

SUBMISSION

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To: Ministry of Agriculture and Forestry

Submission on: **REGULATORY REGIME TO ACCOMPANY FONTERRA
CAPITAL RESTRUCTURING**

From: Federated Farmers of New Zealand

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Contact:

ANN THOMPSON
DAIRY POLICY ADVISOR

Federated Farmers of New Zealand
Box 715, Wellington, New Zealand

P 04 494 9191

F 04 473 1081

* athompson@fedfarm.org.nz

SUBMISSION

REGULATORY REGIME TO ACCOMPANY FONTERRA CAPITAL RESTRUCTURING

1. EXECUTIVE SUMMARY

- 1.1. Federated Farmers welcomes the opportunity to submit on the Regulatory Regime to accompany Fonterra Capital Restructuring.
- 1.2. Federated Farmers submits that when the **combined** liquidity of the Fonterra Shareholders' Market (FSM) and the Fonterra Shareholders Fund ("Fund") has reached \$500 million, then the share issue and redemption obligation clauses within the Dairy Industry Restructuring Act (DIRA) can be removed or replaced with the ability of farmers to trade shares.
- 1.3. Federated Farmers submits that a "one off" compliance assessment be done to ensure that the necessary liquidity is present in the combined Fund and SFM.
- 1.4. Federated Farmers submits that no further regulation is required.

2. INTRODUCTION

- 2.1. Federated Farmers is pleased that the issue of altering the Dairy Industry Restructuring Act (DIRA) to accommodate the possibility of allowing farmers to trade shares in order to enter or exit Fonterra is being considered by the Ministry of Agriculture and Forestry (MAF). Indeed, the Federations' submission to the Primary Produce Select Committee on the DIRA (New Sunset Provisions) Amendment Bill expressly mentioned this need. As a consequence, we agree with the problem definition as laid out in Question one of the discussion document.
- 2.2. In order to gather farmer opinion for our submission, Federated Farmers held a survey¹, asking all dairy farming members for their responses to most of the questions covered in the MAF discussion document. Over a 24 hour period, fifty five responses were received, all Fonterra suppliers, and it was from this time period that the Federation has formed its opinion. More were received outside of this time limit, and although they were not included in the statistical data, their comments have been considered in producing this submission.
- 2.3. **Question one: Do you agree with the problem definition "to identify a regulatory regime that both provides for both the freedom of farmers to enter and exit Fonterra and allows the opportunity for the TAF proposal to be implemented"?**

¹ Federated Farmers surveyed approximately 6,500 dairy farmers. While a response rate of 55 is not huge, it is in the scheme of things, and given the time frame (24 hours), the other obligations on farmers and their willingness to participate in any survey, this response is seen as being good. Not all questions were answered by everyone, hence the variation in total numbers for each question asked.

- 2.4. **Agree.**
- 2.5. **Rationale:** Given that the intent of the open entry and exit clauses were included within the DIRA originally to promote efficiency within Fonterra and to allow farmers the right to freely come into and exit Fonterra, and that this intention is integral to the Act, it must be replaced as Fonterra is contemplating no longer issuing and redeeming shares. It will instead be requiring farmers to trade shares.
- 2.6. Federated Farmers agrees with MAF in that maintaining the current share issue and redemption requirements of DIRA would prevent Fonterra from developing its capital structure.
- 2.7. **Question two: Do you agree that efficient milk pricing and deep, liquid, transparent, well-informed and fungible share and fund markets are necessary and sufficient elements for ensuring the freedom of farmers to enter and exit Fonterra?**
- 2.8. **Partial agreement**
- 2.9. **Rationale: Fungible shares and Fund market.** Federated Farmers believes that the ability of farmers to use both the Fonterra Shareholders' Market (FSM) and the Fonterra Shareholders Fund ("Fund") will allow the necessary fungibility to give sufficient depth to the market. This is especially so, given the added flexibility of allowing farmers a period of up to three years to trade the required shares (a condition stipulated by Fonterra), in order to either enter into or exit out of Fonterra.
- 2.10. **Entry and exit.** While some farmers are unable to see that it is through legislation that they have been readily able to enter and exit Fonterra easily, Federated Farmers is cognisant of its value.
- 2.11. However, the vote held by Fonterra on the TAF proposal to allow a period of up to three years to trade shares to gain entry to or exit from Fonterra, showed that the majority of farmers were willing to take this option.
- 2.12. There is some discussion within the MAF document of the likelihood of volatility of the share price and that this would prevent easy entry and exit to/from Fonterra for farmers. Federated Farmers submits that volatility here would be no different from any other market, and as farmers would be able to stand in the market and trade all year they will have options. Farmers are used to volatility in the dairy industry, and their vote for the TAF proposal must hold.
- 2.13. It is also understood that 'lumpy' prices due to the majority of shares being placed into or withdrawn from the market at certain times happens in all listed businesses. Again, the ability to take advantage of the three year rolling average, fungible markets and volume providers all help smooth this to a certain extent.
- 2.14. **Liquidity:** Federated Farmers found that upon survey, half the respondents (23/44) would be prepared to sit in the FSM actively trading dry shares, with both buy and sell offers on the table at the same time.

