The New Zealand Dairy Board

Will the Board's Monopoly Exporting Privilege Survive?

by W.D. Dobson

The New Zealand Dairy Board (NZDB), the world's largest private dairy exporting firm (U.S.$3.6 billion in sales for 1995–96), has been immersed in controversy in recent years. At the heart of the turmoil is the Board's statutory, single-desk (monopoly) exporting privilege provided by a 1961 act of New Zealand's parliament. The Board is defined as a state trading enterprise (STE) under General Agreement on Tariffs and Trade (GATT)/World Trade Organization (WTO) rules.

Criticisms of monopoly exporting practices of the NZDB, Canadian Wheat Board, and Australian Wheat Board have been pointedly called to the attention of politicians and trade officials. Proposals to limit STEs and render their activities more transparent almost certainly will be brought forth in the WTO negotiating round scheduled to begin in 1999. New Zealanders who were interviewed were confident that New Zealand's experienced trade negotiators and NZDB can resist successfully efforts under the WTO to strip the NZDB of its monopoly exporting privilege.

However, the issue is more complex than New Zealanders' ability to resist WTO proposals. Indeed, internal pressures to modify or eliminate the Board's monopoly exporting privilege could produce more change than that of the WTO proposals. Whether changes originate from WTO proposals or internal forces, any substantial modifications of the NZDB's monopoly exporting privilege will inject uncertainty into world dairy markets. New dairy exporting arrangements emerging from New Zealand in the wake of such changes could increase the amount of competition facing U.S. firms planning to expand dairy exports and defend their domestic markets—hence, the rationale for addressing the question, Will the NZDB's monopoly exporting privilege survive?

Evolution of the NZDB

The Board, based in Wellington, New Zealand, had about 6,000 employees in the mid 1990s, most of whom work in eighty-five offshore subsidiaries or associate companies. It serves as the exporting arm and establishes base milk prices for the 14,000 New Zealand dairy farmers who produce milk manufactured into dairy products by New Zealand's dairy processing cooperatives. In most years, 85 to 90 percent of the dairy products manufactured in New Zealand are exported. The Board competes in dairy export markets with Nestle, Kraft, Borden, M.E. Franks (a Belgium-owned, U.S.-based firm), Australian dairy exporters, Ireland's Dairy Board, Ireland's Kerry Group, and others.

Competitors and New Zealand business people point out that the Board has benefited from superior management. Evidence supports such claims.

CEO's of the NZDB have been listed in business publications ranking New Zealand's top-ten business executives. Sir Dryden Spring, NZDB chairman, reported in an August 1997 issue of *Agra Europe* that the Board has increased its share of internationally traded dairy products (milk equivalent basis) from 19 percent in 1990 to about 28 percent in 1997, mainly at the expense of European Union (EU) dairy exporters. Spring predicted that this trend would continue as the EU cuts export subsidies to comply with the Uruguay Round GATT agreement.

Like many other New Zealand firms, the NZDB was stripped of subsidies (interest subsidies and tax advantages) after the Labour Government came to power and launched an economic liberalization program beginning in 1984. New Zealand's government permitted the NZDB to retain monopoly exporting privileges under the reform program. However, New Zealand firms can request NZDB authorization to export dairy products for their own account. A few firms making such requests have received Board authorization to export low-volume products such as premium ice cream and specialty cheeses that do not compete with NZDB exports. The Board does not make domestic dairy product sales or control New Zealand's dairy imports.

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The New Zealand government's decision to allow the NZDB to retain monopoly exporting stands in contrast to developments in Ireland. When Ireland considered joining the European Economic Community (EEC) in 1971 the monopoly nature of Ireland's Dairy Board was thought to be legally indefensible and commercially constricting. Accordingly, Ireland gave up the Irish Dairy Board's monopoly exporting privileges when it entered the EEC in 1973. Given freedom to do so, two large Irish dairy firms—the Kerry Group and Avonmore Foods (now Avonmore-Waterford Group Public Limited Company)—chose to export dairy products for their own account.

