

Fonterra's participation in the farmgate milk market in Australia

1. INTRODUCTION

Fonterra is pleased to provide this information on its business activities in Australia and the structure and operations of the farmgate market for milk in Australia.

2. BACKGROUND

2.1 The Fonterra Group

Fonterra is a New Zealand based dairy cooperative and a leading food producer in Australia and New Zealand. Fonterra's Australian business has evolved rapidly in recent years to include world class manufacturing sites, strong domestic ingredients and consumer businesses, and export operations. This growth has been backed by investments of approximately \$2 billion.

Fonterra's operations in Australia are primarily undertaken by two companies, Fonterra Australia Pty Ltd ("Fonterra Australia") and Fonterra Brands (Australia) Pty Ltd ("Fonterra Brands"). The majority of the milk collection, milk processing and manufacturing is undertaken by Fonterra Australia, while our consumer dairy products business is operated by Fonterra Brands.

Fonterra operates 12 dairy manufacturing sites located in regional areas in Australia and employs more than 2,000 people. Each year, we collect 1.8 billion litres of milk, which represents around 20 per cent of total Australian production. We collect this milk from approximately 1,500 milk suppliers in Victoria, Tasmania, Western Australia (WA) and New South Wales (NSW).

In Australia, Fonterra is a leading producer of cheese, yoghurt, dairy desserts and dairy spreads. The company also operates regional fresh milk businesses in WA, NSW and southern Queensland, although we represent less than five per cent of the fresh milk market in Australia.

Fonterra Brands markets some of the country's leading dairy brands such as Ski, Mainland, Perfect Italiano, Nestle Diet, Western Star and Brownes. Fonterra is a wholesaler only for these products. Consumers purchase them through a variety of retail channels, such as supermarkets, convenience stores, cafes and restaurants.

While Fonterra Brands is a very important part of our business, the majority of milk we collect is used to produce bulk dairy commodities, such as milk powders, dairy based fats and proteins, and bulk cheese and butter. These dairy ingredients are sold to leading food and nutrition companies both domestically and in export markets.

2.2 Australian dairy industry

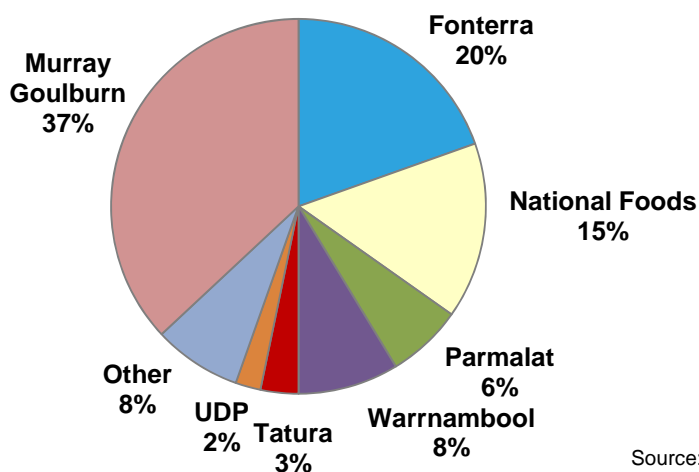
The Australian dairy industry is a well established, large and diverse sector. More than nine billion litres of milk are produced annually in Australia by up to 8,000 farmers. This milk is used in numerous products and sold in a variety of markets.

Milk is a key ingredient in a range of consumer products, including fresh products like drinking milk, custards, yoghurts and dairy desserts, as well as products with a longer shelf life, such as cheese, butter, UHT milk and milk powders. It is also used to produce bulk ingredients such as milk powders, proteins, fats and oils for food and nutrition companies.

This diverse range of processed dairy products is manufactured by a number of different companies in Australia, each with their particular specialties and business priorities. For example, Fonterra is the largest cheese and dairy spreads producer in Australia, Murray Goulburn is Australia’s largest manufacturer of milk powders, and National Foods and Parmalat are the major players in the consumer fresh milk market.

These different companies compete in the national farmgate milk market for the raw milk they need to manufacture their end-products. This market is highly competitive as each company needs a secure supply of high quality milk to manufacture their particular suite of dairy-based products.

