The Diversity of Co-operative Structures in New Zealand Agribusiness.

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Although the importance of co operatives within New Zealand agribusiness is widely recognised, there is less recognition of the diversity of co operative structures that exists. It is this diversity that will be explored in this paper. It will be argued that the framework of the NZ Co operative Companies Act 1996 has been a key factor, but not the only factor. The legislative framework is itself a function of underlying attitudes and the business culture within New Zealand agribusiness and the wider community.

The co-operative business model is strong within many of New Zealand's agribusiness industries. (Evans and Meade 2005) This has relevance to the broader New Zealand economy given the dominance of agribusiness within the export sector. (Statistics New Zealand 2007) The strength of co-operatives within agribusiness is particularly the case in dairy processing and marketing, with dairy being New Zealand's most important export industry, and one mega co-operative (Fonterra) processing and marketing about 95% of national dairy production. The co-operative dominance is somewhat less within meat processing and marketing, but two large co-operative companies (PPCS and Alliance), hold a combined market share of more than 50%. Within the horticultural industry there is a broad range of marketing co-operatives although investor–oriented (non co-operative) companies are dominant. There are also many co-operatives in the agricultural supply industries, with fertiliser production and processing dominated by two farmer owned co-operatives, and most farmers belonging to at least one general farm merchandise supply co-operative.

The Co-operative Companies Act of 1996

Starting in 1984, New Zealand underwent a major and rapid economic transformation from a highly regulated to a highly deregulated economy. The details have been well documented elsewhere (Willis 2001; Dalziel & Lattimore 2004) and will not be reported in any detail here. However, this economic transformation did have major relevance to the changing business environment in which agribusiness was operating. By the late 1980s, all input and output subsidies had been removed. By the early 1990s, the inappropriateness of statutory marketing boards with monopoly powers was also being seriously questioned. (Dobson 1990, Schroder *et al* 1993; Sullivan and Scrimgeour 1995) Indeed the overall concept of mutuality, and whether it was appropriate in a modern capitalistic economy, was given scrutiny. When the New Zealand Companies Act was rewritten in 1993 it seemed for a while that co-operatives would be left to wither under outmoded legislation such as the Co-operative Companies Act of 1956. However, concerted lobbying by various agricultural leaders led eventually to the New Zealand Co-operative Companies Act of 1996. This Act stated in its preamble that its purpose was, *inter alia*,

> to reaffirm the value of the co-operative company as a means of facilitating its shareholders carrying on business on a mutual basis. (New Zealand Government 1996)

A key aspect of the 1996 Act is that co-operatives registering under this Act are indeed companies. They are business structures with all of the normal strictures of non co-operative investor oriented firms (IOFs). The defining aspect of a New Zealand co-operative company is that it operates according to the principle of mutuality with members having an implied common interest in working together for mutual benefit, but with this taking place within the overall framework of a modern economy.

The New Zealand Co-operative Companies Act of 1996 has been written as a companion Act to the New Zealand Companies Act of 1993. In effect, the conditions of the Companies Act 1993 also apply to the Co-operative Companies Act 1996 unless specifically specified otherwise. This provides great flexibility to co-operatives, and some co-operative companies specifically register under both Acts without any incompatibility.

New Zealand co-operatives have no

significant taxation benefits relative to other companies. Shareholders of non co-operative companies receive credit for any company tax paid on the dividend component of company profits and this avoids any double taxation. In co-operative companies, the members are responsible for paying tax on any rebates, and the co-operative is liable for taxes on retained profits at normal company tax rates. Accordingly, there are no incentives for forming co-operatives beyond those of mutuality.

Consistent with this perspective, Evans and Meade (2005) in their review of co-operatives within New Zealand agribusiness observed (Section 1.7):

> The institutional environment for co-operative formation in New Zealand is fairly neutral relative to that in other jurisdictions. Co-operative legislation is flexible, less tied to co-operative principles than corresponding legislation overseas, and free of policy preferences favouring co-operatives over IOFs and other organisational forms.

