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## BRIEFING ON GLOBALDAIRYTRADE

<b>Date:</b>	24 June 2008	<b>Priority:</b>	Medium
<b>Security Level:</b>	Commercial-in-Confidence	<b>Document Number:</b>	<b>B08-717</b>

### Action sought

Minister	Action sought	Deadline
Minister of Agriculture	Note the contents of this brief; and  Indicate how you prefer to respond to media criticism of Fonterra's globalDairyTrade auction.	25 June 2009

<b>Does the paper have financial implications?</b>	No
<b>Risks</b>	N/A
<b>Level of Risk</b>	N/A

### Ministry Contacts

	Name	Position	First Contact	Telephone	
				(work)	(after hours)
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## BRIEFING ON GLOBALDAIRYTRADE

### Purpose

1. *This brief provides you with background information on Fonterra's globalDairyTrade auction. It also outlines a range of options that could be taken to address the media and market commentary about globalDairyTrade.*
2. *You are also meeting Fonterra's [WITHHELD UNDER s9(2)(a)] on Thursday 25 June 2009. Officials have requested that a senior Fonterra representative be made available to provide you with Fonterra's views on globalDairyTrade.*

### Key Points

3. In July 2008, Fonterra launched an internet-based trading platform, globalDairyTrade (gDT), which it uses to sell a portion of its whole milk powder (WMP) product.
4. Fonterra views gDT as crucial to the company's future, as it:
  - a) provides a simple and efficient mechanism for discovering a competitive market price for WMP, which also provides a transparent reference point for deriving Fonterra's milk price paid to farmers;
  - b) enables Fonterra's customers to better manage their price risks, especially as a futures market develops;<sup>1</sup> and
  - c) presents Fonterra with a strategic opportunity regarding the development of what could easily become a global dairy product exchange.
5. Since its launch, gDT has attracted negative attention from both international and domestic commentators, with domestic critics (i.e. Lachlan McKenzie, Federated Farmers and Fran O'Sullivan, NZ Herald) demanding:
  - a) Fonterra commissions an independent review of gDT, and
  - b) the Government to express a position on gDT.

The result is that Fonterra is in the inevitable position whereby gDT is presumed "guilty until proven innocent". This is an undesirable situation and could warrant either MAF or Ministerial comment/intervention. This is an issue that officials are keen to seek your views on and is potentially an issue you could raise with [WITHHELD UNDER s9(2)(a)]. Some options are outlined in the body of the paper.

6. MAF strongly supports gDT and considers that an auction system can be instrumental in discovering a competitive market price. Based on MAF's internal analysis and the comparative analysis conducted by NZX Agrifax, officials are highly sceptical of the allegations that gDT may have adversely influenced international dairy prices.

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<sup>1</sup> NZX are developing a WMP futures trading platform.

## Recommendations

7. We recommend that you:

a) **Note** the contents of this report.

**Noted**

b) **Discuss** with officials your preferred approach for managing down some of the negative commentary regarding gDT.

**Discuss/not required**

Peter Fraser  
Principal Advisor  
Sector Performance Policy

Hon David Carter  
Minister of Agriculture

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## BACKGROUND AND ANALYSIS

### Background

1. In July 2008, Fonterra launched an internet-based trading platform, gDT, which it uses to sell a portion (between 25 and 31 percent) of its whole milk powder (WMP) for future delivery. The balance of Fonterra's WMP and the company's other products continue to be sold via the traditional means of direct and closed negotiations with individual buyers.
2. In effect, gDT forward sells some of Fonterra's WMP, as do negotiated forward sales, but does so via a different sales channel.
3. Fonterra's decision to establish an auction platform was driven by:
  - a) **Customer demand** – large buyers of dairy products are actively looking for risk management tools that would assist them in managing exposure to price volatility. An auction system delivers a transparent reference price, which enables Fonterra's customers to better manage their price risks, especially as the financial instruments market develops. Indeed, NZX is currently developing a WMP futures markets.
  - b) **Transparency around milk price** – an auction price for WMP provides a transparent reference point for Fonterra's milk pricing formula, used to derive the domestic milk component of the Fonterra payout.
  - c) **Reduced transaction costs** – an auction provides for a simple and efficient way to discover the maximum price that buyers are willing to pay, regardless of market conditions at the time.
  - d) **Strategic opportunity** - Fonterra considers that the move towards more open and transparent dairy commodity market (rather than negotiations behind closed doors) is inevitable. Fonterra therefore sees gDT as a strategic opportunity regarding the development of what could become an exchange.
4. In the future, Fonterra plans to deepen and extend gDT by:
  - a) increasing the volume of WMP sold,
  - b) making more products available for sale via the auction, and
  - c) encouraging other firms to sell dairy commodities via gDT.
5. gDT was developed and is operated by an independent US-based manager, CRA International, which is recognised as a world-class operator in the field.

