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WHITHER COOPERATIVE DAIRY COMPANIES?

**ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE**

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WHITHER COOPERATIVE DAIRY COMPANIES?

The variety of ownership structures

Firms are established where the costs of contracting between input suppliers and final consumers are high. They are an efficient means of processing information and coping with real world uncertainty, risk and behaviour. This seems a rather obvious point, but is important in considering the ways in which business forms change over time.

In competitive markets a variety of arrangements can be observed. Firms with differing ownership characteristics may coexist in the same market or predominate in certain sectors. Most capital intensive large-scale enterprises are organised as conventional companies owned collectively by investors who provide the capital. Some firms are owned by their customers – mutual insurance companies and some fertiliser companies are examples. Worker-owned firms are typical in labour intensive professional services, such as law and accounting. The form of business organisation that has dominated the dairy industry is cooperatives owned by farmers who supply them.

While there is a wide variety of ownership forms, all face the problem of determining who is best placed to bear the risks of receiving residual income or funding residual losses. The ownership risks (i.e. the right to residual income) of a typical dairy cooperative reside with members who supply milk, although not all farmers who sell milk to the firm need be members. The risk capital of a cooperative is typically supplied by its members, in the form of retained earnings. In an investor-owned firm residual income risks are borne by the people who supply capital to the firm; typically they would not be its suppliers of raw materials.

The critical difference, therefore, is that with a cooperative, the suppliers of risk capital also supply the bulk of the raw material; with an investor-owned firm there is no such conventional link.

The role of owners

Whatever organisational form is adopted, the owners of a business typically have two key roles.

First, owners provide equity capital and ultimately bear the risk of their investment. Their rights to the underlying assets of the business are generally subordinate to the claims of other funders (such as banks) and of workers and managers.

Secondly, the role of owners is to control the activities of the managers of the firm. Managers and owners may have different objectives. Managers may have a greater interest in how much they are paid than in seeking higher profits for the owners. In addition, the information available to owners and managers may differ. A farmer, for example, has less information than a manager about the detail of production processes or markets.

No particular form of business ownership is superior to all others regardless of the circumstances. The variety of business forms we observe reflects the range of viable ways of assigning risk in a competitive environment. Provided that regulations and tax rules do not favour any particular form of ownership, those forms that survive and coexist are likely to be the most successful.

In this context, research such as that commissioned in 1995 by the Dairy Board, which shows that the performance of cooperatives in a range of industries is comparable to that of investor-owned companies, is unsurprising but uninformative.

The results are unsurprising because the mere existence of cooperatives in a competitive environment suggests that they are likely to operate at similar levels of profitability and efficiency as other investor-owned firms. They are uninformative because freeze-framing the comparative performance of firms at any point in time masks underlying forces that continue to shape the ways in which businesses are organised. Furthermore, the fact that cooperatives and investor-owned companies demonstrate comparable performance in an industry which is open to competition says nothing about the likely performance of the Dairy Board, which enjoys a statutory monopoly, or of cooperatives in a highly controlled industry such as dairying.

Which form predominates in any industry in any period may depend on circumstances that are particular to that industry or that period. But circumstances change. In industries in which the need for capital is increasing rapidly, moves from cooperative to corporate structures are likely. Thus barely a month goes by without a report of another mutual insurance company choosing to become a conventional

investor-owned firm. Many building societies, Trustbank, and the Australian Stock Exchange have become publicly listed companies or are on a path to listing.

In agriculture the Western Farmers Co-operative in Australia was restructured as a vehicle to hold a majority interest in the publicly listed company Wesfarmers Ltd. There has been a massive increase in shareholder wealth, while farmer control has been retained through the 52.4 percent of the issued capital of Wesfarmers controlled by a farmer-owned holding company.¹ The Dairy Farmers Group, Australia's largest dairy cooperative, is considering proposals to list on the Australian Stock Exchange. This is despite the fact that listing in Australia means a loss of tax concessions, a situation that does not apply in New Zealand. The largest dairy cooperatives in Ireland have restructured along similar lines to the Wesfarmers model. In the United States, the United Kingdom and elsewhere, many agricultural cooperatives have been changing their structures.

