



Foreign Agricultural Service

GAIN Report

Global Agriculture Information Network

Required Report - public distribution

Date: 5/13/2002

GAIN Report #NZ2013

New Zealand

Dairy and Products

Semi-Annual

2002

Approved by:

David Young
U.S. Embassy

Prepared by:
Sven Koops

Report Highlights: New Zealand's fluid milk production in 2001/2002 is forecast to rise nearly 5 percent to a new record. Dairy cow numbers have significantly increased and good climatic conditions during the season, including the February-March period resulted in higher than normal production in most areas. Both cheese and nonfat dry milk exports in 2001/2002 are forecast to increase by about 14 percent, while butter and wholemilk powder exports are forecast to decrease by about 9 and 11 percent, respectively. Since the dairy industry merger last year, Fonterra has established a range of new alliances, the most significant being with Nestlé SA to form Dairy Partners Americas. Fonterra expects to generate more than half of its earnings through overseas operations by 2010 if it can realize its growth goals to become a fully global marketer. National milk production is forecast to increase by 3 percent in 2002/2003.

Includes PSD changes: Yes
Includes Trade Matrix: Yes
Semi-Annual Report
Wellington [NZ1], NZ

SECTION I. EXECUTIVE SUMMARY

Final estimates of total milk production for the season ending 2001/2002 indicate an increase of 4.8 percent from 13,162,000 MT (1.078 billion kg MS) for the 2000/2001 season to 13,776,000 MT (1.128 billion kg MS). Of this, 13,373,000 MS will be used for manufacturing purposes. The remainder will be used in domestic consumption which remains stable at 346,000 MT, feed use consumption of about 40,000 MT, and minimal exports.

Milk volumes were up about 5 percent during the January-February period (Summer) compared with the same period last year. Production in Northland, which usually provides 10 percent of New Zealand production, is down 17 percent due to higher than average rainfall during summer. Output in the Waikato and Bay of Plenty (which produces about 40 percent of national milk production), is up about 11 percent on last season. Milk volumes in the lower North Island have been up 15 percent compared to the same period last year. In the South Island production was also up compared with the same period last season (by 14 percent). Overall it is expected that the season will finish strongly.

Cheese production in 2001/2002 is forecast to increase by 17 percent to 330,000 MT, absorbed by rising exports (expected to be up 14 percent for 2001/2002). However, the demand situation remains highly variable and is dependent on the variety. Import demand in Japan, New Zealand's most important market, ran at lower levels than the industry expected. This is mainly a reflection of Japan's weak economy.

Butter production is forecast to decrease by 3.4 percent to 340,000 MT for the 2001/2002 season. Fonterra's intentions in the longer run are to diversify away from its dependence on the relatively weak and volatile butter markets such as in Russia and the Middle East and increase the production of cheese and whole milk powders. Demand from Russia remains steady, albeit at a reduced level. Lower prices and returns for markets in North Africa indicate the general deterioration in market conditions. Exports are estimated to drop by 9 percent in 2001/2002.

Skim milk powder production (the PSD series includes infant formula and nutritional powders) is forecast to increase 7.9 percent in the 2001/2002 season to 290,000 MT. Exports are forecast to increase by 13.8 percent to 280,000 MT. NZ Milk, Fonterra's international consumer products division, has launched a new milk powder product in August 2001, which is said to show promising potential in South East Asia and Latin America.

Whole milk powder production (the PSD series does not include infant formula and nutritional powders) is forecast to remain at a similar level as in 2000/2001, that is, 455,000 MT. However, exports for whole milk powder are forecast to decrease 10.8 percent. Import demand from Iraq has been falling since the change in the sanction rules in 1999, which saw a surge in requirements and, consequently, overloaded supply channels. Brazil's falling demand has been another source of negative pressure on the market, however, its recent appreciation of its currency may see this trend reversed.

The total milkpowder market remains uncertain and volatile due to export subsidies by both the EU and the U.S. This has caused further significant reductions of price levels, and it is expected that price levels

will not fully recover as stocks are building up worldwide. It is estimated that as of February 2002, Fonterra had 70,000 tons more stock of dairy products than normal. One industry analyst has emphasized that New Zealand has moved from a situation of slight undersupply last season to a slight oversupply this season. The immediate market outlook remains poor but it is expected that conditions will stabilize later in the year, with some upside to prices. Butter and skim milkpowder are being taken off the EU market which should provide some stability to the market. However, next season's payout to farmers by Fonterra is forecast to be considerably lower (NZ\$ 4.00/kg MS or US\$ 1.8/kg MS vs. NZ\$ 5.30/kg MS or US\$ 2.39/kg MS this season).

