Fonterra Co-operative Group Limited
Washington Office
The Watergate, Suite 1000
600 New Hampshire Avenue, NW
Washington, D.C. 20037
Ph. 202-338-1743 Fax 202-338-1744
www.fonterra.com

September 4, 2007

John R. Mengel
Chief Economist, USDA – AMS, Dairy Programs
Office of the Chief Economist
STOP 0229-Room 2753, 1400 Independence Avenue SW
Washington DC 20250-0229

Reference: FEDERAL REGISTER, JULY 3, 2007, VOLUME 72, PAGE 36341
Docket No: AMS-07-0047, DA-06-07

The following paper is designed to provide general information relating to the international dairy market and specifically the structure of the relationship between buyer and seller and the nature and length of contracts typically entered into. The intention of this paper is to aid USDA in their deliberations regarding the most effective way to manage the internal reporting of export contracts for US origin NFDM being sold into the world market.

Background on Fonterra

Fonterra is a New Zealand based dairy cooperative, formed in 2001 from the merger of two existing cooperatives and the New Zealand Dairy Board. Fonterra is owned entirely by our New Zealand farmer shareholders, who supply approximately 75% of the milk Fonterra processes around the world. Fonterra handles over 90% of the milk produced in New Zealand, of which around 95% is exported to over 120 countries.

93% of all dairy products are consumed within the country of production – often behind high tariff walls. Fonterra has therefore made the decision to invest in and develop local sources of dairy products rather than relying solely on the sale of New Zealand origin dairy products into the internationally traded dairy market. This is in accordance with Fonterra's mission *"to lead in dairy"*.

Fonterra therefore places an increasing emphasis on expanding its activities in other dairy industries – procuring, adding value and selling dairy products within key markets and even exporting from those markets, as is the case in the US. Some 25% of Fonterra's milk and dairy products is now procured outside of New Zealand and this percentage is likely to grow as New Zealand's production is unable to keep pace with international demand.

Fonterra has developed investments in a range of countries including China, Australia, Latin America, South Africa, Europe and India. In the US Fonterra is involved in a 50/50 joint venture, DairiConcepts, with our partner Dairy Farmers of America (DFA), with whom we operate a number of plants throughout the country. Fonterra also has a commercial alliance with Dairy America, which represents the exporting interests of the principal milk powder manufacturers in the US.

The globally traded dairy market

Dairy trading on the international market involves a relatively small number of credible dairy commodity suppliers and traders, selling to a relatively small number of large and medium sized buyers plus a larger number of smaller buyers.

The internationally traded dairy market accounts for just 7% of the global dairy market thus it is a small part of the overall global dairy industry and as such operates under very different conditions than the 93% of milk sold and consumed within domestic or regional borders. One such difference is that contract transparency is relatively poor with a range of prices for transactions being contracted at any given time.

The following highlights some of the issues associated with dealing in the international dairy market:

- Process involved in sales contracts
  Contracting is typically conducted face to face, with the buyer having pre-qualified the supplier through a range of specification deliverables, quality assurance and other relevant compliance mechanisms. Similarly the supplier has pre-qualified the buyer through past performance (i.e. a credible history including a history of honouring contractual commitments, a clean payment record and mutual trust). Volume and timeframe supply agreements setting out buyer and supplier obligations are common place.

- Additional certification & regulatory requirements
  Regulatory authorities in the customer's final market dictate certification criteria and standards which must be met to enter the dairy commodity into the country. In addition the buyer frequently specifies certification requirements beyond country regulations to facilitate ease of sale of the customer's final product range when using the imported dairy commodity.

  The time it takes to apply and gain specific certification requirements frequently impacts on contract delivery timeframes. Therefore the seller is generally not in control of the time sequence and is unable to know at the time of contract when the precise date of shipment will be.

- Time lag between contract and delivery
  There is frequently an insurmountable and considerable gap between contract signing and shipment. It is not uncommon for a contract negotiated, for example, in the month of April to cover deliveries for the period from July through September. What this means is a three month contract can have a five to six month time lag between contract negotiation date and final delivery date.

  Moreover, in many instances product contracted to be sold into the international market is not necessarily product that the seller has on hand and in stock at the date the contract is signed.

- Spot sales
  Aside from standard length contracts there is also, on occasion, the opportunity for international market suppliers to take on spot sales. Even these transactions however typically take two months to execute from date of contract negotiation through ultimate delivery.

  The dairy commodity market has a low ratio of spot sales, and they are far less common than three to six month delivery contracts. Dairy commodity customers on the world market are typically well established buyers with long track records of making regular purchase decisions in a standardised pattern. Spot sales on the other hand tend to be incremental sales over and above an already existing three or six month contractual commitment. They are sometimes driven by unforecast demand growth, delivery because of non-performance from another supplier or supply chain delays or difficulties including complaints.

- Relationship between price and volume
  Another issue in the export market is that price is often related to the quantity of a contractual commitment. Large or medium sized contracts will be typically shipped in a series of deliveries over the three to six month contract period. This is usually requested by the customer in an attempt to align supplies with their forecast usage, or the suppliers as they align deliveries with their supply chain capability.

- Links to final user
  Suppliers operating in the internationally traded dairy market must develop direct customer relationships. Suppliers such as Fonterra will have well established customer relationships that have evolved to the point where the supplier has an intimate appreciation of the customer's business drivers, capabilities and what can be negotiated and what cannot. Years of commercial dealings have built up a level of trust between the major dairy commodity buyers and their suppliers. The relationships are remarkably stable and this perhaps sets the dairy commodity business apart from other internationally traded agricultural commodities.

  There is a clear correlation between the customer relationship and the length of the contract. Longer term contracts will both be requested and granted to well established, credible buyers.

- Typical contract periods
  For a supplier such as Fonterra a short term spot sale would typically involve a low volume contract for "immediate" delivery request via an established customer. It will still however take one to two months to complete after production.

  A medium term sale typically covers three months of deliveries but typically takes five months to complete from date of contracting to final invoice date. Global multi-national food companies typically purchase on three month delivery contracts, but at times go longer and at times augment with spot purchases.

  A longer term sale is typically six months, but may extend out as far as twelve months. This timeframe is typical for leading nutritional customers who have secondary packing formulations and have a longer supply chain to their final customer. Relationships between supplier and customer are very strong and there are usually strong technical support and service components tied to performance. The timeframe for completion of these contracts is typically eight

months for a six month contract and beyond a year for twelve month contracts, though the latter are rare.

I hope that the above information is of use as you reach your conclusions regarding the level of reporting required of US dairy exporters. I would be happy to answer any questions or provide further details if required.

Best regards

Rick Walker
Vice President, Government Relations & Trade
Fonterra USA