



USDA Foreign Agricultural Service

# GAIN Report

Global Agriculture Information Network

Template Version 2.09

Required Report - public distribution

**Date:** 5/16/2005

**GAIN Report Number:** NZ5007

## New Zealand

### Dairy and Products

### Semi-Annual

### 2005

**Approved by:**

David Rosenbloom  
U.S. Embassy

**Prepared by:**

Alastair Patterson

---

**Report Highlights:**

New Zealand's milk production during the 2004/05 season (June-May) is now forecast at 14.6 million tons, a decrease of 2.5 percent from the previous season. Exports of butter, cheese, skim and whole milk powder will all decline from year earlier levels. Fonterra failed in its takeover bid for the Australian dairy company National Foods. Changes to Fonterra's capital structure will include the introduction of contract milk supply; while peak notes and supply redemption rights have been replaced by a more simplified system. As of mid-May, an investigation into the claimed deliberate release of Food and Mouth disease is ongoing.

---

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

**SECTION I. EXECUTIVE SUMMARY**

New Zealand's milk production during the 2004/05 season (June-May) is now estimated at 14.6 million tons, 825,000 tons below our initial forecast and 2.5 percent less than a year earlier. Post's estimate of New Zealand's dairy herd at the beginning of the 2004/05 season has been adjusted downward to 3.97 million cows and heifers in calf or milk. This reflects slower growth (1.3 percent) in New Zealand's dairy herd. Undesirable weather and flooding in major producing regions also contributed to the decline in milk production. Decreased milk flows resulted in a manufacturing shortfall of approximately 75,000 tons for Fonterra. During the 2004/05 season, Fonterra sourced approximately 2 million tons of ingredients in New Zealand and an additional 500,000 tons from other countries.

Fonterra failed in its takeover bid for the Australian dairy company National Foods, losing to the Philippine-based conglomerate San Miguel. Fonterra decided last month not to increase its already revised offer of A\$ 6.20 per share to beat San Miguel's A\$ 6.40 bid. The cooperative instead opted to sell its 19 percent stake in National Foods to San Miguel. Although not successful in assuming ownership of National Foods, Fonterra did record a A\$ 210 million profit from the sale of its shareholding. Industry observers are divided over the merits of the decision, with some stating that it was prudent, while others argue that Fonterra missed a strategic business opportunity. Ownership of National Foods would have given Fonterra a dominant position in the Australian dairy industry and a stronger value-added business. It is generally agreed among industry observers that it is vital for Fonterra to solidify its base in the Australasian market in order to facilitate its longer-term goal of aggressive expansion into Asia.

Since Fonterra's creation in 2001, there has been an ongoing debate over how the cooperative's capital structure can be improved. At a meeting held in May 2005, farmer-suppliers voted to change two aspects of Fonterra's capital structure. Contract milk supply will be introduced, while peak notes and supply redemption rights are being replaced by a more simplified system. These changes, to be initiated in the 2005/06 season, will reduce costs and administrative complexity in the supply system. Fonterra anticipates that its capital structure will again be reviewed in the next three to five years. Debate continues over the need for greater transparency between the commodity and value-added parts of Fonterra's business and whether its cooperative structure should be replaced.

New Zealand's police responded on May 10, to a claimed deliberate release of foot and mouth disease on Waiheke Island, a short ferry ride from the city of Auckland. Although the threat has proven so far to be a hoax, New Zealand's Ministry of Agriculture and Forestry (MAF) have taken the threat seriously. Risk materials have been restricted from movement on and from the island, including live animals, hay, equipment used with animals, untreated products from animals, milk, cheese, meat, and wool. MAF has indicated that the island will not be officially cleared of having the disease until May 23.

