

Capital Structure

2010 Proposed Constitutional Changes

Trading Among Farmers

This booklet gives Fonterra shareholders an overview of recommended changes to Fonterra's Constitution in relation to Trading Among Farmers. More detail on the changes to the Constitution is set out in the *Proposed Changes to the Constitution* booklet included in your meeting pack. It is important to read both booklets.



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IMPORTANT INFORMATION

This booklet along with the Proposed Changes to the Constitution Booklet are important documents, and require your immediate attention. They should both be read in full prior to you casting your vote on the special resolution to be put to Fonterra shareholders at the Special Meeting on 30 June 2010. The booklets have been prepared to assist you in understanding the special resolution. Please contact your Directors, Shareholders' Councillors, local Area Managers or Fonterra's Supplier Services Team (freephone 0800 65 65 68) if you have any questions about the special resolution or either of the booklets.

This booklet along with the Proposed Changes to the Constitution Booklet describe the constitutional changes that Fonterra shareholders are being asked to vote on at the Special Meeting on 30 June 2010. They supersede all other material previously provided to shareholders in relation to these changes, including the April 2010 consultation booklet.



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ABOUT THE BOOKLETS

The proposed changes to Fonterra's Constitution that you are being asked to vote on are set out in the Proposed Changes to the Constitution Booklet. If approved by shareholders, these changes would enable the Fonterra Board to be able to take steps to implement a regime for Trading Among Farmers.

But Trading Among Farmers can only start when the Board is satisfied that everything is in place to take that step (currently expected to be no earlier than towards the end of 2011). The proposed changes to the Constitution set out the pre-conditions that the Board must satisfy before it can do this. The Board would be able to determine the final detailed design of any regime for Trading Among Farmers, including the nature and detailed terms of key components. But the Board would need to do this within the scope of the pre-conditions and key thresholds, limits and protections that are in the proposed changes to the Constitution.

The description of Trading Among Farmers outlined in this booklet reflects the Board's current expectations of how a regime for Trading Among Farmers could work to meet the objectives discussed with farmer shareholders and noted in this booklet. **The final design of Trading Among Farmers may differ from what is outlined in this booklet where the Board considers that the objectives require changes or can be met in a more appropriate or efficient way.** However, in doing so the Board must ensure that any thresholds, limits and protections in the Constitution are met.

The proposed changes to the Constitution enable the Board to put in place a regime for Trading Among Farmers before the end of December 2013 or a later date specified by the Board. But the Board is not obliged to do so if, during this period, the pre-conditions cannot be met. If this were to be the case, then the status quo would continue (including Fonterra's obligations to issue and redeem shares) and, after the period allowed for has expired, the changes to the Constitution that relate to Trading Among Farmers that had been approved by shareholders would be of no further effect.

The meeting on 30 June 2010 is intended to be the only one where shareholders will vote on proposed changes to Fonterra's Constitution before any implementation of Trading Among Farmers by the Board. It is important you read the detail about the proposed changes to the Fonterra Constitution and that you read the explanatory notes set out in the comments section in the Proposed Changes to the Constitution Booklet. This will provide you with the information that you need to enable you to vote.

CONTENTS

LETTER FROM THE CHAIRMAN	2
LETTER FROM THE CHAIRMAN OF THE SHAREHOLDERS' COUNCIL	3
WHAT'S PROPOSED AND WHY?	4
FARMER FEEDBACK ON TRADING AMONG FARMERS SINCE THE APRIL BOOKLET	21
WHAT ARE WE VOTING ON?	23
FREQUENTLY ASKED QUESTIONS	25
GLOSSARY	28

FURTHER INFORMATION ON CAPITAL STRUCTURE

If you have any questions about Fonterra's existing capital structure, you can obtain a copy of Fonterra's investment statement which outlines that structure from Fonterra's Supplier Services Team (0800 65 65 68) or www.fonterra.com or by contacting your local Area Manager.



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Letter from the Chairman

Last November, shareholders voted on further evolution of our capital structure by supporting Step One - Strengthening the Share Structure - and Step Two - Restricted Share Value.

Recently we have been discussing with you a further step in the evolution of our capital structure - Step Three - Trading Among Farmers. Feedback received in farmer meetings, through the Shareholders' Council, Area Managers, Fencepost and a range of other channels has been extremely valuable. This feedback has told us that shareholders believe that Trading Among Farmers is the right development for our Co-operative. You have told us that you particularly like the fact that it can be designed in a way that preserves farmer control of the Co-operative.

As a result of your feedback, we have continued to develop the way that Trading Among Farmers could work. We expect that this will continue right up until the time that Trading Among Farmers is implemented. An outline of your feedback is set out in this booklet.

Your Board has heard from you that you want us to get on with it and to take the next steps towards Trading Among Farmers. To do this we are recommending changes to the Constitution for a shareholder vote to take place at a Special Meeting to be held on 30 June 2010. This booklet and the documents in the pack contain the information you need for you to consider these changes to Fonterra's Constitution. This is what you'll be voting on at the Special Meeting.

Moving to Trading Among Farmers would be an important step in strengthening Fonterra's future. It would stop money washing in and out and provide the Co-operative with permanent equity, which can be used to provide better returns to you.

Step Three is also a chance for all of us to help secure Fonterra's leadership in both New Zealand and the global market place, by being a reliable partner to the world's largest food companies. Permanent capital allows us to be much more responsive to our customers' needs.

The Board has listened to shareholders and has again worked closely with the Shareholders' Council in developing the proposed changes to the Constitution. The Board has voted unanimously in favour of this approach, which also has the support of the Shareholders' Council.

I encourage you to take the time to read all of the information provided in your meeting pack and consider the implications it will have for your farming business and the Co-operative. Please don't assume you have read it all before. We have consulted with you to get as much feedback as possible and have used that feedback to refine the proposals. But you need to be comfortable with the final proposal.

As noted above, we are holding a Special Meeting on Wednesday, 30 June 2010. A move to Trading Among Farmers would be an important decision for us all and the Board has decided on a televised link to seven venues, including the main venue at Palmerston North. Details of all of the venues are set out elsewhere in this pack, on Fencepost and in Farmlink. To encourage maximum participation in the vote, the Board has also decided to offer electronic as well as postal voting for the Special Meeting. If you are able, we would like to see you at one of the venues, but if you can't make it in person, please cast a vote by post, via Fencepost, by fax or by way of a proxy to participate in this important decision.

Thanks to all for your participation in the consultation process. You have given us your feedback and this has added value to the steps we are taking to strengthen and secure our Co-operative. Fonterra has a great future ahead of it and your Board is confident that we will look back on this decision to introduce Trading Among Farmers as a critical advancement in the evolution of our capital structure and of our co-operative model.

A handwritten signature in black ink, appearing to read "Henry van der Heyden".

Henry van der Heyden

Chairman



Letter from the Chairman of the Shareholders' Council

The Fonterra Shareholders' Council believes that Trading Among Farmers provides a unique opportunity to move our Co-operative and New Zealand dairying forward.

A key goal is to eliminate the redemption risk currently faced by Fonterra and to provide a permanent capital base for our Co-operative.

Trading Among Farmers will also be designed to provide Fonterra's supplying shareholders with greater flexibility in managing your investment in Fonterra shares.

Farmers should expect Fonterra to be better positioned to deliver improved results if redemption risk is eliminated. Equally, supplying shareholders will have the opportunity to capture the benefits of greater financial flexibility on farm if Trading Among Farmers is adopted.

