

# [Fonterra’s position in the global dairy market](https://assignbuster.com/fonterras-position-in-the-global-dairy-market/)

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| | | Fonterra | | An participant in an Oligopoly | | Fonterra’s Position in the Global Dairy Market | | | | Glenn Duncan - 0705186 | | 28/01/2012 | | | Introduction: Fonterra, New Zealand’s mega-cooperative could be described as a two headed beast. Fonterra operates as a monopoly in raw milk supply, and domestic market and as an Oligopoly on the global market. Fonterra evolved from a developing NZ dairy industry looking to progress in an increasingly competitive global dairy market. In the 1930’s there were more than 400 separate dairy co-operatives operating throughout the country, they were export focused and had their own international marketing arm in the form of Dairy Export Produce Control Board, its key market being England, supplying the motherland her butter and cheese. From 1930 to 1960 New Zealand saw consolidation through a desire to become more efficient and utalising improved technology such as refrigeration and transport. The number of co-operatives declined from over 400 to 168, still predominantly supplying England. Increase protectionism through the formation of the EU (European Union) and England’s entry into the EU saw a further need for the NZ dairy industry to diversify via the NZDB (New Zealand Dairy Board, created in 1961) by product innovation and establishing new markets for NZ dairy products. Between 1980 and 1995 the NZDB established over 80 subsiuaries and associated companies throughout the world to market NZ’s dairy produce. By 1995 through a need for efficient production the industry had further consolidated to 13 companies. There was however a disconnect between the NZDB and these companies, due to a unclear definition of ownership of the NZDB, where the NZDB was pushing commodities such as milk powder and the co-operatives were producing value added products such as cheese to increase their margins, there was also staunch competition between co-operatives to beat the payout their neighbour paid to its shareholders. “ The co-ops hell bent on beating their neighbours had little interests in shifts of market demand. It’s fair to say farmers were also disconnected from the global markets that bought their products. For most, the world ended at their co-operative and they had little understanding, or interest, in key factors influencing payout. "(Ferrier, 2004) In 1996 the Dairy Board Amendment Act transferred ownership of the NZDB assets to the 12 remaining co-operatives, the threat of forced deregulation became the pivotal point which lead to the creation of Fonterra through the industry considering what was required to ensure NZ dairy was to survive the future. 32 options were considered to take the dairy industry forward; the farmers chose a single co-operative as the structure because it gave them suited the long term nature of the farming business and because it gave them market power. “ By having market power, Fonterra gives the farmers the only viable means by which they can move more of their milk towards the higher end of the value chain and utilize the value creation potential of the business itself"(Ferrier, 2004). This strategy included a focus on cost cutting to ensure Fonterra was competitive in the global market, “ The 45% drop in cost of goods sold per KGMS(excluding the price of raw milk) was achieved through greater processing and distribution efficiencies. " (Schoeman, 2010). Looking at the statistics Fonterra has succeeded in achieving this goal for its farmer shareholders. [pic] [pic] [pic] Figure 1: Fonterra financial results 2011 Source: www. fonterra. com Does Fonterra on the global market meet the criteria of an Oligopoly? Few large mutually interdependent firms: Yes The global dairy market whilst competitive is dominated by a relatively small number of organisations who have significant market power both in their region and on the global sphere. Many of these organisations are mutually interdependent, forming joint ventures and trading with each other, one of Fonterra’s biggest customer is Nestle believed to be worth NZ$1bn. [pic] [pic] Figure 2: Rabobanks ranking of the top 20 dairy companies. Figure 2 shows Fonterra ion the top 5 dairy companies in the Global market, the top ten companies would be considered to be true global players in the dairy industry. A Firms produce similar or highly differentiated products: Yes The bulk of the world’s dairy trade is in 5 core commodity products, bulk cheese, WMP (whole milk powder), SMP (skim milk powder), butter and butter oil, whey and whey products. [pic] Firms competing in the market are increasingly looking to differentiate their products by the way they market their products and through product innovation. Example: Fonterra participating in the Global Dairy Trade auctions which are conducted as ascending-price clock auctions run over several bidding rounds.  In each auction a specified maximum quantity of each product is offered for sale at a pre-announced starting price.   Bidders bid the quantity of each product that they wish to purchase at the announced price [pic] Model of Global Dairy Trade Auctions: Source: www. globaldairytrade. info/ Significant Barriers to entry: Yes, capital cost, protected markets, raw material supply. There are significant barriers to any parties’ entry into the dairy market, the establishment of a supplier base either through poaching suppler farmers from another organisation or the purchase of existing farms, NZD$ 210m for 16 farms in recent Crafar farm sale, to the construction of a dairy plant, “ Miraka-The state of the art $90 million dollar plant at Mokai, 30 km northwest of Taupo is the cornerstone of a unique alliance of Maori trusts and incorporations". Government protection of foreign markets also creates a barrier to entry. “ The heavy intervention in domestic dairy markets by the developed countries often generates surplus production relative to domestic consumption requirements. Because the domestic policies usually keep domestic prices above world market levels, many developed countries–particularly Canada, the European Union, and the United States–are forced to export these surpluses with considerable subsidy. Those export subsidies depress world market prices, making cost-effective dairy production more difficult in many developing countries". (Cox, Zhu, Agricultural, & Economics, 2005). Even with the recent breakthroughs in