Queensland Dairyfarmers' Organisation

Queensland Dairyfarmers' Organisation Limited ABN: 90 090 629 066

Mr Ian Rickuss MP
Chair,
Agriculture, Resources and Environment Committee,
Parliament House,
Brisbane, Queensland 4000
Email: arec@parliament.qld.gov.au

29th August 2013

Dear Ian,

Re: Inquiry into the Milk Pricing (Fair Milk Mark) Bill 2013

The Queensland Dairyfarmers' Organisation Ltd (QDO) welcomes the opportunity to provide to the Queensland Agriculture, Resources and Environment Committee the following submission for the Committee's consideration in relation to the Committee's inquiry into the Milk Pricing (Fair Milk Mark) Bill 2013.

Currently the Queensland dairy industry is at crisis point brought on by the combination of natural and manmade disasters in the form of severe flooding and the supermarket 'milk price war'. The QDO is focused on finding solutions and supporting initiatives which may assist the industry to restore its sustainable competitive profitability and to be able to grow again to meet the daily fresh milk needs of the Queensland population, while also contributing to the economic growth of Queensland.

In support of QDO's submission I have also attached the July 2013 edition of the Northern Dairy Situation and Outlook report, which contains the latest information and data on the Northern dairy industry.

The QDO is happy, where possible, to provide further information Committee members may require and would welcome the opportunity to discuss our submission in greater detail.

Yours Sincerely,

Brian Tessmann
President
Queensland Dairyfarmers' Organisation Ltd

Queensland Dairyfarmers' Organisation Limited ABN: 90 090 629 066

Submission to the

Agriculture, Resources and Environment Committee

Inquiry into the Milk Pricing (Fair Milk Mark) Bill 2013

29th August 2013

Introduction QDO

The Queensland Dairyfarmers' Organisation (QDO) is the peak industry body for the Queensland dairy industry, with approximately 70 precent of all Queensland dairy farmers being members. The QDO provides a wide range of advocacy, support and information services to its members and the industry across Queensland.

The QDO is a member of the Australian Dairy Farmers (ADF), which is a member of the National Farmers Federation (NFF). The QDO is also a member of the Queensland Farmers Federation (QFF).

Queensland Dairy Industry Snapshot

The dairy industry is a vital part of many rural and regional communities of Queensland, providing employment and economic benefits, and product value-adding through food processing and manufacturing, transport, wholesale and retail industries.

The Queensland dairy industry at farm gate generates some $226 million worth of milk production each year from some 510 dairy enterprises and after processing, this value increases to approximately $700 million in drinking milk and other value-added dairy products. The industry covering both the dairy farming and manufacturing directly employs more than 2,500 Queenslanders.

The Queensland dairy industry has six main processing plants and a number of smaller processors producing niche market products. The two main milk processing companies in Queensland include Lion Dairy and Drinks and Parmalat and then the next is the medium sized Norco Cooperative based in Northern NSW, which also have a Queensland milk processing plant at Labrador.

Virtually all of the milk produced by Queensland dairy farmers on a daily basis is consumed by Queenslanders as fresh milk.

The Queensland industry is currently at a crisis point. It is facing serious challenges, including the impact of recent natural disasters, the ongoing impacts and market failure caused by the supermarket ‘milk price war’ (SMPW), increasing costs of operations, and the need to compete for resources.

Of major concern is that due to these impacts over the last three years farmers farm gate prices have been forced down while Queensland milk production has continued to decline, falling further and further short of meeting the requirements of the Queensland market, clearly representing market failure.

Domestic fresh milk production versus southern seasonal milk production for export

Within Australia there are two distinct dairy industries, being;

1. the domestic fresh milk market supplied by dairy farmers with year round flat higher cost production systems, and
2. the manufactured dairy product and export market supplied by dairy farmers with lower seasonal production cost systems.

Queensland, northern NSW and Western Australia produce milk for the domestic drinking milk markets whereas southern states including Victoria, Tasmania and South Australia produce milk largely destined for manufactured product and export markets.

As virtually all of Queensland milk produced is used as drinking milk, it makes Queensland farmers highly susceptible to variations in the price of drinking milk and as such the ongoing supermarket ‘milk price war’.

With only two main processors in Queensland, combined with the requirement to supply milk in a flat supply system with high quality standards for only the domestic fresh milk market makes for a difficult operational environment for dairy farmers with limited or no alternative supply and production system options.

It should also be noted that the Queensland drinking milk supply chain on a national comparative basis was already under the significant pressure before the start of the current supermarket ‘milk price war’, with regional retail prices being on average lower than the national average.

Natural Disaster Impacts

The Queensland dairy industry has suffered from two severe and record setting flood events in three years. In early 2013 severe flooding affected over half of Queensland dairy farmers, causing some $40 million in damages and lost production, which follows the 2011 disaster impacts causing losses of about $80 million. These impacts combined equate to half of one years farm gate GVP of the Queensland dairy farm sector.

Queensland milk production has fallen from 523ML produced in 2010 to 458ML being produced for the 12 months to the end of July 2013. This reduction is due to impacts from natural disasters at the same time combined with lower farm gate prices caused by the SMPW, rising costs and as a result a high rate of farm exits from the industry.

Over the same time the packaged milk sales in Queensland has grown from 497Ml to 551ML. This means that there is a shortage of Queensland fresh milk to meet the demand of Queenslanders by some 100Ml per annum currently, forcing milk to be imported from southern States to fill the supply gap.

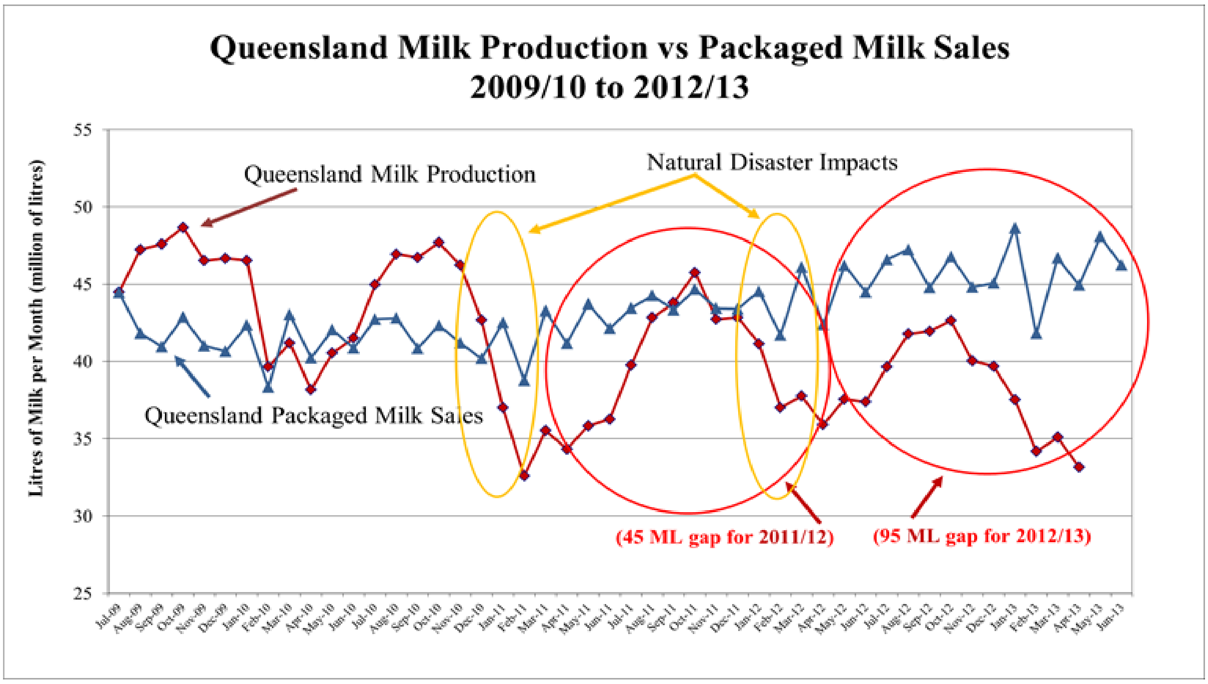


Figure 1 Queensland milk production vs packaged milk sales 2009/10 to 2012/13

While a combined industry recovery program is assisting impacted dairy farmers where possible, the recovery from these major natural disaster impacts will take an extended period of time. With lower and suppressed farm gate returns combined with these disaster impacts for some dairy farmers they will not be able to recover and will be left with no alternative but to exit the industry.

Future Growth of Queensland Fresh Milk Market

Queensland continues to demonstrate population growth, with the average annual population growth rate for Queensland over the past 5 years being some 2%. ABS projects that the population will grow by more than 2% per annum over the next 10 years, providing good scope for expanding demand for fresh milk. At medium level ABS population forecasts for Queensland the Queensland dairy industry will need to produce another 110 million litres of milk per annum by the year 2022 to meet market demand, as shown in the graph below.

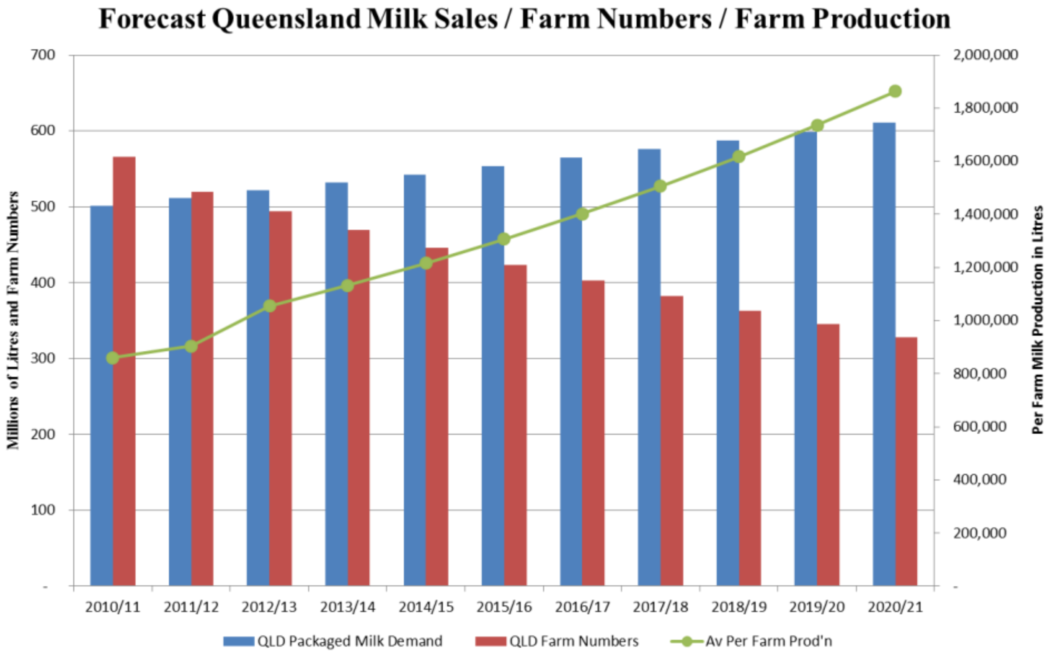


Figure 2. Forecast Qld Milk Sales, Farm Numbers & Farm Production 2020-21

The ability of the Queensland industry to meet this forecast market demand opportunity will hinge on a number of major factors, including but not limited to:

1. remaining the first best option to supply high quality fresh milk to the local market,
2. farm gate prices increasing to provide positive competitive sustainable business returns for dairy farmers,
3. being able to secure finance to invest in expanding the production capacity of their farms to be able to, on average, double per farm milk production over the next decade,
4. being able to compete for resources such as water, labour, and grain,
5. being able to successfully manage climate and other risks,
6. being able to attract and retain the next generation of dairy farmers.

Additionally with the world's population also expanding rapidly, potential opportunities will again arise for the Queensland dairy industry in the international marketplace.

The QDO is working with stakeholders and Government to explore potential new high value export opportunities for the Queensland industry.

"Milk Price War" and Market Failure Impacts

On the 26th January, Wesfarmers owned company Coles launched a national advertising campaign using Coles store brand milk at a discounted price of up to 33 percent reducing the price to $1 per litre. Immediately following the Coles announcement Woolworths dropped their price of Woolworths brand milk to match the price and other stores followed suit with some such as Aldi, cutting the price even further to $1.99 for 2 litres and $2.89 for 3 litres.

The strategy instigated by Coles to cut their store brand fresh milk to $1 per litre was targeted at not just seeking to attract more customers to their stores but to also expand their market share for their Coles store branded milk and market share of domestic retail food sales, which has largely been at the expense of processor brands and small independent retailers. This decision by Coles was made either with a poor understanding of, or no regard for the impact on dairy farmers, milk processors, local corner stores, independent service stations or the tens of thousands of other workers who depend on the fresh milk industry for their livelihood.

The discounting of milk by Coles and as followed by other retailers inevitably forced down farm gate prices for milk, which has been supported by public statements from Woolworths and other retailers stating that the reduction in price is unsustainable.

The targeted heavy discounting of store brand fresh white milk products by Coles, and followed by other major supermarket retailers, has caused a national reduction in the average retail price of fresh milk, a loss of processor brand share in milk sales, stripped wholesale value from the milk category, and commoditised a wider range of products.

Processors, in an effort to reduce the loss of market share of their branded milk products to heavily discounted supermarket private label, have resorted to discounting and undertaking additional advertising expenditure in both grocery and non-grocery channels. Processors have managed to regain some lost market share, however at lower overall margins.

The heavily discounted supermarket store brands have also caused a shift in sales from small retail stores to major supermarkets. Some small food service outlets now source product direct from major supermarkets at prices which are cheaper than the available wholesale price through “route trade” deliveries direct from processors. This has also added to the loss of processor brand sales and thus processor brand market share.

The increasing price gap between heavily discounted supermarket private label or store brands and processor brands is a major problem for processors with the price difference now being some $1.12 per litre.

When supermarkets set the price of both brands on the supermarket shelf and then discount their store brand to unstainable levels, using it as a sacrificial discount marketing agent, to attract shoppers to grow overall grocery sales and at the same time supermarket store brand market share and power, it is at the expense of processor brands sales. The QDO believes these tactics are predatory and need to be addressed by Government.

Since the supermarket milk price war started, processors have lost profitability as they have lost market share of their brands and wholesale margin to supermarket $1 private label milk.

Both major processors in Queensland, Parmalat and Lion Dairy and Drinks, have indicated that the drop in price is having an impact on their businesses, with a reduction in profits flowing through to impact on farmers.

This is turn has seen processors reduce farm gate prices to farmers, and shorten contract terms and tighten contract conditions over the last three years.

Parmalat has recently provided an additional one cent per litre (1cpl) to its suppliers and Lion is now also offering a slight increase but still not enough to restore farm profitability for the majority of farmers and in the latter example the addition of freight charges has left many farmers worse off. Norco, as a cooperative pays its farmers based on the cooperative performance and has delivered similar or slightly better farm gate prices to the top end of the major processor price offers.

The impact on retail sales and wholesale returns has varied state-to-state, due to the differences in retail prices and sales mix. The impacts on supply chain returns is estimated to be greatest in Queensland, where retail prices of branded lines are lower and virtually all milk produced is used for the domestic fresh milk market, without the availability of an alternative market.

The changes in access to regional private label packing contracts for major supermarket chains has also significantly altered the milk requirements of domestic focused processors such as Lion and Parmalat, affecting respective company margins, profits and the ability to maintain farmgate milk prices.

Resulting price structures and signals from processors, combined with higher operational costs and natural disaster impacts have been undermining the stability of regional milk supply and producer confidence in the reliability of supply chain returns.

The Queensland Dairy Accounting Scheme (QDAS), operated by the Queensland Department of Agriculture, Fisheries and Forestry (QDAFF), presents that farm profitability has fallen sharply since the SMPW started to where farmers have experienced negative returns over the last two years, which is resulting in more and more farmers having to exit the industry.

As was the case in 2007, if processors acted to increase prices in the current market environment they would lose further market share to the supermarket $1 private label milk. In contrast to 2007, over the last two and half year in order for processors to try and protect market share and slow the rate of market share loss have resorted to discounting and undertaking additional advertising, both of which have impacted their margins and profitability.

The QDO conservatively estimates that since January 2011, the ‘milk price war’ has cumulatively cost Queensland dairy farmers $50 to $60 million in reduced farm gate prices and approximately $70 million in lost opportunity milk sales.

Confidence levels across the dairy farming community are very low, and this is putting at risk a return to the medium-term stability of production to meet regional domestic market needs. Confidence as measured by the National Dairy Farmer Survey (NDFS) in February and the Queensland Dairy Farmer Survey (QDFS) in May was significantly lower in 2013 compared to 2012. The percentage of subtropical farmers describing themselves as being positive about the future fell from 45% to 31%. These are the lowest level of confidence recorded since the inception of the NDFS in 2004 – a year that followed a significant market downturn and widespread drought.

The QDFS under taken in May 2013 has also measured a significant reduction in profitability and confidence of Queensland dairy farmers with 68% of respondents not being able to cover their monthly operational costs from their monthly milk cheque. Only 30 percent replied that they expected to be dairying in 5 years and 8% were unsure.