Representatives of New Zealand's integrated dairy industry have rebuffed calls for the Board to relinquish monopoly exporting. A former CEO of the NZDB explained the industry's stance as a strategy to protect an important source of competitive advantage for New Zealand's dairy industry. Monopoly exporting functions as an entry barrier which discourages foreign firms from integrating into dairy processing in New Zealand to secure low-cost milk produced on New Zealand's pasture-based dairy farms. (Costs of production on these New Zealand dairy farms average approximately half those of the average U.S. dairy farm.) Currently foreign firms have little incentive to integrate into milk processing in New Zealand because they would be required to channel their dairy exports through the NZDB and, in the process, relinquish part of their processing and exporting profits to the Board. Also, products processed in New Zealand by foreign firms would be exported to destinations chosen by the Board—not necessarily to distribution facilities of the foreign firms. Only if foreign firms secured authorization from the Board to export for their own account (which is unlikely) would they gain important advantage from obtaining milk for processing in New Zealand. Absent monopoly exporting authority for the NZDB, the benefits of low milk production costs would be transferred partly to foreign firms.

New Zealand dairy industry officials claim that monopoly exporting benefits the industry by preventing "weak selling" by New Zealand exporters. This argument says that, absent monopoly exporting, New Zealand firms would compete against one another in foreign markets, bid down the prices received for New Zealand dairy exports, and reduce industry revenues.

Concentration of dairy processing in New Zealand has risen in recent years, accompanied by an increase in the ability of large cooperatives to export for their own account. While the NZDB served as the exporting arm for ninety-five dairy manufacturing cooperatives in 1970/71, this number had declined to fourteen in 1995/96. Moreover, two of the fourteen cooperatives accounted for two-thirds of the manufactured dairy products exported from New Zealand. The NZDB's Dryden Spring forecasts that the number of cooperatives quite rapidly will be reduced to as few as three.

Many of New Zealand's smaller dairy processing cooperatives in the 1960s and 1970s didn't have the capital or marketing expertise to export dairy products effectively. However, this is not true today of the larger cooperatives, which have pushed for greater autonomy in exporting.

The consolidation of New Zealand dairy cooperatives coincided with the Board's decision to put increased emphasis on exporting differentiated dairy products such as branded cheeses, butter, and milk powders marketed in consumer packages, dairy-based food ingredients for food service businesses, and dairy-based pharmaceuticals. This eventually weakened the value of monopoly exporting to large cooperatives. In the late 1980s, the NZDB adopted a core strategy calling for the firm to lift the 30 percent or 40 percent of milk sold as differentiated products to 100 percent as rapidly as possible. While this objective has been difficult to fully achieve, the Board reported that it obtained about three-fourths of its export earnings from differentiated products in the mid 1990s. Dryden Spring reported in the firm's 1996 annual report that this strategy continues to be pursued for the following reason:

> Commodity markets are declining in absolute size and are quite incapable of absorbing the (New Zealand) industry's increasing milk production (increases averaging over 5 percent per year during 1990/91 to 1995/96 and 12 percent for 1995/96 to 1996/97). This inescapable dynamic underscores the need for the industry to continue pressing forward with its value-added strategies.

These developments beg the question: Do large cooperatives that produce differentiated dairy products for export benefit from services of an intermediary that serves as monopoly exporter of dairy products? Hugh Friel, deputy managing director of Ireland's Kerry Group (a successful cooperative/public limited company that exports differentiated dairy and other food products), says no. Friel indicates that producing differentiated dairy products to specification for a foreign buyer is an iterative process requiring extensive consultations between seller and buyer. He argues that an intermediary can't explain the applications and technical characteristics of the product as effectively as the manufacturer. Thus, Friel claims that it is counterproductive to have a dairy board as an intermediary between the foreign buyer and the processing plant during this process. Partly for these reasons, the Kerry Group has stopped exporting through Ireland's Dairy Board.

The NZDB recognizes the importance of this issue. Accordingly, it has given large New Zealand cooperatives authority to work with foreign buyers to develop differentiated products to specification. However, the Board still remains an intermediary that is concerned with whether the large cooperatives will comply with the Board's overall export strategies. The large cooperative's push for autonomy and the Board's desire to coordinate the New Zealand industry's dairy exports create pressures for both Board and cooperative management.

