

**GOVERNANCE &
REPRESENTATION**

**DRAFT
PROPOSAL**

G&R

ENHANCING OUR EXISTING MODEL

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This booklet outlines a series of proposals that will fine-tune and modernise parts of our already strong governance and representation model. We have developed these proposals off the back of our earlier 2013 review work, which gave us a solid foundation to build from, new research and governance best practice that has been published since then.

We've also taken into account input from experts, and your farmer feedback. Thank you to all of you who have contributed to the review so far. You turned out to more than 200 shed meetings across the country, you emailed and phoned us and you gave us a wide range of feedback.

The Committee has combined the research, advice and your feedback to develop proposals that will improve our governance and representation model and ultimately, support our ability to increase farmers' wealth through the Milk Price, dividend and share price.

We've summarised the main feedback themes in the front of this booklet before showing how they have been considered within the proposals.

We've listened to the areas where you think the Co-op can improve and the shared outcomes we're all looking for. We've heard from farmers that you are open to considering any change that delivers a stronger and more effective governance structure, so these proposals are based on best practice, tailored to suit the needs of our 100 per cent farmer-owned and controlled Co-operative.

The Committee think it is important that we challenge ourselves to consider the significant changes put up within parts of this draft proposal, and have a quality conversation within our Co-operative.

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The proposals that we have designed are laid out for your consideration within this booklet.

The next stage is for you to think through these proposals and give us your feedback so we can consider it in a final recommendation. Importantly, this next stage will also include further input from an independent expert panel. The panel is made-up of local and international experts in the governance and representation fields, including: Chris Moller (NZ), Adrie Zwanenberg (Netherlands), Michael Cook (US), and Dame Therese Walsh (NZ).

If the final recommendation requires constitutional change then we will need a farmer vote. We would plan to do that at a Special Meeting in late May.

It is important we keep up the momentum so that the final recommendation delivers us the change needed to take our Co-op forward.

GOVERNANCE & REPRESENTATION REVIEW COMMITTEE

Board of Directors Representatives

- John Wilson
- Nicola Shadbolt
- David MacLeod
- Michael Spaans
- Malcolm Bailey

Shareholders' Council Representatives

- Duncan Coull
- Ian Brown
- Murray Linton
- Greg Kirkwood
- Bill Millar

SUMMARY OF FARMER FEEDBACK & AGREED OUTCOMES

IN BRIEF: FARMER FEEDBACK

We had some very clear messages come back from the farmer base. As you'd expect, on some issues there was a broader range of feedback. The most consistent message was that farmers want to get the best people into governance and representation roles within the Co-op.

Farmers want a forward-looking system that moves the Co-op further away from the politics of the old legacy companies, while also maintaining our traditional Co-op principles.

Below is a summary of the feedback we have received to date. As you go through the different sections of the proposal we have also included excerpts of specific farmer feedback.

GOVERNANCE

On governance farmers said that the role of Directors needs to be better defined and more focused on core governance functions.

You want better access to information on the skills needed on your Board. When considering candidates for governance roles, you want to see how they measure up against those requirements. You want a focus on the personal attributes of Directors, as well as their technical skills, and more information on the performance of our existing Directors.

You acknowledged the need to consider workloads, the diversity of skills required on our Board, and the trade-offs required when considering a reduction in the number of Directors.

You reiterated that farmer control is non-negotiable and our governance processes are part of this, but there was discussion about the best way to achieve it. Many farmers felt that it was still important that people with 'skin in the game' were sitting on the Board. Others thought it should just be the best people for the job.

Farmers had a lot to say about the current election and appointment process. Different methods for electing our Farmer Directors were discussed, and there was a willingness to look at alternatives to the current voting system.

There was good debate about the operation of the current Candidate Assessment Panel, and a call from farmers for independent involvement in the process and clearer direction from the Board on its view of Director candidates.

REPRESENTATION

On representation there was recognition of the important role the Shareholders' Council plays in representing your collective interests.

You told us you want to see better information about the way your voice is considered by the Council, the way Council then communicates your collective views to the Board, and the reasons behind the final decision.

There was recognition that the Co-op is struggling to attract new candidates to stand in some Wards and that we should create better succession opportunities for our young farmers.

Several farmers put forward ideas to restructure the Wards. These ideas included creating a new body within Council to do work on national issues, leaving others in the Ward to carry out local representative activity, and amalgamating Wards.

OPERATING MODEL

There was acknowledgement of the strength in maintaining separate governance and representation roles. Farmers agreed that the Board should be responsible for making the best decisions for the Co-op, while the Shareholders' Council has an important role to play in holding the Board to account and ensuring that farmers' voices are well represented.

But it's also fair to say there is a sense of frustration that at times, the Co-op doesn't always get the information flows right. We've heard that farmers want better, more timely information back from the Co-op on business decisions that affect them.

GROWING FUTURE LEADERS

On growing future leaders, farmers overwhelmingly wanted improved pathways for our future governors and representatives to come up through the ranks and take up the baton of leadership.

We had a great discussion about the best ways to identify and mentor talented young farmers, while recognising that the pressures of building equity in their Co-op were a barrier to participation in leadership.

Alongside these concerns, the Committee also heard some positives. Farmers see real potential in a Board populated with the best governors who are capable of running a complex global Co-op and a Council filled by their peers who can really represent their interests.

AGREED OUTCOMES

Within the feedback, the outcomes that farmers wanted was clear and shared by the Committee. We have drawn it together into six agreed outcomes.

1.

The primary role of the Co-op is to maximise the value of our milk and grow our wealth.

2.

100 per cent farmer control and ownership of our Co-op and living our Co-op principles is non-negotiable.

3.

Ongoing positive engagement in our Co-op requires greater transparency, less politics and better communication.

4.

There is strength in maintaining separate governance and representation roles and we want processes that give us the best chance of getting the best people for those jobs.

5.

We want maximum flexibility to ensure that our Co-op can respond quickly to its environment in the future.

6.

Ensuring our future is important. We need to refocus our efforts on farm-to-leadership succession and development processes.

Thank you for your feedback to date. As you work through these proposals, you will see how the main themes and shared outcomes have been taken into account.

THE PROPOSALS AT A GLANCE

Below is a short summary of the key changes that we are asking you to consider. These are described in detail within this booklet.

We have combined the results of our earlier 2013 work, further research and expert advice, and considered your feedback to develop proposals that improve our governance and representation model and achieve our six agreed outcomes.

In some instances, the way we propose to deliver these outcomes is a significant change to what the Co-op has now. We encourage you to read the detail behind each proposal included in this booklet so you can understand the thinking behind these changes.

The Committee believes that it's important that farmers make up the majority of our Board. Within these proposals, the current definition of a farmer has been reviewed with that in mind.

We've also dedicated a section of the booklet to explaining how your 100 per cent farmer ownership and control of the Co-op is preserved and strengthened through the changes within these proposals.

GOVERNANCE

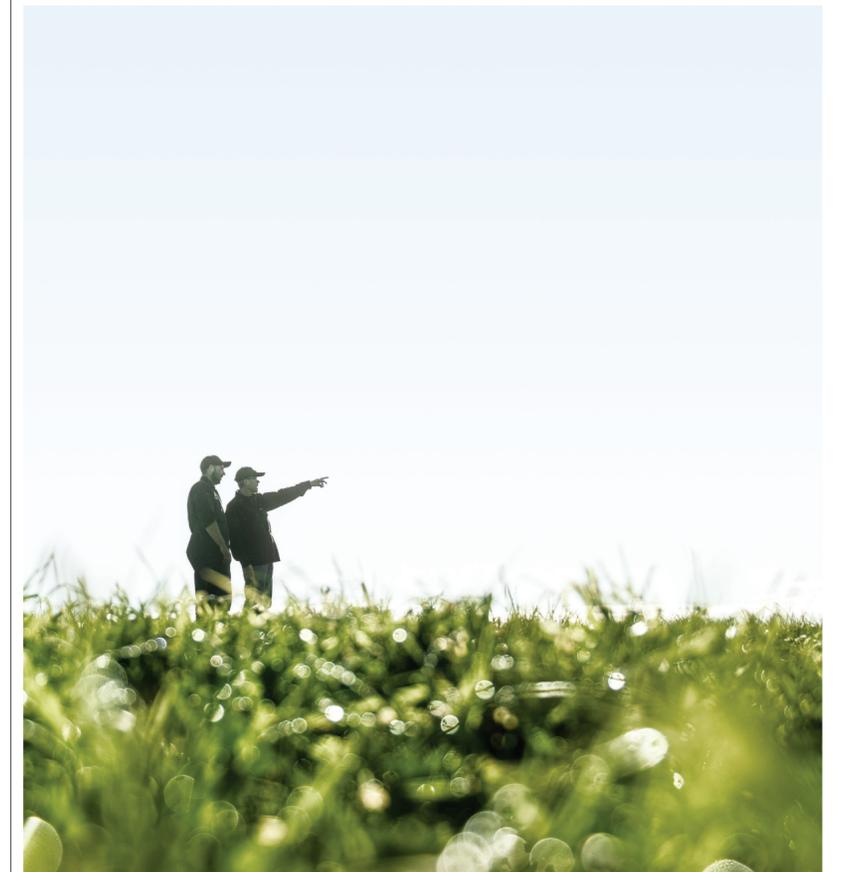
- Reduce the number of Directors on the Board to a maximum of 11.
- Maintain majority (6) Farmer Directors. The Chairman must be a Farmer Director.
- Change eligibility rules for Farmer Directors, principally to allow for modern farm ownership structures (including the increased use of Limited Partnerships).
- Strengthen the current skills matrix to introduce attributes and use this matrix to assess Board candidates.
- Include an on-farm knowledge and skill requirement.
- Introduce a new appointment process for all Directors that:
 - Moves away from the Single Transferable Vote election system for Farmer Directors.
 - Includes 100 per cent independent assessment.
 - Shareholders' Council observes the Board Committee and is consulted on the nominated Directors.
 - Provides better information to farmers to help them make the final decision on who sits on their Board.

