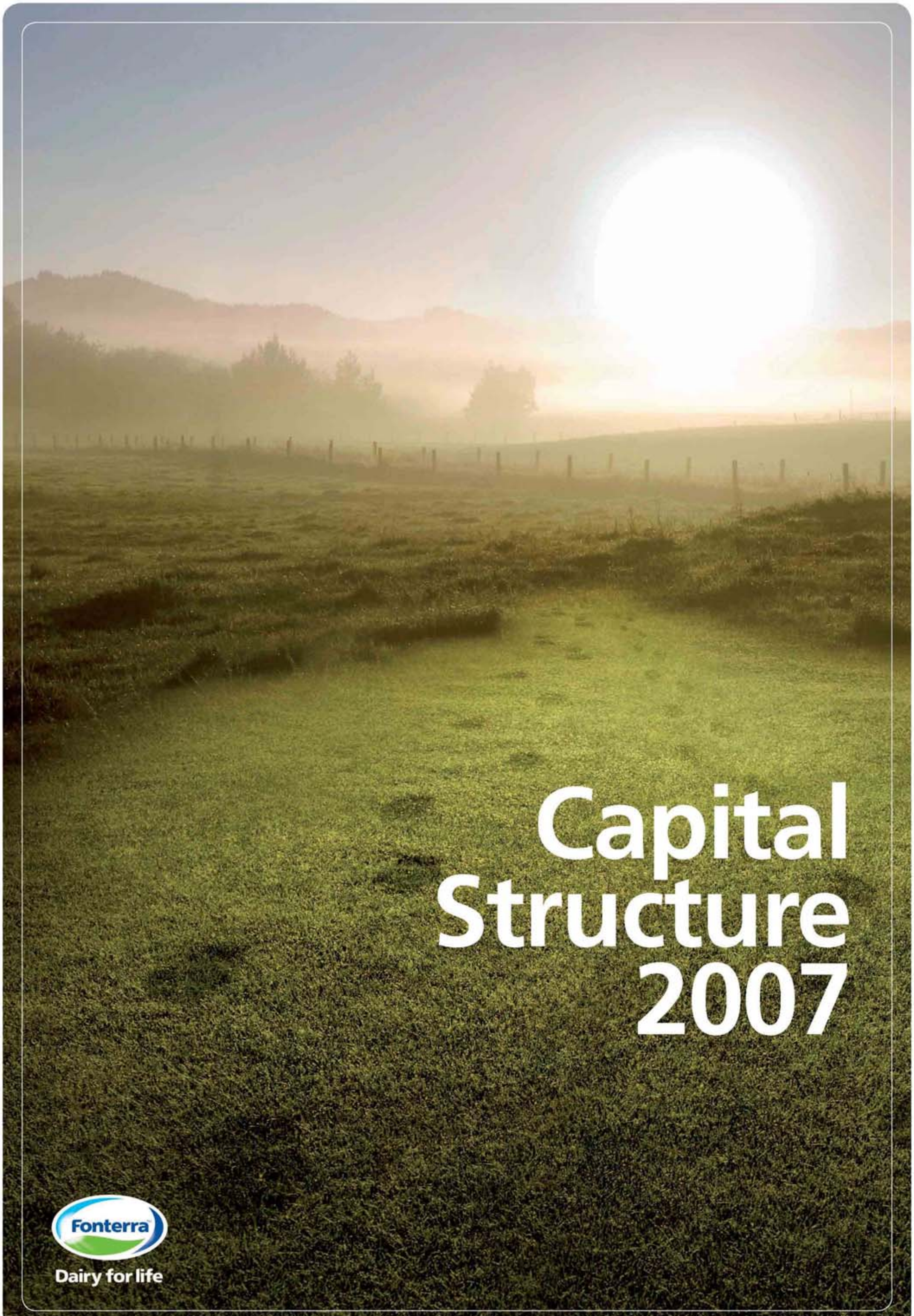

Capital Structure 2007

The Case for Change

The global dairy market is undergoing rapid structural change. This change presents Fonterra with significant opportunities to move another step forward, to protect both Fonterra shareholders and the New Zealand dairy industry for the future. But we will need to change our capital structure if we are to take advantage of these opportunities.

Fonterra's dairy farmers face two choices. Stand still and enjoy the good conditions today, or keep moving and ensure the next generation also enjoys good returns. Standing still would see us overtaken, at speed, and opportunities to maintain and secure our position will be lost.

By moving forward and capturing the opportunities in the global market, we can create a more stable and secure future for the Co-operative, while ensuring that Fonterra remains at the forefront of changes in the global dairy market.