The Queensland Dairy Accounting System (QDAS) report for 2011/12 presented that milk returns averaged from 51 to 54.8 cpl, while the margin over feed costs ranged from 24.7 to 30 cpl, the Dairy Operating Profit for 2011/12 declined by 36% from 2009/10. QDAS data also presents that average net cash results for 2009/10 was 5.6 cpl then dropping to 2.1 cpl in 2010/11, then to (-0.6) cpl in 2011/12 and is now forecast to decline further to (-4.2) cpl for 2012/13, which equates to the average Queensland dairy farmer making a loss of approximately ($40,000). The results from this analysis are included in the Northern Dairy Industry Situation and Outlook Report, July 2013 (see pages 33 to 37).

ABARES Farm Survey estimates for 2012/13 indicate average farm cash incomes for Northern NSW and Queensland dairy farmers fell by 40% from the 2011/12 and that average farm business profit declined from $14,100 to a loss of ($39,000). The ABARES survey report also presented a drop in milk receipts of 3 cents per litre from 2011/12 to 2012/13 and fodder costs increased by over 13%.

Since the start of the ‘milk price war’ more than 80 dairy farming families have exited the Queensland industry, down to some 510 dairy farmers currently, at a time when Queensland is short of milk. This equates to the loss of some 80ML of fresh milk production capacity per annum from the industry.

With the average farm constituting a $3 million investment in fresh milk production, this equates to a loss of over $240 million of investment in fresh milk production, as well as a loss of some 240 jobs in fresh milk production at farm level. Across the processing sector many more staff have been put off as processors have had to reduced costs and rationalise operations in the domestic fresh milk sector, including laying off product research and innovation staff.

A regional market failure situation has evolved from the start of January 2011 demonstrated by;

- natural disasters caused a loss of Queensland milk production to where there was a shortage to meet the needs of the local market,
- at the same time Coles initiated its $1 per litre Coles brand discount marketing campaign which led to the ‘milk price war’ amongst retailers,
- the impact of the ‘milk price war’ has seen retail prices, whole margins, processor profitability, farm gate prices and farm profitability all decline in a market short of milk to meet demand,
- unlike the other industries such as the fruit and vegetable industry when the floods impacted supply to the market the price via the function of supply and demand rose to stimulate supply, however with the Queensland fresh milk industry supply was impacted to below demand, prices did not rise but fell due to the market power interference by Coles led supermarket milk price war, which has not allowed the market supply and demand function to properly work,
- the last time period where Queensland milk supply was close to the regional market demand line was in 2007 caused by many years of severe drought impacts combined with low farm gate prices. The processors responded to the tightening supply and demand situation, and concerns from farmers at that time, by increasing the prices of their products in the market place to be able to then afford to pay farmers a much higher farm gate price as well as providing longer five year term contracts. This initiative combined with improved climatic conditions allowed milk production to stabilise and grow again, as shown in the following graph,

- since the supermarket milk price war started processors have lost profitability as they have lost market share of their brands to supermarket $1 private label milk. This in turn has seen processors reduce farm gate prices to farmers and shorten and tighten contracts. QDAS presents that farm profitability has fallen sharply since the SMPW started to where farmers have experienced negative returns over the last two years, which is resulting in more and more farmers having to exit the industry. As was the case in 2007, if processors sought to increase prices in the current market environment they would lose further market share to the supermarket $1 private label milk. In contrast to 2007, processors in an attempt to try and protect market share and slow the rate of market share loss have resorted to discounting and undertaking additional advertising,
- This ‘catch 22’ for milk processors caused by the supermarkets use of fresh milk as a sacrificial discount marketing agent and to grow the market share of their own store brand milk at the expense of processor brands means that the market supply and demand function has not been able to operate as it should in a free, transparent and freely functioning market.

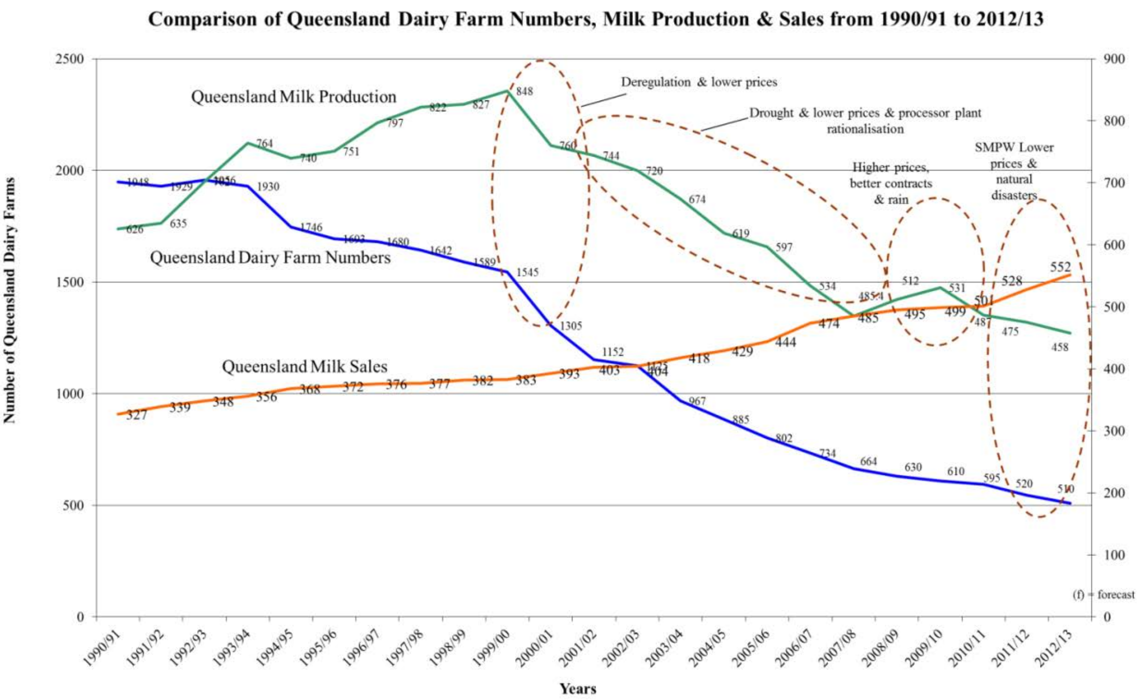


Figure 3. Queensland dairy industry historic trends & causal factors

The current regional market failure caused by the major supermarkets has forced processors to source milk from southern milk production regions and freight it to Queensland to fill the market gap. However this option also highlights market failure as it is not economic or sustainable in the medium term, as demonstrated by the following table.

The following table provides an overview of regional farm gate prices ranges for Southern Queensland, Northern NSW, Central NSW and Northern Victoria and also cost ranges in cents per litre to transport milk from each region to be processed in Southern Queensland for that market. The table then provides a comparison of the landed cost of milk into Southern Queensland. As can be seen from the comparison of 2012/13 figures the landed cost of sourcing milk from Northern Victoria to fill supply gaps in Southern Queensland is more than the cost of sourcing milk within the region.

The opening prices for Southern exporting regions have increased significantly for the 2013/14 year being up by over 25%, being driven by strong global demand, high world dairy prices and a lower Australian exchange rate. This differential is highlighted to a greater degree when the increases in opening prices for 2013/14 in the Southern regions is taken into account, unless Northern farm gate prices increase significantly this year.

Figure 4. Landed cost comparison

	2012/13 average prices & freight costs in cents per litre				2013/14 forecast Nth Vic
	Sth Qld [1]	Nth NSW	Cent NSW	Nth Vic	
Farmgate	**48-53**	**46-52**	**45-50**	**38-41**	44-48
Freight	**3-4**	**5-6**	**8-10**	**17-20**	17-20
Landed cost	**51-57**	**51-58**	**53-60**	**55-61**	61-68

* This assumes milk prices on a year-round basis, given likely pricing by fresh milk processors in that region
The above price reflect Tier 1 pricing and do not include Tier 2 prices
The above price ranges may vary further depending on the allocation at farm level of the Tier 1 and Tier 2 volumes.

With the current regional market failure and lack of profitability and options for farmers combined with the record low confidence levels, if there is not a rapid change in the trading environment and a significant increase in farm gate prices for Queensland dairy farmers many more farmers will be forced to exit the industry placing the industry at risk of not being able to recover.

The market growth forecast for the next decade equates to an additional 110ML and with transport costs increasing, Queensland dairy farmers still offer the most competitive first option for the year round supply of high quality fresh milk if the regional market was allowed to be transparent and to function properly.

The information and data presented, clearly demonstrates the impact that decisions beyond the control of dairy farmers are having on them and not allowing the regional market to function properly to restore a regionally sustainable farm gate price to stimulate regional milk production to fulfil the demand in the region's market.

Supermarkets competing for change and control

Over the last year major retailers have continued to aggressively compete for market share and growth of their store 'private label' brands. Changes in structure of private label supermarket milk contracts and potential new store brands are likely to translate into more competition amplifying pressure on existing processor owned fresh milk brands and processor margins.

Both major supermarket chains have announced plans to source a portion of their private label milk products through arrangements that provide a more direct linkage to milk producers and greater certainty with longer term contracts (5-10 years), which will take effect in 2013/14 and later, while also looking at opportunities to develop new exclusive parochial regional provenance products.

This year this trend accelerated when Woolworths and Coles announced direct supply arrangements with dairy farmer groups for the supply and marketing of their store brand fresh drinking milk. Both arrangements involve the supermarkets seeking to use direct relationships with farmers to promote that they are looking after farmers and thereby, improve public relations and to increase farmgate price transparency. The true outcome of these new arrangements with farmer groups is yet to be seen as they will not truly come into effect until mid-2014.

A UK history lesson in cause and effect

Currently the longer term implications are starting to mirror what has occurred in the United Kingdom over the last decade as the major supermarket chains place more and more pressure on the fresh milk market following the introduction of aggressive discounting tactics, private label growth strategies, new contracts and supply arrangements.

Since the mid-1990s in the United Kingdom the supermarket sector which is dominated by five major supermarket chains have increased their control and dominance of the milk market through a combination of strategies, including aggressive discount driven marketing of their store brands, introducing more store brand ranges to compete with processor brands, brand mimicking, shelf space pressure tactics, all which have severely affected the profitability and viability of processor owned brands over time.

The major UK supermarkets have also harnessed contracting and tendering processes to take more direct control over the supply chain including for example contracting processors to be toll milk bottlers and packers, and contracting groups of farmers to supply direct to the supermarket with special supply conditions placed on the farmers.

The resultant change in the UK domestic milk market is that since the mid 1990's the gross farmgate liquid milk gross margin has increased by some 4 percent from 1996 to 2010, processor liquid milk gross margin has increased by some 20 percent, however retailer liquid milk gross margin has risen by over 600 percent. At the same time supermarket 'private label' products have grown their market share to dominate the market at the demise of processor owned brands, the retailer price of liquid milk has increased by approximately 50 percent.

As such, consumers have ended up with less choice and paying more. The following graph presents the change in gross milk margins by supply chain sector over time and impacts on retail price and consumer choice.

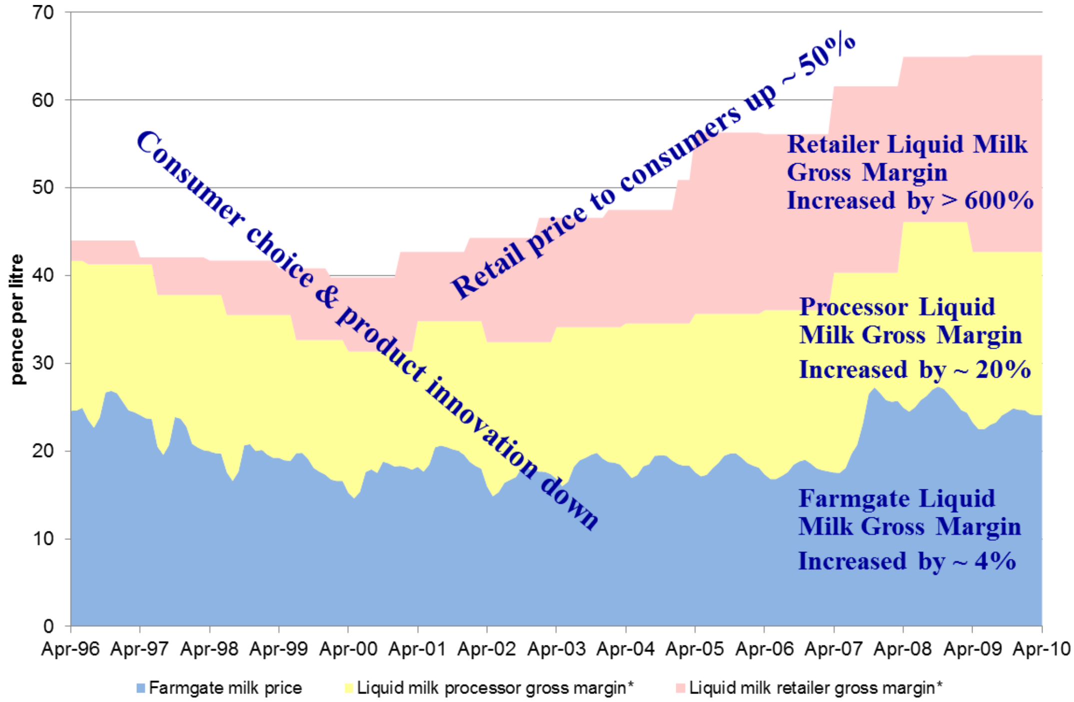


Figure 5. United Kingdom Gross Milk Margins 1996 to 2010 source DairyCo

Objectives of the 'Fair Milk Mark' Bill

QDO understands that the 'Fair Milk Mark' Bill is for an Act of the Queensland Parliament to provide for the setting of a fair price to be paid for the production of milk and the establishment of a fair milk mark to assist consumers to purchase milk for which a fair price has been paid to dairy farmers.

The QDO further understands that the objectives of the Milk Pricing (Fair Milk Mark) Bill 2013 are:

1) to provide for the setting of a fair price to be paid to dairy farmers for the production of milk to ensure a sustainable dairy industry continues in Queensland; and
2) to establish a fair milk mark to be placed on containers of milk to indicate to Queensland consumers that a fair price has been paid to the dairy farmer who produced the milk.

The QDO also understanding that the Milk Pricing (Fair Milk Mark) Bill 2013 introduces a non-compulsory marketing mechanism to:

I. introduce a Fair Milk Mark for all milk that is sold in Queensland where the farmer is paid at least 8 cents per litre above the cost of production;
II. address the competitive imbalance created by deregulation and unethical marketing practices of the supermarket duopoly;
III. give consumers the opportunity to express their support of our domestic dairy industry;
IV. outlines a program of ministerial consultation with other state jurisdictions to introduce similar legislative instruments to ensure the Queensland dairy industry is not disadvantaged by increased trans-border trade, including developing an industry code of conduct;

V. legislates an ethical market for fresh milk in the Queensland dairy supply chain; and

VI. introduces a penalty system for any milk that is sold in Queensland bearing a Fair Milk Mark for which the farmer has been paid less than 8 cents per litre over the cost of production.

QDO Supports the Objectives of the 'Fair Milk Mark' Bill

The QDO supports the objectives of the "Fair Milk Mark" Bill as the Bill;

- proposes a non-compulsory marketing mechanism to address the market failures resulting from the supermarket duopoly and the extreme downward pressure being placed upon Queensland farm gate milk prices and dairy farming profitability,
- would introduce a fair milk mark on a milk bottle that identifies that the farmer was paid a fair price above his or her costs of production. Currently the majority of Queensland dairy farmers are receiving prices less than the true cost of production and that is why we are seeing more and more farmers, investment and employment leaving the industry at a time when Queensland is short of milk to meet the needs of Queenslanders. Queensland dairy farming families need a competitive sustainable return on assets to be able to keep producing fresh milk to meet the needs of the Queensland,
- provides consumers with clear and transparent information to enable them to make an informed decision on their choice of purchase of fresh milk, particularly if consumers wish to know that if they purchase fresh milk with a 'Fair Milk Mark' on it they can have confidence that the Queensland dairy farming families producing that milk are being paid a sustainable price, compared to other options which may, or on average is likely not to provide a sustainable farm gate price to dairy farmers,
- provides milk processors with an opportunity to differentiate their milk brand to unsustainably priced fresh milk such as supermarket store brands priced at $1 per litre,
- with all of Queensland dairy farmers milk being sold in the domestic fresh milk market the 'Fair Milk Mark' would help support better returns for Queensland dairy farmers,
- while major processors may not take up the 'Fair Milk Mark' due to their reliance on major supermarkets, the initiative would provide small Queensland milk processors with another opportunity to differentiate their fresh milk in the domestic market and further demonstrate to consumers that their milk supports the sustainability of Queensland dairy farming families.

It needs to be noted that the QDO has investigated this option commercially however the major processors did not wish to pursue the initiative. While a precise reason for not supporting the initiative was not given by the major processors it may well be because the major processors whom currently supply the major supermarkets with milk for their supermarket store brand milk, do not wish to upset that retail relationship and thus the main market avenue to Australian consumers for their own branded products. With this situation the QDO again also reiterates the need for Government support to establish a 'Fair Milk Mark' system.