SECTION II. STATISTICAL TABLES

PSD Table: Fluid Milk

PSD Table						
Country	New Zealand					
Commodity	Dairy, Milk, Fluid				(1000 HEAD)(1000 MT)	
	Revised	2000	Preliminary	2001	Forecast	2002
	Old	New	Old	New	Old	New
Market Year Begin		06/1999		06/2000		06/2001
Cows In Milk	3300	3337	3269	3557	3330	3755
Cows Milk Production	12835	12235	13705	13162	13980	13776
Other Milk Production	0	0	0	0	0	0
TOTAL Production	12835	12235	13705	13162	13980	13776
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	12835	12235	13705	13162	13980	13776
Intra EC Exports	0	0	0	0	0	0
Other Exports	15	15	15	15	15	15
TOTAL Exports	15	15	15	15	15	15
Fluid Use Dom. Consum.	400	346	400	346	400	346
Factory Use Consum.	11931	11832	12766	12759	13041	13373
Feed Use Dom. Consum.	489	42	524	42	524	42
TOTAL Dom. Consumption	12820	12220	13690	13147	13965	13761
TOTAL DISTRIBUTION	12835	12235	13705	13162	13980	13776
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	0	0	0	0	0	0

PSD Table: Cheese

PSD Table						
Country	New Zealand					
Commodity	Dairy, Cheese				(1000 MT)	
	Revised	2000	Preliminary	2001	Forecast	2002
	Old	New	Old	New	Old	New
Market Year Begin		06/1999		06/2000		06/2001
Beginning Stocks	13	13	12	34	12	25
Production	270	297	282	281	295	330
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	283	310	294	315	307	355
Intra EC Exports	0	0	0	0	0	0
Other Exports	248	253	255	267	270	305
TOTAL Exports	248	253	255	267	270	305
Human Dom. Consumption	23	23	27	23	27	25
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	23	23	27	23	27	25
TOTAL Use	271	276	282	290	297	330
Ending Stocks	12	34	12	25	10	25
TOTAL DISTRIBUTION	283	310	294	315	307	355
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	36	32	28	38	30	38

PSD Table: Butter

PSD Table						
Country	New Zealand					
Commodity	Dairy, Butter				(1000 MT)	
	Revised	2000	Preliminary	2001	Forecast	2002
	Old	New	Old	New	Old	New
Market Year Begin		06/1999		06/2000		06/2001
Beginning Stocks	93	93	75	72	53	50
Production	347	344	355	352	345	340
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	440	437	430	424	398	390
Intra EC Exports	0	0	0	0	0	0
Other Exports	338	338	350	347	340	315
TOTAL Exports	338	338	350	347	340	315
Domestic Consumption	27	27	27	27	26	25
TOTAL Use	365	365	377	374	366	340
Ending Stocks	75	72	53	50	32	50
TOTAL DISTRIBUTION	440	437	430	424	398	390
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	29	26	20	27	25	26

PSD Table: Non-Fat Milk Powder

PSD Table						
Country	New Zealand					
Commodity	Dairy, Milk, Nonfat Dry			(1000 MT)		
	Revised	2000	Preliminary	2001	Forecast	2002
	Old	New	Old	New	Old	New
Market Year Begin		06/1999		06/2000		06/2001
Beginning Stocks	54	54	49	54	38	70
Production	210	227	195	267	197	290
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	264	281	244	321	235	360
Intra EC Exports	0	0	0	0	0	0
Other Exports	204	222	195	246	197	280
TOTAL Exports	204	222	195	246	197	280
Human Dom. Consumption	11	5	11	5	11	5
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	11	5	11	5	11	5
TOTAL Use	215	227	206	251	208	285
Ending Stocks	49	54	38	70	27	75
TOTAL DISTRIBUTION	264	281	244	321	235	360
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	3	1	2	1	2	1

PSD Table: Whole Milk Powder

PSD Table						
Country	New Zealand					
Commodity	Dairy, Dry Whole Milk Powder				(1000 MT)	
	Revised	2000	Preliminary	2001	Forecast	2002
	Old	New	Old	New	Old	New
Market Year Begin		06/1999		06/2000		06/2001
Beginning Stocks	40	40	44	38	40	7
Production	420	380	495	455	530	455
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	460	420	539	493	570	462
Intra EC Exports	0	0	0	0	0	0
Other Exports	382	378	465	482	500	430
TOTAL Exports	382	378	465	482	500	430
Human Dom. Consumption	4	4	4	4	4	4
Other Use, Losses	30	0	30	0	30	0
Total Dom. Consumption	34	4	34	4	34	4
TOTAL Use	416	382	499	486	534	434
Ending Stocks	44	38	40	7	36	28
TOTAL DISTRIBUTION	460	420	539	493	570	462
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	4	4	4	3	4	3

Trade Matrix: Cheese (MT)

NEW ZEALAND DAIRY EXPORTS			
Calendar Years 1999-2001			
CHEESE			
Destination	1999	2000	2001
Japan	53,087	54,802	55,315
Australia	30,512	31,608	40,528
United States	32,606	32,357	38,206
Belgium	13,359	17,024	20,008
United Kingdom	19,800	11,606	15,029
Korea, South	6,260	10,932	12,828
Mexico	9,619	11,224	11,903
Philippines	8,710	10,153	8,983
Saudi Arabia	5,531	6,384	8,755
Netherlands	3,173	938	7,687
Egypt	5,602	5,944	6,804
Algeria	7,687	5,970	6,706
Jamaica	3,803	5,465	5,736
Taiwan	4,643	6,161	5,078
Hong Kong	2,992	3,862	4,321
Venezuela	1,638	3,193	4,170
Other	36,165	39,769	39,178
TOTAL	245,188	257,393	291,236
Source: Statistics New Zealand			

