

# **Before the Dairy Industry Advisory Committee**

**Statement of Paul Campbell, General Manager Strategy**

**Fonterra Co-Operative Group Ltd.**

**October 12, 2010**

## **The Impact of US Dairy Policy on International Trade**

Mr. Chairman, members of the Committee, my name is Paul Campbell. I am the General Manager Strategy for Fonterra, and am based in London, England. I have been with Fonterra since its formation in 2001. Before that I held a number of roles within Fonterra's legacy companies.

Fonterra has a significant presence in the U.S. with annual U.S. sales of over \$2 billion, and, with its partners, employing between 600 and 700 people. Its commitment to the US dairy industry is not as a trader but as a participant, having made and continuing to make substantial capital investments and technological innovations within the industry. Through its investments in the United States, Fonterra is able to source milk for the export of dairy products to markets such as Mexico, Asia, and the Middle East, which New Zealand will not be able to supply as world demand for dairy products grows.

I have appended to this submission my personal CV, along with a brief history and description of Fonterra.

I am pleased be here today to talk to you about the impact of US dairy policy on international trade. In this submission I will:

First, briefly recap the changes that have occurred in the structure of the international dairy trade that have led to the increasing importance of the US to that trade,

Second, review the opportunities that the further expansion of global demand for dairy present to exporting countries, particularly the US, and

Third, address the risks inherent in the trade and some steps that may be taken to mitigate those risks.

### **WHERE WE ARE NOW AND HOW WE GOT HERE**

Historically, the amount of dairy product traded internationally has been around just 7% of total world milk production. Thus, with 670 million metric tons of milk produced in 2008 globally traded dairy volume was about 45 million tons of milk equivalent, or 8.7 million tons of dairy product.

In 2008 the US produced about one-eighth of the world's milk, exported about 7% of that production, and was a current net exporter in both volume and value terms of dairy products,

with a dairy trade surplus of over \$700 million. Since 2003, in value terms US dairy exports have increased a remarkable 276 percent, US export quantities have more than doubled, and the US share of global dairy trade increased from 4.5% to 12%. By way of comparison, in 2008 New Zealand produced about 1/4<sup>th</sup> of the milk produced in the US and supplied around 28% of the internationally traded market.

While in 2009 US dairy export numbers suffered along with everyone else's, 2010 has shown a resumption of US export growth to record numbers. Significant increases in exports to Asia – which will be a recurring theme in this paper – have led to a 39 percent increase in total export volumes and a 69 percent increase in export value compared to year-ago levels.

Why has this happened? Well, several reasons. First, as just mentioned, increased demand, particularly in Asia, but also structural changes affecting the traditional dairy exporting industries in the EU and Australia. Reform of the Common Agriculture Policy (CAP) in the EU began in 2003 with cuts in price support for butter and SMP and the introduction of direct payment to milk producers, and has continued with the phasing out of milk production quotas starting in 2008. This has significantly reduced the role of the EU, once the dominant dairy exporter in international markets. Sustained drought in Australia has forced changes to that industry that have similarly affected their ability to export.

To put some real numbers to what has happened with these suppliers, in 2003 the EU produced 151 million tons of milk and supplied 36% of the international trade, while in 2008 production was 149 million tons and the EU share of the world market was 29%. For Australia, production dropped from 11 million tons in 2003 to 10 million tons in 2008, and its global market share declined from 11% to 8%.

The result is that these traditional exporters are just not available to meet increased demand in a meaningful way. This leads to the second point referenced above.

