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Report Highlights:

New Zealand's milk production in 2004/05 is forecast at 15.45 million tons, an increase of 3 percent over the previous season. Whole milk powder exports in 2004/05 are forecast to rise 3.3 percent to 711,000 tons, while skim milk powder, cheese and butter exports are expected to remain at year earlier levels. New Zealand dairy farmers are now engaged in a serious debate over the future capital structure of Fonterra.

Includes PSD Changes: Yes
Includes Trade Matrix: Yes
Annual Report
Wellington [NZ1]
[NZ]

SECTION I. EXECUTIVE SUMMARY

New Zealand's milk production during the 2004/05 season (June-May) is forecast at 15.45 million tons, an increase of 3 percent over a year earlier. New Zealand's dairy herd, as of the beginning of the season, increased 2 percent to 4 million cows and heifers in calf or milk.

Cold spring weather (August - September 2004) hurt grass growth and resulted in reduced milk flows in much of New Zealand's key dairy farming areas. Fonterra anticipates that peak milk flows, around early November, will fall below a year earlier. However, increased production later in the season is likely to boost total milk flows for the year as a whole. Also negatively impacting this year's milk production is the extensive flooding experienced in some areas of the North Island last July that disrupted farming operations. Some farms in the lower North Island are still recovering from the extensive flooding of February 2004.

Fonterra has now reached stable inventory levels for all dairy products thanks to a specific program implemented in 2002 and 2003 to adjust inventories downward to manageable levels. Exportable supplies of whole milk powder will be noticeably larger this season and this commodity is expected to show the largest growth in export volumes in 2004/05. In contrast, skim milk powder, cheese and butter exports are forecast to remain at similar levels to last year.

The New Zealand dairy industry's market strategy continues to place an emphasis on maintaining growth in its sales of milk protein concentrates (MPCs). The U.S. market accounted for 55 percent of Fonterra's 167,000 tons of MPC exports in 2003. New Zealand is keenly aware that the United States has few import barriers on MPCs. The New Zealand industry was satisfied with a report conclusion issued in May 2004, by the United States International Trade Commission, 'Conditions of Competition for Milk Protein Products in the U.S. Market', that imports of milk protein concentrates had done little damage to U.S. dairy farmers.

There is strong industry debate regarding Fonterra's cooperative structure and the methodology utilized for share valuation. A lack of transparency in the share value setting process has caused some industry observers to suggest that Fonterra should alter its structure. Fonterra maintains, however, that it will retain its cooperative structure, with it evolving to suit the industry's changing needs. One option being discussed is to separate Fonterra's value adding business, 'New Zealand Milk', from its commodity business, 'Ingredients'. Fonterra's farmer suppliers would retain ownership of Ingredients and outsiders would be able to invest in New Zealand Milk. Fonterra insists that this division will not occur and that it will remain a cooperative. It maintains that its annual 3 percent growth in milk flows, providing an additional NZ\$ 200 million funding per year is adequate to finance its business expansion over the next three to five years. Many analysts, however, believe that ultimately Fonterra may need access to additional capital beyond that level which shareholders can provide.

SECTION II. STATISTICAL TABLES

PS&D TABLES

New Zealand Dairy, Milk, Fluid						
					(1000 HEAD)	(1000 MT)
	2003	Revised	2004	Estimate	2005	Forecast
	USDA	Post	USDA	Post	USDA	Post
	Official	Estimate	Official	Estimate	Official	Estimate
	[Old]	[New]	[Old]	[New]	[Old]	[New]
Market Year Begin		06/2002		06/2003		06/2004
Cows In Milk	3842	3842	3920	3920	0	4000
Cows Milk Production	14346	14346	14880	15000	0	15450
Other Milk Production	0	0	0	0	0	0
TOTAL Production	14346	14346	14880	15000	0	15450
Intra EC Imports	0	0	0	0	0	0
Total Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	14346	14346	14880	15000	0	15450
Intra EC Exports	0	0	0	0	0	0
Total Exports	47	47	45	50	0	50
TOTAL Exports	47	47	45	50	0	50
Fluid Use Dom. Consum.	360	360	360	360	0	360
Factory Use Consum.	13895	13895	14430	14545	0	14995
Feed Use Dom. Consum.	44	44	45	45	0	45
TOTAL Dom. Consumption	14299	14299	14835	14950	0	15400
TOTAL DISTRIBUTION	14346	14346	14880	15000	0	15450
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	0	0	0	0	0	0