The QDO wants to see a transparent and fair market for dairy farmers, which would see dairy farmers receive a fair sustainable return and support their business growth to be able to meet the growing needs of our domestic market as well as fulfilling high value export opportunities in our region of the world which has rapidly growing populations. This would underpin a competitive and productive Queensland dairy industry which would provide more wealth and employment generation for the Queensland economy.

Mechanics of the 'Fair Milk Mark' Bill

In clause 4 of the Bill, sets the objective of the Act to "(a) establish a fair price be determined for Queensland's fresh milk to ensure the continued sustainability of the dairy industry." The QDO has recently had an independent analysis undertaken of costs and returns of Queensland dairy farming systems using data from the Queensland Dairy Accounting Scheme (QDAS), operated by the Queensland Department of Agriculture, Fisheries and Forestry. The results from this analysis are included in the Northern Dairy Industry Situation and Outlook Report, July 2013 (see page 37). The QDO believes that this form of analysis using the QDAS data can establish what a rate of return needs to be for different Queensland dairy farming systems to underpin there sustainability.

In clause 5 of the Bill, uses the term 'typical cost of production' on top of which a predetermined amount of cents per litre will be added to determine a minimum fair milk price for products displaying the 'Fair Milk Mark'. And clause 6 of the Bill establishes criteria to be considered when determining the typical cost of milk production.

The QDO recently commissioned independent analysis of costs and returns of Queensland dairy farming systems using data from QDAS also provides a basis to establish 'typical costs of production' for different types of Queensland dairy farming systems.

The results from this analysis are included in the Northern Dairy Industry Situation and Outlook Report, July 2013 (see pages 33 to 37). The QDO believes that this form of analysis using the QDAS data can establish what 'typical costs of production' are for different Queensland dairy farming systems.

QDO believes an independent authority could be commissioned to undertake such analysis on an annual basis to establish "typical costs of production" for different types of Queensland dairy farming systems and which would be a minimum price which would ensure the sustainability of typical Queensland dairy farms.

While the market failure problems of the fresh milk industry is particularly acute for Queensland the QDO would like to see such an initiative adopted on a national basis and as such supports the objectives of clause 9 of the Bill which, obliges the Queensland Minister to try to negotiate with relevant ministers in other state and territory jurisdictions toward establishing a fair milk price across all state and territorial jurisdictions and creating a federal code of conduct for the national dairy supply chain.

Need for a Free and Transparent Market

The QDO would like to see a free and transparent market for fresh milk in Australia that provides fair competition and fair prices. However due to the excessive retailer market power of major supermarkets this is currently not the case and market failure, particularly in the Queensland fresh milk market, caused by the major supermarkets is driving down processor and dairy farmer returns and profitability and forcing farmers, investment and employment out of the industry.

Currently, the two major supermarkets account for more than 70 percent of packaged grocery sales in Australia and between 50 and 60 percent of dairy product sales. This large market share gives the major supermarkets an immense amount of market power in their negotiations with processors and farmers. This is particularly the case when the major supermarkets are the largest avenue to the Australian consumers for the sale of processor branded products. This level of market power is unprecedented globally in developed economies.

The QDO, Australian Dairy Farmers and other groups representing farmers, food manufacturers and small retailers are seeking changes in Federal Government legislation and regulation to rebalance market power and bring about fair dealing in the market place including;

- amending and strengthening the Competition and Consumer Act 2010 to prevent predatory pricing and deceptive and misleading conduct including that:
    - an ‘effects’ test be reintroduced;
    - a definition of unconscionable conduct be inserted into the Act; and
    - a statutory duty of good faith be enacted as part of the Act.
- a Mandatory Code of Conduct covering the whole of supply chain, headed by an Ombudsman or Commissioner that can enforce compliance of the code, to provide a better balance of market power and ensure that contracts, prices and supply conditions are fair, conscionable and not unsustainable.
- strengthening the ACCC Collective Bargaining authorisation for dairy farmers to provide a better balance in market power for dairy farmers.

It is clear that measures must be urgently taken to stop the impacts and losses being inflicted on dairy farming families and the domestic dairy industry. Without government action, the implications for the Queensland industry are dire.

Ultimately, action to protect the Queensland industry is also in the interest of consumers and helps ensure a viable supply of high quality fresh milk for Queenslanders now and for the future.

Northern Dairy Industry

QDO Queensland Dairyfarmers' Organisation

Regional Industry Situation & Outlook

In collaboration with Subtropical Dairy

Update: July 2013





Introduction

- This report has been prepared as an initiative of the Northern Dairy Industry Strategic Plan, facilitated by the Queensland Dairyfarmers' Organisation (QDO), on behalf of the Northern Dairy Industry to improve the awareness of the situation and outlook facing the regional dairy supply chain.
- The QDO has compiled information for the report and combined it with information and data provided by Dairy Australia, Queensland Department of Agriculture, Fisheries and Forestry, ABARES and independent consultant Graeme Busby.
- The report provides an up to date assessment of the Northern Dairy Industry and analyses the current and future milk supply and demand prospects in Northern NSW and Queensland, and other significant industry issues.
- This is the 7th annual Northern Dairy Industry Outlook designed to provide analysis for the benefit of industry participants and stakeholders including service providers, input suppliers, investors and Governments.
- This study uses data provided by QDO, QDAS, collective bargaining groups, milk processors and the 2013 Australian Dairy Situation and Outlook Report. The production of this report is supported by the Subtropical Dairy Program and Dairy Australia.
- This paper was compiled with co-operation from the production and processing sectors and has taken into consideration the regional industry challenges and the market outlook in the short to medium term.
- This report, compiled in July 2013, updates previous analyses and is an up to date adjunct to National Dairy 2013: Situation & Outlook report.
- This report contains:
  - A summary of highlights from the National Dairy 2013: Situation & Outlook released in May 2013, produced by Dairy Australia,
  - An outlook for supply and demand for milk in the northern dairy industry region,
  - Factors affecting profitability and sustainability of the regions milk production, dairy farmers and processors,
  - Future challenges for milk production in the region,
  - Summary of opportunities from domestic and international market growth.
- This report draws on farmer intentions and farm information from surveys undertaken by Dairy Australia in February 2013 (the National Dairy Farmer Survey – NDFS) and a survey undertaken by QDO and Premium, of Queensland dairy farmers in May 2013 (QDFS).
- The analysis has identified a number of critical issues relative to the current and future stability and sustainability of regional milk production relative to local domestic market demand and other potential market opportunities.
- This report can also be viewed at www.dairypage.com.au.
- The National Dairy 2013: Situation & Outlook report can be viewed at www.dairyaustralia.com.au.

Summary Points

- The northern dairy region supplies a steadily expanding regional fresh milk market which is largely driven by population growth, and in the recent year, combined with an increase in per-capita consumption.
- From 2008 to 2010 stronger milk prices and longer term contracts, combined with good seasonal conditions and lower bought-in feed costs helped to stabilise and then regrow regional milk supply and producer confidence.
- However, devastating floods, cyclones and prolonged wet conditions disrupted production across the Northern dairy industry in 2011 and again in 2013 causing significant damage and losses to the industry.
- At the end of 2010 and the start of 2011, severe flooding and cyclones cost the northern dairy farm sector some $80 million dollars in lost production and damage, with Queensland losing 54 ML in milk production in 2011, dropping from 523 ML produced in 2010 to 469 ML in 2011. Milk production in Queensland during 2012 did not recover, finishing at 472 ML.

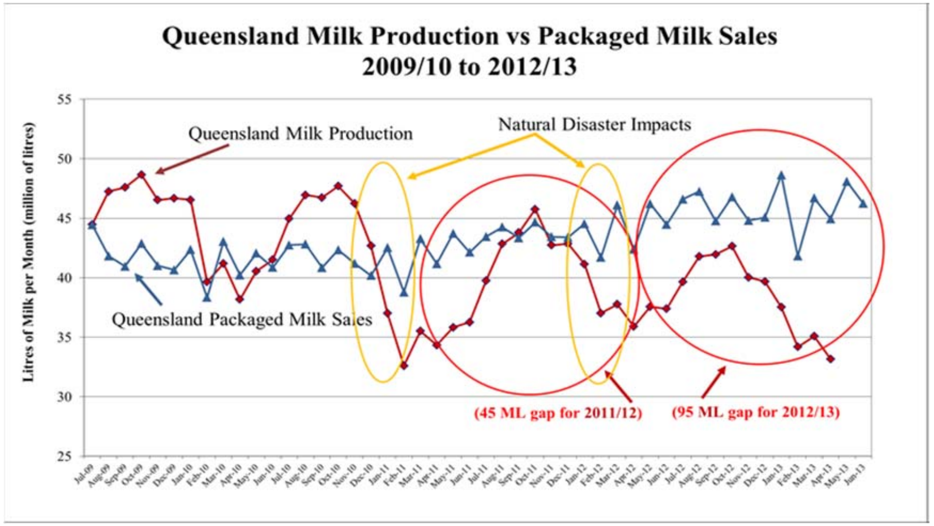


Figure 1 Queensland milk production vs packaged milk sales 2009/10 to 2012/13

- At the start of 2013, again severe flooding caused by ex-cyclone Oswald impacted more than half of Queensland dairy farmers. This flooding is estimated to have cost the dairy farm sector some $40 million dollars in lost production and damage for 2013. For the first half of the 2013 calendar year Queensland milk production has fallen by some 16 ML compared to the same period for 2012 or some 36 ML less than the same period in 2010. These flood events have also impacted many dairy farmers in the Northern NSW region.
- While a combined industry recovery program is assisting impacted dairy farmers where possible, the recovery from these major natural disaster impacts will take an extended period of time. With suppressed farm gate returns combined with these disaster impacts for some dairy farmers they will not be able to recover and will exit the industry.
- Queensland dairy farmers numbers have continued to decline to 510 at the time drafting this report.
- In NSW milk production will finish slightly down for 2012/13 by 1.5% to just over 1 billion litres, with Northern NSW making up 29% or around 310 ML, Central/Inland NSW accounting for some 18% or 197 ML and Southern NSW accounting for around 53% or 563 ML. Northern and Central NSW made up the majority of the decline in production being down some 3.7% and 3.4% respectively.
- NSW farm numbers have also continued to decline, by 3.75% from 2010/11 to 2011/12 and is estimated to have dropped by some 4% to be currently around 716.
- The regional fresh milk market has continued to grow slightly above population growth this year. Sales growth for drinking milk in Queensland grew by 3.5% for the first 9 months of the 2012/13 year, however in NSW the growth was just 1%. This follows growth of some 5% in Queensland and close to 4% in NSW for 2011/12.
- Targeted heavy discounting of store brand fresh white milk products by major supermarket retailers has caused a loss of processor brand share in milk sales, stripped wholesale value from the milk category, and commoditised a wider range of products.

- This has caused loss of processor profitability and subsequently reductions to farm gate price for dairy farmers. The increasing price gap between heavily discounted supermarket private label or store brands and processor brands is a major problem for processors with the price difference now being some $1.12 per litre
- The changes in access to regional private label packing contracts for major supermarket chains has significantly altered the milk requirements of domestic focused processors such as Lion and Parmalat, affecting respective company margins, profits and the ability to maintain farmgate milk prices.
- Resulting price structures and signals from processors, combined with higher operational costs and natural disaster impacts have been undermining the stability of regional milk supply and producer confidence in the reliability of supply chain returns.
- Confidence levels across the dairy farming community are very low, and this is putting at risk a return to the medium-term stability of production to meet regional domestic market needs. Confidence as measured by the NDFS in February and the QDFS in May was significantly lower in 2013 compared to 2012. The percentage of subtropical farmers describing themselves as being positive about the future fell from 45% to 31%. These are the lowest level of confidence recorded since the inception of the NDFS in 2004 – a year that followed a significant market downturn and widespread drought.
- The QDFS has also measured a significant reduction in profitability and confidence of Queensland dairy farmers with 68% of respondents not being able to cover their monthly operational costs from their monthly milk cheque. Only 30 percent replied that they expected to be dairying in 5 years and 8% were unsure.
- The Queensland Dairy Accounting System (QDAS) report for 2011/12 presented that milk returns averaged from 51 to 54.8 cpl, while the margin over feed costs ranged from 24.7 to 30 cpl, the Dairy Operating Profit for 2011/12 declined by 36% from 2009/10. QDAS data also presents that average net cash results for 2009/10 was 5.6 cpl than dropping to 2.1 cpl in 2010/11, then to (-0.6) cpl in 2011/12 and is now forecast to decline further to (-4.2) cpl for 2012/13.
- ABARES Farm Survey estimates for 2012/13 indicate average farm cash incomes for Northern NSW and Queensland dairy farmers fell by 40% from the 2011/12 and that average farm business profit declined from $14,100 to a loss of ($39,000). The ABARES survey report also presented a drop in milk receipts of 3 cents per litre from 2011/12 to 2012/13 and fodder costs increased by over 13%.

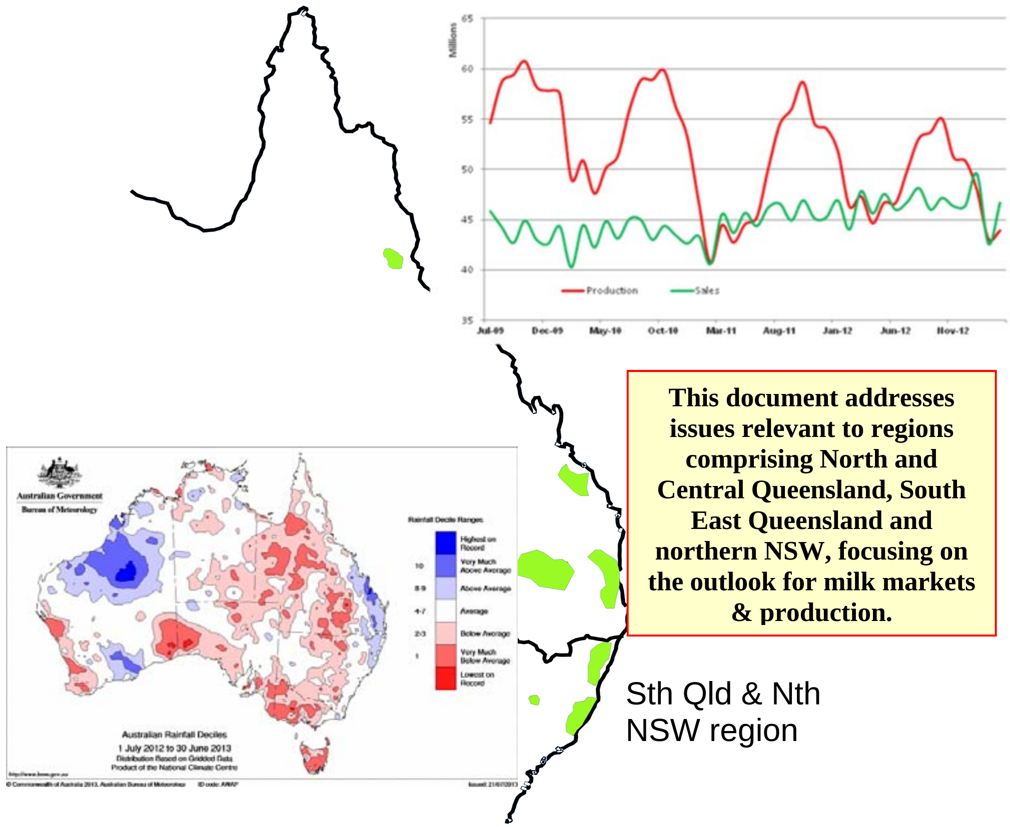


Figure 1 Graph: Northern region (Qld and Northern NSW) monthly fresh milk sales and farm milk supply (million litres)

- Since the start of 2011 more than 80 dairy farmers have exited the Queensland industry. With the average farm constituting a $3 million investment in fresh milk production, this equates to a loss of over $240 million of investment in fresh milk production in Queensland over the last 28 months, as well as a loss of some 240 jobs in fresh milk production at farm level. Across the processing sector many more staff have been put off as processors seek to reduced costs and rationalise operations in the domestic fresh milk sector.
- With poor farm gate returns for many farmers, there are threats to further investment in the capacity of farm structures and skill levels necessary to manage a wide range of risks including poor seasonal conditions, or to gain sufficient efficiency benefits from adoption of innovation. This risk will be amplified with the forecast adverse impacts of increased climate variability and other impacts on production costs.
- If trading and environmental conditions improve significantly, there remains an underlying capacity to recover production, as shown in the past seasons, when higher farmgate prices and longer-term contracts were made available to dairy farmers, at a time when milk processors could extract additional returns from the market place.
- Over recent months there has been a number of significant changes occurring which will influence the Northern dairy industry over the years ahead, including high world prices and growing world demand for dairy products, a falling Australian exchange rate, significant increases in southern farm gate prices, growing domestic market demand, announced changes to milk procurement by both major supermarkets and a general shortage of milk production to meet market demand.
- In response to the impacts caused by the current supermarket ‘milk price war’ dairy farmer advocacy organisations have been lobbying the major supermarkets to stop the $1 per litre discounting, as well as lobbying the Federal Government to make amendments to the Competition and Consumers Act and to adopt a mandatory Code of Conduct covering the whole supply chain to stop the current supermarket tactics currently impacting the industry. Farm organisations are also seeking additional collective bargaining provisions to make the provision more effective for groups of dairy farmers. The Northern dairy farmer advocacy organisations have also been working with government and other key stakeholders to look for new export opportunities which provide competitive sustainable returns to seek to again diversify market exposure beyond the domestic fresh milk market.

