

NEW ZEALAND ECONOMICS ANZ AGRI FOCUS

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A YARN OF WOOL

FEATURE ARTICLE: THE WOOL INDUSTRY'S BATTLE FOR SURVIVAL

The wool industry's battle for survival has seen a number of ownership changes and new branding initiatives emerge: such nuances are heartening. But in general, farmers continue to show disunity and a lack of collective enthusiasm to invest in one particular proposal. Critical elements to change farmers from being price takers to price makers include more investment, consolidation of the clip through fewer channels, closer partnering with retailers, clearer benchmarks, better information flow and price signals, and the repositioning of strong wool and its associated end products as fashion items. Farmers can support change in the way they commit their wool for sale, or invest capital.

THE MONTH IN REVIEW

Little rain and lots of heat over a six-week period that begun in early February turned the season into a game of two halves. This dry period tipped the entire North Island and parts of the West Coast into official drought zones. Overall, the production and financial effects vary by sector, region and farm type.

RURAL PROPERTY MARKET

General sentiment in the rural property market since the start of 2013 has been one of slightly softer prices, but better turnover. Total turnover is up 10 percent for the first two months of the year compared with last year. Price movements have been a mixed bag. Dairy aligned and lifestyle properties have held their value, but grazing and horticultural property prices have struggled.

KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

The modest bounce in NZ's soft commodity price basket has continued, supported by the recent turbo-charging from dairy prices. The dampener continues to be the NZD.

ECONOMIC BACKDROP

The NZ economy has started 2013 on a positive note with strength seen in residential construction, business and consumer confidence, and the housing market. The Canterbury rebuild continues to underpin GDP growth in the vicinity of 2.5 percent, although the labour market backdrop remains soft. Drought is casting a shadow over the economy. Fiscal consolidation and NZD strength are also still strong headwinds. 2013 looks set to be another year where the economy performs okay, but with disparate sectoral performance.

BORROWING STRATEGY

Shorter-term wholesale interest rates have fallen. However, global long term interest rates have risen, steepening the yield curve. With OCR cuts unlikely, and interest rates on a gradual upward trajectory, fixed cover should be slowly increased.

EDUCATION CORNER: CHANGING FACE OF WATER MANAGEMENT PART II

In September 2011 we highlighted that a number of changes were in the wind for on-farm water management. Recent industry and regulation developments are starting to provide some clarity on the specific changes required from landowners over the coming years. This month's Education Corner details some of the recent industry and regulation developments, highlighting areas of commonality and disagreement between industry and regulators, and shows things are developing more quickly than many appreciate.

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SUMMARY

The wool sector has been in a trend decline for decades. The current industry model is decentralised, with up to 35 exporters and characterised by low profitability, wild swings in commodity prices, and prospects linked to Asia in tandem with the wider meat industry agenda.

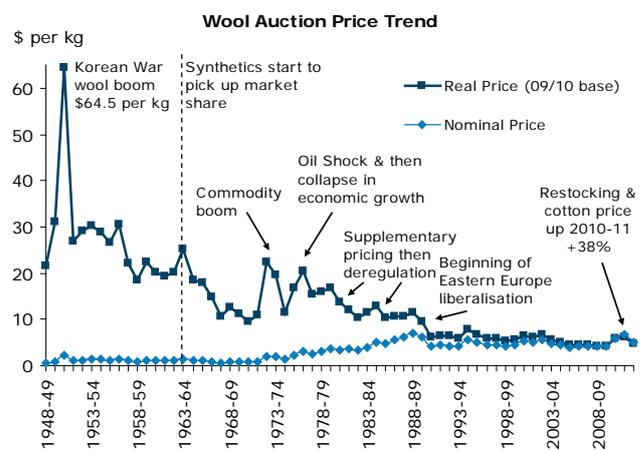
In this environment, the finger is naturally being asked: where to from here? This has seen a number of ownership changes and new branding initiatives emerge: such nuances are heartening. However, there are still many channels to market, fragmentation in reaching the final consumer, and a lack of information and price feedback from retailers and manufacturers. The current model may drive competition – and some would argue innovation – as a consequence, but for a nation (economic model) of 4.4 million people, it makes for a number of inefficiencies and lack of downstream investment. It also makes for a confusing picture in assessing the merits of different proposals to improve farm-gate prices. Little wonder most initiatives have received limited farmer support. Past experiences have been that extracting premiums directly from manufacturers isn't possible without a significant commitment and support from retailers. This is where some of the more recent farmer proposals have started to head, perhaps offering some hope. But in general, farmers continue to show disunity and a lack of collective enthusiasm to invest in one particular proposal.

Critical elements to change farmers from being price takers to price makers include more investment, consolidation of the clip through fewer channels, closer partnering with retailers, clearer benchmarks, better information flow and price signals, and the repositioning of strong wool and its associated end products as fashion items. One simple mechanism to help increase the information feedback loop and price signal from consumers/retailers to farmers on value differences would be a "national wool schedule", which clearly identifies the various values for different categories of wool according to buyers' preferences. Farmers can support change in the way they commit their wool for sale, or invest capital.

The meat industry is typically the venting point for farmer angst: there is also a complimentary industry, namely wool, where little commentary is directed. More research on the meat industry is on our hit list for later in the year, but for this edition of Agri Focus we have decided to examine the wool industry. To do this we have taken research that was completed by Massey University's¹ Elena Garnevaska, Daniel Conforte and Samuel Dunlop in the summer of 2011 and updated it with recent developments from the last two years.

Certainly trying to understand and keep up-to-date with the wool industry's current structure and the merits of various proposals has not been easy and is often confusing for farmers. Therefore, we have endeavoured to provide a snapshot of the industry's current structure, New Zealand's place in the global fibre market and a summary of recent branding initiatives.

THE CURRENT STRUCTURE OF THE NEW ZEALAND WOOL SECTOR



The New Zealand wool sector has a history of many ups and downs. This rich history dates back to early colonial times when it was New Zealand's major export earner. It also kick-started New Zealand's wider economic development through investment in infrastructure, such as transportation and shipping. Since then the sector has experienced a long-run decline in its contribution to export earnings and sheep farmers' incomes, despite a few periodic upward spikes in prices. **Looking at the broad trend for wool prices (real) shows a downward trend since the 1950s.** To be fair, wool has not been alone in experiencing this: such trends have been widespread across various commodities and when prices were in decline theorists postulated the same going forward (recall the 1980s and agriculture being a sunset industry!). Ironically, declining prices fostered underinvestment (less supply), which when matched with Asia's growth (demand) has seen expectations of long-term commodity price decline replaced by calls for a super-cycle of commodity price strength.

¹ International Food and Agribusiness review volume 14, issue 3, 2011: New Zealand Wool Inside: A Discussion Case Study; 18th International Farm Management Congress, Methven, Canterbury, New Zealand: New Vision for New Zealand strong wool industry.

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As sheep numbers have declined, so has wool production. New Zealand's annual wool production now totals 126,000 clean tonnes, which is down 45 percent since 1990-91. Over this time the yield per head is little changed at 4 kilograms: productivity enhancements have been flat, with the attention on meat production as opposed to wool production. **Today, crossbred wool makes up the bulk of New Zealand's wool production,** accounting for approximately 90 percent of total production and 75 percent of total exports. Merino and mid-micron wool both evenly account for the remaining 10 percent of production.

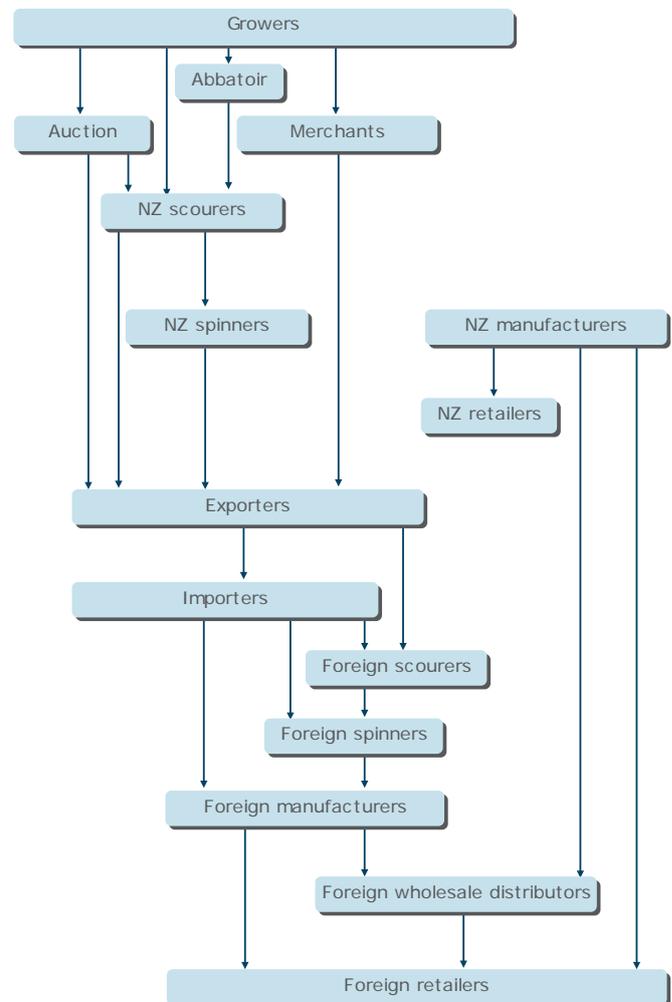
With the decline in wool prices and a rise in lamb prices (despite present challenges!) **there has naturally been a bigger emphasis on meat production over the last 25 years. Market signals work! Typically, sheep breeds that produce higher lambing percentages, heavier lambs and that are suited to the New Zealand climate, produce crossbred wool. Hence, the large proportion of production is crossbred.** Most of New Zealand's wool is shorn (85 percent of total production). The remaining 15 percent is slipe wool. Slipe wool is a by-product of the meat industry whereby wool is recovered from pelts of slaughtered animals in abattoirs.



Traditionally farmers sold their wool through auctions, but there has been a recent move to private sales. It is now estimated that approximately half of New Zealand's wool is sold via auctions, with the other half sold privately. The two major auction brokers are Elders Primary Wool (EPW) with an estimated 42 percent market share and Wool Partners International (WPI)² with 32 percent. Independent wool merchants that have long-term relationships with growers on a regional basis purchase most of the wool sold privately. Some exporters and manufacturers

also have procurement divisions that deal directly with growers. This means farmers have four main channels through which they can sell their wool.

Flow of New Zealand strong wool through the supply chain



The New Zealand wool exporting sector has been consolidating for some years now. Despite this so-called consolidation **there are estimated to be 35 exporters, with the top six estimated to control up to 80 percent of total exports.** This is a huge level of decentralisation considering wool exports total less than \$800 million. Wool Services International (WSI)³ is the largest, with a market share of 30-35 percent followed by Masural (15-20 percent), Brooks-Banks (15-20 percent), Furhman (10-15 percent), WG Robinson (10 percent), and

² See branding initiatives section for more detail on Wool Partners International present situation.

³ Wool Services International has recently been purchased by Australian wool merchant Lempriere, see branding initiatives section for more detail.

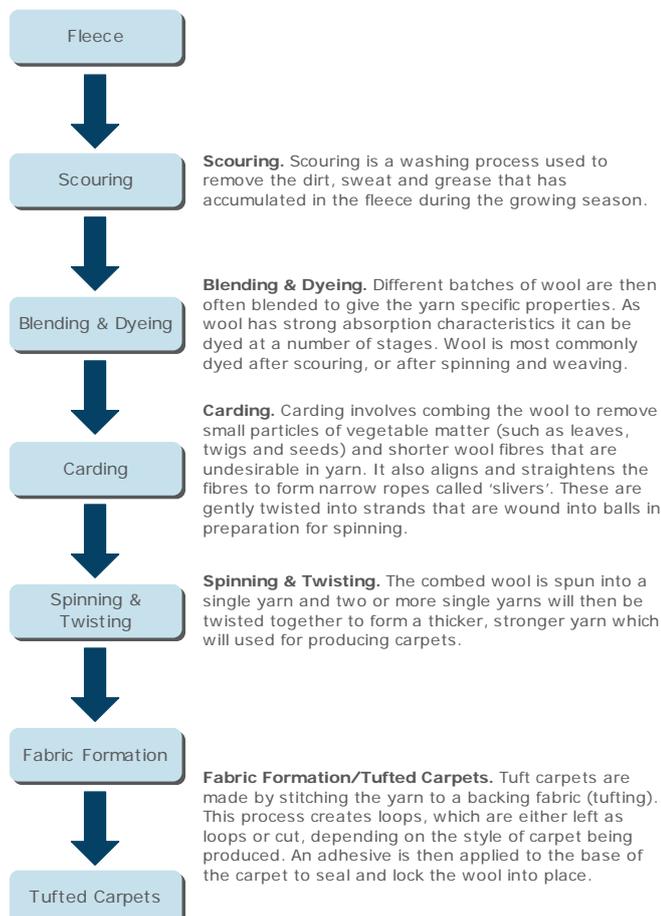
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Bloch and Behrens (around 6-10 percent). We'd like to think a lot of boutique players round out the remainder, though we suspect this would be a heroic assumption to make.

The two major scourers in New Zealand are Cavalier Wool Scourers (with an estimated 60 percent share of installed capacity) and WSI (35 percent). WSI is the only exporter that has its own scouring facility; the other exporters outsource the scouring process. The exporters of yarn have the wool spun locally on a commission basis. Raw wool and yarn is then sold to foreign processors, or importers who then on-sell to wool processors or manufacturers.

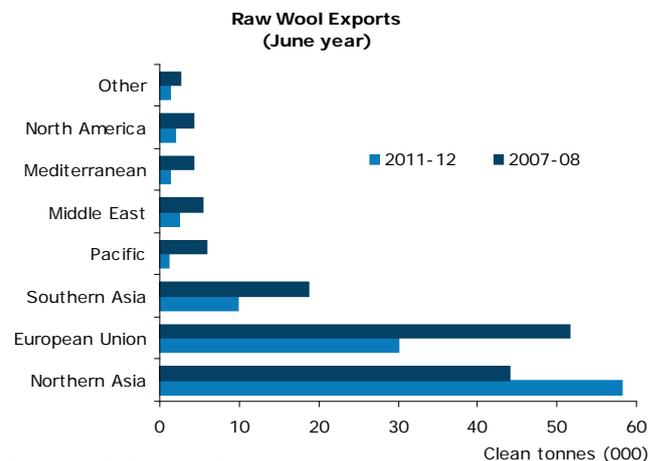
The two leading carpet manufacturers in New Zealand are Godfrey Hirst and Cavalier Corporation, which together account for over 80 percent of domestic production. Both companies own spinning mills from which they meet their own yarn requirements. Cavalier Corporation is also involved in scouring, being a 50 percent shareholder of Cavalier Wool Scourers. Both companies traditionally sell most of their New Zealand-produced carpet on the domestic market.

Steps involved in woollen processing



From its raw initial form to the manufacturing of the final product, wool has to undergo either woollen processing or worsted processing. Strong wool, which is primarily used for the production of tufted carpets undergoes woollen processing. Finer wool that will be used for woven apparel, carpets and upholstery will go through worsted processing. The main steps in woollen processing for tufted carpet manufacturing are scouring, blending, carding, dyeing, spinning and twisting, and then fabric formation or tufting. The margins along the chain vary with the yields obtained from wool, other fibres that are blended in and the cost of each process.

New Zealand exports around 90 percent of its wool production. Over 70 percent of this is raw wool for manufacturing of carpets and rugs. Value-added wool products such as tops, yarns, carpets, rugs and other wool products account for around 23 percent. The top export markets for New Zealand wool in the last decade have been China, UK, Germany, India and Italy. However, more recently China's share has increased significantly from 19 percent in 2005 to nearly 50 percent today, while the share of the other major destinations, especially Europe, has decreased. **New Zealand's total value of wool exports in 2011-12 was \$777.1 million, which contributed 1.7 percent to New Zealand's total merchandise exports.**



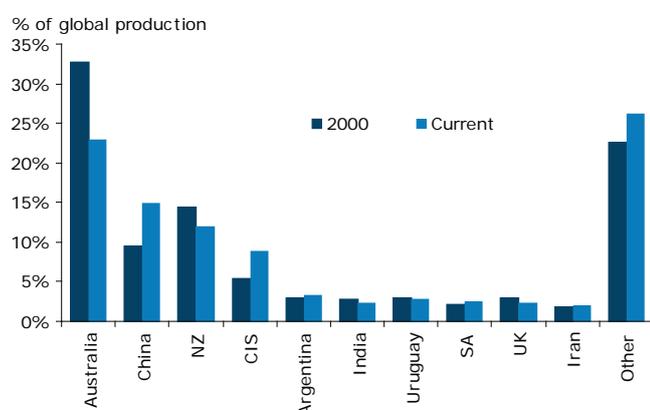
BEYOND OUR BORDERS – NEW ZEALAND'S PLACE IN THE GLOBAL FIBRE MARKET

Global clean wool production has declined from over 2 million tonnes in 1990 to around 1.1 million tonnes today. Approximately 60 percent goes into clothing and apparel, with the remainder being utilised for the production of carpets, upholstery and other intermediate products.

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The three key players in the global wool industry in the last decade have been Australia, China and New Zealand. Australia is currently the biggest wool producer, contributing 23 percent of the world's wool production and 45 percent of the world's raw wool exports. Australia's total production has averaged around 240,000 tonnes (clean) with 85 percent of it merino wool (<25 microns), which is used for clothing and garments. China is the major market for Australian wool exports (75 percent), followed by India (8 percent) and Italy (4 percent).