## Analysis

### *Criticism of global Dairy Trade*

6. The launch of gDT in July 2008 coincided with the peak of dairy prices, which subsequently fell sharply, as the global financial crisis unravelled. This triggered negative market and media commentary on the effect of gDT on international dairy prices. Indeed, with hindsight, the timing of the launch was extremely unfortunate.
7. The following claims were reflected in the media:
  - a) Concerns by Fonterra's international competitors that gDT **caused the decline in international dairy prices**. This argument was cited by EU representatives as a justification to reintroduce dairy subsidies; an action that has since been followed by the US.
  - b) Concerns by local commentators that by introducing a spot market Fonterra **accelerated the decline in the international prices**. This was based on the argument that **price transparency is not advantageous to the seller in a declining market**. These views were publicly expressed by Lachlan McKenzie (Dairy Section of Federated Farmers)<sup>2</sup>, Craig Norgate (ex Fonterra CEO) and Wyatt Creech (former Deputy Prime Minister and currently the Chairman of Open Country Cheese).
  - c) Whether the design of the auction is such that it makes gDT **easily gamed** (although it is unclear by whom and for what purpose) has also been raised by a senior NZ Herald journalist, Fran O'Sullivan.
8. Mr McKenzie has repeatedly (and publicly) called on Fonterra to commission an independent review of gDT whereas Fran O'Sullivan called on the Government to express its position on the auction (26 February 2009, 31 May 2009).

### *Fonterra's actions to date*

9. Fonterra issued several statements disputing media claims that gDT was somehow responsible for the decline in international dairy prices.
10. Fonterra has not commissioned an independent review of gDT, and officials understand that it is unlikely to do so, because:
  - a) any review commissioned by Fonterra is unlikely to be viewed as independent;
  - b) such review would be effectively second-guessing Fonterra's business strategy, thus setting an unhelpful precedent for the future; and

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<sup>2</sup> It is important to note that there is a degree of inconsistency within Federated Farmers as its president, Don Nicolson, when commenting on the US dairy subsidies, stated that Fonterra is not in the position to influence international prices.

- c) the mere fact that gDT is being reviewed may undermine market confidence of the platform's long term viability, which in itself may lead to gaming behaviour.

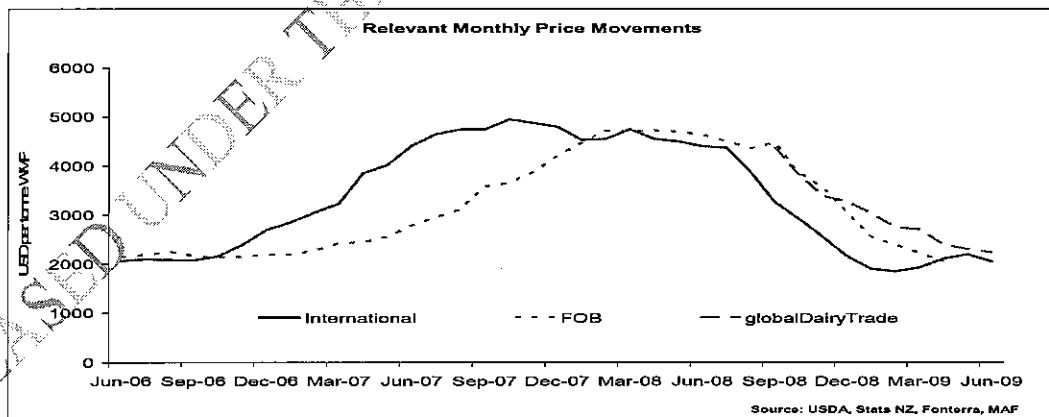
#### *MAF's view on auctions*

11. As a matter of principle, MAF considers that an auction process can be a useful way to discover a competitive market price, as it:
  - a) Provides a **simple and efficient** means of allocating resources to the highest value use.
  - b) Provides a **reference price** and assures **price transparency**. An auction makes pricing data that is often used in bilateral contracts (indeed, it is increasingly common for contracts to have 'most favoured nation'-type clauses whereby the contract price is the lowest price offered).
  - c) Action platforms, while typically starting as short term product markets, can **evolve into an exchange** where an instruments market complements the product market.
12. The key point is that a well designed auction discovers market prices rather than setting them. The purpose of an auction, therefore, is to **discover a competitive price** at any given point in time, regardless of market conditions at that time.
13. The argument that a seller should only operate a spot market when prices are rising is both short sighted and naive. In addition to assuming that buyers will accept such a proposition and do so without changing their behaviour, it fundamentally misses the point that a well designed auction provides value to both buyers and sellers by allowing them to manage and trade risk. In this sense dairy products are no different from any other hard or soft commodity.