Internal criticism of the Board

Internal critics of the NZDB's monopoly exporting privilege and other Board practices include former New Zealand finance minister Ruth Richardson; New Zealand's commerce minister, John Luxton; New Zealand Treasury officials; New Zealand business people who wish to partner with foreign firms to export dairy products for their own account; and Alistair Betts, a former NZDB group general manager of marketing. According to these critics, Board reforms are needed to

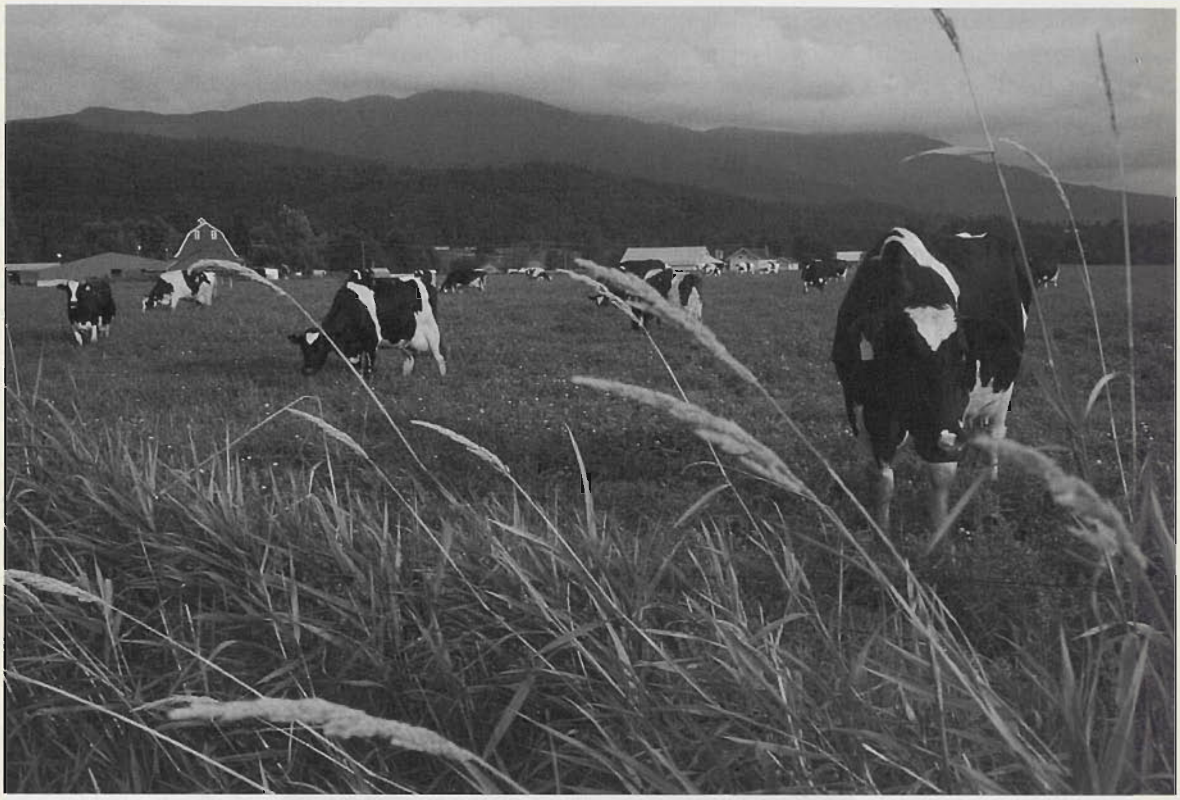
- create incentives for additional foreign investment in New Zealand's dairy industry;
- acquire the equity capital needed to permit the Board to become a more dominant player in international dairy and food markets; and
- provide a corporate structure that would reveal in an unambiguous fashion how effectively the Board performs.

New Zealand's dairy farmers disagree about the need for changes. In response to a survey carried out in the mid 1990s, 89 percent of the farmers said that the NZDB should control exports of all New Zealand dairy products.

Richardson dismisses the New Zealand dairy industry's adherence to monopoly exporting to avoid "weak selling" as anachronistic, suggesting that the argument made sense in the interwar years when many producer boards were formed, but not today. Rejecting claims that the Board's monopoly exporting privilege is a useful entry barrier for New Zealand's dairy industry, she argues that the monopoly and regulatory powers of producer boards have discouraged new ideas and new investment in agriculture. Foreign investment, she points out, has helped to invigorate New Zealand's manufacturing, forestry, and tourism industries. She asserts that this has not happened in agriculture and horticulture and that these sectors are undoubtedly the poorer.

Betts claims that the Board must change its structure to compete more effectively against Nestle, Kraft, and other multinationals and increase its branded, consumer-pack business. Arguing a point that has supporters within the Board, Betts contends that the NZDB has the nucleus of talent and some resources needed to become a major global dairy food company but that it will require additional capital to achieve such status. His plan would establish the consumer products division of the NZDB as a separate company and take in external capital to buy international food brands and businesses.