New Zealand Dairy, Cheese						
	(1000 MT)					
	2003 USDA Official [Old]	Revised Post Estimate [New] 06/2002	2004 USDA Official [Old]	Estimate Post Estimate [New] 06/2003	2005 USDA Official [Old]	Forecast Post Estimate [New] 06/2004
Market Year Begin						
Beginning Stocks	51	60	20	45	9	38
Production	285	301	305	313	0	319
Intra EC Imports	0	0	0	0	0	0
Total Imports	2	2	2	2	0	2
TOTAL Imports	2	2	2	2	0	2
TOTAL SUPPLY	338	363	327	360	9	359
Intra EC Exports	0	0	0	0	0	0
Total Exports	290	290	290	294	0	293
TOTAL Exports	290	290	290	294	0	293
Human Dom. Consumption	28	28	28	28	0	28
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	28	28	28	28	0	28
TOTAL Use	318	318	318	322	0	321
Ending Stocks	20	45	9	38	0	38
TOTAL DISTRIBUTION	338	363	327	360	0	359
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	38	46	40	41	0	40

Note that inventory levels for all commodities have been updated. Post estimates inventories to be between 10 and 15 percent of exports for each commodity at the start of the season. This is to cover the production shortfall from June to August. Fonterra heavily reduced its inventories during 2002 and 2003 and the numbers have also been updated to reflect this.

New Zealand Dairy, Butter						
	2003	Revised	2004	Estimate	2005	(1000 MT) Forecast
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]
Market Year Begin		06/2002		06/2003		06/2004
Beginning Stocks	51	80	29	60	18	50
Production	390	392	405	407	0	407
Intra EC Imports	0	0	0	0	0	0
Total Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	441	472	434	467	18	457
Intra EC Exports	0	0	0	0	0	0
Total Exports	386	386	390	391	0	381
TOTAL Exports	386	386	390	391	0	381
Domestic Consumption	26	26	26	26	0	26
TOTAL Use	412	412	416	417	0	407
Ending Stocks	29	60	18	50	0	50
TOTAL DISTRIBUTION	441	472	434	467	0	457
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	22	21	18	29	0	30

New Zealand Dairy, Milk, Nonfat Dry						
	(1000 MT)					
	2003 USDA Official [Old]	Revised Post Estimate [New] 06/2002	2004 USDA Official [Old]	Estimate Post Estimate [New] 06/2003	2005 USDA Official [Old]	Forecast Post Estimate [New] 06/2004
Market Year Begin						
Beginning Stocks	100	80	80	50	60	35
Production	299	289	321	301	0	315
Intra EC Imports	0	0	0	0	0	0
Total Imports	0	0	0	1	0	1
TOTAL Imports	0	0	0	1	0	1
TOTAL SUPPLY	399	369	401	352	60	351
Intra EC Exports	0	0	0	0	0	0
Total Exports	314	314	336	312	0	311
TOTAL Exports	314	314	336	312	0	311
Human Dom. Consumption	5	5	5	5	0	5
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	5	5	5	5	0	5
TOTAL Use	319	319	341	317	0	316
Ending Stocks	80	50	60	35	0	35
TOTAL DISTRIBUTION	399	369	401	352	0	351
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	1	1	1	1	0	1

