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OPPORTUNITIES IN THE NEW ZEALAND SEAFOOD INDUSTRY

Role of Aotearoa Fisheries in the Wider New Zealand Fishing Industry

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Kia ora tatou

I've been invited to speak about the opportunities facing the New Zealand seafood industry generally. Given my background, I think it more appropriate for me to approach this more general topic from the perspective of Aotearoa Fisheries Limited (AFL) given its newness and its relatively significant position in the sector. Although I am a New Zealand businessman with a limited but growing background in the New Zealand seafood industry, I have found material benefit in blending people with diverse commercial backgrounds at board level.

I have organised my address in five parts, namely -

- Part 1: AFL – a description
- Part 2: Issues Part One: What issues face AFL?
- Part 3: Issues Part Two: What issues face the industry?
- Part 4: Moving Forward: AFL's direction
- Part 5: Questions for the industry: how could the sector operate smarter and more efficiently?

Our Assets and Operations

The assets within the company originate from a full and final settlement of all commercial fishing claims under the Treaty of Waitangi between Maori and the Crown. With the passing of the Maori Fisheries Act last year, AFL was born! There are two sets of assets that were conferred on the company– 100% subsidiaries that are grouped into divisions, such as Moana Pacific Fisheries and Pacific Marine Farms, and two joint ventures – the Sealord Group, which is owned equally with Nippon Suisan, and the Prepared Foods Group, which is owned in partnership with Ocean Ranch.

AFL enjoys a full exposure to the New Zealand seafood sector. Its operating divisions and joint ventures own factories that chill, cut, freeze, can, coat, and reconstitute fish. Fish is sold alive, chilled, frozen, fresh and most combinations between. We deal in lobsters, paua, oysters, mussels, and all varieties of finfish.

We harvest fish from the waters of Antarctica to the North Sea, and we sell to customers from the Bluff to the Far North, as well as to foreign customers in each continent.

Our People

The board of AFL comprises me as Chairman, Craig Norgate, Keith Sutton, Matanuku Mahuika and Craig Ellison. These people provide a breadth and depth of industry and commercial skills to the company.

The management team is headed by Robin Hapi, as CEO, supported by Tom McClurg, General Manager Strategy and Planning, and Danny McComb, Chief Financial Officer. The various divisional operating managers comprising Brent Marshall, Jim Pendleton and Dean Moana also report to Robin Hapi.

Our Shareholders

The beneficial owners of AFL are iwi. There are two types of shares in the company; - control shares that are owned by Te Ohu Kai Moana (being the successor body to the Treaty of Waitangi Fisheries Commission), and income shares that are owned 80% by iwi with the remaining 20% of income shares being held by Te Ohu Kai Moana. The income shares impose an obligation on AFL to pay a dividend of at least 40% NPAT each year after an initial transitional dividend free period. Iwi and Te Ohu Kai Moana will share in the gain and pain of the performance of AFL, which in turn will be affected by the performance of the wider industry. Te Ohu Kai Moana has seven recently appointed directors, including myself, Shane Jones (as Chairman) and Wira Gardiner (as Deputy Chairman).

Mission Statement

AFL's mission is to maximise shareholder value! AFL shares are not listed and there is a restricted ability for iwi to sell shares. Management's objective is to maximise the net present value of the company's net cash flow, gross of any dividends paid.

Issues faced by AFL

AFL emerged from a highly contentious argument over whether its assets ought to be decentralised amongst iwi or held in common for and by all iwi. Ultimately, this argument for me, turned on the question of the durability of the settlement, which was a statutory imperative imposed on the allocation design. Against this background, AFL confronts a heightened set of performance expectations. Ongoing commercial success and profitability are the key requirements of durability. In addition, there is also an expectation that the Settlement will re-empower Maori involvement in the management of their customary and commercial fisheries. The possession and ownership of customary rights and the ITQ are the twin pillars of such empowerment. Dilution of these rights, whether by regulatory attenuation or by uncompensated expropriations, will be vigorously resisted by AFL. I believe the Crown carries the same commercial and moral obligations to not undermine its durability as a party to the settlement.

Maori have a common interest with other quota owners to protect their property rights. This has only been fitfully acknowledged – such as, for example, the key role that Maori played in the removal of resource rentals. It seems to me however that industry effort to protect ITQ and empower quota owners is not sufficiently united. Longer term benefits have sometimes been undermined by short term opportunistic behaviour. This is not to encourage the industry to gang up on domestic consumers; but it is to say that the industry should maintain an industry-wide focus in the design and implementation of industry regulations.