Trade Matrix: Butter (MT)

NEW ZEALAND DAIRY EXPORTS			
Calendar Years 1999-2001			
BUTTER			
Destination	1999	2000	2001
United Kingdom	45,094	39,019	37,613
Belgium	27,024	41,605	34,426
United States	18,083	26,174	26,597
Egypt	31,372	24,417	23,365
Mexico	15,827	17,461	21,004
Canada	3,282	11,408	18,113
Latvia	20,058	17,776	16,732
Iran	14,987	30,760	15,658
Australia	8,126	9,811	10,087
Taiwan	9,403	10,602	8,971
Hong Kong	5,051	6,784	8,845
Morocco	10,711	7,016	5,938
Algeria	4,003	2,834	5,184
Saudi Arabia	6,374	6,556	5,170
Denmark	2,040	3,866	5,061
Singapore	8,254	16,023	4,914
United Arab Emirates	6,326	11,587	4,605
Philippines	4,426	5,225	4,534
Malaysia	3,696	4,765	4,473
Other	66,982	65,039	43,191
TOTAL	311,121	358,727	304,480
Source: Statistics New Zealand			

Trade Matrix: Non-fat Milk Powder (MT)

NEW ZEALAND DAIRY EXPORTS			
Calendar Years 1999 to 2001			
NON-FAT DRY MILK			
Destination	1999	2000	2001
Philippines	18,151	26,094	38,971
Malaysia	29,578	31,767	30,939
Indonesia	17,418	19,576	24,967
Thailand	10,523	10,061	22,310
Taiwan	19,570	18,960	20,948
Japan	16,887	14,217	19,199
Saudi Arabia	10,070	12,164	11,757
Vietnam	7,658	6,469	10,184
Cuba	1,148	0	10,167
Hong Kong	7,434	10,218	9,157
Australia	8,539	8,387	8,678
Mexico	8,588	6,742	7,679
China	9,093	6,089	7,008
Peru	9,350	6,540	5,915
Singapore	7,939	6,078	4,843
Egypt	3,219	3,333	4,810
Venezuela	2,857	3,333	4,433
Myanmar	1,794	2,451	3,369
Yemen, Rep of	2,582	2,214	2,875
United States	2,556	886	1,073
Other	21,841	19,528	25,404
TOTAL	216,795	215,108	274,685
Source: Statistics New Zealand			

Trade Matrix: Whole Milk Powder (MT)

NEW ZEALAND DAIRY EXPORTS			
Calendar Years 1999-2001			
WHOLE MILK POWDER			
Destination	1999	2000	2001
Vietnam	14,999	20,339	56,974
Indonesia	3,526	39,089	45,275
Venezuela	28,468	29,954	44,283
Malaysia	39,078	50,139	37,793
Mexico	13,524	3,588	35,178
Sri Lanka	30,503	28,070	31,857
China	28,876	23,521	29,638
Philippines	12,743	18,976	26,435
Thailand	22,193	26,385	24,868
Saudi Arabia	14,949	17,035	20,484
Taiwan	17,384	16,235	19,895
El Salvador	14,898	16,193	17,419
Canada	5,200	9,857	10,989
Cuba	0	3,044	10,864
Hong Kong	13,290	15,396	10,378
Peru	14,468	10,726	7,959
Algeria	8,579	7,618	7,589
Singapore	10,714	16,508	6,724
United States	6,694	3,990	3,421
Other	71,981	69,009	71,678
TOTAL	372,067	425,673	519,700
Source: Statistics New Zealand			

SECTION III. PRODUCTION & POLICY

PRODUCTION & FORECASTS

Milk Production

Milk production for the 2001/02 is now forecast to increase 4.8 percent from last season's record 13,162,000 metric tons (1.078 billion kilograms of milksolids) to reach a new record of 13,776,000 metric tons or 1.128 billion kg MS. This compares to our earlier 2001/2002 forecast increase of only 2 percent. Of this, 13,373,000 metric tons (1.096 billion kilograms of milksolids) is estimated to be used for manufacturing purposes, and the remainder for the domestic market, on-farm use, and exports.

The increase in milksolids production stems from a larger national herd, despite less favorable spring and summer weather conditions. However, warmer temperatures and decent rain throughout February-March suggest a strong finish to the season. Production from Northland contributes about ten percent to total NZ production but was down 1 percent due to excessively wet weather conditions. The South Island contributes approximately 19-20 percent to total NZ production (compared with 10 percent ten years ago). Fonterra produces approximately 96-97 percent of New Zealand's milk (Tatua 0.8 percent; Westland 2.5-2.8 percent).

Herd Statistics

The New Zealand dairy herd for the 2001/02 season is estimated at 3.755 million head (this figure does not account for deaths of about 2 percent during the season). This is a 5.6 percent increase from the previous season, which is due to: (1) increased cow numbers from conversions following the end of the New Zealand Dairy Group moratorium (December 2000) on new dairy farm conversions. New dairy conversions totaled 205 (10 in the North Island) which added an additional 99,000 cows mainly in Canterbury, Otago, and Southland (for a 15 percent growth in South Island cow numbers from last season); (2) high returns for dairy farming relative to alternative land uses; and (3) continued expansion of the North Island herd (previous forecasts from the Livestock Improvement Corporation assumed North Island cow numbers were static to falling when they actually continued rising significantly).