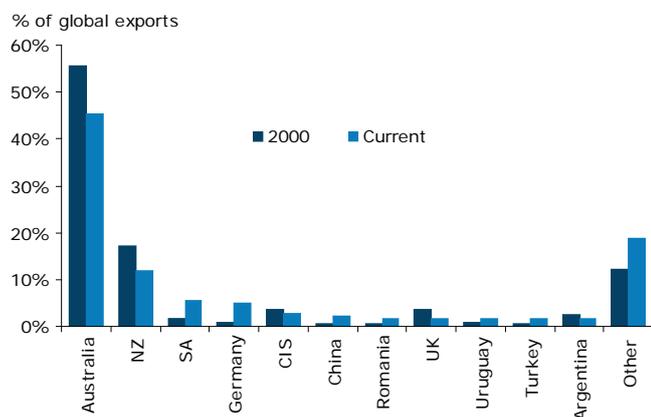
Share of global wool production



Sources: ANZ, IWTO

China is the second largest wool producer (15 percent of total production), the largest wool importing country, and consumes the majority of the world's raw wool for carpet and clothing manufacturing. Historically the majority of these products have been re-exported as finished products, but in the last few years domestic consumption has started to take a larger share. China is now estimated to import almost 45 percent of the world's raw wool. In 1990 its share was just 3.5 percent.

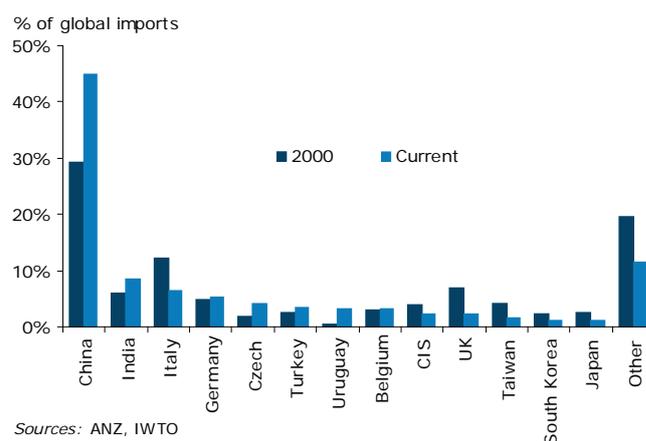
Share of global wool exports



Sources: ANZ, IWTO

New Zealand is the third-largest wool producer (12 percent) and the second-biggest exporter (12 percent) after Australia. New Zealand is responsible for supplying 45 percent of the world's carpet wool. China has increased their wool production and consumption in recent years, while Australia and New Zealand have both reduced their wool production.

Share of global wool imports



Sources: ANZ, IWTO

Overseas, the supply chain of the importing businesses varies by country depending on the structure of the industry in each country. Such differences explain why wool exporters use a variety of channels to sell wool in each country.

There are many examples, but in places like Nepal and India, rug manufacturing is labour-intensive due to low labour costs. Therefore, one importer will often purchase a container of wool. This is then sold in small increments to individuals who take the wool home and spin it into yarn. Then it's brought back as yarn to the original importer, who will pay the individual for doing the spinning. The yarn is then amalgamated together and on-sold for the next stage of processing. This means there can be hundreds (or thousands) of individuals in the supply chain.

In contrast, China, which still has a lot of low cost labour but is much more mechanized with economies of scale, tends to purchase thousands of tonnes at a time. This is then directly converted into finished product through a vertically-integrated supply chain. It is estimated China could have 40-50 major importers and manufacturers as opposed to the hundreds, or thousands in India. The UK and Europe have some similarities to both China and India. In Europe there are a combination of agents who act as principals, which means they will purchase the wool even though they say they are agents and on-sell it in smaller lots. The agents will buy-in twenty tonnes and then on-sell it to smaller manufacturers,

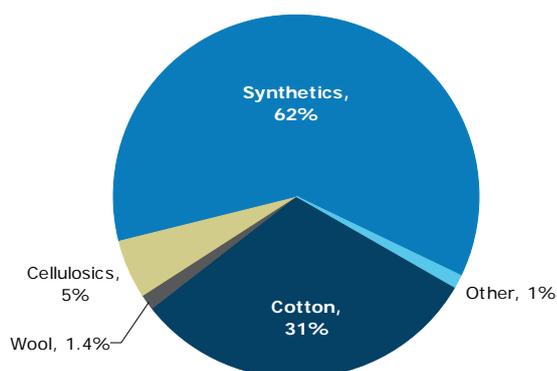
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but there are also bigger manufacturers that directly import larger quantities for their own use from spinning through to carpet manufacturing. In other markets like Iran it can be even more complex, where an agent is required due to cultural and language differences, as well as a labyrinth of bureaucracy to navigate. **Therefore, wool exporters tend to use a combination of models to access our offshore markets due to the wide range of industry structures across those importing countries.**

THE MARKET FOR INTERIOR TEXTILES

Synthetic fibres represent the greatest competition to wool in the carpet and rug industry, accounting for approximately 98 percent of consumption. The major synthetic fibres used in carpet and rug production are nylon, polypropylene, and polyester. **Nylon is used in 65 percent of carpets sold in the US, while polypropylene is used 30 percent of the time.** While the worldwide consumption of all textile fibres has increased significantly, from approximately 15 million tonnes in 1960 to just over 80 million tonnes now, the consumption of wool has declined since the 1950s. **The share of synthetic fibres has increased from 10 percent in 1960 to nearly 70 percent in recent years. Over the same period, wool's share declined from 10 percent to 1.4 percent currently.**

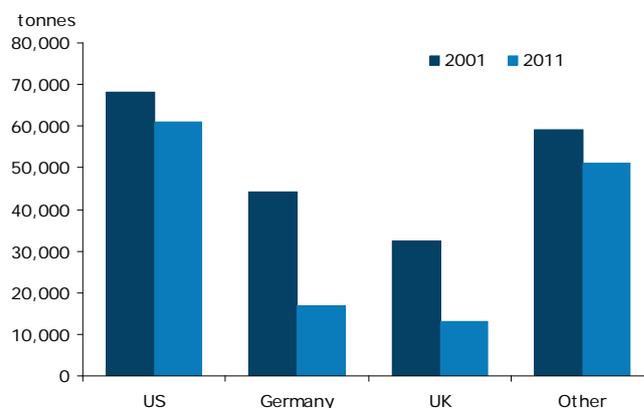
World fibre production by type



Sources: ANZ, IWTO

The US is the largest market for interior textiles with a total consumption of around 1,000 million square metres per annum, with an estimated retail value of around US\$12 billion. **Wool products account for approximately 2 percent of total sales volumes.** The US is also the largest importer of wool floor coverings and New Zealand strong wool is estimated to be used in 45 percent of all wool carpet consumed in the US.

Top 20 importers of wool floor coverings



Sources: ANZ, IWTO

The US carpet manufacturing sector is dominated by two companies, Mohawk Industries and Shaw Industries, which together have a market share of approximately 60 percent. Two medium-sized manufacturers, Beaulieu and Dixie, account for another 20 percent of the industry, while approximately 25 to 30 smaller manufacturers make up the rest. Most of the wool carpets sold in the US are imported and sold under private brands. Godfrey Hirst is considered to be the largest provider of wool-tufted broadloom carpets in the US.

Carpet retailers can be divided into three main categories: large national chains (20 percent market share), companies affiliated with buying groups (30 percent market share), and independent stores (50 percent market share). Of the national chains, the largest ones are Lowe's and Home Depot. These large chains make company-wide buying decisions giving their individual stores no flexibility as to what they stock. Wool carpets make up 0.2 percent of these national chain inventories. Of the companies affiliated with buying groups, CCA Global Partners is the largest, and is estimated to have a 65 percent market share in this category. These organisations make collective purchases, but members have some flexibility as to what products they can stock. Lastly, independent retailers have complete control over their stocking and marketing decisions. All retail organisations generally carry either the Shaw or Mohawk brands, but rarely both. They complete the rest of their stock with products from smaller manufacturers.

RECENT BRANDING INITIATIVES

In recent years there have been a number of new initiatives floated with the aim of revitalising the promotion and marketing of

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strong wool in New Zealand, and overseas.

Some have been successful, others have failed, and the jury remains out on others, as they are only just starting to get off the ground. Below, we outline several of the main initiatives and the current state of play. These are:

1. The Elders Primary Wool (EPW) & Primary Wool Cooperative (PWC) joint venture.
2. Wool Services International, recently purchased by Lempriere.
3. Wool Partners International (WPI) & Wools of New Zealand (WONZ).

ELDERS PRIMARY WOOL (EPW) AND PRIMARY WOOL COOPERATIVE (PWC)

This is a 50/50 joint venture formed in 2005 between Elders Rural Holdings Limited and the Primary Wool Cooperative. The PWC contributed to the joint venture via a procurement base plus its storage facilities and transport operations. EPW contributed a sourcing capacity of 50,000 bales, and its wool management, trade and marketing assets and expertise. EPW was a wool merchant, broker and handler, and offered wool management services to farmers with wool stores, buyers and field representatives throughout the country. Currently EPW has a team of 50 staff and handle around 220,000 bales per annum. From the five board members, two are representatives from PWC and the remaining directors and the Chairman are from Elders.

The PWC was founded in 1972 when 400 growers from the East Coast region of the North Island came together to form what was known then as the East Coast Wool Cooperative. In 2001, the cooperative purchased Elders Wools. **Currently the PWC has a membership of nearly 1,000 farmers.** Farmers' shareholding in the PWC is based on the volume of wool supplied. **A member has to own 1 share, valued at \$1 for every 5kg of wool, with a minimum share holding of \$1000.** Members are not obligated to sell their wool through the co-operative though. **The shareholding entitles them to receive a rebate of 3 cents per kg of wool on brokerage fees.** So on 5,000 kilograms of wool there is a rebate of \$150, which equates to a 15 percent return on the \$1,000 of shares that would need to be held. Additionally, bonus share offerings have been made periodically to increase the shareholding of existing members. These were of fixed value and could be redeemed with the approval of the cooperative directors. Voting rights are based on one vote per share, but are capped at 20,000 votes per shareholder.

EPW was originally an Australian-owned rural services company that started operations in New Zealand in 1903. In 2001, after an acquisition by New Zealand interests, Elders sold its wool interests to the PWC. In 2005, Elders entered into the aforementioned joint venture with PWC to form EPW. There's been some speculation around the viability of Elders Australia (currently being sold) and its effect on the EPW Partnership. Elders Australia does not have a direct shareholding in EPW and Elders NZ operates independently of Australia. The directors of the PWC believe the long-term aim is to acquire the full share of the brand and supply chain interests from EPW when it is financially viable.

Branding initiatives by the joint venture

The flagship for EPW has been the "Just Shorn" retail venture that was launched into the US market in April 2011. Just Shorn is targeted at the highest end of the carpet market and aimed at encouraging consumers to pay a premium for high quality carpets and rugs made from New Zealand wool and procured exclusively through EPW. The program includes an on-farm accreditation system aimed at providing the assurance that high quality wool is produced in a responsible way with regard to environmental and animal welfare issues.

Traceability technology developed by AgResearch is at the core of the Just Shorn quality assurance program. The process involves mixing minute quantities of a phosphorous coated nylon fibre mixed with the wool at the scouring and blending stage. The phosphorous coating can be detected by an electronic reader, preserving the identity of the wool along the entire supply chain. The technology is aimed at assuring the provenance of wool and at stopping unscrupulous suppliers free riding on New Zealand's efforts.

The major partner in the Just Shorn initiative is the US-based retailer CCA Global Partners. CCA Global Partners is a large co-operative retail group and the largest carpet retailer in the world. It has seven different retail sectors that operate under several brands such as the International Design Guild, Prosource, CarpetOne, Floor and Home, and Flooring America. Originally the Just Shorn-branded carpets were only distributed through International Design Guild outlets, but in July 2012, CCA Global Partners extended its distribution across all their retail divisions. EPW has licensed the brand to CCA Global Partners and its dedicated manufacturers. Additionally they have invested \$5 million in the brands development and in-store displays, while CCA Global Partners has invested in publications and a website targeted at professionals. Marketing

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materials provide emotive images of Kiwi farmers as responsible custodians of land and stock.

The pricing strategy has been to start selling yarn at the market price and then move up the premium ladder as brand recognition and value increase. This approach has been based on past experiences, that extracting premiums directly from manufacturers isn't possible without a significant commitment and support from retailers. **Communication efforts target the interior design consultants and architects who serve high-end consumers,** who perceive carpets as a fashion item and tend to change carpets every six to seven years. EPW have had the yarn produced in New Zealand and exported to a select number of International Design Guild premium manufacturers, such as Fabrica.

Any price premiums at the retail end are channelled back from CCA Global Partners to EPW via a royalty on the wholesale price of the carpet. So far the wool supplied to the Just Shorn program has attracted a \$0.40 cents per kilogram (clean) premium. This is nearly a 10 percent premium over the average auction price achieved in the last year. EPW trades the wool – not PWC. PWC members trade wool through EPW in the same manner as non-members. PWC pays rebates out of the income it generates from the EPW trading.

WOOL SERVICES INTERNATIONAL (WSI)

WSI has just been bought by Australian wool merchant Lempriere. The Melbourne-based company recently met the 90 percent threshold that allows it to compulsorily acquire all remaining shares. Lempriere launched the takeover late last year, offering 45 cents a share, valuing WSI at \$31 million, a 22 per cent premium to the trading price before the offer emerged.

The Australian company locked up 75 per cent of WSI's shares when it acquired the majority stake owned by the Allan Hubbard-related companies Woolpak Holdings and Plum Duff, and entered into lock-up agreements with some of the firm's executives.

WSI's scouring assets attracted a rival bid by Cavalier Wool Holdings, a joint venture between Cavalier Corp, Direct Capital Investments and the Accident Compensation Corp, to build a national wool scouring monopoly, which won Commerce Commission authority to do so. Lempriere acknowledged the group's interest, but subsequently said it has "no intention to dispose of WSI scouring assets."

The Australian company now has plans to undertake a strategic review of the New Zealand wool merchant, and plans to align WSI's business practices, systems and processes with Lempriere's. Lempriere owns specialist merino wool merchant The Merino Co with businesses in the US, Argentina and South Africa, and is one of the world's major suppliers of fine wool to European, Japanese and American fashion houses. The 150-year-old Australian company has been held in the same family for five generations, with William Lempriere the current Managing Director.

Prior to recent events WSI was a vertically integrated wool scourer and exporter, which started operations in 1992. It had an annual turnover of NZ\$200 million and exported to 30 countries. WSI has been estimated to have an approximate 30-35 percent share of wool exports (slightly more than 40 percent of carpet type wools). Prior to WSI being overtaken by Lempriere it was publicly listed with 65 percent ownership held in a few hands and the rest held by management and 3,500 farmers. WSI controls approximately 40 percent of New Zealand's wool scouring. Wool for scouring and exporting is procured through auctions, private sales and independent merchants.

Branding initiatives by Wool Services International (WSI)

WSI have three branding initiatives: Purelana, Glacial, and Redband, all targeted at carpet and rug manufacturers.

Purelana is a scoured-wool brand that was launched in 2005. Its value proposition is based on sustainability, and on a paper-based traceability system from procurement through to processing and marketing. The program requires growers to exclusively supply WSI for a contracted period of between one and three years. WSI offers two main direct supply options to farmers. One is a forward contract based on a forward price of up to a year, and the other is a spot market contract price. The long-term supply contract is intended to create consistency in timing, quantity and quality. The direct supply system minimises costs to farmers by reducing handling costs between the farm and the wool scour, avoiding brokerage charges and marketing fees. Loyal farmers have benefitted somewhat from these economies of scale.

The Glacial brand is positioned as exceptionally clean and bright scoured wool with a superior capacity to take dye. The special scouring process is twice as costly as the normal process and is therefore only applied to the best quality wool.

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Glacial is targeted at manufacturers of pure white and pastel shade carpets and rugs. The imaging suggests that farmers for this brand are encouraged to be innovative in stock management practices, pest control and shearing practices to ensure quality of the fleece. Although still a small business, it has been considered one of WSI's flagship products.

Redband is aimed at visually differentiating bales of scoured wool. Instead of using the usual brown metal bands to wrap wool bales, WSI changed to a red band so their bales of wool can be identified when combined with others. Although the initiative started out with small expectations, over time WSI customers' perception of the Redband as a sign of quality assurance has grown.