Co-operative Structures and Functions

New Zealand agribusiness co-operatives can be broadly classified into three business structures and two business functions. The business structures are labeled here as ‘traditional’, ‘capitalist’ and ‘hybrid’. The business functions are ‘input supply’ and ‘product marketing’.

The distinction between ‘traditional’ and ‘capitalist’ is essentially that the capitalist co-operatives have mechanisms for capital gain on the shares held by members, whereas traditional co-operatives do not. Traditional co-operatives therefore work more on the principle of ‘cheap in cheap out’. Traditional co-operatives often have large unallocated reserves whereas in capitalist co-operatives these are more likely to be allocated to individual members.

An alternative nomenclature would be to refer to the capitalistic co-operatives as new generation co-operatives. This has been avoided in this paper because new generation co-operatives are sometimes defined in other countries in ways that are more constraining than what is considered here. Another alternative nomenclature would be to simply refer to them as modern co-operatives. However, the inherent danger with such nomenclature is that the term ‘modern’ is not fixed in time.

Hybrid co-operatives are those that have two classes of share, with one being transactor shares and the other being investor shares. New Zealand legislation provides no limit on the proportion of co-operative shares that are held respectively by transactors and investors. However, at least 60% of the voting shares must be held by transacting members if the business is to retain the term ‘co-operative’ (or an abbreviated version thereof) within its name. The specific allocation of voting rights is determined by the constitution of the co-operative, with the default position being that only transactor shares carry a vote.

The functional distinction between a supply co-operative and a marketing co-operative is not always clear cut in the New Zealand context. Some processing and marketing companies, such as Fonterra, which is the dominant milk processing and marketing co-operative, also have a farm supplies division. Similarly there are two co-operatives in the kiwifruit sector, Satara and Eastpack, which provide product packing and storage services but do not market the product. (All kiwifruit are marketed by the grower owned ZESPRI organisation which retains statutory powers as the sole marketer of New Zealand kiwifruit.)

Over time there has been a move towards capitalist and hybrid structures but most co-operatives are probably still of the traditional type. There is no obvious association between function and chosen structure.

Some Case Studies

The case studies chosen here have been selected to illustrate the diversity that exists both within and between traditional, capitalist and hybrid co-operatives. Fundamental to this choice of case studies has been the assumption that there is no such thing as a typical co-operative in the New Zealand context. All dollar figures reported in these case studies are New Zealand dollars. The relationship between the NZ dollar and the US dollar fluctuates according to market forces. In 2007 the NZ dollar fluctuated between approximately 68 cent and 81 cents. (National Bank 2008) Prior to 2008 and the widespread implementation of the NZ IFRS reporting standards, it has been normal for New Zealand co-operatives to report their issued share capital as equity despite this capital being redeemable in some circumstances. This historical convention is followed in the reporting

of these case studies, except where explicitly noted otherwise.

The information reported in these case studies has been collected from company reports and websites, supplemented by discussions with company officials, directors and members.

PPCS

PPCS (formerly 'Primary Producers Co-operative Society') is an example of a large traditional co-operative. It is the largest of the meat companies in NZ, and according to its website (PPCS Limited 2008) it exports to approximately 60 countries and had an annual turnover in 2006/7 exceeding $2billion. It claims a market share of 37% of sheep meat exports, 35% of beef exports and 54% of venison exports. It is owned by 9000 farmer suppliers. Both PPCS and Alliance, which is the other significant meat industry processing and marketing co-operative and which also fits within the 'traditional' category, have open membership with most assets held as unallocated reserves. PPCS shareholding is related to throughput of product, but most commercial farmers soon reach the maximum limit on shareholding. Any profits are either paid as rebates or else retained, and there is no dividend paid on capital.