**SECTION II. STATISTICAL TABLES**  
**PS&D TABLES**

<b>New Zealand Dairy, Milk, Fluid</b>						
	2003		2004		2005	
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]
		06/2002		06/2003		06/2004
	(1000 HEAD)(1000 MT)					
<b>Market Year Begin</b>		06/2002		06/2003		06/2004
<b>Cows In Milk</b>	3842	3842	3920	3920	4000	3970
<b>Cows Milk Production</b>	14346	14346	15000	15000	15375	14625
<b>Other Milk Production</b>	0	0	0	0	0	0
<b>TOTAL Production</b>	14346	14346	15000	15000	15375	14625
<b>Intra EC Imports</b>	0	0	0	0	0	0
<b>Total Imports</b>	0	0	0	0	0	0
<b>TOTAL Imports</b>	0	0	0	0	0	0
<b>TOTAL SUPPLY</b>	14346	14346	15000	15000	15375	14625
<b>Intra EC Exports</b>	0	0	0	0	0	0
<b>Total Exports</b>	47	47	50	50	50	50
<b>TOTAL Exports</b>	47	47	50	50	50	50
<b>Fluid Use Dom. Consum.</b>	360	360	360	360	360	360
<b>Factory Use Consum.</b>	13895	13895	14545	14545	14920	14170
<b>Feed Use Dom. Consum.</b>	44	44	45	45	45	45
<b>TOTAL Dom. Consumption</b>	14299	14299	14950	14950	15325	14575
<b>TOTAL DISTRIBUTION</b>	14346	14346	15000	15000	15375	14625
<b>Calendar Yr. Imp. from U.S.</b>	0	0	0	0	0	0
<b>Calendar Yr. Exp. to U.S.</b>	0	0	0	0	0	0

<b>New Zealand Butter</b>						
(1000 MT)						
	<b>2003</b>	<b>Revised</b>	<b>2004</b>	<b>Estimate</b>	<b>2005</b>	<b>Forecast</b>
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]
<b>Market Year Begin</b>		06/2002		06/2003		06/2004
<b>Beginning Stocks</b>	51	80	31	60	21	50
<b>Production</b>	392	392	407	407	407	336
<b>Intra EC Imports</b>	0	0	0	0	0	0
<b>Total Imports</b>	0	0	0	0	0	0
<b>TOTAL Imports</b>	0	0	0	0	0	0
<b>TOTAL SUPPLY</b>	443	472	438	467	428	386
<b>Intra EC Exports</b>	0	0	0	0	0	0
<b>Total Exports</b>	386	386	391	391	381	320
<b>TOTAL Exports</b>	386	386	391	391	381	320
<b>Domestic Consumption</b>	26	26	26	26	26	26
<b>TOTAL Use</b>	412	412	417	417	407	346
<b>Ending Stocks</b>	31	60	21	50	21	40
<b>TOTAL DISTRIBUTION</b>	443	472	438	467	428	386
<b>Calendar Yr. Imp. from U.S.</b>	0	0	0	0	0	0
<b>Calendar Yr. Exp. to U.S.</b>	21	21	29	29	30	30

<b>New Zealand Cheese</b>						
	(1000 MT)					
	<b>2003</b>	<b>Revised</b>	<b>2004</b>	<b>Estimate</b>	<b>2005</b>	<b>Forecast</b>
	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]	USDA Official [Old]	Post Estimate [New]
<b>Market Year Begin</b>		06/2002		06/2003		06/2004
<b>Beginning Stocks</b>	51	60	36	45	29	38
<b>Production</b>	301	301	313	313	319	293
<b>Intra EC Imports</b>	0	0	0	0	0	0
<b>Total Imports</b>	2	2	2	2	2	2
<b>TOTAL Imports</b>	2	2	2	2	2	2
<b>TOTAL SUPPLY</b>	354	363	351	360	350	333
<b>Intra EC Exports</b>	0	0	0	0	0	0
<b>Total Exports</b>	290	290	294	294	293	270
<b>TOTAL Exports</b>	290	290	294	294	293	270
<b>Human Dom. Consumption</b>	28	28	28	28	28	28
<b>Other Use, Losses</b>	0	0	0	0	0	0
<b>Total Dom. Consumption</b>	28	28	28	28	28	28
<b>TOTAL Use</b>	318	318	322	322	321	298
<b>Ending Stocks</b>	36	45	29	38	29	35
<b>TOTAL DISTRIBUTION</b>	354	363	351	360	350	333
<b>Calendar Yr. Imp. from U.S.</b>	0	0	0	0	0	0
<b>Calendar Yr. Exp. to U.S.</b>	46	46	41	41	40	40