There remains a lot of work to be done before Trading Among Farmers could be implemented and much detail to be worked through. Even so, the Council supports this proposal being put to a vote of supplying shareholders so we can provide Fonterra with a sound basis for future planning.

Farmer confidence in the Milk Price has been paramount in the Council's deliberations on Trading Among Farmers. We consider the establishment of a Milk Price Panel, coupled with continuity of Council's performance monitoring and representation roles, should provide shareholders with the necessary level of comfort.

Continued farmer ownership and control of Fonterra is also vital. The Council is satisfied the shareholding caps and limits provided for in the proposed constitutional changes adequately safeguard the interests of supplying shareholders and the interests of the Co-operative as a whole.

Pending a successful outcome to the vote on the proposed changes, Council's focus in the coming months will shift to consulting with the Board on the finer details of Trading Among Farmers. These include the governance of the Authorised Fund and the rules and mechanisms around the proposed market.

Our objective here is to ensure our Co-operative continues to develop in a way that safeguards and promotes the interests of Fonterra farmers and consequently the New Zealand economy.

I would like to thank all those shareholders who have contributed to this proposal by attending meetings and putting forward your views. Please vote and have your say on Fonterra's future.

Blue Read
Chairman
Fonterra Shareholders' Council

What's proposed and why?

SUMMARY

- The Board unanimously recommends changes to Fonterra's Constitution that would enable the Board to put in place Trading Among Farmers.
- To do this, you are being asked to vote on changes to the Constitution which would enable the Board to take steps to establish a regime for Trading Among Farmers. These changes include the pre-conditions that the Board would need to decide are satisfied before Trading Among Farmers can come into effect.
- These changes to the Constitution have to be approved by a special resolution. This means that the vote will need to be passed by not less than 75% of the votes of eligible shareholders who vote on the resolution.
- The key features of Trading Among Farmers are described in this booklet, but the final details would be put in place by the Board in accordance with the key thresholds, protections and pre-conditions that would be voted in by shareholders if the special resolution is passed.

WHAT'S PROPOSED?

Following consultation and feedback, the Board has decided to recommend to farmer shareholders that a regime for Trading Among Farmers be put in place. It is expected that it would take at least 15 months to finalise all the details required to implement this fully.

The Board is proposing that the Co-operative should move to Trading Among Farmers by:

- Asking farmer shareholders to approve changes to the Fonterra Constitution that would allow the Board to take the steps necessary to finalise and put in place a regime for Trading Among Farmers. These changes to the Constitution are set out in the Form A Constitution contained in the Proposed Changes to the Constitution Booklet. They include the pre-conditions that the Board must decide are satisfied before Trading Among Farmers can be implemented.
- The Board would then finalise the detailed design of a regime for Trading Among Farmers that is consistent with the key thresholds, limits and protections set out in the changes to the Constitution. The Board can only implement Trading Among Farmers if it is satisfied that the pre-conditions set out on page 8 are satisfied. However, within these constraints, the Board would have the ability to approve the detailed aspects of a regime for Trading Among Farmers. When it is satisfied with these steps, the Board can then decide that the Form B Constitution contained in the Proposed Changes to the Constitution Booklet would come into force.

You are being asked to vote at the 30 June 2010 meeting to approve the Form A and Form B Constitutions and it is not expected that there will be another vote on the move to Trading Among Farmers.

THE ESSENCE OF TRADING AMONG FARMERS

A regime for Trading Among Farmers would build on the progress made in the first two steps of capital structure change that received almost 90% support from our farmer shareholders voting at last November's annual meeting.

If Trading Among Farmers were to be implemented as currently proposed, the existing obligations of Fonterra to redeem shares under the Constitution and the Dairy Industry Restructuring Act 2001 (DIRA) would end. Instead, farmers would trade shares among themselves on a Fonterra Shareholders' Market. We refer to this as removing redemption risk. This would provide Fonterra with permanent share capital.

Under any new regime, the Board has completely ruled out considering whether the public should be allowed to own Fonterra shares via a public listing.

WHY DO WE NEED TO FURTHER CHANGE OUR CAPITAL STRUCTURE?

Trading Among Farmers would be designed to create permanent share capital for Fonterra. Permanent share capital would have two important benefits for farmer shareholders and the Co-operative. First, it would stop loyal shareholders being penalised when money washes out of the Co-operative via share redemptions. One way or another, it is our loyal shareholders who effectively have to fund these redemptions. Second, Trading Among Farmers puts the Co-operative in a stronger position to grow farmer shareholder returns from a stable capital base.

Redemption Risk

Although drought years have been challenging, we have managed redemption risk within the current capital structure reasonably well so far, largely because the milk volume in New Zealand has been steadily growing. We've been able to offset the impact of redemptions by attracting new capital through conversions and growth milk.

But our current capital structure may not work as well in the future if we encounter a period where there is more money going out of the Co-operative via redemptions than coming in from growth milk, conversions or Dry Share issues.

It makes good sense for us to look at ways to deal with redemption risk now, while the Co-operative is in a good position with a solid balance sheet. It would be difficult to undergo an orderly process of capital structure change in an environment where we were facing rapid, large-scale redemptions.

We should also act now to make our current capital structure more flexible. We need to find better ways to make farmer participation in the Co-operative more accessible – for new farmers wanting to join, and for existing shareholders under pressure to free up cash by selling their Fonterra shares.

What's proposed and why?

Growing shareholder returns

Fonterra's long-term strategy is to:

- Deliver sustainable Co-operative performance by delivering a competitive Milk Price now and in the future while growing profitability from our Commodities and Ingredients business, including providing uncompromising standards of quality and safety, and leveraging Fonterra's plant flexibility and logistics capabilities;
- Grow lasting customer partnerships with the world's leading food companies which are poised for extensive future growth. These partnerships will build on Fonterra's global reach, leading dairy expertise and innovation to deliver distinctive services and dairy ingredient products; and
- Build trusted brands in chosen markets, by leveraging existing leadership positions and creating and building leadership in new dairy categories.

By creating permanent capital, Trading Among Farmers would better enable Fonterra to pursue this strategy. Fonterra would have a more secure foundation to invest to meet the volume, product and service requirements of our customers.

With Trading Among Farmers in place, the Co-operative would be better positioned to respond to these opportunities.

WHAT ARE WE TRYING TO ACHIEVE?

In considering a design for Trading Among Farmers, the Board is focusing on these key objectives:

- Maintaining Fonterra as a sustainable co-operative with voting rights linked to milk supplied to Fonterra.
- Removing Fonterra's obligation to redeem shares. This provides permanent share capital on which the business can operate and invest.
- Ensuring Fonterra has sufficient permanent share capital to give the Co-operative the funding needed to continue to have the ability to drive the highest sustainable returns to farmers.
- Ensuring that the arrangements give farmers confidence that they will be able to buy and sell shares when they wish at prices that reflect a well informed and liquid market.
- Ensuring the arrangements produce a stable outcome in the sense that they will meet the above objectives for the foreseeable future.

These objectives are underpinned by the ongoing need to give shareholders and other stakeholders confidence around the determination of the Milk Price.

PROPOSED CONSTITUTIONAL CHANGES

The changes to the Constitution that you are being asked to vote on are set out in detail in the Proposed Changes to the Constitution Booklet. That booklet details the changes, including the key thresholds, limits and protections that would be built into Fonterra's Constitution.