The Federation also understands that up to 100 million Fonterra shares² changed hands over the past season. This indicates that farmers are focussed on working on their business and that the FSM will have adequate and active liquidity.

- 2.15. Federated Farmers also found that 43 percent of respondents (22/51) would be prepared to hold up to 20,000 extra shares and a further 43 percent would contemplate holding between 20,000 to 100,000 dry shares. Eight percent (4/51) would consider holding more than 100,000 dry shares, and three percent (3/51) would not hold any extra shares. This latter group were generally philosophically opposed to trading at all. Given farmers are only currently allowed to hold up to 20 percent more than their three year rolling average, and that the size of farms varies widely, these results show that farmers are ready to make a liquid market. The TAF proposal will allow farmers to hold shares up to 200 percent of their production, based on the three year average.
- 2.16. **Efficient milk pricing, well informed and transparency:** With regard to the milk price being efficient and its consequent effect on dividends and retentions, Federated Farmers submits that, as Fonterra is a co-operative, run by farmers, for the benefit of farmers, that the steps Fonterra has taken in the last three years makes manipulation of the milk price unlikely. Fonterra now has a dividends and retentions policy, a global platform to discover the milk price (globalDairyTrade), a futures market to derive a forward pricing curve and the beginnings of a share trading scheme. Fonterra also has a global reputation which would be destroyed by such open manipulation.
- 2.17. Fonterra also has a defined process to discover the price of milk and a governance structure on milk pricing overseen by the Shareholders' Council. The annual accounts are open to all suppliers where milk price versus profit can be fully scrutinised by members of the co-operative.
- 2.18. As a consequence, Federated Farmers submits that Fonterra has limited opportunity to manipulate the milk price, even if it did have the motive Regulation by government on how this is set is not required.
- 2.19. Federated Farmers notes MAF's comments that commercial incentives to price milk efficiently and to maintain the liquidity of the share markets over time, would allow less regulation rather than more.
- 2.20. **Question three: In the context of Fonterra's TAF proposal, what additional or alternative key elements do you consider to be necessary for ensuring the freedom of entry and exit for farmers?**
- 2.21. **No additional elements are necessary.**
- 2.22. **Rationale:** Fonterra is a co-operative, run by farmers, for the benefit of its supplying members. Federated Farmers submits that it is the business of the co-operative to entice farmers into supplying and continuing to supply it. It is not the role of government to regulate for this to happen. As discussed in paragraphs 2.16 and 2.17 above, Fonterra can be seen as

² Personal communication with Fonterra officials

having evolved to being aware of its obligations to the shareholders (the farmers).

- 2.23. **Question four: MAF has proposed that a pre-condition on the minimum size of the fund is set at a value of between NZ\$500 million and NZ\$900 million. What value do you consider would be the most appropriate for a pre-condition on the minimum size of the fund?**
- 2.24. **\$500 million, made up from the combined liquidity of the FSM and the Fund**
- 2.25. **Rationale:** Fonterra has stipulated that the Fund size at launch would likely to be in the region of \$500m, and the Directors came to this figure after consultation with independent experts.
- 2.26. Federated Farmers submits that as the Fund and the FSM will act more or less in a state of equilibrium that the total liquidity of the Fund **plus** the FSM be taken into account. From the Federated Farmers' survey, 64 percent (33/51) supported amalgamating the liquidity of both markets (Fund plus FSM), while 22 percent (11/51) supported liquidity in just the Fund in order for the pre-condition be met.
- 2.27. Farmers were also asked about the value of the pre-condition liquidity. Predictably, 67 percent (29/43) supported having the fund somewhere between \$500m and \$900m.
- 2.28. Given that Fonterra will start running the Fund when there is 'approximately' \$500m, it would be unworkable for a regulation to be put in place that would prevent trading to happen. Our survey failed to give participants the option of just \$500m – options were: \$900m, \$500m - \$900m, <\$500m, and extra two percent of dry shares, and 'your suggestion'.
- 2.29. Federated Farmers submits that the pre-condition should be \$500m, given that 'approximately' is too difficult to regulate for.
- 2.30. Federated Farmers also submits that the pre-condition minimum size should be based on the **combined** liquidity of the FSM and the Fund.
- 2.31. **Question five: Do you consider that once the pre-condition on the minimum size of the fund is met, the share and fund markets would be sufficiently liquid to ensure the freedom of farmers to enter and exit Fonterra at the outset?**
- 2.32. **Federated Farmers considers that the market will be sufficiently liquid**
- 2.33. **Rationale:** The beauty of this Fund (and the FSM) is that it will be transparent. Farmers will be able to see current market trends, take advice, and choose to buy or sell.
- 2.34. It is unfortunate that no non-Fonterra suppliers chose to reply to the survey, so Federated Farmers is unable to gauge their understanding of what could be a 'sticky' entry into the co-operative. However, the ability

to buy in over a period of three years will give new entrants the ability to buy shares at times of excess shares being present in the market.