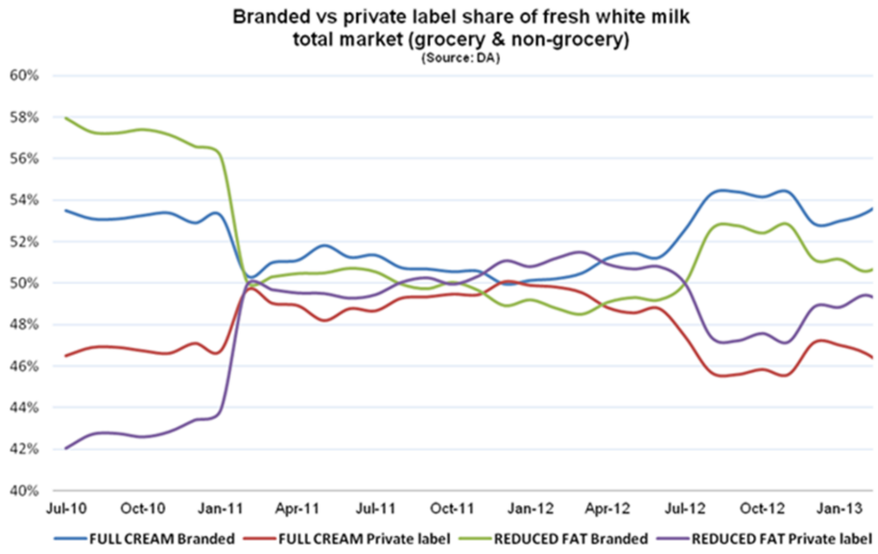


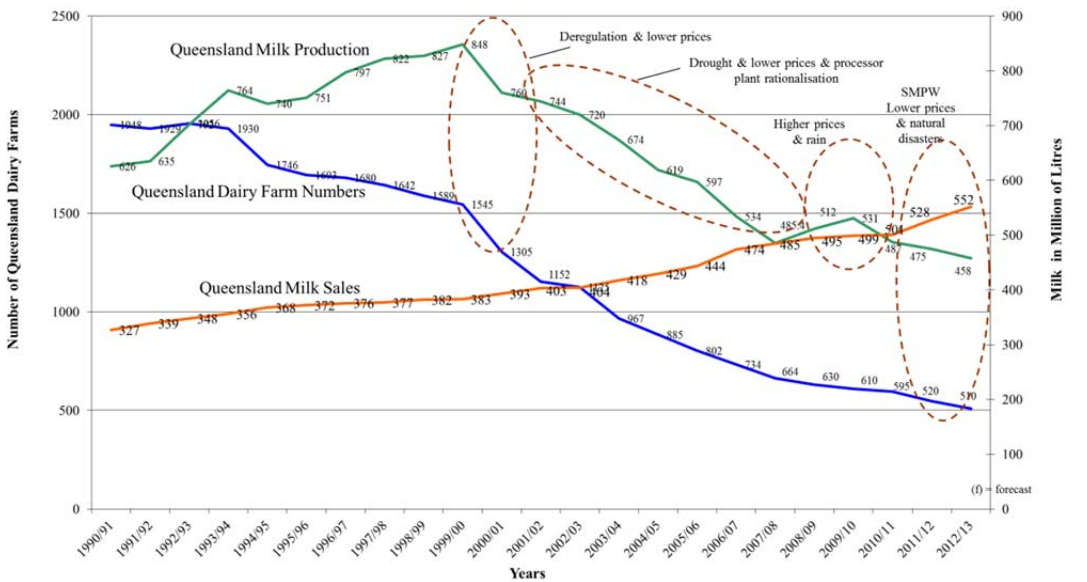
Figure 2 Branded vs private label share of whole and modified milk

Lessons from History

The following graph provides a historic view of the Queensland dairy industry by farm numbers, milk production, packaged milk sales and major natural and manmade disaster impacts and highlights the following;

- The number of Queensland dairy farmers has declined from 1,545 in the year 1999/2000 when the domestic milk price was deregulated to an estimated 510 dairy farmers at July 2013, a decline of 66%.
- Total Queensland milk production has declined from 848 million litres in 1999/2000 to 458 million litres for 2012/13.
- Average per farm production has increased from 1999/00 to 2012/13 from 549 to close to 900 thousand litres per annum per farm, including impacts from natural disasters and lower prices caused by the supermarket milk price war.
- Total packaged milk sales in Queensland have increased from 327 million litres in 1990/91, to 382 million litres in 1999/00, to 552 million litres in 2012/13.
- Since 2011 the Queensland dairy industry has not produced enough milk to meet the needs of the Queensland fresh milk market. For the 2012/13 the deficit in supply is some 95 million litres. This milk is imported from southern regions to fill this supply gap.
- From 2000/01 to 2012/13 QDAS has measured total farm cash costs increasing from 36.7 to 59.4 cpl or by 62%. The cash margin over this period was very tight due to lower prices and drought impacts through to 2007 when processors responded to farmer concerns and the loss of milk production to offer higher prices with longer term contracts. This initiative combined with improved climatic conditions allowed milk production to stabilise and grow again. The processor where able to offer higher farm gate prices and longer term contracts at that time as they could extract additional returns from the market place by increasing prices.
- Since the supermarket milk price war started processors have lost profitability as they have lost market share of their brands to supermarket $1 private label milk. This is turn has seen processor reduce farm gate prices to farmers and shorten and tighten contracts. QDAS presents that farm profitability has fallen sharply since the SMPW started to where farmers have experienced negative returns over the last two years, which is resulting in more and more farmers having to exit the industry. As was the case in 2007, if processor sought to increase prices in the current market environment they would loss further market share to the supermarket $1 private label milk. In contrast to 2007 processors to try and protect market share and slow the rate of market share loss have resorted to discounting and undertaking additional advertising.

Comparison of Queensland Dairy Farm Numbers, Milk Production & Sales from 1990/91 to 2012/13



2012 Situation & Outlook highlights

Australian dairy scene

- The Australian domestic market's share of total industry milk production is expected to be just under 60% in 2012/13—with the export share estimated at around 42%—given relatively flat milk production (Graph below displays market mix since 1990).

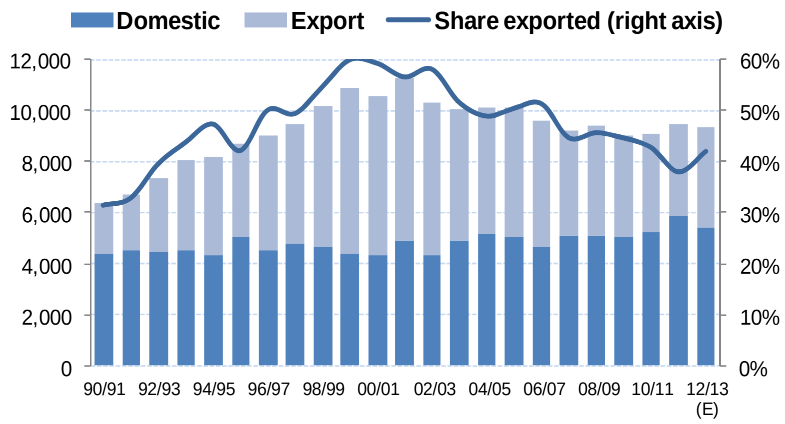


Figure 3 Australia's Milk Market Share

- For 2012/13 farm businesses across many of Australia's dairying regions were challenged by falling farmgate prices, higher input costs and unfavourable seasonal conditions ranging from severe drought to severe flooding.
- These challenging conditions have meant milk production has been constrained during the 2012/13 year, being down some 3 percent, with all dairy regions, except one, recording falls in production.
- While many farmers realise the opportunities offered in growing international dairy markets, short-term oscillations in returns and profitability have strained finances and have been challenging confidence.
- Recent significant increases in southern opening prices of more than 24 percent, off the back of high world prices, a lower Australian exchange rate and responding to challenging production conditions, should see an uplift in confidence and help dairy farmers to rebuild their production capacity. Opening prices have been announced from around $5.60/kgMS with some over $6/kgMS, up from an average opening price around $4.30/kgMS in 2012. This implies a potential full-year average price around $6.00/kgMS, up from $4.90 to $5.10/kgMS in 2012/13. The potential step up through the season will depend on processor carryover benefits and value-added sales through the season. Graph below shows indicative commodity prices.

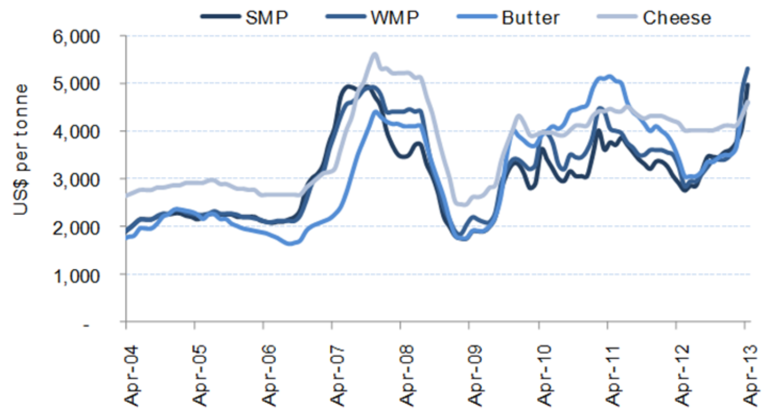


Figure 4 World indicative commodity prices

- Farmgate pricing expectations are indicative given the range of pricing options available to farmers, seasonal pricing variations, incentives, processor conversion costs & contract arrangements.
- In northern 'drinking milk' regions there was once again flooding affecting southern Queensland and northern NSW, although not as extensive as in previous seasons. Production has declined in both QLD and NSW, while improved farmgate prices in Western Australia have not been enough to lift production above last year.

- Cashflow challenges were brought sharply into focus as many farm businesses struggled to manage milk-to-feed price ratios and variable weather reduced homegrown fodder yields. In some cases falling land prices and higher debt loadings pushed businesses beyond prearranged credit limits and into relying on extended payment terms from suppliers.
- The National Dairy Farmer Survey (NDFS) undertaken in early 2013 presented that farmer confidence had dropped significantly, with the decline in farmers' terms of trade. The Northern dairying regions continue to have low level of confidence. Significant variation remains in confidence around the nation as farmers adjust to milk pricing and market dynamics.
- While the Australian exchange has dropped to the low 90 cents US, there is still significant potential for rapid currency fluctuations due to the precarious economic circumstances in the USA and Europe and a slowing Chinese economy.
- For exporting regions, while prices for some commodities have hit fresh highs, there is still concern around the market's ability to bear such rapid increases in commodity prices without cannibalizing long-term demand.
- The shift in sales volumes from route trade to the supermarket channel has slowed. Despite a recent recovery in branded milk sales, over the longer term, a loss of retail sales value in the milk category has occurred due to the change in sales mix as private label lines have increased share of sales and branded modified milk sales declined combined with processor discounting their brands to seek to slow market share losses. The next graph shows brand share for different products within supermarkets in 2012.
- Following a lead from US and European retailers there is likely to be an increase in retailers seeking additional product label information in response to consumer concerns. Themes may include nutrition, sustainability, environmental impact, energy use and animal welfare standards.

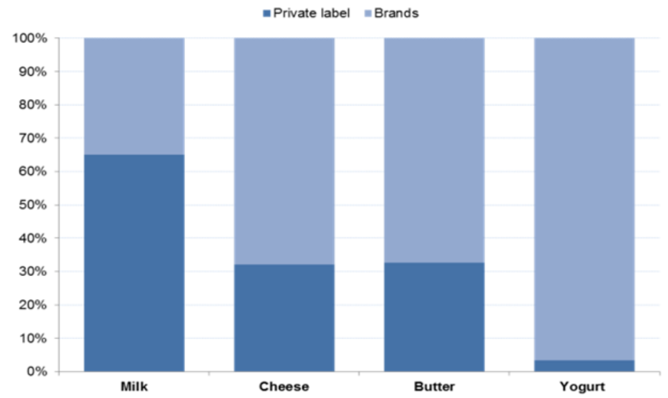


Figure 5 Market Share Private vs Branded

- The following graph (Figure 6) displays branded products' share of supermarket sales from January 2011 to January 2013. This graph presents that brand milk sales have regained some market share back from private label over the last year but that this market share regain has faded in recent months. Processors have had to resort to discounting and additional marketing expenditure to achieve these results. It is too early at this stage to gauge if the regain of brand market share can be sustained, however recent trends suggest not.

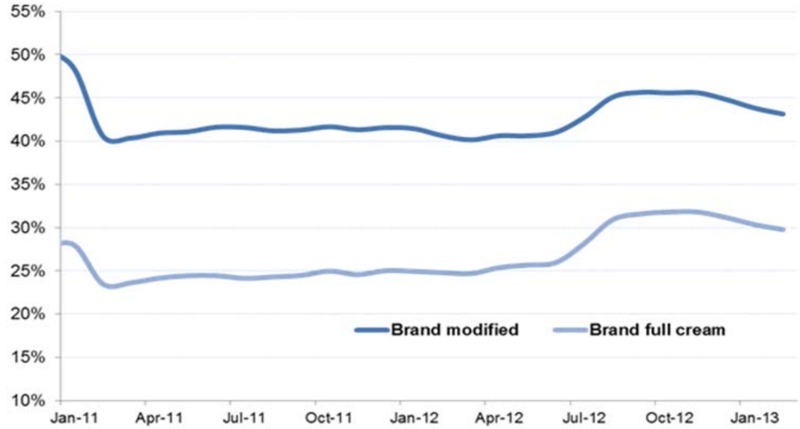


Figure 6 Brand share of supermarkets 2011-2013

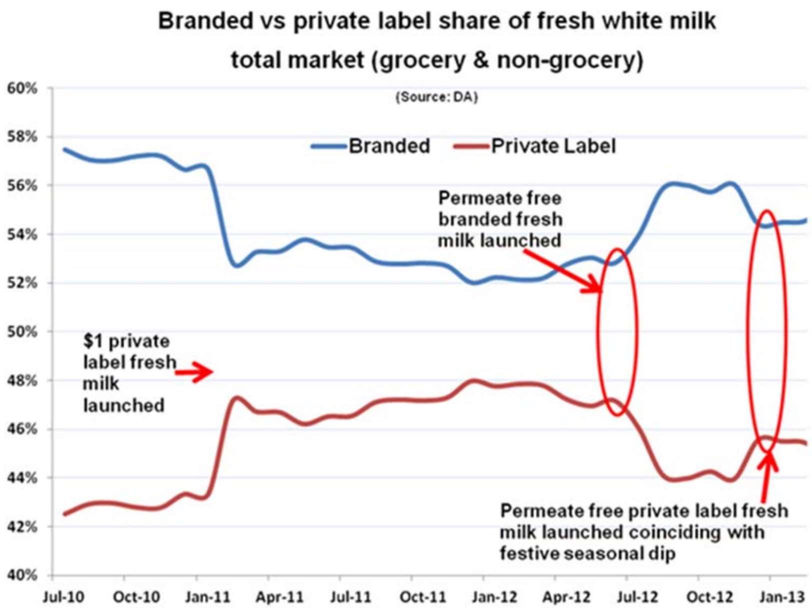


Figure 7 Branded vs private label share of fresh white milk total market

- The above graph presents that the major step in the regain of branded market share occurred with the launch of permeate free branded milk, which at the same time some processors also discounted their branded product. The graph also presents that this regain faded when the major supermarkets launched their own permeate free private label.
- The intensification of retailer competition through heavy-discounted staple food products including fresh white milk has reduced supply chain returns in directly affected areas, although the impacts vary across industry.
- In drinking milk focused regions, the balancing act between fresh supply and demand continues as processors adjust their intake requirements and pricing to meet the demands of a highly competitive retail marketplace, where supermarkets continue to use their store brand fresh milk as a sacrificial discount marketing agent, to attract shoppers, leverage grocery sales and also at the same time grow the market share of the store brand products.
- The two major supermarkets have announced new sourcing strategies intended to increase farmgate price transparency and improve public relations associated with milk price discounting. Long-term contracts between Coles and east coast cooperatives and a direct sourcing trial for Woolworths suggest a changing landscape for suppliers. While the longer-term contracts in place are positive, those falling outside of new agreements harbour some concern around how the situation will develop.
- The Australian dairy market mixed volume and value growth throughout the past year, with continuing cautious spending by households affecting discretionary food spending, which has in turn particularly impacted the convenience and route trade sectors. The Figure 8 below shows average household weekly food outlays 2010-2012.