You will see in the Proposed Changes to the Constitution Booklet that there is a Form A and a Form B Constitution. The Form A Constitution sets out the framework for the Board to take steps to implement a regime for Trading Among Farmers, including the pre-conditions that the Board must decide are satisfied (see page 8) and the implementation time period (until the end of December 2013 unless extended by the Board). The Form A Constitution contains the changes that are proposed to be made to the current Constitution.

The Form B Constitution is the new form of constitution that would apply under Trading Among Farmers. While the Board is given discretion under the Form B Constitution in relation to the final shape of any regime for Trading Among Farmers (as set out below), it cannot make any changes to the Form B Constitution without a further 75% shareholder vote. This would be the New Constitution if Trading Among Farmers were to be implemented. The Board would be able to bring it into force when it is ready to do so. No further shareholder vote is expected to be required to enable this to occur.

If the pre-conditions are not satisfied for any reason and the Board does not implement Trading Among Farmers within the time period allowed for in the Form A Constitution, then the Form B Constitution would never come into force and the pre-conditions and transition arrangements in the Form A Constitution (basically the whole of clause 49) would come to an end. This would mean that all of the obligations of Fonterra to issue or redeem shares under the current Constitution and DIRA would remain in place.

PROPOSED IMPLEMENTATION BY THE BOARD

Following a successful vote on the proposed changes to the Constitution, the Board would be authorised to take the steps necessary to finalise a regime for Trading Among Farmers. In order to meet the pre-conditions, the Board would have to ensure that the regime for Trading Among Farmers includes the Fonterra Shareholders' Market and the Fonterra Shareholders' Fund. Subject to the thresholds, limits and protections set out in the Form B Constitution (such as the overall threshold on the number of Dry Shares), the Board is able to finalise the details of the Fonterra Shareholders' Market and the Fonterra Shareholders' Fund (and any other aspect of a regime for Trading Among Farmers) in ways that it considers would best meet the overall objectives.

While the Board and Management works up the concepts outlined in this booklet through to implementation, we would keep you informed of any new information. We want to have transparency. Some detail will change, but any changes will be within the broad framework set out in this booklet.

The Board would continue to work with the Shareholders' Council as it takes steps to finalise a regime for Trading Among Farmers.

What's proposed and why?

WHAT ARE THE PRE-CONDITIONS TO GET TO TRADING AMONG FARMERS?

The Form A Constitution sets out key pre-conditions that the Board must decide are satisfied before any regime for Trading Among Farmers can commence. These pre-conditions are designed to ensure that the Fonterra Shareholders' Market and the Fonterra Shareholders' Fund can operate in a way that should result in well-discovered prices for Fonterra shares.

The pre-conditions are intended to ensure that the Board can only decide to start Trading Among Farmers if it is satisfied that:

- All of the rules and systems for the Fonterra Shareholders' Market have been set up in a way that Fonterra shareholders can trade shares among themselves. The Board would want to be satisfied that the Market is properly set up.
- All of the rules and systems for the Fonterra Shareholders' Fund have been set up. The Board would want to be satisfied that the market for investing in units in the Fund is well designed, and that the Fund and the Fonterra Shareholders' Market would work well together and be stable.
- All necessary changes to legislation that are required for Trading Among Farmers have been passed. This includes changes to DIRA on terms which the Board thinks are required to facilitate Trading Among Farmers. The Government has advised that it would look to make the necessary changes to DIRA to accommodate Trading Among Farmers in consultation with Fonterra and other stakeholders subject to finalisation of design details, in particular around the linkage between the unit and share markets (see page 18). We will continue to work with the Government on the legislation package after the 30 June 2010 vote.
- All consents and approvals from regulatory and other bodies that are needed for Trading Among Farmers are in place. We will work to obtain these after the 30 June 2010 vote.
- The Shareholders' Council has resolved (by a majority of 50% or more of Councillors) to support the Board's resolution for the New Constitution to come into effect.

The exact wording of these pre-conditions is set out in clause 49.2 of the Form A Constitution that is included in the Proposed Changes to the Constitution Booklet.

Separately to the specific pre-conditions, the Board has indicated already that before it would implement Trading Among Farmers it would need to form a view on the price that shares are likely to trade at when trading commences on the Market. The Board would seek expert advice on this matter and would take into account the most recent valuation by the Valuer and the share price base value (currently \$4.52) that is provided for in the current Constitution.

The timing of the introduction of Trading Among Farmers would be influenced by the factors outlined in this booklet, including the requirements set out above. The Board would also take steps to keep our shareholders and other stakeholders such as banks and rural professionals fully informed about the transition to any new regime.

When the Board is satisfied that all of the above requirements have been satisfied, it would then pass a formal resolution. This resolution would allow the regime for Trading Among Farmers to proceed and to take effect from dates specified by the Board.

It is possible that the Fonterra Shareholders' Fund could be introduced in advance of Trading Among Farmers. But it is considered that this would not be feasible without there being certainty that Trading Among Farmers would be implemented (and the timing for this). As a result, there is no certainty that the Fund would start to operate before trading on the Market commences.

There are many considerations to take into account in deciding the final details of when the Fonterra Shareholders' Market and the Fonterra Shareholders' Fund would be implemented to support Trading Among Farmers. These include financial market conditions, regulatory requirements and dovetailing the changes with the end of a Season and the end of Fonterra's financial year. These decisions would be made by the Board as part of its design of a regime for Trading Among Farmers, but the proposed changes to the current Constitution do allow the Fund to be introduced before Trading Among Farmers commences.

THE DESIGN FOR TRADING AMONG FARMERS

In order to meet the objectives set out on page 6, the Board would look to design a regime for Trading Among Farmers that:

- Promotes enough volume of trading so that farmers can have a reasonable level of confidence that they would be able to buy and sell shares when they need to.
- Produces prices that reflect a well informed and liquid market.
- Avoids the worst consequences of one-sided share trading where a large number of farmers may be wanting to buy or sell shares at the same time.
- Assures farmer-shareholders and other stakeholders that the market has integrity with well structured rules that are subject to robust monitoring and enforcement.

The Board has developed a working model of a regime for Trading Among Farmers that it considers could meet its objectives and the goals set out above within the framework that would be established by the proposed changes to the Constitution. For example, the role of Registered Volume Providers (which is discussed on pages 12 and 13) under a specific contract with Fonterra would be to provide sufficient volume to the market. The ability of farmers to sell rights to the Fonterra Shareholders' Fund (see pages 13 to 15) and greater flexibility in the Share Standard (see page 10) would help to lessen the risks of one-sided trading.

However, a good deal of the detailed aspects of this working model would be developed following a successful vote on the changes to the Constitution.

The proposed working model set out below contains a mixture of features that are provided for in the New Constitution as well as features that are subject to the Board's discretion. We have indicated in relation to the features described below whether they would be required by the New Constitution or are subject to the Board's discretion. Features which would be in the New Constitution are described in more detail in the Proposed Changes to the Constitution Booklet and, once adopted, can only be changed by a further special resolution of shareholders. The features that are subject to the Board's discretion are generally the areas where further detailed work would be undertaken.

What's proposed and why?

Once the detailed components of Trading Among Farmers have been finalised, the intent is that they would represent an integrated system designed to meet the needs of farmer-shareholders and the interests of other stakeholders (such as banks, unit holders and Registered Volume Providers).