WOOL PARTNERS INTERNATIONAL (WPI) AND WOOLS OF NEW ZEALAND (WONZ)

Wool Partners International (WPI) was created in 2008 by PGG Wrightson as a wool trading and marketing company. WPI was floated with the idea of becoming 50 percent owned by PGG Wrightson and 50 percent by farmers through a holding company to be named Wool Growers Holding. **The initial public offering to fund Wool Growers Holding was not successful.** PGG Wrightson then went ahead with the plan and transferred to WPI all its strong wool business – a wool procurement team, an auction management team, an international trading division, a network of wool stores and quality control facilities spread throughout the country, as well as the exporting company Bloch and Behrens. **In 2008 WPI bought Wools of New Zealand (WONZ), a wool marketing division from Meat and Wool New Zealand.**

During 2009 to 2011 there were two further unsuccessful attempts to raise \$50 million from farmers and create a Wool Partners Cooperative (WPC). The idea was that WPC would acquire most of the wool trading assets of WPI, consolidating 50 percent of the crossbred clip. **In 2011, Wools of New Zealand brands, including Laneve, was sold to Wools of New Zealand Trust after the WPI initiative failed. The other assets remain under the control of PGG Wrightsons.**

WONZ launched a new prospectus in October 2012 inviting farmers to invest in this new company. The proposal was targeted to raise \$10 million from farmers. Farmers were invited to subscribe for one share for every 2 kilograms of wool produced per annum i.e. \$0.50 per kilogram. The minimum subscription was \$5,000 and there was no maximum. It was estimated to reach this target would require around 2,000 growers producing

10,000 kilograms per year, or approximately 14 percent of the crossbred wool clip. A number of farmers who had been paying a voluntary levy to WONZ were also set to receive one extra free share for every two additional shares they purchased in recognition of prior support. **Though the capital raising target was \$10 million, the business has reached in excess of \$7 million from approximately 700 growers (exceeding the \$5 million threshold minimum).** It is now operational, although it is expected the business plan will take longer to implement.

A lack of apathy from past industry failures to consolidate the clip, combined with the amount of required capital and involvement of brands and other exporting and processing assets from PGG Wrightsons in the WPC offer, was a "party stopper" for many farmers. **In this case, WONZ now directly owns the Wools of NZ and Laneve brands and no other parties are directly involved.** The WPC proposal was to set itself up in direct competition with the existing wool trade. The WONZ business seeks to work with exporters to establish Direct-to-Market Contracts.

Farmers will be required to pay an annual levy or "Wool Market Development Commitment" of \$0.15 per kilogram of wool produced. This is to provide working capital and to help make up the current shortfall in capital-raising. This is fixed for the period June 2013 to June 2018, but may increase by \$0.20 per kilogram if the average wool price reaches \$4.50 per kilogram (clean) for three consecutive months.

Of the capital raised approximately \$0.9 million will go to repay its debt in the WONZ Trust associated with the purchase of the Wools of New Zealand and Laneve brands along with holding costs (approximately \$1 million of debt has been converted to shares by the lenders). A further \$550,000 will go to fund the issue costs. The prospectus details how WONZ will use the remaining capital it raises to further develop their already established long-term manufacturer and retail relationships. They also plan to develop supply chains through direct-to-market contracts and fund R&D to create further products.

Branding initiatives of WONZ and Laneve

The Wools of New Zealand and Laneve brands are targeted at carpet and rug manufacturers. The Wools of New Zealand brand was launched in 1994. **The use of the brand in carpets and rugs requires a minimum of 80 percent total fibre content from wool and a minimum of 60 percent of the wool content to be New Zealand sourced.** The products have to pass performance testing of

FEATURE ARTICLE: THE WOOL INDUSTRY'S BATTLE FOR SURVIVAL

durability, appearance retention and colour fastness. The manufacturers are licensed to use the brand and no exclusivity is required. The Wools of New Zealand brand has over 100 partners involved in yarn or carpet production.

The Laneve brand is positioned as an integrity brand, providing assurance to the consumer that the wool is sourced from farmers with high standards of animal welfare and environmental sustainability. A paper-based traceability system enables the wool to be traced back to the farm. Growers have to comply with a code of practice about health, nutrition and safety.

Under the WONZ proposal grower shareholders will be asked to join a Group Integrity Program. This is a QA program which addresses management techniques and wool traceability. Promotion activities are aimed at communicating directly with manufacturers and retailers, through advertising in specialist interior design magazines. An online training program called the Wool College is aimed at training retail staff to communicate with consumers about the benefits of wool and the value proposition of Laneve. The expectation is that eventually manufacturers will pay a royalty to use the brand, or alternatively pay a price premium for the branded wool.

SO – WHERE TO FROM HERE?

We like the spirit of some of the new initiatives. However, there are still many issues that need to be addressed to reposition New Zealand strong wool as a fashion item and change the position of farmers in the supply chain to extract more value. **Issues that need to be resolved include:**

- 1. More unity amongst farmers,** so new initiatives that are successful quickly gather enough critical mass to provide more consolidation of the clip through one channel and a larger pool of investment.
- 2. Better information flow and deeper relationships between supply chain partners.** This would help reduce inefficiency, improve the feedback of market signals, and provide closer collaboration on investment etc.
- 3. Supply chain consolidation.** There are still too many middlemen sitting between farmers and end consumers and all are taking a clip of the ticket.
- 4. More proposals, or support for existing proposals and structures that closely connect farmers to key retailers** who act as the ultimate gatekeepers for end consumers.

- 5. More research and investment** into repositioning New Zealand wool and its associated end products, such as carpets, as must-have fashion items for the wealthy and fashionable.

Past experiences continue to colour thinking too much. This creates conflict and disunity amongst farmers and other supply chain partners. Sheep farmers need profitable returns from both wool and sheepmeat if the industry is to have a bright future. One of the advantages of sheep farming is that it provides dual incomes from completely different markets.

While there has been some consolidation in the supply chain, more would not go amiss. We question whether having four main wool sales channels and 35 “competing” exporters across a \$771 million export base is effective. Farmers can support this in the way they commit their wool for sale, or invest capital. **To date, no one proposal has yet reached critical mass, but the amalgamation efforts of WONZ and EPW could be the start of something larger further down the track.** The business strategies and motives of both are not that far apart this time around. To split support across these two businesses looking to change the paradigm of New Zealand strong wool seems illogical, but highlights current farmer disunity and apathy.

Research, innovation and promotion are necessary for the future health of the wool sector, in reducing the costs of production, the development of new processing techniques, and finding innovative uses and markets. The dropping of the wool levy was understandable, but it has left a hole that needs to be filled – ideally through commercial parties. Some of the new branding initiatives are seeing an increase in marketing investment, but again, when added together there is still a lack of critical mass and they are only targeting one part of the supply chain. **An increase in critical mass needs to be extended into other parts of the supply chain from growing wool through to turning it into a fashion item.**

Providing additional value to retailers by leveraging off the unique traits of (New Zealand) wool – its comfort, warmth, intimacy, naturalness, safety, ethics, sustainability, heritage, animal welfare etc – **requires the wool supply chain to cooperate and provide a free flow of information from the grower to the consumer and back and forth.** Carpets are a fashion item and style, colour, pattern and texture are critical along with budget, warranties and retail brand validation (quality). Fibre type and origin are secondary considerations when purchasing decisions are made.

FEATURE ARTICLE: THE WOOL INDUSTRY'S BATTLE FOR SURVIVAL

Targeting sophisticated niche consumer markets requires substance and product integrity. The wool sector, if it is to take advantage of the genuinely unique traits of New Zealand wool, needs to work toward developing and setting benchmarks for these traits. This will require third-party accreditation around quality and traceability to be credible. This will provide a strong basis to respond to synthetic claims of superior performance and possible recycling credentials.

These standardised benchmarks, along with the lack of information and price feedback from retailers and manufacturers to farmers, has been a key ingredient missing along the supply partner chain. Craig Hickson (WONZ board member) has been advocating for more effective feedback loops and the reinforcement of desirable behaviours to farmers.

Effective feedback from retailers/customers to farmers requires the value differences between various wool attributes to be reflected in the price paid to the farmer in a transparent manner. Then farmers can better understand the pricing difference created by moving their wool clip fibre diameter, vegetable matter, colour or staple length up or down a category. This allows an informed decision in determining what the net reward would be for changes made to the characteristics of the wool produced.

Wool attribute value differences are imputed in the market price paid (at auction or by private sale) but unfortunately, in most cases it is not clear to the farmer how each of the 'sale' wool characteristics contribute to the price paid.

For example, how many farmers know that the value per kg clean increases as lamb wool reduces in fibre diameter, from 32 microns down to 27, by micron increment? Likewise the differing values between colour category ranges, vegetable matter, or staple length. If farmers don't know these things, things will continue to be done as they always have been done with the same outcome.

Currently the wool industry appears to operate across numerous stratas, with little communication taking place more than one step up or down in the supply chain. This must change to allow customers "needs and wants" to be communicated and reinforced with farmers.

A simple mechanism to help increase the feedback loop from consumers/retailers to farmers on value differences, would be a "national wool schedule", which clearly identifies the various values for different categories of wool according to a buyers

preference i.e. wool value by category for staple length, fibre diameter, vegetable matter, colour etc.

Only when farmers are informed about the specific characteristics of their wool in a clear and transparent manner can we expect continuous improvement to kick in.

UPSHOT

The wool industry is in a battle for survival.

In the last few years there have been a number of structural shifts in the ownership of different parts of the supply chain and branding space. However, there are still many channels to market, and fragmentation in reaching the final consumer. This leads to a number of inefficiencies and a lack of investment. It also makes for a confusing picture when assessing the merits of different proposals to improve farm-gate prices. Past experiences have been that extracting premiums directly from manufacturers isn't possible without a significant commitment and support from retailers. This is the direction recent farmer proposals have started to head, perhaps offering some hope. But in general, past experiences have coloured farmers' thinking and created disunity. This is displayed in a lack of collective enthusiasm by farmers to invest in one particular proposal.

Changing farmers from price takers to price makers requires more investment, consolidation of the clip through fewer channels, closer partnering with retailers, clearer benchmarks, better information flow and price signals, and the repositioning of strong wool and its associated end products as fashion items.

Just as we see across the meat industry, there is often a lot of finger pointing towards the processors and exporters. Rather, addressing these industry challenges needs to start at the farm gate. Farmers can support this in the way they commit their wool for sale, or invest capital.

THE MONTH IN REVIEW

ASSESSMENT

Little rain and lots of heat over a six-week period that began in early February turned the 2012-13 farming year into a season of two halves. This dry period tipped the entire North Island and parts of the West Coast into official drought zones. Rain was received in mid/late March, helping relieve many regions in the South Island and lower North Island, but more follow-up rain is required in April. Hawke's Bay and many of the regions in northern parts of the North Island remain very dry. Many of these regions have been struck the hardest by the drought, and the mid/end March rain only settled the dust. Overall, the production and financial effects vary by sector, region and farm type. In general, livestock producers are the hardest hit, while arable and horticultural growers have had a better time so far.

DAIRY

The 2012-13 dairy production season started with a lot of promise with total production to January increasing 6.5 percent on last year's previous record high.

Nevertheless, it has been a different story since the dry conditions started to bite in early February. In the North Island the worst-affected regions of Northland, Waikato, East Coast and Central North Island, milk flows dropped by 10-20 percent y/y over February and at the end of March are now tracking 30-35 percent behind the same period last year. In other North Island regions, the drop was not quite so significant, but at the end of March most were tracking 10-20 percent behind the same period last year.

As the dry conditions bit, nearly all North Island dairy farmers moved to once-a-day milking and dried off low performing stock. Low performers and any empty cows have been sent to the freezing works early. This has brought about a massive shift forward in this years cull cow slaughter with an extra 191,000 cows processed for the year-to-date. This is a 80 percent increase on the same period last year.

While some farmers dried off their entire herds early, most have dug into winter feed reserves, or imported extra supplement to continue milking. The feeling has been that it has not necessarily stacked up to feed extra imported supplement, because of the milk price forecast at the time, high cost of feed and time of the season the cows would have to be fed, even if they were dried off. Therefore, many choose to continue to milk to collect some revenue rather than none, to help pay to feed the cows. As April has approached this has increasingly been reassessed, with more and more farmers drying off the remainder of their herd as the focus turns to next season. **This potentially means total production will finish the season 10-20 percent behind last year's record in the**

worst affected regions. As the focus starts to shift to next season, getting cows through the winter and up to condition will be paramount to the recovery.

In the South Island, apart from the West Coast and top of the Island, **most regions have had a good run due to better seasonal conditions, or being under irrigation.** More recently though irrigation takes have been restricted or stopped, shifting a number of farmers to once-a-day milking and drying off low performers. In February and early March production is estimated to have been in line with last year, but more recently daily milk flows have started to drop by 5-15 percent y/y as herds have moved to once-a-day milking.

MEAT AND FIBRE

In the sheep and beef cattle sectors the news is mixed. Breeding properties generally destocked finishing stock early at lower weights and prices. Finishers who had specialist feed crops have been able to benefit. Current attention has been on ewe mating as the lack of grass will affect next years lamb crop. At this stage it is too early to tell how much of the increase in this seasons slaughter is brought forward finishing stock versus the turnoff of breeding stock.

HORTICULTURE AND VITICULTURE

In the horticulture, arable and viticulture sectors the dry and calm conditions have generally led to high-quality crops with fewer disease and pest issues.

Grain growers have been happy to have good harvesting weather. Generally, this has produced good quality harvests with few moisture-related quality issues – a sharp contrast to the year before. Anecdotal evidence on yields has varied by crop and region. For barley and wheat crops these have been average to slightly above. For maize it has been a mixed bag, with some regions lack of water failing to completely fill out cobs. If it stays dry then there could be some pressure to strike autumn-planted crops.

In the kiwifruit sector the dry conditions in the main growing regions has dramatically reduced the effects of Psa. It now looks like a 90 million tray crop can be expected (-10% y/y), with slightly than better expected Gold production as vines have shrugged off Psa. **Conversely, it has been too early to assess what the final impacts of the dry conditions might be on size and quality.**

In the viticulture sector, the Marlborough grape crop is expected to be above last year, but not overly large. The crop has been reported as in good condition with less wind impacts. **Well-managed vineyards are expected to produce above-average quality.**

RURAL PROPERTY MARKET

SUMMARY

General sentiment conveyed by rural property market statistics since early 2013 has been one of slightly softer prices, but better turnover. Total turnover is up 10 percent for the first two months of the year compared with the same period last year. The turnover of dairy and horticultural-aligned property has improved, whereas dry stock and arable property turnover has been flat to slightly softer than the same period last year. Price movements have been a mixed bag once again. In general, dairy-aligned and lifestyle properties have held their value, but grazing and horticultural property prices have struggled.

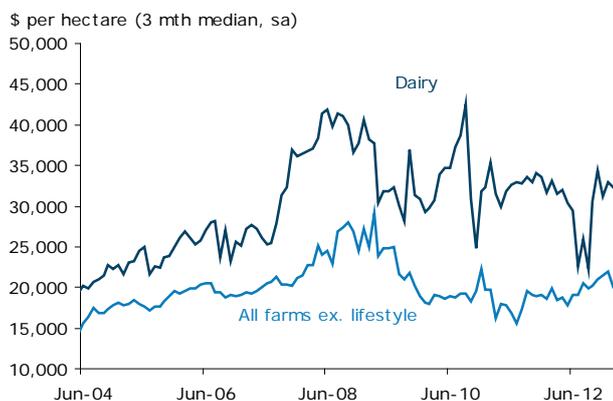
The rural property market statistics are yet to reflect the drought conditions much of the North Island and parts of the South Island have experienced this summer. Absent this, many of the competing cross winds remain similar to our last update.

Interest rates certainly remain favourable; there are buyers with strong balance sheets; lower inflation has helped moderate some cost pressures; and offshore investors are still keen for exposure to NZ's agriculture story despite the high NZD. Conversely for commodity prices it depends on the sector (milk up, sheep/wool depressed). There's still a significant proportion of farmers with weak balance sheets especially in the dairy sector and the setting/implementation of more environmental regulation continues to be pushed ahead in many regions (see education corner for an update).

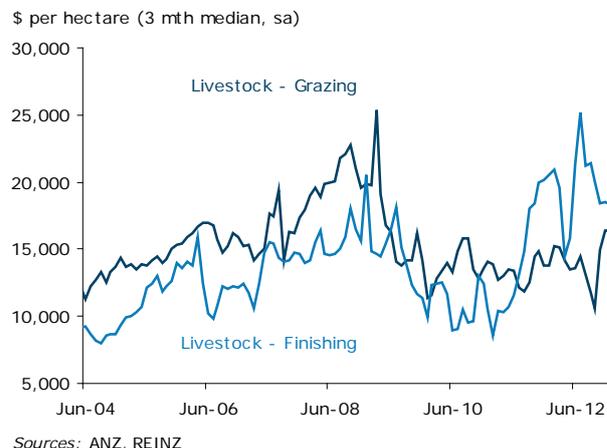
The table and charts below show the official REINZ statistics for farm sales in the 3-month period ending February. The table is broken down into farm sales by each of the main farm types, both the number of sales during the 3-month period, and the median price per hectare. The figures have been seasonally adjusted and therefore the components may not necessarily add to the total. While the data is volatile, it is the best available on current market conditions.