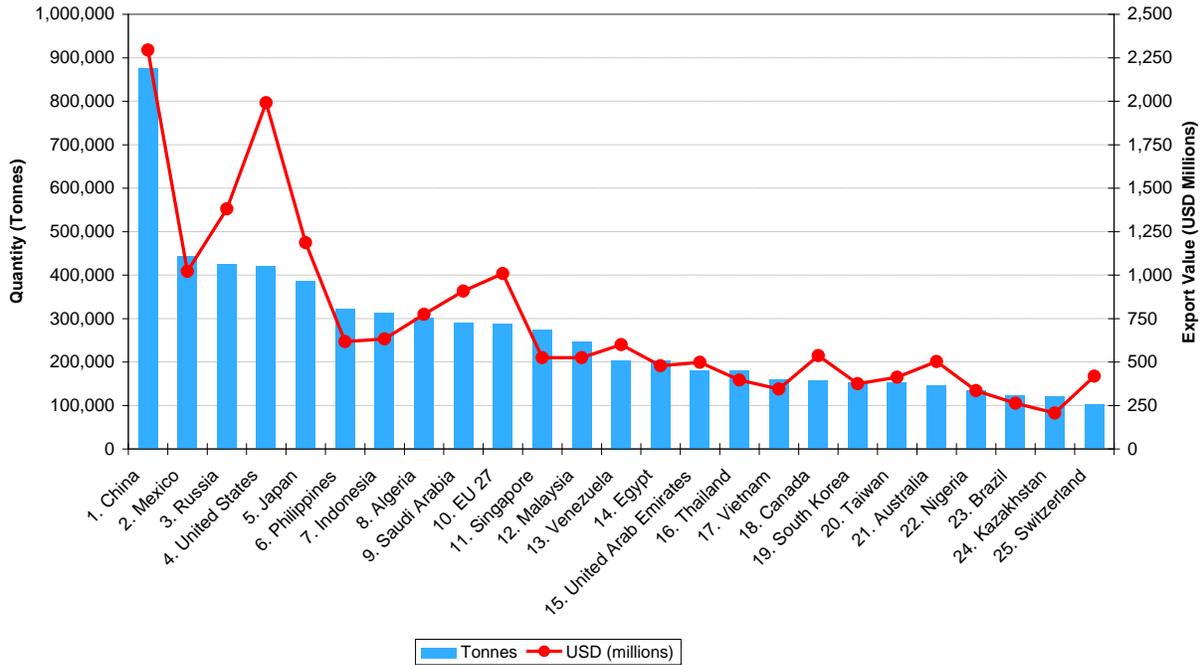
### **THE OPPORTUNITES FOR US DAIRY INHERENT IN INCREASED GLOBAL DEMAND FOR DAIRY PRODUCTS**

The OECD and UN Food and Agriculture Organization (FAO) recently projected that global dairy prices will be 16-45% higher in 2010-19 relative to 1997-2006. FAO stated: “[t]he dairy sector is expected to remain one of the fastest growing sectors . . . with strong potential as the popularity of dairy products rise mainly among developing country consumers and as demand rises with increasing affluence.”

These conclusions track the testimony in an earlier meeting of this Committee, when Tom Suber of the US Dairy Export Council discussed a study by the Innovation Center for US Dairy (often referred to as the Bain Study) that concludes that global demand for dairy products – particularly from Asia – will grow ahead of the capacity of Europe, Australia and New Zealand to create supply.

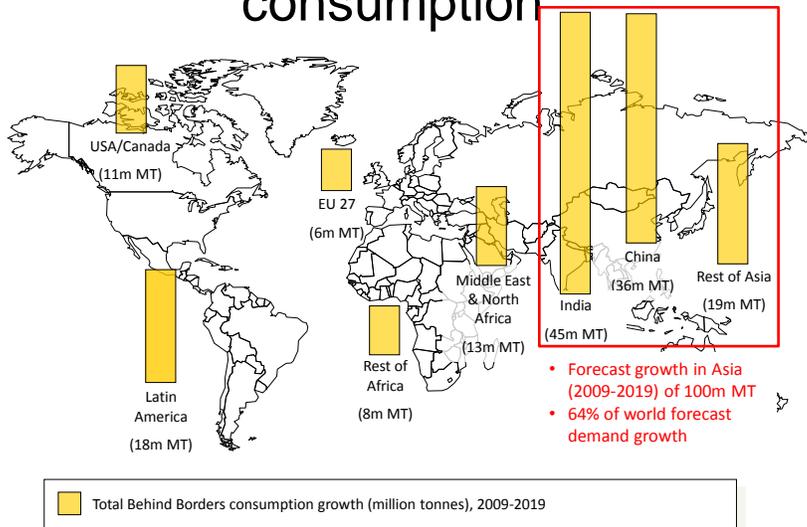
What do the real numbers tell us about that demand? From 2003 to 2008, total dairy product imports into Asia increased for 2.4 to 2.7 million tons, and even in the face of global recession jumped to 3.1 million tons in 2009. The emergence of China as the world's largest dairy importer is reflected in the following graph.