Many ownership forms but common ownership problems

In examining their ownership structures, mutually owned companies and producer cooperatives are reassessing where the balance lies between structures which:

- protect suppliers by removing the potential conflict of interest between a supplier and a shareholder who are not one and the same;
- allow suppliers to switch companies if a purchaser is not performing;
- provide access to necessary capital independently of the financial strength of suppliers;
- free up suppliers' capital, allowing them to invest it in their own businesses or to spend it in other ways; and
- tap into commercial expertise, brands and market knowledge and access which can only be supplied by a major shareholder.

1 Since its creation, the market value of Wesfarmers has increased from about A\$25 million to more than A\$1.2 billion.

For dairy cooperatives these issues were not so acute when suppliers had a choice of cooperatives to join, sold relatively similar quantities of a homogenous product (milk) on broadly similar terms, and did not have to supply much off-farm capital because value-added processing was limited. As New Zealand Dairy Group chairman John Storey is reported as saying, the dairy industry's structure was designed for the 1950s and 1960s.² At that time the issues of flexibility in capital raising, accountability and risk were not as pressing since a large proportion of the output of cooperatives consisted of a limited range of products sold in regulated markets with favourable market access. Circumstances have clearly changed. Mr Storey questioned whether the industry had the right structures to take dairying into the twenty-first century.

Like most other markets, consumer markets for dairy products have become increasingly competitive and complex. Relative world prices for bulk foods are declining – having halved since 1950/51. The industry is looking to more sophisticated 'value-added' products to counter this trend. But here it faces the growing power in world markets of retailer purchasers and stiff competition from existing brands. To develop value-added products and brands is capital intensive and risky. One observer has described these trends in a US context as follows:

Historically, bulk products flowed through commodity markets to food processors, who in turn marketed standardised products to consumers. But consumers now want tailored foods, and to ensure that they get them processors want more specific farm products. In response, processors and producers in many segments of US agriculture now go around traditional spot markets to more direct market channels.³

New Zealand's ability to respond to these market shifts is reduced by current institutional arrangements which by and large prevent foreign purchasers dealing directly with New Zealand manufacturers of dairy products. Nevertheless, dairy products are increasingly being manufactured to the specifications of end consumers. Dairy companies facing increases in milk supply and a need to manufacture more sophisticated products have had to embark on large capital investment programmes. Greater vertical integration, involving processing of raw milk through to final consumer products, is commonplace.

² *National Business Review*, 8 April 1994.

³ Drabenstott, M, 1994, 'Industrialization: Steady Current or Tidal Wave?', *Choices*, Fourth Quarter, p. 5 quoted in Fulton, M, 1995, 'The Future of Canadian Agricultural Cooperatives: A Property Rights Approach', *American Journal of Agricultural Economics*, December pp. 1144-1151.

The higher levels of investment have meant that many cooperatives have extended their operations into fields related to food processing, but unrelated to the supply of milk. Firms with investment and expertise in operating dairy processing plants and distribution networks have found they can apply their plant and skills to other activities, such as the processing, marketing and distribution of fruit juices and other food products.

The wider range and diversity of activities of cooperatives, growing capital requirements, and the pressures for greater accountability for performance in a more competitive environment are the three main factors that have been driving mutually owned companies and cooperatives to review their ownership structures. These are discussed in turn in more detail.

(i) *Diversity of activities*

In presenting the proposal to convert Colonial Mutual Life Assurance Society into a listed investor-owned company, the chairman of the company noted that, due to the diversification of the business, the interests of members in their capacity as policyholders and in their capacity as owners were diverging. He pointed out that:

Policyholders look to normal equity, fixed income and property investments, managed for sound performance, to provide their returns. They do not normally want the performance of their policies to be dependent on the success of operating subsidiary businesses of the company. To restructure, so that policyholders' interests are solely in the performance of their policies, should enable a better focus for both policyholders and company alike.