PPCS was formed in 1948 as a livestock procurement and meat marketing company but with processing contracted to other companies. Over time, PPCS has purchased its own processing plants, often by purchasing assets of other companies that were in financial distress. More recently it purchased as a going concern 'Richmond Meats', which was one of the 'big four' New Zealand meat companies (including co-operatives), first through the purchase of shares via the stock exchange, and then through a full takeover which was completed on 2005. The purchase and takeover of Richmond Meats was particularly controversial, as it involved illegal use of undisclosed nominees for which PPCS was fined in the New Zealand courts, and which also led to forfeiture of some shares. The purchase was also controversial in terms of business strategy as it required major borrowings by PPCS secured against existing PPCS assets. As of August 2007 PPCS had liabilities of $415 million. Balance sheet equity was $268 million of which $54 million was share capital (redeemable to departing member after three years as non transactors) with the balance as unallocated reserves. PPCS made a net deficit for the year ending 31 August 2007 of $42 million.

The future directions of PPCS are a matter of considerable discussion amongst its members, and these issues have been widely canvassed within the popular press. Sheep meat production in New Zealand is tending to decline due to conversions of sheep farms into dairy farms. It is widely believed that plant rationalisation and divestment of assets may be required. PPCS is arguably in a difficult position given its high debt, low equity, and limited options for raising additional equity capital.

Ravensdown Fertiliser Co-operative

The Ravensdown Fertiliser Co-operative is one of two co-operatives that dominate the New Zealand fertiliser industry. Ravensdown has approximately 50% market share of agricultural fertilisers. Ravensdown has also diversified into marketing farm chemicals and animal health products to its 26,000 farmer members.

As of 2007 Ravensdown had book assets of $389 million and liabilities of $121 million. Of the $268 million equity, 78% was issued to members as share capital. Annual revenue in 2007 was approximately 500 million. (Ravensdown Fertiliser Co-operative Ltd 2007)

Farmers are required to hold shares in proportion to their fertiliser business with the co-operative. Shares have a nominal value of $1 but bonus shares are issued periodically (typically annually) in line with changes in the net asset backing of the co-operative. This has meant that the required shareholding per tonne of fertiliser purchased has risen from 120 shares in 2000 to 164 shares in 2007. Most of this increase came from retained earnings which were used to reduce debt. New members of the co-operative are allowed to build up their shareholdings over a period of years (in practice up to about 13 years) based on retention of rebates relating to their purchases rather than 'upfront' payment of cash.

Ravensdown retains open membership. If Ravensdown were to close off its membership then it could be argued that this would be counterproductive in terms of its business strategy, which has a strong focus on maintaining and enhancing market share. Ravensdown is an example of a co-operative that has been able to grow rapidly and to also retain a very strong balance sheet through a high level of retained earnings. In so doing it has

delivered ongoing rates of capital gain to its members in excess of inflation.

A key difference between Ravensdown and PPCS is that although both co-operatives have shares that retain a $1 nominal value, Ravensdown shareholders achieve capital gain through bonus share issues, ie the capital standard required to purchase a tonne of fertiliser increases over time. Another key difference is that, unlike PPCS, Ravensdown has no maximum on the shareholding of each member. However, there is a maximum on the number of votes which any one shareholder may have, equal to 0.125% of total shareholding.

Tatua

The Tatua Dairy Co-operative is a small co-operative having 118 members in 2007 and producing approximately 13 million kg milk solids (protein and fat). (Tatua Co-operative Dairy Company Ltd 2007) This equates to approximately 140 million litres of milk per annum. Tatua has a longstanding business culture of research investment and consumer products (local and export) which contrasts with the mainstream NZ dairy industry which has traditionally focused on export of basic commodities and ingredients.

Tatua is also unique in the New Zealand context in relation to business structure. As well as having shares which are held in proportion to production (currently five shares of 50c per kg milksolids) suppliers are also required to hold milk supply entitlements (MSEs). These entitlements are tradable by either sale/purchase or lease between members. It is through the granting to members of MSEs that Tatua controls the amount of desired growth. It also means that members have the potential to achieve capital gain through their tradable MSEs. In effect Tatua is a closed co-operative. A new member would need to not only be located within the Tatua milk catchment (as defined by Tatua) but would also need to purchase milk supply entitlements from existing members.