<b>New Zealand Milk, Nonfat Dry</b>						
	(1000 MT)					
	2003	Revised	2004	Estimate	2005	Forecast
	USDA Official	Post Estimate	USDA Official	Post Estimate	USDA Official	Post Estimate
	[Old]	[New]	[Old]	[New]	[Old]	[New]
<b>Market Year Begin</b>		06/2002		06/2003		06/2004
<b>Beginning Stocks</b>	100	80	70	50	55	35
<b>Production</b>	289	289	301	301	315	237
<b>Intra EC Imports</b>	0	0	0	0	0	0
<b>Total Imports</b>	0	0	1	1	1	1
<b>TOTAL Imports</b>	0	0	1	1	1	1
<b>TOTAL SUPPLY</b>	389	369	372	352	371	273
<b>Intra EC Exports</b>	0	0	0	0	0	0
<b>Total Exports</b>	314	314	312	312	311	240
<b>TOTAL Exports</b>	314	314	312	312	311	240
<b>Human Dom. Consumption</b>	5	5	5	5	5	5
<b>Other Use, Losses</b>	0	0	0	0	0	0
<b>Total Dom. Consumption</b>	5	5	5	5	5	5
<b>TOTAL Use</b>	319	319	317	317	316	245
<b>Ending Stocks</b>	70	50	55	35	55	28
<b>TOTAL DISTRIBUTION</b>	389	369	372	352	371	273
<b>Calendar Yr. Imp. from U.S.</b>	0	0	0	0	0	0
<b>Calendar Yr. Exp. to U.S.</b>	1	1	1	1	1	1

<b>New Zealand Dry Whole Milk Powder</b>						
	(1000 MT)					
	2003	Revised	2004	Estimate	2005	Forecast
	USDA Official Post	Estimate	USDA Official Post	Estimate	USDA Official Post	Estimate
	[Old]	[New]	[Old]	[New]	[Old]	[New]
<b>Market Year Begin</b>		06/2002		06/2003		06/2004
<b>Beginning Stocks</b>	78	100	63	85	53	75
<b>Production</b>	619	619	677	677	700	609
<b>Intra EC Imports</b>	0	0	0	0	0	0
<b>Total Imports</b>	2	2	2	2	2	2
<b>TOTAL Imports</b>	2	2	2	2	2	2
<b>TOTAL SUPPLY</b>	699	721	742	764	755	686
<b>Intra EC Exports</b>	0	0	0	0	0	0
<b>Total Exports</b>	635	635	688	688	701	615
<b>TOTAL Exports</b>	635	635	688	688	701	615
<b>Human Dom. Consumption</b>	1	1	1	1	1	1
<b>Other Use, Losses</b>	0	0	0	0	0	0
<b>Total Dom. Consumption</b>	1	1	1	1	1	1
<b>TOTAL Use</b>	636	636	689	689	702	616
<b>Ending Stocks</b>	63	85	53	75	53	70
<b>TOTAL DISTRIBUTION</b>	699	721	742	764	755	686
<b>Calendar Yr. Imp. from U.S.</b>	0	0	0	0	0	0
<b>Calendar Yr. Exp. to U.S.</b>	3	3	4	4	4	4

## TRADE MATRICES

<b>New Zealand Butter Exports</b>			
Partner Country	Calendar Years, Tons		
	2002	2003	2004
Belgium	66664	71025	45496
Denmark	790	15328	33181
Russia	23407	29779	22619
Iran	32791	36615	20971
United States	4528	4587	8899
Egypt	24615	18405	8897
Australia	5088	6591	8221
Taiwan	6437	6814	7463
Georgia	730	2457	6675
Saudi Arabia	2613	6530	6146
Azerbaijan	78	2117	6015
Canada	3612	5216	5121
Other	79490	42601	42520
<b>Total</b>	<b>250843</b>	<b>248065</b>	<b>222224</b>

<b>New Zealand Cheese Exports</b>			
Partner Country	Calendar Years, Tons		
	2002	2003	2004
Japan	42890	44697	52793
Australia	37826	34257	39349
United States	47252	36671	36772
Korea South	10570	11195	16380
Belgium	18865	29435	15643
Mexico	13907	15931	12366
Philippines	9081	10313	12148
United Kingdom	16271	18296	11071
Saudi Arabia	9506	10345	8869
Taiwan	5632	5958	7247
Egypt	6104	6195	5070
Other	60463	61640	59382
<b>Total</b>	<b>278367</b>	<b>284933</b>	<b>277090</b>

<b>New Zealand Skim Milk Exports</b>			
Partner Country	Calendar Years, Tons		
	Quantity		
	2002	2003	2004
Philippines	24293	49066	39803
Malaysia	20316	24582	29320
China	19767	20716	26966
Thailand	22939	19581	20438
Japan	29162	12841	16031
Indonesia	23545	15452	14714
Saudi Arabia	12428	14114	12962
Singapore	8014	11757	12049
Mexico	25082	10017	10061
Taiwan	13400	10857	9411
Yemen	3238	3360	6925
Australia	1406	4506	6101
Vietnam	13387	9519	5638
Other	98544	80897	39138
<b>Total</b>	<b>315521</b>	<b>287265</b>	<b>249557</b>