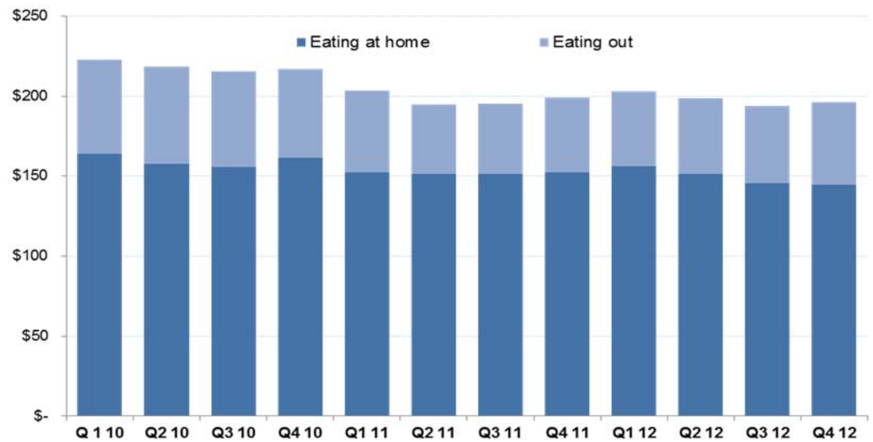
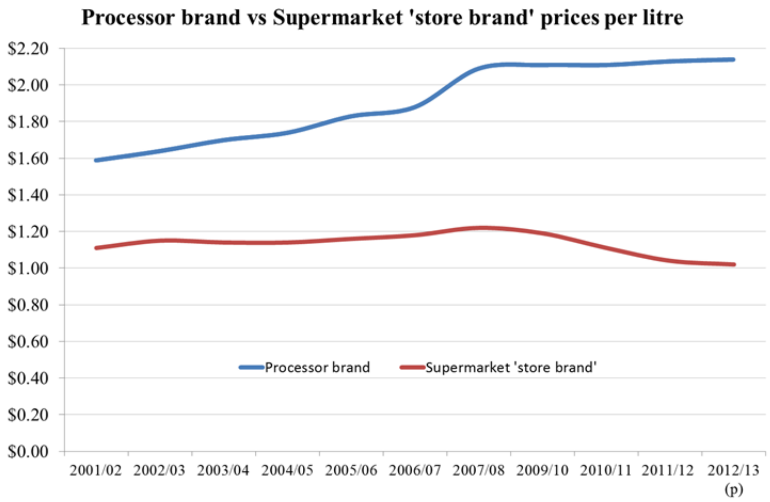


Figure 8 Weekly household food spending in $ 2010 to 2012

- The following graph highlights the major challenge for processors in the price competition between processor brands and heavily discounted supermarket private label or store brands. The graph shows the increasing price gap between the two brand categories to a point where now the price difference is more than $1 per litre.



- Markets remain highly competitive in the face of low-growth in volumes and limited scope for price rises outside the rising pressure from higher export and farm gate prices in the southern export focused regions.
- Figure 10 (to the right) shows average per capita consumption from 2006 to 2012, presenting a rise in per capita consumption since 2009/10.
- Volume growth has been experienced in categories that are not exposed to discretionary spending by consumers.
- The graph Figure 9 compares average retail prices for 2 litre branded milk (Jan 2011 to Feb 2013).

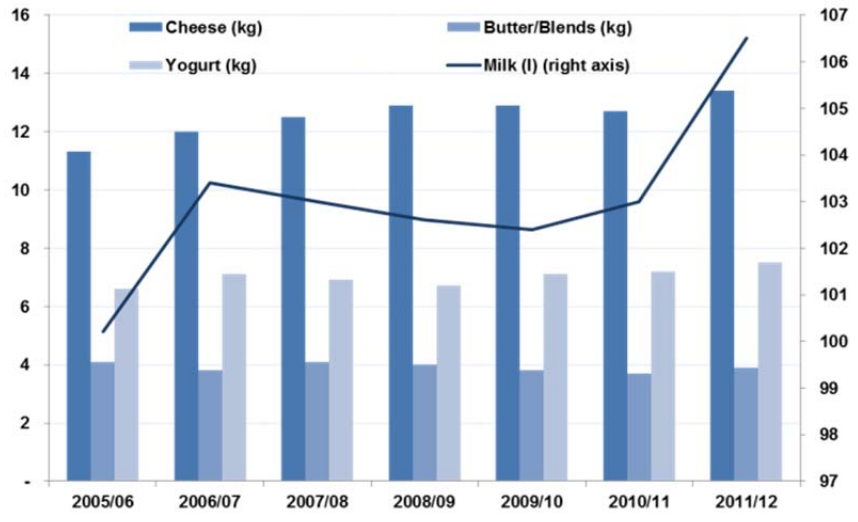


Figure 10 Average per Capita Consumption of Dairy Products 2006-2012

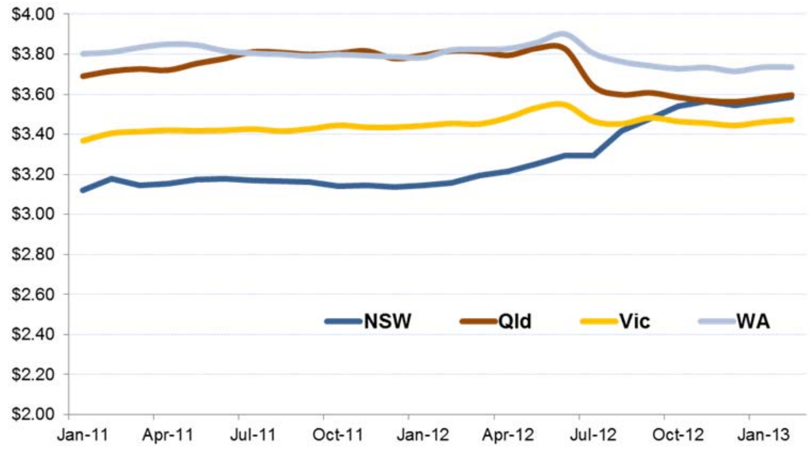


Figure 9 Average retail prices for 2 litre branded milk 2011-2013

World dairy scene

- Despite challenging economic conditions in the US and EU economies continuing over the past 12 months, demand has remained steady. The focus of growth continues to be China, South-East Asia, and parts of the Middle East, supported by more prosperous economic conditions.
- Dairy commodity markets have flipped from supply driven softening to a rising market driven by supply constraints from the major export producers. This began in late 2012 as drought conditions in the US significantly cut production expectations. Commodity prices accelerated to new peaks following drought declarations in New Zealand during early 2013.
- Prior to the NZ drought, buyers approached increased market prices by reducing purchase volumes and running down stocks in anticipation of declining prices. However, reduced availability post-NZ drought has sent buyers chasing supply security, driving up prices, but also increasing substitution risk at a time when vegetable fat and protein prices are fairly stable (and thus attractive). All major dairy regions have experienced production challenges during the last 12 months. This situation, combined with farmgate margin pressure has seen supplies on global markets tighten considerably.
- Northern Hemisphere production in the lead up to the season peak is expected to be flat, suggesting the next opportunity for increased global market supplies is the Southern Hemisphere spring.
- Global markets continue to hold significant potential for the future of the Australian dairy industry. Population growth and increasing incomes in developing countries paint a positive picture for dairy demand. However, questions persist about the most effective way to seize the market opportunity given the Australian industry's resources and structure and translate it effectively into a prosperous farm sector. Figure 11 (below) shows average export returns and MG milk prices from 1993 to 2013.

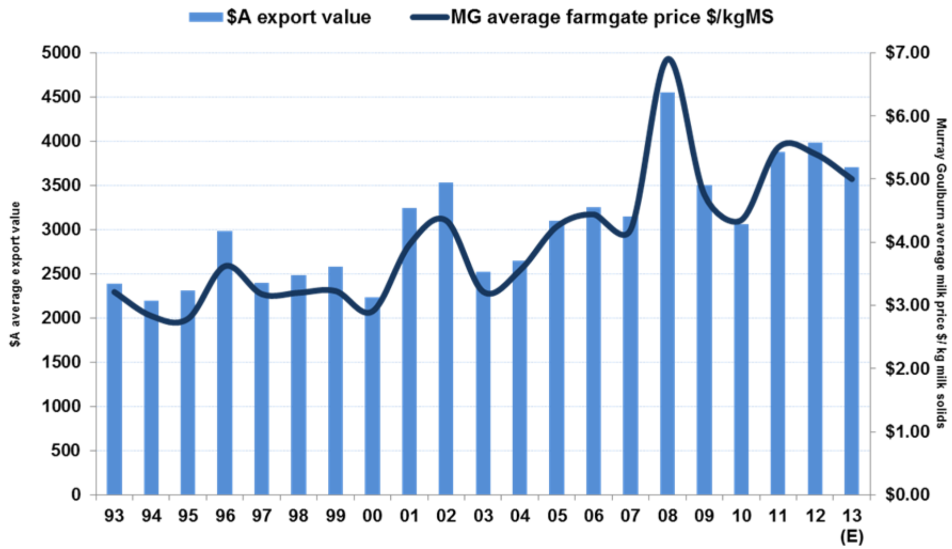


Figure 11 Average export returns and milk prices 1993 to 2013

Australian & Regional industry snapshot

The snapshot view of the situation & outlook affecting each sector of the Australian and Northern regional dairy value chain shows prospects for a rough road to recovery from the economic downturn, poor farm gate returns, high input costs and unfavourable climatic conditions.

Production & resource inputs

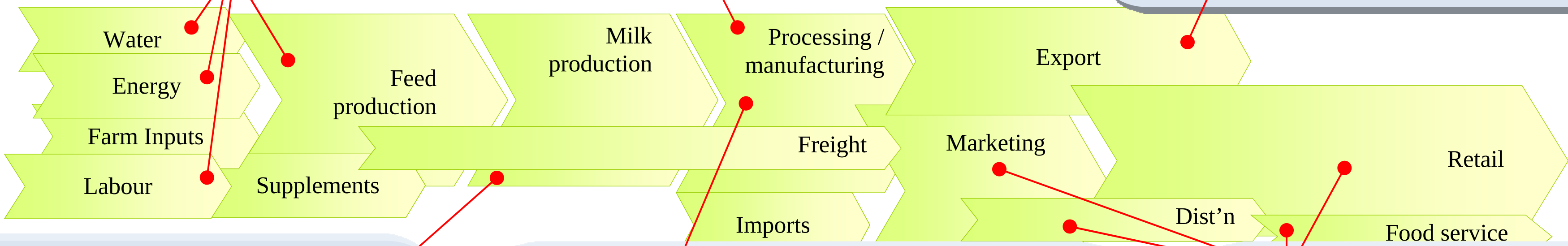
- Elevated global grain prices significantly lifting on-farm variable costs.
- Electricity, labour & other input cost increases continue to challenge farm margins. Reduced ability to compete for skilled labour.
- Good water allocations & steady carryover supplies mean short-term security for irrigators. Medium-term policy concerns remain. Limited opportunity for new water supplies.
- Although dairy cattle prices are lower than last season's, large numbers of cattle are still being exported.

Product manufacturers

- Stocks remain tight. Few export manufacturers have large volumes of unallocated inventories.
- Competition for supermarket supply contracts across a range of products.
- Seeking to reduce processing & supply chain costs, while seeking to balance innovation & throughput
- Increased interest in investment from foreign parties to service dairy demand in other countries, such as China.

Exporters

- Demand remains firm, driven by China and South-East Asia, supported by stable demand in the Middle East.
- All major exporters have experienced challenging production conditions this season.
- Lower AUD improving competitiveness.
- Preparation for policy changes in the EU and to some extent the US.
- Rapid increase in dairy commodity prices amplifies substitution risk for dairy.
- Exporting processors are competing for milk supply.



Milk Production

- Industry caught in a margin squeeze, affecting low input producers, having to buy grain;
- Significant costs increase pressures for high input producers with much higher feed prices & higher use of a range of farm inputs with increases prices.
- Seasonal conditions challenging: floods, no spring rainfall, weak or no autumn break.
- Rising on-farm costs & retail supermarket pricing undermining domestic supply chain margins, farm gate prices & confidence in both domestic & export regions.
- Requirement of processors for farmers to have flat production systems to match fresh milk market profiles has added to farm costs structures & risks.

Fresh dairy processing

- Continuing to balance regional fresh demand & supply using sharper pricing signals.
- Supermarket pricing is maintaining strong pressure on domestic processor & manufacturer margins.
- Market continues to grow, however value per unit has declined with supermarket pricing pressure & the growth of private label products, combined with processor discounting brands push back against market share loss to discounted private label products.
- Introduction of alternative supply arrangements with supermarkets adding new layers of complexity to supply arrangements.
- Seeking to reduce processing & supply chain costs, while seeking to balance innovation & throughput.
- A number of small processors with a number moving more toward direct farm supply & away from major processors for milk supply.
- Regional market 'local' provenance & some niche export opportunities for small processor growth

Domestic marketers & retailers

- Consumers remain value-oriented as cost-of-living pressures remain major concerns.
- Low food price inflation, as retailers continue to compete on price & focus on private label strategies.
- Major supermarkets competing for consumer 'loyalty' & trust & seeking offer value plus other benefits.
- Seeking supply chain arrangements to promote direct connection of shoppers to producers & socially responsible practices.
- Smaller independent retailers & route trade operators have been placed under severe pressure by major supermarket private label pricing & marketing tactics.
- High route trade distribution costs provide major retailers with fresh milk category cost & price advantages.
- Increasing food service competition with retailers.
- International competition increasing in industrial sector.

Drivers of the industry's future

The scenarios for the future size and structure of the Australian dairy industry in the medium to long term will be shaped by a number of primary drivers. The ultimate outcomes will be based on how well the Australian dairy industry responds to such future opportunities and risks affecting the industry's competitiveness and sustainability. Outcomes are also determined by how well the sectors of the value chain align their responses, as this will affect the industry's capacity to adapt, innovate and differentiate.

Primary Drivers → **…have direct & indirect effects on….** → **…future scenarios for the industry:**

Changing global economics

- Developing economies driving economic recovery and food demand
- Challenges to competitiveness of agricultural production in first world countries
- Transition to low-carbon economy
- Costs of competing products influenced by biofuel demand
- Volatility of commodity markets in tight supply

Climate variability

- Adaptability & sustainability of proven production systems
- Increased complexity and need for long-term resilience of business
- Increased competition for water
- Volatility of feed input supply and costs
- Uncertainty of policy settings affecting resource access and emissions

Advancing technologies

- Need for accelerated adoption of new technologies to address production challenges
- Requirements for different skill sets
- Functionality of both dairy and its competing products
- Consumer acceptance of technology platforms

Changing trade & social policies

- High priority placed on food security/affordability
- Greater concern for environmental impact
- Varied societal empathy for farm sector
- Potential competition from emerging low-cost exporters
- Weakened appetite for multilateral trade reform – impacts of bilateral agreements on competiveness
- Development of technical and ethical trade barriers

Consumer & community demands

- Consciousness for enjoyment, wellness and healthy eating
- Concern for ethics in food production systems
- Compliance demands on farm and processing enterprises
- Acceptance of GM use in production inputs
- Affordable food as a policy priority

Future opportunities:

- Global dairy demand outpacing supply
- Changing economics for competing food ingredients
- Attracting investment to the industry
- Flexible and adaptable production systems
- Adopting technology to lift profits
- Widening scope for product functionality
- Building farm business skills to mitigate risk, manage volatility, and grow wealth.
- Transformational advances in plant & animal technologies

Areas of industry risk:

- Vulnerable production systems
- Attracting, retaining and developing skilled people
- Producers operating on volatile production margins
- Reduced relevance as a reliable dairy exporter
- Threats to dairy's industry reputation
- Increased accountability and costs without effective measurement
- Moving too far away from competitive production base
- Affordability critical to dairy's role in addressing nutritional needs

Farmgate market

A strengthening of world dairy markets and a lower exchange rate is being reflected with higher opening farmgate milk prices in southern regions for 2013/14, compared with 2012/13. However currently Northern milk suppliers are not seeing any marked increased in prices for 2013/14 due to the decline in processor margins from intensive price-based retail competition, and changes in market access for processors and signals in prices to farmers from processors.

Queensland and North NSW

Farmgate prices

- 2012/13: 46-53 cpl with variation due to different exposure to changes in liquid milk market access (affecting % of Tier 2 prices)
- 2013/14: similar starting price ranges expected with potential for increases driven by higher southern prices and competition for milk, but limited due to lower processor margins caused by supermarket milk price war. Average prices likely to increase with less Tier 2 volumes as supply is falling below demand for the region with suppliers exiting industry.
- Most supplying Parmalat are locked into agreements until 2015 at a lower price to prior years, however a 1cpl increase has been given this year.
- Lion is currently negotiating conditions and price which is similar to the prior years however with changes to tier allocation, quality and pickup charges. Lion is implementing a limited distance pickup based on minimum volume limits. This will see a number of farmers isolated and may force them to exit the industry.

Key dynamics

- With major increases in feed and other costs combined with suppressed farm gate milk prices and ongoing farm exists, milk supply is expected to decline further in 2013/14, unless farm gate milk prices improve and or operational costs decline significantly.
- The region is suffering from a deficit of supply to meet fresh milk market demand following losses of production in 2011 and this year due to natural disasters.
- Contract offers, options, pricing, terms and timing will affect producer sentiment, intentions and investment.
- The region is still totally exposed to the current risks of the domestic fresh milk retail environment, with major supermarket tactics lowering the overall return to the supply chain.