REPRESENTATION

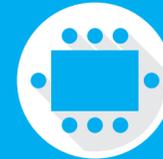
- Clarification of the role of the Shareholders' Council.
- Introduction of a maximum term for Councillors of two three-year terms.
- An extra Councillor within the Wards of the sitting Shareholders' Council Chairman and Deputy Chairman to assist with their workload.
- Improved reporting on the performance of Council.
- Details of the performance assessment process for individual Councillors will be communicated to farmers.
- Formal introduction of an agreed set of attributes and capabilities, to assess Councillor candidates during elections.
- A commitment to review the Shareholders' Council structure within the 2017 financial year.

OPERATING MODEL

- Publication of interface guidelines so that Board, Council and Management interfaces are transparent.
- Improved communications via clearer pathways and better use of new communication tools.
- Enhanced development pathways and succession planning for governance and representation to create a pipeline of future leaders.



GOVERNANCE



Proposed Board composition –
size, eligibility & balance



Getting the required attributes
and right skills onto our Board



A new Director
appointment process



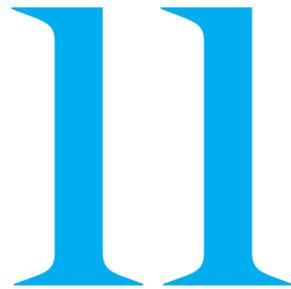
Strengthening
farmer control

PROPOSED BOARD COMPOSITION – SIZE, ELIGIBILITY & BALANCE

The rules around the composition of the Board, how big it is and who can sit on it are critical. This section sets out our proposals on these issues.

IN BRIEF

- **SIZE:** Reduce size of Board from 13 to 11 Directors
- **ELIGIBILITY:** Change eligibility rules for Farmer Directors, principally to allow for modern farm ownership structures (including increased use of Limited Partnerships)
- **BALANCE:** Majority (6) Farmer Directors. Chairman to be a Farmer Director



SIZE OF OUR BOARD

Why 11 Directors?

When Fonterra was formed it was envisaged that the size of the Board would be reduced over time.

In response to your feedback we reviewed best practice guidance and relevant research, and thought hard about our diverse skill requirements and the unique Director workload that comes with Fonterra's status as a regulated, multi-national Co-op based in New Zealand.

Workload considerations

Fronting up to farmers as owners and being accountable for the performance of the Co-op will always be a very important part of our Board's responsibilities. Our unique regulatory requirements and our Co-op structure require a heavy Board committee work programme. As New Zealand's largest multi-national company, stakeholder relations will also continue to be a factor in Directors' workloads.

In feedback some farmers said that workload should not be an excuse and that Directors should be happy to just be on Fonterra's Board.

The reality is that good people usually have diverse interests and are in high demand. If the workload of our Directors is too high, we won't attract the kind of people we want and need on our Board. In addition, our Co-op benefits from having Directors who are exposed to ideas and experience from other organisations.

Research considerations

Research shows that there is no 'right' number for a Board nor is there any solid evidence of a link between company performance and Board numbers.

We acknowledge and agree with the body of research about the effectiveness of human decision making. It generally concludes that smaller groups are more likely to create an environment for efficient decision making, personal involvement and increased personal accountability. However, when this theory is applied to governance, it is

just one factor. The requirements of the company are just as important in determining the right size of the Board.

Overall, we think that a reduction of two Directors strikes the right balance between our continuing drive for diversity, the ability for the Board to responsibly manage its workload, and efficiency.

If you are interested in reading more on this subject, you can view some of the research that we have looked at on the GRR section on Farm Source online.

ELIGIBILITY CRITERIA

Eligibility criteria for Directors are a key tool for reinforcing farmers' ownership and control interest in the Co-op, but they also act as a barrier to participation in Fonterra's governance, which limits access to the skills we need.

A number of requirements are imposed on us by law and by our regulatory framework (including the Companies Act 1993, Financial Service Providers (Registration and Dispute Resolution) Act 2008 and the Fonterra Shareholders' Market Rules). We are not proposing to change any of those.

Fonterra also has some requirements that it imposes on itself under the Constitution.

The eligibility criteria for Farmer Directors has served us well but it needs to be updated to make sure we're not excluding people who should qualify as Farmer Directors.

As many farmers have sought to diversify the geographical areas where they have farming interests, and as the capital requirements for large-scale farming operations have increased, farmers have partnered with other farmers, family members and friends to invest in multiple farming operations.

The result is that legal ownership structures have become more complex. Legally, farmers often have indirect interests in farms – the more direct ownership arrangements contemplated by the current Constitution are becoming less common.

The law has also changed. In 2008 Limited Partnerships were introduced and are commonly used to hold interests in farms.

The way we intend to accommodate these changes is to replace the current elected director eligibility criteria in clause 12.3 of the Constitution with a requirement for a majority of the Board to have an 'Owner's Interest'.

We would also remove the current limitation (in the last sentence in clause 12.3 of the Constitution) on there being more than one shareholder of a company that is a Shareholder, more than one member of a partnership that is a Shareholder, or more than one joint Shareholder, who may be eligible for election as a Director.

While that limitation may have been appropriate when dairy farming was (typically) undertaken on a smaller scale and with simpler ownership structures, it no longer seems necessary and could have arbitrary consequences.

We are exploring the use of a term in the constitution along the following lines. We'd like your views on it:

'Owner's Interest' means a direct or indirect interest in a Shareholder that is supplying milk to the company which comprises either:

- a) a direct or indirect legal or beneficial interest in that Shareholder (including as a beneficiary of a trust); or*
- b) a right or entitlement to participate (directly or indirectly) in the distributions of, or made by, that Shareholder, and, without limiting the entities, arrangements or structures through which any such interest may arise or be held, a person will be deemed to hold such an interest if he or she:*
 - c) is a Shareholder that is supplying Milk to the Company; or*
 - d) is a shareholder in a company that is a Shareholder that is supplying Milk to the Company; or*
 - e) is a partner in a partnership that is a Shareholder that is supplying Milk to the Company.*

There are some points that stand out.

The text above does not have any qualification tied to the size of a person's interest in a Shareholder – a relatively small interest (in dollar terms or as a percentage) is sufficient. This is also a feature of the current eligibility criteria. Currently, one share in a Shareholder is enough.

We don't want to introduce this sort of requirement because it's subjective and it's important that wealth never becomes a criteria for participation in the governance of our Co-op. Skin in the game is skin in the game – it shouldn't matter how much you have.

It's also important to remember that the test will work alongside the requirement in the skills matrix, for some of the Board to have on-farm knowledge. We discuss this next.

The test still does not assist people who have strong governance skills and experience but no legal, beneficial (e.g. through a trust), or financial interest in a Shareholder. For example, if you are a director of a large-scale farming operation but you do so in return for a fee, and you have no shares or other ownership interests in the farming operations, you are unlikely to qualify.

We think this is an appropriate line to draw.

KEEPING THE CONNECTION BETWEEN THE BOARD ROOM AND THE FARM

The Committee believes that it is still important that farming knowledge remains at our boardroom table. The question is, how do we achieve this without sacrificing our ability to match skills to strategy over time?