Satara

Satara is a kiwifruit and avocado packhouse and coolstore co-operative. It holds an approximately 13% market share for these functions. It also has its own orchard division. The orchards are both owned and leased. (Satara Co-operative Ltd 2007)

Satara is one of only three hybrid co-operatives in New Zealand. The other New Zealand hybrid co-operatives are Eastpack, which is another kiwifruit packhouse and coolstore co-operative, and LIC (formerly Livestock Improvement Corporation), which is the dominant supplier of breeding services, including semen and animal recording, within the New Zealand dairy industry.

A distinguishing feature of Satara is that the investor shares are publicly listed, and anyone can purchase these shares on the NZAX stock exchange (www.nzax.co.nz). This contrasts to the situation with both Eastpack and LIC, where investor shares can only be traded amongst transactors.

Satara is registered under both the New Zealand Co-operative Companies Act of 1996 and the New Zealand Companies Act of 1993. Satara's constitution defines that transactor shares carry 60% of the voting entitlement.

Satara's transactor shares have a nominal value of $1 and are redeemable. As of 2007, and in line with the new NZ Equivalents to International Financial Reporting Standards (NZ IFRS), these are now reported as liabilities in the balance sheet.

Investor shares in Satara (16.3 million shares) were first issued to the existing transactors in 1999, and these were then listed publicly in 2004. (Satara Co-operative Group Ltd 2004) Prior to public listing they were able to be traded privately. They have no nominal value and represent the residual value of the co-operative. In November 2007 they were selling for $1.04 which was well below the asset backing of $1.92. Over the preceding year shares had sold between $1.04 and $1.21.

The rationale for moving to a hybrid structure at Satara was that there were considerable unallocated net tangible assets. Existing shareholders, many of whom were heading towards retirement, were keen to gain access to these assets. Allowing capital gain on the transactor shares would have raised the barrier for new members to join, and could also have led to potential problems of redemption risk.

Satara has a formula based system whereby profits from providing services to transactor members, after deduction of a capital charge, are returned to transactors as rebates. Profits from the orchard division, together with the capital charge for services to transactors, are either paid as a dividend to investors or retained to finance growth. The fact that investor shares have consistently had a market value less than the asset backing per share suggests that the

investor market has lacked enthusiasm for the investment product. This is consistent with industry perceptions that only small quantities of shares have been purchased by outside investors.

Fonterra

Fonterra is New Zealand's dominant dairy co-operative with approximately 11,000 members. Production in 2006/07 was 1.25 million tonnes of milksolids (protein and fat) equating to 14.3 billion litres of milk. The milksolids are processed and marketed in various forms such as milk powder, cheese and casein in more than 140 countries. (Fonterra Co-operative Group Ltd 2007) Fonterra was formed in 2001 with the amalgamation of Kiwi Dairy Co-operative, New Zealand Dairy Group (NZDG) and the New Zealand Dairy Board. Prior to the formation of Fonterra, Kiwi Dairy Co-operative and NZDG were the two largest of the four remaining New Zealand dairy co-operatives, and the New Zealand Dairy Board had statutory responsibility for the marketing of all of New Zealand's dairy production. Formation of Fonterra required special legislation (the Dairy Industry Restructuring Act of 2001) which imposed specific conditions on Fonterra's operation, including open membership and some strictures on its powers to dominate internal dairy markets within NZ.

Fonterra not only processes and markets the milk of its members, but also processes and markets milk produced in a range of overseas markets. It is the dominant cross border marketer of dairy products, claiming more than one third share of internationally traded dairy products. (Fonterra Co-operative Group Ltd 2007) Countries in which it has significant behind borders processing and marketing of non New Zealand milk include Australia and Chile.

Fonterra's members are required to hold shares in proportion to their production, with one share required for every kg of milksolids (defined as the quantity of milk protein and milkfat). The value of this share is set each year by the Board of Fonterra ($6.79 in 2007), based on the discounted value of expected future earnings as determined by valuers appointed by the company. It is known as the 'fair value share'. A consequence of this valuation methodology is that it has led to the capitalised share value (approximately $8.5 billion) significantly exceeding the balance sheet equity (approximately $5 billion), which itself includes both tangible assets and the amortised value of purchased intangible assets.