As I've mentioned, AFL's ultimate beneficial owners are iwi, and this is partly reflected by AFL's statutory duty to endeavour to co-operate with iwi on commercial matters. AFL must therefore support iwi organisations as the key mechanism by which Maori participate in fisheries. Iwi have both customary and commercial fishing interests, which along with the interests of other fishery stakeholders, are best protected in the long run by reliable and integrated property rights.

While the Maori Fisheries Act 2004 legislates for commercial co-operation, it also attempts to isolate AFL from Maori political processes. Te Ohu Kai Moana is cast in a governance role as the interface between a political process of appointing Commissioners on the one hand (albeit the term *Commissioner* has disappeared) and appointing and monitoring commercially competent directors of AFL on the other.

Issues facing the Industry

As I have mentioned, the newly formatted AFL, is a new kid on the block – and as such, I am reticent to lecture you about the problems faced by your industry – all of which no doubt touch your businesses regularly, if not daily. What I can share, which is hopefully of some interest, are the range of industry-wide issues that crop up for AFL and the approach we take towards them.

The matters that occupy the board and CEO agenda traverse the following list, which we would prefer was smaller!

- Value of the dollar
- Dilution of property rights
- MFish costs and performance
- Environmental lobby
- Distance from markets
- New species into the QMS
- Fisheries management by owners
- Overcapitalisation of quota
- Seafood prices
- Size of the industry
- National and world economies

Value of the Dollar

The New Zealand dollar remains strong and most exporters would love it to be back in the halcyon days of the mid 40's. Of course the most damaging thing in

business about currency is its short-run volatility, which we try and manage by hedging exposures. But even in the long-run, currency will favour those fishers from poorer countries, which is a phenomenon that is not confined to the fishing industry. Many commentators are saying there is a fundamental realignment of the world's currencies to reflect a lower long-run value of the US dollar, as the economies of the USA, China, Japan and Europe come to a new set of relationships. Such commentaries are no more than interesting.

To date we have all used hedging strategies and foreign exchange mechanisms, and it's probably true that the industry is more experienced in their application today. However these mechanisms offer a time advantage and a smoothing advantage, but ultimately they simply slow the transition to the new FX rate. The only enduring "solution" is to focus on long-run efficiency, by minimising costs and maximising revenues. For some of our divisions, that has been achievable – and for others, it has proved a challenge.

On the positive side, the industry has been buffered somewhat from record high oil prices – so in this area, at least some of the stars are in alignment.

Erosion of Property Rights

I've touched on the subject of property rights already – but as a new observer, I perceive a steady erosion of our property rights. Some examples are (1) the continued presence of illegal catching in the sector – in some cases almost matching the legal harvest; (2) the dilution of the term "utilisation" when considering how fisheries should be managed, and (3) the reallocation of increases in stock abundance to non commercial users.

The quality of aquaculture property rights seems to have gone backwards in the last twenty years. To some extent, that outcome was invited. The alternate view is that we lack the imagination, will, and unity to demand something better.

Ministry of Fisheries

AFL considers that the cost of administering the fisheries sector is too high. These costs are a tax on the industry and like any tax must be rigorously examined and contested. My particular beef is the lack of discipline regarding the Conservation Services Levies and an insatiable demand for more funding from the Department of Conservation that is not matched by better outputs and outcomes.

AFL insists, as should the industry, on improved performance in this administration, including accountability and transparency.

The fact that improvement is achievable is demonstrated by the Fish Serve example, where costs have fallen by around 33% from the 2000/01 year to the 2003/04 year.

We require similar achievements in other sectors of the Ministry.

The performance of the Compliance division must also improve. The continued state of illegal harvesting in key Maori iconic species is unacceptable. We do not

accept that such harvesting cannot be better prevented with existing resources. Part of the solution is to achieve an effective engagement with relevant industry groups that have a property right in these fisheries.

Environmental Lobby

Conservation legislation pursues the concept of “sustainable utilisation”, which is a laudable objective that is supported by AFL and its shareholders. But there is an unbalanced emphasis placed on preservation by some within the environmental lobby. An unemotional assessment of the trade-off between utilisation and preservation requires candid and objective debate if we are to achieve sustainable utilisation. A positive example is provided by the SLED program in the squid industry. And yet some prejudice seems to remain amongst administrators, given the absurdly low figures used in the MalFRM calculations.

No doubt election year will bring forth another bout of claims of the adverse impact of the industry on wildlife. It is not acceptable to abate property rights to assuage the preferences of one group however. Likewise, it is also unacceptable for the industry to not engage in developing the trade-off between preserving and using wild fisheries.