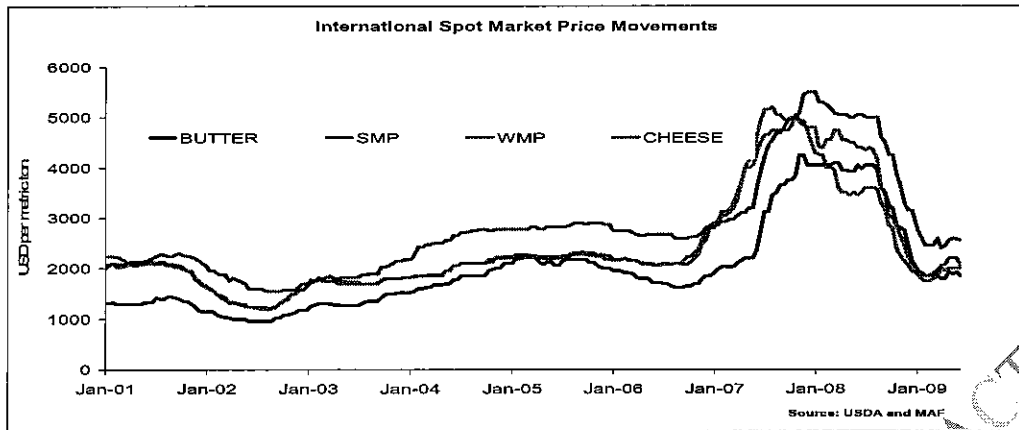
#### *MAF's views on gDT*

14. MAF strongly supports the gDT initiative, and is highly sceptical of the suggestions that gDT can be responsible for adverse shifts in international prices (indeed, this view is also shared by Brendan O'Donovan – Chief Economist at Westpac, and expressed in The Press on 7 January 2009). This position is based on the following factors:
  - a) Although a significant player in the cross-border dairy trade business, **Fonterra does not possess market power in the world dairy market**. Cross-border dairy trade accounts for only 6% of world's dairy production, and while Fonterra has over 30% share in the cross-border trade, this represents only 2% of the world dairy production. This is hardly a position of market dominance.

- b) **gDT is just one sales channel in the global market.** The amount of product currently sold via gDT is not significant in terms of both New Zealand's total WMP exports (approximately 25%) and more importantly of world WMP production (approximately 3.7%). Again, the volumes traded are hardly significant enough to cause an overall price movement.
- c) There is a number of **strong economic factors that are behind the price falls** for dairy products, including:
- (1) increased domestic milk production in such markets as Asia, the EU and US, as a response to high world prices;
  - (2) increased supply of NZ and Australian milk, as both countries recover from drought;
  - (3) reduced global demand, due to higher prices and credit restrictions driven by the global financial crisis; and
  - (4) the EU and US government interventions.
15. **MAF's data analysis reinforces our views gDT is not a negative influence on international dairy markets.** The first graph (see below) maps international spot market prices, FOB prices of WMP (which reflect prices of forward sales) and gDT prices (which are a subset of FOB prices). MAF conducted some rudimentary econometric analysis of this data. While there is insufficient data to be precise about causality with respect to gDT and spot prices (though this will improve over time) initial results do not support the claims that gDT either caused prices to fall or increased volatility. An interesting observation is that, for Fonterra, prices achieved via gDT have somewhat cushioned FOB price falls.