The opportunities for Fonterra are best reflected in the overall global demand for dairy which is growing at an average 2.7 per cent a year. That's 147 billion litres of growth over the next 10 years or the equivalent of a whole New Zealand dairy industry opening up every year for the next 10 years. World economic forecasts are for four per cent growth per annum for the next 10 years. People are wealthier, they are consuming more and recognising the benefits of dairy. For our farmers, this means growth.

Alongside this, Fonterra and our farmers are among the lowest cost producers of milk in the world. Fonterra is also the largest supplier to global markets. Our performance last season and our forecast for the current season shows we can deliver a healthy return, even when the dollar is high. So if we are doing so well, why do we need to change?

Firstly there's growing competition. At least one new major low cost supplier of unsubsidised dairy products will emerge to compete with New Zealand and Australia in the globally traded market. Candidates include Brazil, Argentina or possibly Russia, the Ukraine or another Eastern-European country. Meanwhile, countries are developing their own dairy industries to meet local demand. China's industry, for example, is already twice the size of New Zealand's and growing at four to five times the rate. All of this milk will be consumed in the local market.

What this means is that there are good opportunities for Fonterra to participate in the countries that are looking to grow their local dairy industries. We are already doing this in Australia, the United States and some parts of Latin America. We are now looking to replicate the model in China and elsewhere.

Annual growth in fresh dairy is expected to be around three per cent. Meanwhile, the globally-traded market where we are traditionally strongest is likely to grow from around 43 billion litres to around 48 billion litres (an increase of around 1.2 per cent per annum) over the next decade. There is money to be made in both segments.

As long as we continue to grow New Zealand farmers' productivity and stay one of the lowest cost and competitive suppliers, there will always be a market for New Zealand farmers' milk. But the sector here is maturing and we need to retain and grow our business for the next generation.

In the nineties, New Zealand milk production was growing at five per cent a year. Today, it's two to three per cent and that's likely to be the case for the next 10 years. New Zealand is only so big and there are environmental and other constraints on growth.

The challenge now is to keep doing well what we've always done *and* capture the international growth opportunities in fresh dairy which have never existed before.

We've got an advantage because Fonterra's business starts at the farm vat and covers every step in the supply chain. Milk sourcing and collection, manufacturing, inventory management, demand and supply forecasting, commodity sales, consumer marketing, we do it all. We can take this expertise and apply all or part of it in any market.

We have refreshed the strategy to ensure it captures growth opportunities in both segments (liquid fresh milk and globally-traded ingredients).

The strategy has four platforms: -

1. Ensure Fonterra remains one of the lowest cost, sustainable dairy co-operatives in the world – an absolute priority
2. Build trusting partnerships with customers by being a multi-origin supplier, allowing us to build more valuable relationships through supply chain integration and innovation
3. In high growth markets, where it is not practical to use New Zealand produced milk, we will leverage our cow to consumer expertise to build profitable businesses using locally-produced milk
4. Make Fonterra products the first choice of customers and consumers where we do business

The strategy ensures farmers' milk will be collected, processed and sold for the best price, just as it is today. But it also ensures our growth prospects are not limited solely to growing milk supply in New Zealand. We want to protect the future for Fonterra's farmers by building a business in other countries using other people's milk to complement our core New Zealand-based business. But the big issues are access to capital and whether all of our shareholders want to invest in this growth.

In the past Fonterra has been raising capital exactly in line with the amount of milk that has come out of New Zealand. More production has meant more capital. It has worked well so far. That's because Fonterra's investment requirements have tended to keep pace with the growth in our farmers' milk production.

But to take advantage of the opportunities in the global dairy market and protect our position for the next generation, the investment strategy can't stay tied to the amount of milk produced here. More money will come in the door as production increases, but not at the pace or amount we need to lock down the much bigger growth opportunities over the next few years.

We can't stand still. Strategy and capital structure go hand in hand. That is why we need to be looking now at what capital structure will best serve our strategy and deliver the answers to the other issues farmers want resolved, such as redemption risk, retaining control of their co-operative and choice about where their money gets invested.

Redemption is an important issue and strong performance doesn't solve it. In fact the better the co-operative performs, the higher the potential redemption risk. Why? As the share value rises, the younger generation of farmers see it as a barrier to entering the industry, while the older generation see a fast track to retirement. They can sell their shares and unlock cash but keep their land.

Investment choice is therefore important. One size does not fit all and all our farmers have different appetites for risk.

To date Fonterra has made overseas investments without changing capital structure. But that doesn't mean capital for growth is not an issue. These investments in total represent a small part of Fonterra's total value. If you break down the Fair Value Share, over three quarters of the value is in New Zealand, including commodity, ingredients and consumer businesses. Just less than 10% is in Australia while the remainder is scattered around the world. Our investments are a beach head we can build on.