Chart 1. Australian industry by milk volume (2008-09)



Source: Dairy Australia

The Australian industry is integrated into the global dairy market. Not only does more than a third of the industry’s revenue come from export sales, but local food companies purchase dairy commodities in a globally competitive environment.

Therefore, global dairy commodity prices have a major impact on the Australian industry. As Dairy Australia has stated: “Australian dairy farmers operate in a deregulated and open market; the only government involvement being in the administration of food standards and food safety assurance systems. Consequently, international prices are the major factor determining the price received by farmers for their milk.”

3. MILK SUPPLY

3.1 Farmgate milk purchases

The various companies competing for milk supply from Australian dairy farmers each offer different pricing mechanisms and options, including short and long-term contracts, cooperative arrangements and agency agreements. These different pricing options reflect

the business needs of the dairy companies in terms of the volume, quality composition and seasonality of their raw milk inputs.

The range of pricing mechanisms also reflects the different corporate structures of the companies involved (for example, cooperatives versus public companies versus private companies) and the historic regulated separation between market and manufacturing milk in Australia. Fonterra's milk supply arrangements in Australia differ from those in New Zealand, where we operate as a cooperative and suppliers need to be shareholders.

3.2 Fonterra supply arrangements

Fonterra's 1,500 Australian farmer suppliers are paid on the basis of the yield of butterfat and protein in the milk they supply to the company. This is due to the fact that butterfat and protein are the key elements to Fonterra's manufacturing business.

As a result, we do not offer farmers a price based on volume (i.e. cents per litre), but rather in dollars per kilogram of milk solids (i.e. the combination of butterfat and protein). This means there is no one single Fonterra farmgate milk price, but rather each supplier receives a price based on the quality composition of the milk they produce.

At the beginning of each financial year we write to our suppliers detailing our monthly prices for the coming season. These milk prices reflect the returns we receive for our dairy products on domestic and international markets. Fonterra operates three sets of prices in Australia: one that is available equally to all Victorian and Tasmanian suppliers, and then a different set of prices for farmers that supply our regional fresh milk businesses in WA and NSW.

The prices change each month in line with the seasonal milk production curve. In southern Australia, dairy farms generally have the lowest milk production costs and the highest productivity in spring, while the on-farm costs of producing milk are highest in autumn and winter. In order to utilise our dairy manufacturing assets throughout the year and offer security of product supply to our customers, Fonterra offers higher prices outside of the spring months to provide a production incentive to suppliers.

For Victorian and Tasmanian farmers supplying manufacturing companies like Fonterra, the opening price at the beginning of the financial year has historically been a conservative estimate of the expected market returns. Then prices have usually increased incrementally across the season with what is known in the industry as 'step-ups' (farmgate milk price increases backdated to the beginning of the financial year).

Fonterra's WA and NSW suppliers generally do not receive step-ups, although their prices are traditionally higher than the Victorian and Tasmanian prices in line with the focus on fresh milk products and the domestic market of our manufacturing sites in these states.

While the step-up process has been the norm in south-east Australia, in 2008-09 an unprecedented mid-season downward price adjustment occurred due to the global financial crisis and the associated collapse in commodity prices. To date in 2009-10, the milk price system has returned to more normal conditions, with Fonterra announcing our first step-up in September of this year.

3.3 Bonlac Supply Company supply agreement

Like most manufacturing dairy companies, our suppliers are generally not subject to long-term milk supply contracts. Suppliers are able to move to alternative companies if they

choose after a notice period. They also have the flexibility to alter their supply arrangements to Fonterra (e.g. to not supply during certain days or for weeks or months at a time).

Rather than operate under an individual contract, the majority of Fonterra's suppliers are members of the Bonlac Supply Company ("BSC") and come under the formal supply agreement between BSC and Fonterra.

BSC is owned by more than 1,300 dairy farmers who supply Fonterra. The company operates on cooperative principles and acts as a collective group for negotiating prices with Fonterra and as an agent for supplying milk to Fonterra in Victoria and Tasmania (where more than 90 per cent of our milk is sourced). BSC also has an investment in Fonterra's Australian operations through Unsecured Capital Notes.

