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An analysis of the Global Co proposal

By Tony Baldwin

The NZ Dairy Board is our largest business organisation. It's also our largest export earner– by far – with annual sales of $ 7.65b pa. NZ Dairy Group, based in Hamilton, is our largest dairy cooperative company, with annual sales of $3.4b pa and 58% of total production. Kiwi Dairy Group, based in Hawera, is our second largest diary cooperative, with annual sales of $2.6b and 30% of total milk production.

These three entities want to merge to form a single, integrated cooperative dairy company for all of NZ. Last year, its working name was "Mega Coop". This year, it's "Global Co". It will be our biggest company by far – 2.5 times bigger then Telecom (in turnover). To glue it all together, the industry's leaders are pushing the Government, behind closed doors, to pass special legislation to override our Commerce Act – a central pillar of our business law.

In the first of a two part article, Tony Baldwin – leader of the previous Government's Producer Board Project Team (1999) and policy adviser in the Department of the Prime Minister and Cabinet (1991-98) – comments on the proposal from three different perspectives: the Government, consumers and dairy farmers.

Our 'Third World' Economy

In her opening statement to Parliament on 13 February, Helen Clark zeroed-in on a key problem at the heart of our economy:

"*For too long New Zealand has been trying to sustain First-World living standards on the back of Third-World exports. That does not add up, but it does explain why over the last half century, as others have taken their economies upmarket, ours has drifted steadily towards the bottom rungs of the OECD ladder."*

She is absolutely right. In a nutshell, NZ makes tons of stuff that rich countries don't need or want. About 20% of our export income comes from selling pretty basic, low-value dairy commodities – powders, butter and cheese. In fact, powder makes up about 40% of total dairy exports and most of it is sold in Asia.

The current higher dairy payouts are a false bubble that sadly will burst at some stage. International commodity prices for dairy products are forecast to keep falling over the medium to longer term. So why are we locking ourselves and our farmers into processing even more milk?

Is Global Co a Good Solution?

Global Co is not just a 'farming issue' – something for farmers to worry about, addressed by the press in its 'agricultural section'. Global Co will have a massive impact on the economy. It should be seen as a major business issue. It is also a key test of how the Government views business. The key questions are:

- Is Global Co likely to make the best possible use of our scarce resources, moving us away from (in Helen Clark's words) "Third World exports"? In my view, *not likely.*

- Is Global Co a suitable vehicle for a large international investment strategy targeting dairy consumer products in South America and elsewhere? In my view, *no.*

- Is Global Co an improvement on the rejected Mega-Coop proposal of 1999? In my view, no – it's probably *worse*.

- Should Global Co be given special legislation to override the rules that apply to all other NZ businesses? In my view, *absolutely not.*

- If the Government capitulates (by agreeing to special legislation), who will suffer? *All of us*, especially farmers and NZ consumers over the next 10 years – with the clear exception of Global Co's senior managers and their consultants, who will do very well.

- Is there a better option? *Definitely.*

Let me explain why.

Government's Role

The dairy industry is, beyond doubt, hugely important to our economy. It ties up massive amounts of equity capital, debt finance, land and water, electricity, plant and machinery, intellectual property, skills and labour, not to mention human energy and spirit.

The Government's 'number one' job in helping to grow the industry and the economy is to ensure that:

- whoever uses the resources is under heavy and constant pressure to extract the greatest possible value (consistent with normal environmental and business rules); and

- if they don't, the resources must be able to pass readily to other competing users, to let them try to do better at creating value.

Without these two things, our economy won't make it.

Global Co misses the mark on both counts. It locks-in barriers to the reallocation of resources; and, it seeks to retain a massive cushion to insulate itself against real pressure to perform.

The result is that the industry will continue to waste resources by failing to realise their full potential.

NZ Consumers' Perspective

Global Co will be able to raise prices and reduce volumes of NZ dairy products. It will also be able to reduce the quality of service supporting those products, without any real fear of loosing market share to competitors. But worst of all, it will be able to stall innovation on the NZ dairy market. These are all serious losses to the NZ economy.

Global Co will also be able to extract 'rents' from NZ consumers, by raising local prices. Technically, this is 'just a wealth transfer' from NZ consumers to Global Co. Economists don't count it as a loss to the economy, unless it disappears overseas. However, it's worth noting that the Commerce Commission in 1999 estimated this 'wealth transfer' at $25-147m per year – not a bad gift from us consumers to Global Co's manager and suppliers. I am surprised it's not a 'red light' concern for this Government.