The Committee proposes that an 'on-farm knowledge' skill is included in the Board skills matrix see pages 10-11.

It is difficult to define the skill using a fixed metric such as number of years farming, and we want to keep the pool of talent we can choose from as open as possible, so we propose the following description for the on-farm knowledge skill requirement:

Has on-farm dairy knowledge, having run or owned a dairy operation as a member of our dairy Co-operative.

NOTE: A member of the Fonterra Co-operative would include someone with an Owner's Interest.

REFERENCES: Janis Sarra "Corporate Governance in Global Capital Markets, Canadian and International Developments" (2002) 76 Tulane L. Rev 1691, 1724; Financial Markets Authority Corporate Governance in New Zealand: Principles and Guidelines, Yixi Ning, Wallace N. Davidson III and Jifu Wang, "Does Optimal Corporate Board Size Exist? An Empirical Analysis" (2010), Journal of Applied Finance (Formerly Financial Practice and Education), Vol. 20, No. 2; David Larcker, Brian Tayan, "Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences" (2015); Jeffrey L. Coles, Naveen D. Daniel, Lalitha Naveen, "Boards: Does one size fit all?," (2008) Journal of Financial Economics 87, 329-356.

GETTING THE RIGHT BALANCE ON OUR BOARD

We've discussed size and eligibility criteria. The balance of people on the Board is the last leg of the composition section.

We need to balance our need for flexibility and to give ourselves the best chance of getting the right skills to match our strategy, with the non-negotiable requirement to respect 100 per cent farmer ownership and control and to live our traditional Co-op principles.

We are not proposing any changes to the existing Fonterra Shareholders' Market Rules. Under the Fonterra Shareholders' Market Rules, if there are more than eight Directors on Fonterra's Board, at least three of them (or one third rounded down) must meet the definition of Independent Director.

We are proposing to change our constitutional requirements.

Currently, under the Constitution, there can be a maximum of nine Farmer Directors and a maximum of four Board-appointed Directors. (The four Board-appointed Directors must be Independent Directors because of the Fonterra Shareholders' Market Rule requirement.) Under the proposed change the Constitution would simply require the majority of the Directors on our Board to have an Owner's Interest.

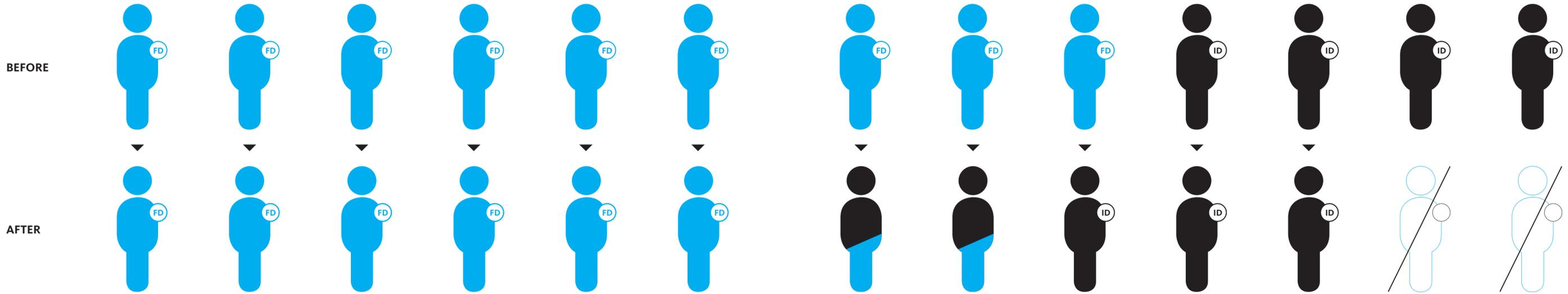
Currently the Board Charter requires that all Directors elect the Chairman of the Board and that the Chairman must be a Farmer Director. This will not change.

We've described the impact of the proposed change in a before and after diagram below.

It's important to remember that there are a number of other requirements for Directors that support the requirements discussed earlier. These won't change. For example, the Fonterra Shareholders' Market Rules also prescribe the minimum number of Directors we need to have and how many of them need to live in New Zealand. The Companies Act sets out a list of people who are prohibited from being Directors and requires all Directors to act in the best interests of our Co-op. If you are interested in this subject and would like to know more about the current requirements for Directors, we've summarised them in a table which you can access on Farm Source online.

We are also proposing to introduce a required attributes and skills matrix for the Board. This is discussed in the next section.

WHAT OUR BOARD COULD LOOK LIKE



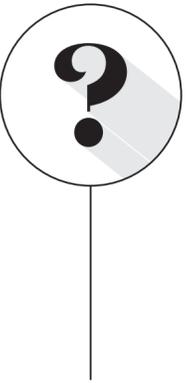
KEY

FD = Farmer Director: Meets current shareholder definition under clause 12.3 of the Constitution and would meet proposed Owner's Interest test

ID = Independent Director: Meets definition of Independent Director under the Fonterra Shareholders' Market Rules

Light Blue = Could be Farmer Director or Independent Director

Note: Chairman must be a Farmer Director in accordance with Board Charter



THOUGHT STARTERS

Do you believe the new proposal will widen the pool of candidates with the required attributes and right skills for our Board?

Do you think this is the best balance between Farmer Directors and Independent Directors?

Do you agree with the new definition of an 'Owner's Interest'?

A MODERN BOARD THAT ADHERES TO OUR CO-OP'S TRADITIONAL PRINCIPLES

When combined with a more targeted appointment process and a reinvigorated focus on our succession planning and development pathway, the proposal for the Board's new composition strikes a better balance between where we've come from and where we want to get to.

The proposal:

- Is more inclusive of our diverse shareholding base – anyone with skin in the game can put themselves forward as a Director.
- Ensures that the Co-op ethos stays at the heart of our organisation by requiring a majority of the Board and the Chairman to have an Owner's Interest.
- Introduces an on-farm knowledge skill requirement.

- Better ensures we get the best Directors with the required attributes and right skills by widening the pool of potential candidates who qualify to be Directors.

GETTING THE REQUIRED ATTRIBUTES AND RIGHT SKILLS ONTO OUR BOARD

OUR ATTRIBUTES

- Understanding of and commitment to the highest standards of governance
- Understanding of and empathy with the Co-op
- Ability and knowledge to comprehend the wider commercial and economic framework in which Fonterra operates
- External governance experience
- Proven track record of creating value for shareholders
- Global perspective
- Time available to undertake a Director's responsibilities
- Sound judgement
- Ability to apply strategic thought to important issues
- Ability to question, challenge and critique
- Unquestioned honesty and integrity

ATTRIBUTES

Our Co-op's Directors need to show they believe in and value the Co-op and that they have the ability to deliver governance at a level expected for a global dairy business.

These attributes are what we expect every Board member to demonstrate. They are what make them fit to govern our Co-op. We have implicitly looked for this in all our Directors in the past but it is important to call them out explicitly and set these expectations.

Where a Director doesn't have or demonstrate an attribute, this should be addressed straight away. In the case of Directors who are new to the industry, they will be put through Fonterra's rigorous induction programme on being appointed.



New Zealand corporate governance guidelines recommend the use of a skills matrix to identify current and future needs of the organisation



SKILLS

The Co-op has a good skills list today that is used when we select and appoint our Independent Directors. It's regularly published in Farm Source magazine to show our farmers what skills we are looking for on the Board.

Your feedback made it very clear that skills are the most important factor in making up the Board. When you talked about the skills list, you asked why we didn't select all Directors on this basis – not just our independents.

Today, this list does not define the relative weighting of how much of each skill we need on the Board. Some skills should be exhibited by a number of Directors, while others may only need to be in one or two. In corporate governance this is called a skills matrix.

The best way to ensure our board has the right mix of skills for the job is to make improvements to this tool and use it when selecting any Director. It is proposed that an external review of our skills for the Board be undertaken. This will include defining the minimum required levels of each skill and the desired levels.

We need to ensure that our Board has the skills to govern Fonterra – a complex, international Co-operative, operating in multiple industries, answering to diverse stakeholders, and delivering value to its owners.