3-Month Seasonally Adjusted		Current Period	Previous Period	Last Year	10-Year Average	Chg. P/P	Chg. Y/Y	Chg. P/10yr
Dairy	Number of Sales	59	63	48	75	↓	↑	↓
	Median Price (\$ per ha)	32,200	33,000	33,100	28,700	↓	↓	↑
Livestock – Finishing	Number of Sales	75	74	70	64	↑	↑	↑
	Median Price (\$ per ha)	17,800	18,300	20,900	13,100	↓	↓	↑
Livestock – Grazing	Number of Sales	203	195	215	237	↑	↓	↓
	Median Price (\$ per ha)	13,200	16,400	15,000	14,800	↓	↓	↓
Horticulture	Number of Sales	37	38	17	52	↓	↑	↓
	Median Price (\$ per ha)	92,200	92,200	160,400	146,500	↔	↓	↓
Arable	Number of Sales	14	11	15	19	↑	↓	↓
	Median Price (\$ per ha)	26,900	23,600	21,700	25,000	↑	↑	↑
All Farms ex. Lifestyle	Number of Sales	418	408	386	483	↑	↑	↓
	Median Price (\$ per ha)	20,100	21,900	20,000	19,400	↓	↑	↑
Lifestyle	Number of Sales	1,602	1,638	1,419	1,615	↓	↑	↓
	Median Price	496,000	490,000	466,000	400,000	↑	↑	↑

Farm Sales, Median Price

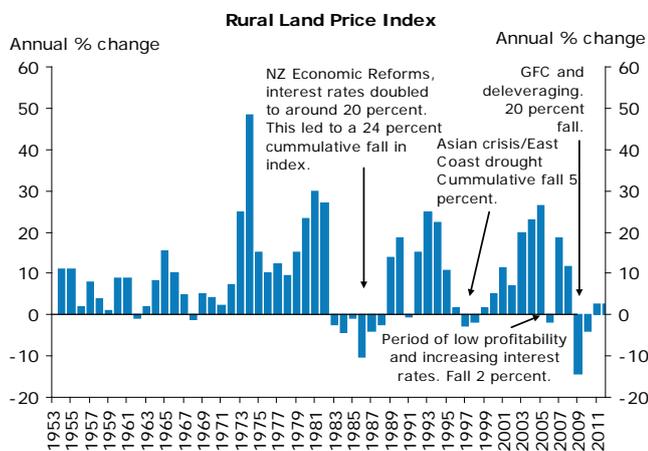


Farm Sales, Median Price



RURAL PROPERTY MARKET

The current drought has the potential to influence the rural property market if undue financial stress emerges down the road. While most would suggest the market and banks usually look at droughts as one-off events, history suggests differently. Looking at the past four major droughts of 1982-83, 1988-89, 1997-99 and 2007-08 in the chart below shows these periods have all coincided with a downward correction in rural property prices. However, these periods were also marked with other notable events that reduced the returns in the main rural sectors through a range of impacts. For example the 80s was characterised by economic reform, deregulation of agricultural subsidies, high interest rates and the share market crash.



Sources: ANZ, Quotable Value New Zealand

It is difficult to say how this drought will affect the property market. Its effects vary by region, sector, and even farm type. In the dairy sector, estimates now range from a \$100,000 to \$150,000 hit in profitability for an average-sized dairy farmer in the worst-affected areas of the North Island. This means many may struggle to turn any profit this season. This is despite a solid first half for milk production and recent improvement in dairy prices. However, with a recent rally in global dairy prices, the release of a range of bank support measures, and low interest rates, any increase in working overdrafts should be able to be adequately dealt with next season, provided the weather is kinder.

This is not to say there will not be pockets of stress. In the regions that have recently received rain, more is still required. In Northern parts of the North Island, many of these regions are yet to receive significant rain and these are some of the regions struck the hardest by the drought. If pasture and cow conditions do not improve before the autumn/winter and expensive feed has to be purchased to get through to next season then this scenario is bound to increase longer-run stress for any who were struggling prior to the drought.

Elsewhere, the present stress in the meat and fibre sector is more to do with lower wool and sheepmeat prices as opposed to drought conditions. **The forecast 50 percent decline in profitability for an averaged sized farm in 2012-13 is almost entirely driven by price and margin adjustment.** The main effects of drought will be felt in the 2013-14 financial year, where lower numbers of breeding stock and lambing percentages will weigh on the number of stock that can be sold. **Still, stronger balance sheets in the meat and fibre sector usually absorb such shocks.**

Examining the backward-looking indicators for the rural property market on page 13 shows that the average price was \$20,100/ha for the 3-month period ending February. This was slightly back from the recent two-year high in January, but remains healthy by post-GFC standards. **Turnover equated to 87 percent of the 10-year average, which is the second highest level since the GFC in October 2008.**

Turnover of dairy properties has been stronger than expected, improving back toward 80 percent of its 10-year average since the beginning of the year. The average price achieved during this period has shown good stability, ranging in line with the post GFC average of \$32,500 per hectare. **In the month of January, 25 dairy farms were sold with an average sale value of \$32,000/ha, or \$31 per MS.** The average farm size was 136 hectares and the average production/ha was 1,050 kgs of MS. **In February, 17 dairy farms were sold with an average sale price of \$35,500/ha, or \$45 per MS.** The average farm size was 119 hectares and the average production/ha was 792 kgs of MS.

Finishing land prices seem to have stabilised around the \$18,000 per ha mark in recent months and turnover remains high, especially in dairying hotspots. In fact turnover is currently nearly 20 percent above the 10-year average and at a post-GFC high. While the \$18,000 per hectare is a drop of 10-20 percent from the prices achieved during the 2011-12 season, it is still more than 40 percent up on the 10-year average of \$13,000 per ha. This emphasises how far things have come. **As mentioned previously, the trend in finishing land prices has been up, but it looks like this has now matured.** Arable land sales have also been solid, with prices very close to their 10-year average, and up on the same period last year. In contrast, the average grazing price for February has started to show some of the pressure from lower sheepmeat and wool prices.

Horticultural property sales have been steady and prices have shown some slight improvement due to better quality crops. Turnover has been around 75 percent of its 10-year average in the three months ending February and the average price was \$92,200/ha.

ECONOMIC INDICATORS

EXCHANGE RATES

	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZD/USD	0.82	0.84	0.82	↓	↑
NZD/EUR	0.64	0.63	0.62	↑	↑
NZD/GBP	0.55	0.54	0.52	↑	↑
NZD/AUD	0.80	0.81	0.78	↓	↑
NZD/JPY	78.0	78.2	64.9	↓	↑
NZD/TWI	75.6	75.2	73.0	↑	↑

NZD Buys USD



NZ INTEREST RATES

	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Official Cash Rate	2.50	2.50	2.50	↔	↔
90 Day Bill Rate	2.62	2.66	2.74	↓	↓
1 yr	2.70	2.58	2.70	↑	↑
2 yr	2.87	2.69	2.86	↑	↑
3 yr	3.07	2.85	3.08	↑	↓
5 yr	3.50	2.77	3.53	↑	↓
10 yr	4.00	3.80	4.23	↑	↓
Effective Rural Rate	6.38	6.39	6.55	↓	↓
Agricultural Debt (\$b)	49.63	49.59	46.85	↑	↑

Key NZ Interest Rates



We expect the NZD to remain elevated over the next two months, supported by offshore demand for bonds and confidence that "Cyprus contagion" will be contained. But while financial market metrics such as interest rates and commodity prices point to a stronger NZD, these need to be considered in light of the headwinds the real economy is facing. Accordingly, we expect the NZD to "range trade" at an elevated level, rather than mounting an assault on fresh highs.

The main near term driving force is a very real one: offshore investment in NZ Government bonds (NZGS). Data bears this out, with \$2.3bn of net offshore buying of NZGS in January and February. However, things are likely to be hot up in April when the Government syndicates a \$2bn April 2020 NZGS bond deal. If, like the last syndicated bond deal, a large chunk of the deal goes offshore, this will be associated with substantial NZD buying, propping up the NZD.

But while the near term picture is positive, and is set to keep the NZD elevated through April, as we head into the Southern Hemisphere winter the going is set to get tougher. There are challenges from (1) the drought; (2) the potential for the Fed to pare back its QE program in coming months, and (3) the self-limiting aspect of ongoing currency appreciation.

How the drought finally plays out remains to be seen, but any changes on Fed policy will have an immediate impact. It is also worth reiterating comments that the RBNZ made about the NZD in its March Monetary Policy Statement, when it said "all other things equal, a higher exchange rate relative to the baseline, in the absence of a corresponding relative strengthening of New Zealand's economic outlook, would warrant lower interest rates". We doubt the Bank would cut the OCR, but equally, if the NZD does strengthen further, the consequences for the economy will be very real and forthcoming OCR hikes delayed further.

We continue to look to an early 2014 start to OCR hikes. Recent activity data has been strong, culminating in the recent release of data showing GDP jumped by +1.5 percent in Q4.

However, forward-looking data points to trend growth of 2-3 percent, with boosts from the Christchurch rebuild and strength in the Auckland housing market offset by the drought, high NZD, and patchy labour market. In addition, inflation remains subdued, giving the RBNZ considerable breathing space to assess what looks to be a stop-start outlook.

With monetary policy on hold for at least another 12 months, short-end interest rates remain anchored. However, long-term interest rates are likely to continue rising (very) gradually in line with global benchmark interest rates, steepening the yield curve.

ECONOMIC INDICATORS

INFLATION GAUGES

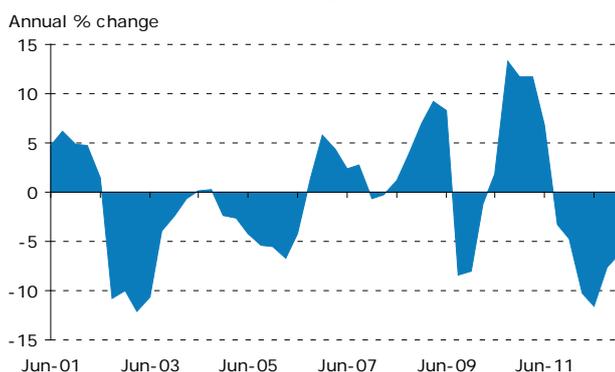
Annual % change	Current Qtr	Last Qtr	Last Year	Chg. Q/Q	Chg. Y/Y
Consumer Price Index	0.9	0.8	1.8	↑	↓
Farm Input	1.5	3.8	7.4	↓	↓
Net Imp. Margins PPI	-6.4	-7.6	-4.7	↑	↓

Farm Input Inflation Gauge



Sources: ANZ, Statistics NZ

Net Implied Margins PPI Ag/Forestry/Fishing (Outputs - Inputs)



Sources: ANZ, Statistics NZ

Despite annual on-farm input cost inflation slowing to 1.5 percent y/y, lower margins in the livestock sectors have seen all discretionary spending reduced. This will have promoted some discounting by service providers. A lot of capital expenditure was delayed earlier in the season and is unlikely to take place now in drought-affected regions. The drought could also affect capital expenditure next year as farmers initially focus on reducing working overdrafts.

Additionally, the drought will have contrasting effects on other farm inputs. Breeding livestock prices in both the dairy and sheep sectors have fallen (albeit for slightly different reasons). While many do not have the grass cover to buy additional stock, lower prices will flow through into lower inflation pressure. Conversely, the opposite could again happen next season if pasture conditions are favourable. **Feed costs have increased.** Feed costs typically account for 20-30 percent of working expenditure for an average-sized dairy farmer and 7 percent for an average-sized meat and fibre farm. Some have dug into winter feed reserves, but most have had to import some additional feed. This has seen Palm Kernel Extract prices rise to \$350 per tonne which is up nearly 30 percent (\$80 per tonne) on the same period last year. The use of more irrigation in the South Island than last year will have also increased electricity usage and production costs.

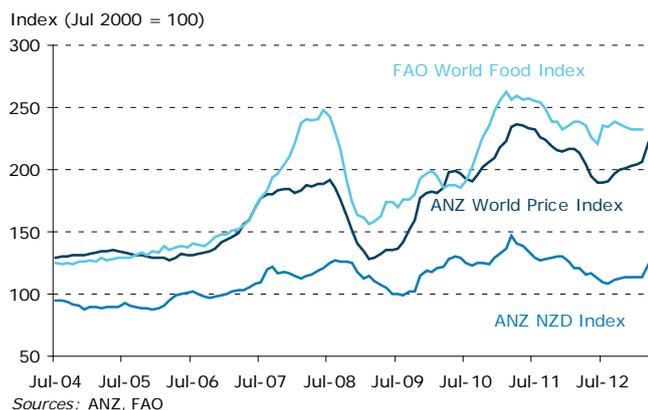
One of the saviours in recent years has been **lower interest rates.** Our measure of the effective rural interest rate is it has averaged 46bps lower year-to-date. For the average dairy farmer with debt of \$21 per kg MS, this translates into an annual interest cost saving of \$13,100, or \$95 per ha. For the average dry-stock farmer it is an annual saving of \$3,400, or \$5.20 per ha.

Quarterly PPI margins improved in December for all sectors, apart from seafood and sheep/beef and grain farming. There was a modest 0.7 percent improvement in output prices as commodity prices lifted. The largest quarterly improvement in output prices was in dairying, followed by other livestock enterprises (poultry and deer). The biggest decline was in sheep/beef and grain farming (-2.0% q/q). **Input prices declined by 0.5 percent q/q.** The largest quarterly decline was for sheep/beef farming (-2.0% q/q), followed by crop and other farming (-0.9% q/q). Lower tradable inflation pressure and livestock prices are the main drivers. **Overall, net margins rose the most for dairying,** up 4.3 percent q/q, but they remain 16.1 percent down y/y. **Net margins for seafood experienced the largest quarterly decline,** back 4.9 percent. The only sector to record a positive yearly net margin was horticulture/viticulture up 4.7 percent y/y.

KEY COMMODITIES: OVERALL INDEX AND DAIRY

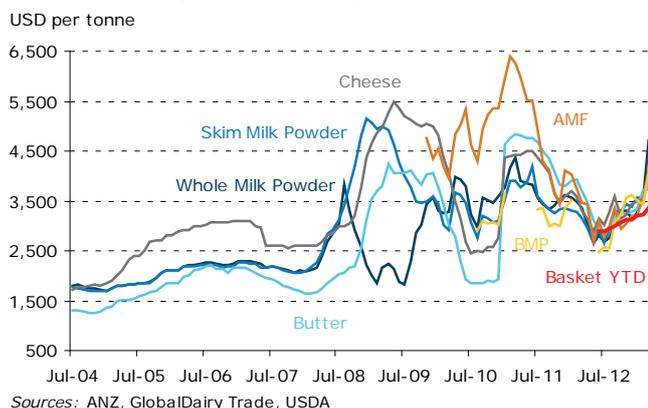
ANZ COMMODITY INDEX					
	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
ANZ NZ Index	123	114	121	↑	↑
ANZ World Index	221	206	213	↑	↑
FAO World Food Index	231	232	238	↓	↓

Soft Commodity Price Indices



OCEANIA DAIRY PRICE INDICATORS					
USD per tonne	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Whole Milk Powder	4,707	3,561	3,362	↑	↑
Skim Milk Powder	3,904	3,573	3,160	↑	↑
Butter	3,726	3,726	3,683	↔	↑
Anhydrous Milk Fat	4,118	3,568	3,458	↑	↑
Butter Milk Powder	4,052	3,424	na	↑	na
Cheese	4,071	3,540	3,306	↑	↑
Basket YTD	3,360	3,220	na	↑	na
Milk Price YTD (\$ per MS)	5.60	5.50	na	↑	na

Dairy Products - NZ Export Market Prices



The modest bounce in New Zealand's soft commodity price basket has continued with in-market prices up 16.9 percent since mid last year. The dampener of course has been the NZD, with farm-gate prices increasing by 12.8 percent over the same period. More recently, turbo-charged dairy prices have provided an additional boost. In the other main sectors prices are either flat-lining, or continuing to post small incremental increases.

The question is: where to now? International soft commodity prices as measured by the FAO index are little changed in recent months as markets await the main Northern Hemisphere planting and growing season. **All indicators at this stage point toward a large increase in the growing area of key crops**, such as corn, wheat and soybeans. **If normal weather patterns occur** during the growing season, then crop yields are likely to return to trend and combined with the increase in area planted would deliver some large crops. **Such a scenario will place downward pressure on global soft commodity prices later in the year.** However, the downside is limited somewhat by low inventory levels that need to be rebuilt. For New Zealand's in-market prices this will provide some downside pressure as we progress through the 2013-14 season.

Dairy prices appear to have overshot the mark in March/early April. Nonetheless, they are likely to remain at high levels as we head into the first half of the 2013-14 season.