New Zealand Dairy, Dry Whole Milk Powder						
	(1000 MT)					
	2003 USDA Official [Old]	Revised Post Estimate [New] 06/2002	2004 USDA Official [Old]	Estimate Post Estimate [New] 06/2003	2005 USDA Official [Old]	Forecast Post Estimate [New] 06/2004
Market Year Begin						
Beginning Stocks	78	100	57	85	40	75
Production	615	619	625	677	0	710
Intra EC Imports	0	0	0	0	0	0
Total Imports	0	2	0	2	0	2
TOTAL Imports	0	2	0	2	0	2
TOTAL SUPPLY	693	721	682	764	40	787
Intra EC Exports	0	0	0	0	0	0
Total Exports	635	635	641	688	0	711
TOTAL Exports	635	635	641	688	0	711
Human Dom. Consumption	1	1	1	1	0	1
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	1	1	1	1	0	1
TOTAL Use	636	636	642	689	0	712
Ending Stocks	57	85	40	75	0	75
TOTAL DISTRIBUTION	693	721	682	764	0	787
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	3	3	3	4	0	4

TRADE MATRICES

Cheese				
Tons				
Country	January - December		January - August	
	2002	2003	2003	2004
Japan	44,459	45,698	27,336	34,739
United States	47,742	37,842	28,001	27,226
Australia	40,128	36,338	23,978	30,522
Belgium	19,169	29,274	19,511	12,945
United Kingdom	17,016	19,258	11,166	9,488
Mexico	13,462	14,674	8,822	7,314
Korea, South	10,307	11,059	7,213	11,412
Saudi Arabia	9,737	9,891	6,851	6,977
Taiwan	5,953	6,286	4,206	5,397
Other	70,916	71,615	40,573	50,782
Total	278,888	281,934	177,658	196,801

Butter				
Tons				
Country	January - December		January - August	
	2002	2003	2003	2004
Belgium	68,938	72,395	51,050	35,434
Iran	33,623	37,477	17,180	9,539
Russia	24,801	30,713	14,553	14,709
Egypt	32,928	25,409	14,837	7,672
United States	21,049	22,871	15,271	24,783
Denmark	4,808	20,816	7,092	23,008
Mexico	23,415	19,080	10,262	8,132
Canada	14,401	12,566	7,799	5,891
Saudi Arabia	7,049	11,033	6,235	6,786
Taiwan	10,829	10,596	6,910	7,102
Philippines	5,452	9,604	6,343	5,916
China	5,847	9,603	5,612	6,217
Australia	6,337	8,482	4,581	6,938
Thailand	7,487	7,938	4,200	3,888
United Arab Emirates	4,826	6,270	3,187	5,116
Indonesia	6,278	6,017	3,452	3,360
Morocco	8,951	5,739	3,354	1,498
Singapore	7,658	5,561	3,660	3,816
Malaysia	4,541	5,280	3,092	3,706
Other	101,713	49,015	24,238	29,454
Total	400,930	376,464	212,907	212,963

Non-Fat Dry Milk				
Tons				
Country	January - December		January - August	
	2002	2003	2003	2004
Philippines	25,223	50,631	36,534	25,727
Malaysia	20,895	25,264	14,136	21,424
China	20,084	21,125	11,858	18,569
Thailand	23,444	19,940	12,828	12,870
Belgium	12,047	19,331	48	205
Indonesia	24,200	16,013	9,844	9,842
Saudi Arabia	12,650	14,349	8,769	7,401
Japan	29,740	13,145	9,010	11,574
Singapore	8,206	12,082	9,287	8,470
Taiwan	14,250	11,409	8,451	6,763
Mexico	25,538	10,205	1,366	9,385
Vietnam	13,664	9,751	5,538	3,731
Cuba	6,346	9,158	5,312	128
Netherlands	8,905	8,875	0	185
Australia	1,483	4,562	4,018	3,313
United States	1,485	823	702	692
Other	75,611	48,197	25,139	27,861
Total	323,772	294,861	162,839	168,139