This will mean a more expansive investment strategy, because we have to grow to preserve our position for the next generation. But what about the risks? Can't we grow more slowly?

A slower pace will not achieve our growth goals. The world is changing rapidly and we need to be faster on our feet in identifying and taking the investment opportunities which will lift our returns. If we hold back, those opportunities and the advantages they bring will go to others. But this doesn't mean speed will replace good sense in our investment strategy. Fonterra's investment policy is clear – it has to represent the best use of shareholders' money, the price has to be right and the returns need to be favourable for shareholders in the long term. That policy will apply as much in the future as it has in the past.

As we grow, maintaining control and protecting the co-operative are critical. They guarantee the milk will be collected, sold at the best prices, the best returns will come back to farmers and decisions will be made based on what is best for farmer-owners. A farmer co-operative will remain at the heart of our capital structure.

Standing still is not an option. If we don't make changes to our capital structure, we will have to change our strategy to one that suits the regional commodities business, which is what Fonterra would fall back to without the necessary capital for growth.

Capital Structure Preferred Option

- Today we have a Supplier Co-operative, which is 100 per cent owned and controlled by farmers. Our preferred option would retain this – let's call it Fonterra Farmer Co-operative.

- At the same time we want to create a second company – let's call it Fonterra.

- All the assets and liabilities in today's co-operative would go into Fonterra. And for around two years both of these entities would be 100 per cent owned and controlled by farmers.

- But ultimately, the second company, Fonterra, would be listed. To illustrate how it might look after listing, Farmers would own about 80 per cent of it, 65 per cent through the Fonterra Farmer Co-operative and around 15 per cent through their own shareholding in Fonterra. The remaining 20 per cent would be held by the public, although no one shareholder could hold more than 10 per cent of Fonterra, except for the Fonterra Farmer Co-operative.

- Fonterra Farmer Co-operative and Fonterra would have contractual and constitutional arrangements between them to ensure that farmer-supplier rights are protected and farmers remain in control for as long as they see fit.

- In stage two, farmers would hold two shares in place of the current Fair Value Share -- supply backed shares in the Co-operative and listed shares in Fonterra.

- Little would change on a day-to-day basis in how farmers deal with the Co-operative. They would still get a payout comprised of a milk price plus a return on their investment in the Fonterra Farmer Co-operative. Separately if farmers hold shares in Fonterra, they would receive a dividend on those shares.

- But the introduction of additional capital would mean that Fonterra would be in a better position to pursue the growth opportunities that are going to come up in the global dairy industry in the next few years.

Preferred option – Governance

- Farmer Co-operative and Fonterra governed by separate boards, each with a majority of farmer-elected directors.
- Ten directors on Farmer Co-operative board -- eight farmer-directors, elected by farmers, and two appointed independent directors.
- Fonterra also to have 10 directors -- six farmer-directors, who also sit on the Co-operative board, and four separate independent directors.
- Common directors on both boards intended to facilitate day-to-day information sharing and co-operation between the two organisations. It would provide the necessary stability for both organisations, which the Board believes is a key factor.
- The Chairman of the two organisations should be a farmer-director and also be the same person, in the Board's view.
- Fonterra Farmer Co-operative controls appointments to Fonterra's Board because of its majority shareholding. In legal terms, Fonterra would be a subsidiary of the Co-operative.
- Farmer-directors would have the same power to elect their directors and call them to account. Farmer Co-operative directors would still come up for election each year, on rotation.

Special Protections - Constitution

The following special protections for farmer shareholders would be incorporated into Fonterra's constitution.

Number One: The Fonterra Farmer Co-operative could not own less than 50.1 per cent of Fonterra unless the Co-operative's shareholders agreed with at least a 75 per cent vote. This makes sure that the farmer shareholders have to agree to take the co-operative's shareholding below 50.1 per cent.

Number Two: No shareholder could hold more than 10 per cent of Fonterra's shares, other than the Co-operative. This protection would make it impossible for any other entity to get control of Fonterra.

Number Three: Milk pricing arrangements would be laid out clearly, including the basis upon which the milk price would be set and how amendments to this process would occur.

Number Four: Fonterra's headquarters must remain here in New Zealand.

Number Five: A cornerstone "Co-operative Share" would be enshrined in Fonterra's constitution and this would provide further protections for farmer shareholders by ensuring:

- Fonterra Farmer Co-operative's shareholders would always have the right to have all of their milk collected by Fonterra.

- Service obligations would be dictated, including maintaining adequate capacity in New Zealand to process all milk.

These special protections could only be changed through at least a 75 per cent farmer shareholder vote.