The abrupt slowing in NZ production caused a larger-than-expected gap in supply between peak seasonal production in the Southern and Northern Hemispheres. This saw buyers scrambling to secure product to fulfil short-term needs, especially WMP. This caused a 45 percent surge in the GDT-TWI and massive 40 percent increase in WMP prices. The spike in WMP prices is significant as this makes up around 60 percent of the basket of dairy products used to determine the milk price. **This has provided more upside to the 2012-13 milk price, with Fonterra upgrading their forecast by \$0.30 to \$5.80 per kg MS.**

The key will be where prices settle over coming months, as this will have a large influence on the 2013-14 milk price. Demand remains solid in emerging markets, especially China, Algeria, Venezuela and Brazil. Supply growth above the seasonal norm in the Northern Hemisphere remains non-existent, even with the US performing better than expected. This is due to a lack of profitability, implying higher prices are required. Known inventory levels are low in NZ and elsewhere (apart from the US). Current indicators are pointing to around the US\$3,800-US\$4,000 per tonne mark. **At spot NZD prices this translates into a milk price around \$6.50 per kg MS as an early indication.**

KEY COMMODITIES: BEEF AND LAMB

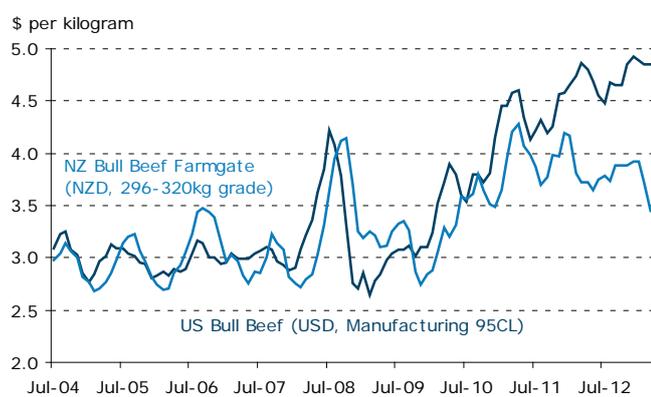
BEEF PRICE INDICATORS

\$ per kg	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
US Bull Beef ¹	4.85	4.85	4.87	↔	↓
NZ Bull Beef ²	3.45	3.72	3.72	↓	↓
NZ Steer ²	3.55	3.71	3.71	↓	↓
NZ Heifer ²	3.50	3.65	3.75	↓	↓

¹ USD, Manufacturing 95CL

² NZD, 296-320kg Grade Bull & Steer, NZD, 195-220kg Grade Heifer

Beef Indicator Prices



Sources: ANZ, Agrifax

The beef schedule has wilted faster than the grass over the past two months. The surge in beef cattle and cull cow slaughter due to the dry conditions across the North Island have placed pressure on plant capacity and the prices meat processors are willing to offer. In contrast, in-market price indicators for the main cuts and co-products have all improved and the NZD has been slightly softer. This suggests that when the cull cow turn-off slows, schedule prices will bounce back. Schedule prices are now approximately 7-12 percent below a year ago. In NZD terms manufacturing beef prices are little changed. Prime cuts are back a couple of percent and co-products are mixed largely offsetting one another. **This suggests prices could easily bounce back by 5-10 percent if other things remain the same.**

So far, total beef production is running 27 percent ahead of last year. Industry forecasts for the 2012-13 season are currently for a 9 percent lift. Most of this comes from normalisation in the dairy cull cow slaughter where low empty rates and good cow and grass condition in the autumn last year allowed dairy farms to carry higher stocking rates into the 2013-14 season. The current debate is how much of the increase in this year's slaughter has simply been brought forward versus the rundown of capital breeding stock. The feeling at the moment is most of it has been brought forward. Cull cows as parts of, or whole herds have been dried off early – this likely to limit the peak in April/May. For beef cattle there has been only a 11 percent increase in the bull beef and steer slaughter so far. This implies finishing stock have not been aggressively turned-off yet, suggesting capital breeding stock have not been culled in great numbers either.

The drought has had the same impact on lamb prices as beef prices. The surge in supply, combined with a lower GBP and euro, has seen farm-gate prices hit a five-year low. The schedule price is expected to stay subdued until pasture conditions improve and slaughter rates slow from seasonal highs. So far total NZ lamb slaughter is running 20 percent ahead of last year. Industry forecasts are for a 6 percent increase in the 2012-13 season, due to a 5 percent increase in the number of lambs born in the spring. Mutton slaughter is running 20 percent ahead of last year, due to a 41 percent increase in the North Island. The longer the drought continues in key sheep producing regions, such as the East Coast and Central North Island, the larger the effect will be on next year's lamb crop and prices.

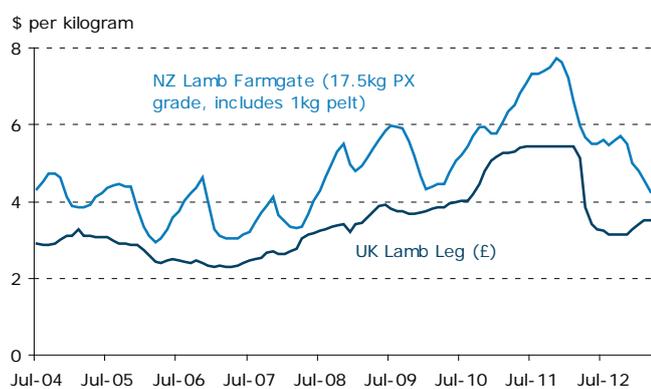
While in-market prices for major cuts of the carcass remain 20-30 percent down on this time last year, the recent surge in supply has not altered them too much. Chinese buying is reportedly filling the gap and has recently surpassed the UK as NZ's largest market on a volume basis. However, the average export price is just half the UK's, which means it remains NZ's most valuable market.

LAMB PRICE INDICATORS

\$ per kg	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Lamb ¹ (NZD)	4.25	4.55	5.96	↓	↓
UK Lamb Leg (£)	3.51	3.51	5.12	↔	↓

¹ 17.5kg PX grade, including 1kg pelt

Lamb Indicator Prices



Sources: ANZ, Agrifax

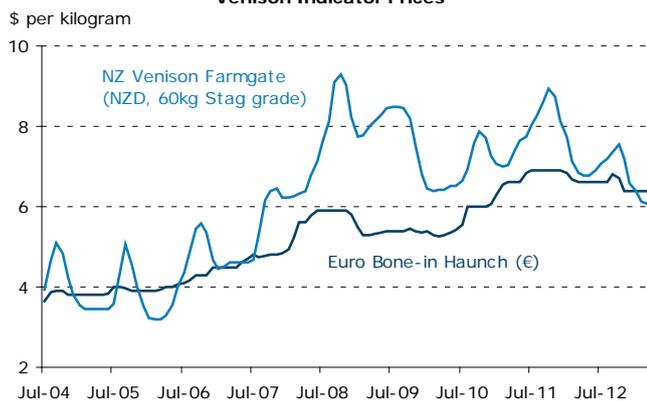
KEY COMMODITIES: VENISON AND WOOL

VENISON PRICE INDICATORS

\$ per kg	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Venison ¹	6.05	6.12	6.85	↓	↓
Euro Bone-in Haunch (€)	6.40	6.40	6.60	↔	↓

¹ 60kg Stag AP grade

Venison Indicator Prices

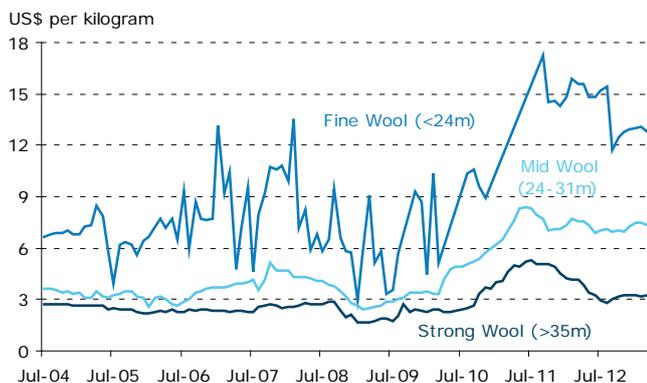


Sources: ANZ, Agrifax

CLEAN WOOL INDICATOR PRICES

\$ per kg	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Fine Wool (>24m)	15.58	15.58	19.05	↔	↓
NZ Mid Wool (24-31m)	8.93	8.93	9.23	↔	↓
NZ Strong Wool (>32m)	3.97	3.80	5.11	↑	↓
USD Fine Wool (>24m)	12.78	13.07	15.58	↓	↓
USD Mid Wool (24-31m)	7.32	7.49	7.55	↓	↓
USD Strong Wool (>32m)	3.26	3.19	4.18	↑	↓

Wool Indicator Prices (Clean)



Sources: ANZ, Beef + Lamb NZ, Wool Services International

Venison markets have been more stable recently. Middle cuts remain under pressure though, and combined with the lower euro this has placed some extra downward pressure on the farm-gate price. While most cuts have been selling better (after some downward pressure earlier in the year) there is still an issue with selling more expensive middle cuts. Economic conditions in Europe are steering consumers toward cheaper shoulder and leg cuts. These middle cuts are likely to remain under pressure as continuing tough economic conditions in Europe persist and the supply and affordability of lamb middle cuts from NZ increases.

Despite the dry conditions as the schedule price has softened further, slaughter rates have slowed. February production was back 20 percent on last year, with a 19 percent drop in the number slaughtered and a slight fall in weights. September year-to-date production is back 6 percent. Stag slaughter dropped by 25 percent y/y in February, whereas hind slaughter was back 11 percent, suggesting farmers have tried to hold finishing stock to await higher prices in the winter and spring. With in-market prices stabilised (apart from middles) and supply soft, as long as the euro does not move lower then farm-gate prices should remain stable before a 10-15 percent seasonal increase kicks-in.

Wool prices have improved slightly in recent months. They seem to have benefitted from better demand out of China and India and a 17 percent increase in cotton prices since November. Demand out of India and China for raw wool has improved from restocking. End demand out of China and the US has also reportedly improved as economic growth picks up. Forward-looking indicators for economic growth in China and the US remain positive for 2013, suggesting an environment of slow incremental gains in demand and price. Year-to-date wool exports are up nearly 16 percent on the same period last year. Good auction clearance rates around the 90 percent mark suggest farmers have not been willing to hold wool back despite prices being 22 percent below last year.

The price competitiveness of wool versus cotton has continued to improve since the start of the year. Cotton prices hit a one-year high in March on concerns output from the major growers will drop as farmers choose to grow other crops. Currently there is fierce competition between grains and cotton for planting area. The price ratio moved against cotton over much of 2012. The current cotton-corn ratio is 6.8 versus an historical average of 9.4, while the cotton-soybean ratio is 3.7 versus the historical average of 4.8. Stronger cotton prices will help wool, but they are not expected to reach the heights of 2010-11, as end demand remains sluggish and global stocks – especially in China – remain historically high.

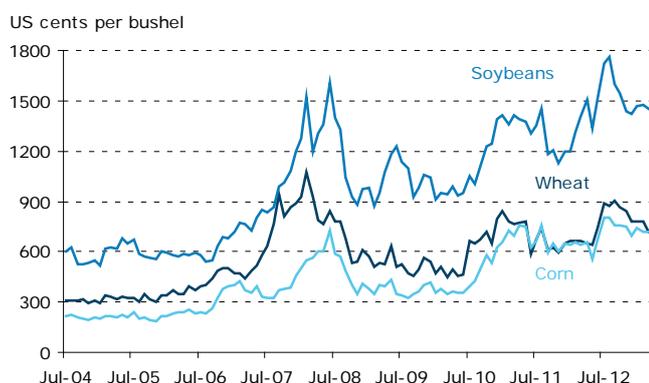
KEY COMMODITIES: GRAIN AND FERTILISER

GRAIN & OILSEED PRICE INDICATORS

USD cents per bushel	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Wheat	7.2	7.8	6.6	↓	↑
Soy	14.5	14.7	14.0	↓	↑
Corn	7.2	7.2	6.4	↑	↑
Australian Hard Wheat ¹	346	350	275	↓	↑

¹ NZD per tonne

CBOT Future Grain & Oilseed Indicator Prices

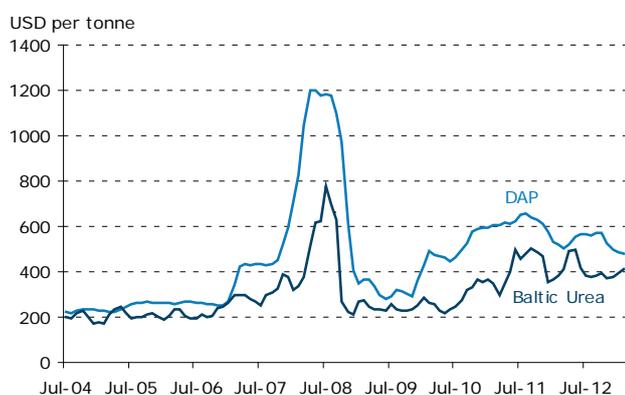


Sources: ANZ, Bloomberg

FERTILISER PRICE INDICATORS

USD per tonne	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
DAP	482	485	517	↓	↓
Urea	412	393	383	↑	↑

Fertiliser Indicator Prices



Sources: ANZ, Bloomberg

The "Mexican stand-off" between buyers and sellers in the local grain market has ended with the onset of widespread dry conditions and a shortage of Palm Kernel Extract (PKE). Local barley and wheat prices have moved up over March as dry conditions bit over most of the country. Some buyers have been looking to secure contracts for next season, but most growers seem happy to wait and see where prices land. The interest for next season is coming about as winter feed reserves are currently being used to get through the dry period and the prospect of a higher milk price might make feeding wheat and barley a more attractive option next season. **PKE prices are still high; above \$300/tonne country-wide for April/May delivery.** Spot sales over most of March have been next to non-existent because of a shortage of supply, and contracts being given higher priority. There are several boats of PKE on the water, or on order, so supply is expected to be higher in April as they arrive. **This will potentially help relieve short-term price pressure for buyers.**

Global corn production forecasts for 2012-13 have been dropped slightly to 854.07 million tonnes after dryness in Argentina and South Africa caused lower expectations. USDA estimates for corn stockpiles in the US before the next harvest are 632 million bushels, which is the lowest level in 17 years. Total consumption in the US is also expected to rise. Expansion in the poultry market for corn feed has accounted for much of this. US exports have been lower though due to competition from South American crops and strong levels of exports from India and the EU.

Despite some improvement in corn and wheat prices in late March **downward pressure is likely to emerge as a record area of corn and wheat is planted this Northern Hemisphere growing season.**

Global fertiliser markets have remained relatively stable in recent months with supply and demand finely balanced. Looking forward, elevated crop prices are likely to support an increase in application rates of most nutrients in most key regions. Additionally many large consumers took the opportunity to liquidate excess fertiliser inventories over the back-end of 2012 and into early 2013. **With Northern Hemisphere planting now underway prices are likely to find some support on the back of expanding trading activity and restocking in anticipation of increased applications.** The US is expected to set the tone of the up-tick in fertiliser prices as they plant a very large crop in response to low inventory levels and high prices for all grains and other feedstocks.

KEY COMMODITIES: HORTICULTURE

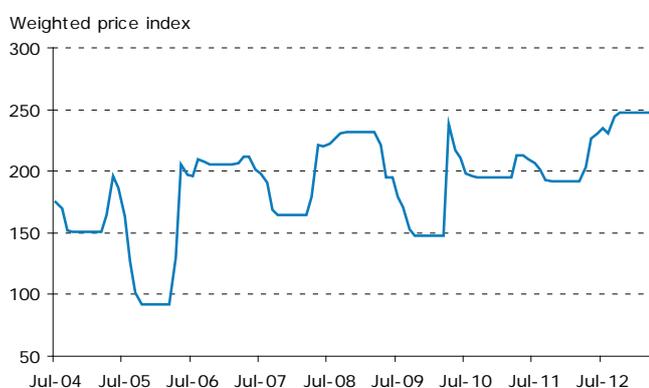
HORTICULTURE PRICE INDICATORS					
	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Kiwifruit (USD per kg)	3.1	3.2	3.1	↓	↑
Apples (Weighted Index)	247	247	192	↔	↑
Wine (USD per litre)	6.2	6.3	5.5	↓	↑

Kiwifruit Indicator Price



Sources: ANZ, Zentrale Markt- und Preisberichtsstelle

Apple Indicator Price Index



Sources: ANZ, Zentrale Markt- und Preisberichtsstelle

Wine Indicator Price



Sources: ANZ, NZ Winegrowers

Horticulture has been more positive than the pastoral sector due to better quality crops and price prospects. There are only small pockets that have not been able to irrigate in the dry conditions, leading to lower-quality fruit and reduced yields. However, the majority of the sector looks set to enjoy high-quality crops with reduced disease incidents and wind damage due to the calm, hot conditions. This could potentially lead to better price premiums.

It is anticipated this year's kiwifruit crop will total around 90 million trays, which will be down 10 percent from last year. Green volumes are expected to be in line with previous seasons, with the impact of Psa on Green volumes not expected to be material. The Gold crop volume will be where the majority of the decline occurs, with a significant amount of the original variety (Hort16A) removed and replaced with Gold3. It will not be known until the end of spring this year what the pace of the Gold3 recovery pathway will be, and a better understanding of the impact of Psa on newly grafted Gold3 in the high-infection risk spring period is gained. Based on observations to date, it is clear that Psa continues to have a mixed impact on the Gold3 variety. Infection levels vary significantly between Gold3 orchards, though in the majority of cases it appears to be performing better than Hort16A in a Psa environment. **The lower rainfall in the main growing areas has had the positive effect of lowering incidence of Psa. This means some growers are set to harvest larger crops than previously anticipated. Drier years also usually indicates higher dry matter in the fruit, which generally means very good-tasting fruit – a key driver to getting repeat purchasers.**

The overall pipfruit crop is expected to lift by 1.5 percent to 16.9 million 18kg cartons. The colour, size, and taste are all reported as exceptional due to the calm, hot conditions in combination with irrigation when required. In addition, pest and disease issues have been less prevalent because of these conditions. Combined, this is likely to make it one of the best pipfruit crops ever produced. It is also being viewed as one of the most diverse crops ever produced, with volumes of all the newer apple varieties forecast to increase. With a diverse high-quality crop that is low in pest and disease issues this is expected to boost its appeal and price premiums in more valuable markets such as Asia. Fixed prices for Royal Gala this season have been reported as \$21 to \$28/TCE, which compares well to last year's average of \$21/TCE.

The upward trend lift in wine prices has continued, driven by better bulk prices. The latest monthly bulk price is up \$1.3 per litre on last year (43% y/y).