<b>New Zealand Whole Milk Exports</b>			
Partner Country	Calendar Years, Tons		
	Quantity		
	2002	2003	2004
China	54836	77461	86010
Saudi Arabia	25809	30126	48398
Sri Lanka	29739	38526	43378
Malaysia	46234	51560	40567
Venezuela	21357	43292	34869
Philippines	29958	36582	31442
Mexico	25042	39862	27786
Thailand	24796	33735	27489
Oman	8465	14588	26579
Algeria	15246	16894	24670
Cuba	15912	15331	24223
Indonesia	38983	37583	23731
Canada	20518	21127	23655
Taiwan	20000	17759	19412
Nigeria	3076	10356	19109
Vietnam	13893	30450	16568
Singapore	15066	11999	13013
United Arab Emirates	8555	6249	11043
Other	111495	104121	87188
<b>Total</b>	<b>528980</b>	<b>637601</b>	<b>629130</b>

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

New Zealand's milk production during the 2004/05 season (June-May) is now estimated at 14.6 million tons, 825,000 tons below our initial forecast and 2.5 percent less than a year earlier. This is the first time New Zealand's milk flow has fallen since the 1998/99 season. Post's estimate of New Zealand's dairy herd at the beginning of the 2004/05 season has been adjusted downward to 3.97 million cows and heifers in calf or milk. This reflects slower growth (1.3 percent) in New Zealand's dairy herd.

Undesirable weather and flooding in major producing regions also contributed to the decline in milk production. However, there is large variability between regions, with some recording increased production levels. By mid-season, Fonterra's milk flows were 5 percent lower than the previous season, but positive weather conditions later in the season increased production, halving this decline by May 2005.

Decreased milk output resulted in a manufacturing shortfall of approximately 75,000 tons for Fonterra. The cooperative has continued to meet customer commitments by sourcing product from other countries. During the 2004/05 season, Fonterra sourced approximately 2 million tons of ingredients in New Zealand and an additional 500,000 tons from other countries. This reflects Fonterra's strategy to increasingly source ingredients from third parties to meet overseas customer demands. The shortage of supply encouraged Fonterra to fill existing sales contracts first. This may have had a greater influence on production decisions than the relative prices of dairy products on international markets. The variance that can be seen in the change in export volumes of Fonterra's dairy products reflects these production decisions. Reserves are now at minimum levels offering minimal costs for end of season carry over volumes.

***Butter***

New Zealand's butter production for the 2004/05 season is forecast to decrease 17 percent to 336,000 tons. Butter exports are estimated to decline 18 percent to 320,000 tons as a result of this reduced supply, despite butter prices increasing more strongly than other dairy commodities on international markets during the past 30 months.

***Cheese***

New Zealand's cheese production is forecast to decline 6 percent to 293,000 tons for the 2004/05 season. Exports are estimated to decrease 8 percent to 270,000 tons as a result of tighter supply.

***Skim Milk Powder***

Skim milk powder (SMP) production in New Zealand for the 2004/05 season is forecast to decrease 21 percent to 237,000 tons. As a result of this reduced supply, exports are forecast to decrease 23 percent to 240,000 tons.

***Whole Milk Powder***

New Zealand's whole milk powder (WMP) production is forecast to decrease 10 percent to 609,000 tons for the 2004/05 season. Exports are forecast to decline 11 percent to 615,000 tons as a result of tighter supply.

**MARKETING*****Failed National Foods Takeover Bid***

Fonterra failed in its takeover bid for the Australian dairy company National Foods, losing to Philippine based rival San Miguel. Fonterra chose in early April not to increase its second offer of A\$ 6.20 per share to beat San Miguel's A\$ 6.40 bid. The cooperative instead opted to sell its 19 percent stake in National Foods to San Miguel. With 56.5 million shares Fonterra will receive over A\$ 360 million, an A\$ 210 million profit, which the cooperative states it will invest in strategic interests elsewhere. The takeover process began in October 2004 when Fonterra launched an initial takeover bid of A\$ 5.45 for National Foods as a result of its disapproval of merger negotiations between National Foods and SPC Ardmona (the initial bid is discussed in NZ2022).

