

# **PRESENTATION TO AAAC GRAIN LOGISTIC FORUM**

**16 JULY 2009**

## **THE POWER OF THE COOPERATIVE**

I wonder what Australia's agricultural landscape would look like without cooperatives or more correctly "cooperatively styled" companies. Could we realistically expect to see organisations like CBH evolve if left to market forces at their creation? Paradoxically of course those market forces are now bearing down on CBH, but before we get into that a little background may be useful so we know what we are talking about.

Firstly, what do I mean by "cooperatively styled". The features that define an enterprise as a cooperative can be created in many ways, for example, by statute or under the various cooperative acts or simply under the Companies Law. In the latter case these "cooperative features" are enshrined in the Company's Constitution and have been upheld by the Courts.

I mention this because it shows that there are many ways to create and structure a cooperative and moreover it is possible to design cooperatives that are not rigid but are able to adjust to changing times and changing markets. Again we will come back to that.

## **LESSONS FROM HISTORY**

I once read a definition of history that it “is about the forces that bear down on us and the people that stand at their junction”.

Cooperatives have been a powerhouse and probably one of the principal sources of development capital in Australia. So why is it that most of them have turned away from their cooperative heritage and embraced a company structure? The reality is that what was built with such purpose and foresight can be so easily undone by the cooperatives own structure. What was created by powerful forces can be undone by subtle forces, some of which are internal and some external.

## **INTERNAL FORCES**

The academic literature is full of the dysfunctions of cooperatives.

- The so called “Horizon” pressure, that is, the horizon for the cooperative and the horizon for the member could, or more likely, will differ.
- The so called “Portfolio” pressure, that is, the member may not only be fully invested in his/her business but also overweight in the cooperative. A kind of “double-up” investment. The member cannot balance his portfolio by choice. The

popular academic view is that this discourages a member from investing in the cooperative or to seek to withdraw capital. The later is potentially the case in CBH as members become more and more aware of its value.

- Again the popular wisdom is that there will arise “Inter-generational” pressures. Some will see themselves as over invested, a sort of “we’ve done our bit” attitude. We built it up and took nothing out and the next generation gets the benefit. Some will see themselves as not needing to invest or that they are better equipped to invest than the cooperative is, particularly as they begin to understand their own risk/return environment.

The “Horizon”, “Portfolio” and “Intergenerational” pressures could be debated for some time, but I’d like to move onto three internal forces that I think have great importance to CBH. These are the “Free-Rider” the “Socialist” and the “Valuation” pressures.

## **FREE-RIDER PRESSURE**

This is where a member’s equity or the benefit that a member receives is not in proportion to the members use of or contribution to the cooperative.

Once more I’ll slip into the world of academia and introduce “Pareto’s Principle”. This has often been summarized as “eighty percent of your troubles come

from 20% of your problems” and conversely 80% of your benefits come from 20% of your efforts. In other words concentrate on the most important and not on the least important.

In effect, Pareto’s Principle suggests that in many things a few (20 percent) are vital and many (80 percent) are trivial. Hence it is often referred to as “The Vital Few and the Trivial Many”.

The principle is alive and well within CBH. I think it fair to say, and in fact generally accepted that with the achievement of scale efficiencies and aggregation into larger operations the top 25% percent of CBH Members produce the lion’s share of volume. We all know this I think. Equally, we also generally accept those growers in the bottom 25 percent are potentially delivering a very small percentage of overall tonnes.

So in an economic sense the backbone of CBH today is reliant on the “Vital Few” whilst the “Trivial Many” hold the key to the direction of CBH.

Traditionally, as I understand it there has been little commercial recognition of individual member patronage or indeed the natural efficiencies associated with that member’s location, size and commercial interface with CBH. I understand that this is starting to change and will gain pace as CBH acknowledges the imbalances in its own Members contributions.

I accept that I am speculating here as I cannot tell you the exact degree of concentration within CBH. For fear of flogging a dead horse I would like to quote the Wheat Export Authority in its Australian Wheat Industry Overview in May 2007. The WEA estimated that there were 24,462 farms of which 15% accounted for 53% of production. They also estimate that 53% of farms accounted for 90% of production.