Whole Milk Powder				
Tons				
Country	January - December		January - August	
	2002	2003	2003	2004
China	55,874	78,774	51,685	66,529
Malaysia	47,955	53,290	33,071	28,261
Venezuela	21,738	44,030	16,920	17,088
Mexico	25,506	40,623	24,812	20,010
Sri Lanka	30,331	39,257	24,805	29,329
Philippines	32,331	39,103	28,269	18,620
Indonesia	39,841	38,468	30,323	12,612
Thailand	25,307	34,593	21,911	19,386
Vietnam	14,196	31,098	18,250	12,488
Saudi Arabia	26,227	30,617	17,268	28,499
Canada	20,666	21,289	15,387	14,502
Taiwan	21,658	19,730	13,064	13,885
Jordan	13,584	18,224	5,947	0
Algeria	15,903	17,162	10,136	16,654
Cuba	15,939	15,457	8,062	12,782
Oman	8,599	14,825	4,342	16,100
El Salvador	14,106	12,571	7,865	5,791
Singapore	15,560	12,495	9,679	10,237
United States	3,409	3,270	1,122	2,843
Other	99,541	92,851	56,257	72,716
Total	548,270	657,730	399,175	418,332

Casein, Caseinates, and Other				
	Tons			
Country	January - December		January - August	
	2002	2003	2003	2004
United States	54,836	63,249	42,009	35,394
Germany	21,247	18,349	13,341	9,011
Japan	8,819	10,209	6,685	7,559
Mexico	13,477	9,188	5,404	5,686
Canada	4,733	4,864	3,588	1,644
Italy	2,899	2,860	1,853	2,123
Korea, South	3,064	2,445	1,519	1,959
Australia	1,552	2,260	1,570	1,383
Other	15,965	14,001	8,912	10,099
Total	126,592	127,425	84,881	74,858

SECTION III. SUPPLY, DEMAND POLICY AND MARKETING**PRODUCTION**

New Zealand's milk production during the 2004/05 season (June-May) is forecast by Post at 15.45 million tons, an increase of 3 percent on the previous season. This follows last years 5 percent increase in milk production on a similar increase in cow numbers. New Zealand's dairy herd at the beginning of the season is estimated to have increased 2 percent to 4 million cows and heifers in calf or milk.

Cold spring weather (August - September 2004) hurt grass growth and resulted in reduced milk flows in much of New Zealand's key dairy farming areas. Supplemental feeding will offset this negative impact to some extent, although farmers will balance the benefits versus cost to determine the level of supplemental feeding. Fonterra anticipates that peak milk flows, around the start of November, will fall below a year earlier. However, a continuing trend towards higher production levels later in the season is forecast to boost total milk flows for the season. This is due to the increase of South Island dairy farms, whose season finishes later than their North Island counterparts.

Also negatively impacting this year's milk production is the extensive flooding experienced in some areas of the North Island last July that disrupted farming operations. This prompted affected farmers to move cows to unaffected areas. Most of the stock has returned for the start of the season and grass is beginning to grow in these areas. The stock is returning in variable condition, reflecting the shortage of grass and other feed in the central and southern North Island. Many of the lower North Island farms damaged in heavy flooding in February are also still recovering (see NZ4008).

It is difficult to predict the long-term impact that changing weather patterns such as El Nino will have on New Zealand's dairy industry. New Zealand's low cost agricultural production relies on its ability to grow grass, which is determined by temperature and rainfall. Farmers will need to adapt to climatic changes, with different areas of New Zealand becoming hotter or colder, dryer or wetter than historically. New Zealand's dairy industry appears unconcerned, with a strong focus on improving cow production and efficiency through genetic and management improvements.