Industry observers are divided over the merits of Fonterra's decision, debating at what share price point the value of synergies would have been lost. Some argue that Fonterra should have been willing to pay more and has missed an important strategic opportunity, as merging with National Foods is the superior option to other potential investments involving dairy companies in Australia. Others state that Fonterra's actions prove that the cooperative's directors are unwilling to expand at any cost. All agree that Fonterra would have potentially developed superior synergies from a successful merger with National Foods than San Miguel will. Ownership of National Foods would have given Fonterra a dominant position in the Australian dairy industry and a stronger value-add business. This is vital to Fonterra's future expansion plans, as its own value-add business has been performing poorly in comparison to its commodity business.

Fonterra is now looking at other assets in Australia and potential joint ventures in Europe, Asia and North and South America. It is generally agreed among industry observers that it is vital for Fonterra to solidify its base in the Australasian market in order to facilitate its longer-term goal of aggressive expansion into Asia. Australia is still viewed by Fonterra as part of its domestic market and industry observers think it is likely that Fonterra will look at other potential takeover or joint venture targets in Australia following its failed takeover of National Foods and the additional capital available following its subsequent share sale. Industry observers generally agree that the Australian industry will undergo considerable consolidation during the next five to ten years. Fonterra has hinted at its desire to be part of this consolidation and its CEO, Andrew Ferrier, has stated that there are many benefits from New Zealand and Australian dairy industries working together in the future. He has also publicly stated the importance of Fonterra solidifying its Australasian base, in particular in chilled milk and yogurt markets. Analysts are divided over predicted potential options available to Fonterra. The two most commonly cited options currently include the purchase of all or part of Parmalat Australia, if the company's bankrupt Italian parent decides to sell the business, and purchasing part of the value-add business of Dairy Farmers, a farmer owned cooperative, if this part of the business is privatized.

With its bid of A\$ 6.40, San Miguel valued National Foods at A\$ 1.9 billion. It is paying 13.3 times historic earnings before interest, tax and depreciation for National Foods. This compares to the dairy average of 10.3 times and fast-moving consumer goods average multiple of 8.7 times. San Miguel was also rumored to be assessing the possibility of taking over New Zealand based Dairy Foods, although this is now considered unlikely following the National Foods purchase. Dairy Foods is Fonterra's main competitor in New Zealand's consumer dairy market. Fonterra will assess any opportunities to purchase divestments if Dairy Foods is sold to one of several multinational companies currently assessing whether to bid to takeover the company.

***Fonterra's Value-Add Strategy***

It was announced in April 2005 that Fonterra's consumer products arm, New Zealand Milk, would be renamed Fonterra brands. Under this strategy all Fonterra Brands packaging will carry the Fonterra corporate logo. Fonterra is hoping that by linking its consumer brands to its corporate name both will be strengthened in the eyes of consumers. Fonterra Brands will remain a separate financial entity to Fonterra.

In 2004 Fonterra hired Sanjay Khosla, formerly of Unilever, to head New Zealand Milk. New Zealand Milk has performed poorly since Fonterra's creation. Its success is important, as part of Fonterra's overall strategy is to increase and stabilize returns to farmers by increasing the emphasis on value-added products. Khosla is planning to greatly consolidate New Zealand Milk's 100 brands so that it can focus on those performing strongly. Following this, New Zealand Milk will assess markets and decide which brands to introduce into each, either through joint ventures or alone. It is planning to focus on a sustainable, steady approach, rather than high risk/high return ventures. Khosla is aiming to begin improving New Zealand Milk's financial returns by the end of 2006.

***Fonterra's Capital Structure***

Since Fonterra's creation in 2001, there has been ongoing debate over how the cooperative's capital structure can be improved. At a meeting held in May 2005, farmer-suppliers voted to change two aspects of Fonterra's capital structure. Contract milk supply will be introduced while peak notes and supply redemption rights have been replaced by a more simplified system. These changes are to be initiated in the 2005/06 season, reducing costs and administrative complexity in the supply system for farmers. Fonterra anticipates that its capital structure will again be reviewed in three to five years. Debate continues over the need for greater transparency between the commodity and value-added parts of Fonterra's business and whether the basic cooperative structure should be replaced.

Fonterra shareholders voted overwhelmingly in support of introducing contract milking. To be eligible for contract supply a farmer will be required to be an existing shareholder, with the number of shares required yet to be determined. Contracts of up to three years will be allocated by tender at a price determined by tender. By using contracts, farmers with an existing shareholding in Fonterra can tender for a contract as an alternative to purchasing additional shares for additional milk volume, as has been the situation. This is likely to increase New Zealand's milk production as both existing farmers and new farmers can potentially expand production for much lower cost. This will allow Fonterra to improve its economies of scale in production and marketing internationally. But it also may reduce the amount of capital that it receives from farmers to fund further expansion and may additionally motivate some farmers to sell a portion of their shareholdings, which Fonterra is obligated to buy back. Fonterra is proposing that up to 3 percent of its supply may come from contract milk in the system's first year of operation, rising to between 9 and 10 percent in the third year, with a set maximum of 15 percent.