Special Protections - Legislation

Fonterra has asked the Government to enshrine some of the special protections in legislation as a further backup to the constitutional provisions.

Both Fonterra and the Government are committed to the Co-operative remaining at the heart of our capital structure. The government also wants to see Fonterra's home base remain here in New Zealand with a majority New Zealand ownership.

We have agreed with the Government that it would promote legislation so that:

- Fonterra would be required to maintain its headquarters in New Zealand with its Chairman, CEO and CFO living in New Zealand.
- No other shareholder other than Fonterra Farmer Co-operative could hold more than 10 per cent of Fonterra shares.
- Only New Zealand dairy farmers would be able to be shareholders in the Co-operative.
- 50.1% of Fonterra's shares would be required to be held by New Zealanders.
- In the event that a 75 per cent shareholder vote approves taking the Co-operative's share in Fonterra below 50.1 per cent, the Co-operative's share in Fonterra could not go below 35 per cent. That means the Co-operative would continue to have effective control of Fonterra.
- Fonterra would be required to have its primary listing in New Zealand, although we expect it could be listed in other countries such as Australia.

Pre-conditions

In addition to the special protections the Board has also set a number of pre-conditions that Fonterra must meet before taking this to the second vote. If Fonterra does not meet these pre-conditions, this will not be going anywhere. The Board is adamant on this point.

The five pre-conditions are:

- A transparent and robust mechanism delivering a competitive milk price
- Superior business performance across Fonterra
- Acceptable share market conditions
- Acceptable listing value for current shareholders
- Acceptable legislation to support any change

All of these pre-conditions are there to protect existing farmer shareholders.

Fonterra needs a transparent and robust milk price and needs to demonstrate that our strategy is worth supporting. Fonterra would need to list at the right time. And most of all it needs to maximise value for our existing shareholders.

Acid test for the Preferred Option

The key goals of any capital restructure are to:

- Reduce redemption risk
- Enhance shareholder choice
- Provide extra capital for growth

In addition to these three goals, we must also maintain protections for our shareholders – the key one is to maintain farmer control. And any new structure must also support the strategy and integration.

Redemption risk:
The current redemption risk is unacceptable if we are to pursue an expansive, value-enhancing strategy. At the moment, all capital is linked to milk supply and this can come and go. As a result the Co-operative has no permanent capital on its balance sheet. As well as being a risk, it makes it difficult for the Board to feel confident when making large investment decisions.

Under the preferred option redemption risk would be eliminated for Fonterra and substantially reduced for the Fonterra Farmer Co-operative. Redemption risk would be easier for the Co-operative to manage because its primary assets would be liquid shares in Fonterra with a market value. In addition the Co-operative would have more options than it has now to manage redemption in the future.

Enhancing shareholder choice:
The preferred option would offer shareholders the opportunity to hold just supply-backed shares in the Co-operative alone or to increase their participation in the investment strategy by holding Fonterra Group listed shares. Compared to the situation today, farmer suppliers would be able to significantly reduce their exposure to Fonterra if they chose to. Some may choose not to hold any shares in the listed entity, while others may choose to have a significant holding.

Providing capital for growth:
The extra capital would be raised by issuing shares to the public. Of all the options the Board considered, the preferred option best ensures we would be able to raise capital at a competitive cost.

So the preferred option addresses all three key capital structure pressures.

Trade-offs

Any change to Fonterra's capital structure will involve trade-offs. There are four elements – strategy, integration, control and ownership.

The Board strongly believes that Fonterra should not compromise on strategy. It is convinced that to grow farmer shareholder wealth Fonterra must implement all four parts of its strategy (see Case for Change).

The best chance for Fonterra to implement its strategy is to stay as an integrated business. This gives it a real advantage because Fonterra's business starts at the farm vat and covers every step in the supply chain. Milk sourcing and collection, manufacturing, supply and demand forecasting, commodity and specialty ingredients sales, consumer marketing - Fonterra does it all. Consistent with its strategy, Fonterra wants to take this expertise and apply all or part of it profitably in any market. Fonterra can then achieve whatever synergies are relevant to each market it is operating in. This is Fonterra's unique advantage, and it shouldn't be traded. Certainly there will be times when Fonterra will want to buy or sell a business, but this will be driven by commercial reasons not capital structure.

Fonterra would not trade control and doesn't intend to. While Fonterra has made changes to the co-operative model over the years, it has never lost sight of the fact that co-operatives were formed so that farmers could band together to give them more control over their own destiny.

As the Board sees it, ownership is where Fonterra has some flexibility, as long as it is smart about it. Yes, it lets others share in Fonterra's earnings, but before they can do this they have to provide capital, which Fonterra can then use to lift earnings further.