KEY COMMODITIES: OIL AND FREIGHT

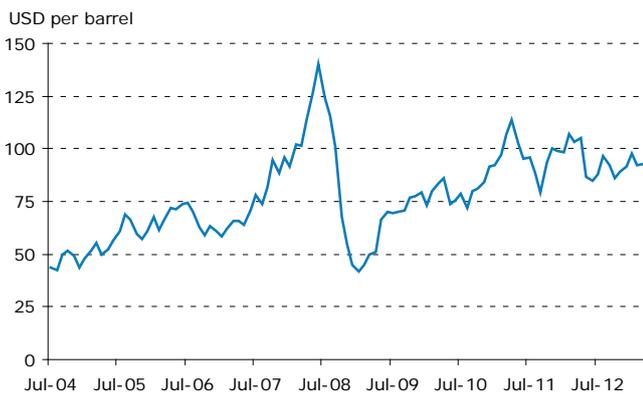
OTHER COST INDICATORS

	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Crude Oil ¹	93	92	103	↑	↓
Ocean Freight ²	850	757	934	↑	↓

¹ USD per barrel, grade WTI

² Baltic Dry Index

Crude Oil Indicator Price (WTI)



Sources: ANZ, Bloomberg

Ocean Freight (Baltic Dry Index)



Sources: ANZ, Bloomberg

Oil markets are likely to continue to firm as seasonal demand in the US and China lifts. The start of the US driving season and China's summer should see oil inventories drawn down and oil imports increase – but rising US unconventional oil supplies will keep stockpiles from falling too far. Iran could also be a drag if a return of sanctioned oil exports occurs, but conflicts in North Africa continue to support a supply risk premium.

There is greater upside for Brent crude oil. Brent is expected to continue to be supported by increased demand from China and tight North Sea and North African supplies, even if political tensions elsewhere start to ease. Saudi Arabia's supply tightening response and ongoing production issues in the North Sea and North Africa will be able to keep higher non-OPEC supplies in check for the near-term.

China's oil imports surpassed the traditional top consumer (the US) in December and this trend is expected to continue to support Brent markets. Investors tend to be pre-emptive and we anticipate prices to improve as China begins to build stockpiles (commercial and government) ahead of the seasonal pick-up in summer demand (Jun-Sep). Encouragingly, government mandates to close China's independent teapot refineries (capacity of less than 40kbbbls/day) and granting of licenses to import crude oil supplies direct from the seaborne market should also improve demand for raw crude oil supplies.

In contrast, WTI faces two significant hurdles in the form of rising North American supply and high stock levels that are currently near 20-year highs. Increased US and Canadian unconventional oil output should keep US stockpiles from falling too far, even during the peak seasonal demand period. US oil production is forecast to increase about 14 percent to 7.3mbbls/day over the year after virtually zero growth in oil production over the previous decade. Canadian oil supplies are expected to rise 10 percent to 3.6mbbls/day this year, of which about 2.2mbbls/day will be exported to the US.

The Baltic Dry Freight index rose in March on expectations that a retracement in iron ore prices will stimulate demand and shipping activity again. There has also been a sharp increase in both panamax (coal, agricultural goods) and handymax (agricultural goods) freight rates over the last month.

ECONOMIC BACKDROP

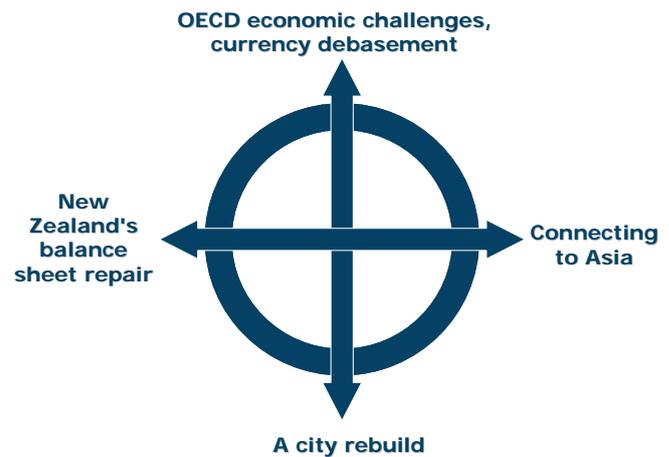
SUMMARY

New Zealand's economy started 2013 on a positive note with strength seen in residential construction, business and consumer confidence, and the housing market. The Canterbury rebuild continues to underpin GDP growth in the vicinity of 2.5 percent although the labour market backdrop remains soft. Drought is casting a shadow over the economy though and threatens to dampen primary production and national income growth. Fiscal consolidation and NZD strength are also still strong headwinds. 2013 looks set to be another year where the economy performs okay, but with disparate sectoral performance.

Key structural influences on the economic outlook include:

- **A soggy national balance sheet.** New Zealand still needs to get its house in order in numerous areas. Our net external indebtedness and current account deficit are elevated, and the household savings rate is poor. The next leg is via tighter fiscal policy. Unfortunately saving comes at the expense of growth.
- **An uncertain global scene.** We're seeing improvement in early 2013, but we suspect we'll remain prone to wobbles. Europe remains a mess.
- **A perverse mix of monetary conditions,** considering New Zealand's net international investment position (negative to the tune of 71 percent of GDP). Interest rates are low and the currency is overvalued relative to local fundamentals. Both look set to be off-kilter for a while yet.
- **Rising connectivity to the fast-growing Asia region.** This is manifesting in strong commodity prices, a rising share of exports heading towards Asia, and more inbound tourists from the region.
- **The rebuild of New Zealand's second-largest city, which is ramping up.**

On top of this we have the usual array of cyclical forces: the housing market is responding to low interest rates, while residential investment (a very pro-cyclical component of the economy) still sits at lows, and there is a large and growing shortage of houses (30k+) in New Zealand's largest city. All these factors portend some pent-up-demand that could be unleashed.



This combination of structural and cyclical forces is resulting in mixed economic messages and a polarised economic compass. Financial conditions are flagging strong growth; the national balance sheet is not. Business confidence has consistently overestimated growth – expectations have not met reality. We're seeing some bright spots in housing. Historically low mortgage interest rates and a shortage of available properties on the market have underpinned a run-up in prices, with prices now around 5 percent above their 2007 peak. Conversely, the labour market remains weak, with the unemployment rate at 6.9 percent and employment contracting for three quarters in 2012. Whipsaws from Mother Nature and drought conditions – a key driver of agriculture production – exacerbate the uncertainty.

Viewing economic outturns over the past few years provides the distinct impression that the New Zealand economy has only three gears – fifth (as with a strong December quarter GDP outturn), neutral (the previous two sub-par quarterly GDP outturns), and reverse (the second half of 2010). Such are the trials of an economy navigating various offsetting shocks.

Indeed the economy is described as “uneven”, according to the RBNZ, though we prefer the term “polarised,” with our “spinning compass” still in vogue.

With no significant rainfall in prospect for drought-affected regions, **the situation on the farm remains grim and historical experience shows it takes two years for agriculture production to return to pre-drought levels. That's a big hole for our economy. Nevertheless, both business and consumer confidence gauges have started the year on an improving note,** with our Confidence Composite pointing to annual growth of around 2½ percent. This looks doable, though we fully expect the year ahead to be full of wobbles.

BORROWING STRATEGY

SUMMARY

There has been no change to the OCR since our last edition, but floating and short-term wholesale interest rates have fallen in the wake of the RBNZ talking down OCR hikes for 2013. However, global long-term interest rates have risen, and this has spilled over into the NZ market, steepening the yield curve. With OCR cuts unlikely, and rates on a gradual upward trajectory, it does make sense to slowly increase fixed cover. However, there is no rush, and borrowers need to be mindful of other business uncertainties, and the simple fact that fixing still costs more (albeit not much more) than floating.

OUR VIEW

Indicative rural fixed rates have fallen at the short end, but have increased at the long end since our last edition two months ago. Although the yield curve has “steepened” as a consequence, it is still reasonably flat in comparison to where it stood through much of the post-GFC period, making the decision to move from floating “less intolerable”. More importantly perhaps, the overall level of interest rates remains very low, whether fixed or floating.

Regardless of the level of interest rates and the slope of the yield curve, any decision to fix ought not to be taken lightly, particularly given pressures on farm incomes. If the drought worsens, borrowers may well find they want the flexibility and savings associated with floating. This is often a point that gets lost.

What does seem unlikely is that we will see the OCR go lower from here. The RBNZ presented a scenario in its March *Monetary Policy Statement*, which signalled OCR cuts in the event that the NZ Dollar Trade Weighted Index remained elevated. However, we doubt it will come to that, or that the RBNZ will be eager to cut rates given concerns over the booming Auckland housing market. We have also observed that the AUD has barely budged despite significant RBA rate cuts across the Tasman. We therefore regard the hurdle to cut as very high.

With New Zealand rate cuts off the agenda and the next move for the OCR higher, it is natural for borrowers to think that there may be savings to be had in fixing. Past experience has certainly demonstrated this, particularly when rates rose rapidly off lows, as they did in the mid-2000s. Although we don't envisage the same magnitude of rate rises this time around, the basic maths are the same: if you can get in before rates rise, you stand to gain. The trick is, getting your timing right, and knowing how high rates may go.

For some borrowers, it is not a fixed versus floating debate. Indeed, some borrowers will have a natural preference for being fixed. If that is the case, the question becomes, when will term rates rise?

However, for borrowers, considering the fixed versus floating decision comes down to an analysis of how quickly floating rates might rise, and how that stacks up against the various fixed rates on offer. In that regard, we find breakeven tables to be useful, as they show where rates need to be in future in order for one strategy to be equivalent to another.

At the moment, breakeven numbers for all future periods increase steadily as one moves forward in time. For example, the 1 year rate needs to move from 5.72 percent now to 6.11 percent in 12 months for one to be indifferent to being fixed for 2 years at 5.92 percent. That's a rise of 0.29 percent. As we noted in our last edition, such an outcome is not implausible given that by the end of the year the market will be focussing on OCR increases in 2014.

Rural Lending Rates (incl. typical margin)		Breakeven rates in			
Term	Current	in 6mths	in 1yr	in 2 yrs	in 3 yrs
Floating	5.63%				
6 months	5.67%	5.77%	6.01%	6.40%	6.81%
1 year	5.72%	5.89%	6.11%	6.49%	6.91%
2 years	5.92%	6.10%	6.30%	6.70%	7.05%
3 years	6.11%	6.30%	6.50%	6.87%	
4 years	6.31%	6.49%	6.68%		
5 years	6.49%				

On the basis of breakeven tables, which show a fairly gradual rise in rates, we do see some value in fixing now. However, as we have stressed in the past such a judgement relies on 2 assumptions: (1) rates will go higher without dipping lower first; (2) that one can afford the additional expense of fixing right now. It could be, for instance, that a borrower is prepared to pay more in the long run if cash is tight right now. In fact, that principle sits behind every decision to borrow – after all, if we had all the money we needed now we wouldn't need to borrow in the first place!

Still, the biggest objection to fixing is the lack of flexibility it creates. But on the other side of the coin, being fixed creates certainty, but the flexibility versus certainty judgement is one only you can judge.

Putting it all together then, our view remains similar to what it was a few months ago. Fixing some debt makes sense given the likely direction of rates, but we are likely to see dips, and it will be a long time before the OCR goes higher, so time is on your side. With more uncertainty creeping in courtesy of the drought, more, rather than less caution is warranted.

EDUCATION CORNER: THE CHANGING FACE OF WATER MANAGEMENT PART II

SUMMARY

In September 2011 we highlighted that a number of changes were in the wind for on-farm water management. Recent industry and regulation developments are starting to provide some clarity on the specific changes required from landowners over the coming years. This month's Education Corner details some of the recent industry and regulation developments, highlighting areas of commonality and disagreement between industry and regulators, and shows things are developing more quickly than many appreciate.

The dairy sector's new sustainable dairying water accord has a fair bit of commonality with proposed regulations. It sets the bar at, or higher than, regulatory requirements in some areas such as riparian planting, effluent, and water use management. However, the main sticking point with regulators for dairying and other sectors is proposed nutrient leaching limits for different classes of land. There are striking differences in the way different regional councils are proposing to deal with nutrient-leaching limits. Further central government reforms to the RMA have also created more uncertainty on the process of reform and how high the bar will be set. The critical question is not whether there will be nutrient-leaching limits, but where the bar will be first set, how different land uses will be initially allocated leaching limits, and what the phase-out profile will be to give landowners time to adapt their operations.

Our advice to landowners is very similar to our last update though. Landowners should make sure they're up to speed with what regional councils are doing in their area. Ensure they have access to current and future water needs via resource consent, even if it costs now. Factor their ability to access water and any other possible water quality restrictions into their financial decisions. Make sure they are modelling nutrient flows in their business and understand the key drivers. And if in doubt, seek professional advice.

There have been some notable developments in the freshwater policy space since our first update in September 2011. The land and water forum released its two final reports on managing water and the dairy industry announced their plans on a successor to the Clean Streams Accord. Several influential regional councils are busy progressing regional plans to better manage water in their catchments, and the government has announced further reforms that focus on freshwater management. **When you scratch below the surface on these, developments reforms to freshwater management are moving more quickly than many appreciate.** Both industry and regulators (central and local government) are in the midst of, or have already outlined expectations

on what they want to achieve. Targets for freshwater management are being defined and the implementation phase for many of the initiatives and reforms are in motion.

In a short space of time more is happening on freshwater management than during the first 20 years of the Resource Management Act (RMA) being in effect. Essentially both sides of the poker table have played a good game since the Land and Water Forum was enacted back in 2009, but now the cards are being laid on the table. This is highlighting areas of commonality and disagreement on how far (and how quickly) freshwater reform should go in the next 10 years, and what the consequences of this could be for both the wider community and individuals.

With this as the background we thought it was timely to look at how things are evolving and what the potential implications are for landowners. Firstly, we outline the major recent developments on both sides of the table between industry and regulators. Then we analyse the areas of commonality and disagreement.

DAIRY SECTOR EXPECTATIONS

The Clean Streams Accord, which expired in 2012, is set to be replaced by The Sustainable Dairying Water Accord. The new accord outlines a number of new commitments to address the dairy sectors impact on water quality and quantity. It is more comprehensive than its predecessor, encompasses all the major dairy processors, and potentially has more teeth to address the chorus of concern emanating from individual communities through to pro-environmental advocates.

It centres around a step change in the management of risks to waterways from the effluent, waterway access, and nitrogen management aspects of dairying. It is also set to include all dairy companies and landowners as opposed to just Fonterra. This wider coverage of the different aspects of water management and inclusion of all the players in the dairy industry consequently makes it broader and more comprehensive.

Perhaps more importantly though is that it has more teeth than the original accord. This should provide more credibility of the dairy sector's step-up in its efforts. It has hard targets and timelines around each of the initiatives and **most dairy companies have already signalled that many of the new commitments will be conditions specified in supply contracts.** This means the non-compliant cannot shop around for another dairy processor. **There will be annual reporting with a third**

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party independent audit included to ensure transparency and robustness. Additionally there will be support mechanisms for education, training and facilitation of best practice for all facets of the accord. **Interestingly the accord is also being extended to dairy-support properties from 2017**, potentially including many sheep and beef properties that are periodically used to graze dairy stock during certain times of the year.

We will not detail all the initiatives here, but the key ones included in the accord cover five main areas:

- 1. Riparian management of waterways:** All dairy farms must prepare a riparian management plan that sets out where riparian planting is to occur. Planting is to be completed by 2030. Mandatory stock exclusion from streams on the milking platform is expected. A permanent fence must be used to exclude dairy cattle from rivers, streams and springs over 1 metre wide and 0.30 metres deep that permanently contain water. All lakes are included as well as wetlands that are identified by a regional council in its regional plan as being significant. In addition, landowners are encouraged to apply stock exclusion practices to any third-party land used for grazing dairy cows. Mandatory stock crossings are also expected on all points on a waterway where cows cross and return more than once a month.
- 2. Nutrient management:** Dairy landowners are expected to manage Nitrogen (N) and Phosphorus (P) loss from dairy farming systems, acknowledge the need to manage within nutrient loss limits and pursue continuous improvement in nutrient use efficiency. Specifically this involves an industry-wide monitoring and reporting system on nutrient losses/efficiency along with support and educational help to facilitate continuous improvement.
- 3. Effluent management:** All effluent systems have to be capable of being compliant with the relevant regional council rules and/or their resource consent for 365 days of the year.
- 4. Water use management:** All farms have to comply with regional rules controlling water takes, which will mean greater focus on the volumes taken, and on having the appropriate consents. There must be improving water use efficiency in irrigation systems and around the cowshed, with 85 percent of farms having installed water meters by 2020.
- 5. New dairy farm conversions:** Comprehensive good practice standards are required for all new dairy farms, including a nutrient management

plan. A nutrient management plan is more comprehensive than a nutrient budget as it takes into account a much wider range of activities related to freshwater and the risks posed through nutrient loss.

There is a phased timeframe for all the changes to occur. For some the changes will be a bolt out of the blue, for others it will be business as usual. The initiative is a signal from all the major power brokers that a step-up in water management is required.

MEAT AND FIBRE SECTOR EXPECTATIONS

The meat and fibre sector commitments to address water management issues are harder to gauge. There are a range of activities that are being undertaken by different sector participants, but most focus on the promotion of best practice as opposed to enforced monitoring and hard targets for continuous improvement.

Most meat companies have farm assurance programs that include some environmental commitments as conditions of supply.

However, in general these programs tend to focus on animal welfare, food safety and traceability. Water management initiatives under the assurance programs tend to be either non-existent, or provide only promotion and guidance on best practice. At present there is also a lack of detailed information, data, and technology to accurately assess the sector's impact on variables such as water quality. Beef + Lamb New Zealand have an environmental strategy for the sector, but a lack of resources means it's focused more at the national level in the policy and advocacy space, with some measuring activity and promotion of best practice.