New dairy farmers joining Fonterra, or existing members who expand their dairy operations, are required to purchase shares at the 'fair value' share price. Similarly, farmers retiring from farming can have their shares redeemed at this price. To reduce the potential problems of a major share redemption from farmers leaving the co-operative, Fonterra has the option of paying out the shares in the form of capital notes that earn interest that is linked to market interest rates. These capital notes are traded in the market.

Farmers are paid for their milk in two components, these being a 'milk price' and a 'value add' component. However, the specific allocation between these two currently has no financial implication, given that all members receive both components in relation to their production.

In 2007 Fonterra commenced a major review of its capital structure. This was driven by a perception that the existing structure was inconsistent with Fonterra's long term growth ambitions including an increasing level of 'behind border' operations external to New Zealand. The existing structure was considered constraining in relation to provision of the necessary capita necessary to support such a strategy. Also, the very success of the growth strategy posed redemption risks for the co-operative. There was also perceived to be a need for providing more flexibility of investment options to individual dairy farm suppliers.

Accordingly, in November 2007 the Fonterra Board presented its preferred option to its members. In essence, this was for a two company model comprising a separate co-operative and a publicly listed company. All existing processing and marketing assets would be vested in the publicly listed company. The co-operative would supply milk to the company and would hold a majority of shares in the listed company. It is intended that members will, following a period of consultation and possible modification of the proposal, vote on the setting up of the new company structure in 2008. However, shares will not be available to the public until there has been another vote of co-operative members and this will not occur before at least 2010.

A key issue with the proposed structure is that it will require clear operating rules for determining the milk price paid to farmers. Given

Fonterra's market dominance within New Zealand as a purchaser of raw milk, there is no market determined price for this raw milk. This will be a key issue both for farmers and potential investors. This absence of a market determined price is in contrast to the situation with Satara, which also has both supplier members and investors, in that there are multiple suppliers of the services that Satara offers, and hence considerable competition in the provision of the packing and coolstore operations.

Reflections

It was stated in the introduction to this paper that the NZ co-operative sector is characterised by the diversity of structures. Fundamental to this is legislation, which itself reflects societal attitudes, that co-operatives are simply a form of business model designed to accommodate the principle of mutuality. However, there is nothing intrinsically socialistic about the legislation. It provides no particular support to the co-operative sector or to the individual businesses that belong to co-operatives. Rather, it provides a framework which allows co-operatives to compete with investor owned companies on a level playing field. The legislation leaves it to the constitution of each co-operative to determine issues such as voting rules (eg per member or per unit of activity), share redemption rules, and valuation procedures. Arguably the key element of the NZ Co-operative Companies Act is that at least 60% of the voting power within the co-operative must be held by transacting members.

It is notable that the major co-operatives seem to have no difficulty in obtaining debt finance. This reflects the importance of the agribusiness sector and the sophistication of the commercial banking system. The existing model of Fonterra, with debt servicing ranking before milk payments to farmers, and with farmers having either no or very limited practical options to supply another processor, gives a particularly high level of security to lenders. However, entry of new processors into the market, which has started to occur, could rapidly change this situation.

It is likely that the structure of New Zealand co-operatives will continue to evolve given both the legislative flexibility and structural tensions that exist within many co-operatives. It is clear that some traditional co-operatives are in a potentially difficult situation in relation to capital availability as their industry becomes more capital intensive. Inadequate profits and retention thereof has the potential to leave a traditional co-operative with no escape route within its current structure. Co-operatives that allow capital gain on shares have the potential to fund growth from members' capital, but are susceptible to redemption risk if the business is contracting. In the case of hybrid co-operatives there is still insufficient case history to determine whether or not these are long term structures or alternatively just the first stage of a demutualisation process. Inherent to all of the tensions that exist over capital structure is the issue of members retaining control yet being either unwilling or unable to provide the necessary capital in a world that has become increasingly capitalistic.

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