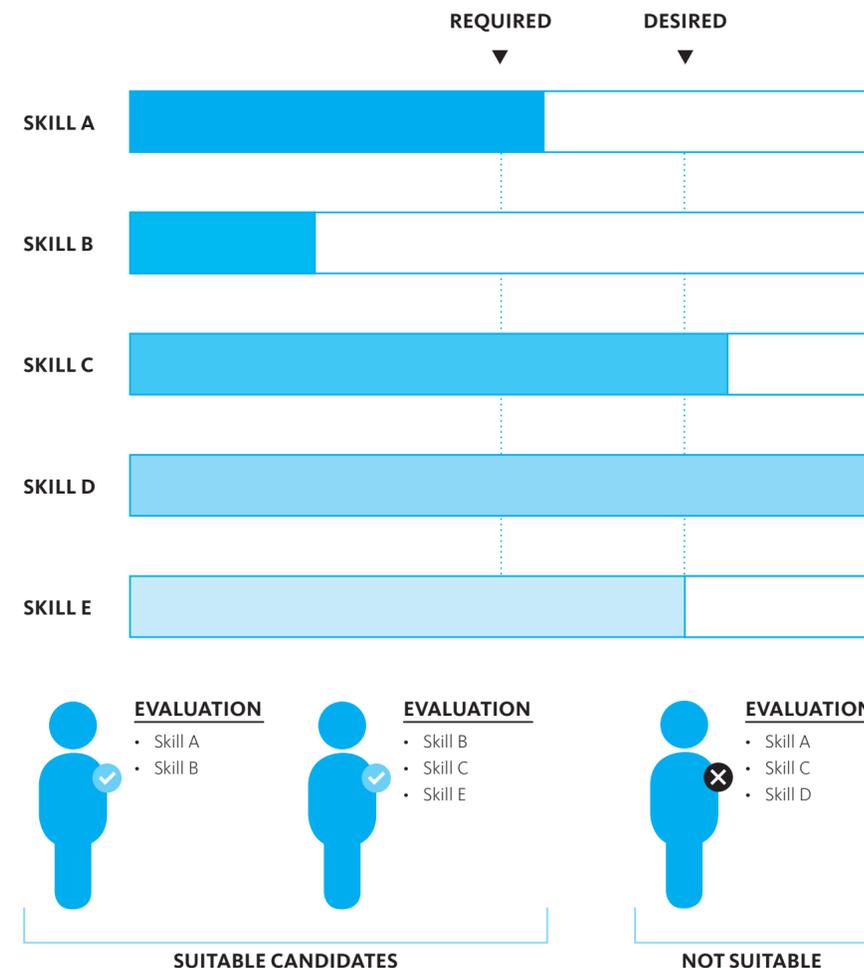
Having minimum levels of skills for the Board helps to define who is the best candidate for the Board when a vacancy opens up. It also provides useful information for farmers when making decisions on re-electing a current Board member.

As the needs of Fonterra will change over time, the Board will update and publish this matrix at least every year.



SKILLS MATRIX EXAMPLE

In this example skill matrix we can see the current levels of each skill across the whole Board. Each skill has a required level on the matrix – only Skill B is not at that level today. There is also a desired level for each skill – where having more directors with it is seen as beneficial. Skill A is not at this level but C, D and E are.



In an ideal world we would have the desired complement of both skills A and B. Any Director who is selected needs to have Skill B and, ideally also has Skill A – but not the other way around.

The selection process has found three candidates with the right attributes. But only two are suitable at this time because they have Skill B – the third candidate is not. The first would be ideal because he/she also has Skill A.



A NEW DIRECTOR APPOINTMENT PROCESS

IN BRIEF

- From current Single Transferable Vote (STV) election process for Farmer Directors plus pure Board appointment process for Independent Directors to a new appointment process for all Directors:
 - Shareholders' Council observer status on Board Committee.
 - 100 per cent Independent assessment and selection Panel.
 - Shareholders' Council consultation on all Board appointments.
 - 50 per cent farmer support required for all Directors.

Good governance requires a great team and that starts with the selection process. This section sets out our proposal for changes to the appointment process for our Directors.

APPOINTMENT PROCESS

Many of you identified issues with the current process for selecting our Farmer Directors. The issues included:

- Some farmers feel that they don't have the right information or the experience to judge candidates.
 - Many would like the Candidate Assessment Panel to be more independent.
 - Some find it hard to get to roadshows and many

farmers wonder if all that the process shows us is who is a good presenter.

- Farmers want to know what the Board thinks about people who are standing for re-election as they are best placed to provide a view.
- We've got a lot of talent in our farmer base but some of us think that the public, political nature of the current election process puts people off standing.
- Some farmers find the current Single Transferable Vote (STV) election system confusing and question whether it reflects the majority view of the best candidate.
- Others think that people's choice of candidate is overly influenced by electioneering due to the limited

candidate information that is supplied to farmers prior to voting.

We've therefore designed a new process for selecting our Directors.

Some farmers thought that the Shareholders' Council appointing Directors would be a good idea but this was countered by the view that Electoral College type structures are generally very politicised and have not worked well in the past. We have not adopted this kind of model.

There was general consensus that the process for selecting Independent Directors has delivered good quality Directors and has worked well, so we started there.

The proposal takes the best of that process and applies it

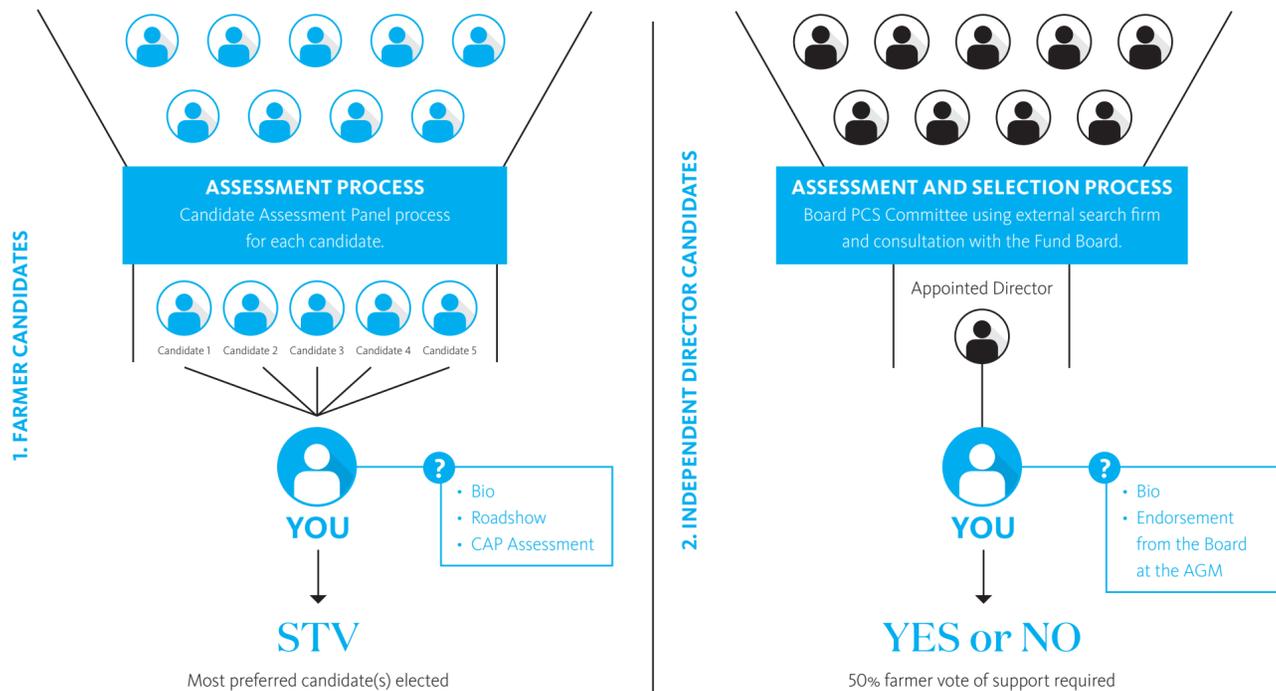
to Farmer Directors too, so all of our Directors are subject to the same selection process. After all, once they are on the team we expect them to be able to do the same quality job.

We've added a series of checks and balances to the process to make sure that every one of us can put ourselves forward, that the assessment and selection process is independent, that there is Shareholders' Council observer status on the Board Committee, and that farmers get the information they need to support the final decision, which is still theirs.

