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Fonterra restructure 'not in the national interest', says report

Jenny Ruth | Thu, 16 Jun 2022

An MPI-commissioned report recommended against Fonterra's restructuring. (Image: Getty)

Fonterra's restructuring "would not be in the national interest" and will tilt the market for raw milk in the dairy giant's favour, reducing the pressure on it to perform, warns a report commissioned by the Ministry for Primary Industries (MPI).

Despite that report's conclusions, the government is planning to greenlight the restructuring with a couple of minor tweaks, which will mean changes to the Dairy Industry Restructuring Act (DIRA).

The report by consulting firm TDB Advisory is dated Dec 6, 2021, three days before 85% of Fonterra's farmer shareholders voted in favour of the restructuring proposal.

However, it wasn’t published on MPI’s website until April 27.

TDB concluded that the restructuring would mean farmers will have a greater “artificial” incentive to join Fonterra, while existing Fonterra farmers will have less incentive to leave, reducing the contestability of New Zealand milk.

That's counter to the objectives of DIRA “of providing incentives for Fonterra to be as efficient as possible and perform in the long-term interests of its farmer-shareholders, the dairy industry and the wider economy”, TDB said.

Diverging interests

What is in Fonterra’s best interests commercially is not necessarily the same as the national interest or the interests of farmers, it said.

“While Fonterra enjoys a 79% market share and operates under its own special legislation, it is important that constraints remain on Fonterra that counterbalance its privileged position in the dairy sector and the national economy.”

TDB said there will be upward pressure on Fonterra’s milk price at the expense of a lower dividend, although there will also be pressures in the other direction, too.

These are essentially the same conclusions as those of another report by consulting firm Castalia that became public in late May.

Open Country Cheese, Fonterra’s largest domestic competitor, commissioned the Castalia report, which Fonterra rubbished.

"Fonterra disagrees with the report and a number of its conclusions, including the assertion that protections for a fair milk price will be eroded and that the restructure will cause Fonterra's milk price to increase," the company said.

Fonterra wants to change from requiring farmers to own one share for every kilo of milk solids they supply to holding one share for every three kilos supplied.

Making it cheaper

The dairy giant wants to make it cheaper for farmers to join the cooperative at a time when it expects milk supply to be flat or declining.

TDB's report says if the restructuring goes ahead, there will be conflicting incentives between farmers who hold the minimum number of shares required and those holding the maximum number allowed.

Under the current structure, all farmers are indifferent to receiving their return via the milk price or by way of dividend, it said.

Under the new structure, some farmers will be able to hold 12 times the number of shares – four shares per kilo will be the maximum allowed – of other farmers holding the minimum number.

Suppliers with the minimum holding "will benefit three times more from receiving the return in milk price than dividend", TDB said.

Conversely, those holding the maximum permitted number of shares "will benefit from a lower milk price and higher dividend".

Management's interests

Farmer suppliers' economic interests are to maximise returns from both milk and dividends, but Fonterra's management has "an incentive to grow the size of Fonterra as larger companies generally pay higher salaries, give senior managers more prestige and more projects to work on", TDB said.

"Thus, management will tend to favour an ownership and capital structure which attracts and retains suppliers to grow the company relative to its competitors," it said.

The government has clearly recognised the competing pressures on the farmgate milk price Fonterra pays farmers, because one of the conditions of it changing DIRA is to give the Commerce Commission greater powers.

It also wants to increase the degree of independence of Fonterra's internal milk-pricing setting processes by increasing the number of ministerial appointees to the milk price panel from one to two.

Castalia recommended the milk price panel become completely independent of Fonterra.

Currently, Fonterra can set the actual farmgate milk price at a different level to the base milk price, but it has to publicly disclose any difference and the reasons for that difference and the Commerce Commission is charged with reviewing this process.

But TDB said the commission "is at an information disadvantage in assessing whether the base milk price calculation is appropriate".

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