31 March 2001

Rt Hon Helen Clark
Prime Minister

Hon Jim Anderton
Deputy Prime Minister

Hon Michael Cullen
Minister of Finance

Hon Jim Sutton
Minister of Agriculture

Dear Prime Minister and Ministers,

We John Fernyhough and Brian Allison, are writing to you jointly in relation to the dairy industry's GlobalCo proposal.

Our experience

We were both appointed directors on the NZ Dairy Company Board until our recent retirements, John's at the end of 1999 following a stroke and Brian's last month. Brian was appointed to the NZDG Board in 1989 and John was appointed in 1995. We were the only independent directors and were appointed by the farmer-directors for our business expertise.

Until recently Brian was also a director of the New Zealand Dairy Board.

We were also both on the board of New Zealand Dairy Foods Limited. Brian was Chairman of that company. Dairy Foods is the leading New Zealand supplier of dairy products to the New Zealand market.

Our view in summary

We are both strongly of the view that, from the standpoint of farmers and the nation, GlobalCo is seriously flawed, in relation to process, strategy and design – so much so that it is likely to harm farmers, NZ consumers and our economy as a whole.

We have no dispute with the view that the New Zealand dairy industry is at a cross roads. Over time the Dairy Board has lost its effectiveness as the industry leader. As a consequence the rest of the industry needs to be better integrated with the international market so that the customer needs, products, quality, service and investment are brought into effective harmony.

It must be recognised that the basic driver for growth and efficiency comes from the farms themselves where we continue to have comparatively low costs, relative economies of scale (principally in the South Island) and entrepreneurial momentum. The present industry structure runs the risk of prejudicing this advantage through bad governance, false investment signals, unreasonable risk taking and a distorted focus on adding true value to New Zealand milk.

Achieving the integration of processing and marketing activities is critical to future success provided this occurs within a commercial structure. However, this structure must provide competitive pressure on efficiency, market pricing for milk, sound investment signals and recognition that capital should be rewarded independently of supply.

Why is GlobalCo flawed?

The corruption of these requirements persuades us that the GlobalCo concept is fundamentally flawed. Essentially it is a concept generated by industry politics rather than rigorously applied commercial principles.

Inevitably the weaknesses of GlobalCo arise from the unresolved issues of the industry. Implementing GlobalCo means that the process of resolution is halted because the principal catalyst was the competition of ideas and operations between the two major companies.

Major unresolved issues which hang over GlobalCo include the following:

1 Farmer Control

GlobalCo will cement in place the false concept that it is essential for dairy farmers to control directly 100% of the facilities and operations between farm and market. In addition it will lock in a poor commercial structure for the total enterprise.

In practice this is locking into the past. It is giving precedence to an illusory concept of control over better processes for maximising returns and wealth. Dairy farmers and New Zealand as a whole, would be better off with less reliance on a single co-operative structure along with the recognition that other people's capital and ideas are essential for baking a bigger cake.

2 Governance

This concept of control has given rise to a narrow minded notion of Governance which requires an over manned Board dominated by farmer members and leadership. This means that New Zealand's largest and most export oriented business will depend for its governance on a group of people of very limited commercial experience and expertise.

For dairy farmers this is a situation where narrowing the talent pool to meet political criteria will raise the level of risk to which GlobalCo exposes itself.

3 Rationale

GlobalCo owes its conception to three dubious principles.

First there is the deeply imbedded faith in monopolistic marketing and the desire to retain it. However there is no reliable assessment of the value or cost of this to New Zealand. In addition the dairy business has changed dramatically since the heyday of single desk selling and the Dairy Board itself has developed many of the vices inherent in a self serving monopoly.

Secondly, there is a view that any attempt to restructure the industry's export marketing structure must be accompanied by an unacceptable loss of value and that this would give rise to destructive competition between its successors. These arguments simply defy commonsense.

Thirdly, the economic concept of critical mass has become a foundation stone for GlobalCo with the assumption that the New Zealand dairy industry needs greater marketing mass in order to compete successfully. Overall size is not a good criterion for determining strategy and structure for a very diverse set of geographical and end-use markets.

Innovation and ideas are more important. Moreover the required mass can be achieved in other more effective ways.

4 Risk

The strategies currently in vogue reflect the belief that New Zealand has the opportunity to secure a relatively dominant position in world wide dairy product markets. Moreover, it is suggested that this will result in great accretion of wealth to dairy farmers and the community.

This simplistic belief has been taken up naively by many dairy farmers and uncritically by much of the rest of the community.

The strategies which flow from this involve both New Zealand milk products and substantial investment in those of other countries. Since GlobalCo is unwilling to unbundle its core business – adding value to New Zealand milk – from its investment ambitions, co-operative dairy farmers will be required to invest compulsorily in what is a high risk business strategy.

It should be obvious that individual dairy farmers would be well advised not to put all their eggs in one investment basket. An ability to spread their own investment risks should be a fundamental requirement.

The New Zealand Dairy Industry is a strange blend of forward looking dynamism and 'head in the sand' conservatism. Its greatest weakness is the powerful ignorance of matters outside the farm gate which infects the minds of the majority. New Zealand generally and dairy farmers in particular need to have self correcting mechanisms which the single company concept implicitly rejects. Two major companies going about their business in competition and with constructive tension between them would provide a far more effective and lower risk structure than is presently proposed.

Loss of competitive advantage

There has been a significant bio-technical revolution which has taken place in the last five to ten years. It is quite possible that this revolution will pass New Zealand by. Cows produce milk for about eight months of the year. It is quite possible that biotech will extend that to ten months of the year and that is an increase of approximately 25% in New Zealand’s total production.

Biotechnology substantially passed the New Zealand dairy industry by because the Dairy Board in the 1980s decided that the future for New Zealand dairy was to eschew Biotech in order to promote clean and green. The Genome project has made that view obsolete but New Zealand’s refusal to follow lines of research that ultimately led to the Genome project offshore has cost New Zealand dearly.

The point is that had there been two major New Zealand dairy companies at the time the decision was made, one of them might have adopted the New Zealand Dairy Board approach but the other would have been equally likely to have adopted the approach of investigating and adopting the new technology. With one company making a bad choice the consequences are very serious because the corrective mechanisms are not in place

Commerce Commission Review

A 75% vote of NZ dairy farmers will simply not address the serious risks created by this proposal for New Zealand consumers and our economy as a whole.

The Commerce Commission is the appropriate place to ensure that the claimed international benefits of GlobalCo outweigh the very apparent costs of creating a monopoly in New Zealand. In our opinion, GlobalCo is not significantly better than the industry’s 1999 ‘Mega Coop’ proposal and, as you are no doubt aware, the 1999 proposal was unable to demonstrate the claimed international benefits to the Commission.

If the benefits are so clear, as the industry’s current leadership asserts, they should have no difficulty in showing them to the Commission on rigorous economic criteria.

It is highly regrettable, however, the leadership is seeking to avoid Commerce Commission review because the claimed benefits are so speculative and relatively small, whereas the costs and risks are so certain and relatively large. ‘Now or never’ urgency is not a valid argument.

Next step

We would urge you as strongly as possible to refer the GlobalCo proposal to the Commerce Commission for proper scrutiny.

We would not normally be speaking out about these issues. Our approach has always been to make constructive contributions at the board of directors level. However, this is an issue of such gravity we feel duty-bound to express our concerns to you.

Yours faithfully,

John Fernyhough

Brian Allison