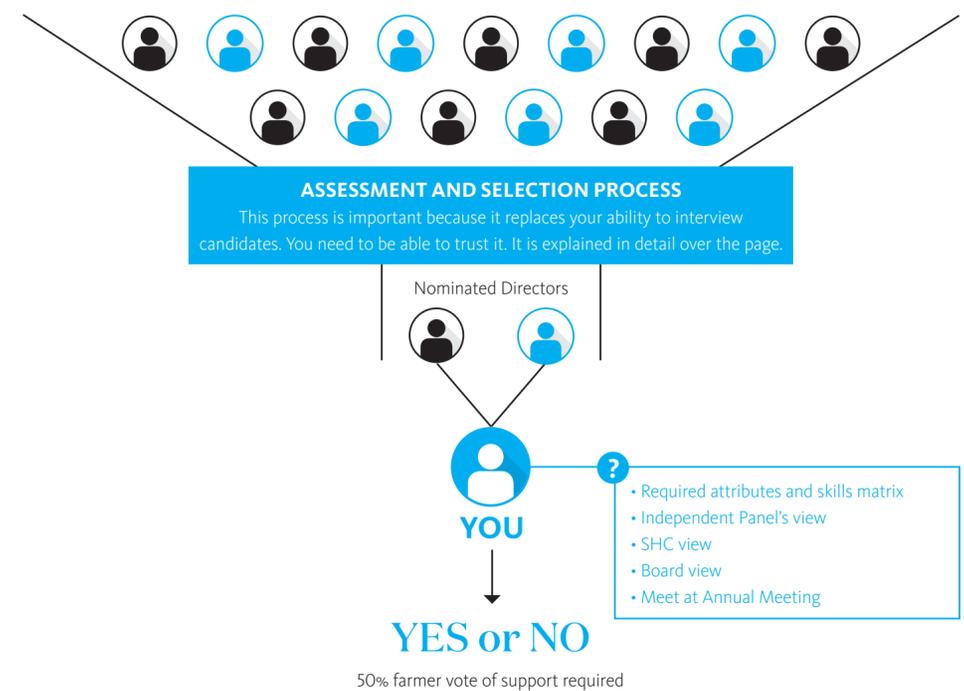
The Committee thinks there are some big advantages in the proposed model over what the Co-op is doing now and believes it will consistently deliver a better governance outcome.

We describe the current and proposed process in the diagrams below and over the page we explain the proposed process in more detail.

CURRENT APPOINTMENT PROCESS Two Processes for Two Types of Director



PROPOSED APPOINTMENT PROCESS Single Process for All Directors



A NEW ASSESSMENT AND SELECTION PROCESS TO DELIVER AN AGREED OUTCOME

We all want a system for electing Directors that consistently delivers the best Directors with the required attributes and right skills to govern our Co-op. With this in mind, the proposed process has some big advantages over what the Co-op is doing now.

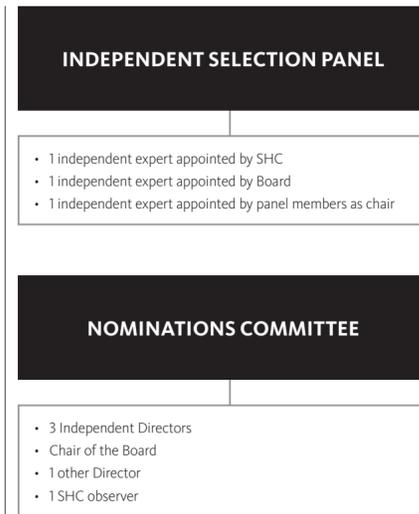
Combined with the plans to make the skills matrix transparent and to enhance our development pathways and succession planning, this proposal:

- Better ensures we get the best Directors with the right skills by delivering a confidential, independent process for assessment and selection that will mean more farmers will be prepared to put themselves forward.
- Delivers better information to us to help farmers make our decision. It solves the problem of having to make a judgement based on a snapshot in a roadshow and limited information from the Co-op's Candidate Assessment Panel (CAP).
- Means farmers don't have to consider candidates who don't meet the grade.

- Provides improved transparency throughout the process – the Shareholders' Council has observer status on the Nominations Committee.
- Gives farmers access to a totally independent opinion and ensures a clearer, professional focus on attributes and skills in the assessment and selection phase.
- Better reflects best practice, but still incorporates our unique Co-op requirements.

We know that to ask someone else to take on the job of assessing and recommending Farmer Director candidates we all have to have complete trust in the process.

We've tested the proposed process and think we've got it about right. We think it has a better chance of consistently delivering the best Directors with the required attributes and right skills to govern our Co-op.



LENGTH OF TERM AND ROTATION OF DIRECTORS

Under the new proposal, we would get the opportunity to decide whether to re-elect each Director every three years.

The Board will be invited to endorse any sitting Director. If that sitting Director is nominated by the Board for re-election, that endorsement would be communicated to farmers prior to voting.

The application of any sitting Director would be considered on its merits alongside all other applications. The need for continuity and experience on our Board would be weighed by the Independent Selection Panel in its recommendation.

If a sitting Director was not nominated for re-election after the Independent Selection Panel's assessment, his or her Directorship would continue until a replacement was elected at the upcoming Annual Meeting.

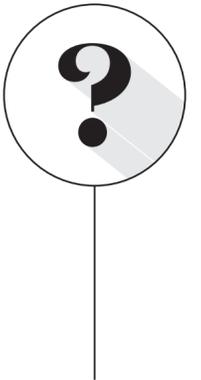
The Chairman would hold his or her office until the Directors elect a new Chairman. So, where a Director who is also the Chairman is re-elected, his or her Chairmanship would continue with Board support as per today.

MAXIMUM TERM

Our existing Board Charter deals with maximum terms for Directors and this will not change.

The charter currently states that after nine years, a Director should consult with the Chairman and fellow Directors before seeking re-election for a further term.

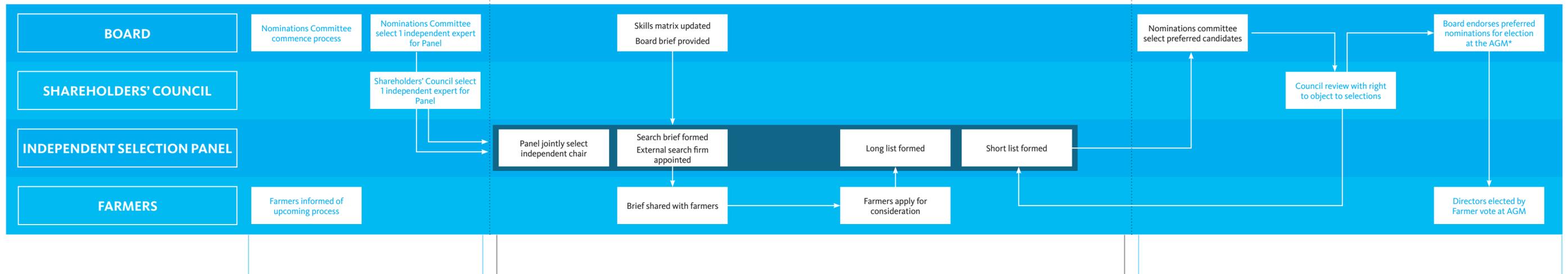
It also states that after 12 years, a Director must seek formal guidance from the Board before reapplying for election and if he or she does so then that fact is explained to farmers, together with reasons for the extension, prior to the farmer vote.



THOUGHT STARTERS

Does the new proposal improve the current process for selecting Farmer Directors?

Would you trust the proposed process to consistently deliver the best Farmer Director candidate(s)?



Commencing the appointment process is an important exercise in shareholder control. Your elected Board and your Shareholders' Council both have an equal voice in appointing the Independent Selection Panel. All farmers are also notified at this stage – anybody considering standing should prepare to put themselves forward.

The selection process will be led by our Independent Selection Panel. This body of three experienced business practitioners will ensure the rigour and independence of the process. The Panel will communicate the search brief with farmers so that those who feel they have the skills required can put themselves forward. Forming the short list will involve extensive due diligence and interviewing.

The majority independent Board Nominations Committee will select its preferred candidates from the Panel's short list. However, the Board won't put any candidates forward to farmers before consulting with the Shareholders' Council. This is an important step as the Council can exercise its right to not support candidates. But ultimately it comes down to a farmer vote at the Annual Meeting – where 50 per cent support for any candidate is required.

* Consultation with Fonterra Shareholder's Fund Board for Independent Directors as per current requirements.

STRENGTHENING FARMER CONTROL

One of the agreed outcomes of this proposal is 100 per cent farmer control and ownership of our Co-op.

Ownership is not affected by the proposal. The nature of our control changes but it is strengthened.

For Independent Directors, there is Shareholders' Council observer status on the Board Nominations Committee, and Shareholders' Council input into the decision on the appointed candidate. Farmers continue to have the final say and get more information about the candidate to make their decision.

For Farmer Director candidates, your involvement in the assessment and selection process and the nature of your vote changes. Control is arguably strengthened.

At the moment, farmers do the heavy lifting of interviewing the farmer candidates. You get some guidance from the Candidate Assessment Panel, then you rank your preferences. At the end of the process the Single Transferable Vote (STV) system operates.