While it means Fonterra will have a smaller piece of the pie, the pie itself should be bigger if it pushes hard on strategy, maintains its competitive advantage and stays in control.

But ultimately something has to give, there have to be trade-offs to address Fonterra's capital structure issues – redemption risk, shareholder choice and capital for growth.

On another level, there is the trade-off between value and control. Fonterra cannot saddle the organisation with so many control mechanisms that value is destroyed. And at the same time it must comply with the corporate governance requirements of a listed company.

A key to maintaining value and obtaining capital at a competitive cost is to ensure a sufficiently broad and deep market for shares in Fonterra. That means there needs to be enough shares circulating to support the share price and ensure investors can buy and sell shares whenever they choose. This was another part of the balancing act as the Board worked through the various options.

What Farmers Would Vote On

- Farmers would be invited to vote on two separate occasions, expected to be about two years apart.
- At least 75 per cent shareholder vote would be required in each case.
- Around May 2008, the first vote would take place.
- Farmers would, in this vote, be voting for two things:
  - First, to change Fonterra's structure to that of two entities.
  - Second, the introduction and road testing of a more transparent milk price mechanism.
- This vote would not change ownership.
- The second vote – expected to be around 2010 – would determine whether to let Fonterra list and introduce external capital.
- To illustrate how this might look after listing, the Fonterra Farmer Co-operative would hold around 65 per cent in the listed company, farmers would hold about 15 per cent directly and about 20 per cent would be held by the public.

INDICATIVE TIMELINE

NOVEMBER 2007
Preferred option outlined
Consultation phase begins

↓

DECEMBER 2007 – MAY 2008
Farmer consultation process

↓

MAY 2008
First vote.
NO CHANGE TO OWNERSHIP

↓

2008 – 2010
Fonterra works to meet preconditions for move to stage two vote.

- A transparent and robust mechanism delivering a competitive milk price
- Superior performance across Fonterra
- Acceptable share market conditions
- Acceptable listing value for current shareholders
- Acceptable legislation to support any change

↓

2010
Second vote

The Other options

The Board looked at many ways to address Fonterra's capital structure. However these alternatives can all be grouped under six broad options, all of which were examined by the Board.

Four were rejected in the first stage of the process. After some months of detailed work on the remaining two options, the Board decided to have both these options independently reviewed before settling on its preferred option.

The following is an outline of the other options and the reasons why the Board rejected them. Ultimately all other options were rejected because they would not have addressed redemption risk, investment choice or capital for growth as effectively as the preferred option and therefore don't allow Fonterra to pursue its growth strategy.

Partial or Full Divestment of downstream businesses

This option was one of two selected for further development and independent review. It aimed to combine Fonterra's international and consumer businesses that could operate autonomously into a separate entity. This entity would have been listed, with the Fonterra Farmer Co-operative holding a majority stake. Fonterra farmer shareholders could also have been offered a direct stake.

Reasons for Rejection

This option would not have allowed Fonterra to pursue its growth strategy, which relies on an integrated cow-to-consumer business. In addition any decision to divest part of the business should be made for the right reasons, not just to address capital structure. Redemption risk would have remained because the parts of Fonterra that can easily be sold off do not represent a significant proportion of the Co-operative's total value.

The following two options maintain an integrated business.

Non-voting "B" shares

This option would have created two separate share classes – an "A" share and a "B" share.
"A" shares would have been:

- Held by farmer shareholders and carried full voting rights
- Issued and redeemed by Fonterra for a low nominal value of a few cents

"B" shares would have carried no voting rights and would have been:

- Non-redeemable but fully tradable
- Entitled to dividends funded from Fonterra's earnings
- Held by individual farmers in proportion to the amount of "A" shares each owns
- Offered to members of the public, which is where extra capital would have been generated

Reasons for Rejections

This option was ruled out because it would have destroyed value. The market would have placed a significantly lower value on non-voting shares when Fonterra had no track record as a listed entity. The non-voting "B" shares would have been likely to trade at a significant discount to their underlying value. This would mean that Fonterra could not have raised sufficient capital at a competitive cost to pursue its strategy under this option.

Hybrid Debt

Under this option Fonterra would have accessed capital for growth by issuing fixed or earnings-linked dividend equities (which are debt-like securities) to the public. These would have been tradable, but would have had limited voting rights.

Reasons for Rejection

Redemption risk would have remained because the ordinary shares held by farmers would still have been redeemable. In addition, the limited voting rights attached to the hybrids would have made them less attractive to outside investors and would have reduced their value. This in turn would have lowered the capital that would have been available for growth. And most importantly any pre-set interest payable on the hybrids would effectively take priority over payout, increasing the volatility of shareholders' earnings.