protectionism there is still some way to go to a free market, “ Considerable scope remains for further removal of trade and domestic support policy distortions in the Doha Round. Even after full implementation of the URAA provisions by developed countries, almost 60 percent of world dairy trade will still be exported with subsidies" (Cox et al., 2005) Currently only 7% of the world’s dairy production is exported, Fonterra currently accounts for 2% of this volume (or 40% of international dairy trade). This indicates there are enormous opportunities for growth if foreign markets are opened up to competition(Federation, 2010). “ In 2009, the overall share of world dairy tradein the global milk pool was just over 7%, which is quite modest. This puts into perspective the role of international trade and underlines the fact that the vast majority of the world’s milk never crosses any border, since the main focus of dairy remains local, at most regional"(Federation, 2010). Imperfect information: Yes Whilst there is a great deal of information available to prospective entrants there is very little information around the costs of production for each competitor. There are various known factors like Fonterra has a low cost of production due to the fact that the NZ climate allows cows to be grazed outside all year round reducing the need for capital investment in barns and the cost of feed in winter months, this however can be offset by transport cost due to the bulk of Fonterra’s production location. The above evidence leads to a conclusion that Fonterra is part of an Oligopoly in the global market. Market Strategies as an Oligopoly: Fonterra’s position in the global dairy trade where it commands a 40% market share with a very high quality product, and low cost of goods means it is more likely to follow a strategy of being a market leader on price and innovation, if you consider the kinked demand curve model it is worth Fonterra taking the risk of leading the market in taking prices higher and having the competitors follow, an example of this is Fonterra lead in participating in the Global Dairy Trade auctions explained earlier. If Fonterra’s takes this strategy its Game Theory strategy would also be to be a leader and take a Dominant Strategy with regards to its overall game plan, taking a path that gives both Fonterra and the overall market the highest payoff for its efforts and risk. The global dairy trade is vitally important to Fonterra growth strategies, having a home market of only 26 million people can limit expansion strategies. Fonterra considers Australia and New Zealand its home market, its domestic market business Fonterra Brands (NZ) Ltd actually reports to Fonterra Brands office in Melbourne Australia. Fonterra has to be defensive of its global market. In its market position Fonterra would be most likely to run a Strategic Entry Deterrence strategy with regards to new entrants into the market, having a low cost of goods does allow it to take a strategy of Limit Pricing if it felt the requirement to do so in a strategic market, a possible example of this would be to run Limit Pricing (cost plus pricing) on large run customers such as Nestle if the account was under threat from a competitor. This would maintain the cash flow and benefits of high volume production. It would not be wise for Fonterra to have a Predatory Pricing strategy as it would attract the attention of anti-trust authorities such us the Commerce Commission in New Zealand and would detract from its position of a corporate with integrity. Is Fonterra Good for the Consumer? The jury may be out on this question as far as your ordinary citizen concerned, however if you weigh up the combined effect of the highly publicized rise in food prices (not all dairy) the NZ consumer is paying on the domestic market, “ Our modeling suggests that these ongoing high prices could reduce NZ’s ongoing economic welfare by $3. 3 billion, or 2% of GDP. "(Allen, 2011) versus the overall economic benefits the NZ citizen / consumer is as a whole better off with Fonterra continuing to perform as it has in recent times. The dairying industry as a whole is a major employer in the NZ economy, “ The dairy sector in New Zealand is a major employer, and is vital for a number of districts. On-farm employment is around 24, 000 nationwide, with dairy processing providing another 10, 000 jobs. These figures do not include those dairy farmers who are registered as self-employed. “(C Schilling, 2010) Fonterra does have a responsibility to the NZ economy, it operations have a somewhat dramatic effect on the performance of the economy, “ The dairy sector, comprising farmers and dairy processors, directly contributed around $5. 0 billion of value added (or GDP) to the New Zealand economy in 2010, around 2. 8% of the total GDP figure. " (C Schilling, 2010). Fonterra earns New Zealand foreign currency to help offset the huge amounts of money leaving NZ in the form of profits and dividends from foreign owned businesses operating in NZ, our banking sector is a prime example, “ Dairy exports were $10. 4 billion in calendar year 2009, accounting for around 26% of NZ’s total goods exports. "(C Schilling, 2010) In the same breath Fonterra’s export success has an impact on other exporters, ““ The impact on export competing industries is negative because of the appreciation of our currency. However, that same appreciation allows us to buy more from overseas as can be seen by the rise in imports and private consumption. "(C Schilling, 2010) Conclusion: Overall data shows that although Fonterra operates a monopoly in raw milk and the domestic market its performance in an oligopoly on the global market has delivered benefits to a wide range of sectors outside of the dairy industry, and has generated living standard improvements across New Zealand’s regional economies, including in metropolitan areas such as Auckland and Wellington. www. fonterra. com www. globaldairytrade. info/ www. uabr. auckland. ac. nz/files/articles/.../v6i2-fonterras-future. pdf http://www. skl8. co. nz/projects/current-projects/miraka-milk-powder-plant/ http://www. nzherald. co. nz/nz/news/article. cfm? c\_id= 1&objectid= 10781767 http://www. svenskmjolk. se/Global/Dokument/Dokumentarkiv/Marknadsrapporter/World%20Dairy%20Situation/World%20Dairy%20Situation%202010. pdf Allen, J. (2011). Insight High food prices will harm the NZ economy. C Schilling, J. Z. a. C. N. (2010). Dairy's role in sustaining New Zealand. Cox, T. 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