The implementation of the contract system has been motivated by the continually increasing fair value share price, which is set annually by Fonterra. If the share price becomes too high it will deter increased production and may instead motivate farmers to 'cash-up' their shares and leave the dairy industry. This is problematic for Fonterra, as it needs to keep increasing its supply to meet global demand. The ability for farmers to 'cash-up' a portion of their shareholdings while maintaining supply levels to Fonterra may reduce the motivation to leave the industry completely as well as lower entry costs for new farmers.

Fonterra's farmer-suppliers also voted to eliminate its Peak Note system. It has now been replaced with a Capacity Charge. This new system seasonally adjusts the price of milk, with

farmers supplying a large proportion of their milk volume at peak receiving up to 3 cents per kg of milk solids less for the year. The aim of both this system and the peak notes system it replaces is to penalize farmers that have a 'steep peak' in production during the season, requiring excess capacity that is only used during this 'peak', while rewarding farmers that supply a steadier volume of product throughout the year. The aim is to motivate farmers to alter their management practices to produce a steadier milk flow throughout the season, allowing more efficient use of Fonterra's processing capacity. Under the peak notes system farmers were required to purchase peak notes equivalent to the extra volume of milk they produce during their 'production' peak. Unfortunately the system wasn't always equitable and was so complicated that most farmers did not understand it.

As part of the Peak Notes system, farmers simultaneously voted to have Supply Redemption Rights replaced with Excess Shares and Unshared Supply. Farmers are now able to hold 20 percent of their product volume in excess shares, allowing them to choose whether to surrender excess shares if production drops. They are also able to supply extra milk without purchasing the corresponding shares during a short-term seasonal increase. If the increase is repeated, however, shares must be purchased.

Although not voted on, Fonterra's overall capital structure was heavily debated during the meeting. Fonterra has repeatedly stated that it will remain a cooperative and will not require any external finance for the next 3 to 5 years. The cooperative states that the additional NZ\$ 200 million dollars it receives in additional equity annually, as a result of its supply base increasing on average 3 percent per year (farmers are required to buy shares for this additional production), is adequate for its foreseeable needs. The cooperative does not have plans to split its value-add business, New Zealand Milk, off or create the opportunity for external investment. Several industry observers have suggested the cooperative should do so, with shares either publicly tradable or restricted to farmer-suppliers. Fonterra is, however, assessing whether to make New Zealand Milk semi-autonomous to leave this as an option in the future and better communicate to farmers their return from the value add business. New Zealand Milk would be required to sign agreements to purchase ingredients from Fonterra the same as other external organizations.

Part of the debate relates to the inability of farmers to assess the value that Fonterra's value-add business creates for them as this proportion of their returns is not stated when they receive their payout. Fonterra's directors have suggested separate financial statements and reporting so farmers can see what proportion of their payouts were created from selling their product as a commodity versus from the value add business New Zealand Milk. Farmers have mixed views over whether their shareholdings should be invested in the higher risk/higher return consumer goods business of New Zealand Milk in an attempt to smooth the commodity cycle, or whether they should invest only in the commodity side of the business. This would free up capital that could be returned to them to invest at their own discretion.

Federated Farmers, an organization representing 18,500 farmers in New Zealand, published four papers discussing Fonterra's capital structure and some of the alternatives available in December 2004:

<http://www.fedfarm.org.nz/issues/Fonterra.html>

### ***Fonterra's International Operations***

Fonterra has sold its poorly performing business in Mexico to Sigma Alimentos. Fonterra states that although its Mexican operation, New Zealand Milk Mexico, was the market leader in Mexico's cheese market, it was in the wrong market segment and its size was neither niche enough to be effective nor big enough to have a strong enough market presence. The

Mexican dairy industry is highly fragmented and Fonterra was never going to be active in its consolidation with its emphasis on consolidation of the Australian dairy sector and expansion in China and other markets.