The two remaining alternatives considered by the Board both involve splitting the business up.

Letter Stocks

The activities and businesses that can operate autonomously would have been ring-fenced into a separate business that remained within Fonterra's overall structure. Farmer shareholders would have held a co-op share or "A" share that would have been linked to milk supply. Farmers and members of the public would have then been offered "B" shares in the ring-fenced business which would have paid them a dividend.

"A" shares would have carried full voting rights. "B" shares would have been non-redeemable but tradable on a listed exchange and have had very limited voting rights.

Reasons for rejection

The limited voting rights and general market concern about the letter stock regimes would have meant the "B" shares would have been likely to trade at a significant discount to their underlying value. This option would not have generated enough capital for growth. And "A" shares could still have been withdrawn by farmer shareholders, so redemption would have remained a risk.

Co-op has "call" option over processing assets

This option would have given the Supplier Co-operative the option of "calling" or purchasing the New Zealand-based manufacturing and global distribution assets of the listed Fonterra at a future point in time.

Reasons for Rejection

This option would have effectively split the business from day one, because the assets that would have been folded into any call option will have had to be established at the outset. This would have hurt Fonterra's ability to pursue its strategy.

The call option and its associated costs and risks would also be have been factored in by investors at the outset. The result would have been a substantially reduced share price, impacting the ability to generate capital for growth. And the call option would have represented a claim over a substantial portion of Fonterra's business – much like a mortgage.

Acid Test for All Options

	Redemption risk	Shareholder choice	Capital for growth
Preferred Option Assumes that preconditions have been met prior to implementation	◕	◕	●
Partial Divestment	◔	◔	◑
Non-voting "B" shares	●	◔	◔
Hybrid Debt	◔	◔	◔
Letter Stocks	◔	◔	◔
Call option over assets	◕	◕	◑

KEY

● Fully satisfied ◕ Largely satisfied

◑ Partly satisfied ◔ Satisfied only to minimal extent

Farmer control	Strategy	Maximise listing value	Reason for acceptance/ rejection
●	●	●	Reduced redemption risk. Provides shareholder choice. Provides capital for growth. Maintains farmer control. Enables strategy implementation. Maximises listing value.
●	◑	◑	Split business hence impact on ability to pursue strategy. Limits capital for growth. Redemption risk remains for Co-operative.
●	◔	◔	Destroys value. Shares would trade at discount. Fonterra unable to raise sufficient capital at competitive cost.
●	◔	◔	Less attractive to external investors, reducing capital available for growth. Interest on hybrids would take priority over payout.
●	◔	◔	Limited voting rights means B shares would trade at discount to value. Would not generate enough capital at a competitive cost. A share could be withdrawn by farmers, so redemption risk remains.
●	◑	◔	Splits business, hence impact on ability to pursue strategy. Does not deliver same capital for growth as preferred option. Investors would see call option as liability, so lower share price would result.

About Fonterra

Fonterra was created in July 2001 when farmers voted to merge New Zealand's largest co-operatives, New Zealand Dairy Group and Kiwi Co-operative Dairies, by an 84 per cent majority. The merger approval was followed by the Dairy Industry Restructuring Act (DIRA) which deregulated the industry, opened it up to competition and enabled the New Zealand Dairy Board to be folded into the new entity, creating a single integrated "cow to consumer" Co-operative.

Fonterra opened for business in October 2001, owned by just over 13,000 supplier shareholders representing some 96 per cent of New Zealand's dairy farmers and 1,111 million kilograms of milksolids. Shareholder numbers have consolidated, particularly with the trend to larger farms, and stood at 10,921 at May 31, 2007, representing 1,246 million kg/MS of production in the same year.

Fonterra is New Zealand's largest company with operating revenues of $13.9 billion in the year ended May 31, 2007 and assets of $12.6 billion. It accounts for 95 per cent of New Zealand's dairy exports, collecting 14.3 billion litres of milk in the 2006/07 season and selling 2.8 million MT of product to customer in 140 countries, two million MT of which was manufactured in New Zealand.

Fonterra represents some 40 per cent of the globally traded market and is its largest supplier of dairy products. This cross-border market accounts for 7 per cent of total global production, with the balance consumed domestically in the country of origin.

Fonterra is organised according to four sales channels supported by group-wide R&D and management resources. It has global manufacturing capability with 24 primary sites in New Zealand, 10 in Australia and 50 spread across China, South East Asia, Africa and The Americas. These four sales channels are Fonterra GlobalTrade, Fonterra Ingredients, Fonterra Brands and Fonterra Foodservice.