In 2005, Fonterra and BSC entered into a nine year supply agreement. Under this agreement, we are obliged to purchase all milk from BSC shareholders that meets minimum quality standards and to offer a uniform competitive price for this milk.

The agreement includes a commitment from Fonterra to pay its suppliers a competitive price based on a minimum bundled return calculated against the prices offered by the major dairy cooperative in Victoria. In the year ending 30 June 2009, Fonterra's payments to farmers exceeded this minimum bundled return by \$28 million.

This agreement does not lock farmers into supplying Fonterra; however it does offer farmers the security of having a guaranteed buyer at a competitive price. It also means any farmer who chooses to invest in growing their business can do so confident there will be a buyer for their milk.

The BSC supply agreement guarantees our Tasmanian suppliers receive the same price as their Victorian counterparts (subject to minor standardisation for additional operating costs). As the Victorian farmgate milk market is the most competitive in Australia, this introduces an important competitive dynamic into the Tasmanian industry.

4. COMMODITY MARKETS

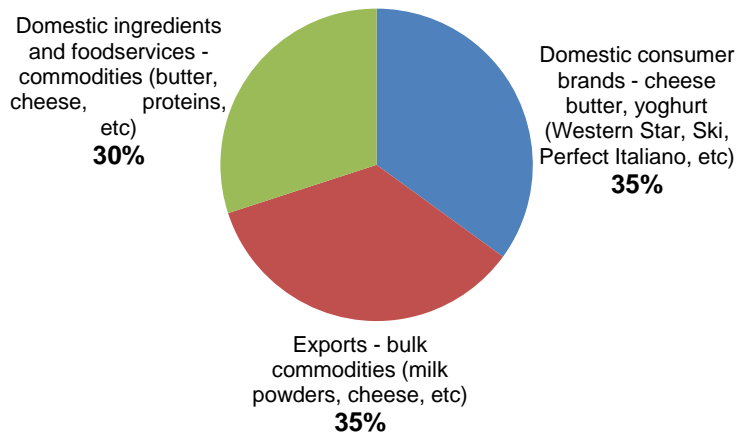
4.1 Farmgate milk price and commodity prices

Fonterra's business is based on dairy manufacturing and around two-thirds of the milk we collect in Australia is manufactured into products sold on dairy commodity markets.

These dairy commodity markets are highly competitive and truly global. Trades occur every day and involve some of the largest food companies in the world. Even local commodity sales involve competition against international dairy producers.

In addition, contracts for bulk dairy commodities, both domestic and international, are written in United States (US) dollars.

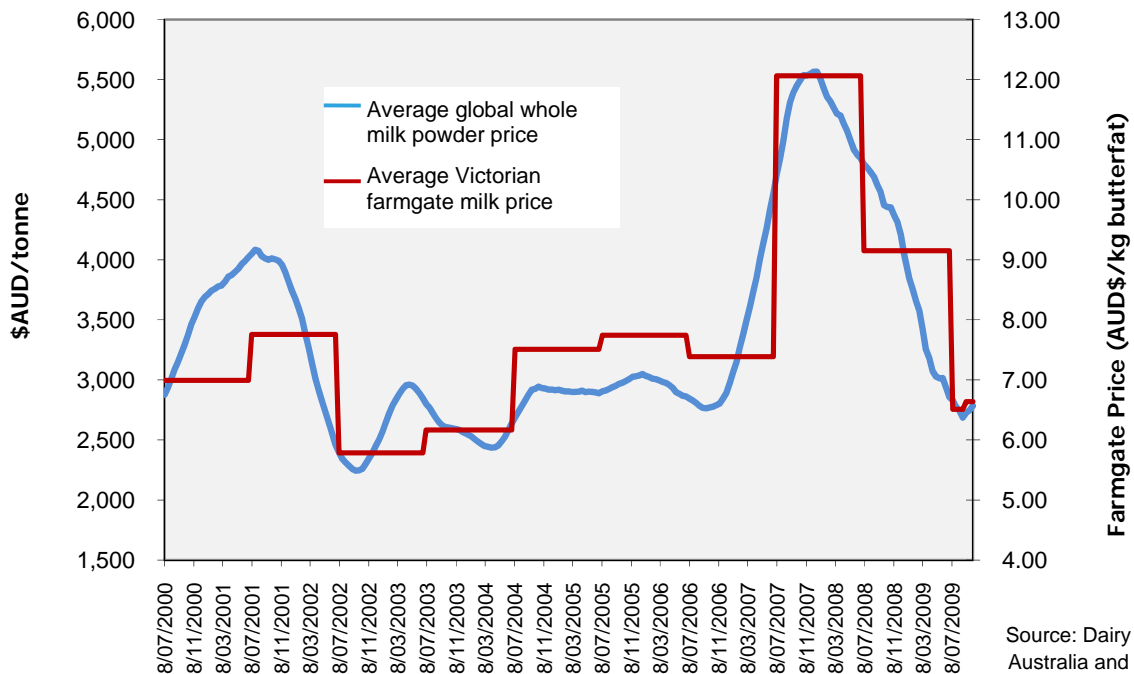
Chart 2. Fonterra's milk usage in Australia