The NZDB presently has the strong balance sheet and capable management required to borrow at favorable interest rates in New Zealand, the United States, and other capital markets. However, if the firm transforms itself into the business favored by Betts, it undoubtedly will require infusions of equity capital. New Zealand's dairy exporting arrangements would differ after such a transformation,



which could trigger other changes. Precisely what those arrangements would be is unclear. One or two large international dairy food cooperatives, in addition to the NZDB's consumer products division, could emerge, leaving part of the NZDB to serve as residual exporter for a few cooperatives. Monopoly exporting would be absent in such a reconfigured dairy exporting industry.

Whether New Zealand's dairy farmers will soon support such a proposed change is unclear. The farmers are reluctant to consider changes that might cause them to lose control of the NZDB. Experiences of Irish dairy cooperatives, including the Kerry Group, which transformed itself into a cooperative/public limited company to acquire domestic and foreign equity capital, suggest that farmer control over new cooperatives that emerge after similar transformations can be retained. However, in such organizations, pressures do emerge which force management to carefully balance payouts to milk producers against conflicting demands related to stock prices and dividends for suppliers of equity capital.

New Zealand Treasury officials, Richardson, Luxton, and others decry the lack of market mechanisms to show how well the NZDB and other producer boards perform. New Zealand's government requires that the NZDB be audited every five years to provide outside assessments of Board performance. A performance audit conducted by the Boston Consulting Group in 1993 showed that the Board scored 7 out of 10 against world best practice and that its performance was improving. In addition, a study conducted by Ireland, Wallace, and Associates, a financial advisory firm, showed that New Zealand's dairy industry has generated superior wealth for the country and provided higher returns on shareholder investment than any other predominantly rural land use. Critics consider such information less meaningful than stock prices, return on investment, and other information available for publicly held firms. Accordingly, they would prefer to have the Board transformed into an organization that would provide such information.

What is one to make of these criticisms? New Zealanders who were interviewed generally believed that as long as developments in New Zealand's dairy industry remain favorable and the Board retains capable management, farmer support for the NZDB will cause politicians to ignore criticisms of the Board's monopoly exporting privilege. However, many argue that, absent favorable conditions, the criticisms are likely to change the Board.

External criticism of the Board

External critics of the Board include the U.S. Dairy Trade Coalition, Trugman-Nash (a U.S.-based cheese importer), and the Wisconsin Farmers Union Milk Marketing Cooperative. Partly in response to critics' requests, six U.S. Senators and twelve members of the U.S. House of Representatives asked the U.S. General Accounting Office (GAO) to evaluate (1) the potential capability of export-oriented agricultural STEs to distort trade, and (2) the potential ability of the NZDB, Canadian Wheat

Board, and Australian Wheat Board to engage in trade-distorting activities, based on their status as STEs. In the studies, GAO analysts investigated complaints lodged by U.S. industry groups about unfair advantages gained by the NZDB through price discrimination or predatory pricing.

GAO analysts concluded that (1) the NZDB benefits from economies of scale, (2) it has market power in international dairy markets, and (3) its ability to influence the market will increase, to the extent that it or other STEs can extend control over supply through collusion with other exporters. But, hampered by lack of data, GAO limited its other findings as follows in a 1996 report:

> While price discrimination is possible and not prohibited under the GATT, we were unable to analyze the extent to which the NZDB or other exporters engage in this practice because we did not have access to public or private companies' transaction-level data. Likewise we were unable to determine whether the NZDB engaged in cross-subsidization between its higher and lower-priced foreign market sales.

In addition, the GAO noted that the NZDB cannot engage in cross-subsidization between domestic and foreign market sales because it neither controls imports nor sells dairy products in New Zealand's domestic market.

Industry critics were less reluctant to criticize NZDB practices. The Dairy Trade Coalition claimed that the NZDB gains unfair advantage over competitors by cross-subsidization between the firm's high-priced and lower-priced foreign market sales. However, the Coalition offered no actual data to support this claim.

Trugman-Nash would prefer to import cheese directly from New Zealand cheese makers rather than buy from the NZDB intermediary.