- 2.35. As shown in our survey, farmers have indicated a willingness to stand in the market (see paragraph 2.14). Federated Farmers would be willing to assist with further research to show the confidence of potential investors supporting our statement that the markets will be sufficiently liquid.
- 2.36. **Question six. Do you consider that regulation of milk price governance and disclosure would be necessary to strengthen confidence in the milk price setting process and therefore support the liquidity of the share and fund markets?**
- 2.37. **No regulation required**
- 2.38. **Rationale:** The vast majority of farmers (84 percent, 45/53) who responded to the Federated Farmers' survey were against regulation of milk price governance, and the Federation wonders if MAF fully understands the role of the Milk Price Panel Fonterra is intending to set up.
- 2.39. As one submitter explains: *"The members of the milk price panel are not there to set the price. They have two roles a) to ensure that the milk price principles are complied with and that the process is auditable; and b) to adapt the rules if the operating environment changes over time so that the milk price principles are complied with. The process sets the price".*
- 2.40. In other words, the setting of the milk price, distributable profits and retentions is based on functions outside of the Panel's control. The Panel would not be able to influence the amounts, only the process, and as this is auditable, it is unlikely to be manipulated.
- 2.41. Farmers were mixed on the idea of regulating disclosure of information. Federated Farmers understands that Fonterra would be bound by the normal securities and exchange rules and also submits that a certain level of transparency would be advantageous to the co-operative in gaining investors, and therefore regulation is not necessary.
- 2.42. As one respondent stated: *"I have no definite answer because the definition of "commercial sensitivity" brings forth its own problems of policing and surety. Confidence in the milk price process will be reflected in the market price of the shares and / or their derivatives".*
- 2.43. **Question seven. Do you consider that it would be necessary for the Trustee of the fund or an independent body to nominate candidates to be the independent members of the Milk Price Panel?**
- 2.44. **Not necessary**
- 2.45. **Rationale:** Interestingly, from the survey there were mixed views on this, with 65 percent (29/44) saying no and 34 percent (15/44) saying yes.
- 2.46. While it is noted that Fonterra intends to have a Fonterra Board-appointed Panel, the majority being non farmer Board members, plus two members being nominated by the Fonterra Shareholders' Council, it

could be mooted that having the Trustee of the Fund or an independent body nominate one candidate might be useful. However, this is for the Fonterra shareholders (the farmers) to demand of Fonterra, not the government.

- 2.47. The Federation also suggests that having a majority of independent people (who are not Board members) on the panel could result in the interests of investors becoming paramount, instead of properly considering farmers' interests. This would run contrary to the co-operative spirit.
- 2.48. The Federation also argues that setting the make-up of the panel in regulation will prevent any flexibility around the need to bring in expertise if required from both outside and inside Fonterra.
- 2.49. **Question eight. Do you consider that regulation of ongoing liquidity requirements would be necessary to strengthen Fonterra's commercial incentives to ensure that the share and fund markets remain sufficiently liquid over time?**
- 2.50. **No necessity to regulate**
- 2.51. **Rationale:** The survey elicited a negative response from 86 percent (38/44) of participants.
- 2.52. MAF itself questions the ability to do this, given that many of the problems that affect liquidity are outside either the regulatory process or a company's control. MAF also notes that the Fund and share markets would require sufficient monitoring and therefore extra regulation would be unnecessary.
- 2.53. Federated Farmers submits that normal market disciplines would apply to Fonterra and consequently there would be no benefit of having such requirements within DIRA.
- 2.54. **Question nine. What form or forms of ongoing liquidity requirements do you consider would be most appropriate to ensure the ongoing liquidity of the share and fund markets?**
- 2.55. Federated Farmers submits that the market be left to set these. There is no room for extra regulation in this area.
- 2.56. **Question ten. What do you consider would be an appropriate monitoring, enforcement and remedy regime for each potential regulatory tool, including milk price governance and disclosure and the three forms of ongoing liquidity requirements?**
- 2.57. Federated Farmers agrees with MAF in its conclusion that the FSM and Fund would be subject to generic securities markets legislation and, therefore, the generic monitoring and enforcement regimes under that legislation. Implementing a system to monitor and enforce regulations that place additional requirements on the TAF system, in order to ensure the freedom of farmers to enter and exit Fonterra, would be difficult to do and should not be attempted due to any unintended consequence and the fact that Fonterra is a co-operative.

