

**CHAIRMAN'S ADDRESS – TRADING AMONG FARMERS
HENRY VAN DER HEYDEN
FONTERRA SPECIAL MEETING
30 JUNE 2010**

At our annual meeting in November last year, we voted in support of two important changes to our Co-op's capital structure – Strengthening the Share Structure and introducing a Restricted Share Value.

At the time, I said we would have a separate consultation process on the Trading Among Farmers concept.

We wanted to have more time for all of us, as farmers and shareholders, to thoroughly discuss and work through all the issues.

We wanted to make sure that any proposal was absolutely in your best interests as farmers – and a lasting, durable solution.

We knew when Fonterra was formed, 9 years ago, that our Co-op's capital structure would need to evolve. At the time we looked closely at co-operative models around the world.

We looked at how these models from different countries could work for us – the relative strengths and how they would withstand changing circumstances.

We agreed on a capital structure for Fonterra – essentially what we have today – that was expected to work satisfactorily for a number of years. But we knew that it would eventually need to evolve.

In particular, we knew the Co-op's balance sheet could come under pressure from redemption risk. The simple reality of Fonterra having to pay cash out to those farmers leaving the Co-op or reducing supply.

It wasn't until the 2007/08 drought that we really felt it, when equity fell by about \$600 million.

New Zealand's milk supply can't just keep on growing at the same pace it has been forever. Also there are physical limits to the expansion of dairying, and alternative land uses may take some land out of dairying in years to come.

If there's a limited pool of milk, other processors will always want a slice of the action and we may see some well-capitalised competitors from overseas competing with us for milk.

The cold hard reality is that there's every chance our Co-op will have periods of lower growth in our milk supply at some stage in the future. And, with the current capital structure – and the need to pay cash to farmers reducing supply or exiting – Fonterra's balance sheet would come under acute pressure.

This could happen quite quickly. And it would be very difficult to fix our capital structure while Fonterra was facing this sort of financial stress.

None of us want to see that.

We showed you a possible solution in 2007. At that time your Board was looking to solve the problem by trading some ownership, but still with farmer control. You told us in no uncertain terms that as far as you were concerned ownership was control – and fair enough.

We listened to what farmers were saying and went back to the drawing board to produce a better solution. And I want to acknowledge that the solution we are putting to you today is a better solution. This is a stronger solution, and one that's been shaped by your feedback.

You were concerned in 2007 about the thin edge of the wedge. There is no thin edge of the wedge with this new proposal.

It retains farmer ownership – voting stays with farmers.

The proposal we are voting on today will enable us to make changes to our Co-op's capital structure that would remove redemption risk. It would be a lasting solution that could remain at the core of our capital structure for many years to come. In a nutshell, we would buy and sell shares from one another, rather than through the Co-operative.

As shareholders, we also need to know what our shares are worth. You and I want to know that when we're buying or selling shares, the value of those shares is always clear.

Trading Among Farmers would achieve that transparency, so that you and I know exactly what a Fonterra share is worth at any time.

The resolution you will be considering is about making changes to our Co-op's Constitution that would allow your Board to take steps to develop the detail required for Trading Among Farmers, including some pre-conditions to ensure it's in farmers' best interests. These preconditions would have to be met before the Fonterra Shareholders' Market could be put in place.

We had four core objectives in looking at Trading Among Farmers:

1. Firstly, to allow us to buy and sell shares with other Fonterra farmers, rather than through the Co-operative – and when it more suits our cash flows.
2. We also wanted to give flexibility when buying and selling our shares with 'three years in and out' rules.
3. We have talked a lot about the need to stop money washing in and out of Fonterra's balance sheet. Andrew will talk more about this and how having permanent capital would put our Co-op in a position to deliver the highest sustainable returns over time.
4. And finally we wanted to provide choice to our shareholders to free-up some share capital through using the Fonterra Shareholders' Fund.

This Trading Among Farmers proposal has been shaped by your feedback.

What we have in front of us today is the result of a lot of robust, healthy discussion within the Co-op and good turnout at the rounds of meetings. Plenty of emails, phone calls, letters, faxes and conversations – along with the input from Council.

I want to thank every one of you who has taken the time and effort to put in a submission or push your ideas forward. Over the past three years the feedback from our farmers has been persistent and outspoken in some cases. But overwhelmingly constructive.

Your feedback and the level of involvement from throughout our Co-op has really helped us find the right solution and go on to refine this proposal.

What's changed as a result of your feedback?

Many of you wanted a limit on the number of shares that Registered Volume Providers could hold. These shares would be held in trust – not owned by the RVPs – and could not be more than 5% of total shares. In practice, shares held by RVPs are likely to be significantly less than this.