In South Africa, Fonterra is planning to form a joint venture called Clover Fonterra Ingredients with Clover SA, South Africa's largest dairy company. Clover SA has annual turnover of NZ\$ 1 billion, processing 30 percent of South Africa's milk production. Fonterra is planning to use the joint venture as a base to enter sub-Saharan Africa, while providing Clover SA with a year round supply of milk products. In Argentina, Fonterra has signed an agreement with SanCor Cooperatives Unidas Limitada (SanCor) in late 2004 to market and distribute SanCor's dairy ingredients outside Argentina. SanCor is Argentina's largest dairy cooperative. The products will be marked on behalf of SanCor under SanCor's brands. In another agreement, Fonterra completed a deal in early 2005 to sell cheese to Itoham, a Japanese food company. Itoham will import cheese from Fonterra to sell in supermarkets and other retail outlets in Japan.

### ***Fonterra Farmer Payouts***

Lower farmer production and the strong New Zealand dollar were offset by record high commodity prices during the 2004/05 season. Fonterra's final payout to its farmer-suppliers for the 2004/05 season will be announced at the end of May 2005. The current Fonterra estimate is NZ\$ 0.45 higher than the previous season at NZ\$ 4.50 per kg milk solids. The payout forecast for the 2004/05 season has so far been raised four times from the initial forecast of NZ\$ 3.50 per kg milk solids. The payout for the 2005/06 season is expected to be much lower as the 2004/05 season's strong exchange rate has been offset by Fonterra's 15 month rolling hedge policy, which saw the season's export revenue translated at approximately \$U.S. 62 cents, rather than the average exchange rate during that period of \$U.S. 72 cents. If the New Zealand dollar remains strong against the U.S. dollar, Fonterra will not have access to as favorable an exchange rate, reducing the payout to farmers.

### ***New Dairy Companies Operating in New Zealand***

A couple of small dairy companies targeting niche markets have emerged in New Zealand's dairy industry over the past 12 months. This is an important aspect of New Zealand's dairy industry as some industry observers were concerned that the creation of Fonterra in 2001 would eliminate the motivation for entrepreneurs to create new dairy ventures. To offset these fears, Fonterra is legally obligated to sell up to 50 million liters of milk per year to each of these manufacturers (up to a total of 400 million liters) at its cost price. In all cases the companies are taking advantage of this legislation as they build their businesses. In the long-term they are developing their own supply base to eliminate reliance on Fonterra.

The first of these two companies is Open Country Cheese, which began production in late 2004. This company's focus is producing cheese for food industry customers internationally. The company is valued at approximately NZ\$ 25 million and is experiencing positive sales levels.

In April 2005 corporate dairy farmer Synlait announced that it was planning to build its own milk processing plant in Canterbury, New Zealand, that will have the capacity to process 200 million liters per year. The company is aiming to supply dairy ingredients internationally to food manufacturers, with a focus on the rapidly growing function foods sector. Synlait is one of New Zealand's largest corporate dairy farmers with 8500 cows and NZ\$ 80 million of assets. Annually it produces approximately 45 million liters of milk. Although current production is less than half a percent of Fonterra's production levels, Synlait is aiming to produce 100 million liters by the time its plant is completed in 2007 and continue to expand

its supply base through ownership and contracts after that. As a small company Synlait is planning to have the flexibility to adapt herds and milk production to meet specific customer needs. The company also plans to provide customers with complete traceability from the farm to final consumer, something that larger processors such as Fonterra have difficulty achieving due to their focus on large-scale volume efficiencies.

There are several existing niche dairy product manufacturers operating in New Zealand. These include Gisborne Milk, Tussock Milk, Top Milk, Klondyke Dairies and Kapiti Fine Foods. There are also two cooperative dairy processors, Westland and Tatua, which collect from approximately 370 and 130 dairy farmer-suppliers each, targeting international market niches.

## **POLICY**

### ***Foot and Mouth Disease Hoax***

New Zealand's police responded on May 10, to a claimed deliberate release of foot and mouth disease on Waiheke Island, a short ferry ride from the city of Auckland. Although the threat has proven so far to be a hoax, New Zealand's Ministry of Agriculture and Forestry (MAF) have taken the threat seriously. Risk materials have been restricted from movement on and from the island, including live animals, hay, equipment used with animals, untreated products from animals, milk, cheese, meat, and wool. Agriculture, dominated by the dairy and meat industries, accounts for two-thirds of total New Zealand export value. New Zealand's Reserve Bank, estimates the cumulative loss in nominal GDP of an outbreak at \$6 billion after 1 year and \$10 billion after two years. At the time of submission of this report MAF was still in the process of confirming that the disease had not been released on the island, stating that it will not be officially cleared until May 23.