Global Co's response is normally as follows: (i) impacts on the domestic market are relatively trivial (though they wouldn't use that expression in public) when compared to the massive gains to be made for NZ in overseas markets under Global Co; (ii) Global Co wont be able to exploit the local market after a transition period because NZ Dairy Foods (now owned by NZ Diary Group and its farmers) will be sold to an entirely separate party, who will be able to compete with Global Co on the domestic market; and (iii) with the 'single desk' powers removed, the way is clear for new entrant competitors in NZ.

Three quick replies:

- 'Dead weight' losses and wealth transfers from NZ consumers are not trivial issues;

- For at least 5 years, the buyer of NZ Dairy Foods will probably rely on Global Co for its key inputs – raw milk, some ingredients and brands. In other words, NZ Dairy Foods will be a pretty weak competitor, for quite a while; and

- The probability of 'green-fields' new entry – someone like Nestle or Kraft building significant processing plant in NZ – was assessed by the Commerce Commission in 1999 as very low (see its 27 August 1999 draft at paras 269-297).

Dairy Farmers' Perspective

Short of selling the farm, a dairy farmer is locked into every part of the dairy value chain. Farmers actually have four discreet investments, which at present are all bundled together:

- First, there's land, livestock, plant and equipment – all used to make milk, which is sold to a dairy processor. A farmer should get a clearly defined, distinct price for selling raw milk.

- Second, every farmer has a compulsory investment in a dairy processor – like Kiwi Dairy or NZ Dairy Group. Farmers have large amounts of capital tied up in processing factories. Each farmer should receive a clearly defined, distinct return on his or her investment in the processing factories.

- Third, every farmer has a compulsory investment, through a dairy co-op, in marketing and exporting dairy products. This function is carried out by the Dairy Board, which is owned by the co-ops (in proportion to their share of supply). Once again, a farmer should receive a clearly defined, distinct return on his or her investment in marketing and exporting.

- Fourth, every farmer receives a share of the ‘rents’ NZ makes under its quota entitlements to sell certain dairy products in Europe, Japan, Canada and a range of other countries. The quotas are negotiated by the Government for NZ and entitle us to export certain volumes of specific goods without paying the normal import tariffs. So we get to sell products at the local price without incurring the tariff. This margin (the tariff not paid) is often called a ‘rent’. It is viewed as a form of compensation to NZ for our loss of market share when Britain entered the EU. The level of the ‘rent’ is quite separate from the rest of the Dairy Board’s business.

Farmers should be able to choose whether to increase their investment in each area. What is the sense in having all your eggs in one basket? It’s not a good investment strategy. Under Global Co, farmers will be forced to put a lot more money in overseas investments, particularly in South America, processing overseas milk. This is a major risk for farmers.

‘Bundling’ the four different returns gives rise to major economic waste, especially in new investment decisions. It also makes it very hard for shareholding farmers to work out which is the profitable part of the business. Monitoring is much weaker. So is pressure on the directors and managers.

How would the Global Co proposal fare if it were subjected to normal market scrutiny? Would market experts recommend say the price was for shareholders was right? Would they say Global Co was likely to grow shareholder wealth more than other options over the next 10 years? The answer is – no one has a clue, because there’s no proper external scrutiny. Compare this to the scrutiny Fletcher Energy got in selling to Shell. Global Co has none of that, yet it’s NZ’s biggest business merger.

Dairy farmers and their resources are also locked-in by huge barriers to switching processors and realising value.

- Shares in dairy co-ops must be sold back to the co-op at nominal value.

- No account is taken of market value – there is simply is no market.

- Co-ops can even retain a farmer’s share capital for 5 years after a farmer has switched.

- A farmer can’t sell co-op shares to another person unless the buyer also purchases the farm.

- A farmer can’t switch to another co-op without the incumbent co-op’s written permission (unless the switch is made at a specific time of the year).

- On top of that, many co-ops simply don’t accept more suppliers.

Bottom-line: there is hardly *any* switching. You may well ask, what benefits does a farmer get from being in a dairy co-op? First, second and third is a guarantee that his or her milk will be purchased every day, no matter how much is produced. Farmers feel safe. Their banks like the security too. But it’s a false sense of security.

The restrictions on coop shares are likely to cause a discount of 150-300%. This is certainly a heavy price to pay for an open guarantee that all milk produced by existing farmers will be purchased (at the same price), even if it's marginal value is extremely low.

The result is that co-ops and the Dairy Board do not have to compete to attract suppliers. This causes a large amount of inefficiency within the system. As economic advisers to the Dairy Board, NZIER quantified the efficiency costs at $190 to $230m per year.

This poor ability to realise real share value, or to switch co-ops, was (in my view) a pivotal factor in the Commerce Commission rejecting Global Co when it was called "Mega Co-op' in 1999.

Commerce Commission

Exempting a transaction of this importance from the normal Commerce Commission process is simply irresponsible. Industry leaders argue Global Co is simply to big and special for the Commission to handle – that the Commerce Act is preventing business from gaining 'critical mass' to compete overseas.