Setting the Share Standard

- Under the New Constitution the Co-operative would not be required to issue and redeem shares as it does now, and instead farmer shareholders would be able to buy and sell shares on the Market.
- Farmer shareholders would still be able to privately buy and sell shares outside of the Market (expected mostly in the context of farm sales or internal re-organisations of shareholdings). Transfers of shares would still need to be recorded in Fonterra's share register, and the information would still need to be captured and reported in relation to transfers (which may include price).
- The Share Standard would continue to apply under the New Constitution, and this would require shareholders to hold a minimum of one share for each kilogram of milksolids produced.
- The Share Standard would be measured on a three-year rolling average of actual production over the previous three Seasons. This is designed to smooth out seasonal production fluctuations and reduce the need for farmer shareholders to buy or sell shares as a result of fluctuations in milk volume in any one Season. The Board could still allow farmers to provide an estimate of production and have the Share Standard measured against this. The Share Standard (and the way in which it would be measured and complied with) would be in the New Constitution.
- The ability for farmer shareholders to split supply would be retained in the New Constitution and the provisions relating to unshared supply and contract supply which are in the current Constitution would continue.

Entry and Exit

- The New Constitution would allow the Board to permit new shareholders a longer period to acquire the number of shares that they would need to hold to meet the Share Standard. It is intended that they would be allowed to acquire their full shareholding over a three year period, with one third of the required shareholding to be held in the first Season, two thirds by the end of the second Season, and the full shareholding held by the end of the third Season. The Board would also have the discretion to allow purchasers of farms and new conversions to buy their shares in this way. It is also intended that this approach should make it easier for farmers to manage transition from contract milk to share-backed production.
- Shareholders who are exiting the Co-operative would similarly be able to sell down their shareholding over three Seasons. This is also in the New Constitution.
- The Board would be able to set a period that is longer or shorter than the three-Season periods noted above for new and exiting shareholders (and can adjust the number of shares that must be bought or sold in each Season depending on the length of that period). The Board currently intends to maintain this period at three years (for entry and exit) but it is possible in the future that it may have to change this depending on the circumstances at the time.

- However, the Board would look at ways to encourage shareholders to back their production with shares during the Season, such as receiving incentives for shared-up milk compared with unshared milk. A pricing incentive like this would remain at the discretion of the Board, just as it is now for pricing contract milk. In addition, under the New Constitution each shareholder's voting rights would continue to be based on their share-backed milksolids.

Dry Shares permitted to be held by an individual farmer

- Instead of being allowed to hold shares up to 120% of production, shareholders would be allowed to hold a greater percentage as Dry Shares. The New Constitution allows the Board, at its discretion, to set this threshold at anywhere between 100% and 200% of production (where production is defined as the minimum number of shares a farmer shareholder must hold under the Share Standard). The Board expects that this threshold would be initially set at 200%.
- The New Constitution would provide that no shareholder (including its related parties, associates, etc) would be allowed to hold interests in Dry Shares exceeding 5% of the total number of Co-operative Shares on issue at any time regardless of their production level.

The total number of Dry Shares

- The Board intends to target Dry Shares at no more than 20% of the total number of Co-operative shares on issue in the medium to long term as a matter of policy (which can be changed by the Board). The New Constitution provides an overall threshold on Dry Shares of 25% of all Co-operative shares on issue at any time.
- It is possible that the overall threshold on Dry Shares could be exceeded, for example as a result of unforeseen circumstances leading to a drop in milk production. If this were to happen, the New Constitution requires the Board to take steps to bring the number of Dry Shares down under the threshold over a time period decided by the Board.

Measurement and compliance

- The rules described below around measuring and complying with the Share Standard are all set out in the New Constitution.
- Compliance with the Share Standard would be measured on the first day in each Season. Fonterra would issue a statement informing shareholders both what their holdings are at that time and what they would need to be based on the three-year rolling average or expected production.
- Each shareholder would then have a period to buy or sell shares to ensure that they meet or exceed the minimum shareholdings required under the Share Standard, but subject to the maximum holdings which any Shareholder is allowed to hold. The period for bringing shares into line would be set by the Board before each Season, but couldn't be any less than six months from the beginning of a Season.
- Shareholders would be reminded during this time to ensure they don't leave things to the last moment. Shareholders who don't want to buy and sell shares on the Market themselves would be able to ask Fonterra to arrange for this to be done by

What's proposed and why?

an independent agent on their behalf during the compliance period. But shareholders who ignore requests would end up having their shareholding bought or sold for them after the end of the compliance period to meet minimum and maximum requirements. These shareholders might have to meet the costs of this depending on the circumstances.

- As is currently the case, Fonterra would have the ability to ensure that shareholders are generally complying with the Share Standard. The Board would be able to set a base level of shares that a shareholder has to hold at all times during a Season, which could be less than the minimum shareholding requirements described above. The Board is not required to set a base limit and, in considering if this would be appropriate, would take into account the circumstances at the time.
- Shareholders who breach the rules and fail to rectify the position when requested to do so could be subject to adverse consequences and incur costs that Fonterra would be able to recover. (See the Form B Constitution for details on this issue.)

Fonterra Shareholders' Market

- The New Constitution allows farmers to buy and sell shares in the Fonterra Shareholders' Market. Fonterra would enter into contractual arrangements with the operator of that Market, to help set the Market up and provide the rules and procedures for trading on the Market, all on terms that the Board approves.
- These rules and procedures would likely allow farmer shareholders to buy or sell shares on any business day during the year, online through Fencepost or by calling an 0800 phone number. The aim would be to give farmers the flexibility they need to adjust their shareholding when it best suits them, helping them to manage cash flows within their farming businesses.
- This would also mean that shares could be bought all year round to better match production needs rather than having to do this at one time when cash flows are often tight.
- The New Constitution allows Fonterra to put in place a facility for farmers who don't want to directly buy and sell shares on the Market themselves to request an independent agent to do this on their behalf.
- It is intended that the costs of transacting shares on the Market would largely be incurred by Fonterra.

Registered Volume Providers (or RVPs)

- Under the New Constitution, the Board would be able to appoint one or more Registered Volume Providers to assist in providing volume in the Market. The aim would be to ensure there are sufficient buy and sell orders creating market depth and that prices don't fluctuate unduly. The ability of RVPs to do this would be enhanced by having RVPs bridge short-term imbalances between buy and sell offers. The role of RVPs will be very important in ensuring that farmers can always buy and sell shares as they wish.
- The New Constitution provides that RVPs would be directly contracted by Fonterra to participate in the Market.
- If RVPs are appointed then the Board would negotiate a contract with them with a view to requiring RVPs to post prices for buying and selling Co-operative shares while the Market is

open. The difference between the prices that they offer for buying and selling (referred to as the "bid/ask spread") would be regulated under this contract with Fonterra. An obligation to offer to both buy and sell shares within a narrow price range would provide a strong incentive for an RVP to try and stay close to a market-clearing price.

- It is intended that the minimum volume of shares that an RVP would have to offer to buy and sell would also be specified in the contract with Fonterra. The aim would be to set the minimum volume at a level that is sufficient for farmers to buy and sell reasonable volumes when they wish at buy and sell prices they could see on the Market.
- We would expect that the key elements of a contract with an RVP would be disclosed publicly under the intended trading rules and continuous disclosure requirements.
- The New Constitution provides that only a custodian could hold Co-operative shares for an RVP. This would be needed only for the limited purpose of allowing the RVP to buy and sell shares (which is envisaged to be on a short-term basis) in accordance with the RVP's contract. Neither the custodian nor an RVP would have voting rights in relation to these shares.
- Fonterra would select RVPs most likely by way of competitive tender. We would expect that parties interested in the role are likely to be substantial financial institutions which have a strong balance sheet and possibly experience in performing similar roles in other markets.
- Under the New Constitution, no more than 5% of Co-operative Shares can be held at any one time by a custodian for RVPs. However, it is envisaged in practice that the proportion of shares held by a custodian would be substantially less than this limit, recognising an RVP's role under its contract with Fonterra.
- The basis upon which an RVP earns a fee from Fonterra for the services it provides would be an outcome of commercial negotiations with the preferred providers. However, the fee arrangements could involve a risk sharing aspect, where Fonterra and the RVP share in gains and losses outside certain thresholds. If this sort of pricing risk were to be faced by Fonterra and an RVP then it could be significantly reduced if the RVP was able to hedge that risk via the market for units in the Fund. If there were to be a linkage to the unit market along these lines, this would assist in reducing price volatility in the Fonterra Shareholders' Market. Fonterra would seek to achieve outcomes along these lines as part of any final contract with an RVP.