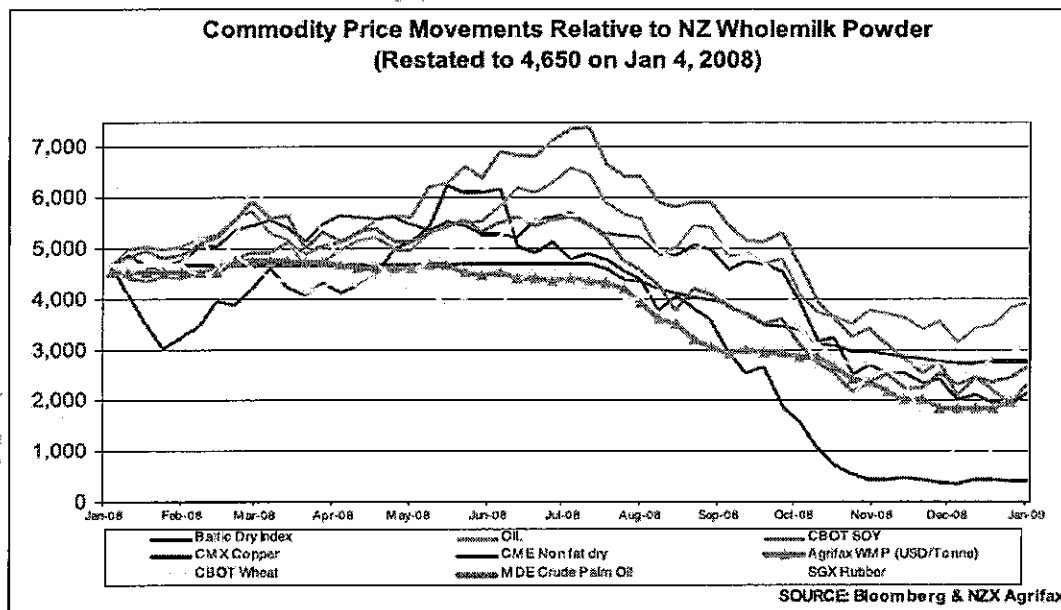


There is also evidence, as demonstrated by the graph below, that dairy commodities, other than WMP (e.g. skim milk powder, butter, cheese) **not** traded on gDT have all experienced similar spot price falls.



*NZX Agrifax's analysis of global Dairy Trade*

16. Agrifax (subsidiary of NZX Limited) is a commercial information service that provides an independent source of export trends, pricing and data services across New Zealand's agricultural sector at both the farm gate and the overseas marketplace.
17. In January 2009, Agrifax produced a report on gDT, attributing the fall in commodity prices to the dramatic decline in consumer demand, not the introduction of gDT. Agrifax's report is appended to this brief.
18. Analysis by NZX Agrifax confirms MAF's views and shows a general downward trend in many leading world commodities, including dairy.



19. Agrifax records the increased uncertainty caused by the credit crisis in the second half of 2008 having a severe impact on world demand with prices for leading commodities, including WMP, sharply falling away. Interestingly, WMP peak prices were at relatively lower levels than most other commodities, and also have shown much less volatility.

*MAF's actions to date*

20. As noted above, increasingly strident demands for Fonterra to conduct an review of gDT places Fonterra in the inevitable position that the platform is essentially "guilty until proven innocent"; yet because any review commissioned by Fonterra is unlikely to be credible such a review is largely pointless.
21. The comparative and econometric analysis outlined above is consistent with a "not guilty" verdict and this finding will become more certain over time as the quantity of data improves.

[WITHHELD UNDER s9(2)(d)]

22. Given the strident nature of the criticism levelled against gDT – especially given the international trade angles – MAF decided to commission what is essentially would have been a 'warrant of fitness' check in February 2009. However, given the recovery in dairy prices that occurred in April this was postponed until June in order to ensure that the reviewers had at least a full year's worth of data.
23. MAF envisaged a two-stage project – stage one would be the 'check' conducted by a specialised economic consulting firm, with the second stage being a peer review of the report by an internationally renown expert (MAF has a short list that included a Nobel laureate and prospective laureates).
24. Conversations with the consultancies resumed early June 2009,

[WITHHELD UNDER s9(2)(d)]

25. [WITHHELD UNDER s9(2)(d)]

*Next steps*

26. [WITHHELD UNDER s9(2)(g)(i), s9(2)(d) and s9(2)(j)]

27. There are other options that could help de-escalate the situation. Two options are outlined for your consideration:

- a) A public release or comment – either by yourself or MAF regarding gDT could be made. Given gDT is held monthly a follow up to the July or August auction is appropriate; and/or
- b) An approach is made by either yourself or MAF to Lachlan McKenzie of Federated Farmers offering to make available the MAF information regarding gDT [WITHHELD UNDER s9(2)(g)(i)]

Such an approach could also be useful in appraising Mr McKenzie that his continued demands for a review [WITHHELD UNDER s9(2)(g)(i)] are also inconsistent with the arguments Mr Don Nicholson, National President, has recently made in the Wall Street Journal regarding dairy protectionism (indeed, this very point was noted in Fran O'Sullivan's article of 31 May 2009). Closing this issue is therefore in everyone's interest.

28. Given that neither Wyatt Creech nor Craig Norgate have renewed their criticisms of gDT an approach to either party is considered unnecessary.
29. Officials are keen to discuss these matters further with you.

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