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Dialogue: Fear dogs dairy industry

By TONY BALDWIN

The Global Dairy Company should not escape Commerce Commission scrutiny, writes TONY BALDWIN* .

Most New Zealanders tend to think our dairy industry is hugely successful and almost an icon. But as an outsider looking in, you would be struck by its strangeness. The way the co-ops and the Dairy Board operate and interact is dysfunctional, highly political and surrounded by suspicion, secrecy, myth and misinformation - not what you would expect from our "most successful industry."

Despite higher farmer payouts this year, our dairy industry has got some pretty big problems. The industry's competitors are getting larger and more diverse. Nestle and Kraft, for example, are in the food business, not just the dairy products business, and they have access to much more share capital. But the proposed Global Dairy Company will still be highly constrained, as any extra share capital will have to come from our dairy farmers.

Despite all the rhetoric and myth surrounding the Dairy Board's supposed strength in world markets, New Zealand accounts for just 2 per cent of total milk production in the world. The bottom line is that the board's ability to influence export prices is relatively low. Meanwhile, commodity milk prices are expected to keep falling in real terms. The GlobalCo merger will not reverse this trend. Nor will it enable us to break through the protections in place in our overseas markets.

The problems in the co-ops and the Dairy Board are fundamental. By special legislation, no shareholder is allowed to hold more than five of the 13 director positions, even though NZ Dairy Group should be entitled to eight directors. The result is a power vacuum. None of the shareholders controls the board and for years it has been a law unto itself.

Because of this structure big issues become highly political. The result is that the board's senior managers run the show, or nothing happens for ages. Under GlobalCo, management control is likely to increase. It will become an even bigger bureaucracy playing bigger games with its directors.

The system for appointing directors means they are usually farmer-politicians, not businesspeople. Very few have outside business experience and almost none have international business experience. Ten of GlobalCo's 13 directors will still have to be farmers. More power will be placed in the hands of fewer industry politicians, but the real power will go to a smaller group of managers.

The production-driven structure of the industry also won't change. The Dairy Board tries to get the two big co-ops to produce a certain mix of dairy products, but a co-op's final payout from the Dairy Board depends on the volume of milk-solids supplied. Kiwi and NZ Dairy are competitors in trying to get more money from the board and it can take ages to agree which co-op will produce what mix of product. GlobalCo will remove this breakdown between marketing and manufacturing, but it is certainly not the best way to do it.

If farmers' annual payout from their co-op is high, the signal is to produce more milk. If it is low, the signal is to still produce more milk, but don't bother converting more land to dairy. The problem is that farmers cannot tell why the payout is up or down, and which part of the business has done well. This won't change under GlobalCo.

Farmers have at least six distinct investments in the industry, including the farm, co-op factories, NZ sales, the Dairy Board, other overseas ventures and returns from export quota. Returns on each investment are bundled together into a single milk payment to farmers. This makes it extremely difficult to monitor performance and leads to some seriously uninformed investment decisions. This won't change under GlobalCo.

Even if a farmer just wanted to sell raw milk and have a share in the initial processing, he or she has no choice. This is no way to achieve a balanced investment portfolio and won't change under GlobalCo.

Farmers cannot readily sell their co-op shares or switch to another co-op as the industry has created all sorts of barriers to selling co-op shares and switching. Even if they sell the farm and the co-op shares, farmers are likely to give up about 150 to 300 per cent of their true value. This is unlikely to change significantly under GlobalCo.

Farmers are therefore in a weak position to put pressure on the directors and managers. Farmers are locked in with no other options and directors and managers know that, so they perform at a political level to keep farmers happy. This won't change under GlobalCo.

Because dairy co-ops do not allow farmers to sell their shares at full value, the difference between the nominated share value and its full value gets pushed into land prices. Dairy land prices are therefore artificially inflated. This won't change under GlobalCo.

Probably the largest single problem holding down the industry is fear. Many industry leaders know GlobalCo is a muddle but they are afraid to speak out. From my experience, many industry leaders have a depressing focus on self-advancement. This will probably get worse under GlobalCo because all the bits in the "black box," which covers everything beyond the farm-gate, will become harder to pin down.

Dairy farmers have lived under the single-buyer system for so long they don't trust anything or anyone else. It is a semi-religious creed where total farmer control is paramount. For this, farmers seem to be willing to pay a monumental price by losing large amounts of wealth.

This would be fine if it didn't cost all of us. Our economy as a whole will be much worse off as a result. NZ consumers will pay higher prices for dairy products and quality and service will fall. But worst of all, we will lose so much innovation and creativity.

A handful of farmer directors overseeing a handful of senior managers simply cannot see all the opportunities and ideas for creating more wealth for farmers. And other businesses will continue to miss out on resources because they are being diverted into dairy.

From the start of this latest reform process, many sensible options were simply discarded by the industry because they did not conform to the political dogma. In essence, GlobalCo is a worst-of-all-worlds compromise between two tribes with quite different philosophies.

Now, for some strange reason, even though Kiwi Dairy has only 30 per cent of the Dairy Board's shares, its inward-looking culture seems to be carrying the day against NZ Dairy Group. Why did NZ Dairy capitulate? I suspect the leadership simply lost its nerve.

There is a lot to worry about in GlobalCo, but the thing that really worries me is that the Government might promote special legislation without sending it to the Commerce Commission. No other business in the Western world would be allowed to bypass the competition watchdog. Dairy industry leaders keep rolling out misleading rhetoric to politicians about how the commission is not the right place to deal with GlobalCo. The industry put a similar proposal to the commission in 1999. In its initial determination, the commission thought the costs would greatly exceed the benefits for our economy. The 1999 proposal was actually much stronger than GlobalCo and despite leaders' claims, the commission does count benefits from increased overseas earnings. The leaders' problem is they cannot objectively show those benefits - they keep using vague, hyped-up marketing jargon, instead of hard facts.

Instead of proving their case to the commission, a new leadership in the industry went to the senior cabinet politicians , pleading that GlobalCo is special and therefore deserving of special legislation.

GlobalCo is not special - it is simply weak - and the leadership doesn't want that fact to be publicly exposed. Helen, Michael and Jim, please don't get sucked in - send GlobalCo to the Commerce Commission like any other business.

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