- 2.58. With regard to the comments from MAF on the pre-condition on minimum fund size, Federated Farmers **agrees** with the notion to have a “one off” compliance assessment.
- 2.59. Federated Farmers does not agree to the need for any other tools for reasons given in the submission above. There is no need to put in regulation tools that are already in place in the markets the Fund will be exposed to.
- 2.60. **Question eleven. Do you consider that option one – maintaining the status quo – would achieve the objectives of ensuring the freedom of farmers to enter and exit Fonterra and allowing the opportunity for the TAF proposal to be implemented?**
- 2.61. **No**
- 2.62. Federated Farmers submits that both mechanisms cannot be in place at the same time. The status quo should stand only until TAF takes over.
- 2.63. **Question twelve. Do you consider that option two – pre-condition, rules regarding milk price governance and disclosure and some ongoing liquidity requirements – would achieve the objectives of ensuring the freedom of farmers to enter and exit Fonterra and allowing the opportunity for the TAF proposal to be implemented?**
- 2.64. **No**
- 2.65. Federated Farmers submits that option two places unnecessary and unworkable regulatory pressure on Fonterra, as explained above.
- 2.66. **Question thirteen. Do you consider that option three – pre-condition and rules regarding milk price governance and disclosure – would achieve the objectives of ensuring the freedom of farmers to enter and exit Fonterra and allowing the opportunity for the TAF proposal to be implemented?**
- 2.67. **No**
- 2.68. Federated Farmers does, however, submit that having one member of the Milk Price Panel be nominated by the Trustee or an independent body may be advantageous, but that this should not be regulated for. The mechanism for this to happen would be for the shareholders of Fonterra to ask for that to be written into the constitution of the Fonterra co-operative.
- 2.69. **Question fourteen. Do you consider that option four – pre-condition and ongoing liquidity requirements – would achieve the objectives of ensuring the freedom of farmers to enter and exit Fonterra and allowing the opportunity for the TAF proposal to be implemented?**
- 2.70. **No**
- 2.71. Federated Farmers submits that trying to find a regulatory tool to remedy liquidity problems is beyond the scope of the DIRA.

- 2.72. **Question fifteen. Do you consider that option five – pre-condition only – would achieve the objectives of ensuring the freedom of farmers to enter and exit Fonterra and allowing the opportunity for the TAF proposal to be implemented?**
- 2.73. **Yes, partly**
- 2.74. However, Federated Farmers submits that having a precondition on the minimum fund size should be the **combined** size of both the FSM and the Fund given that both markets are likely to be fungible.
- 2.75. Furthermore, Federated Farmers submits that the **combined** size of the FSM and the Fund need reach **\$500 million** before the open entry and exit provisions are either removed or replaced with the ability of farmers to trade shares.
- 2.76. **Question sixteen. Do you agree with the potential benefits and costs that are outlined under options one to five?**
- 2.77. While the MAF document does outline the benefits and costs it does not quantify either. Any extra costs will be passed to farmers, reducing Fonterra shareholders' profits. The Federation considers there are sufficient controls and market regulations after the precondition has been met to allow the objectives of DIRA to be achieved.
- 2.78. **Question seventeen. Which, if any, regulatory tools and regulatory options do you consider would be necessary to provide sufficient assurance that the TAF proposal would provide for the freedom of farmers to enter and exit Fonterra, and that this would be maintained over time?**
- 2.79. Federated Farmers submits that a "one off" compliance assessment be done to ensure that the necessary liquidity is present in the Fund and FSM. This would then allow trading of shares to take place and this alone should allow farmers to enter and exit Fonterra with a certain amount of freedom.
- 2.80. **Question eighteen. In the context of the TAF proposal, what additional or alternative regulatory tools do you consider would be necessary to support the freedom of farmers to enter and exit Fonterra?**
- 2.81. Federated Farmers submits that no other tools are required to support the freedom of farmers to enter and exit Fonterra.

3. ABOUT FEDERATED FARMERS

- 3.1. Federated Farmers of New Zealand is a primary sector organisation that represents farming and other rural businesses. Federated Farmers has a long and proud history of representing the needs and interests of New Zealand farmers.
- 3.2. The Federation aims to add value to its members' farming business. Our key strategic outcomes include the need for New Zealand to provide an economic and social environment within which:

- Our members may operate their business in a fair and flexible commercial environment;
- Our members' families and their staff have access to services essential to the needs of the rural community; and
- Our members adopt responsible management and environmental practices.