Distance from Markets

Distance has both good and bad effects on the fishery sector. It turns out that fish, like our tourists, enjoy our “clean, green” country! On the other hand, we have the costs of marketing and freighting our goods across great distances.

As an industry we must use the best that the age of InformationCommunication and Technology can provide us to overcome our distance from international markets. It provides an opportunity for reduced communication costs in maintaining the relationships that typify the industry.

One threat we need to watch are the claims that the transport of NZ fish to the market place uses fossil fuels at a rate higher than local (and usually inefficient) harvesters. Our point of difference in the world market must be maintained and defended.

New Species into the QMS

Since 1986, this issue has been like Goldilock’s porridge – too hot or too cold! Only recently has the government shown signs of getting the policy right. Species will be introduced when there is a net benefit in closing the commons. Clearly, the Ministry needs help in determining when this point has arrived for particular species but AFL agrees with the principle that fisheries should be either open or in the QMS. Continuation or the introduction of halfway houses would be a backward step in our view. Similarly, distorted deemed value policies that undermine the quota market or distort TACCs are an example of regulatory failure.

Fisheries Management by the Owners

The Fisheries Act 1986 provides enormous potential to improve the economic performance of fisheries usage. As mentioned, the Purpose of the Act is to:

“provide for the utilisation of fisheries resources while ensuring sustainability”.
Utilisation means *“conserving, using, enhancing and developing fisheries to enable people to provide for their social, economic, and cultural well-being”.*

Note that the statutory direction is for us to be enabled – not controlled, regulated, or ignored. The Fisheries Act will discharge this purpose when management objectives are set outside the historical and scientifically dubious strait jacket of an “MSY for every fish stock”. The long term value of ITQ will be maximised when owners can buy the management services they select from the suppliers they choose.

Overcapitalisation of Quota

Although maximising the value of ITQ is our aim, some current quota values are very difficult to explain or sustain. Based on current earnings, much quota reflects market values that are a very high multiple of those earnings, which means a higher amount of capital investment for a given amount of earnings. Here I draw the analogy with farm land, most of which is managed and owned within what I would call a cottage industry of many smaller players. We have seen some farm aggregation take place in the dairy industry but that too has been contained by the cost of capital such that the industry remains dominated by many smaller owners.

Presently, AFL has adopted an EVA type performance framework, in which all investment is charged a weighted average cost of capital. This in turn places significant pressure on quota investment for the reasons mentioned. An alternative approach (which would ameliorate the issue) would be to internally price capital at the market price of the asset category, rather than at the average cost of servicing all debt and equity providers.

Ultimately these issues come back to how we manage the combination of risk and cash flow. AFL has been dealt its starting asset and funding cards. Our task is to optimise our portfolio of assets, debt and equity. Quite naturally, we have started the exercise with a focus on the design of our asset portfolio.

Seafood Prices

We all share a common desire to maximise returns measured in \$NZ. This has been more challenging in the face of a high NZ dollar.

We have been keen to grow the domestic market – which has been successful for some operators and for some species. The rising prices for Tarakihi and Hoki are good examples, but more needs to be done. Cutting fish these days can be a marginal exercise.

Even the glamour industry of rock lobster has had a tough year. We have a great product delivered in excellent shape to worldwide markets, but those markets have been very volatile. In particular, the China market is fraught with difficulty, and as we all know, there are “many shades of grey”.

The FTA with China should offer some great opportunities for the seafood sector. The challenge is to capture the benefits of any tariff reductions that eventuate and to establish and maintain enduring relationships in this extremely important market.

Size of the Industry

It is easy to forget that we are a small industry in terms of world production. Our fishery covers a large EEZ and is distant from where we harvest and process. It's silly that operators have not rationalised the assets they hold and co-operated more. Is it sensible for New Zealand fishing companies to run their own half full trucks from and to the same places?

Can co-operation unlock economies of scale? Yes it can. There are many reasons why it doesn't happen, but there are not many good ones. I suspect that there are parts of the industrial chain that verge on being a natural monopoly, but because the industry has grown from the bottom up, many of those opportunities remain untapped. At the same time, the fact that the industry has been largely fragmented has meant that it has been relatively free of competition regulation. The challenge for New Zealand here, as with other industries, is to balance the protection of domestic consumers on the one hand with ensuring the competitiveness of the export side of the industry on the other. A related point, which I will not dwell on, is the extent to which foreign governments subsidise the sector both inside and outside New Zealand. This can dramatically change the economics of the industrial chain to New Zealand firms –as well as provide opportunities to some New Zealand firms.

