Pricing signals

Pricing structures matter. They are like traffic lights on a multi-lane intersection steering the way resources flow, in what volumes and at what times. Fonterra's pricing signals are askew at several major "intersections", particularly in signalling milk flows.

Take two examples: the price farmers pay Fonterra for the right to supply a unit of milk, and the price Fonterra pays farmers for their milk.

Farmers normally have to hold Fonterra shares in proportion to the volume of their supply — one share gives the right to supply one unit of milk.

So the price a farmer pays for the right to supply a unit of milk is the market value of a Fonterra share, which is the present value of expected future dividends. The problem is that this price bears no relation to relevant costs or services.

The correct price for a right to supply is the marginal cost to Fonterra of processing an extra unit of milk, which has nothing to do with the value of a Fonterra share.

Alternatively, Fonterra could ditch the requirement for farmers to buy the right to supply and, instead, buy milk from farmers at prices that reflect the market value of their milk, minus the marginal cost of processing each unit of it. Precedents from other industries may be instructive.

At present, all milk at all times from all farmer-shareholders in all locations receives the same single nationally averaged price, which is calculated at the end of the season when costs and market returns are known. Farmers have a guaranteed buyer, and nothing signals the relative value to Fonterra of different quantities of milk from different locations at different times of the year.

The result is poor alignment between milk flows, processing assets and Fonterra's value-add strategy.

[Extract from Tony Baldwin's 2016 article published in the NZ Herald, which is available here]