Central NSW

Farmgate prices

- 2012/13: 45-50cpl with variation due to different exposure to changes in liquid milk market access (affecting % of Tier 2 prices).
- 2013/14: similar starting price ranges expected with potential for increases driven by higher southern prices and competition for milk. Average prices likely to increase with less Tier 2 volumes.
- Lion is currently negotiating conditions and price which is similar to the prior years however with changes to tier allocation, quality and pickup charges. Lion is implementing a limited distance pickup based on minimum volume limits.

Key dynamics

- Milk supply is likely to remain flat in 2013/14 in response to pricing signals, having dropped some 1.5 % in 2012/13.
- Increasing influence of over-supply patterns affecting milk value/returns.
- Stronger southern milk prices and competition for milk supply is expected to increase Tier 1 prices during the year and will increase Tier 2 milk prices.
- Contract offers, options, pricing, terms and timing will affect producer sentiment, intentions and investment.

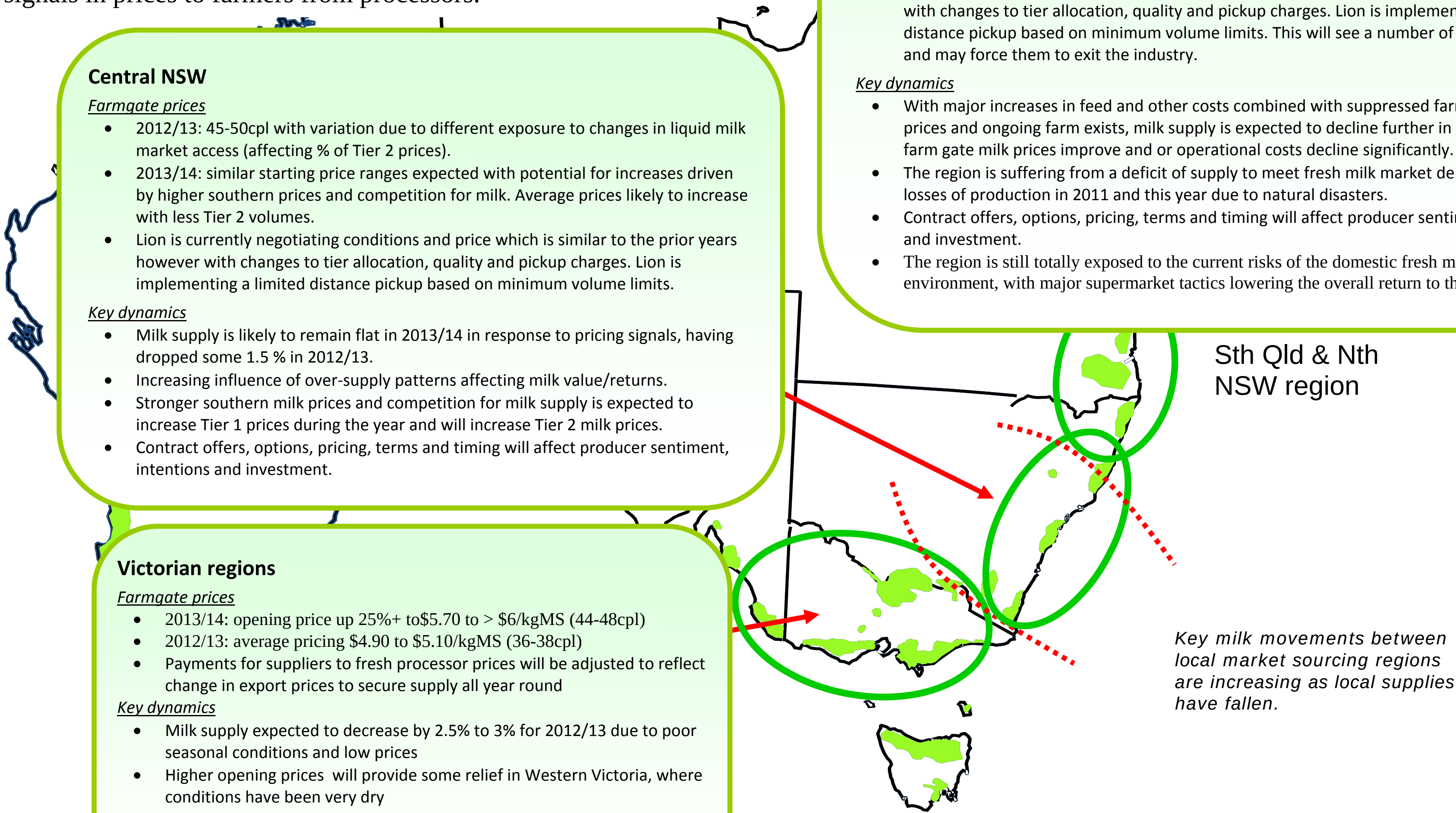
Victorian regions

Farmgate prices

- 2013/14: opening price up 25%+ to$5.70 to > $6/kgMS (44-48cpl)
- 2012/13: average pricing $4.90 to $5.10/kgMS (36-38cpl)
- Payments for suppliers to fresh processor prices will be adjusted to reflect change in export prices to secure supply all year round

Key dynamics

- Milk supply expected to decrease by 2.5% to 3% for 2012/13 due to poor seasonal conditions and low prices
- Higher opening prices will provide some relief in Western Victoria, where conditions have been very dry
- With high export returns and lower milk production companies will be competing strongly for milk to maintain factory throughput and to fulfill supply contracts



Regional milk markets

Sales growth continues but at lower retail prices & returns

- The regional fresh milk market has continued to grow slightly above population growth in the 2012/13 year. Sales growth for fresh milk products in Queensland grew by 3.5% for the first 9 months of the 2012/13 year, however in NSW the growth for the same period was just 1%. This follows growth of some 5% in Queensland and close to 4% in NSW for the 2011/12 year.
- The supermarket sector is gradually strengthening its domination of the sale of fresh milk, and also its market share of 'private label' products, accounting for over 62% of total sales, with the two major supermarket chains accounting for the majority of those sales.
- Consumers have continued to be cautious with uncertain economic conditions and rising non-food living costs by keeping a tight rein on food spending, and minimising discretionary outlays. They have retained a preference for eating more meals at home and economising on eating out. As such retail sales have grown in the lower price categories as consumers seek value.

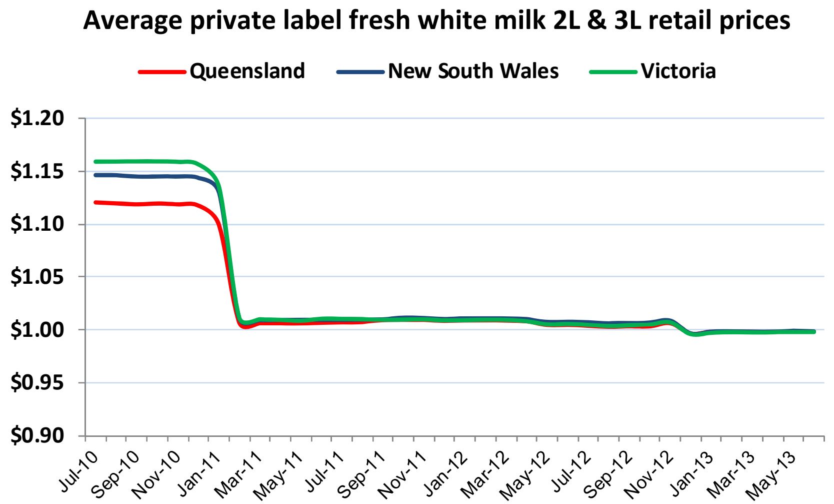


Figure 12 Average private label fresh white milk 2L & 3L retail prices 2010-2013 (Source DA)

- The following graph presents the total fresh milk volume YTD April '13

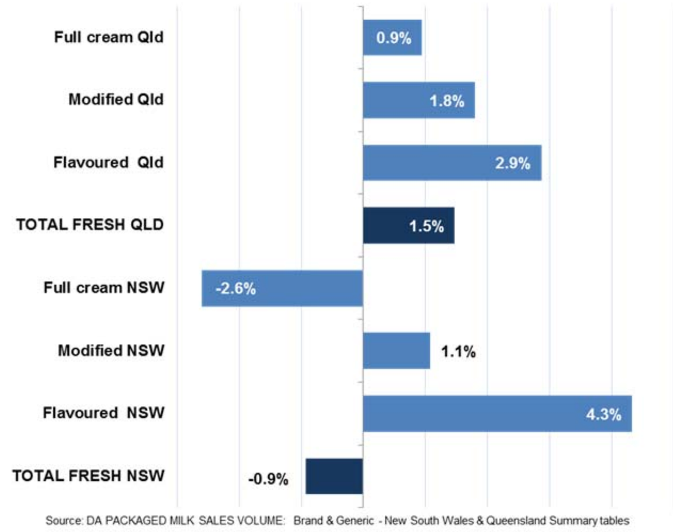


Figure 13 Change in total milk sales volume

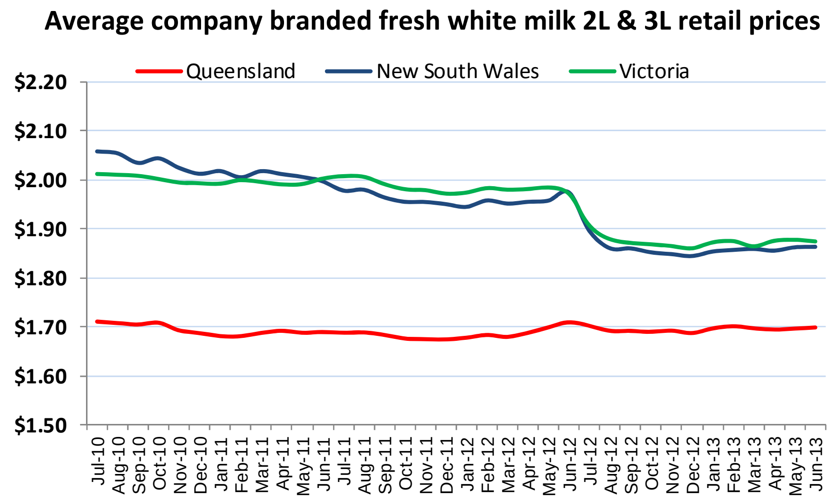


Figure 14 Average company branded fresh white milk 2L & 3L retail prices 2010-2013 (Source DA)

- Queensland proprietary fresh branded milk retail prices continue to be on average about 20% lower than branded products in the other states – reflecting the intensity of competition in supermarkets and convenience outlets. In addition processors in Queensland and Northern NSW also need to pay higher milk input costs to procure milk from the region.
- Milk processors compete in a national fresh milk retail market, wherein major supermarket chains use national uniform pricing policies. These policies do not take account of differential input costs to producers and suppliers.
- Major supermarkets have sustained aggressive price-based competition, keeping the focus on the value of staple food products and meal ingredients. The sustained pricing pressure has kept retail grocery prices of private label products flat over the period since late January 2011, while prices for company branded products through these outlets have fallen in QLD, with some price recovery in NSW.
- A number of major milk processors that supply the domestic market continue to report that they are making little or no profit from major supermarket private label milk contracts.

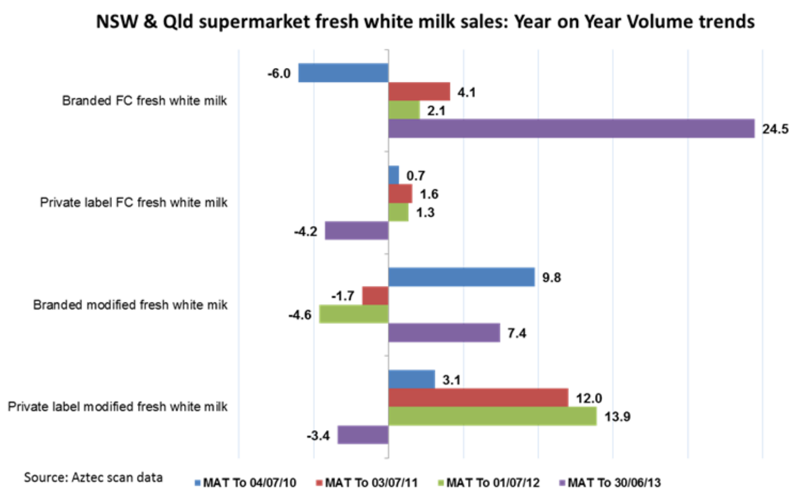


Figure 15 Year on year fresh white milk sales for NSW & QLD Supermarket trade

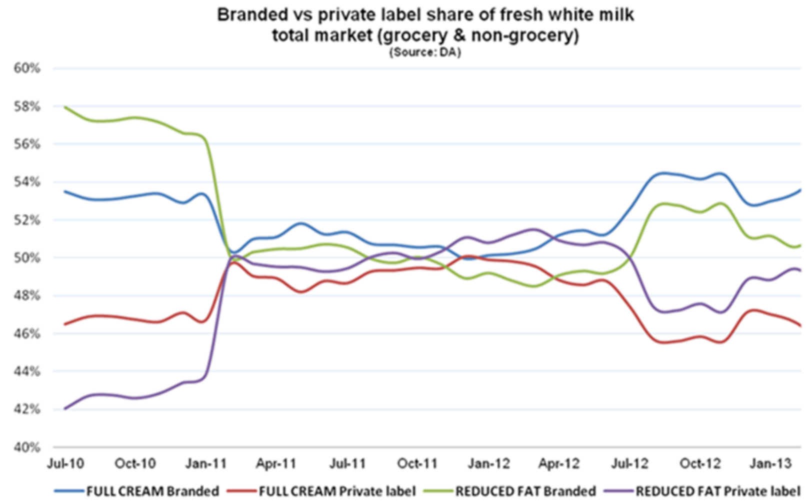


Figure 16 Branded vs private label white milk total market

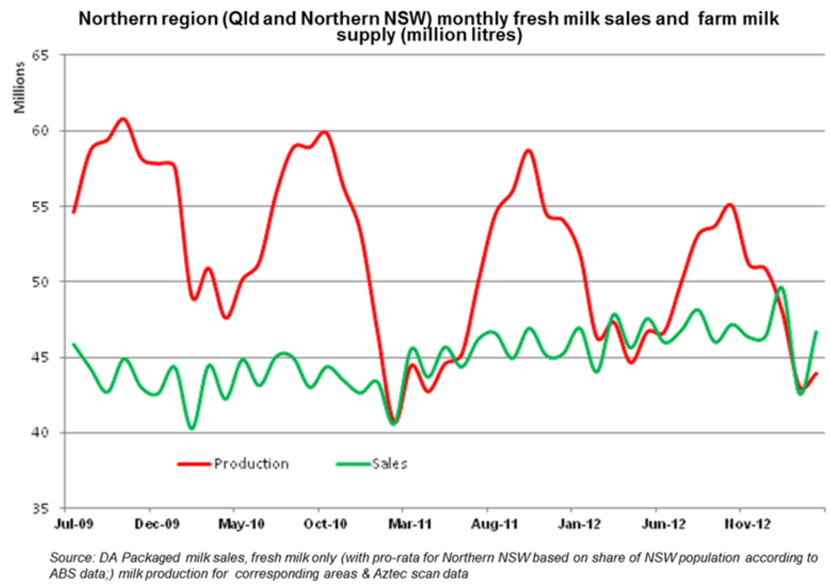


Figure 17 NDI Monthly fresh milk sales and farm milk supply 2009-2012

Future milk needs for Queensland

- The region continues to demonstrate good population growth. The average annual population growth rate for Queensland over the past 5 years has been 2%. ABS projects that the population will grow by more than 2% per annum over the next 10 years, providing good scope for expanding demand as the economy provides consumers with greater confidence. At medium level population forecasts for Queensland the industry will need to produce another 110 million litres of milk per annum by the year 2022 to meet market demand, as shown in the graph below.