Fonterra Shareholders' Fund

- The pre-conditions require that a fund along the lines of the Fonterra Shareholders' Fund would have to be set up by Fonterra and the New Constitution would allow the Board to do this.
- There are a number of commercial, legal, tax and accounting issues in designing how best to achieve the goals of the Fund outlined in this booklet. These will be worked through in developing the final design of the Fund.

What's proposed and why?

- The Board would have an important role in developing the rules and procedures of the Fund, including the rules under which farmers interact with the Fund. The Board considers that the Fund could work generally along the following lines:
 - > Farmers would be able to transfer to the Fund the benefits of their Co-operative shares, including their rights to distributions, and any benefits or losses from changes in the market value of the underlying Co-operative Shares but excluding any voting rights and rights relating to milk payments. We refer to this as the transfer of underlying rights.
 - > A farmer wishing to sell their underlying rights to shares to the Fund would contact the fund manager who would offer them a price determined by reference to the price the Fund's units were trading at. If the farmer was to accept the offer, the intent is that they would receive the cash payment from the Fund within a relatively short period.
 - > Some farmers who sell their underlying rights to the Fund might later want to buy them back and keep the shares. It is envisaged that they would do so at a price determined by reference to the prevailing unit price. Other farmers may no longer need shares subject to arrangements with the Fund (for example, because their production has fallen or they are exiting). One of our goals would be to make it as easy as possible for farmers to exit the Fund in these circumstances, potentially by allowing them to relinquish their underlying rights and their shares at the same time rather than being required to 'buy back' the underlying rights beforehand.
 - > Farmers would retain voting rights and the right to receive the full share-backed milk price in relation to any shares which are the subject of contracts with the Fund that are backed by production. The New Constitution would prevent a farmer shareholder from transferring voting rights to the Fund (or any other similar entity).
 - > The New Constitution would provide that the Fund could not hold shares but any underlying rights to shares could be held by a custodian, if required depending on the final design of the Fund.
- The arrangements outlined above are intended to allow farmer shareholders to sell their underlying rights to the Fund and buy units if desired. Allowing farmers to also do the opposite by easily exchanging units for shares would help drive convergence in prices between the two markets. A close and stable alignment between the price of shares and units could potentially offer significant benefits to farmers. For example, it would mean that farmers who sell underlying rights to the Fund wouldn't be exposed to undue risk arising from differences in the unit price and the price of shares.
- The Fonterra Shareholders' Fund is expected to be a unit trust with an independent trustee. It is intended that the Fund would issue units to the public to raise capital to enable the Fund to buy underlying rights in shares from farmer shareholders. The Board considers that it should target as investors sharemilkers, retired farmers, and the like but expects institutions and the public would also invest in units. This public trading of units would also encourage coverage of Fonterra by market analysts and media, improve price discovery and improve the ability of RVPs to provide liquidity and price stability in the Fonterra Shareholders' Market. These are also important outcomes. To establish a successful unit market, the Fund may need to be established with a minimum size and would need to have features that are acceptable to external investors.

- To ensure limits on the size of the Fund, the New Constitution would set an overall threshold which would be intended to ensure that no more than 25% of all Co-operative shares could be subject to contracts with the Fund by farmer shareholders.
- However, the Board intends, as a matter of policy, that its target threshold would be that no more than 20% of Co-operative shares could be subject to contracts with the Fund (and this policy can be changed by the Board).
- The Board would be able to set a threshold on the number of shares that any individual shareholder could contract to the Fund. The Board is likely initially to set this individual threshold at no more than 33% (but is able to change this at any time). In setting this policy, the Board could consider placing some limits (such as phasing down to a lower threshold over a specified period) on the contracts that an individual farmer shareholder might have with the Fund.
- Like the overall threshold on Dry Shares, it is possible that the overall threshold on Co-operative shares subject to contracts with the Fund could be exceeded. If this happens, the New Constitution would require the Board to take steps to manage the overall number of Co-operative shares subject to contracts with the Fund having regard to the overall threshold.
- It is also envisaged that no individual investor in the Fund could hold more than 20% of the units of the Fund. The Board envisages that Fonterra could hold a 'golden unit' in the Fund that could provide certain protections for the Co-operative on behalf of farmers (for example, in relation to the minimum terms for contracts between farmers and the Fund).
- In designing the final detail of Trading Among Farmers, it would be important that farmers can continue to buy and sell shares at a well-discovered price, and that a deep and liquid market for units would be maintained even if the maximum Dry Share thresholds or the thresholds relating to the Fund were to be reached.

Role of Fonterra

- Like every other company with permanent capital, Fonterra would have an important role in managing its capital once Trading Among Farmers starts. It is likely to do this in a number of different ways including:
 - > by issuing new shares, including "bonus share issues";
 - > by establishing a "Dividend Reinvestment Plan" under which farmers would be entitled to reinvest their dividends and use them to buy Co-operative Shares;
 - > by issuing shares to farmers under a "rights issues" or other means.
- Fonterra would also have all of the usual powers of any company to "buy-back" its shares and to issue new shares whenever it considers it appropriate, subject to disclosure and other obligations under securities laws and the trading rules of the Market. Within these constraints, circumstances in which Fonterra may choose to issue or buy back shares could include facilitating trading volumes through an RVP within a policy that enables Fonterra to manage any balance sheet risk within prudent limits.

What's proposed and why?

- In undertaking these activities Fonterra, and its Board, Council and management, would be subject to extensive rules and regulations under securities legislation and the rules that apply to the Fonterra Shareholders' Market. These rules and regulations would help to protect the interests of farmer shareholders who use the Fonterra Shareholders' Market.
- Fonterra could also issue shares prior to the commencement of Trading Among Farmers to create a sufficient pool of Dry Shares, including by some combination of the above approaches. It could also regularly issue more shares to maintain or grow the pool of Dry Shares if share-backed production were to increase.
- However, Fonterra would be able to regularly raise capital under its retentions policy to strengthen its balance sheet. (Like other companies with permanent capital, we expect that retentions would be the main source of new capital over time.)

Voting

- The New Constitution would maintain the current rules around voting rights - on a poll, voting would remain one vote for every 1,000 kilograms of milksolids supplied.
- However, there would be a specific restriction in the New Constitution on shareholders transferring or "giving away" their votes to third parties under commercial arrangements. In particular, a shareholder couldn't give away any of their voting rights to a Registered Volume Provider or the Fonterra Shareholders' Fund or any other similar fund that might be established. If votes were transferred or "given away" in this way, the Board would be able to disallow the votes and to take other steps to prevent the shareholder and the recipient of the votes from continuing the arrangement.