Source: Fonterra

With this exposure to commodities, the returns we receive on commodity markets determine the farmgate prices we can offer suppliers. This is true for most of the industry in Victoria and Tasmania. Chart 3 shows the correlation between global commodity prices and the farmgate milk price in Victoria over the past decade.

Chart 3. Commodity Pricing and Farm Gate Price



Source: Dairy Australia and Fonterra

Dairy commodity markets have experienced extreme volatility over the past two to three years and this has been reflected in the Australian farmgate milk price.

In late 2006 and 2007 a combination of strong global economic conditions, low dairy stock levels and some supply constraints caused dairy prices to increase dramatically. Over a 12 month period, commodity prices more than doubled, with milk powder prices increasing from US\$2,500 per tonne to around US\$5,500 per tonne.

In 2008, the global financial crisis began to impact the global dairy market and prices for most agricultural commodities collapsed. In 2008, dairy commodity prices fell steadily back to pre-2007 levels, a price drop of more than 50%. Farmgate milk prices tracked the global boom upwards and with the global financial crisis have fallen across-the-board in much of 2008 and 2009.

Another important factor that has impacted farmgate milk prices has been the recent strength of the Australian dollar. Bulk dairy commodity contracts, including sales within Australia, are denominated in US dollars. The recent strength of the Australian dollar relative to the US currency has therefore reduced the returns achieved by dairy companies and affected farmgate milk prices.

4.2 Impact of current prices

This recent period of instability in global commodity markets and a weak US currency has been difficult for the entire dairy industry to manage. Like most companies, Fonterra has been affected by the global recession. We have implemented an active program to reduce costs and streamline operations in response to the reduction in global demand for dairy products.

Undoubtedly, Australian dairy farmers have also been impacted by the global recession, having experienced a period of unprecedented farmgate price volatility. The challenges posed by this price volatility have been exacerbated by the severe drought that has affected large parts of the industry, especially the lower Murray-Darling Basin, in recent years.

While many farmers have been challenged by the difficult market and environmental conditions, we have not experienced a significant number of exits from the industry among our supplier base. Fonterra supplier numbers are holding up well across Australia and we have picked up a number of new suppliers since the beginning of the 2009-10 financial year.

Fortunately, the first quarter of the 2009-10 financial year has seen some stability return to the market and commodity prices have improved as demand has returned. As a result, Fonterra was able to increase the farmgate milk price for all our suppliers on the east coast in September this year. However, the opportunity for farmers to share in the improvement in commodity markets is currently being limited by the strength of the Australian currency.

While there are some positive signs of recovery, we are acutely aware of the difficult business conditions continuing to be faced by our suppliers, especially in the drought affected lower Murray-Darling Basin and in Tasmania where high rainfall levels have caused flooding and other damage.

4.3 Fonterra in Tasmania

Fonterra collects more than 450 million litres of milk per annum in Tasmania from around 300 dairy farmers. This makes Fonterra the largest raw milk buyer in the state. This milk is processed into cheese, butter, milk powder and other dairy commodities at our manufacturing sites in Spreyton and Wynyard. The vast majority (more than 90 per cent) of the dairy

products manufactured at Spreyton and Wynyard are sold outside of the state, either on mainland Australia or in international markets.