Fonterra's Production Capacity

Fonterra owns the three largest dairy factories in the world, all based in New Zealand. Fonterra continues to upgrade its manufacturing base in New Zealand, stating that it will invest an additional NZ\$ 200 million into its Clandeboye plant building a fourth milk drier within the next five years, making it the largest in the world. The biggest is currently Fonterra's Whareroa plant at Hawera, followed by its Edendale plant.

TRADE

Fonterra has reached stable inventory levels, following their controlled reduction during 2002 and 2003. The PS&D tables have been updated to account for this. These inventory clearances are reflected in low international prices of commodity

milk products during this period. This was part of Fonterra's strategy to reduce supply chain costs. Export supply will tighten for the 2004/05 season now that inventories are at stable levels.

Cheese

New Zealand's cheese production is forecast to increase 2 percent to 319,000 tons for the 2004/05 season. Exports are estimated to remain unchanged from last season at 293,000 tons as a result of Fonterra having tighter exportable supplies for the 2004/05 season.

Butter

New Zealand's butter production for the 2004/05 season is forecast to remain the same at 407,000 tons. Lower inventory levels will restrict butter exports, which are forecast to decrease 2.6 percent to 381,000 tons.

Skim Milk Powder

Skim milk powder (SMP) production in New Zealand for the 2004/05 season is forecast to increase 4.7 percent to 315,000 tons. Exports are forecast to remain the same at 311,000 tons, due to tighter exportable supply.

Whole Milk Powder

New Zealand's whole milk powder (WMP) production is forecast by Post to increase 4.9 percent to 710,000 tons. Exports are forecast to increase only 3.3 percent to 711,000 tons as a result of tighter exportable supply.

New Zealand's dairy industry represents over 20 percent of New Zealand's total exports by value, with 95 percent of dairy production exported. Fonterra accounts for 95 percent of New Zealand's dairy exports. Although New Zealand only produces 2 percent of the world's milk, it accounts for one-third of world dairy trade. Through its international acquisitions and joint ventures Fonterra manages 40 percent of world dairy trade. The United States is New Zealand's largest export market by value, taking 11 percent of its dairy exports in 2003. Two thirds of New Zealand's exports by value to the U.S. in 2003 were casein products.

Due to the dairy industry's large share of New Zealand's total exports, New Zealand's objectives for multilateral trade negotiations in relation to dairy are very similar to those for New Zealand's general agricultural negotiations. New Zealand's stance is heavily influenced by its membership of the Cairns Group, in which it plays a constructive role in the negotiations and is fully supportive of the Group's proposals. New Zealand's main focus is on the elimination of export subsidies and increased market access.

MARKETING

Fonterra's Market Strategy

Since its formation in 2001, Fonterra has repeatedly stated its goal to continue the work of its predecessors towards global dairy industry leadership. Fonterra has stated that its goals are for long-term competitiveness and cost leadership; to remain a farmer-owned cooperative; and the continued expansion of its value-add activities. Due to the significant trade barriers facing New Zealand dairy products in overseas markets, future growth will largely come from international acquisitions, mergers, and joint ventures and not from New Zealand-based dairy export increases. Fonterra further benefits from this strategy through ready access to dairy products produced offshore via both established relationships and the spot market, allowing it to guarantee a consistent supply of product to its international customers. Although Fonterra is forecasting consistent growth in New Zealand's milk production of 3 percent per year, the cooperative is increasingly sourcing milk product from outside New Zealand and Australia to meet increasing customer demand.

International expansion plans have been well below initial expectations during Fonterra's first three years of operation. Its new CEO Andrew Ferrier, however, has indicated his desire to expand Fonterra's international operations in the near future. At formation, Fonterra generated 80-90 percent of its earnings from New Zealand production, although its alliance with Nestlé will have altered this percentage in favor of earnings from overseas operations. Fonterra believes that only a third of its future overseas sales growth will be achieved by increasing its exports of New Zealand-produced dairy products, while expanding its overseas operations will generate the lion's share. The principal markets targeted for expansion and promotional activity by Fonterra include Australia, Asia, the United States, Mexico and South America.