**2009 World Dairy Trade  
Top 25 Destinations**



Looking forward over the next ten years we project Asia to continue to lead the growth in dairy consumption.

## Asia leads forecast growth in dairy consumption



- Forecast growth in Asia (2009-2019) of 100m MT
- 64% of world forecast demand growth

Sources: Fonterra analysis. Milk Equivalent (ME) basis.

As a practical matter, this combination of increased demand and structural change in the dairy industries of traditional exporters has led to a convergence of US and international dairy prices. For example, in 2003 US butter prices were almost double the international price (\$2475/ton compared to \$1350/ton) while in 2010 the international price has at times exceeded the US price by nearly \$500/ton. The numbers for cheese are similar.

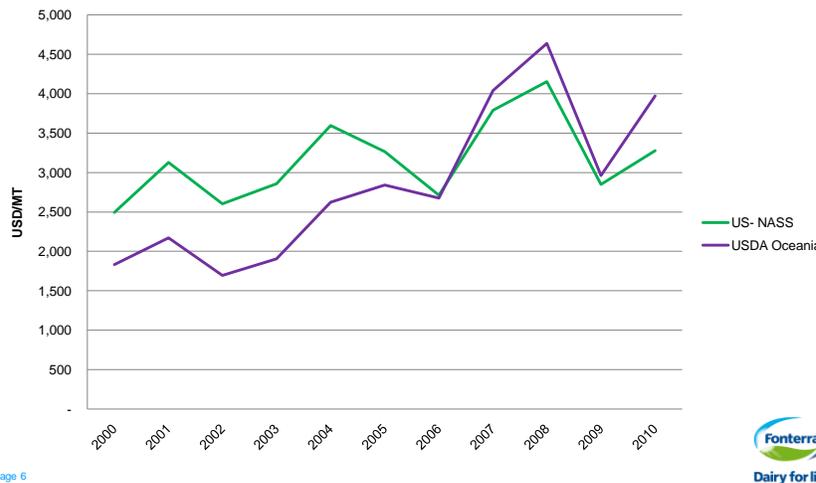
### Annual Butter Prices



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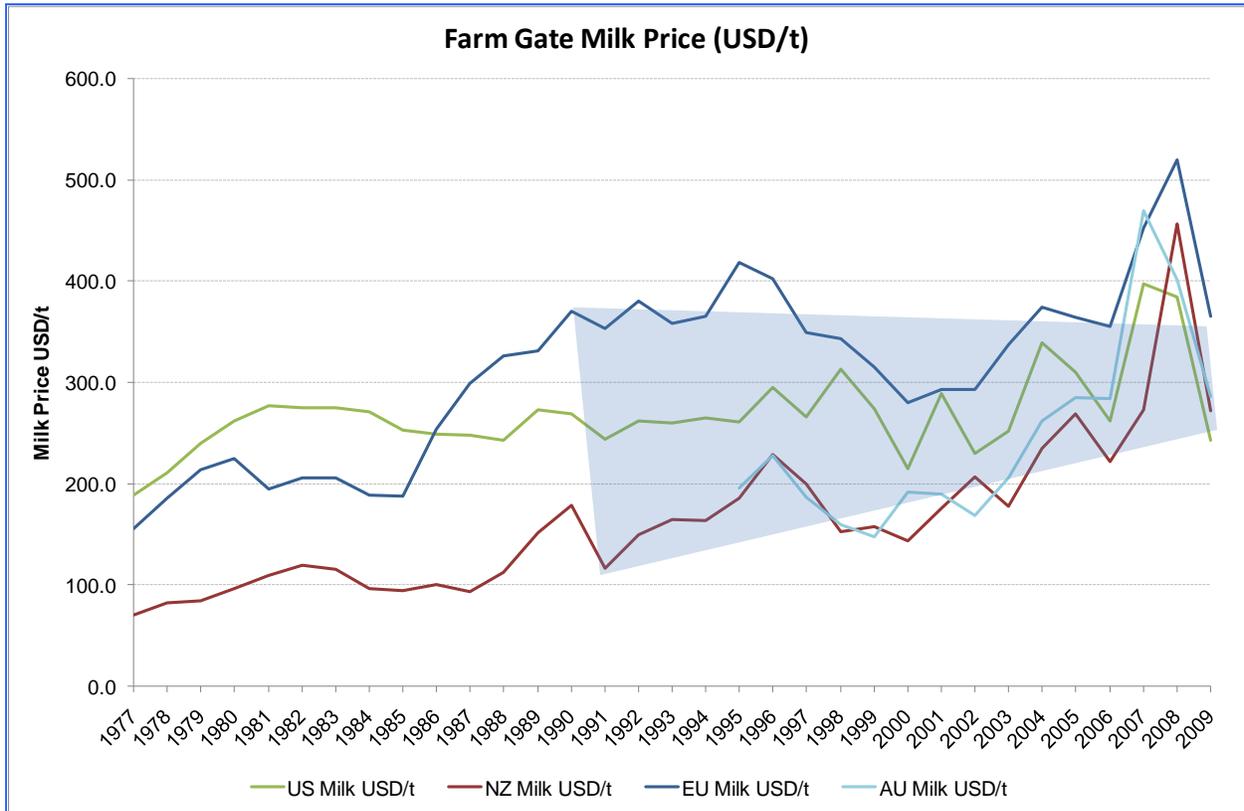
### Annual Cheese Prices



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It is as these prices converge that US dairy policy most clearly affects US competitiveness internationally. As can be seen in the chart below, the farm gate milk price received in the US, EU, Australia and New Zealand are coming closer and closer together. As this happens success internationally becomes a function of competitive advantage, which for the US includes its large scale, feed based, production system at the farm level, and in its intellectual property at the processing end. On the other end of the scale, a complex pricing or regulatory system for milk could make it harder for the US to respond to competition.