All Fonterra's suppliers in Tasmania are BSC shareholders and their milk sales to Fonterra are covered by the BSC supply agreement. This means Fonterra is obliged to purchase all the milk produced by Tasmanian BSC shareholders and to offer these suppliers an equivalent milk price to the Victorian farmgate price.

At present, our two manufacturing sites in Tasmania are close to capacity in the spring peak. As a result, we are not accepting new suppliers in Tasmania outside of current BSC shareholders. However, we continue to accept any milk volume growth among our existing suppliers.

Fonterra remains committed to our business in Tasmania. We have an ongoing capital investment program for the sites at Wynyard and Spreyton around product mix, site efficiency and capacity opportunities. For example, in the next twelve months Fonterra will be installing a new gas-powered energy cogeneration plant at Wynyard. We are also currently reviewing the potential for additional investments in dairy manufacturing in the state.

5. SUPPLIER RELATIONSHIPS

5.1 Business partnerships

Fonterra seeks to develop a genuine two-way business partnership with each of our suppliers. We maintain a team of regional Milk Supply Officers, who offer on-the-ground technical and support services to suppliers. The Milk Supply Officers provide suppliers with detailed pricing, budget and income information tailored to their individual businesses. Through this team we also help our suppliers develop strategies to improve farm management, milk quality and profitability, as well as assisting suppliers develop their food safety plan to meet government regulations.

In addition to the Milk Supply team, we keep our suppliers informed on business and market developments with a variety of communication tools. The Fonterra Supplier Forum is a representative body of Fonterra suppliers that provides direct feedback to management. Suppliers also have access to senior managers at regular regional tours and farmer meetings. In addition, we provide a monthly market update and quarterly magazine to all our suppliers.

5.2 Farmer assistance

We recognise the difficult business conditions faced by most farmers at present and we are working with our suppliers to help them manage the current period.

We have in place six month interest free advances for suppliers in Victoria, Tasmania and NSW to assist the purchase of key farm inputs, such as fodder, water and fertilizer.

In northern Victoria we have also introduced the Northern Supply Incentive. This additional payment is in recognition of the higher operating costs facing farmers in the north of the state due to the drought. Over 2009-10, we expect to pay out around \$1 million to drought affected farmers in the north under this initiative.

Last year we also introduced the innovative Herd Testing Incentive. In an industry first, the Herd Testing Incentive means Fonterra will provide a rebate for 30 per cent of the cost of farmers having their herd tested. Herd testing is an important part of dairy herd management and improving efficiency and milk quality. As such, the testing incentive is an investment by Fonterra in the long-term productivity and competitiveness of the industry.

In Tasmania we have been working with suppliers to manage the difficulties caused by the recent wet conditions. In addition to the interest free advances, we have increased our staff presence on-the-ground to ensure all suppliers have the opportunity to gain on-farm advice from our Milk Supply Officers. We have also rebated to our suppliers all quality penalty points accrued in late September when power outages affected much of the industry. In October, we will be conducting a series of supplier BBQs in Tasmania, which will bring together farmers and Fonterra staff in an informal setting to discuss the current challenges.

Finally, Fonterra operates a corporate social responsibility program to support regional communities, with a budget of more than \$120,000 per annum. We are also working with industry bodies, such as Dairy Australia and Murray Dairy, on key industry and policy issues.

6. OUTLOOK

Fonterra is confident there is a bright future for the Australian dairy industry as a producer of high-quality, nutritious food for domestic and export markets. Despite the recent volatility, the long-term fundamentals for the global dairy market remain strong, with continued population and economic growth likely to drive increased demand in the future.

Fonterra remains committed to the Australian dairy industry. This commitment is evidenced by the fact that last year we spent \$90 million in capital investment at our manufacturing sites, despite the global recession. One of our major investments was the \$26 million upgrade of our site at Darnum Park in Gippsland, which means the site will now supply up to 60,000 tonnes per annum of value-added milk powders to one of the largest food and nutrition companies in the region to be sold throughout the Asia-Pacific region.

In the short-term, we have seen some improvement in global market conditions in recent months, and this has begun to flow through to farmgate prices, albeit limited by the currency situation. As per our commitment to Fonterra suppliers, we will reflect in our Australian farmgate milk price any sustained and significant improvement in market conditions.