I don't know whether the concentration is greater or less within Western Australia but if the national figures apply to CBH then approximately 50% of growers provide 90% of production and probably have about 50% of the voting power. On the other hand 50% of growers provide 10% of production and also have 50% of the voting power. The principle of the "Vital Few and Trivial Many" is dangerously in play.

## **SOCIALISATION PRESSURES**

Let's consider the way in which Member/Shareholders exercise their rights over CBH.

There are approximately 4,800 Members and the 2008 annual report shows that there are 9,000 shares in Members hands; and "on a show of hands every holder of ordinary shares is entitled to one vote and upon a poll each share is entitled to one vote".

A Member's ability to influence the outcome of any matter is, therefore, not related to his accumulated contribution to the business, or to his value to the business but to the maximum number of shares that member is allowed to hold.

Let's now talk about pricing. Am I correct in saying CBH has some 197 receival points and I assume in many instances some growers have multiple choices amongst these receival points whilst others have less choice with greater distances to travel? And is it also the case that the tonnage delivered may vary considerably?

Am I also right in saying that CBH charge a uniform price for the core functions of receiving the Member's wheat, assessing its quality, storing it, blending and other functions without recognising efficiencies of one Member or area compared to another?

The final question is does CBH have any idea of the profitability/benefit to it of any individual or class of member/supplier? I will discuss the matter of "collective" versus "differential" pricing later, suffice it to say this is a very important matter?

Another matter is the use of and return on assets. Does CBH need 197 receival points; is that efficient? To what degree is the vast infrastructure of ports and receival points needed? If we offered them to the

public on a sale and lease back arrangements could we pay the rent? Think about it.

In the absence of a need to provide a specific return on assets or a return to shareholders is CBH over capitalised? Is there a pressure to spend on capital development that would not be accepted in public listed companies or in most of CBH's competitors?

These socialist issues can lead to the misallocation of resources where decisions are based on perceived Member needs rather than the needs of the organization. The focus is often on Member "happiness" rather than the bottom line.

Is this the case with CBH? In normal economic or accounting terms CBH could be seen as overcapitalized?

I heard it expressed by farmers – "It doesn't matter, the access to and use of these assets makes me more efficient on my farm. You should look at the total return, that is, the returns from the farms and the return from the cooperative." In otherwise the collective return.

In fact it does matter. Logic and good business sense tell you that you must look at every element of your business regularly to see that it is paying its way, and

how can you do that if it's wrapped up in a big amorphous whole.

## **VALUATION PRESSURES**

I'm talking here about the commercial value of CBH, not its emotional value as I felt I've dealt with that issue.

Without a doubt CBH is a very valuable business.

At the end of 2006 my company Austock did an internal valuation of CBH and concluded the business was worth well over \$1.0 billion. At that time Austock also did an internal appraisal as to what that value represents to an individual Member if were to be disbursed in the manner used by the AWB, that is, on tonnage delivered over a period, say, five or ten years.

Austock did this, and again I emphasis it did it internally, so it may test the "Portfolio" pressures. You recall these are the pressures where a Member may find him portfolio overweight in a particular sector.

It won't surprise you to know that this analysis suggested that there was considerable value accruing to the top producers. Although at every level the benefit was notable, at the top level of producers it was substantial.

Austock concluded at the time that this was a major internal force and a potential pressure for CBH to reconstruct. Remember this was 2006.

Austock also concluded that this and other internal pressures would combine with obvious external pressures bearing down on CBH.

Lets now discuss some of the external forces that did emerge and there effect on valuation.

## **EXTERNAL FORCES**

Those in this room are more likely to understand the external forces bearing down on CBH better than I do. Accordingly I'll confine my comments to some aspects of these forces in as much as they seem to involve my subject matter.

## **ACCC**

On 14 April 2009, CBH submitted an undertaking with the ACCC that listed among its objectives: -

- Providing a non-discriminatory approach to pricing under which the Port Operator publishes reference prices for the provision of certain standard services annually;

The submission also goes on to seek: -

- The recovery of all reasonable costs associated with the granting of access to the Port Terminal Services and a fair and reasonable return on the Port Operator's investment in the Port Terminal;

The ACCC propose to conduct a public consultation process in respect of undertakings lodged by all Port operators so it is premature to speculate on the ACCC's ultimate view.