Fonterra believes the US dairy industry is well-positioned competitively (as well as geographically) to take advantage of this high growth potential. Given the efficiency and inherent scalability of its grain-based production system - scalability that NZ's pasture based dairy industry lacks – and the quality of U.S. dairy products, the US dairy industry is in an ideal position to fill the inevitable increase in demand for dairy, particularly in Asia.

We also agree with the Bain report's conclusion that to take full advantage of this projected demand gap, the US needs to move quickly and ambitiously to establish itself in these Asian markets, ahead of potential new global dairy players, such as the Ukraine and Brazil, who are likely to come into play in roughly a decade.

This will require a focus on U.S. export competitiveness and potentially some adjustments in U.S. dairy programs. We would suggest that any changes made to US dairy programs should allow market signals to work so that US producers have the incentive to manufacture the particular products that are required by export markets and provide sufficient regulatory certainty that investment in plant and IP is encouraged. Currently the EU Dairy industry is facing some

difficult challenges with, for example, uncertainty over the future regulatory environment around the interface between farmers/processors/retailers in addition to uncertainty around the allocation and size of direct support payments, under the Common Agricultural Policy, to dairy farmers in different member states. This uncertainty creates additional risk for all participants in the supply chain – making investments decisions for growth and innovation challenging for farmers and processors. Finally, we also know from hard experience that supplying international markets is not without risk, which leads to our third point.