U.S. critics object to the ability of the Board to capture the full quota rents on much of the New Zealand cheese exported to the United States. The capture, which is authorized by the Uruguay Round GATT agreement, works like this: The NZDB as sole exporter of New Zealand cheese operates a wholly owned subsidiary in the United States (Western Dairy Products, Inc.) which held license rights to import 59 percent of New Zealand's "within quota" cheese destined for the United States in 1994. By the end of the year 2000, Western Dairy Products, Inc. is expected to hold licenses to import 69 percent of New Zealand's 22,522 metric tons of "within quota" cheese. By acting as both exporter and importer, the NZDB can gain the full difference between world prices and higher U.S. cheese prices. U.S. cheddar cheese prices were a third higher than world prices for the product in 1996. U.S. cheese importers claim that if a U.S. importer purchased the cheese from the NZDB or a cheese maker within New Zealand there would be negotiations to share the "quota rent."

U.S. critics possess documents which, they claim, show attempted collusion between the NZDB and Australian dairy exporters. In 1995, the NZDB sought the cooperation of Australia's Dairy Industry Council to create a single channel through which Australasian supplies of dairy products for certain EU dairy import quota markets would be managed. The single channel for supplying EU quota markets would take the form of a jointly owned or jointly operated company. This proposed venture, which failed to materialize, constituted an attempt by the NZDB to garner quota rents and prevent "weak selling" in EU dairy markets by New Zealand and Australian dairy exporters. The Dairy Trade Coalition cited this effort as evidence that the NZDB seeks to engage in collusive behavior which would distort international dairy markets.

With the possible exception of the last point, information employed by external critics to show that the NZDB engages in unfair trade practices is inconclusive. This is not surprising in view of the GAO's findings. In a June 1996 report, the GAO noted that information submitted by STEs to the GATT/WTO often was of limited value for assessing STE trading practices and that the GAO had no authority to require the NZDB to provide proprietary information needed to adequately investigate critics' claims. GAO's comments underscore the need to secure reports under the WTO to make activities of STEs more transparent and the potential difficulty of getting such information. STEs are likely to resist efforts to require them to submit to the WTO proprietary information which could fall into the hands of competitors.

Will the Board's monopoly exporting privilege survive?

Because of points noted in the article, no definite answer can be provided to this key question. However, the scenarios appearing below show how the NZDB's monopoly exporting privilege might survive or how, alternatively, it might be eliminated. In preparing the scenarios, the old adage "Be careful what you wish for because you might get it" seems applicable to New Zealand farmers wishing to keep, and U.S. critics wishing to eliminate, the NZDB's monopoly exporting privilege.

Scenario 1. Under this scenario, little change occurs during the next several years. New Zealand's dairy farmers use their political power to keep the Board's monopoly exporting privilege. However, out of fear of losing control of the Board, the farmers forego the opportunity to acquire the equity capital needed to develop successful international dairy food companies similar to the Kerry Group of Ireland. The NZDB continues to make concessions to large New Zealand cooperatives to keep them from demanding to export dairy products for their own account, diminishing the Board's power to coordinate the industry's dairy exports. As a result of WTO negotiations, the NZDB and other STEs are required to make a few reporting changes to make their actions more transparent. Pressures for change continue.

Scenario 2. New Zealand's government agrees to relinquish the NZDB's monopoly exporting privilege in WTO negotiations that begin in 1999, partly to gain additional access to U.S. and European dairy markets. U.S. critics of the NZDB congratulate themselves for stripping the NZDB of its monopoly exporting privilege. They neglect to point out that the NZDB already had reduced its North American sales from 18.6 percent of the total in 1990/91 to 8.5 percent of the total in 1995/96 and had become less important as a competitor in the region. Soon after the new trade agreement's implementation period begins, three New Zealand cooperative dairy food companies begin competing aggressively for sales of differentiated dairy products in North America. Those believing that New Zealand's dairy farmers could not expand milk production enough to supply the cooperative dairy companies with low-cost milk find that New Zealand's 12 percent increase in milk production from 1995/96 to 1996/97 was not highly unusual. New Zealand farmers continue to convert the 60 percent of pasture land devoted to sheep and beef raising to dairying, producing year-to-year percentage increases in milk production averaging in the high single digits for several years. Surprised by the success of new competitors, U.S. critics of the NZDB long for the old days before they got what they wanted in trade negotiations.

Scenario 2 obviously has a lower probability of occurring than scenario 1. Scenarios showing less change than scenario 2 could be constructed. But the second scenario makes an important point. Elimination of the NZDB's monopoly exporting privilege will not necessarily reduce the competitive viability of New Zealand's dairy industry. Indeed, if Ireland's experience is useful as a guide, such a change could produce expanded competition for U.S. dairy firms.

■ For more information

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