Fonterra's International Expansion

Negotiations between Fonterra, the Chinese government and the Chinese dairy company Shijiazhuang Sanlu Group Co. (Sanlu) to purchase a stake in Sanlu continue. It is likely that Fonterra will become the second largest shareholder in the company with a 39 per cent stake. China is a key market for Fonterra, who supplied 70 percent of China's dairy imports (excluding whey) in 2002. This is Fonterra's fourth largest market. Chinese urbanization and rapidly rising per capita incomes are increasing demand for western-style food, making China an increasingly important export destination for New Zealand dairy products. Chinese companies outside China's dairy belt face serious difficulties in ensuring a regular milk supply, creating opportunities for Fonterra to supply imported milk products. Fonterra states that this deal will provide Fonterra with a Chinese distribution network, while Fonterra will provide its branding experience in the fast-moving consumer goods category. Fonterra's sales of milk powder may be negatively affected, however, if the Dairy Association of China introduces a fresh milk identification system in major Chinese cities. This may create a consumer perception that fresh is better, which is not necessarily true in China. The system will also penalize China's own dairy companies situated in the North of the country, some distance from the affluent coastal cities, including Sanlu.

In North America, Fonterra's joint venture with Dairy Farmers of America, DairyConcepts, is attempting to gain advantage over competitors by becoming the first to gain regulatory approval for a U.S. plant to supply milk protein products for use in products such as yogurt, ice cream and frozen desserts. This plant, located at Portales, New Mexico, is the only plant in the United States using the ultra filtration process, allowing it to produce a higher grade product than other plants in the U.S. Through its venture with U.S. cooperative Dairy America, Fonterra is the largest exporter of U.S.-produced non-fat dry milk powder. Acquisitions in Mexico have allowed Fonterra to gain a large share of the Mexican cheese and spreads market.

Fonterra is also moving ahead with production and marketing strategies in South America through a strategic business alliance Dairy Partners Americas with Nestlé. Currently operating in Argentina, Brazil and Venezuela, in April 2004 the two partners announced their second phase of development, expanding into Ecuador, Colombia and Trinidad and Tobago. Fonterra is investing U.S.\$ 35 million in this expansion. The third phase involves Fonterra merging Chilean dairy company Soprole into its Dairy Partners Americas venture with Nestlé, who is currently Soprole's major competitor in the Chilean market. Fonterra has a 51 percent shareholding in Soprole, which is one of Chile's four largest dairy organizations. Unfortunately, the other major shareholder of Soprole is against this idea. Fonterra is assessing buying out its current business partner, however it faces uncertainty as to Chilean competition authorities allowing the merger of Fonterra's business with Nestlé's, due to the dominant market share the resulting joint venture would command of Chile's dairy industry.

In Australia, Fonterra is bringing together its existing production and marketing assets, allowing it to manage its business activities more effectively. This reflects Fonterra's strategic view that Australia is part of its domestic market and should be included in its consolidation to ensure its future success. Some industry commentators, however, argue that Fonterra has not adequately articulated a strategy for the Australian market, with some of its investments failing to create the impression of a cohesive strategy. Fonterra's 50 percent ownership of Bonlac Foods and 17 percent share of National Foods, along with shareholdings in other dairy companies in Australia, may allow it to take advantage of trade benefits provided to the Australian dairy industry by the U.S.-Australian FTA that was negotiated in February 2004.

In Europe Fonterra brought its Anchor brand into a new marketing arrangement with the Lurpark brand of ARLA, a European dairy cooperative. This will ensure that Fonterra obtains maximum marketing value from its Anchor brand in the European Union, with a focus on the U.K. Fonterra also has a joint venture with Britannia in India.