Fonterra GlobalTrade is one of the world's largest sellers of bulk commodities (milk proteins, powders, butter and cheese) with sales primarily into Asia, the Middle East and Africa, Latin America and Oceania.

Fonterra Ingredients sells dairy ingredients in the US, Western Europe, Japan and Korea. Sales include dairy commodities as well as specialised ingredients and solutions for largely dairy-based food applications. These specialist productions and applications draw on Fonterra's R&D development programmes and its technical teams.

Fonterra GlobalTrade and Fonterra Ingredients represented $9.9 billion of Fonterra's operating revenue in 2006/07.

Fonterra Brands produces and markets dairy products to consumers in 40 countries, with half of its business concentrated in the Australian and New Zealand markets. It has significant joint ventures in Europe (Arla) and South America (Nestlé) through which consumer products are sold, as well as a range of joint ventures elsewhere. Fonterra Brands represented $4 billion of Fonterra total revenues in 2006/07.

Fonterra Foodservices meets the specialised demands of foodservice customers who wanted branded consumer products as well as core ingredients ands ready-to-use products. This business has a geographic focus in the Asia Pacific region and includes several major quick-service restaurant chains among its customers.

Fonterra shareholders hold one Fonterra share for every kilogram of milk solids they supply. The shares are not tradeable, but are redeemable when shareholders cease or reduce supply. They are independently valued each year by Duff & Phelps. From a nominal value of $3.85 in 2001, Fonterra's shares have steadily increased in value to stand at $6.79 for the current season.

As a co-operative, Fonterra pays out virtually all its income to shareholders in the form of payout in proportion to the supply of milk solids received from them. Since the 2005/06 season, Fonterra's payout has comprised a milk price component payment and a value return – essentially the equivalent of a dividend for a listed company. In the 2006/07 season, total payout was $4.46 per kilogram of milksolids, comprising a milk price component of $3.87 and a value return of 59 cents – a total distribution of $5.6 billion.

For further information refer to www.Fonterra.com

Background on co-operatives

New Zealand's first dairy co-operative was formed in 1871 on the Otago Peninsula to produce cheese. Like other co-operatives, it was established to enable farmers to benefit from the power of pooled resources, giving them assurance that their milk would be collected, processed and ultimately sold.

By the start of the twentieth century, the majority of dairy factories in New Zealand were owned by co-operatives and there were more than 400 dairy co-operatives in this country by the 1930s.

While the "co-op on every corner" was a feature of rural New Zealand in the thirties, the arrival of better technology, such as refrigerated milk vats in the 1950s, meant the consolidation of co-operatives were inevitable. By the 1960s, 400 co-operatives had shrunk to 168.

With 95 per cent of New Zealand's dairy production exported, dairy co-operatives were continually driven by the need to achieve efficiencies and economies of scale. As a result, farmers voted for more and more mergers, reducing the number of co-ops to 12 by 1996. By the late 1990s, just four remained, with the two largest voting to create Fonterra in 2001.

Regardless of whether there are 100 or just one, co-operatives have been part and parcel of the dairy industry for more than 100 years because they work well for farmers. The combination of collective strength, industry efficiencies and the assurance that every day milk is picked up, processed and sold for the best price, with the returns going to farmers, is at the heart of the industry's success.

In the wider context of the New Zealand economy, Fonterra, as a co-operative, is New Zealand's largest business and one of the many co-operatives contributing to the national economy, particularly in the agricultural sector. In 2006, the combined turnover of co-operatives and mutuals was over NZ$27 billion, representing 21 per cent of the country's gross domestic product.

From the Chairman

We thought it was a big decision when we formed Fonterra. But, in my mind, what we are going to outline to you today and the consultation process that will follow is even bigger.

Fonterra is a co-operative and co-operatives have been part and parcel of our dairy industry for more than 100 years. They have been good to us. They work because they give farmers the collective power to ensure that every day their milk is picked up, processed and sold for the best price and that they get paid for their milk.

So the co-operative model has served our farmers well, but only because we have been prepared to change some parts of the model to match our strategy and markets, and to ensure we keep growing to lift shareholder value.

What we are considering tomorrow is a further evolution of the Co-operative to enable Fonterra to continue to adapt and change to ensure it remains relevant and competitive in the changing global dairy market.

This is a point in time when we need to be bold and brave. We have the opportunity to continue to control our destiny, grow earnings and grow wealth. We have the potential to become a truly global dairy company, a huge asset for New Zealand and a national icon.

In the Board's view this is the best way of preserving the future for the farmer shareholders in Fonterra. We believe that what we are outlining tomorrow will help secure the Co-operative's future, and many of us have been working on this almost full time for the past 12 months.