### ***Environmental Issues***

Environmental issues in relation to New Zealand's dairy industry have received a large amount of press coverage in the past 12 months. In particular, a report released by the Parliamentary Commissioner for the Environment looked at the impact that intensification of agriculture, particularly dairy farming, is having on the environment. Many industry observers agree that in the future consumer perceptions of New Zealand dairy farming practices, particularly in overseas markets, could greatly influence the ability to sell New Zealand dairy products. The report stated that intensive agriculture, and in particular dairying, is damaging New Zealand's soil and water quality. This is due to the rapid expansion of the use of nitrogen fertilizers, increased stocking rates and increased irrigation. The report calls for a redesign of New Zealand farming systems.

This report follows the implementation of the Clean Streams Accord in 2003 (see NZ3010). New Zealand dairy farmers are reported to be ahead of the targets set in the Accord, which aims to have dairy cows excluded from 50 percent of the streams, rivers and lakes on farms by 2007 and 90 percent by 2012. Fonterra suppliers have surpassed the 2007 target within the first year of implementation, with 67 percent of farmers either excluding stock from waterways or having no waterways on their farms. 99 percent of Fonterra's farmer-suppliers took part in voluntary environmental assessments of their farms in the first 12 months of the Accord's operation. At the time of implementation many farmers were angry that they were not actively consulted, arguing that the accord was unnecessary as most were already developing more environmentally friendly practices and that other regulations with similar goals were already in place.

**Ongoing Powdergate Inquiry**

In May 2005 the 'Powdergate' depositions hearing began. New Zealand's Serious Fraud Office (SFO) is prosecuting seven men that it accuses of conspiring to defraud the Dairy Board, Customs Service, Ministry of Agriculture and Kiwi Cooperative Dairy group (now part of Fonterra) between 1997 and 2001 (see NZ1042). The Powdergate scandal involved the export of over 7700 tons of dairy product worth nearly NZ\$ 45 million outside the New Zealand Dairy Board's monopoly during this period. If the Justices of the Peace hearing the case agree there is enough evidence to proceed, a full trial will be held in 2006.

**Potential Benefits of Recent and Potential Trade Agreements**

New Zealand and Thailand announced in December 2004 the conclusion of negotiations on a CEP. Both countries hope to have the legal text and schedules finalized and ready for signature in April, allowing implementation of the agreement on July 1, 2005. When implemented, 52 percent of New Zealand's exports to Thailand will become tariff-free, in comparison to the current 4 percent. A bilateral trade deal with Thailand, Southeast Asia's fastest growing economy, will provide a significant boost for New Zealand's dairy exports. Thailand already represents Fonterra's 10th largest export market and generated U.S.\$ 127 million (NZ\$ 192 million) of dairy export receipts in 2004. Tariffs on New Zealand infant milk formula, casein and lactose are to be eliminated on implementation of the agreement, while tariffs on yogurt, buttermilk, milk protein concentrate and butterfat are scheduled for removal in 2009. For whole milk powder, tariffs will reduce from 18 to 15 percent on implementation of the agreement, phasing to zero by 2020.

New Zealand, Australia and the Association of Southeast Asian Nations (ASEAN) began negotiations for a FTA in November 2004, with the first formal meeting held in February 2005. The parties agreed to aim for completion of negotiations in early 2007. ASEAN members already benefit from AFTA, a free trade zone among themselves. These negotiations build on AFTA-CER, a CEP between New Zealand, Australia and ASEAN formed in 2000. ASEAN is an important market for Fonterra as 20 percent of its production by value was exported to member countries in 2004.

New Zealand and Malaysia have completed their separate studies exploring the benefits of a FTA. Their respective governments are currently assessing the studies and FTA negotiations are expected to begin soon if approved by both parties. This process resulted from a bilateral meeting between the two countries at an ASEAN meeting in 2004. Dairy products valued at U.S.\$ 172 million (NZ\$ 260 million)<sup>1</sup> were exported to Malaysia in 2004.

New Zealand signed a bilateral 'goods market access' trade agreement with Russia in November 2003, the first Western country to do so. The deal is viewed as particularly beneficial for New Zealand's butter and sheep meat exports. New Zealand exported U.S.\$ 45 million (NZ\$ 70 million) of dairy products to Russia in 2004.

---

<sup>1</sup> Average exchange rate during 2004, NZ\$ 1 = U.S.\$ 0.664