### **RECOGNIZING AND MANAGING RISK**

It is well known to this Committee that in the past three years we have seen unprecedented volatility in domestic and global dairy markets. However, volatility need not threaten dairy producers or businesses if the right market based tools can evolve to help manage it in commodity prices. Priority should be given to improving market transparency so that buyers and sellers can discover, quickly, what is a fair market price, and so that market-based tools can be developed. The existence of well developed derivative markets for other agricultural commodities (e.g. sugar, coffee, wheat, corn, cocoa) demonstrate that it is possible to develop the same options for dairy. The lack of these tools puts dairy at a disadvantage to substitute products that have these tools available – encouraging processors to look beyond dairy to manage their risk profile.

Some tools already exist to help dairy producers and customers manage price volatility. For example, forward contracting is commonly used as a means of managing price risks, as dairy producers have long used forward contracts to purchase feed inputs and manage volatility in milk prices. Equally dairy processors and end-users use forward contracts to provide greater certainty about forward pricing, production and sales volumes. *globalDairyTrade*, discussed below, is also an example of buyers and sellers managing price risk through their desired mix of short and long term contracts.

In addition, futures markets have significant advantages over forward contracting. They provide liquidity, potentially lower transaction costs, transparent and readily available price information and the ability to hedge to offset financial risk in the market. Through futures and options a buyer or seller can know in advance what their hedged price will be at a future date, with more certainty than waiting to see what the cash market price will be.

For farmers, futures and options markets provide an opportunity to lock in their margins by hedging input costs such as feed (corn, soymeal), fertilizer (limited liquidity) and energy (heating oil, natural gas), as well as their revenues (milk price). Larger corporate US dairy farmers are doing this already through the CME.

Dairy processors are exposed to a number of risks related to market volatility, including rising input costs – particularly for milk, volatile sales prices and related changes in the value of inventory. Derivatives markets provide processors with the opportunity to manage these risks, for example to protect their sales price relative to input costs, lock in input costs or protect upside potential on forward contracted prices if the market price rises in the meantime.

Use of derivative instruments also gives processors more scope to provide certainty to suppliers as to future revenue (milk price), providing farmers with clear market signals to inform their production and investment decisions.

For end-users the advantage of derivatives is the ability to secure a measure of cost certainty where there is limited flexibility regarding output prices (e.g. fast food restaurants protecting their 'menu price'). A number of major dairy end-users already use commodity futures and options to hedge the price of certain commodity ingredients including dairy.

Finally, a number of futures exchanges (in addition to the CME, which is the most developed exchange for trading in dairy commodities) are in various stages of planning futures contracts for various dairy products. These include NYSE-Liffe and RMX. In addition, on October 8 the New Zealand Stock Exchange launched a cash settled futures contract for whole milk powder.

Looking forward, the goal for risk management in dairy is to manage a fundamental shift in the way that dairy markets function. It will take time for appropriate risk management tools to develop and to build the industry's confidence to use them. In order for these options to be effective the industry needs:

- Credible and transparent market reference prices
- Standardized contracts for key commodity products
- Exchanges with sufficient liquidity to attract buyers and sellers
- Tools covering a wide range of traded dairy commodities
- Widespread adoption of hedging practice
- A supportive policy environment with low transaction costs

A new tool that will be useful as an aid to managing risk for all market participants is *globalDairyTrade*, a global trading exchange for dairy products created by Fonterra in an effort to provide a price discovery mechanism in the international dairy market and bring greater transparency to the world market. In brief, *globalDairyTrade* events are managed by an independent trading manager, not Fonterra itself, with bidders around the globe competing for the same product, at the same time, via the internet, in an ascending price clock auction.

A long term goal of Fonterra's *globalDairyTrade* is to serve as a reference price for the development of futures contracts and other derivative instruments. It provides a transparent and credible market price for WMP, AMF and SMP based on actual contracts. By offering three contract maturities for each product *globalDairyTrade* also provides a means of discovering forward prices.

*globalDairyTrade* will continue to evolve as an independent and neutral platform for Fonterra and other suppliers to use as one of their core sales channels for offering commodity dairy products to customers. It is capable of managing a wide range of products, suppliers, source regions and customers simultaneously.