What makes the sector different to dairying is the heterogeneity of meat and fibre farming systems. Along with the wide range of land types this means there is no one simple issue that needs to be addressed, or targeted. Hill-country farms for example generally have lower stocking rates and are more erosion-prone than flat/irrigated farms. This means hill-country farm water quality issues tend to be more focused on sediment and phosphate losses as opposed to nitrate and faecal matter losses, which are bigger issues on flat/irrigated land. **Thus, the nature of the sector means it has a much wider range of freshwater management issues to deal with.**

HORTICULTURE SECTOR EXPECTATIONS

In the horticulture sector the issues are again different to that of the livestock sectors and vary by type of crop/produce. Horticulture New

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Zealand developed a water position for the sector back in 2007, but it is currently being updated to reflect today's operating environment. So watch this space on where they might land.

Nevertheless, the industry is making progress on several important fronts. Horticulture New Zealand has recently extended several research projects to boost the sectors ability to measure water quality as well as quantify the costs/benefits of mitigation. **In 2012, a program of work was commenced to survey and benchmark horticultural land management and quantify nutrient management practices in different grower systems as a result.**

The sector's quality assurance/compliance system is also being adapted to meet the needs of regional councils. Policy has been developed to integrate sector audited self-management systems into regional council planning instruments. Considerable integration already exists (for agrichemical management components of the assurance system) and there are already examples of where the sectors Codes of Practice are being used by regional councils to assess permitted activities that influence the health of soils. The key question is how the use of such Codes, which tend to push best practice and not quantified measures, will work under a regulatory system that specifies loss limits, especially where these are set at an individual property level. Additionally, the sector (through Horticulture New Zealand) is actively involved in the development of central and regional freshwater reforms.

REGULATOR EXPECTATIONS

On the other side of the divide we have central and local government who are rapidly developing and implementing new freshwater management policy. A lot of this policy has been developed through the Land and Water Forum, which is a group of 'water stakeholders' with central and local government observers, who were tasked with developing a common direction for freshwater management in New Zealand back in 2009 and providing advice to the government.

The forum has produced three reports that are (and continue to be) used by government to direct policy on water quality and irrigation. The first report identified a set of outcomes and goals for freshwater management and recommended a number of policy changes to achieve these. This resulted in the National Policy Statement for Fresh Water Management (NPS), which became part of the RMA in May 2011. It also included other analysis, to develop a full package of water policy options for the

government to consider. The second and third reports provided recommendations on the methods, tools and governance processes required for setting and managing limits on water quality and quantity with a focus on water and nutrient trading.

The government have subsequently just released (mid-March) a second round of freshwater reform proposals for stakeholder consultation, with feedback due in early April. The proposals build on the NPS and are based on and consistent with recommendations contained in Land and Water Forums reports. **The reforms are grouped according to three key areas:**

1. Planning as a community

While it is acknowledged some collaboration is already occurring at the regional and national level there are also many tensions as highlighted by recent Court appeals on some regional plans. **The Government is now proposing to immediately implement an optional collaborative planning process, where regional councils will have the choice to use either the existing process (Schedule 1 RMA), or the proposed new collaborative planning model.**

If the new collaborative model is chosen, councils will have to comply with requirements relating to:

- Partnering with iwi from the beginning of the process (to enable iwi and councils to be able to shape the nature of their relationship to suit local needs before decisions are made).
- The appointment of at least one collaborative stakeholder group.
- Giving public notice of the proposed methods of engagement with the wider community, nature of advice sought from stakeholder groups, timeframes and deadlines for processes and what to do if collaboration breaks down.
- The use of an independent hearings panel that has power to run mediations and allow cross examination.

A decision by a regional council whose process complies with all the above requirements will then be subject to very limited appeal rights. Environment Court appeal rights will be restricted to points on which a council deviates from the recommendations of the hearings panel.

The new collaborative planning model is intended to facilitate inclusive community discussion early in the process and the gathering of robust information rather than legal action and conflict.

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2. A national objectives framework

The government intends to establish a regulated national objectives framework to support regional councils when setting freshwater objectives and limits. The framework will have a standard list of possible values, such as swimming, fishing or irrigating and set the minimum national standards for those values. It is envisioned that a regional council (or individual catchment) will consider which values from the framework are relevant for a particular freshwater body and what standards will therefore apply. A subset of values will apply nationally to all water bodies.

The framework will not be fully populated with every value and water body type immediately, but will be populated progressively over time as information becomes available.

3. Managing within quantity and quality limits

The new reforms include a number of proposals to amend the system for managing fresh water quantity and quality. The management of both is still proposed to take place at the local levels, with central government providing direction, guidance and support to ensure the proper processes, tools and techniques are available.

The proposals express the desire to achieve efficient allocation and use of freshwater within limits and to deal with competing uses effectively, transparently and equitably. It is acknowledged this is a 'big ask' so the proposals do not seek to build a new system and have it all in place on a specific date, but instead build a complex system in a "step-wise fashion" over time.

The immediate proposals for managing water quantity are to ensure that councils can obtain the information needed for freshwater accounting systems; to account for all freshwater takes to improve the efficiency of water use; and provide guidance on the specification of permits, such as ensuring permit durations are not unnecessarily short. The immediate reform proposals for managing water quality are intended to strengthen the science, research, knowledge and information; government leadership; and the development of good management practice toolkits.

In the longer-term, the next stage of reform includes tackling the following, more difficult, tasks:

1. Providing national guidance, direction or regulation on transition issues regarding water quantity, the choice of methods and tools to manage water quality, and compliance and enforcement regarding water quantity limits.

2. Introducing alternative tools to allocate freshwater other than "first-in,-first served".
3. Facilitating transfer and trade of water permits – for example, by unbundling freshwater take and use permits, reducing transaction costs and developing standard trading platforms.
4. Developing a new transfer, or offsetting mechanism for managing water quality.
5. Introducing incentives for efficient freshwater use (both quality and quantity) – this could include pricing tools, national efficiency standards and increased metering.

For landowners, the key long-term reform is the mechanism for dealing with over-allocation of either nutrient loss or water takes, for those areas where this is an existing issue. Given the tension that exists between economic dependence on on-going access to water resources (or the ability to lose nutrients), and the requirement to operate within limits, it would be hoped this key area will not be left "floating" for too long.

It is a little unclear at this stage how the proposed changes will affect implementation of the NPS by regional councils, which are in various states of progress. There have been murmurs that there will be a number of further changes to regional council plans between 2016 and 2019 as a result of the reforms to the RMA later this year, and others that will occur down the track. This potentially creates a great deal of business uncertainty for all landowners and potential investors. But given the significance and complexities of freshwater reform, it's important time is taken to get a workable solution that is as fair and equitable as possible for all stakeholders.

Nevertheless, under the introduction of the NPS in 2011, all regional councils have been required to implement their changes by the end of 2014, or had to adopt a staged process of reform by the end of last year that showed implementation as part of their regional plan by 2030.

The NPS objectives were to drive national consistency in local RMA planning and decision-making while allowing for an appropriate level of regional flexibility. Essentially the NPS directs regional councils to use the RMA to establish water quality targets and set enforceable limits to maintain or improve water quality in a catchments rivers, lakes, and streams. The next round of reforms is starting to provide some more flesh to this framework.

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Most regional councils (apart from three) have adopted a staged program of reform. Below is a diagram which summarises each regional council's current approach and timeline for the implementation of the NPS.¹ As the diagram shows it is a bit of a moving feast across the country. A range of approaches have been adopted to implement the reforms and each region has a different timeline for their implementation. This means the effects on landowners' operations will take place at different speeds and with varying impacts. **While further government reform for freshwater this year may alter some of these approaches, proposed policies and timelines, it is clear that changes are in the wind for all landowners around the management and use of freshwater over the next 10 years.**

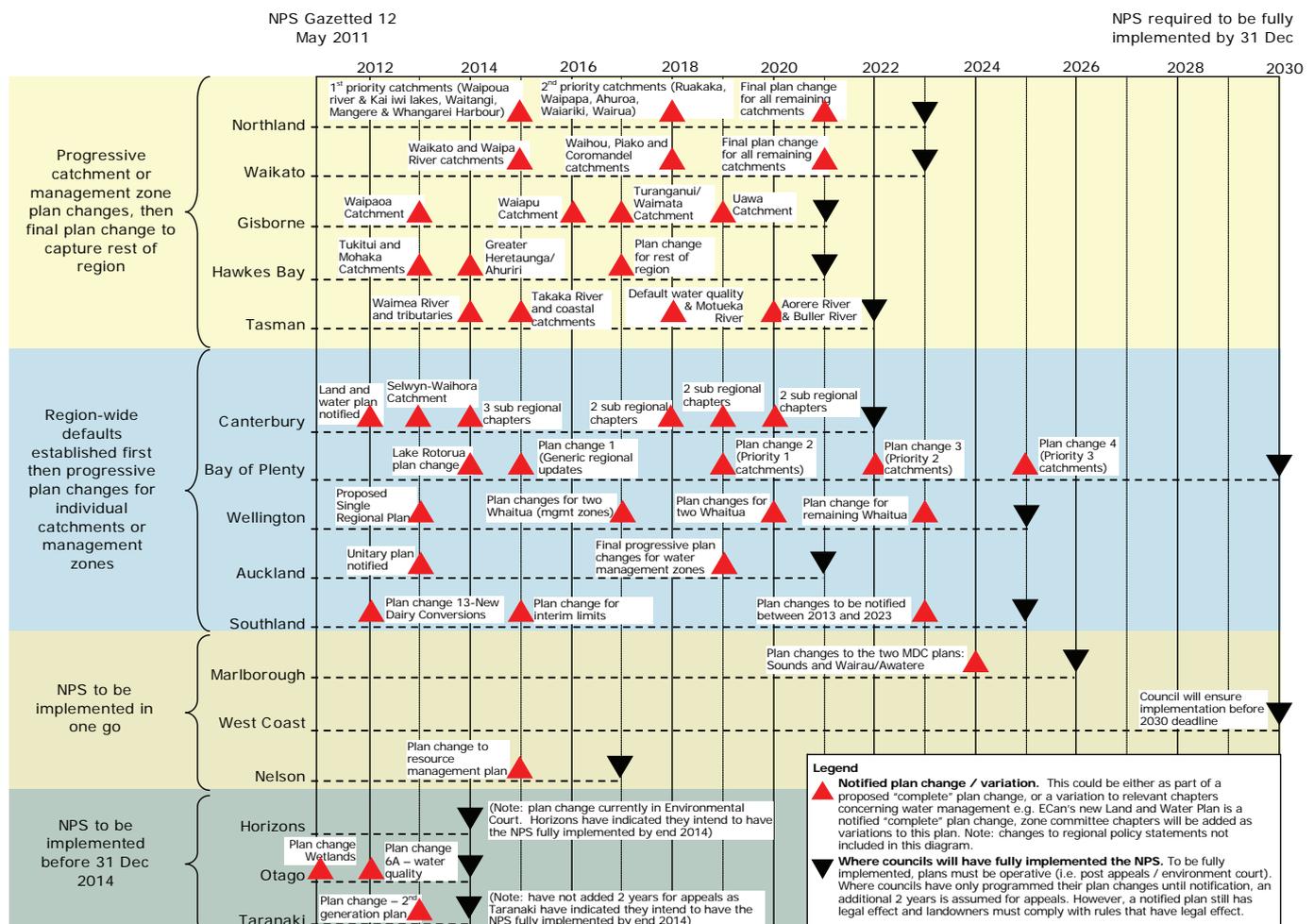
In our last update we discussed some of the changes occurring in the Waikato and Horizon regions for the

management of freshwater. More recently landowner attention up and down the country has been focused on nutrient-leaching limits in proposed regional plans and the knock-on effects to land use flexibility, freedom to operate, profitability and land values. Again there are different regulations and approaches being utilised by regional councils. Below is an update on where some of the more advanced and influential regional council plans currently sit.

HORIZONS ONE PLAN

At the end of March the final decision by the Environment Court on Horizon's One Plan is due for release. However, two interim decisions have been released by the Court. These have clearly pointed the plan back in the direction it came from and is closer to the version of the plan notified back in 2007. This has been disappointing to the primary sector for many reasons, but largely because there seems to have been little economic analysis on the impacts of the proposed plan on individual landowners, sectors and the broader Horizon's economy. Consequently, many landowners believe

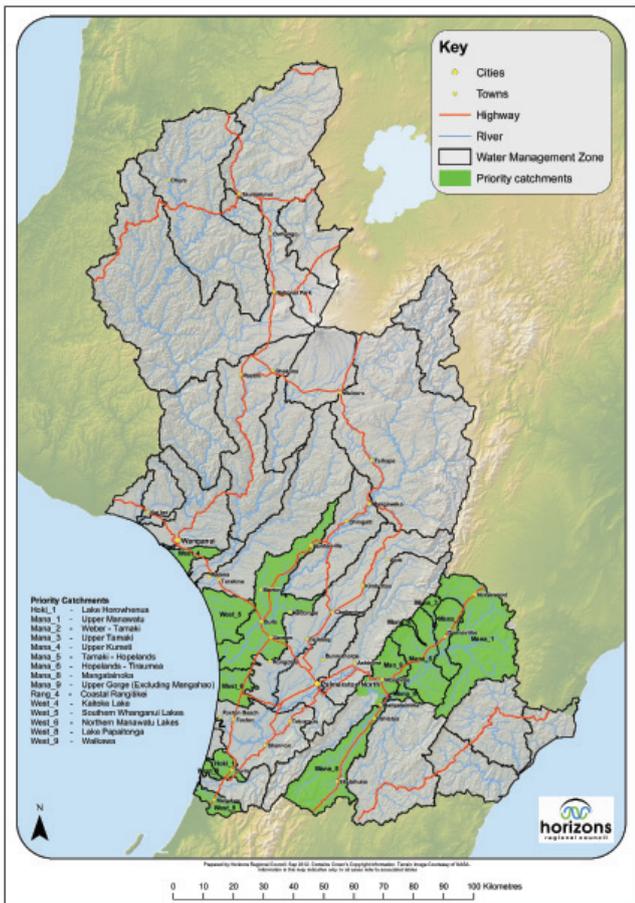
¹ The NPS defines a limit as "the maximum amount of resource use available, which allows a freshwater objective to be met", and a target as "a limit which must be met at a defined time in the future".



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this has led to a lop-sided debate on the cost and benefits of the proposed policies. The independent commissioners appointed to hear the plan in 2010 made substantial changes. These changes generally suited the primary sectors better. The 2010 decision required a step up in freshwater management, based on best management practices and what could be practically implemented on farm.

Map of priority catchments in Horizon’s regional council



As things stand all intensive farms within identified priority water management zones (which as a total accounts for about half of all current intensive farming systems in the region) are now required to have a controlled-activity consent at the least.

A key part of these consents is that landowners must reach a Nitrogen-leaching limit. The leaching limits vary by the class of land and are based on land use capability, but they’re also expected to step down through time. In general, the current 5-year guideline is to reach an N loss target of between 20 to 25 kg N/ha per annum. The rub for many, especially dairy landowners, is that

most currently leach anywhere from 30 to 50 kg N/ha meaning current farm management practices will need to be dramatically modified to reach the proposed benchmarks.

While there are a number of actions that can be taken to reduce nutrient losses, each has a different level of cost. Recent analysis of monitor farms in the region and other modelling work are showing a wide variation of cost to individual landowners due to a range of factors that need to be taken into account. Dairy New Zealand analysis for a small sample of monitor farms show there needs to be a 23 percent reduction in stocking rates to meet proposed targets along with other management changes. **On average these changes reduced profitability by 18 percent, but there was a wider range of 5 to 37 percent.**

Reducing N to Water – Dairy farm impact analysis				
	Average of current scenario	Average of optimised scenario	Average of restricted scenario	Optimised vs Restricted
Cows/ha	2.9	2.9	2.2	-23%
Total MS	216,490	209,261	163,224	-22%
MS/ha	1193	1165	908	-22%
% wintered off	52	9	80	na
kgN/ha	151	279	51	na
Past intake/ha	10.5	11.4	8.7	-24%
N to water	40	51	19	-63%
NCE	29	33	44	na
\$\$ Surplus	550,472	617,090	519,539	-\$97,550
\$\$/ha	3,046	3,438	2,840	-18%

Notes: Figures were based on the milking platform area only. Model used was grazing systems limited and Overseer V6. Surplus is before payment of interest, mortgage principal, drawings, management wages or tax. Pasture intakes are outputs from Overseer.

The current thinking is many farms will be unable to reach the proposed leaching targets required to comply with the controlled activity status and will need to gain a restricted discretionary consent. This presents a huge level of uncertainty for these landowners. The discretion sits entirely with the regional council. Consent conditions and length are to be based upon current farm leaching losses and what the leaching losses for controlled activity status for that farm would be. **If a farm is leaching above the controlled activity level, consent conditions will stipulate the reductions required and shortened consent length. This presents quite a business risk**

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given the potential impacts on outputs and profitability (both current and the opportunity for gains in the future), which has already started to flow into land values in the priority water management zones.

SOUTH ISLAND REGIONAL PLANS

The three regional Councils in the lower half of the South Island – Environment Canterbury, Otago Regional Council and Environment Southland – are all in various stages of preparing new, or changes to, their regional water plans. These aim to set water quality limits both in rivers, lakes and on water or nutrients leaving the farm.