Similar observations could be made about supplier-owners of dairy cooperatives. In particular, the issue of 'bundled' returns was highlighted as a major problem in the dairy industry in the 1992 ACIL report.⁴ Currently, a significant proportion (around 25 percent) of the farmgate price for milk depends on the performance of off-farm investments in processing facilities and a further element on the premium associated with New Zealand's privileged access to the higher priced European Union butter market. Receiving separate returns for off-farm and on-farm investments as one payment for their milk gives farmers a price signal that encourages them to expand output. They are being told that world markets are demanding extra output that can be sold profitably. What is only slowly being appreciated by farmers is that the extra output will have to be sold at prices that may not cover the total costs of processing

⁴ ACIL, 1992, *Agricultural Marketing Regulation: Reality Versus Doctrine*, New Zealand Business Roundtable.

and marketing the product.⁵ Extra resources, including land, are being artificially attracted into dairy farming.

The annual cost to the New Zealand economy of these distortions is substantial. It takes the form both of over-production of milk, which depresses international returns, and excessive conversion into dairy production of land which would yield higher returns from a national perspective in other uses. These distortions have been estimated to reduce national income by \$145 million annually.⁶ The inclusion of the premium of sales of butter to the European Union in the payout price for milk has been estimated to account for a further annual loss of national income of \$23 million, bringing the total loss to \$168 million.⁷ On this basis, over \$800 million or close to 1 percent of gross domestic product (GDP) has been sacrificed since these issues were first raised in the 1992 ACIL report.

The bundling problem is further complicated because cooperatives are obliged to accept extra output from suppliers. Instead of being market-led they are production-driven. They are therefore required to expand their processing capacity and investment in marketing to support the additional production. Additional off-farm investment can be funded only out of retained earnings. Existing members can have little confidence that both existing suppliers who increase their production and new suppliers incur the costs of processing the additional supply, despite various attempts to impose levies on additional production. In effect, by increasing their production, suppliers capture an increased share of the value of other shareholders' off-farm investments.

The problem of bundling will only be addressed when ownership of the returns to off-farm investments is separated from ownership of the returns to on-farm milk production. Merely sending separate cheques for the returns will not solve the problem so long as the dividend component of off-farm returns is tied to the volume of milk supplied. The only satisfactory way of distinguishing returns from on-farm and off-farm investments is to issue shares in the processing companies and the Dairy Board. Farmers would then have proper information about the quantities and type of milk that can be sold profitably. As investors who could sell their shares if they wish,

⁵ The chairman of the New Zealand Dairy Board, Sir Dryden Spring, attributed 5 cents of the fall in the milk payout price per kg in 1996/97 to the increase in milk supply, but stated that this could be an underestimate (*Straight Furrow*, 9 June 1997).

⁶ Tasman Asia Pacific and ACIL, 1996, *The Economy-Wide Effects of Bundling Milk and Non-milk Products*, New Zealand Business Roundtable.

⁷ Bates, W 1997 (forthcoming), *The Dairy Board's Export Monopoly*, New Zealand Business Roundtable.

they will also have better information about the performance of their off-farm investments relative to alternative investments. This will facilitate decisions on whether more or less capital should be invested on-farm, in the downstream enterprises, or elsewhere.

Relying on the value of dairy land as a substitute measure of the performance of off-farm investment, as suggested in the 1995 study on cooperatives commissioned by the Dairy Board, is clearly inferior. Such an approach means that selling their farm or converting from dairying are the only options for farmers who are unhappy with the risk or performance of their off-farm investments. The artificial inflation of dairy land prices distorts land use and the rise in land values means that wealth that should belong to dairy farmers is transferred to non-dairy industry participants who convert their farms to dairying.

(ii) Capital raising ability

Under existing arrangements, farmers alone must assume almost all investment risk as residual stakeholders and they are, in effect, involuntary investors in processing and marketing. All new investment must be financed out of debt and retained earnings. The sole source of external finance is debt. Prudence dictates that debt should be kept in balance with the equity available from retained earnings since debt would otherwise increase the risk faced by farmers. In contrast, shareholders in investor-owned firms can diversify their risk by increasing or reducing their shareholding, or altering the mix of shares they hold, in accordance with their risk preferences.

Similar constraints on growth are faced by mutually owned businesses. In putting the case for demutualisation to policyholders, the chairman of Colonial stated:

In the second place, the search for growth and strength, which is needed if we are to be able to serve our customers well, requires access to capital when wanted, not just when it can be generated by the business. In a mutual structure, additional capital can only be found through surpluses emerging and retained from the business itself. If Colonial is to be able to take advantage of opportunities as they arise, without putting policyholders' interests at risk, it needs to have a shareholder base to which to look, and which will be keen to see growth and profitability increase.

