zealand are of a very large scale one has to remember that New Zealand is very far away, and depend on being able to take its milk to the rest of the world. In the interview the Board said that this is better done through a co-operative where farmers are still in control. From the interviews it is also clear that farmers are afraid of losing control and going down the same road as Kerry has done in Ireland.

If the farmer’s option only is to supply an IOF, the IOF will only pay what it needs to fill its factory. Further the IOF might act opportunistically and use the situation to lower the price it pays for the milk. This will put the farmer in a vulnerable situation and it will entail higher transaction costs (cost of negotiation). As a co-operative, Fonterra can be expected not to act opportunistically. If external investors were allowed tension between the two different kinds of shareholders, farmers and external investors, would appear and is likely to increase the cost of negotiating for example the milk price. As a result of this the setting of the milk price is undergoing change. As mentioned by the Shareholders’ Council a transparent milk price is essential to avoid tension between the different types of shareholders.

In this study it has been difficult to estimate how much transaction costs would change but if the business was to be cut horizontally one could assume that transaction costs would rise in between the subsidiary and the co-operative. A suggestion given by the Shareholders’ Council is that a more corporate procurement in Australia entails around 15% higher transaction costs. This could give an indication on what would happen in New Zealand if a more corporate procurement was undertaken. Therefore there is still a need for vertical integration in New Zealand to keep transaction costs low.

6.4 Shareholders’ Council

Agency problems or problems with vaguely defined property rights occur to a greater extent in large and complex co-operatives (Cook, 1995). Fonterra was, right from its inception, a large and complex organisation. Since members have no chance of understanding everything that happens in the boardroom the Shareholders’ Council was established to deal with some of these issues.

Further the large collective capital might entail that members lose interest in and ability to control the co-operative association (Cook, 1995). As a result of the members’ lower interest management will run the company their way. Some members feel powerless shrug their shoulders about their situation. However, with the suggested proposal the Shareholders’ Council played a great role and, according to some, it stopped the proposal from going through. Is clear that Shareholders' Council functions well to balance the power of the Board, and that members still have a chance of stopping unwanted things from happening.

From the interviews it can be concluded that parts of the Board seem to have wanted the capital restructure and did not care so much for the co-operative structure. One can guess that it could be because co-operative managers, just like corporate managers, strive for goals as growth maximisation stemming from various theories of the firm. Members wanted to remain in control of their milk processing plants and the opinion of most farmers in the interviews was that they want to be farmers of Fonterra not investors. This is a typical control problem situation with different interests from members and management (Cook, 1995). Because the Shareholders' Council is appointed to follow up on managements' work it is much more up to date with what is going on in the co-operative. Hence the control problem will be reduced in Fonterra. The Shareholders' Council is therefore a great protection for the shareholders. However, a tendency for less involvement from the members can be distinguished. Members know that the Shareholders' Council is responsible for making sure that they are represented in the Board and thus feel that they do not have to be as involved.

To what extent the ginger groups manage to change decisions is hard to tell but the view from The Shareholders' Council is that it does more harm than good. In cases like this it is important to have a council who has the correct information and from that piece of information can make a correct statement. When functioning well the Shareholders' Council is the voice for the members. However, The Shareholders' Council cannot attend to every single member's wants. Since exit options are still poor for most members there is a strong need for a co-operative and thereby a strong reason for Fonterra to continue as a co-operative (Holmström, 1999).

Fonterra is doing business in most parts of the world, which means many different markets. It is also obvious that Fonterra consists of a broad range of members with different interest concerning Fonterra's business policies. Lately more corporate farmers are becoming members and dividing membership in two groups. When expanding in size membership becomes more heterogeneous and thus "multiple, sometimes conflicting, social or economic objectives" exists (Hogeland, 2006). Through the proposed option the Board wanted to provide members with choice regarding investment opportunities as a way of dealing with the two groups. The members did not perceive this in the way the Board wanted and the proposal foundered. This is a clear sign that members still perceive themselves as owners of Fonterra and still wants to keep their co-operative.

In Fonterra's case it is clear that the management's strategy to grow in foreign markets is not in coherence with what the members want. The growth strategy the Board has been pursuing with goals like growth maximisation is something management wanted but not the members.

6.5 Isomorphism

Concerning congruent isomorphism Fonterra is the only co-operative of its size in New Zealand. Before when there were lots of co-operatives all over New Zealand there was more of a "we against them" competition going on that would have strengthen the co-operative ethos. Even though there was competition between the co-operatives the support for the co-operative movement was strong and it resulted in mimetic isomorphism that shaped the co-operatives assembling each other (Bager, 1996). Today competition is off shore and it will be harder to create that sense of unity. Mimetic isomorphism will therefore not occur.

In recent times there has been a lot of investment in the dairy industry and more corporate farmers are now supplying Fonterra. Added to this a lot of IOFs are starting to form in New Zealand. This will lead to the same process as with co-operatives with mimetic isomorphism shaping the organisations towards a more corporate form. Coming back to the fact that Fonterra is the only co-operative of its size, some benchmarking towards IOFs of similar magnitude is used for example in its consumer business. This will enhance the non-congruent isomorphism. If the non-congruent isomorphism will transform Fonterra is difficult to say, but certainly there are persons in the Board that has a more corporate mind and those will definitely amplify the process.