Milk Price

- The requirement to determine the Milk Price in accordance with the Milk Price Manual and the Milk Price Principles would continue under Trading Among Farmers and would be included in the New Constitution. The Milk Price would also continue to be calculated by an independent Milk Price Group and subject to independent reviews and audits.
- To maintain the integrity of the Milk Price in the future under Trading Among Farmers, a Milk Price Panel has been established to assume the role previously performed by the Fair Value Share Committee of the Board. The Milk Price Panel advises the Board on the application of the Milk Price Manual and the Milk Price Principles, and can recommend and provide input into reviews of the Manual. The Panel will be integral in assisting the Board to meet its obligations to ensure that disclosures regarding the Milk Price are clear and well-communicated.
- The Panel comprises five members. Three are appointed by the Board – two must be appointed Directors of Fonterra, and one must be a farmer-elected Director. Two appropriately qualified persons are appointed by the Shareholders' Council and one of these must be independent. The Panel chairman must be an appointed Director.
- Fonterra would continue to ensure that it pays farmers the maximum sustainable Milk Price. The growing depth and standing of globalDairyTrade will help increase the transparency of the Milk Price revenue line. The governance structure is strengthened by the Milk Price Panel and farmers can be confident that disclosures regarding the Milk Price are fully transparent.

- Investors in units issued by the Fund would also want a transparent competitive Milk Price so they could see that Fonterra remains competitive by retaining and growing its base of high-quality milk on which the whole business depends, and more easily understand how the profit after the Milk Price is made up.

Subordination of milk payments

- The effect of the current Constitution is that milk payments to its shareholders are calculated after all other payment obligations have been met, including interest and debt payments. This ranking of milk payments behind other claims is set out in clause 10.1 of the Constitution and has commonly become known as subordination. It is proposed to amend the Constitution to make it more clear that principal repayments, interest and financing costs are paid before milk payments along with all other costs of the Co-operative.
- Farmer shareholders benefit from the subordination of milk payments in several ways including:
 - > Allowing access by Fonterra to debt markets to finance a large-scale and flexible manufacturing footprint in New Zealand, as well as working capital and an international sales network to support the efficient sale and distribution of New Zealand-sourced product; and
 - > These scale, working capital and logistics benefits flow through to the Milk Price.
- The Board believes that the risk that subordination may result in a lower payment for milk to our farmers will be likely to be reduced as a result of the removal of Fonterra's obligations under the Constitution and DIRA to redeem shares and providing more scope for Fonterra to strengthen its balance sheet by growing equity through Dry Shares and retentions.

The Valuer

- It is expected that the Valuer currently appointed under the Constitution would continue to have a role, if the Shareholders' Council decides this is appropriate. The New Constitution reflects this approach.
- The nature of that role would need to change - the Valuer would effectively be no different from any other external person who provides their view on the value of Co-operative shares. The Valuer wouldn't be able to have access to "inside information" about Fonterra (due to limitations under securities laws).
- In addition to providing its view on the value of Co-operative shares, the Valuer (or another independent person) could be contracted to regularly review how well the Fonterra Shareholders' Fund and the Fonterra Shareholders' Market are functioning and interacting with each other. After submission to the Board, the report would be made public and could recommend areas where enhancements are appropriate.

What's proposed and why?

Rules for the Fonterra Shareholders' Market

- Fonterra would help develop and publish market rules that would regulate the conduct of buyers and sellers and Fonterra, and trading procedures.
- These rules could be monitored by the independent operator of the Market with some enforcement by the Securities Commission.
- The rules could be developed with a view to promoting an informed market, which would require Fonterra to disclose information such as:
 - > Prices, volumes, bids, offers, spreads on the Fonterra Shareholders' Market.
 - > Other pricing information, such as globalDairyTrade prices, foreign exchange trends etc.
 - > Information on Fonterra and its strategy, business activities and operating performance.
 - > Access to 'expert opinion' as it relates to Fonterra's value, forecast performance, the market for its dairy products or any other relevant matter.
 - > Access to news, comment and opinions of financial commentators as it relates to Fonterra and its markets being made available on Fencepost and more widely.

LEGISLATIVE CHANGES

It would be necessary for DIRA to be amended before the Board can implement Trading Among Farmers. This is one of the pre-conditions. From the time that Trading Among Farmers starts it would be necessary to suspend the obligation on Fonterra to issue and redeem shares at a share price set by the Board and, in particular the obligation to redeem within 30 days of the end of each Season. Fonterra would continue to have an obligation in its Constitution and in DIRA to accept supply that is backed by shares subject to the current exceptions (such as minimum volumes and transport costs).

We have had discussions with the Government on changes to DIRA to accommodate Trading Among Farmers. Our understanding of the Government's position is that its policy objectives could be met by a market for Fonterra shares with a Fonterra Shareholders' Fund backed by a deep, liquid, efficient unit market, as proposed by Fonterra with strong linkages to the Market. This would enable suppliers to readily sell or purchase Fonterra shares at well-discovered prices.

The Government has also said that, during the process of finalising the detail of Trading Among Farmers after a shareholder vote, it would determine the way in which the current regulatory regime should be modified in consultation with Fonterra and other stakeholders in the dairy industry. This would be to enable Fonterra's capital structure changes to proceed while ensuring that the Government's policy objectives are met on a continuing basis.

TAX

It is your responsibility to seek appropriate professional guidance in respect of income tax.

However, by way of general comment, just like now you would only be taxable on any gain on the disposal of your Fonterra shares if you acquired those shares for the purpose of resale or you are in

the business of dealing in Fonterra shares. Both situations are unlikely where you buy and sell shares to comply with the Share Standard. Fonterra has received a non-binding confirmation from the Inland Revenue Department that, under the envisaged Trading Among Farmers regime, any gains will not be taxable provided you are buying and selling shares to comply with the Share Standard.

If however, you buy and sell Dry Shares with the aim of making a profit from those trades, any gain would be subject to income tax. The tax consequences of any share transaction would depend on your personal circumstances and we recommend you obtain your own professional advice on potential tax outcomes.

Under current law, farmer shareholders would continue to receive a gross return in respect of dividends on wet shares. Dividends on Dry Shares would also be taxable but would be subject to Resident Withholding Tax which will be refunded by the IRD if the farmer is not in a tax-paying position (or the RWT exceeds the farmer's tax liability).

Once Trading Among Farmers is implemented, Fonterra would not obtain a deduction for dividends paid on Dry Shares. Fonterra could continue to deduct dividends paid on the large majority of its shares that are backed by milk supply (wet shares). If Fonterra has insufficient tax losses, the non-deductibility of part of its dividends may put Fonterra into a tax-paying position which would give rise to imputation credits. These imputation credits can be attached to dividends paid on Dry Shares. Imputation credits can be used to offset the tax on the farmer shareholder's Dry Shares and are non-refundable but can generally be carried forward if unutilised.

IMPLEMENTATION

Trading Among Farmers would only start when the Board is satisfied that the pre-conditions outlined on page 8 have been satisfied.

- There is significant work to do to prepare the Co-operative for Trading Among Farmers. It would be essential that that work is done carefully so that we can all have confidence that the Market would perform as expected. In addition, external factors, like volatility in financial and commodity markets, and their impact on Fonterra's earnings, could affect the timing of the introduction of Trading Among Farmers.
- A key component of the structure would be the establishment of the Fonterra Shareholders' Fund. Again there is a lot of work to do to get this set up so that we could be confident that it would work well and would interrelate appropriately with the Market.
- The Board intends to continue working with the Shareholders' Council as the Board develops the detail of Trading Among Farmers.
- As with any process of transition there are risks arising from doing things differently from the way we have done things before. The Board would be prudent and would be consulting with government, regulatory bodies, and advisors over this period. Tax, accounting, securities markets and legal issues would need to be considered and could require some changes to the current model for Trading Among Farmers.

