

9 March 2016

My dear Fonterra Board members,

John Wilson's most recent weekly email to farmers strongly suggests the possibility of another Fonterra Co-operative Support program. This email serves only one purpose: Do not do it. Let me explain why.

In its most simple form, a co-operative is a means for fragmented suppliers of a commodity product to avoid being screwed by more powerful customers. Its main function is ensuring members from being passive "takers" of a milk price established by others. To be farmers, not peasants as Jim van der Poel was not tired of repeating. And rightly so.

As a consequence, wealth creation within the farm gate is a joint effort of the co-operative and the individual farmer. The co-operative tries to maximise milk revenue for each farmer whereby every farmer receives the same price per unit of milk. The farmer tries to run his dairy operation in such a way that his margin is the highest possible. By optimising scale, costs, productivity and stock sales, each farmer chooses her own preferred system leading to the lowest possible unit cost and resulting in the highest profit.

Farmers, therefore, compete with each other on unit costs. The lower my unit cost, the higher my profit, the more that I can invest in profitable on-farm investment. The result of that competition is that the "higher cost and less efficient" farmer is being out-competed and eventually needs to leave the industry. That may be a personal tragedy for the farmer and their family but it keeps the industry healthy. One obvious advantage of that dynamic is that by leaving the industry, supply of milk is being reduced triggering signals for a price increase from the demand side of the market.

By introducing its Co-operative Support program, Fonterra started interfering in the normal and healthy "shake-out of the industry. It tries to influence an on-farm dynamic for which it is not naturally equipped (that is what banks are for), it distorts the healthy development of the sector and it signals solidarity in an area where only competition should exist. Solidarity is on the revenue side of the farm's equation, not on the cost side.

On top of that, it leads to self-serving conduct: even if I do not need the zero interest loan, I will take it because my competitive position vis-a-vis the other farmers should not deteriorate.

The analogy with the "Tragedy of the Commons" comes to mind. When all individual farmers are going to "milk" Fonterra's balance sheet (the common good), they may well act in their own self interest but deplete that resource in the end.

There is a fine line between the true co-operative spirit on the one hand and the tragedy of the commons on the other. By introducing the Co-operative Support program six months ago, Fonterra reached that line. Please do not overstep that boundary this time.

With kind regards

Jan Marten Kingma  
janmarten@kingma.co.nz