In any event my interest is slightly different and that is the impact this consultation process will have on the structure of CBH and its capital value.

If I understand it properly the Port Facilities are now, in effect, social infrastructure, available to any approved exporter. The question is what will be the reasonable return on investment the operator seeks? What, in fact, is that investment? Will the return be based on: -

- The Operators balance sheet values;
- A fair market value of the asset or on that proportion that is used or is usable;
- Replacement value or the cost to someone to build alternative facilities;
- What the market will bear.

Will the return vary for different customers, different geographical features and so on?

May the ACCC, for example, conclude in the case of the Albany Facility that a reasonable return to the operator should NOT be based on CBH's balance sheet value of that asset but on its market value based on its actual not possible throughput.

In any event the "socialising" of CBH's major assets has profound implications for it and for its ultimate value.

## **COMPETITION**

Again I'm not an expert on wheat marketing, storage and transport so you need to be patient with me. As I see it the buying and selling of grain in Australia is open to anyone within reason. No doubt these marketers will have a view on storage costs and pricing at the Ports and will be anxious to share that view with the ACCC.

I have already referred to "collective pricing", that is, my understanding that CBH's policy is to charge a uniform price per ton irrespective of the number of tons delivered or the location or efficiency of a particular site. This must surely come under pressure as both new marketers and the "Vital Few" start to look for the most efficient and cost effective path to market.

I mentioned before that consolidation of the industry seemed obvious in 2006 and that CBH should prepare itself to be a major participant. Since 2006 there has been speculation as to what fits with what and who fits with whom.

It is surprising, therefore, that the first serious step in this process comes from offshore.

## **BRINGING THE FORCES TOGETHER**

I shall now attempt to bring these internal and external forces together and suggest the impact on CBH. I suggest a difficult path ahead: -

- Approved marketers are likely to concentrate on the “Vital Few”;
- There will be considerable pressure on CBH by the marketers and the “Vital Few” to reduce charges at the storage and terminal facilities or at the very least have a transparent and open pricing system that acknowledges the value delivered by different Members or customers;
- CBH will need to substantially review its asset base and the return on individual assets. It will need to embrace business principles common to its corporate competitors but not necessarily common to it;

- CBH will need to understand the value and return of each class of asset and each class of customer and adjust its pricing accordingly. “Collective Pricing” will no longer be appropriate and “Differential Pricing” will need to be introduced.
- There is likelihood that CBH will reduce the number of its “Trivial Few” Members and receival points.

What impact will these forces have on the value of CBH? Potentially considerable depending how the people that stand at their junction respond.

It is now possible to see CBH as almost two separate operations: -

1. An infrastructure business involved in the development and maintenance of infrastructure, freely available to all with transparent, differentiated pricing. There will be pressure on this business to reduce assets to those that are core to the business, increase efficiencies and to ensure an acceptable return on the assets that are deemed to be core to the business. This may possibly lead to an overall increase in charges, but this overall increase will fall differentially on different classes of customers. For the “Vital Few” it may result in a reduction of prices.

2. A commercial business involving all aspects of grain from marketing through to the end consumer. This business will not receive any particular benefit from the infrastructure business but compete openly with others for access to the infrastructure.

## **CBH : A COOPERATIVE OR A CORPORATE**

After all this I will now address the issue that I've been asked to address, namely, CBH: a Cooperative or a Corporate.

Most people when considering this poser would imagine the choice is between a rigid cooperative structure such as CBH down one end of a spectrum and a public company, possibly listed, down the other end of the spectrum.

There are, in fact, many options along the spectrum, and many ways of achieving an objective, assuming that objective can be agreed, and that is certainly a big ask when you consider the diverse attitudes that abound. We are not talking about a homogenous group here.

What do I think should be the objectives of CBH? I will make some suggestions although I think it a bit presumptive as I am only an outsider: -

- CBH must have negotiable currency if it is to participate in the industry's realignment, that is candidly, it needs a share structure that allows it to act adroitly and to bid for assets, or accept bids;
- CBH should move ahead of the pressures that are building up internally and engage the "Vital Few" in a more constructive way;
- CBH should transition itself by abandoning its rigid cooperative structure and by adopting a structure that eases itself more into the commercial world. That could involve retaining some of the cooperative characteristics for a period.