The capital raising problems of dairy cooperatives are likely to increase once institutional arrangements for the export of dairy products are freed up, as seems

inevitable, and foreign purchasers can deal directly with dairy processors and exporters. This is likely to accelerate the move away from bulk commodity lines into differentiated consumer products, with increased investment required for their production.

Some cooperatives are realising that traditional structures are no longer adequate for funding purposes. For example, the managing director of an Australian fruit-processing cooperative has said that:

... partnerships and strategic alliances are increasingly being used to help companies maintain growth levels without the whole capital cost that would be involved if a company tried to do everything itself. Things are moving so fast and capital is so expensive that you can't physically own all the assets and resources necessary to bring products to market in a timely manner.

In contrast to the New Zealand dairy industry, the Australian dairy processing and marketing sector is attracting large amounts of outside capital, both through greater openness to corporate involvement by companies such as Wesfarmers and through foreign investment. Dairy investments include \$500 million by Nestlé, \$150 million by Bonlac and a \$44 million joint venture between the Murray Goulburn Cooperative, Meiji Milk Products and Mitsubishi.

External contributors of equity have done more than merely provide finance and share the risks inherent in new investment. They are contributing institutional knowledge, management, manufacturing and marketing expertise, and forward linkages to markets. Dairy farmers in Australia and elsewhere do not seem to be averse to exploiting these opportunities.

In the New Zealand context, Murray Gough, a former chief executive of the Dairy Board, has recently made the point that:

Some opportunities to grow this business have little direct link to selling NZ dairy products – for example, using NZ technology to improve the profitability of processing another country's milk, or buying a dairy product brand to add to the market power of one of NZDB's distribution companies.

The best of these opportunities can require significant risk capital, but it is unrealistic to expect all farmers to want to commit to hundreds of millions of dollars for investments which may have only a marginal link to marketing of their milk.

The reality is that NZDB must take a less aggressive approach to investments of this nature than its competitors – a constraint which could in the long run

significantly inhibit the ability of NZDB's added-value business to remain globally competitive.

Given that farmer control has also been a factor favouring cooperative structures, a move to structures better suited to the supply of risk capital needs to satisfy farmers that the rewards they will capture will more than compensate them for any perceived loss of control.

The concerns about farmer control seem to be peculiar to those parts of the primary sector that are dominated by producer boards. It is seldom an issue for other suppliers of raw materials such as fish or wood, whose output is also further processed and sold on world markets. Nor is it raised in other contexts, such as the demutualisation of insurance companies. Policyholders do not appear to be driven by a desire to retain control of all aspects of a financial services business for fear that they may miss out on value-adding opportunities.

In a less regulated agricultural sector, the concerns about 'farmer control' are misplaced for several reasons:

- farmers could still form cooperatives, but alternatively they could buy protection in the form of long-term contracts for supply;
- other suppliers would be permitted to bid for their milk – providing more options than a situation in which there is only one monolithic dairy company in a supplier's region;
- while a farming unit may be dedicated to dairy farming in the short term, so too are processing facilities. Indeed, dedicated and capital intensive dairy processing facilities may be more exposed to the risk of losing access to raw material than dairy farmers are of losing an outlet for their milk. There are alternative uses for farmland and good networks for transporting milk but few alternative uses for specialised processing plants;
- pressures for the amalgamation of dairy companies (and therefore a reduction in purchaser options) may be reduced if institutional arrangements that unduly favour mergers are liberalised;⁸ and

8 There was significant comment at the time the Dairy Board Amendment Bill was being considered that amalgamation activity among cooperatives was being driven by a desire to

- in increasingly competitive capital markets, the focus of managers is to provide a market-related return on equity, regardless of the identity of shareholders in the company. Otherwise, the company will not be able to retain or attract capital, and risks being taken over. In the same way that a competitive environment is the best safeguard to ensure farmers receive a market-related return for their milk, the ability to transfer shares in a competitive capital market provides the best assurance available that owners receive market-led returns on their investment. Owners would be appropriately rewarded for their investments in all stages of the 'value-adding' chain.