Under the new proposal, farmers choose the system to interview and select the best candidates and to provide the information farmers need to make a final decision. When that system has done its job, you each decide whether you agree that the candidate the system has selected is right for the Board.

If 50% of farmers don't support a nominated candidate then the Board would:

- Immediately start the appointment process again.
- Be entitled to use the current process in the Constitution for filling unexpected vacancies until a different candidate was elected by farmers.

The Director appointed by the Board in this scenario would be entitled to apply for the position on a permanent basis along with others in the appointment process.

The current constitutional process for filling unexpected vacancies will continue to apply in all other circumstances where a Board vacancy arises.

The diagrams to the right help to illustrate how the farmers' control toolkit changes under the new proposal.

FARMER CONTROL

Current and Future Proposal

NOW

HOW YOU EXERCISE CONTROL NOW

YOU

- Elect Councillor on SHC to represent your interests
- Elect Farmer Directors under STV system
- Ratify Independent Director appointments (50% approval required)
- Have the power to propose, vote on and pass a non-binding resolution relating to the management of the Co-op
- Can call a special meeting of Shareholders (together with members who have 5% of voting rights)
- Can remove Director(s) at any time (50% farmer support required by way of ordinary resolution)
- Control the Constitution including the rules about who can sit on the Board (75% farmer support required to change)

SHAREHOLDERS' COUNCIL

- Board required to consult SHC on special projects
- Can request a special report on any matter of concern (to get information to decide whether to take action)
- Can request Special Meeting of farmers at any time (at which a vote to change our constitution / remove a Director can be held)
- Provides transparency about the Co-op's performance against agreed targets
- Appoints the Milk Commissioner
- Sits as observer on specified Board Committees

BOARD

- Majority (9:4) required to meet requirements for Farmer Director



PROPOSED

HOW YOU EXERCISE CONTROL UNDER THE PROPOSAL

YOU

Same as current system except:

- Farmer Directors and Independent Directors elected by farmers using a single process
- 50% farmer support now required by way of ordinary resolution for all Directors – not just Independent Directors
- Farmers can still remove Directors at any time (50% farmer support required by way of ordinary resolution)

SHAREHOLDERS' COUNCIL

Same as current system +

- SHC sits as an observer on the Board's Director Nominations Committee – this provides increased transparency of the selection and assessment process
- SHC is consulted by the Director Nominations Committee on its recommended candidates
- SHC provides reasons to farmers where it does not support the recommendation of the Director Nominations Committee (e.g. don't agree that skills matrix is fulfilled / Director has the required attributes / Board Committee has ignored Independent Selection Panel's recommendation)

BOARD

- Majority (6:5) required to have an Owner's Interest.
- As is the case now, most Board resolutions will be decided by majority vote*. The majority of Directors with an Owner's Interest will therefore have the ability to control decision making. But all Directors will remain subject to the requirement that they must act in the best interests of the Co-op.



*The only exceptions are those that currently exist – on some matters a higher majority (75%) is required, and the majority is required to include a majority of Independent Directors.

Our involvement in the assessment and selection process and the nature of our vote changes, but control is not diminished.



REPRESENTATION



Role of our Council



Structure & composition of our Council



Attributes & capabilities of our Councillors



Getting the right representatives on our Council

ROLE OF OUR COUNCIL

THE PROPOSAL

It is clear that better access to information and more transparency around our existing processes would improve farmers' understanding of and relationship with the Council.

Today, Council has considerable powers and influence but its role and powers need further clarification.

Perceptions about Council not challenging the Board enough generally came from a lack of information about how Council operates and its powers. The Council's powers are described on pages 16 and 17. We discuss the interface between the Council, Board and Management on page 26. We believe that the Council has adequate tools to fulfil its representation role.

We all know from running our own businesses that the prerequisite to accountability is role clarity. The role of Council is further confused by the lack of clear role definition in the Constitution. Instead the Constitution contains a list of functions.

The Committee proposal is to include a clear definition of Council's role in the Constitution as:

The role of the Shareholders' Council is to represent the collective interest of Shareholders.

The Shareholders' Council already communicates with farmers in offshore milk pools, for example Bonlac Supply Company in Australia. We propose to formalise the Shareholders' Council's ability to do this by amending the

Constitution to include the following function:

Consulting with suppliers who supply Milk to the Company or its subsidiaries, whether in New Zealand or elsewhere, in relation to matters of mutual interest, and, where appropriate, representing the views of those suppliers to the Board.



THOUGHT STARTERS

Is the proposed statement of Council's role clear enough, or should it have more detail?

Are you happy to formalise the Shareholders' Council's ability to speak to offshore suppliers?

The role of the Shareholders' Council is to represent the collective interest of Shareholders.

”

STRUCTURE & COMPOSITION OF OUR COUNCIL

A COMMITMENT TO REPORT BACK TO FARMERS IN THE 2017 FINANCIAL YEAR

The proposed changes will impact the role the Council plays and the structure it needs to carry out those roles. Observer status on the Board Nominations Committee is an example.

The Committee is proposing to look into this topic and consider your feedback over a longer timeframe. The Council will investigate whether its structure could be improved and report back on its findings within the 2017 financial year.

The Council has recognised that the Chair and Deputy Chair have difficulty in fulfilling their Ward duties and propose that an additional Councillor be selected in the Chair and Deputy Chair's Wards.

The Committee proposes that the same Owner's Interest requirement to be applied to the relevant Board members also be applied to Councillors so that we have one standard of eligibility across the Co-op.

ATTRIBUTES & CAPABILITIES OF OUR COUNCILLORS

THE PROPOSAL:

There is a general consensus among farmers that to strengthen the Council we need to do more to lift the skills and capabilities of the individual Councillors and increase their accountability for performance.

The Committee also recognises the need for Council's members to have a level of age, gender and background diversity that is reflective of our Co-op's farmer-base.

This can be achieved, in part, by defining the attributes and capabilities our Councillors require, and formally including them in the Council's systems – including its succession and development planning, appointment processes and performance reviews.

It is important that we avoid defining the attributes in a way that puts people off standing for election because they don't think that there is room to grow. But equally, we shouldn't apologise for drawing a line in the sand about the minimum standards we expect in our Councillors. This is a critical part of improving the effectiveness of Council.

The Committee also proposes that the Council publish details of the formal performance assessment process that each Councillor goes through annually. Individual results will not be made public, but Council will provide farmers with reports on its overall performance.

We are also proposing to improve succession planning and the development pathway for our future representatives. See more details on page 29.

Newly elected Councillors will go through the Co-op's induction programme and receive training throughout their term to help them grow into their representative role



ATTRIBUTES AND CAPABILITIES THAT COUNCILLORS NEED TO HAVE OR BE WORKING TOWARDS

Passion for the Co-op and understanding of the Co-operative ethos that underpins it

Honesty and integrity

Courage to question / challenge the status quo

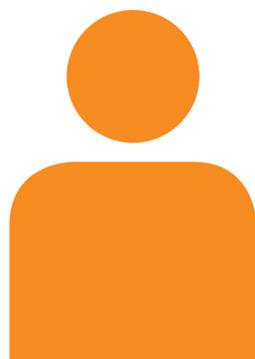
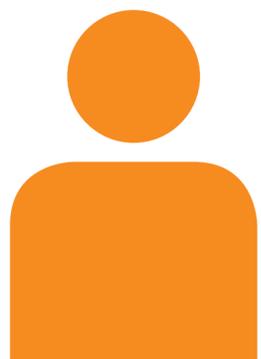
In-depth farming knowledge and experience, and knowledge of the dairy industry

Awareness of the regulatory frameworks in which the Co-op operates and an understanding of the key drivers of wealth – Milk Price and profit

Business acumen – financial literacy and ability to think strategically

Communication skills (including presentation / public speaking capability)

Interpersonal skills (approachable nature, empathy with fellow farmers)



GETTING THE RIGHT REPRESENTATIVES ON OUR COUNCIL

THE PROPOSAL:

Overall farmers are comfortable with our Ward election process. We propose to make a number of small changes to improve our ability to make good decisions and to make the role of a Shareholders' Councillor more attractive.