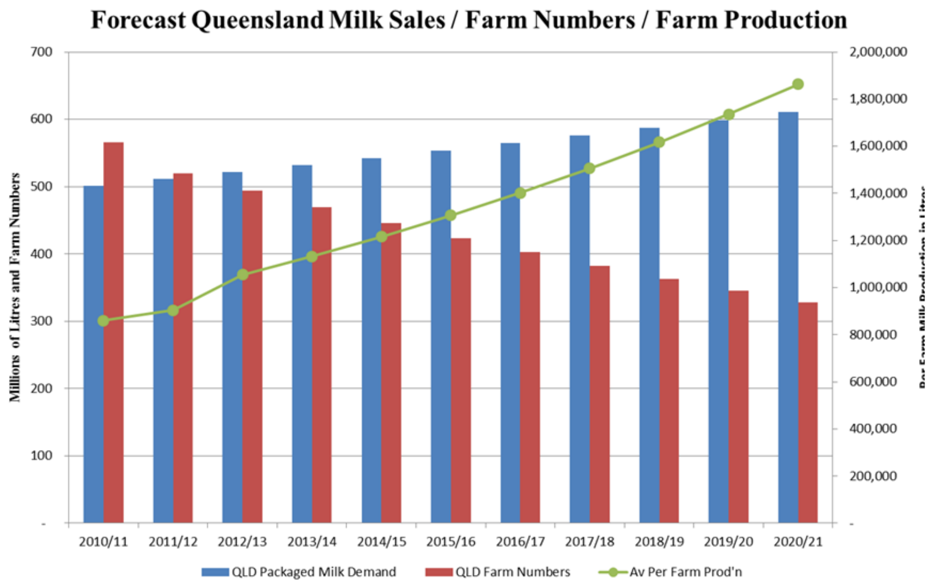


Figure 18 Forecast Qld Milk Sales, Farm Numbers & Farm Production 2020-21

Intense retail competition & changes to value chain

Retail competition is reducing returns

- The expanded use of private label lines is a key component of retailer strategies. Major grocery chains have continued to use heavily discounted store brand or private label fresh milk in promotional campaigns over the past 28 months**.** The impacts on the milk category have been most profound with $1/litre private label pricing (for 2 litre and 3 litre packs) in place since January 2011. The major impact being the loss of retail sales value in the category has occurred due to the change in mix as private label lines increased share of sales and higher value branded modified milk sales declined.
- The effect of this discount price competition has been:
  - A higher share of sales of lower-priced private label products (chiefly in modified milk products), at the expense of company brands, weakening the overall wholesale returns to processors. The chart below shows the estimated annualised effect on sales volumes since the campaigns commenced.
  - The shift in sales from convenience and food service outlets to major supermarkets, which has included food service outlets which source product direct from major supermarkets at prices which are cheaper than available through the “route trade”.
  - Processors in an effort to reduce the loss of and to seek to regain market share of their branded milk products lost to heavily discounted supermarket private label, have resorted to discounting and undertaking additional advertising expenditure in both grocery and non-grocery channels. Processors have managed to regain some lost market share, however at lower overall margins.

- The impact on retail sales and wholesale returns has varied state-to-state, due to the differences in retail prices and sales mix. The impacts on supply chain returns is estimated to be greatest in Queensland, where retail prices of branded lines are lower and virtually all milk produced is used for the domestic fresh milk market, without the availability of an alternative market.
- The market growth of competitors to Coles and Woolworths such as from Aldi will result in ongoing intense retail competition and the ongoing use of dietary staples as sacrificial discount marketing agents.
- The battle for the perception of "best value" for shoppers has remained intense and the trust propositions have been widened recently to address practices in production systems and accountability for the origin of fresh food products across categories, which includes greater prominence given to 'local' supplies and the 'provenance story.' The 'provenance' factor may help strengthen the northern market for northern producers, as opposed to the current use of interstate milk freighted in to address local supply gaps.
- The two major supermarkets have used selected food categories in their campaigns, which has resulted in food price deflation, while at the same time they both have grown their market share and profitability. This growth has largely been at the expense of the independent grocery sector and route trade operators.
- These changes have caused reductions in milk prices for those suppliers, which vary case by case depending on individual contract volumes and Tier 2 exposures.
    - The combined effect of lower overall wholesale margins and changes in market access has been passed onto farmers in reduced farmgate prices. This has lowered the regional average milk income to producers, and increased the range of prices being achieved at the farmgate. In some regions it has meant that many farmers are not able to make a profit on the supply of their milk.
- Lower overall wholesale prices as a result of an increased share of private label sales volumes will result in greater commoditization of the milk sector. This will weaken the brand proposition in fresh white milk undermining the viability of marketing and product innovation, and force changes in the respective roles and contributions that private label contracts and branded milk products have in processors' business models.
- At the same time, the major supermarket chains are changing the way in which they contract with processors for the toll-packing of private label lines including.
    - Woolworths has in recent years shifted from national to state-based supply of private label product volumes, switching from Lion to Parmalat in Queensland and NSW in 2012. This has reduced Lion's requirement for fresh milk, which has been reflected in the significantly lower tier 1 contract requirements from its own direct contract suppliers and from DFMC suppliers.
- Both major supermarket chains have announced plans to source a portion of their private label milk products through arrangements that provide a more direct linkage to milk producers and greater certainty with longer term contracts (5-10 years), which will take effect in 2013/14 and later.

Industry analysts believe there is scope in the future for dairy to lift unit values by responding to a number of emerging trends supermarket chains wish to exploit:

a) greater interest in 'provenance,' the story or origin of products is conveyed to consumers. This includes an interest in 'local' supply or a direct 'line of sight' to producers. The recently announced intentions of Woolworths to source milk direct from Manning Valley dairy farmers for a product priced between existing private label and brand price points is the most recent example.

b) Offering stronger traceability through to source, to support provenance initiatives such as those in (a).

c) Innovation in product convenience and packaging that cuts time for consumers in meal preparation or facilitates improved scope for snacking.

d) Product features that support health or lifestyle needs.

e) Other “sustainable sourcing” propositions that connect with consumers.

Innovations in these areas should provide opportunity for greater diversity of dairy product ranges and retail market values, but will take investment in product and supply chain development. Within this environment, niche products across dairy categories have scope to flourish.

There is likely to be an increase in the ethical requirements of retailers, with product-label information to establish points of difference in response to consumer concerns. These will increase in scope as sustainability measures have a greater influence on the food industry, covering issues such as environmental impact, energy use, animal welfare standards, and other ethical production issues—following the lead of US and European retailers.

While the economic outlook remains mixed, sustained pressure on the food service sector to compete for pockets of growth will ensure a continued focus is applied to meal and ingredient costs. Operators will continue to look for lower cost but functional solutions.

Per capita consumption of fresh milk has increased slightly to just over 105 litres per person per annum.

Niche branded high-value products continue growing despite the price competition.

There is evidence of strong interest in ‘natural’ product, evidenced by the support for permeate free products marketed as being more natural.

Market structure: The supermarket sector share of total milk sales some 60% in the year to March 2013, which includes sales through independent food stores.

Private label penetration of total fresh white milk sales is about 41% overall, but the share of sales in supermarkets is close to 52%.

Flavoured fresh milk has a 10% share of total milk sales, of which 56% of flavoured milk is sold in non-grocery outlets. Retail prices for branded products historically differed between states due to the relative intensity of competition, but have recently converged.

<table>
<tr><th>State or Region</th><th>Woolworths *</th><th>Coles</th></tr>
<tr><td>QLD</td><td>Parmalat</td><td>Lion</td></tr>
<tr><td>NSW</td><td>Parmalat</td><td rowspan="2">Lion</td></tr>
<tr><td>Sth NSW, Nth Vic</td><td>MG</td></tr>
<tr><td>Vic</td><td>Lion</td><td>Lion</td></tr>
<tr><td>SA</td><td>Lion</td><td>Lion</td></tr>
<tr><td>TAS</td><td>Lion</td><td>Lion</td></tr>
<tr><td>WA</td><td>Lion</td><td>Harvey</td></tr>
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Table 1 Major private label contracts by region

*A tender process is underway at the time of this report

Processing change

During the last year there has been a number of changes announced in the processing sector with relevance to the northern dairy industry. Overall in the domestic fresh milk market processors, under margin pressure in the milk category, continued to focus on matching milk supply volumes to monthly processing needs to avoid costs associated with handling surplus milk and employing discount and advertising tactics to protect and try and regain brand market share back from supermarket discount private labels, while also searching for additional cost efficiencies internally and externally in the search for margins.

Murray Goulburn (MG): In April this year, MG announced a 10-year contract to supply Coles with approximately 200m litres of fresh white drinking milk under Coles' private label, commencing from 1 July 2014 in the NSW and Victoria.

- MG also announced they had reached an agreement to supply Coles exclusively with fresh milk under its own Devondale brand as well as return its Devondale branded cheeses to the retailer's shelves before the close of 2013.
- MG has held a range of farmer meetings in NSW over recent months to discuss MG plans and their desire to 'sign up' NSW dairy farmers to supply MG to meet the needs of the new contracts and domestic market opportunities for MG. At the time of preparing this report MG has written to NSW dairy farmers to gauge their intent to 'sign up' to MG in July and that MG was seeking to start taking supply from NSW dairy farmers as early as October this year.
- MG also announced that to fulfil its new drinking milk supply agreement with Coles, it will be investing $120m in building two new state-of-the-art milk processing plants in Melbourne and Sydney. In August 2012, MG announced a $200m investment program to expand capabilities in UHT processing, butter and cheese production to seize export opportunities in Asia and the Middle East.

Fonterra Australia: Fonterra is investing further in processing and manufacturing capacity in Victoria. Fonterra has signalled it will reduce the number of its brands in Australia from over 20 to 4 or 5. The reduction in brands was flagged as Fonterra announced its financial results for first-half FY13 which saw earnings from the Australian consumer business down 31%, which Fonterra management presented has been caused by the impacts of the retail war and competition from private label brands. Last year Coles dropped Fonterra's Mainland cheese brand after the processor declined to supply a private label product.

Lion Dairy & Drink Division (LDD): LDD confirmed in early April 2013 that it had lost contracts to supply Coles private label drinking milk (from 1 July 2014) in Victoria, NSW and QLD. At the same time, LDD reconfirmed that it was undertaking a 'strategic review' of its business. LDD's parent, Kirin, has recorded $2.2bn in accounting write-downs over the last four years.

Earlier in 2012/13, LDD continued rationalisation of its manufacturing capacity with the closure of its milk plant at Baulkham Hills in Sydney and centralisation of operations at the nearby Penrith plant to ensure 'long-term sustainability'. LLD is making further investments in processing and manufacturing capacity in Victoria and Tasmania.

In April LDD reported that it had again suffered a further decline in revenue of 6% and that LDD 'remains a long way from achieving an acceptable return on invested capital, with revenue pressure offsetting efficiency gains', due to impacts from continued discounting, product rationalisation and expansion of retailer-owned-brands. LLD reported that flavored milk and yogurt did achieve growth. LDD also reported that the launch of permeate free milk across Dairy Farmers and Pura has helped achieve a stabilisation of branded milk volumes since its launch last June, however lower price realisation in grocery and the sustained channel shift from non-grocery to grocery continues to crimp margins.

LDD reported that it remains focused on innovation across its portfolio to drive value in the market, for the benefit of all players in the supply chain.

LDD is currently in price negotiations with its farmer supply base. In southern regions LDD has opened prices for the season up 20 percent, however prices offers for NSW and Queensland are only marginally higher with higher pickup charges, especially for dairy farmers more than 200 kilometers from factories, where their net farm gate price would actually drop with the increased pickup charges. Dairy farmers are being required to pay half of the freight costs.

It has been advised that the negotiations with the Dairy Farmers Milk Cooperative (DFMC) have not come to an agreement as Lion seeks to change its long term supply arrangements with DFMC and as such the price for the 2013/14 season will be settled by an independent arbitrator.

LDD is seeking to contract larger suppliers in preferable geographic locations and not continue to take supply from smaller suppliers. LDD had announced earlier in the year it did not wish to contract suppliers with less than 1.5 and 0.8 million litres of annual supply in NSW and Queensland respectively. DFMC has also rejected this proposed restructure.

Parmalat Australia: French company Lactalis, parent company of Parmalat Australia. In late 2012 Lactalis purchased specialist cheese maker Jindi for a reported $20m in late-2012 from Menora Foods, its distribution company.

Lactalis has approved further capital investment for growth in Australia, including the development of a UHT facility at Bendigo in Victoria and plans for a powder plant at Rowville. It has also been reported that Lactalis has further investments planned for Queensland and New South Wales to meet the demands of both the local market and the export market into Asia.

In Queensland, Parmalat at the start of this year introduced a new Parmalat Queensland Demand (PQD) scheme to replace the current PDA and POPSG payment systems. The new PQD scheme was negotiated by Parmalat and the collective bargaining group Premium. The new system has a two tiered approach linked to retail milk sales, with suppliers having a tradable first tier allocation.

In response to pressure on farm gate returns and negotiations with Premium, Parmalat as at 1 June Parmalat increased the farm gate price to their suppliers by 1 cpl. This is the first increase in price by any processor for some time. In response to flood impacts and difficult trading conditions Parmalat also provided other relief measures for farmers associated with contract supply conditions.

Norco Co-operative: Norco this year bought back the ‘front end’ of its milk business including licensing rights to its branded fresh milk and dairy products from Fonterra Brands. The deal saw the cooperative re-enter the marketing, sales and distribution business for fresh milk and take back staff, processing and also packaging operations at its Raleigh and Labrador sites.

Norco in April announced a five year fresh drinking milk supply agreement with Coles, which will start from 1 July 2014. Norco had previously been contractually prevented from dealing with retailers due to its arrangement with Fonterra Brands.

Under its new contract with Coles, Norco will supply the supermarket in southeastern Queensland and northern NSW. To be able to deliver this additional milk volume, Norco has presented they will spend $6m on upgrading its plant at Labrador, which will see the cooperative supply Coles with an additional volume of some 50m litres of milk p.a., effective from 1 July 2014. The expansion and processing of the milk at Labrador may lead to other opportunities with major retailers looking to supply a parochial milk brand to the Queensland market.

A2: A2 Corporation opened its new Smeaton Grange facility near Camden (NSW), further increasing its production capabilities in Australia. At a cost of $15m, the new plant is expected to process approximately 60m litres of milk p.a. While A2 still only makes a small share of market sales, A2 sales continue to achieve strong growth at premium price levels.

Small Processors: In Queensland and Northern NSW there has been a gradual and ongoing expansion of existing small milk and dairy product processors, growing their market sales in regional and niche markets. During the year a number of small processors have contracted additional dairy farmers to supply milk direct to them as opposed to purchasing their milk supply needs from major milk processors. Examples of this include small processors such as Richmond Dairies, Maleny Dairies, Mungalli Creek Dairy, Barambah Organics and the recent launch of the new small milk processor in SEQ of Scenic Rim 4 Real Milk.

Milk2Market (M2M): The newly launched M2M model represents a significant departure from traditional exclusive supply arrangements between farmers and processors or brokers.

M2M offers two main services being milk supply management and a milk exchange. M2M offers individual farmers a service to sell their milk to multiple buyers. M2M offers farmers a choice to forward contract for a fixed term for all or part of their milk supply, potentially offering similar risk management options for the dairy industry as other agricultural sectors have. For buyers of milk, the M2M model would allow for direct contracts with individual farmers, facilitating increased transparency and traceability. For some processors and manufacturers, the benefits may be in more efficient supply management via M2M.

In a direct contracting scenario, there would be a toll processing arrangement which may not fit with the business models of all processors and manufacturers. Ultimately, the success of the M2M model is expected to depend on the willingness of all participants along the supply chain embracing the reintroduction of an exchange-type system for buying and selling milk. While the establishment of an effective milk exchange should allow for greater price transparency for all industry participants, it could be some time before there is sufficient take-up and liquidity to make it an effective mechanism.

Retailers competing for change & control

Over the last year major retailers have continued to aggressively compete for market share and growth of their store ‘private label’ brands.

Changes in structure of private label supermarket milk contracts and potential new store brands are likely to translate into more competition amplifying pressure on existing processor owned fresh milk brands and processor margins.

A UK history lesson in cause and effect

Currently the longer term implications are starting to mirror what has occurred in the United Kingdom over the last decade as the major supermarket chains place more and more pressure on the fresh milk market following the introduction of aggressive discounting tactics, private label growth strategies, new contracts and supply arrangements.

Since the mid 1990s in the United Kingdom the supermarket sector which is dominated by five major supermarket chain have increased their control and dominance of the milk market through a combination of strategies, including aggressive discount driven marketing of their store brands, introducing more store brand ranges to compete with processor brands, brand mimicking, shelf space pressure tactics, all which severely affected the profitability and viability of processor owned brands over time.

The major UK supermarkets have also harnessed contracting and tendering processes to take more direct control over the supply chain including for example contracting processors to be toll milk bottlers and packers, and contracting groups of farmers to supply direct to the supermarket with special supply conditions placed on the farmers.

The change which has resulted in the UK domestic milk market is that since the mid 1990's is that the gross farmgate liquid milk gross margin has increased by some 4 percent from 1996 to 2010, processor liquid milk gross margin has increased by some 20 percent, however retailer liquid milk gross margin has risen by over 600 percent. At the same time supermarket 'private label' products have grown their market share to dominate the market at the demise of processor owned brands, the retailer price of liquid milk has increased by approximately 50 percent. As such consumers have ended up with less choice and paying more. The following graph presents the change in gross milk margins by supply chain sector over time and impacts on retail price and consumer choice.