As mentioned above, there used to be a very strong support for the co-operative movement in New Zealand. However, since New Zealand is so far away from Europe and the US where lots of co-operative knowledge is gathered, it is hard to get people with suitable knowledge on the Board (pers. comm., Mason, Holmes). This entails that people on the Board might not have enough knowledge about co-operatives to run Fonterra in the most efficient way for a co-operative. Instead it will be run more like a corporate company, which will make it harder to keep the co-operative structure.

7. Conclusions

The specific attributes of Fonterra mentioned in 3.7 may imply that the theoretical discussion in this thesis do not apply to Fonterra or only limitedly so. On the basis of the specific attributes a number of propositions could be stated. An attempt to answer these propositions follows.

- The work of the Shareholders' Council implies that the members feel more involvement in Fonterra.

According to the theory large co-operatives have a large number of alienated members. Even if this seems to be the case also in Fonterra, with some members feeling despondent, considering this proposal members did take action and showed that they were not happy with the proposal and that they did not want to lose control over their co-operative. Whether this is due to the Shareholders' Council or not is more difficult to say. In some ways the work of the Shareholders' Council will cause less involvement from the members. Members feel safe knowing that the Shareholders' Council will make sure that the shareholders interests are being looked after and hence put some of the responsibility on the Shareholders' Council.

- The work of the Shareholders' Council increases the members' degree of trust in Fonterra.

The Shareholders' Council cannot protect the relationship between the Board and the members in all situations. Some things the board does will inevitable harm the trust. When membership grows and interests are becoming diverse trust and identity has disappeared from some co-operatives, as stated by Hogeland. This does not seem to be the whole truth in Fonterra and the Shareholders' Council functions well to keep the identity of the co-operative.

- The members think that the Shareholders' Council functions well to balance the power of the Board of Directors.

It is stated in theory that members no longer have much say in large co-operatives. The Shareholders' Council functions well to align the interests of management and members as well as assessing managements' work. Members of Fonterra believe that by changing directors they can still control, which happened in the last election where one director did not get re-elected. By being well informed the Shareholders' Council reduce agency problems, which in turn will help keep the co-operative structure.

- Members perceive themselves as owners of Fonterra.

The impression from this study is that most members feel that they are the owners of Fonterra. It also seems like they want to remain owners and in control of the processing of their milk. They are very aware that if their milk is not being picked up all they produce is of no value. Even if the restructure predicted economic benefit, members do not seem to want to be part of that. Some members are open to other solutions than a pure co-operative as long as the core business stays a co-operative. The question whether a pure co-operative can survive in today's society remains.

- The fact that the Fair Value Shares are appreciable is highly valued by the members.

The positive side of the fair value share is that it, to some extent, deals with the free rider problem. The value of Fonterra's fair value share is high in relation to some co-operatives with a nominal share and hence creates an entry barrier. The entry barrier has lately become an issue when new farmers find it hard to enter the co-operative. At least according to the theory this should give the co-operative a better chance at surviving. However, since Fonterra's valuation method is not clearly understood by all members the question to what extent this is happening remains.

- If the members consider that there are new business opportunities for Fonterra they would be willing to invest more money in the co-operative, provided that their investments had clearly identifiable property rights.

The concern with investments does not seem to be about securing property rights. Some members seem to be willing to invest as long as the investment is in processing members' milk. Members do not seem to be interested in being part of a co-operative, which is investing in a wide range of activities not involving the process of members' milk. At the time of the study no options for additional capital contributions on top of the individual milk supply were available for members. The issue with vaguely defined property rights do not appear to be severe in Fonterra. The horizon problem does exist since younger farmers that recently started their business will have less free equity to invest in Fonterra since their debt ratio is likely to be higher than a member that has been in dairy for a long time. Exceptions do appear.

- The membership is fairly homogeneous as concerns the interests that Fonterra is to promote for the members.

All members have one thing in common, that they produce milk. But this is also the only thing some members have in common. As Fonterra is a large co-operative it is inevitable that a wide range of interests exists. The south island seems to be more corporate minded since lots of large investments have been made here, whereas the north island is characterised by smaller farms that have been run by the family for generations. For a large and complex co-operative to survive it may be essential to focus on the interest that all members have in common, namely the collection and processing of their milk and leave the rest as an optional choice. By addressing farmers' choice the Board was trying to address this issue, but perhaps a more careful analysis of what the members want is necessary to come up with a solution that more members can agree on.

- There are relatively few conflicts within the membership as to the business policies of Fonterra.