What's proposed and why?

- While the Government supports Fonterra's objectives in pursuing changes to its capital structure, the nature of changes to DIRA are not yet known. This, and the need for regulatory approvals and waivers, may also affect the timing of introduction of Trading Among Farmers.
- The Board is conscious that some aspects of the structure would not be able to start fully immediately since the Board expects to adopt a prudent and measured approach to the evolution of Trading Among Farmers. This is likely to result in the Board starting off significantly below the various thresholds (although ensuring they were set at levels intended to ensure there would be enough depth in the Market and the Fund) so as to allow them to be able to grow in response to the way that the new regime develops over time. For example, the Board intends to target a threshold of 20% on the total number of Co-operative Shares that could be subject to contracts with the Fonterra Shareholders' Fund (with a constitutional threshold of 25%). It would not be sensible to allow farmers to immediately place rights in respect of 20% of total shareholding under contracts with the Fund.
- What this means is that, if the number of contracts farmers wish to place with the Fund at the outset significantly exceeds the target size of the Fund, it might be necessary to look at the rules on how farmers access the Fund. These could include setting an individual threshold lower than 33% or considering whether there should be any limits on how long a farmer can keep their underlying rights to shares in the Fund.
- Similar issues arise in relation to the management of Dry Shares. The Board would initially seek a level of Dry Shares that support sufficient trading volumes in the Market, but that is likely to be well below the 20% target threshold.
- The Board would be looking to keep all shareholders informed of decisions made and progress towards Trading Among Farmers, and would work with the Shareholders' Council to achieve this.

FURTHER DETAILS

Further details about the proposed changes to Fonterra's Constitution can be found in the Proposed Changes to the Constitution Booklet. This gives more information in relation to each of the areas outlined above.

Farmer feedback on Trading Among Farmers since the April booklet

This section outlines the key areas of feedback from farmers on Trading Among Farmers since the April booklet.

Fonterra Shareholders' Fund

During consultation we asked for your views on what limits should apply to the Fonterra Shareholders' Fund. There was general support for introducing a limit on the maximum number of shares that are subject to contracts with the Fund at both an overall Co-operative level and for individual farmers.

In considering what these limits should be, the Board considered the following:

- The importance of farmers continuing to back a substantial amount of their production with shares in which they hold the full economic benefits. This ensures the strong links between supply and ownership that underpin the Co-operative.
- The individual limit should improve flexibility for farmers but apply in a way that everyone gets an equivalent opportunity to take up this flexibility.
- The role of the Fund to provide some 'breathing space' for farmers based on where they are in their farming lives.

Taking into account these considerations, the Board is proposing a constitutional limit of 25% of Co-operative shares that can be subject to contracts with the Fund but will target an overall threshold of 20%. The Board can set individual thresholds and intends to set, as a matter of policy, initial individual thresholds of 33% of shares that could be subject to contracts with the Fund.

It is appreciated that the maximum individual thresholds envisaged may not give the financial flexibility from the Fund that some farmers may expect. But the role of the Fonterra Shareholders' Fund would only be one element of a package intended to provide additional flexibility for farmers in their interactions with the Co-operative. Other elements, such as the 'three-year entry' (which would apply to farmers switching from contract to share-backed supply) would also contribute to greater flexibility. For example, a new entrant could be required to hold only a third of their required shares at the end of the first season, but could have a portion of these shares subject to contracts with the Fund.

As noted on page 15, the Board considers that it would be appropriate that no individual investor in the Fund should be able to hold more than 20% of the units in the Fund. The Board expects that Fonterra could hold a 'golden unit' in the Fund that could provide certain voting protections for the Co-operative on behalf of farmers. These aspects would need to be included in the rules of the Fund, which the Board would be able to approve.

What are we voting on?

One special resolution will be proposed at the Special Meeting.

- The special resolution will amend Fonterra's current Constitution to authorise the Board to take steps to move to Trading Among Farmers, subject to specified pre-conditions being satisfied.
- The resolution will provide for the New Constitution to replace the current Constitution when the Board resolves that the pre-conditions have been satisfied.
- There will be an expiry mechanism if the pre-conditions (referred to above) are not satisfied by 31 December 2013 or a later date set by the Board. If this occurs the pre-conditions, and the New Constitution, will cease to have any effect and the Constitution will remain very similar to now.
- The Board will also be authorised to implement rules and processes for transition from the existing capital structure to Trading Among Farmers.

The amendments to the body of the current Constitution which will take effect on the passing of the special resolution are shown in **blue** in the amended Constitution (marked "Form A Constitution") sent with this Booklet.

The new Constitution marked "Form B Constitution" (that would apply only if pre-conditions are met and the Board resolves to proceed) is set out as Annexeure 2 to the Form A Constitution. As a result it will form part of the amendments to the current Constitution. However, to show clearly how this Form B Constitution will differ from the Form A Constitution we have marked those differences in **red** in the Form B Constitution.

Further details about the possible timing for the implementation of Step Three can be found on pages 19 and 20.

TIMING

We have heard that you are keen for Fonterra to move towards Trading Among Farmers so that redemption risk can be eliminated in the 2011/2012 Season.

At the same time, the Board will need to be satisfied that all of the features of the Market and the new operating environment are well designed and ready to operate before we move off the current system.

As a result we are moving to Trading Among Farmers in the following way:

- At the Special Meeting on 30 June 2010, shareholders will be asked to vote on the transitional amendments to the Constitution to enable the Board to establish the Market and commence trading. Apart from getting on and making those preparatory arrangements, very little will change during this interim period (other than if it was possible to introduce the Fund earlier).

What are we voting on?

- Then the Board will begin the transition to Trading Among Farmers. This will not happen until after the end of Season adjustments are made in July 2011 at the earliest. Trading Among Farmers will only start when the Board is satisfied that the pre-conditions outlined on page 8 have been satisfied.
- Naturally a lot will be happening in the period between the 30 June 2010 vote and full implementation of Trading Among Farmers. We will keep all shareholders informed of progress in this period.

What if I have questions?

If you have questions about the special resolution or information in this booklet, you can contact your Directors, Shareholders' Councillors or Area Manager using the contact details set out in the latest Farmlink, or by accessing the section on capital structure under Fencepost on www.fonterra.com.

Frequently asked questions

If Trading Among Farmers comes in, how will shareholders know that there will be buyers and sellers in the Market when they need to reduce or increase their shareholding?

A key to giving farmers confidence that shares can be bought or sold on any given day at a well-discovered price is the volume of share trading. In a normal season between 50m and 100m Fonterra shares are turned over just as a result of buying and selling by conversions, growing farmers, farm sales, and farmers exiting. Last season this alone would have made Fonterra's share the eighth most transacted share in New Zealand.

On top of this underlying trading volume, we would look to design mechanisms to encourage a market for share trading. The rules around when farmers need to buy, hold and sell shares would aim to give farmers more flexibility about their shareholding relative to production. For example, farmers would be able to buy and sell shares over three years and hold shares up to twice their production, and it is intended that shares could be bought or sold on any business day. In addition, Registered Volume Providers could be introduced to provide short term buy and sell offers.

What would happen to the restricted \$4.52 share price once trading begins?

If Trading Among Farmers were to be brought in, it would be the Market that would determine the share price, not Fonterra. However, the Board has already indicated that it would need to form a view on the initial share price before it could allow trading to start. In forming this view, the Board would take into account the most recent restricted market valuation and the share price base value (currently \$4.52).