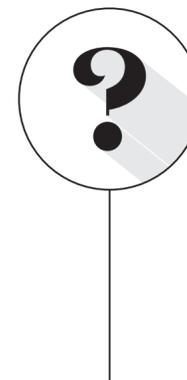
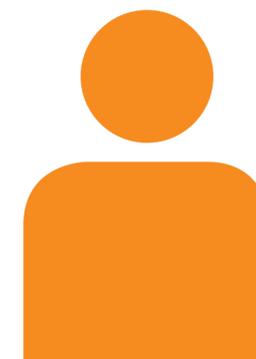
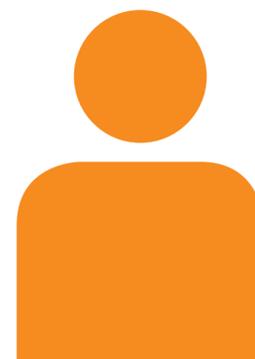
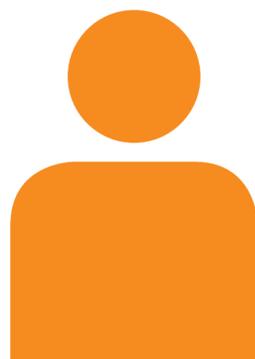
We propose to introduce a maximum term of two, three-year terms for Councillors after which a Councillor must retire unless he or she is asked by the Council, for continuity or experience reasons, to extend the term by another three years. At the conclusion of three terms, that person must retire.

The maximum term for Councillors should make the role more attractive to people because they know they will be able to retire. It will also ensure that the Council is refreshing itself on a regular basis and that there are opportunities for new talent to come through from the farmer base.

Your Shareholders' Council will create and publish an attributes and capabilities list for the Council and provide farmers with information about the current gaps on the Council prior to their vote so that they can better assess who to vote for in their ward.

The Council must decide whether to endorse sitting Councillors who wish to stand for re-election.

Is there anything else we could do to continue to improve the effectiveness of Council?



THOUGHT STARTERS

Do you agree with the proposed attribute and capability list?

What other/ different attributes or capabilities would you like in a Councillor?

Do you agree with a maximum term of six years?

Should there be a stand-down period between sitting on Council and putting yourself forward for selection onto our Board?

OPERATING MODEL



An improved operating model

AN IMPROVED OPERATING MODEL

Our proposals so far have shown how we can improve our governance and representation and fine-tune the role, structure and composition of the Board and the Shareholders' Council.

But the job is only half done if we don't provide the best environment for them to work together and provide clear rules of engagement based on what we want the relationship to achieve.

In 2013 the original governance and representation working group identified the following things as key to the success of the relationship:

- Respect and trust with clear communication
- Clarity and discipline regarding communication protocols
- Defined communication pathways:
 - For shareholders with concerns
 - For Board to discuss issues impacting on-farm business and / or ownership interest
- Director discipline: ensure key issues directed to Council
- Strong leadership relationship and behaviours between two chairs
- Early warning to the Council of red flags

Using these findings as a guide, we have identified three areas for improvement within the operating model:

1. Refinement and publication of the interface document that explains the working relationship between the Board and Council
2. Clearer communication pathways between the Board, Council and farmers
3. Creation of formal, separate development pathways for growing future governors and representatives.

We are confident that improvements in these three areas will help to increase farmer engagement, clarify what can be expected from the working relationships between Board and Council, and result in clearer communication. This is so that farmers get the information they want and feel they are being heard, and create development pathways that identify and attract a pipeline of farmers to take on future leadership roles within our Co-op.

The sections and diagrams following show how we plan to implement these improvements.

GIVING FARMERS MORE CLARITY OF THE RELATIONSHIP BETWEEN BOARD, COUNCIL AND MANAGEMENT

Currently the Board, Management and Council follow the guidelines in a working interface document that sets out:

- The principles of the Board-Council relationship.
- Interfaces between the Board and the Council, including protocols for the different types of meetings that occur, quarterly reporting expectations and protocol for meetings of the Council's Performance Committee.
- Information flows between the Board, the Council and farmers, including protocols in relation to confidentiality and how both parties expect the other to engage.
- Interfaces between Management and the Council including how the Council is able to interact with Management.
- Protocols in relation to the role of the Board and Council in supporting proposed Shareholder Resolutions and Shareholder Relations Committee resolutions.
- The role and reporting lines of Council staff.

To date this has been a live document shared between the Board, Council and Management. We're now proposing to publish it on Fonterra.com so farmers have open access to it. This will enhance the understanding of each party's roles. As owners, it will put farmers in a better position to be able to judge whether the Board and Council are functioning as they should. It makes the Board and our Shareholders' Council more accountable and builds trust among farmers.

Is there anything else we could do to continue to improve the way we work together?

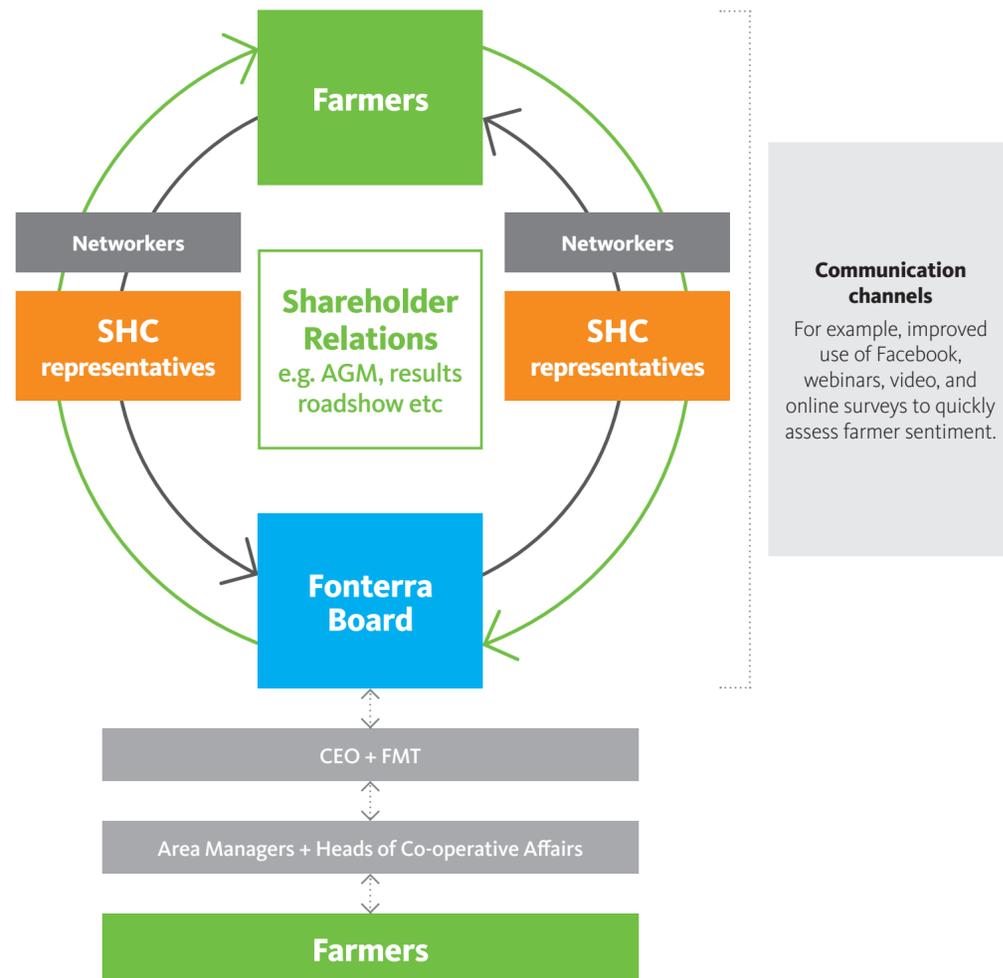
IMPROVED COMMUNICATION WITHIN THE CO-OP

Our Co-op hasn't always got communications to our farmers right. The same can be said for the way we share

information within our governance and representation structure. During the review the Committee identified ways of clarifying the channels of communication, so that clear, timely information is shared within all parts of our structure.

The model below shows how communication will flow within the new operating model.