Hopefully, I've taken you down a path that leads the listener, even the most committed cooperative believer, to the view that CBH needs a "make over". Don't just listen to me; listen to the internal forces, particularly the "Free-rider" pressure. Don't just listen to me; listen to the external forces and pay particular attention to the "Vital Few" as they have other options.

Does CBH have to completely abandon its cooperative heritage? Possibly not, but it will need to reconstruct and embrace the sort of commercial principles I have discussed.

I have already pointed out that there are a considerable range of options from the rigid cooperative structure of CBH to the embracing of corporatization; far too many to canvass at this discussion and in the time available. In fact, selecting the appropriate model is a very complex affair involving statutes, company law and tax.

Let me briefly give you just three of the options that CBH may have, but please remember that these are not extensive and given merely as examples: -

### Option 1: Single Entity

CBH could seek to convert itself into a company under the Company Law and seek to maintain some of its cooperative character through its Constitution. There are a range of options in relation to voting and Board structure, in fact too many to enumerate here. It is also possible to provide some public participation, albeit limited, and some liquidity for Members.

This option provides some scope to address the “Free-rider” and “Horizon” pressures through some liquidity, and provides CBH with more maneuverability and ability to respond to the changing commercial conditions.

### Option 2, Dual Entities

CBH could be split into two separate entities, namely “CBH infrastructure”, and “CBH Commercial” with Members holding shares in both organizations, either on the basis of who is on the register at that time, or on some tonnage basis over time.

CBH Infrastructure converts to a company under the Company Law, but with a constitution that enshrines most of its cooperative characteristics including restriction on the transfer of shares.

CBH Commercial is a company under the Company Law, listed or unlisted, with no restrictions in its Constitution.

This option recognises the different earning potential between the two businesses; keeps the infrastructure in the hands of the Farmer/Members and opens up the non-infrastructure activities to commercial practices.

### Option 3: Multiple Entities

This is similar to option 2 but Members receive shares in multiple vehicles, for example, in the ports, in the regional infrastructure in the Members immediate area, and in CBH Commercial.

This involves the break-up of CBH into homogeneous elements, either on the basis of geography or more likely producer groupings. It is messy but don't rule it out.

## **THE PEOPLE THAT STAND AT THE JUNCTION**

May I repeat the definition of history I gave you earlier as “the forces that bear down on us and the people that stand at their junction”. The people most obviously standing at the junction of CBH are the members of the Board.

There are 12 Board Members 9 of whom are grower Board Members representing 4 districts. This regional structure adds its own dynamics and potential dysfunctions and compounds the issues facing CBH.

A Director may make decisions considered to be in the best interests of the organisation but these decisions may not be perceived to be in the best interest of the local area that the Director represents.

This is a very difficult situation and my experience is that Boards of Cooperatives are very often responding to membership influences, not the market, and worse still those influences are often factionalised.

Any reconstruction along the lines I've discussed depends, of course, on the reaction of the Board of CBH and like all things reconstruction needs to take place or be accepted at the top.

Let me add further complexities. There are other parties standing at the junction of the forces. There are farmer and statutory bodies and Governments, each with their own mission and not necessarily with CBH's interest foremost in their minds.

There is one more - the tax man. Let me put a simple but contentious view to you. Much of the infrastructure that comprises CBH has been paid for by the tax man adding to the view that it is social infrastructure for the benefit of all. Don't think for a minute there will not be plenty of parties reminding the Government of this, and the ACCC when it does it review.

## CONCLUSION

I have talked about the external forces bearing down on CBH. I believe you understand these better than I. I have merely put these in a different context and talked about differential pricing and the impact on the value of CBH.

I have pointed out many of the internal forces bearing down on CBH, and here I believe my comments have some authority. Some here may think that pressures such as "Horizon" and "Intergenerational" are not

great or are manageable. You might be right, but I don't think so.

But I do know that if you ignore the Free-rider pressures and the "Vital Few" you do so at your own peril.