Fonterra is undertaking a number of things to help it to get to this point. These include a focus on strong performance by the Co-operative to grow earnings, and continuing the current retentions policy to strengthen the balance sheet so as to grow the value of farmers' investment in the Co-operative.

How would Fonterra ensure that farmers' right to open entry and exit is preserved?

We are looking to preserve open entry and exit through a well-functioning Fonterra Shareholders' Market, allowing farmers to buy and sell shares when they need to at a well-discovered price. We are proposing that new entrants would be able to buy all their shares in the Season they start supply, or buy shares over three years, while exiting farmers would be able to sell all their shares in the Season they cease, or sell their shares over three years. Our discussions with the Government on changes to DIRA are aimed at ensuring that open entry and exit would be maintained on these terms.

How would Fonterra raise capital once the 20% Dry Share target threshold has been reached?

The Board's current intention is that it would be preferable to gradually build up Dry Shares over time so it would take some time before the 20% target threshold is reached. However, Fonterra would have several options for raising capital even at this point. For example, growth in milk supply at recent levels would allow for new shares to be issued, and ongoing retentions

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Frequently asked questions

would continue to provide additional capital to support the Co-operative without the risk of that capital being redeemed.

Fonterra's future business activities will remain focused on growing value for our farmer shareholders from the milk they supply to the Co-operative. Well into the future, living within the target 20% threshold on Dry Shares may require the Board to make decisions about the scope of activities undertaken by Fonterra. But that is appropriate and the choices and trade-offs can be made in the light of circumstances at the time.

What would happen if milk supply falls over time?

If milk supply was to fall and Fonterra was within the Board's target 20% threshold on Dry Shares then this would simply reduce the number of wet shares and increase Dry Shares. In such a case, the Co-operative would not need to take any specific steps. Once the 20% threshold was reached the Board would have the ability to take steps to manage Dry Shares within the 25% constitutional threshold. A response might be, for example, an orderly buy-back of shares.

The Board would have the opportunity and the time to tailor its response to the causes of the decline in milk supply, for example whether it was the temporary result of a drought or reflected longer-term structural changes in the dairy sector. Fonterra would certainly be in a better position to deal with a decline in milk supply over time under a Trading Among Farmers regime than is the case now with capital that is not permanent.

What advice would be available on the price for the share once trading begins?

The Shareholders' Council proposes retaining the Valuer for a period following the launch of farmer trading to provide their view on share value. Farmers would be able to use this information to form their own view on value when they buy or sell shares. The Board could also contract the Registered Volume Providers to publish periodic reports on their view of the value of the share price. We expect that there will also be other sources of advice available on the expected value of the share price, as institutions such as banks will take a close interest in Fonterra's share price.

Would the Fund or Registered Volume Providers be able to influence decision making in the Co-operative?

Neither the Registered Volume Providers nor the Fonterra Shareholders' Fund would be able to have any voting power in the Co-operative. Votes in the Co-operative would continue to be based on milksolids backed by shares.

Would Dry Share investors be able to exert additional influence in the Co-operative?

Under Trading Among Farmers, some farmers are likely to have a different level of investment in the Co-operative than others. However, farmers would still have the same level of control they always had, as voting rights will continue to be based on milksolids backed by shares.

Would the Board be able to change the upper limits of the individual or Co-operative thresholds for Dry Shares?

No, the threshold of up to 200% which applies to individuals holding Dry Shares and the 25% threshold on total Dry Shares on issue would be set in the Constitution and could only be changed with a 75% shareholder vote.

Would I be forced to sell shares if I buy up to my 200% limit, and then there is a drought?

The three-year rolling average for measuring compliance with the Share Standard that is proposed to be in the New Constitution would help to substantially reduce the extent to which a farm's shareholding requirements change between seasons. As well, the Board can still allow farmers to substitute their three-year rolling average with a production estimate based on their farms' size and stocking rate, as is the case currently. These mechanisms would help minimise farmers having to sell shares following one-off events that impact production.

Why wouldn't the Board just focus on maximising the dividend instead of the Milk Price once all these Dry Shares are issued?

The Board is obliged to pay the maximum sustainable price for milk under the Milk Price Manual and the Milk Price Principles, and that would continue to be the case under Trading Among Farmers. Even if a farmer were to invest to their maximum Dry Share holding, they would still receive the majority of their income from milk payments (at the currently announced forecast Milk Price and dividend this is over 90%). The obligation to pay the maximum sustainable price for milk is also now overseen by a new Milk Price Panel including Board members and Shareholders' Council appointments, and will continue to be independently reviewed by the Auditor.

How would the Milk Price be calculated?

Fonterra's Milk Price will continue to be calculated under the Milk Price Manual and the Milk Price Principles.

In broad terms, Fonterra derives an annual milk price by reference to a basket of core commodity products that account for the full 'bucket of milk' where prices can be readily observed at the point produce leaves New Zealand. Prices derived from globalDairyTrade are an increasingly significant reference for those prices.

The economic costs from the farm gate to the port of transforming raw milk into those commodities are then deducted to derive the Milk Price. Costs of production are based on the most efficient of Fonterra's manufacturing facilities and the average scale of those plants, and Fonterra's actual farm-gate-to-factory collection costs. Costs are scaled up to account for Fonterra's full annual milk volumes. Production costs incorporate an allowed recovery of an independently-reviewed cost of capital. These calculations are overseen by the new Milk Price Panel.

It is possible that investors in the market for units could initially see some issues around the setting of the Milk Price. This could potentially influence the pricing of units. However, the governance arrangements, integrity of price setting under the Milk Price Manual and the increasing role of globalDairyTrade in deriving reference prices, as outlined above, should see these concerns diminish over time.

Glossary

April booklet means the booklet entitled "Capital Structure - Trading Among Farmers" that was provided to shareholders prior to the round of Consultation meeting that began on 12 April 2010.

Board means the board of directors of Fonterra.

Constitution means the constitution of Fonterra, as amended from time to time.

DIRA means the Dairy Industry Restructuring Act 2001.

Dry Shares means shares additional to those required to cover milk supply to Fonterra.

Fonterra or **Co-operative** means Fonterra Co-operative Group Limited.

Fonterra Shareholders' Fund or **Fund** has the meaning given on page 13.

Fonterra Shareholders' Market or **Market** has the meaning given on page 12.

Form A Constitution and Form B Constitution are references to the proposed constitutions to apply in the transitional period following the Special Meeting, and on full implementation of Trading Among Farmers (respectively).

New Constitution means the Form B Constitution which is attached to the Form A Constitution as Annexure 2 and which will apply to Fonterra on full implementation of Trading Among Farmers.

Proposed Changes to the Constitution Booklet means the separate booklet sent out with this booklet, which contains the Form A Constitution and the Form B Constitution, together with explanatory notes on those two documents.

Registered Volume Provider or **RVP** has the meaning given on page 12.

Share Standard means the number of Co-operative Shares a shareholder is required to hold from time to time as determined in accordance with the Constitution.

Season means a period of 12 months ending on 31 May in each year.

Special Meeting means the special meeting of shareholders of Fonterra to be held on Wednesday, 30 June 2010.

Valuer means, at any time, the person holding office as the Valuer in accordance with clause 20.1 of the Constitution.



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Your question (tear off and give to your Director/Shareholders' Councillor):

Name: _____

Supplier No: _____

Email: _____

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Name: _____

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Email: _____



Dairy for life



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