WORKING RELATIONSHIP BETWEEN YOUR BOARD AND COUNCIL
Communication Pathways



CREATING A PIPELINE OF FUTURE LEADERS

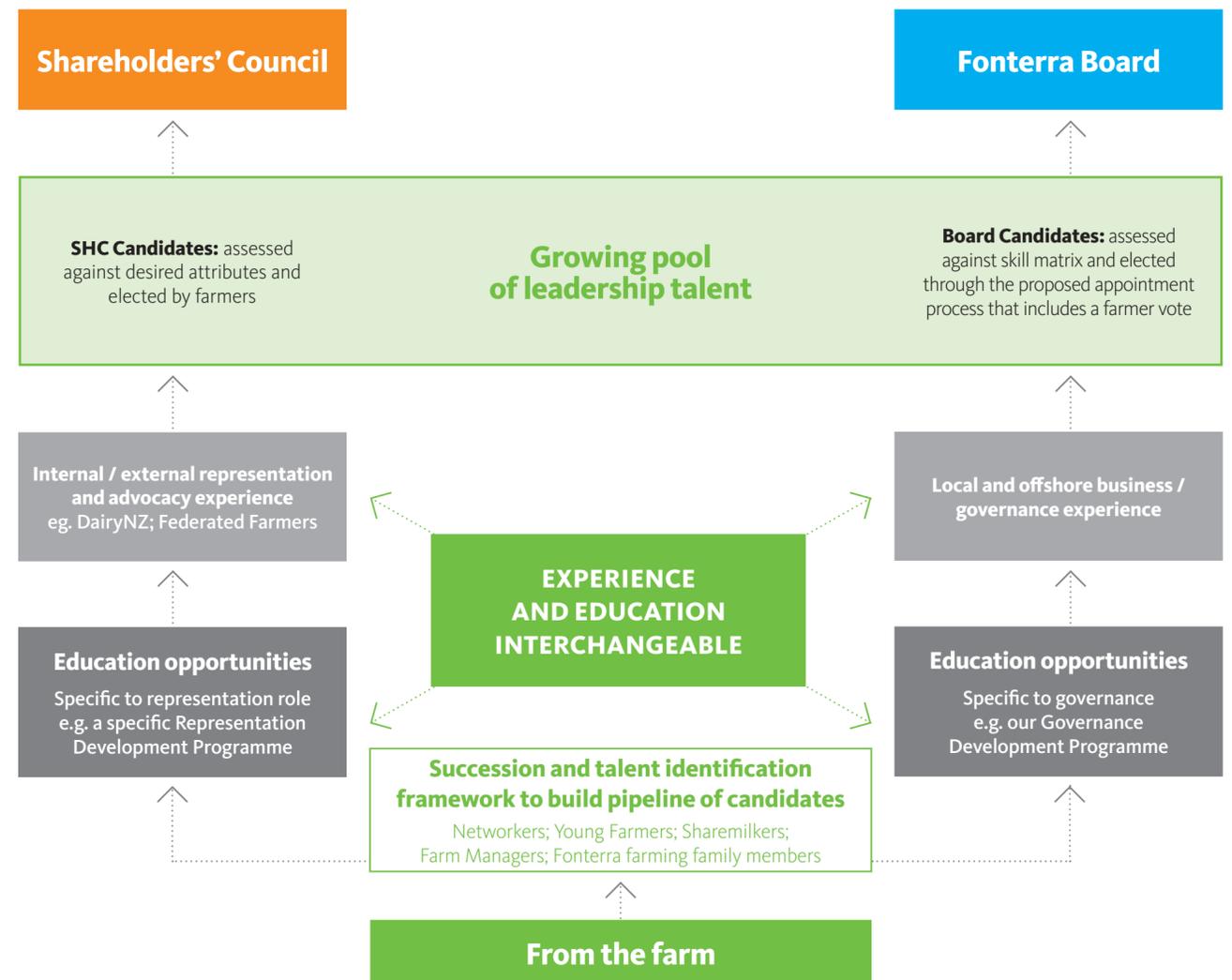
A development pathway that identifies and attracts a pipeline of young farmers who can come through the ranks

and take on the baton of leadership was a key outcome for this review.

The diagram below shows our intention to create two separate development pathways for future governors and

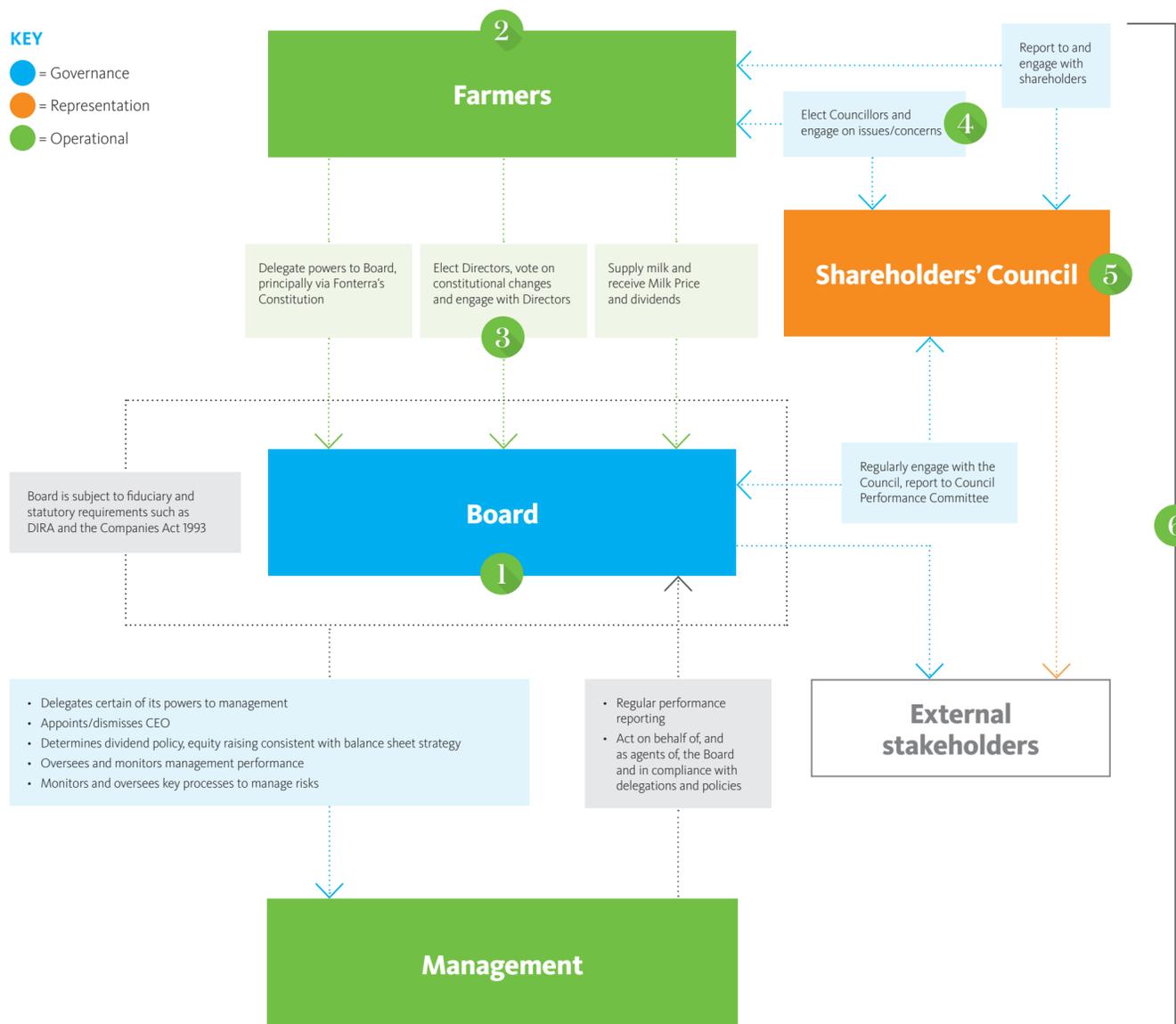
representatives. We are also exploring the re-establishment of a representation development programme, to mirror our successful Governance Development Programme.

GROWING LEADERSHIP
Improving Our Development Pathway



SUMMARY OF PROPOSED CHANGES

GOVERNANCE & REPRESENTATION MODEL



QUICK GUIDE TO CHANGES

1

- 11 Directors
- Majority (6:5) Farmer Directors
- Chairman must be a Farmer Director
- Modernised eligibility requirement for Farmer Directors

Pages 6-9

2

- 100 per cent ownership and control maintained

Pages 16-17

3

- One selection process for all Directors
- Introduction of required attributes and a skills matrix for assessing Board candidates
 - 'On-farm knowledge' skill requirement included in this matrix
- Assessment by 100 per cent independent panel
- Shareholders' Council has observer status on Board Committee
- Shareholders' Council consultation on nomination
- Farmers retain final say

Pages 10-15

4

- Introduction of attributes and capabilities matrix to guide decisions
- Shareholders' Council view on sitting candidates to assist decision
- Details of the performance assessment process for Councillors to be published

Pages 22-23

5

- Clarify role in constitution
- Changes to enhance effectiveness:
 - Attributes and capabilities matrix to guide development processes
 - Maximum term to encourage refresh
 - Additional support for Chair and Deputy Chair in Wards
 - Review of structure to be completed within the 2017 financial year

Pages 20-21

6

- Improved Operating Model
 - Transparent interface guidelines so farmers can understand how the parts of the model are expected to work together
 - Better communication
 - Enhanced development pathway from farm to Co-op leadership

Pages 26-29



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