The national herd is expected to grow by a total of 385,000 by 2006/2007 but at a decreasing rate as: (1) payouts are expected to be lower on average than during the 2000/2001 and 2001/2002 seasons due to an appreciating NZ dollar and lower commodity prices; (2) entry costs for new suppliers to Fonterra have substantially increased (NZ\$ 3.85/kg MS or US\$ 1.73 versus NZ\$ 2 or US\$ 0.9, previously); and (3) the peak notes scheme is expected to constrain the growth of new supplies. Under this scheme new and existing milk suppliers who increase milk production around the season's peak production period are required to contribute capital towards additional processing capacity.

The rate of dairy conversions has also begun to tail off. Only 60 new farms will be converted to dairying in the 2002/2003 season. Especially in Canterbury the drop is marked with only 10 applications (down from last year's 84), however, cow numbers from conversions are estimated to grow by 27,000 and raise production by 8 million kg MS. A total of 60,000 cows will be added next season but cow numbers in the Waikato will decrease by 10,000, leading to a net increase of about 50,000 cows.

Per cow production gains are expected to be somewhat minimal, yet, increased farm productivity of 4 percent per annum remains a key goal of the dairy industry. The bulk of increasing milk production will come from increasing cow numbers.

Cheese

The forecast for increases in cheese production in 2001/2002 is 17 percent to 330,000 MT, which will be absorbed by rising exports (up 14 percent). However, the demand situation is highly variable and dependent on the variety. Import requirements in Japan, New Zealand's most important market, ran at lower levels than the industry expected earlier, and is said to be a reflection of Japan's weak economy.

Butter

As expected earlier in the season, butter exports for the 2001/2002 season are likely to decrease: from 347,000 MT to 315,000 MT, a drop of 9 percent. Fonterra maintains its strategy to diversify away from its dependence on relatively weak and volatile butter markets such as in Russia and the Middle East and concentrate on producing more cheese and whole milk powders. Events since September 11 also add uncertainty in the Middle East butter market. Generally, worldwide demand for butter is decreasing. On the upside, however, it is argued that processed consumer-oriented products (e.g. bakery products and snack foods) make up an increasing share of food consumption and combined with a forecast increase in demand for convenience foods, this may lead to a slow recovery of butter prices. Yet, rising milk fat content in milk coupled with less milkfat use in fresh products and cheese, and changing consumption patterns towards oil-based products, may see the current market deterioration continue.

Non-Fat Dry Milk Powder

The PSD table for non-fat dry milk powder has been adjusted to reflect changed components of this category. The series now includes infant formula and nutritional powders, which were previously included in the dry whole milk powder category. Similarly, the whole milk powder category is adjusted to reflect this change. This reflects the data available, which is based on this composition. Consequently, non-fat dry milk powder production is forecast to increase this season (2001/2002) by 7.9 percent to 290,000 MT. Exports are forecast to have grown by 13.8 percent to 280,000 MT by the end of this season.

Whole Milk Powder

Whole milk powder production is forecast to remain at similar levels as in 2000/2001, that is, 455,000 MT. Exports for wholemilk powder are forecast to decrease 10.8 percent to 430,000 MT. Production will continue to shift from skim milk powder/butter to WMP and cheese, both of which yield less butter in the process, due to a relative surplus of butter world-wide. Strong foreign import demand supports this shift, however, increasing supplies of WMP may also slow the trend. WMP export prices had been high but for the second half of 2001 prices were down as the EU cut demand for WMP in calf feed.

Casein

New Zealand's casein production is forecast to rise by 5.4 percent to 97,000 MT in the 2001/02 season, from last season's 92,000 MT.

Farmgate Prices

For the soon to end 2001/02 season, a payout of NZ \$5.30/kg MS (US \$2.39/kg MS) is forecast by Fonterra. The current season's payout is unlikely to be revised further downwards after the recent collapse in commodity prices and the appreciating New Zealand dollar (1 NZ\$ = 0.45 US\$), however, next season's payout has been revised downwards. Fonterra Co-operative Group Ltd. has advised shareholders that its forecast of the likely final payout for the 2002/2003 season (June/May) is NZ\$ 4.00 (US\$ 1.80) per kg MS, down from a February forecast of NZ\$ 4.50 (US\$ 2.03). Falling commodity prices and a strengthening New Zealand dollar are being cited for this adjustment. This will mean that for an average farm with 250 cows, income will fall from NZ\$ 420,000 (US\$ 189,000) for the current season to NZ\$ 315,000 (US\$ 141,750). However, production increases may mitigate the decrease in income. Fonterra comments that although commodity prices are close to their lowest levels in 20 years, a NZ\$ 4.00 (US\$ 1.80) payout would still be among the highest in recent years. Currency hedging by Fonterra will limit the impact of an appreciating NZ dollar to about NZ\$ 0.10 (US\$ 0.045) per kg MS.