(iii) *Accountability of boards and managements for performance*

A more open and competitive environment over the last decade has increased the importance to owners of sound management of dairy cooperatives. At the same time, it has increased the nature and severity of monitoring problems faced by owners.

Again the parallels between cooperatives and financial mutuals are close. As the chairman of Colonial explained:

In the third place, if the company is to be a strong and vital organisation, its Board and management must be, and be seen to be, accountable to a group of owners who require performance. Certainly policyholders are interested in the performance of their policies, but they have no real reason to be concerned beyond that. While in some ways it may be comfortable for directors and management to have no vitally interested group seeking performance, such comfort is not desirable. Our view is that, if policyholder members exchange their membership rights for shares which they can hold or sell as they wish, the most favourable climate for success will be created. It will leave the board and management accountable to shareholders for overall performance, while still having to manage investments prudently to honour commitments to policyholders.

In other sectors monitoring problems in a more competitive environment have been tackled by changes in ownership patterns, board structures, and executive compensation.⁹ For example:

increase market share to retain shareholder equity in the Dairy Board. See, for example, *The Independent* of 19 April 1995.

⁹ For a discussion of the implications of deregulation for the airline industry in the United States see Kole, S and Lehn K (1997), 'Deregulation, the Evolution of Corporate Governance Structure, and Survival', *The American Economic Review Papers and Proceedings* (May), pp. 421-425.

- ownership has tended to become more concentrated with large individual anchor investors more actively monitoring the performance of managers;
- the level of executive rewards has increased to reflect the greater scope for superior management to increase returns to investors. The proportion of compensation that is linked to the overall performance of the firm has increased; and
- board structures have been altered and generally reduced in size. Smaller boards facilitate greater scrutiny of management and more effective decision making.

Cooperatives as they are currently structured may be hampered in responding to a more competitive environment. Voting rights that are not related to equity in the firm mean that investors do not face the true risks and rewards of management decisions. This makes it less worthwhile for them to monitor the performance of management. Cooperatives cannot generally make equity in the firm a significant proportion of a manager's compensation package. Not being able to value equity in cooperatives with reasonable confidence means that a major variable for measuring investment performance is missing.

Cooperatives could instead try to use other measures of firm performance and to link managerial pay more closely to those benchmarks. The 1995 study of cooperatives commissioned by the Dairy Board encouraged the adoption of "performance measures and accountability of management", and an emphasis on "effective and measurable achievements in innovation in products, processing and markets". Alternative goals and benchmarks, however, may focus the effort of managers in the wrong direction. Readily measured targets, like increases in the value of production or market share, may or may not be consistent with the real goal of increasing the wealth of owners. A strength of investor-owned firms is that owners share a single, well defined objective: to maximise the net present value of the firm. The price of shares is a readily measurable benchmark of management performance.

Whither Cooperatives?

How might owners of cooperatives better respond to the challenges of maximising the value of their investment and adequately monitoring management performance?

Clearly the worst possible response would be the current proposal to create a single monopoly processor and exporter of all dairy products by amalgamating the Dairy Board and all dairy cooperatives. This would reduce farmers' choice and increase their sense of alienation. It would not solve the bundling problem. It would not solve the problem of access to finance. It would preclude the benefits of competition, innovation and diversity. It is a central planners' delusion that one organisation can do everything. The strategy would be very high risk. For example, the company's decision as to whether it was in the food industry or in the dairy industry would become an industry-wide gamble in which all participants would sink or swim. The proposal would be the equivalent of trying to douse a fire by throwing petrol on it.¹⁰ Some cooperatives are already (or are considering) changing their structures so that farmers who increase their production face a greater share of the costs of doing so. For example, some cooperatives require additional capital contributions from new suppliers and existing suppliers who increase production. The problems with this approach have been noted. In particular, the payments system would remain a commercial cocktail of bundled returns to on-farm and off-farm investments.

Other strategies pursued in New Zealand or overseas have included:¹¹

- introducing proportional voting based on the amount of milk supplied;
- narrowing the ranges of products that the cooperative makes; and
- pooling supplier returns (and setting capital requirements) on a business unit basis to try to distinguish between returns on different types of raw product and off-farm assets.