U.S. Imports of New Zealand Milk Protein Concentrate

The New Zealand dairy industry's market strategy continues to place an emphasis on maintaining growth in its sales of milk protein concentrates (MPCs). The U.S. market accounted for 55 percent of Fonterra's 167,000 tons of MPC exports in 2003. New Zealand is keenly aware that the U.S. has few import barriers on MPCs, due to imports increasing after new world trade rules were set in 1994. The New Zealand industry was satisfied that a report issued in May 2004, by the United States International Trade Commission, 'Conditions of Competition for Milk Protein Products in the U.S. Market', found that regardless of these low barriers, imports of

milk protein concentrates had done little damage to U.S. dairy farmers. Through a joint venture between Dairy Farmers of America, Fonterra is producing MPCs at its Portales plant in New Mexico. The factory is the only one in the United States producing high-protein MPCs using an ultrafiltration process.

POLICY

Fonterra's Share Value and Capital Structure

There is strong debate regarding the Fonterra's cooperative structure and the method used to value its shares. Fonterra has begun extensive consultations with its shareholders and undertook a tour of Australia and the United States involving farmer representatives in August 2004 to study other cooperative structures. Fonterra maintains that it will retain its cooperative structure, evolving it to suit the industry's needs. For a change in Fonterra's capital structure to occur its shareholders need to vote 75 percent in its favor.

The cooperative currently uses a 'fair value' share system for determining its share value. The value is based on an estimated value range calculated by Standard & Poor's. Fonterra has set its fair value share price at NZ\$ 4.69 for the 2004/05 season, a 7 percent increase over the previous season. Fonterra's current fair value share value is 56 percent greater than its initial value of NZ\$ 3 set during Fonterra's creation in 2001. Fonterra maintains that the price trend indicates that Fonterra is creating value as the share price takes into account the long-term benefits to the cooperative's shareholders. Suppliers are unaware of what portion of their payout is the result of commodity prices versus value-add activities. Although the share value increases have increased the asset value of farmers with shares, the higher share value places a larger burden on farmers wishing to start new dairy operations or expand existing ones. Fonterra has admitted that this may make it difficult to generate adequate milk flows in the future.

The lack of transparency of the value setting process and Fonterra's potential future need for additional external capital has caused some industry observers to suggest that Fonterra alter its structure. One option is to separate its value adding business, 'New Zealand Milk', from its commodity business, 'Ingredients'. Fonterra's suppliers would retain ownership of Ingredients and outsiders would have the ability to invest in New Zealand milk. This has created industry wide debate. Fonterra maintains that this separation will not occur and that it will remain a cooperative, never incorporating external ownership into any of its core businesses. Fonterra states that its annual 3 percent growth in milk flows is providing an additional NZ\$ 200 million funding per year, adequate for the next three to five years. Many analysts, however, believe that in the future Fonterra may need access to additional capital beyond what shareholders can provide in order to continue investing in its commodity and value adding businesses.

New Zealand Milk's poor performance since the cooperative's creation has supported some analysts' arguments that the value-added business is a poor fit inside a producer oriented cooperative structure. Fonterra has reassured its suppliers that the disappointing returns are due to strong milk commodity prices, which reduces New Zealand Milk's margins while increasing revenues for Fonterra's commodities business, Ingredients. The cooperative argues that this situation is beneficial to farmers as the value-add businesses provide a natural hedge during times of low commodity prices. To date Fonterra's business has been driven by

continually increasing supply, which is typically sold as commodities. In the future Fonterra may need to decide whether to focus on its commodity business or value added business. If it focuses on its value added business the currently fair value scheme could distort signals to farmers. This may motivate farmers to purchase more shares and supply more milk, which may make it more challenging for Fonterra to create more value per liter of milk.

Another contentious issue that Fonterra's shareholders are currently debating is its Peak Notes scheme. This scheme is designed to ensure that farmers with a strong peak of production during the season hold more capital in Fonterra. This is due to the extra processing capacity that Fonterra has to invest in to meet the demands of peak milk flow for a short period of the season. The current system is complicated to use and many farmers are against the recognition of different production curves. Fonterra, however, argues that a system is needed as producers with flat production curves can be 'picked' by other processors to suit a particular purpose, leaving Fonterra with a large proportion of producers with 'peaky' production curves, increasing its costs.