Since July last year, world dairy prices in New Zealand dollar terms have fallen by more than 35 percent. A spokesperson for Fonterra reports that the price declines were partly a result of the EU adjusting export subsidies on milk powder and butter (for the third time since July causing butter prices to be down by 18 percent compared with a year ago). However, the problem is also reported to be that New Zealand has gone from a period of a small undersupply to a slight oversupply of milk, and the dairy market is known to be very sensitive to shifts in supply. Despite the fall in dairy prices by 35 percent, Fonterra's payout forecast has only declined by about 25 percent, which suggests, according to some economists, that Fonterra performs soundly, as the company had lined up good forward sales. While Fonterra expects commodity prices to slowly recover as demand increases relative to supply, analysts warn about a further strengthening of the New Zealand dollar. Fonterra officials report that milk volumes for the 2002/2003 season are likely to be up 3 percent as cow numbers continue to increase.

POLICY-STRATEGY

Fonterra Has Ambitious Growth Plans But Maybe Limited By Its Funding Options

A Fonterra official reports that Fonterra's growth strategy targets annual growth of about 15 percent per annum, a level necessary to retain and improve Fonterra's position as a global marketer. At current levels Fonterra generates between 80-90% of its earnings from New Zealand production, although the establishment of the substantial alliance with Nestlé will alter this percentage in favor of earnings from overseas operations. Fonterra believes that the New Zealand production can achieve a third of the necessary growth (or five percent), leaving two thirds to be achieved by seeking growth through expanding and establishing overseas operations. Therefore, the current trend of alliance formations with foreign firms will continue in the foreseeable future, and as a consequence, New Zealand production as

a proportion of total earnings will become less important. Using a base index of 100 for the year 2002, it can be shown that by 2010 NZ production will contribute less than 50 percent to Fonterra's earnings.

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
NZ prod	80	85	91	97	105	114	124	135	149	164
O/seas	20	30	42	55	70	87	108	131	157	188
Growth	100	115	132	152	175	201	231	266	306	352

Funding the growth in overseas investments is a key priority in Fonterra's long-term strategy. It is widely believed by business analysts that Fonterra will not be able to achieve its growth target with its current capital and ownership structure, which means that capital beyond NZ dairy farmers will be required. Consequently, without changes to its current ownership structure Fonterra is unlikely to achieve both high growth and maintain exclusive ownership by NZ dairy farmers. For example, the recent alliance with Nestlé SA in the Americas requires Fonterra to contribute cash in the vicinity of US\$ 200 to 300 million, with further capital layouts required in the future. Fonterra appears to plan to finance its growth strategy, without planning changes to the co-operative ownership structure, by raising capital through bonds issues, establishing short and medium term loan options, and materializing synergies and efficiencies from the merger. Proceeds of around NZ\$ 123 million (US\$ 55.4 million) from the forced sale of its New Zealand Dairy Foods division will also add to its cash reserves.

Fonterra has recently raised NZ\$ 200 million (US\$ 90 million) from capital notes issues. Fonterra's group controller said the company would in the future probably borrow more on capital markets than from banks, as it sought to exploit its relative size and strong credit rating. Banks would be used solely for stand-by funding. Recent credit ratings support Fonterra's strategy. Fitch Ratings, an international ratings agency, has assigned a foreign currency long-term rating of AA-, a short-term rating of F1+, an AA- to unsubordinated notes issued under Fonterra's US\$ 2 billion Euro Medium Term Note Program, and an A+ to any subordinated notes issued under that program. Finally, an F+ rating was assigned to the US\$ 1.5 billion Euro Commercial Paper program and US\$ 1.5 billion USCP program. Fonterra has just completed its first major debt raising in international markets with the issue of NZ\$ 1.018 billion (US\$ 451 million) of Eurobonds under its Euro Medium Term Note program.

Fonterra's long-term rating outlook is said to be stable, reflecting Fonterra's position as a near monopsony; its near monopoly status for exports; its diverse range of products and export markets; its least cost producer status; high entry barriers to the industry; and its substantial contribution to the NZ economy (7 percent of GDP). Fonterra's financial profile is also in good shape. Milk supply costs are paid in installments, and Fonterra can withhold up to one third of the amount due to ensure debt servicing commitments are being met first. The risks Fonterra faces are identified as: loss of milk supply due to unforeseen circumstances (e.g. climatic conditions, disease, etc.); competitors establishing significant processing capacities; land use changes away from dairy farming; integration problems resulting from the recent merger; and co-operative ownership and the limitation to raise capital from external sources.

The strong credit rating underlines Fonterra's ability to fund its acquisitions and joint venture strategy from the strength of its balance sheet. However, Standard and Poor is cautioning that Fonterra's rating is likely to be lowered if it becomes a consumer food company. The current ratings assume that the business mix does not alter materially. While Fonterra's move to differentiate the cost of milk and the profit component is seen as positive, Fonterra's more risky investments in foreign countries could potentially constrain the sort of financial flexibility Fonterra enjoys in the payment schedule to its NZ suppliers. The fact that operations in New Zealand diminish in importance relative to overseas investments will be accompanied by a diminished financial flexibility, which could affect credit ratings, and consequently, its ability to raise funds through capital markets.