Some overseas cooperatives have gone further. Memberships have been closed, members have been required to produce according to delivery contracts, and cooperatives have assumed the right to refuse certain deliveries from their members. In some cases, delivery rights have been made tradable among members.

¹⁰ There are few examples of industries that comprise a single firm which do not owe their existence to government regulation. While in most industries there are several large-scale enterprises, they coexist with smaller operators. The existence of multiple firms indicates that economies of scale are, at some point, offset by other factors, such as management and information costs.

¹¹ Cook, M (1995), 'The Future of US Agricultural Cooperatives: A Neo-Institutional Approach', *American Journal of Agricultural Economics*, 77(5), p. 1158.

However, these solutions are inevitably compromises that fail to adequately address underlying problems. Cooperatives could end up retaining some of their least flexible features, while forgoing the flexibility and other benefits of a conventional investor-owned company.¹²

The most direct approach to addressing the array of problems cooperatives face is to adopt a structure that is closer to a conventional investor-owned firm. The market value of shares would better reflect the efficiency of business operations and to outside investment would be available when needed. Farmers could more readily manage risk and have greater liquidity. If desired by suppliers, those features of a cooperative that are attractive or important to them could be retained. For example, farmer control could be retained by a founder's share and farmers could remain majority shareholders through a holding entity if they wished. The structures adopted by of Wesfarmers in Australia and some dairy cooperatives in Ireland provide examples of such moves. Any restriction on shareholding, however, reduces the marketability of the shares and is likely to raise the firm's cost of capital.

Conclusion

No one would want to argue that cooperatives should be banned as a form of business organisation. Clearly they may make sense in certain industries at certain stages of their development. Nor should change be imposed by legislative fiat, although no special statutory privileges should be granted to cooperatives. The demutualisation of life offices and other cooperatives has been led by their boards and managements, not by governments. The issue for the boards, managers and owners of dairy cooperatives to consider is what organisational structures are best suited to today's requirements.

Despite the compelling logic of the arguments for change, it would be premature to say that dairy cooperatives are at a crossroads which is likely to lead in a more promising direction. Facing crossroads in the past, many leaders in the dairy sector

¹² For example, modifications to cooperative structures described in the previous paragraphs would either be difficult to implement within the existing statutory framework for cooperatives or they would add complexity to the already convoluted arrangements for deciding how much milk is 'surplus' and who is producing it. In the absence of tradable shares, the modifications would also retain arbitrary distinctions between returns to on-farm and off-farm investments through opaque allocation and pricing formulas, or constrict industry development through transferable supply quotas.

have shown a remarkable tenacity to ignore the signposts, leave the road and 'bush-bash' their way through trackless terrain. Changes to existing institutional arrangements, like those contained in last year's minimalist amendments to the Dairy Board Act, are just one example of a lost opportunity.

However, the imperative to adopt more satisfactory ownership arrangements in the dairy industry so that it can better respond to an increasingly competitive and dynamic environment is inescapable. While the Dairy Board attempts to defend its statutory privileges and to shore up support for cooperative structures with research that is essentially meaningless, a sea-change is occurring in other sectors that were formerly dominated by mutually-owned firms, including the dairy sectors of some other countries. Other leaders in the dairy industry who better appreciate global market trends and the problems of having to cope with unplanned volume increases can see the necessity for such changes in New Zealand. Problems for them include the preoccupation of many farmers with payout levels and security, and the complexities of dairy industry politics.

It seems likely that we are in the last days of the monolithic statutory monopoly structure. The minister of agriculture has recently stated that its demise is inevitable. In the interests of the wider community, the government has to take account not just of industry views but of the clear evidence that current arrangements are distorting resource use in agriculture and damaging the national economy.

There is also reason to doubt the long-term durability of a traditional cooperative structure in the dairy processing sector in New Zealand, particularly once existing export restrictions are relaxed. Change is necessary and desirable. The future 'market share' of cooperative arrangements will be determined by how well their decision makers meet suppliers' concerns. Moves to adopt structures closer to conventional investor-owned companies are likely, linking suppliers' interests more directly with the performance of their farming operations on the one hand and their off-farm investments on the other. Delays in making such moves will mean New Zealand continues to suffer large losses in potential national income and farmers miss out on the benefits that stakeholders in mutually owned companies and cooperatives in other countries have gained from organisational change.