Farmer Payouts

Fonterra's final payout to its farmer shareholders for the 2003/04 season is NZ\$ 4.25 per kilogram of milk solids. Fonterra states that the large gain over its NZ\$ 3.85 forecast at the beginning of the season was the result of higher commodity prices, increased supply chain efficiencies and merger benefits. Fonterra announced in October 2004 its forecast payout for the 2004/05 season as NZ\$ 4.05 per kilogram of milk solids. The main cause of this 5 percent drop is due to the continuing strength of New Zealand's currency and Fonterra's inability to hedge the weaker U.S. dollar at as favorable a rate as in the past. The average conversion rate for 2004/05 will increase to U.S. 60-62 cents, from an average of U.S. 52 cents the previous season. Fonterra forecasts milk product commodity prices to remain strong during the 2004/05 season.

Live Dairy Cattle Exports to China

New Zealand live dairy cattle exports increased significantly in 2003 and 2004 due to strong Chinese demand for New Zealand bred Friesian dairy cows with specific attributes. New Zealand has the current advantage over other potential export countries of being free of major bovine diseases such as BSE. The value of these particular animals is substantially higher when exported to China rather than sold domestically. Exports to China in 2003 totaled 8,860 animals. Exports between January and August of 2004 have totaled 34,000 animals. This is a contentious issue, with some industry participants warning that New Zealand is effectively 'giving away' years of genetic research and development. Others argue that if New Zealand doesn't take advantage of the situation then others will. They also argue that China only controls a limited percentage of the world's arable area and that the Chinese market will continue to expand so rapidly that it will always need outside sources of milk.

Potential Benefits of Future New Zealand Trade Deals

The New Zealand government is currently working towards trade deals with China, Thailand and Chile that could be beneficial to New Zealand's dairy industry. Trade and economic framework discussions for a Free Trade Agreement (FTA) with China were initiated in January 2004. New Zealand and China are currently undertaking a joint feasibility study with the results to be released in November 2004. New Zealand hopes that this will lead to negotiations on a trade deal, which are expected to commence in early 2005. Both countries have expressed a desire to conclude a FTA in 2005. New Zealand's efforts to reach a trade accord with China were enhanced by its willingness to meet China's demand to be recognized as a market economy. This provides China with relief from the anti-dumping provisions it accepted when it joined the WTO.

New Zealand and Thailand are likely to agree on a free trade agreement by the end of 2004. Fonterra currently accounts for more than half of New Zealand's exports to Thailand (approximately NZ\$ 200 million per year), which could be expanded if current quota and tariff barriers were reduced. Thai dairy farmers, however, have asked that their government exclude dairy products from free trade negotiations with New Zealand.

New Zealand's dairy industry could also benefit from a trade deal with Chile, which is currently in negotiations with the New Zealand government. Benefits may be limited, however, due to the influence of Chile's dairy industry, which in the past opposed a FTA between the two countries. Fonterra currently holds a 51 percent stake in Soprole, one of Chile's four largest dairy organizations. Soprole currently exports more than it imports from New Zealand. Fonterra maintains that its focus is on continued expansion of Chilean export production rather than importing New Zealand milk products.

Additional Resources

www.fonterra.com (New Zealand's main dairy cooperative, 95 percent of exports)
www.westland.co.nz (small dairy cooperative)
www.tatua.com (small dairy cooperative)
www.maf.govt.nz (various reports on New Zealand's dairy industry)
www.lic.co.nz (herd improvement cooperative)
www.dexcel.co.nz (New Zealand's dairy industry research organization)
<http://www.fedfarm.org.nz/fonterra.htm> (represents farmer interests, discusses capital structure and peak notes)