Fonterra Share Price Linked to Stiff Performance Targets

Fonterra has been set tough performance measures, after Standard & Poors estimated fair value share price of NZ\$ 3.85 (US\$ 1.73) (the final value will be announced some time in May). The fair value share price is based on a Commodity Milk Price (CMP) which Standard and Poor will announce soon. The CMP is based on returns of a hypothetical highly efficient marketing company, and thus represents a benchmark against which Fonterra can benchmark its own performance. Currently, Fonterra falls short by between NZ\$ 0.32 to 0.37 (US\$ 0.14 to 0.17) per kg MS indicating a performance gap of NZ\$ 300 to 400 million (US\$ 135 to 180 million). Closing the performance gap is a top priority for Fonterra if it wants to maintain its fair value share price. Fonterra intends to achieve this by: (1) capturing merger benefits of NZ\$ 190+ million (US\$ 85.5 million); (2) achieving revenue growth of 8 percent p.a. for NZ MILK; (3) improve EBIT by 7.6 to 10.6 percent over three years for NZ Milk and NZ Milk Products; and (4) achieve a weighted average cost for capital of 9 percent. In order to close the performance gap, five key organizational priorities have been identified: (1) establishment of new people processes and an organizational culture that rewards good and bad performance accordingly, as well as views employees as an important organizational resource; (2) align and renew the company's strategy; (3) instill a performance ethic and establish timely and accurate reporting and forecasting; (4) finalize the establishment of Dairy Partners Americas joint ventures; and (5) consolidate its Australasian portfolio.

Sale of New Zealand Dairy Foods (NZDF) to Rank Group

Fonterra has sold their 70 million "A" shares in NZDF to the Rank Group for NZ\$ 1.75 per share (US\$ 0.79). Fonterra was required to sell its 50 percent stake in NZDF by September 27, 2002 under the Dairy Industry Restructuring Act in order to ensure the continuation of competition in the New Zealand consumer market for dairy products. An independent valuation estimated each share to be worth between NZ\$ 1.75 to 1.98 (US\$ 0.79 to 0.89). In order to gain the remaining 49.9996 percent held by 6,200 holders of "B" shares, the Rank Group had improved its offer from originally NZ\$ 1.70 (US\$ 0.77) to NZ\$ 1.75 (US\$ 0.79) per share (for all "A" and "B" shares). In return, NZDF directors' recommended to "B" share holders to sell their shares as well as agreed to sell their own shares in NZDF, which holds approximately 40 percent of the New Zealand dairy market with rights to use the Anchor, Fernleaf, and Chesdale brands in New Zealand, as well as owning the Fresh 'n' Fruity, Royal Tasman and Ornelle brands.

New Consumer Powder Range

New Zealand Milk is marketing a new consumer powder range under the "Anchor" and "Fernleaf"

brands. The new product is targeted at children between the ages of one and four, with a special formulation of vitamins and minerals to meet nutritional needs and boost the immune system. The product has been successful in South East Asia and Latin America with promising potential. The product is part of NZ Milk's strategy to target the precise nutritional needs of consumers at every stage of their life.

NZMP's New Milkpowder Plant at Edendale

Construction work on a new milkpowder plant at Edendale is on time for the plant to be commissioned in July for the beginning of the 2002/2003 season. The investment of NZ\$ 150 million (US\$ 67.5 million) will increase the sites processing capacity from 5.1 to 8 million liters.

Would-be Dairy Exporters Note Supply Difficulties

After the deregulation of the NZ dairy industry in September 2001, smaller independent exporters were given the right to export milk powder and under the Dairy Industry Restructuring Bill, which repealed the Dairy Board, anyone is free to export dairy products to non-quota markets. However, two New Zealand exporters with clients in Taiwan and Vietnam claim that they cannot get NZ-made milk powder unless they agree to work with Fonterra's overseas agents – which the exporters claim would make any transaction financially unviable. One of the exporters claims that Fonterra will not supply dairy products to exporters whose customers appear on Fonterra's own customer list. In a similar fashion, Westland, which is currently one of two independent dairy companies (the other one is Tatura, which does not produce milk powder), is reported as saying that they would consider long-term arrangements if exporters provided details of the product's destination. However, Westland is also reported as noting that currently they are not interested in supplying product because they can achieve substantial premiums for their products through their own sales network.

According to Fonterra, there is no legal obligation to supply product to exporters who end up competing with their own brand. This leaves practically only one option for new exporters: to set up their own manufacturing plants. Under the current law, they can then receive up to 20 percent of the milk from existing Fonterra suppliers. Fonterra is contracted to supply 250 million liters of milk to independent processors each season until 2006/2007. For the current season Fonterra is supplying approximately 211 million liters.

ALLIANCES

Fonterra on the Ground in India

Fonterra announced earlier this year that it is now formally on the ground in India's NZ\$50 billion (US\$ 22.5) dairy market. A joint venture between Fonterra's consumer products division New Zealand Milk and Britannia Industries has received the necessary regulatory approval and commenced operations in late March. The new company will be based in Bangalore and will market a wide range of dairy products, including butter, cheese, dairy whiteners, ghee, and liquid milk. Britannia Industries is well known in India, especially in baking. NZMP officials report that while the domestic operators supply the bulk of India's milk market through an informal market, there is a NZ\$5.8 billion (US\$ 2.6 billion) formal market, that the new company would target. That sector is reportedly growing at nine

percent per year and good sales growth is foreseen, with the joint venture expected to supply a range of new product innovations. Britannia will have access to Fonterra's R&D to upgrade product quality and reducing product costs.