Otago Regional Council has notified a plan change that takes a bold approach to managing water quality in the region. **As well as setting limits on nutrients, sediment and bugs in the region's waterways, it sets limits for all of these at a "farm gate" level. That is wherever water leaves the farm it has to meet certain criteria for nitrogen, phosphorous, sediment and E. Coli.** There have been some fairly robust discussions about whether or not this approach is warranted, or whether expecting landowners to meet limits they can't yet measure, is a step too far. In addition the plan sets a discharge limit on Nitrogen of 20 kg N/ha/y in mapped "sensitive" water catchments, or groundwater zones.

A decision from the Council on the submissions heard to date is expected sometime in April.

In Canterbury the council is currently hearing submissions on its new land and water plan that classifies each sub-region according to their nutrient state. The impetus of the new plan has come from the NPS, but also the commissioners that were appointed to get a regional plan in place before returning it to an elected council. The plan is a two-stage process where water-quality limits are set both at a region-wide and sub-regional level. There is also a 5-year phase-in period for the proposed changes.

Existing farm use (i.e. occurring prior to 30 June 2017) is allowed to continue, unless it is in a lake zone where compliance requirements are higher. All existing farms though must record the annual Nitrogen-leaching losses using Overseer and provide them to the council on request. If a farm is in a lake zone, a farm environment plan is required to be prepared, implemented and there is audited compliance to meet the commitments in the plan. However, if you are wanting to change land use prior to 2017, or increase the volume of water for irrigation and/or there is a 10 percent increase in Nitrogen-leaching losses compared with the average

loss from the property during 1 July 2011 to 30 June 2013, a resource consent is required. This has basically placed a moratorium on all dairy conversions without existing resource consents until sub-regional plans are developed and clarified. There are some exceptions, and if a resource consent has already been granted for nutrient discharge, then things can continue as normal.

After 1 July 2017 land classes will be categorised according to their degree of sensitivity (land use capability assessment similar to Horizon's). As yet unspecified nutrient loss limits may be applied to each land class, and farms within their land classes will be expected to fall within as yet unspecified nutrient run-off limits. Farms at the high end of the scale will be expected to prepare and implement a farm management plan to mitigate nutrient losses (same as farms within lake zones now). Where nutrient losses exceed limits, it may be necessary to apply for resource consent to continue to farm. A "cap and trade" system may be implemented at the catchment level, whereby those with "nutrient loss credits" may be able to sell them to those who have "nutrient loss deficits".

While a region-wide limit after 2017 for Nitrogen-leaching losses has been set at 20 kg N/ha/y, the twist is sub-regional (catchment) limits could change targets and mostly these are not yet developed.

The plan sets the framework for comprehensive catchment-based community limit setting processes. This involves the community sitting in a room together deciding which social and economic outcomes they want to achieve, and how different water quality scenarios will impact on those. One of the key debates in the plan centres around how a change in farming activity is defined and managed in catchments that are classified as 'over allocated' for nutrients, or currently not meeting desired water outcomes. These discussions are underpinned by the wider strategic discussions across the region about optimising water storage, future irrigation potential and how these will impact on environmental flows and nutrient management. In the absence of certainty around how land use will be regulated, there will be some questions over the level of risk associated with investment in water storage.

The map overleaf shows the likelihood of getting a resource consent based on a catchments current water quality outcomes. In the pale blue or green zones, gaining a consent is likely depending on allowed nutrient discharge and catchment water quality levels. Orange zones are a maybe, and lake or red zones are unlikely. In the

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is a way to go in this space with many questions about compliance and mitigation costs to meet these targets, the knock-on effects on profitability and land values, and the ability to service high-debt levels.

Thankfully, a focus on using “average” farm data seems to be starting to shift to an attempt to gain an understanding of the proposed policy impacts across the wide range of situations landowners are finding themselves in.

Equally, on the regulatory side, there are many additional needs around education, having enough skilled staff to apply the proposed regulation, new systems/technology to monitor compliance and science gaps. **One area of common concern has been the use of Overseer as the tool used to model nutrient losses.** These have generally encompassed:

1. The need for protocols on the inputs used.
2. The basis for using it as an annual compliance tool (given the model is itself based upon long-term averages).
3. Education and training on its use across the service industry.
4. Concern about its margins of error and need for more credibility around the system.
5. Better research into its use for a range of different industry practices and farming operations (especially arable farming).

Other livestock and horticultural sectors still have some way to go in their understanding and management of water quality, let alone the implications of this regulatory tsunami on their businesses. This is because of the wider variation in farm types and practices. This means industry efforts to date have been focused on measuring and monitoring programs to better understand the issues. **However, this is not expected to exempt landowners from new regulation.** For example, hill-country meat and fibre farmers are no doubt going to face increasing pressure on controlling sediment and phosphate losses into waterways, both from regulators, but also from fellow land owners down-stream who would otherwise be expected to carry an even greater burden in reducing impacts. With increasing pressure on all land users to play their part, the mandatory fencing of waterways, riparian planting and planting of erosion-prone country is starting to be examined by some regional councils where before this wasn't a consideration.

Ultimately, changes to the management of water by each regional council will come down to a community's willingness to pay, either

directly or through forgone opportunities.

However, the benefit from addressing water issues will flow directly to the local community also. There are no easy choices. **Water is one natural resource where finding solutions and a path forward will be particularly important. No one can ignore the cost of the erosion of a natural resource such as water.** Assessment of the costs come down in large degree to an ethical consideration on the state in which we want to leave such natural resources for future generations. The tension is that much of New Zealand's economic engine room is dependent on access to water (or a level of discharge to waterways) and our current approach has been built on yesterday's management regimes.

One thing is for sure: landowners will be the ones ultimately responsible for achieving and implementing any changes to farming practices required to meet public expectation of better freshwater management. Landowners have been, and continue to, respond to this with massive investment and innovation. The critical thing for these policy frameworks is to ensure the motivations and mechanisms are right to allow innovation and investment to continue in timeframes that also allow for landowners to continue operating as economically-viable businesses.

Our advice to land owners is similar to last time. Land owners should be proactive by:

- Ensuring they are up to speed with their local regional council plans.
- Ensuring they have access to current and future water needs via resource consent, even if it costs now.
- Factoring in the ability to access water and any other possible water quality restrictions into their financial decisions (e.g. when purchasing a new block of land in a 'sensitive' catchment for possible intensification).
- Making sure they're modelling nutrient flows in their business and understand the key drivers.
- Asking for professional advice if in doubt.

While science-based decisions on water resources are (relatively) simple, political pressures driven by a growing population, or the needs of key industries, make the situation one of conflict. **Balancing the competing economic and environmental objectives of individual land owners, the local community and the country will involve trade-offs.**

KEY TABLES AND FORECASTS

FX RATES	ACTUAL			FORECAST (END MONTH)						
	Feb-13	Mar-13	3-Apr	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
NZD/USD	0.825	0.837	0.842	0.84	0.84	0.84	0.83	0.81	0.80	0.78
NZD/AUD	0.807	0.803	0.805	0.80	0.80	0.80	0.80	0.80	0.81	0.81
NZD/EUR	0.632	0.653	0.656	0.63	0.61	0.60	0.57	0.55	0.53	0.51
NZD/JPY	76.33	78.87	78.58	72.2	72.2	72.2	71.0	69.7	68.5	67.3
NZD/GBP	0.544	0.551	0.557	0.57	0.55	0.54	0.52	0.51	0.49	0.47
NZ TWI	75.5	76.9	77.3	75.3	74.6	74.1	72.5	71.0	69.6	68.2

INTEREST RATES	ACTUAL			FORECAST (END MONTH)						
	Feb-13	Mar-13	3-Apr	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
NZ OCR	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.00	3.25
NZ 90 day bill	2.66	2.64	2.64	2.80	2.80	2.80	3.20	3.30	3.30	3.70
NZ 10-yr bond	3.72	3.49	3.52	3.70	3.90	4.00	4.10	4.30	4.40	4.60
US Fed Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
US 3-mth	0.29	0.28	0.28	0.30	0.30	0.30	0.30	0.35	0.35	0.60
AU Cash Rate	3.00	3.00	3.00	2.75	2.75	2.50	2.50	2.50	2.50	2.50
AU 3-mth	2.97	3.10	3.05	2.90	2.90	2.70	2.70	2.70	2.70	2.70

ECONOMIC INDICATORS	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
GDP (% q/q)	1.5	0.5	0.3	0.8	0.8	0.7	0.7	0.6	0.6	0.6
GDP (% y/y)	3.0	2.5	2.5	3.2	2.5	2.8	3.1	2.9	2.7	2.7
CPI (% q/q)	-0.2	0.5	0.5	0.5	0.3	0.7	0.7	0.7	0.2	0.2
CPI (% y/y)	0.9	0.9	1.0	1.3	1.7	2.0	2.1	2.4	2.3	2.3
Employment (% q/q)	-1.0	0.8	0.2	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Employment (% y/y)	-1.3	-0.8	-0.4	0.4	1.8	1.3	1.5	1.5	1.4	1.4
Unemployment Rate (% sa)	6.9	7.1	7.0	6.9	6.7	6.6	6.4	6.3	6.3	6.3
Current Account (% GDP)	-5.0	-5.0	-5.0	-5.1	-5.2	-5.3	-5.2	-5.2	-5.1	-5.1
Terms of Trade (% q/q)	-1.4	0.8	0.5	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Terms of Trade (% y/y)	-9.1	-6.2	-3.3	0.3	2.1	1.5	1.4	1.3	1.2	1.2

Figures in bold are forecasts. Quarter-on-Quarter yoy: Year-on-Year

NEW ZEALAND'S 20 LARGEST EXPORT MARKETS

NZ'S TOP EXPORT MARKETS FOR THE 12 MONTHS ENDED FEBRUARY 2013 (NZ\$M)

	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	Singapore	Hong Kong	Malaysia	Indonesia	Taiwan	India	Saudi Arabia	Philippines	Thailand	UAE	Nether-lands	Canada	Algeria
Sheepmeat	2,619	7	410	227	44	4	527	245	12	28	49		51		99	1	3	9	145	90	13
Beef	2,127	16	85	957	198	121	29	18	44	39	26	36	137		10	40	11	23	31	81	
Other Meat	442	42	17	21	42	30	28	54	7	27	9	5	2		13	3	2		19	4	
Milk Powder	6,947	50	2,198	15	27	8			190	138	296	279	151	1	267	209	202	401	6		377
Butter	1,917	77	186	120	18	15	1		35	17	49	47	52	1	100	67	30	39	10	19	42
Cheese	1,467	231	103	51	308	134	23		10	16	28	61	30		82	60	14	16	28		25
Whey/Casein	1,989	54	266	781	211	49	3	157	63	1	28	42	12	7	30	25	2	1	8	31	1
Kiwifruit	1,076	67	116	26	318	64		195	10	31	15	8	95	3		2	6	3			4
Apples	374		3	47	6		49	41	12	23	12	6	18	23			1	32	20	33	6
Other Fruit/Vege	566	247	7	30	137	24	2	4	9	5	15	1	13	2		1	15		1	1	2
Wine	1,199	371	31	270	14	2	277	10	16	21	3	1	1	1		1	2	6	26	77	
Wool	783	51	389	22	21	2	46	44		6	7	1	10	33			9		1	3	
Skins/Hides	553	20	198	2	9	23	3	2		32		9	4	12			9				
Logs	1,721		1,120		170	258							10	155			4				
Sawn Timber	1,104	329	163	159	78	54	1	1	5	1	15	21	37	3	26	52	30	8	10		
Fibreboard/Plywood	377	56	27	10	214	1				1	9	21	3	3		9	1				1
Wood Pulp	587	62	173		84	66			5		19	89	22	12		4	24				
Fish/Seafood	1,469	276	361	131	131	46	11	21	29	91	8	4	7		2	2	22	5	6	13	
Crude Oil	2,004	1,798			33				123			24									
Aluminium	1,033	83	37	54	474	118	59	2	1	19	2	4	3	15			2		81	2	
Remainder	15,616	5,908	1,246	1,352	654	579	310	154	297	354	256	186	177	451	75	191	192	68	170	214	2
TOTAL	45,972	9,746	7,135	4,275	3,189	1,597	1,371	945	868	849	845	844	836	719	703	667	614	601	575	548	462

NZ MERCHANDISE EXPORTS ANNUAL CHANGE BETWEEN THE 12 MONTHS ENDED FEBRUARY 2013 AND A 12 MONTH SPAN A YEAR EARLIER (NZ\$M)

	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	Singapore	Hong Kong	Malaysia	Indonesia	Taiwan	India	Saudi Arabia	Philippines	Thailand	UAE	Nether-lands	Canada	Algeria
Sheepmeat	-356	-1	201	-83	-21	-1	-48	-80	-2	-16	7		-6		1		-2	-1	-37	-22	13
Beef	78	-1	72	148	16	-32	-9	-4	-5		9	-57	9		2	-2	5	2	-9	-49	
Other Meat	-14	10	4	-1	2	3	-2	-18		10	6	-9	-1		4				-11	-1	
Milk Powder	-96	-31	453	2	5	-10			-49	77	-63	-1	-31	-77	-27	-76	-38	42	-4		7
Butter	-651	-24	-37	-3	-11	-14	1		-19	-3	-15	-14	-12	-29	-25	-7	-22	-1		-9	-51
Cheese	91	-18	29	46	-5	18	-20		1	-3	2	11	-4		40	3		-4			13
Whey/Casein	198	-12	51	59	10	1	-1	33	9	-6	6	12	-1	4	6	-1		1	5	1	1
Kiwifruit	2	3	27	-3	16	-12		-34		2	2		20			1	1	-1	-1	2	
Apples	10		3	4	6		3	-10	3	-2	1	1	-6	6			11	10	-19		
Other Fruit/Vege	-103	-76	3	-7	-22	1	-1		-1	2	-1	-1					1		-1		1
Wine	18	-6	8	28	2		-32	3	2	2	1						1		-4	14	
Wool	-147	-41	-27	-4	1		-18	1		-1			-1	-8			-1	-1	-1	-1	
Skins/Hides	-29	3	-7		1	1	-3			-5		1	2	-11			2				
Logs	22		119		-11	-52							-2	-32			1				
Sawn Timber	15	1	37	2	-15	5	-1	-2				-6	3	-3	8	3	-4	-2	7		
Fibreboard/Plywood	-11	-11	2	-5	9						2				-2	3					
Wood Pulp	-46	-7	-22		6	-24			-6		-4	6				-4	-4				
Fish/Seafood	-34	-2	85	-23	6	6	-3	-1	-8	-78	-1	2	-1		-1	-3	-6	1	-2		
Crude Oil	-312	-490			33				123			24									
Aluminium	-126	-10	6	-15	-137	8	6	1		9	1	1		-4					-1	-2	
Remainder	-416	-375	161	80	-37	48	-52	-3	-15	28	-13	23	-1	-81	6	-14	-31	-15	6	13	1
TOTAL	-1,908	-1,088	1,169	227	-146	-57	-181	-114	35	13	-56	-5	-32	-236	13	-97	-86	32	-71	-54	-15

NZ MERCHANDISE EXPORTS ANNUAL CHANGE BETWEEN THE 3 MONTHS ENDED FEBRUARY 2013 AND A 3 MONTH SPAN A YEAR EARLIER (NZ\$M)

	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	Singapore	Hong Kong	Malaysia	Indonesia	Taiwan	India	Saudi Arabia	Philippines	Thailand	UAE	Nether-lands	Canada	Algeria
Sheepmeat	-9	-1	104	-24	-1		-3	-19		-4					1			-1	-7	5	-2
Beef	67	-2	48	65	-3				-6	-2	-1	-11	5		1	-1	2	1	-1	-25	-1
Other Meat	-12	2		-1	2	1		-12		2		-2			1				-3		
Milk Powder	62	-6	175	2	2	2			-1	24	-33	-1	-5		21	-19	-15	-24	-3		1
Butter	-123	-10	-12	14		-3			-6	-1	-4			-24	1	-1	-8	1			
Cheese	37	14	14	4	-7	19	-5				-2	4	2		7	2		-2	5		
Whey/Casein	12	-2	5	3	-3	1	-1		3	4	-1	-2	3	-1	4	-2				-3	-2
Kiwifruit	-8	2	-6											-4							
Apples	5		1				1											1	1		
Other Fruit/Vege	-49	-32	3	-2	-14	-1	-1	-1		-1							1		-1		
Wine	-18	-12	2	7			-19	1	1	1								-1		1	
Wool	-28	-4	2	-3	-1		-8	1		2	-2		-1	-1			-1				
Skins/Hides	-12	1	-14		-1	-1	-2			-4		-1	2				-2				
Logs	106		108		-3	9							1	-9							
Sawn Timber	-9	4	7	-1	-7	3		-2	-1			-2	3		-2	-5	-1	-3	1		-1
Fibreboard/Plywood	-16	-7		-1	-7						-1					1					
Wood Pulp	-8	2	-3		-2	-11			-2		-1	11	-1				-3				4
Fish/Seafood	-8		40	-7	-4	-1	-1	2	-8	-34						-1	-3			-1	-2
Crude Oil	-135	-169							35												
Aluminium	-20	-3	5	-4	-27	-6	3			4		1								-1	
Remainder	-106	-67		32	-16	31	7	9	-4	-5	-15	11	7	-32	-1	-8	-16	-3	4	5	-8
TOTAL	-273	-290	480	85	-92	44	-28	-18	11	-19	-60	12	7	-65	33	-34	-46	-32	-4	-18	-11

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