Farmers started this business in 1871 to market their milk collectively. The business today is a far cry from those days and a far cry from even six years ago when we formed Fonterra. We have changed in ways that would have been inconceivable to earlier generations of farmers.

To recap on some milestones:
- When the UK joined the EU, the UK was almost our sole export market, so we established a network of companies to market our products globally.
- When it was clear that too many small co-operatives meant too many inefficiencies, we merged.
- When we needed funds to grow, we shifted ownership of the Dairy Board over to the Co-operatives.
- When deregulation was on the cards, we took the big step forward to create the single integrated Fonterra.

I've heard people say that with our payout forecast of $6.40 why do we need to do anything? While $6.40 is good for farmers, it doesn't give the Co-operative the capital to implement our strategy. It may lessen the redemption risk. But that is debatable because our shareholders can choose to redeem their shares regardless of the level of payout. And $6.40 does nothing to address shareholder investment choice.

The Board has determined that we can not stand still. There are some huge opportunities coming up in the global dairy industry, and we believe we are in a good position to take advantage of these opportunities to benefit shareholders.

But we need to change our capital structure if we are to harness these opportunities. The Board's preferred capital structure option is the only option that we believe would allow us to implement our growth strategy. What we are proposing is a significant evolution, not tinkering at the edges.

There is a simple reality. Without a new capital structure we will have to revisit our strategy.

Our preferred option supports the business strategy to grow earnings and wealth, by addressing the key concerns of redemption risk, shareholder choice and access to capital.

The challenges we face are matched by the opportunities within our reach. We need to face up to the decision squarely. We have bitten off these challenges before and added value to the Co-operative. We just have to do this again.

If I look back over the past 12 months I think the single biggest concern, shared by everyone in this organisation, has been that this will be the thin edge of the wedge. That if we let outside capital into the Co-operative that “they” will eventually get control. But as you’ve seen, the Co-operative cannot drop below 50.1 per cent of ownership without 75 per cent of farmers saying yes.

The Co-operative cannot drop below 50.1 per cent without at least a 75 per cent shareholder vote. There are the additional protections of the 35 per cent legislated minimum and the 10 per cent limit on individual shareholding.

In all our deliberations we think that we are unlikely to get close to 50.1 per cent for at least ten years. And if we achieve that point then, it would be because of success, which we should be celebrating.

The most likely scenario for when this will occur will be when Fonterra is looking to raise funds to take advantage of a strategic growth opportunity in the market. The company would issue shares to fund the opportunity. The Co-operative may choose not to take up the share offer. As a result its shareholding in Fonterra would be reduced.

But should this point come, we do have some other options rather than diluting our ownership below 50.1 per cent. A few years down the track, when we do have a good track record, the market would be more accepting of non-voting shares. So that is just one of the options farmers would have open to them at that time if they wanted to stay at 50.1 per cent. And there are other options but they are best talked about in smaller director meetings during the next few months.

During this exercise we have all gone through a stage of wanting to legislate from the grave. In other words we have wanted to make sure that future generations had no opportunity to dilute the Co-operative’s ownership and control of Fonterra. I am sure many of our farmers will have that same reaction over the next months.

But, again, our farmers need to reflect on this, because if we put excessive controls in place, we will destroy value. In other words the market will devalue our shares.

Putting excessive controls in place would also be removing any flexibility for future generations. The Board has looked at putting something in place for this generation and the next …for our sons and daughters. But the Board does not believe it is appropriate for us to put handcuffs on future generations. Times will change, the market will change and we must respect that future generations need to make their own choices.

The Board believes it has struck the right balance between the need to protect our existing shareholders and the need to give future shareholders flexibility.

So you could look at the Board’s preferred option and call it the thin end of the wedge or you could look at it as an opportunity to grow value for our farmer shareholders. In the end that is the decision our farmers have to make.

I believe we need size and scale if we are to fulfill our potential and to build wealth for our farmer shareholders. It is time to choose whether we want to stay in a bubble with a less than ideal business model with our profits intact, but with nothing to hand on to our grandchildren? Or whether we continue on the path to become a multi-national in control of our own destiny, growing earnings, growing wealth and sharing profits. As I said at the outset we have the potential to become a truly global dairy company, a huge asset for New Zealand and a national icon.

The changes we’re talking about are big and bold, but don’t underestimate the capacity of farmers for big and bold steps.

Whenever we have evolved the co-operative model there have been trade-offs, and today is no exception. But as we have done in the past, we want to take the best of the Co-operative with us. We must always ensure that farmers have the ability to remain in control.

If you look back at the changes we’ve made over the years, one thing is clear. We have always been prepared to move ahead. And now is the time to take up the next challenge.