Fonterra Signs Deal in Mexico with Liconsa

Liconsa, Mexico's largest importer of milk powder, signed a supply contract in Wellington on March 14, 2002, which will see NZMP, the ingredients division of Fonterra, supplying product worth around NZ\$100 million (US\$45 million) over the next 12 months. This gives NZMP access to a distribution network for liquid and powdered milk through 7000 retail outlets. Mexico is now one of New Zealand's largest dairy markets, with sales running at over NZ\$400 million (US\$ 180 million) annually. Liconsa had altered its purchase arrangements and would henceforth buy from only a selected group of suppliers of which NZMP was one. Fonterra added that NZMP is now the world's largest supplier of dairy ingredients.

Fonterra and Nestle Establish Dairy Partners Americas Joint Venture

On March 25, 2002, Fonterra Co-operative Group and Nestle SA signed an alliance agreement, called Dairy Partners Americas. The two companies agreed to set up a 50:50 joint venture in the dairy business in North, Central, and South America. The alliance will initially have 10,000 staff and first year turnover of about US\$1.4 billion. Nestlé SA brings to the arrangement dairy infrastructure in the Americas, trusted dairy brands, and product development expertise. Fonterra provides expertise in the development of dairy farming, in livestock and milk technologies, large-scale milk procurement, processing and management, as well as strong market positions in a number of countries throughout the Americas. The alliance will initially target markets, in the next several months, in Argentina, Brazil, Paraguay, Uruguay and Venezuela. The companies have agreed to co-operate in manufacturing and distributing shelf-stable dairy products, such as UHT milk, as well as refrigerated milk-based products such as yogurts, and beverages in supermarket chillers, liquid milk, and ingredient milk powers. The deal does not cover butter and cheese. Fresh milk for Dairy Partners of Americas' joint ventures will be sourced in the Americas and dairy ingredients from New Zealand. Joint venture companies will have access to the brands of both companies. Fonterra has said that the agreement was undoubtedly New Zealand's biggest-ever offshore commercial deal and is consistent with its strategy to work with the world's leading dairy and food companies to profitably grow Fonterra into one of the world's leading multinational dairy companies. Last year, Fonterra had turnover in the Americas of US\$1.7 billion.

Joint venture with Arla Foods in UK

Fonterra has entered into a joint venture, 75 percent-owned by Europe's biggest dairy cooperative, Scandinavian-based Arla Foods, which is known for its Lurpark brand. The joint venture has begun packaging New Zealand butter under the Anchor brand in factories in Sweden and Denmark for the UK yellow fats market. The Danish factory focuses on butter fats, while the Swedish factory makes spreadable butter. New Zealand dairy produce will be used, but as quota is limited at 76,000 tonnes, Fonterra may source milk through the Arla alliance. The alliance will also give Fonterra an opportunity to use the Anchor brand with other products, such as liquid milk, cream, and yogurt. Fonterra is reported as saying that in a (butter) market where demand is falling it is important to create scale and efficiencies through better use of existing production facilities. The joint venture will enable both parties

to better exploit production facilities and thus enhance services to large retailers and consumers. Arla Foods was established in April 2000 with the merger of Arla of Sweden and MD Foods of Denmark. It processes seven billion liters of milk and employs 20,000 people worldwide. In the UK, Arla is the third largest supplier of fresh milk and best known for its Lurpark butter.

Fonterra Export Agreement with Dairy America

NZMP, Fonterra's ingredients division, has signed an agreement to become a major marketer of U.S. skim milk and create value for NZ farmers from third-party milk by further strengthen its global marketing network. Dairy America, a marketing company representing major U.S. co-operatives, accounts for 70 percent of skimmilk exports from the U.S. and is expected to ship more than 100,000 MT annually. Since production in New Zealand has gone towards more wholemilk powder because of the difficulty of finding markets for butter, opportunities for skimmilk powder could not always be taken full advantage of. The export agreement will mean that those problems will no longer arise. NZMP receives a commission for the sales. The anticipated sales volume will make NZMP the strongest single marketer for skimmilk powder.

Fonterra's Plans Undisclosed for Further Involvement in Chile

Fonterra, which already owns 51 percent of Soprole – Chile's biggest dairy producer – remains silent about its plans for further involvement. Fonterra's new partner, Nestlé, is also involved in Chile and it is understood that both have applied to Chile's monopoly watchdog for approval for a joint venture. A Chilean government official in New Zealand commented that the best chance for approval would be for Fonterra-Nestlé to export most of its production, thereby alleviating fears of the Chilean market of being flooded with dairy products.