To an extent, AFL has internally achieved some rationalisation benefits. On a larger scale, the discussions between Sanford and Sealord last year, while ultimately unsuccessful, did indicate that there are gains from such scale exercises.

World Economies

Unfortunately, the AFL (let alone NZ) tail cannot wag the global dog.

But on a serious note, there is a need to keep a watching brief on developments in the world economies, and trade relationships between countries. The FTA with China provides an obvious example, but there are also rafts of changes in many bilateral discussions occurring, as the Doha WTO rounds slowly grind forward. Knowledge of these developments is necessary, despite its glacial progression in some markets.

The industry tends to depend on a couple of individuals to monitor these events, which may not be smart. I am aware of and would like to acknowledge the work of Alastair Macfarlane (SeaFIC) and the group within NZ Trade and Enterprise for keeping fish to the forefront in these negotiations!

Moving Forward : AFL's approach

Many within the industry have watched with curiosity as to how AFL would function. Would it be a straight passive investor, or a comprehensive operator? Would it allow its stable of companies a free hand, or would it impose a tight corporate regime on its various levels of management?

We have divisionalised our wholly-owned operations, and established a head office in Wellington. Divisional GM's are given the necessary autonomy to operate – including being able to call on the resources and services of the head office. But a defining performance change is the adoption of an EVA type framework to plan and measure the performance of both operating divisions and people.

Eventually, the remuneration of all levels of management will be made to largely depend on the value that is created, or lost. In the short term, this will inevitably lead to a better focus on the optimality of AFL's asset and funding portfolio's. Such a rationalisation will not involve a mad cap sell off or a buying spree. But it will promote a more effective configuration of the company's balance sheet.

An EVA type culture is never easy to implement. For one thing, it represents a big paradigm shift, and that usually invites resistance, even if only subtle. One of the reasons I support the framework is that it emphasises the reality that capital is costly. In widely-held unlisted organisations, there is always the risk that management will paradoxically treat shareholders funds as cheap, or even free, on the basis that, unlike a Bank, shareholders cannot demand its return, or even demand a dividend. While it is true that absolute profits are boosted by lowering the ratio of debt to equity, the flipside is that the rate of return to equity progressively reduces as the level of equity increases.

The EVA approach is not perfect, but it does not have to be. It only has to be better than the other imperfect alternatives. We need to be on guard against complexity and an excessive focus on the short term. There will be inevitable issues concerning the value of assets and capital. But remember that these arguments also arise in the use of conventional measures.

We have outlined our EVA type approach at the last couple of Hui A Tau. We consider that transparency to shareholders is essential to ensure their ongoing support – and of course that is doubly important for AFL given the fact that our shareholders will also own a sizeable chunk of New Zealand's ITQ, independently of AFL.

What can we do smarter?

Most of the issues I've talked about lead to the promotion of a co-operative or unified approach. That unity doesn't just start or stop with the operators. For example, a unified approach is required to protect the QMS from value eroding regulations.

We will never enjoy secure property rights while competing users of fisheries are not integrated with the QMS. An artificial fragmentation of management effort and perverse economic incentives arise from their exclusion.

The major competitive threat to ITQ now lies in unconstrained recreational fishing, the aquaculture regime and uncompromising preservationists. The expansion of these three influences directly reduces the returns to the industry. Multiple uses should be matched with multiple responsibilities for fisheries management.

I've also talked at length about rationalisation within the industry. An obsession with controlling a circle of activity to the exclusion of other mechanisms will usually be suboptimal – especially given the complexity of this industry. Joint ventures can and do work – witness AFL and other companies within the industry. We have some examples of profitable co-operative ventures between intensely competitive firms.

In an environment of weak prices and a strong currency, it is timely to think through what advantages can be achieved with a broader and more innovative approach to managing our assets.

Closing of Address

Our door is certainly open. We see commerce as comprising win/win arrangements. Win/lose arrangements are not sustainable. AFL does not seek a reputation for pursuing either side of win/lose contracts. I'm keen to ensure that prejudicial baggage is left at the door in our commercial dealings, and we welcome constructive input from anyone.

I hope this goes some way to explain what you can expect from AFL. We are new to the scene and our ideas will evolve on many issues. However, we will retain a strong economic focus across a long term horizon. We intend to act strongly in the general interests of our iwi shareholders. We see no room for complacency. We remain deeply concerned about the security of our key asset – quota. No one faces stronger incentives concerning its management than us, but we also see our fortunes and those of the rest of the industry as inter-dependent.

I wish you well in your respective endeavours.

Kia ora koutou katoa