This is misleading rhetoric. In its assessment of the costs and benefits, the Commission counts gains from extra strength in overseas markets. The real problem is that the industry can't quantify them – they remain vague, 'feel good' marketing platitudes.

'Critical Mass'

It is beyond doubt that firms need big balance sheets to roll out new international consumer brands. Financial grunt is vital. But so is expertise, accountability to shareholders and an ability for farmers not to have to invest their money in high-risk ventures. Don't forget that NZ manages about 2% of total world production. Sure, we have 30% of traded dairy products but only 8% of dairy products are traded. Most countries make their own.

Also bear in mind that:

- Nestle has a turnover of more than US$15b. Kraft, US$8b+. Both are investor-owned companies. They can keep getting bigger.
- Global Co will still only be 12th largest in the world, one third the size of Nestle, with a turnover of about US$5.4. And it can't get any more share capital except from NZ farmers. It will *never* keep up. Global Co is a 'dead-end' because it wont have access to fresh share capital. Global Co may jump NZ under to 12th largest, but for how long? How long before the others get further away from us due to Global Co's inability to raise new equity capital?
- This pushes the Dairy Board into risky joint-venture deals to in South America, processing South American milk.

If I were a farmer, this would make the hairs on the back of my neck stand up! There is a real risk here of farmers' capital being used by overseas joint venture partners as 'soft money' to underwrite riskier consumer-end activities. The money is 'soft' in the sense that it is 'captured' – the shareholders can't walk away very easily – so it's not as expensive to service.

Summary of costs

The costs of Global Co for New Zealand will be very high, especially for farmers, including:

- Under-valuing farmers' investment in the industry by 30-50%;

- Forcing farmers to live with a badly undiversified portfolio of investments – all their 'eggs in one industry basket';

- Forcing farmers to commit more capital to manufacturing and marketing, with no ability to effectively monitor the returns generated in each sector, and no options for reducing their exposure except by selling the farm;

- Weak pressures on directors and managers to perform. In any large enterprise, this only effectively achieved if suppliers and shareholders can 'vote with their feet'. In the dairy industry, politics and in-fighting are the paralysing substitutes;

- Management capture. With such a large business and relatively limited experience at overseeing complex multinational businesses, many of the 10 farmer directors are likely to be 'captured' by Global Co's management – seduced into thinking they are in control, when they are simply being carefully massaged by the senior management;

- Distorted land prices. This is because changes in the market value of capital invested in the industry are not reflected in farmers' shares. So dairy land prices are distorted (often inflated), which of course impacts on other competing land users; and

- A seriously production-driven industry.

For NZ consumers, we finish up with a Government-sanctioned monopoly with the power to take extra money from us to prop-up Global Co's overseas ventures and subsidise its payout to farmers. At the same time, Global Co with be able to reduce the quantity and quality of domestic dairy products without having to worry about competitors reducing their market share.

Government's Likely Response

The Government will probably try to reassure NZ consumers that it will put place a racy new regulatory regime specifically designed to protect farmers, keep Global Co lean, mean and innovative, and prevent it from exploiting NZ consumers.

The Government and the industry will then claim that NZ can have all the putative up-sides of Global Co but avoid all the domestic down-sides.

After 8 years as a policy adviser to the Government, trying to come up with clever regulatory regimes to counter monopoly behaviour, I'd have to say that is simply impossible. In fact, it's only likely to make matters worse. You can't stop human creativity working around rules, especially when there is a big trophy sitting on the other side – in this case, in the form of extra dollars from NZ consumers, a large amount of internal fat to live off and, for the directors and managers, a huge sense of power and excitement.

Conclusion

Our farmers are the best in the world – the most innovative, the most cost-effective. But dealing with issues beyond the farm-gate has always been treated within the industry more as politics than business.

International markets are complex. In their own words, farmers don't wont to end up 'peasants' to overseas corporates. But put simply, Global Co driven by two things: fear and lack of trust. Underneath it all, farmers are really saying: 'We want to make more money from our milk but we don't trust any else to do it except a few 'experts' appointed by farmers – and we would like to believe the hype around our strength as a 'single desk. We've heard it for some many years, it must be true – isn't it?!'

And what if those few 'screw up'? Where do farmers and NZ consumers go then? The fortress will collapse, eventually, and there will be no one else to turn to.

The costs of the Global Co massively outweigh the benefits. The industry leaders know it wouldn't pass the 'public benefit' test under the Commerce Act – that's why they are cosying up to the Government for an exemption.

It would be a tragic mistake – for all New Zealanders – if the Government gave them one. Especially when there are simpler, better alternatives.

Disclaimer

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