Fonterra and Dairy Farmers of America Extend Joint Venture

Fonterra and Dairy Farmers of America (DFA) have announced an extension of their companies' DairiConcepts joint venture. The venture, forged in 2000, is a 50/50 partnership between DFA, the world's largest dairy co-operative, and NZMP, Fonterra's global ingredients business. The extension of the joint venture, effective March 1, 2002 will see an existing DFA plant in New Mexico significantly expanded to feature the first commercial production of milk protein concentrate (MPC) in the United States, as well as other dairy ingredients for many market applications in the U.S.'s fastest growing food sector, convenience foods. Fonterra has stated that establishing a U.S. source of MPC is an essential step for it to meet the needs of customers in the NAFTA region.

INDUSTRY

NZ Genetics Servicing Northern Hemisphere

New Zealand bulls reportedly are picking up steady trade around the world, starting the northern hemisphere sales season. NZ bulls frozen semen is selling on its merits as farmers in other countries pick up on the efficiencies in milk production from pasture. Northern hemisphere buyers are mainly in United Kingdom and Ireland, with some in the United States. In the Southern hemisphere, Australia is expected to be the biggest market, with the market looking promising after a good season for many farmers. Dairy feeding systems in Australia are a mix of pasture and grain, and NZ genetics are proving

efficient and profitable. South Africa is also providing solid business with potential as the dairy industry grows. Argentina has been a major market for NZ genetics.

NZ Takes Canadian Dairy Case Back to WTO

New Zealand, along with the United States, successfully applied late last year for the World Trade Organization to re-hear their case against a Canadian dairy export scheme which both countries believe is illegal. NZ firmly rejected Canada's view that the WTO appellate body's decision was the end of the matter. The appellate body declined to rule on the complaint that Canada was providing illegal export subsidies to its dairy industry, as it felt it had insufficient information at that stage to make any determination. Canada's de facto export subsidies cost NZ about US \$33.6 million a year because of their depressing effect on world dairy prices.

NZ Dairy Farms' Energy Use Among the Lowest in the World

A MAF-commissioned study shows that NZ dairy farms use less energy than dairy farms overseas, despite the fact that energy use has doubled over the past 20 years – mainly due to increased nitrogen fertilizer usage and energy costs involved in the manufacture of urea (NZ's prime source of nitrogen). The increased use of spray irrigation was, however, also identified as a potential sustainability issue, especially in drier areas like Canterbury where deep wells have substantial energy requirements. The OER energy ratio used for comparison – total primary energy input per kg MS to the calorific energy output of those milksolids – in New Zealand is 0.59, compared with 2.8 in the U.S. and 0.67 to 2.4 in the EU. NZ farms with irrigation and high nitrogen applications may also have higher OERs than conventional and organic farms in Europe. The study also suggested that NZ can improve its ratio by bettering its fertilizer and water management practices. The energy use on NZ dairy farms is about 18 gigajoules per effective milking hectare. Of this 35 percent stems from fertilizers, 25 percent from electricity, 20 percent from fossil fuels, and 13 percent from running capital equipment and farm structures. On spray irrigated farms, electricity use jumped to 40 percent.

New Zealand also leads the world in efficient nitrogen use with a 98 percent efficiency rating compared with an OECD average of 62 percent, Canada 75 percent, and Australia 62 percent. New Zealand's efficiency stems from the fact that dairy farmers apply nitrogen strategically with smaller and more frequent applications, thus reducing the likelihood of nitrogen surpluses which result in nitrogen leaching and volatilization.

New Zealand Dairy Research Institute (NZDRI) Renamed Fonterra Research Centre

New Zealand's NZDRI has been renamed Fonterra Research Centre as part of the alignment of Research and Development resources with Fonterra's new business strategies. The new R&D structure is designed to bring together technology and innovation into Fonterra's growth strategy. Six technology streams – Intellectual Property, Food and Environmental Assurance, On-Farm Productivity, Bioactives & Health, Food Systems and Process Technology – will be used to identify and fund programs, scientists and institutions that will deliver Fonterra's research priorities. The Fonterra Research Centre will ensure that Fonterra continues to have core scientific competencies within the company, protect knowledge and deliver cost efficiencies and synergies. The research center will have a budget of NZ\$ 110 million (US\$ 49.5 million) and includes research centers in Germany, Mexico, the UK, U.S. and Australia.

Dairy InSight Proposes Levy to Fund Industry Good Activities

Dairy InSight has come into existence after dairy industry deregulation when it was realized that no organization existed that could take over the industry good functions of the former Dairy Board. Dairy InSight co-ordinates and funds all industry good activities but does not provide services directly to farmers. Organizations like Dexcel, which undertakes a major proportion of all dairy research and extension for the industry will remain the main service provider. Considered crucial for the industry, Dairy InSight performs industry good activities, research infrastructure, capabilities and on-going programs. It is proposed that dairy InSight should be funded by an industry levy under the Commodity Levies Act, which requires 50 percent farmer support to provide the basis for an application to the Minister of Agriculture. The vote – to be held at the end of May – is on both a per farm and per kilograms milksolids basis, and for it to be successful, it must be supported by both. If the majority of farmers support the levy it would mean that town supply farms and boutique companies are also be levied. The suggested levy rate is 3.4 cents (US\$ 0.015) per kg MS or an average of NZ\$ 2700 (US\$ 1215) per farm per year. In the past a similar amount was deducted from the payout by the NZ Dairy Board. All funding applications for research will be on a contestability basis.

For more information on Fonterra, please visit: www.fonterra.com