Some members feel that Fonterra should engage in processing members' milk only. Other members think that it is a step in the evolution to engage in activities in other countries, processing non-members milk as well. Since most members do not consider exit as an option voice is their only option. As a result of this the diversity of economic interests varies. In Fonterra certain ginger groups exist, trying to influence decision-making. This can be defined as an influence problem. To what extent this is harmful for Fonterra is hard to judge but it is an indicator that some VDPR problems that commonly exist in co-operatives also exist in Fonterra. The ginger groups could also be a result of the portfolio problem if the involved members are unhappy with the co-operative's investment portfolio. These problems are likely to be fewer than in a co-operative without a Shareholders' Council.

- The members feel that their transaction costs when selling their milk would increase if the capital structure were to be changed.

For many members Fonterra is their only logistically sensible option. If Fonterra no longer existed the fear among some members is that an IOF will only pay what it has to, to fill the factory, and later it will try and lower the initial price to increase its profit. The proposed structure would create two types of shareholders and a tension is likely to appear. This would increase the transaction costs for many farmers. Even though market failures occur less frequently, the situation in Ireland, where a large amount of options for the farmers exists is not yet happening in New Zealand. Further the aim if the Shareholders' Council is to monitor the work of management performance, which should lower the agency cost. Hence the situation in New Zealand with few options entails that there is still a need for a co-operative.

- Fonterra is not influenced by the way IOFs conduct their raw material procurement.

Fonterra is a large and complex co-operative, which is operating internationally (95% of its production is exported). Since many of its customers are IOFs it is inevitable not to be affected by their practices and non-congruent isomorphism appear to be present. In Australia Fonterra is already procuring its raw material in a more corporate way. A further issue is people with little co-operative knowledge in management; the way Fonterra is run is likely to be influenced by the way an IOF is run since people with a background in an IOF will infuse their values, norms and cultures into Fonterra. Fonterra is thereby exposed to mimetic isomorphism.

- Fonterra is such a large firm in the New Zealand business life that it is Fonterra itself that sets the agenda for the country's dairy industry.

Being such a large company and being a big part of New Zealand's business Fonterra plays a great role. In New Zealand Fonterra can be said to set the agenda. However, other co-operatives usually manage to keep a higher payout than Fonterra. Fonterra is mostly competing on the world market and hence is starting to face tougher international competition from other low cost producing countries and on the world market it is hard to set the agenda for Fonterra.

- The fair value share is considered to be a better valuation tool than the stock exchange.

By members who understand the valuation method the fair value share is considered to be a fairly good valuation tool. However, the lion's part of the members in this study is not a member for the return on an investment but for the benefit of being member of a strong co-operative that they are in control of.

To sum up, the specificities of Fonterra seem to play a great role in the keeping of such a large and complex co-operative. The members are aware that if their milk is not being picked up all they produce is of no value and that this makes them dependent on the collection being done in a fair way. Even if the restructure predicted economic benefit, members do not seem to want to be part of that. Some members are open to other solutions than a pure co-operative as long as the core business stays a co-operative. It seems like the management and the Board are ready for restructure but that the members have not yet experienced that the problems in stage 4 are very serious and hence are not ready for any reorientation in stage 5. The question whether a pure co-operative can survive in today’s society remains, but attributes like the Shareholders Council does help members to remain in control.

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Appendix 1: Question guide

Shareholders' Council

1. Can you give examples of what the Shareholders' Council does for the members? And more specifically what it has done during the capital restructure process?

2. For the following propositions do you agree or disagree? If you agree could you give examples of how the Council achieve its results?

   - The work of the Shareholders' Council implies that the members feel more involved in Fonterra.
   - The work of the Shareholders' Council increases the members' degree of trust in Fonterra and the Board.
   - The members think that the Shareholders' Council functions well to balance the power of the Board.

Fair Value Share

3. How does it work?

4. Why does Fonterra have the Fair Value Share?

5. How does the fact that the Fair Value Share is appreciable affect the members?

6. Does the Fair Value Share help members to assess the value of their investments?

7. If the members believe that there are new business opportunities for Fonterra they would be willing to invest more money in the co-operative, provided that their investments had clearly identifiable property rights. Agree or not? If you agree, in what ways can identifiable property rights be achieved?

Membership

8. Do you think that members perceive themselves as owners of Fonterra? What is the reason for this? If you don't agree, why do you think they no longer see themselves as members?

9. The membership is fairly homogenous as concerns the interests that Fonterra is to promote for the members. Yes or no?

10. There are relatively few conflicts within the membership as to the business policies of Fonterra.

Transaction costs

11. If the capital structure were to be changed, what would happen to the process of selling milk? Would it be more time consuming, hard to trust the other party etc?

Isomorphism

12. Do you see any advantages in the way IOFs conduct their raw material procurement?

13. Is Fonterra benchmarking with any IOFs?

Discussion

14. Fonterra is such a large firm in the New Zealand business life that it is Fonterra itself that sets the agenda for the country' dairy industry. What implications do this have for the members? Do they still have a fair chance at controlling their co-operative?

15. What do you think of co-operatives in general, what is their future path?

16. What do you think about the Boards concerned points?

    a. How can capital be raised?
    b. How can redemption risk be handled?
    c. How can farmer choice be addressed?

Pris: 100:- (exkl moms)

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