Volume is the key. For Trading Among Farmers to work and meet our agreed objectives, there has to be enough volume of trading so that we can have confidence that we will be able to buy and sell shares when we want to.

Everyone understands we need RVPs for volume, but we need to know that they are tightly managed. We plan to publish on Fencepost aspects of these arrangements, which are not commercially sensitive.

No one wants the Shareholders' Fund to be able to influence the day-to-day activities of the Co-op or change the nature of Fonterra.

Under the Constitution, no more than 25% of shares could be subject to contracts with the Fund, with a Board target of 20%. We would set the individual cap on the number of shares each farmer could have with the Fund. The initial cap would be no more than 33% but is likely to start off at less than this.

I've said a number of times throughout this process that, under my Chairmanship, our Co-op will always be controlled and owned by farmers. Making sure Fonterra remains a farmer-owned Co-op was an important starting point in developing this proposal. We heard you loud and clear in 2007.

Under Trading Among Farmers, votes remain based on milksolids backed by shares. And as now, the majority of the Board and the Chairman must be farmers elected by you.

As you know, the Milk Price Principles are in our Co-op's Constitution which aims to ensure we receive the highest sustainable return for our milk.

Under Trading Among Farmers, a new Milk Price Panel would be added to the existing independent audit and governance – with two independent Directors. One of these would be the Chair, and there would be a farmer Director and two Shareholder Council appointees.

Voting stays with farmers and milk, as it is today.

Milk is the one thing we all have in common as dairy farmers. No matter how many cows you have, or what type of farming operation you run – the one defining thing that sits behind each of us is milk.

Milk is the Co-op's lifeblood – why we all came together in Co-ops in the first place, to capture the value of a perishable product. We always put our milk into a common pool, built factories together to process it and shared out the returns according to how much milk we supplied.

Ask any farmer here today, and their top priority will be Milk Price. As shareholders we are also investors but the vast majority of our returns still come from milk.

Even a farmer with the maximum 200% of dry shares we have been discussing as part of Trading Among Farmers, would still receive more than 90% of their total returns from the Milk Price.

As I said earlier, none of us wants to see the fundamental nature of our Co-op change. We need to keep milk at the core.

That's what's behind the caps:

- We would have in the Constitution a 25% cap on total dry shares, with a Board target of 20%;
- A 200% threshold on individual shareholding;
- No one's dry shares can exceed 5% of total wet and dry shares on issue;
- And no more than 25% of shares could be subject to contracts with the Shareholders' Fund. The Board target would be 20%.

So to recap what we are voting on today.

The proposed changes to our Co-op's Constitution would allow your Board to take steps to develop the detail required for Trading Among Farmers. This includes some pre-conditions that would need to be met before the Fonterra Shareholders' Market could be put in place.

In addition to the normal 75% shareholder vote, these pre-conditions mean that that you can be absolutely sure that we won't go ahead with Trading Among Farmers unless it will work for us as farmers. And it would need to have the backing of the Shareholders' Council.

If the changes to the Constitution are approved today, over the next 15 months or so your Board and Management would develop the detail of Trading Among Farmers through to implementation. Shareholders' Council would be closely involved.

The detailed rules would be developed. Some of the things we've talked about might need to change, but the framework and pre-conditions set up by the proposed changes to the Constitution couldn't change without a further 75% shareholder vote. We will be keeping you fully informed along the way so that there are no surprises at any stage.

That means that your Board and Management will be getting on with the mechanics, and working with Council to make sure that it is implemented in a way that works for us as farmers.

You'll be able to see how this work is progressing at every stage. Effectively, we are considering today a proposal, that will take capital structure off the table for some time.

Of course there will be future evolution. No board can think that their company's capital structure will be static forever. Circumstances change.

But in putting Trading Among Farmers forward, your Board is confident that this is a durable solution. That's our duty as your directors, to make sure that Fonterra's capital structure is robust and that we are protecting you against risk, such as redemption.

Trading Among Farmers will address the current shortcomings in our Co-op's capital structure such as capital washing in and out. It will give you clarity around what your shares are worth. And – in combination with our retention policy – it will provide the equity that Fonterra needs to deliver the highest sustainable payout to its farmers.

Trading Among Farmers will ensure Fonterra remains farmer controlled and owned, and that our loyal shareholders have an incentive to hold shares and put more equity into the Co-op

For too long, it is those loyal shareholders, you and me, that have been penalised and had to effectively fund all that money washing in and out each season – including paying out farmers who leave the Co-op.

Your Board has voted unanimously in support of the special resolution – Trading Among Farmers. It has the full support of our Shareholders' Council, and I encourage you to give it your support today.

Thank you.