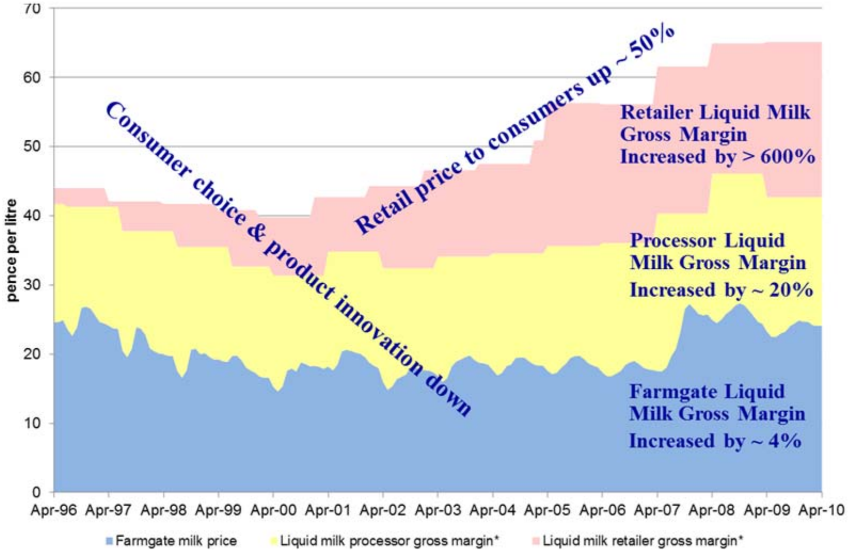


Figure 19 United Kingdom Gross Milk Margins 1996 to 2010 source DairyCo

Australia's major supermarkets change tact

For the last year is has been mooted that the major supermarkets were looking to change the way in which they procure their milk for their store brands, while also looking at opportunities to develop new exclusive parochial regional provenance products.

The development of exclusive provenance products was earlier exemplified by Coles' initiative in sourcing product from Warrnambool Cheese & Butter marketed under Great Ocean Road brand and by Woolworths' labelling the 'state of origin' for products including its private label milk.

In April this trend accelerated when Woolworths (WOW) and Coles announced direct supply arrangements with dairy farmer groups for the supply and marketing of their store brand fresh drinking milk.

Both arrangements involve the supermarkets seeking use their direct relationship with farmers to promote that they are looking after farmers and thereby improve public relations and to increase farmgate price transparency. The true outcome of these new arrangements with farmer groups is yet to be seen as they will not truly come into effect until next year.

There has been a lot of debate about the pros and cons of the approach by the major supermarkets including questioning of the net result on wholesale margins for these supermarket private label contracts. Both major supermarkets claim to be 'cutting out the middle man' by sourcing milk directly from farmer owned groups, however all fresh milk needs to be processed and bottled, so those costs structure are still present, whether or not a farmer co-operative is processing the milk or a non-farmer owned processor.

Woolworths Farmers' Own: Woolworths (WOW) officially launched its new 'Farmers' Own' un-homogenised brand at Sydney's Royal Easter Show.

While the new brand arrangement includes milk supply from new industry entrant 'Milk2Market', WOW's major move is toward establishing a supply agreement with a farmer group from Manning Valley (mid-North Coast NSW), post ACCC approval. The initial trial of un-homogenised 'Farmers' Own' will involve Parmalat processing up to 15m litres of the group's milk p.a. on a on a fee-for-service basis after Parmalat agreed to release the farmers from their contracts held with Parmalat.

The WOW initial trial involves 7-8 farmer members from a group of 54 farmers, originally formed to work with Parmalat several years ago. The group reportedly took the direct supply initiative to WOW having encountered difficulties in supplying Parmalat.

The stated key goals for the Manning Valley famers in seeking a direct supply agreement with WOW included securing (a) long-term supply arrangements, (b) higher farmgate milk prices (10-15% higher is the stated expectation), and (c) influence on how the producers' product is marketed. The Manning Valley farmers initially proposed that the Farmers' Own product would be un-homogenised, reflecting their desire to influence how the product is marketed; subsequent reports have included mention of both homogenised and unhomogenised milks, priced between $2.00 and $2.50 per litre.

NSW supermarket retail sales of fresh white milk in the last three years average approximately 300m litres; so the 15m litres under the Farmers' Own initiative would represent less than 5% of fresh white milk sales in the state. Yet that 15m litres represents around 14% of WOW's annual private label sales in NSW. The Farmers' Own products are expected to be on shelves by the end of the year.

Coles: Coles in April announced a significant change to its strategy to procure milk for its Coles branded fresh milk, with long term contracts being issues to the farmer co-operatives of MG and Norco for Victoria, NSW and Southern Queensland. The scale, investment and implications of the new Coles fresh drinking milk supply deals are expected to change the nature of domestic milk supply in Australia.

MG has publicly stated that its 10-year agreement with Coles secures a premium for supply of 200 million litres p.a. of fresh drinking milk (approximately 5% of its total production volume) along with rise and fall provisions, contingent on farmgate price movements.

While Coles has stated that the deal will provide for greater supply chain transparency because both MG and Norco publish their milk prices, there are not yet any details available on the contract pricing that enable a full understanding of how the farmgate pricing will work in practice.

MG has also presented that the deal will be profitable due to the efficiencies gained in using the latest technology at the two new milk processing plants: a greenfield site in Sydney's western suburbs and one adjacent to MG's existing logistics centre at Laverton on Melbourne's western outskirts. MG maintains that it has locked in a fixed premium which is expected to deliver additional profits to farmers through higher farmgate prices and that regional cost structures are being taken into account. MG has also presented that it intends to grow its milk supply to meet Coles' requirements with new farmer-suppliers from both existing and new supply regions, including in NSW to supply the planned Sydney processing plant.

With the Coles five year contract with Norco, which starts mid-2014, Norco becomes Coles' major supplier of fresh drinking milk for private label in southeast QLD and northern NSW, where Coles was previously supplied by LDD. Norco is expected to supply around 65m litres per year to Coles.

Fresh milk processors & retail contracts

Although LDD and Parmalat face changes from 1 July 2014, existing contracts for private label milk remain in place. Further supply chain disruption is expected in the lead-up to the changes in private label suppliers by supermarket retailers.

LDD reduced milk intake in Queensland and on the NSW south coast, citing the loss of private label supply contracts and freight costs as key factors in the decision to end the contracts of a number of suppliers.

Dairy Farmers Milk Co-operative (DFMC) ended contracts with its 22 Mt Gambier (SA) suppliers, following the sale of LDDs cheese factories at Murray Bridge and Jervois to UDP.

Two-tier pricing systems were introduced to limit risks of exposure to potential changing product returns mix and to send clear signals as to the size and value of the available market milk volumes required. However, LDD in late 2012 announced that it would pay Tier 1 prices for all milk supplied by its NSW and southern Queensland suppliers for the period from February-end of June 2013, with an average price around 48 cpl.

Outside Victoria and SA, LDD & DFMC farmers were originally paid Tier 1 milk prices only on milk supply volumes corresponding to the processor's regional requirements ("anticipated full demand," AFD). Milk supply in excess of contracted Tier 1 volumes received Tier 2 prices.

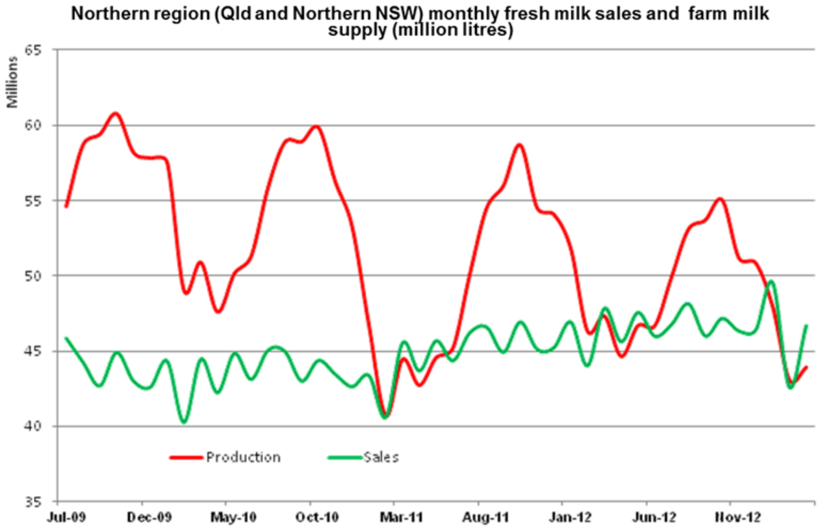
As milk volumes declined, LDD in November 2012 signalled that its requirements would change: the processor subsequently paid Tier 1 prices for all supply volumes received from farmers in Tasmania (effective Jan-Jun 2013), NSW and south-east QLD (effective Dec-Jun 2013). It remains unclear if LDD will reintroduce Tier 2 pricing, however it is seen as unlikely in Queensland and Northern NSW given the declining milk pool versus a growing market combined with a current growing seasonal supply to demand deficit.

Regional milk supply v demand

Supply chain conditions continue to tighten

- After almost a decade long decline in regional milk production until 2008, a combination of higher milk prices, longer term contracts, improvements in seasonal conditions and lower bought-in feed costs stabilised milk production through to 2010.
- Slower milk sales, a reduction in processing plant demand; and stronger milk supply created a surplus in regional milk supply until late 2010 when the effects of flooding cut milk supplies. This caused a deficit in fresh milk supply for a period of 2011 and part of 2012.
- 2012 saw some recovery in milk supplies across the region, however in early 2013 supplies have again been impacted by widespread flooding across much of the northern production regions.
- Over the last two years Queensland has experienced milk sales growth slightly above population growth, with a slight increase in per capita consumption. In the last year NSW market growth has been slightly less than population growth.
- This growth combined with declining milk production in the region has led to tightening the balance between supply and demand to a point where there is a shortage of milk from the northern region to meet demand for significant parts of the year.
- Recent production data and surveyed producer intentions indicates that production in the northern region remains very fragile, and could decline even further if farm returns do not improve in the short to medium term.
- In the wider context of the combined fresh milk supply regions of NSW and Queensland, which is becoming more relevant to processors, the balance between milk supply to processors and fresh milk demand is tight for 5 months of the year.
- This analysis excludes an estimate of milk in southern NSW that is used in manufactured dairy products, to ensure a like-for-like comparison.

- With rationalisation of non-milk processing operations by Lion, the milk intake that is in excess of fresh milk plant needs incurs a higher cost to the processor (including sales of milk into southern manufacturers at seasonal manufacturing values), and earns a Tier 2 price for milk producers.
- With reducing Tier 1 and Tier 2 prices going forward due to domestic market conditions, the ongoing balance between fresh demand and supply in the northern region and across the two states will be dependent on the operating conditions affecting feed costs and other input costs.
- Producers' perceptions of operating at suitable cash margins in future will impact production responses. Given the wider variation in farmgate prices experienced between southern processors and Parmalat and Lion supply bases, the impact on short-term milk production responses cannot be easily generalised.



Source: DA Packaged milk sales, fresh milk only (with pro-rata for Northern NSW based on share of NSW population according to ABS data;) milk production for corresponding areas & Aztec scan data

Figure 20 NDI Monthly fresh milk sales and farm milk supply

Projected demand v supply

Balancing regional supply & demand vs ability to fill gaps

- A potential scenario for future milk supply & market demand has been prepared in adjacent graph to reflect feasible directions in milk supply and market demand. This scenario uses current growth rates as a basis for forward projections of sales and production. Milk sales reflect projected milk processing demand based on an estimated total milk sales requirement for the Qld and Nth NSW region.
- The region continues to demonstrate good population growth. The average annual population growth rate for Queensland over the past 5 years has been 2%. ABS forecasts that the population will grow by more than 2% per annum over the next 10 years, providing good scope for expanding demand. At medium level population ABS forecasts for Queensland the industry will need to produce another 110 million litres of milk per annum by the year 2022 to meet market demand.
- The ability of the regions industry to meet this forecast market demand opportunity will hinge on a number of major factors, including but not limited to:
    1. Farm gate prices increasing to provide positive returns for dairy farmers,
    2. Ongoing high grain and fodder costs leading to lower use and less milk production,
    3. A deterioration in climatic conditions leading to reduced pasture feed and further increases in fodder costs,
    4. A further loss of confidence in the adequacy of returns leading to more farm exits, investment deferral and or contraction in farm intensity.

- The effect of shortages in supply to the northern region in the first half of each year has been mitigated to an extent by the fact that processors are effectively treating the wider region from central NSW to southern Queensland as a single milk pool and transporting milk longer distances to fill supply gaps. This strategy will be put under pressure this year as processors compete for more milk in the southern regions for dairy products for the export market.
- Many dairy farmers in the northern industry have continued to export heifers, as farmers seek to boost low farm incomes. In 2011/12 the QDFS reported that export of some 16% of heifers has occurred from Queensland dairy farms and that farmers intended to export more heifers this year. This loss of replacement cattle will have affect future production capacity in an existing low cow environment.
- A longer term view of the potential supply and demand shows the challenge facing the region in terms of the changes in the mix of farms and investment that are likely to be required to supply fresh milk demands in future – if the region is to remain self-sufficient. Given the long term average rates of exits, average farm size will need to more than double in the next decade to meet market needs. This will require farmers to be able to invest in expanding their farm operations and the ability to obtain finance.

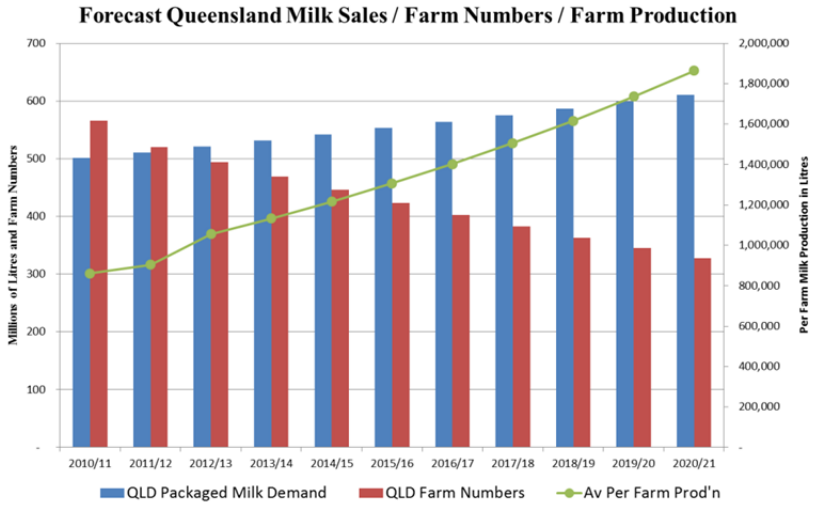


Figure 21 2020-21 Forecast Qld Milk Sales, Farm Numbers & Farm Production

Farmgate prices – South Qld

Prices remain under pressure in QLD and NSW regions as processors margins continue to be impacted by the supermarket milk price war.

Convergence in retail liquid milk prices across the states may add further pressure to the northern processors. The major unknown is the long-term impact of new supply arrangements currently being organised between major supermarkets and processors and direct to groups of farmers.

Note the farmgate milk price forecast for southern regions does not directly apply to suppliers in north fresh milk production regions. The primary reasons are due to different market conditions, cost structures, flat milk production curves, and contractual arrangements.

Milk prices in NSW and QLD have been lower than those in the prior year for most producers due to reduced Tier 1 prices, lower Tier 1 contract volumes and changes to contractual arrangements. Over time, the northern fresh milk market pricing has become increasingly complex as processors seek to balance fluid milk supply with demand.

2012/13 pricing

- A number of major milk processors that supply the domestic market have publically reported they are making little or no profit from major supermarket private label milk contracts.
- Milk supply contracts with higher prices and other incentives for commitment to longer-term supply have been used in recent years to underpin regional supply stability, following regional milk shortages in 2006/07. At that time processors where able to extract the additional returns required to support higher prices, incentives and five year contracts from the market place.
- The significant change in retail market returns in the last two and half years and certainty of market access has generally shortened contractual terms and caused a drop in farm gate prices offer by processors to farmers.

- Two-tiered pricing has been applied by processors such that year-round fresh milk returns will drive Tier 1 prices, while returns from the next best use of use of milk will drive the remainder.
- In 2011/12 prices have generally ranged between 45-58cpl covering most producers. However a number that held longer term contracts had achieved higher outcome with contracts near due, while a number of producers on short term contracts have received a lower price. The bottom end of this range has declined for shorter-term contracts.
- Milk prices this last year in NSW and QLD generally have been lower than the prior year for most producers due to reduced Tier 1 prices, lower Tier 1 contract volumes and changes to contract arrangements.
- The range of milk prices for the 2012/13 year narrowed, particularly for a section of the farmer base who's long term contracts ended or were prematurely ended and farmers were subsequently offered shorter term contracts and lower prices.
- A majority of Parmalat suppliers entered into a new 3-year contractual arrangement as from January 2012 that replaced former PDA and POPS arrangements, with price reductions of 2-3 cents per litre. These also feature 2-tiered pricing reflecting the exposure to milk and other product returns. Parmalat has recently provided an increase of 1 cpl.
- Lion flagged further reductions in Anticipated Full Demand (AFD) in 2012/13 in the northern region, however regional milk shortages have not seen that materialize to any great extent. 2012/13 milk prices for Lion suppliers (direct and DFMC group) in the Northern region entering new contracts largely remained the same as for 2011/12. However this follows significant price and AFD reductions in 2010.
- Norco managed to increase its price slightly in 2011/12 and hold that price for 2012.
- In 2012 respondents to the QDFS presented that recent farm gate price drops averaged some 3.9 cents per litre and would cause a predicted drop in farm income on average of some $39,955 this year.
- ABARES Farm Survey report, published July 2013, presents a drop in milk receipts of 3 cents per litre from 2011/12 to 2012/13 for Northern NSW and Queensland dairy farmers.

The following table provides an overview of regional farm gate prices ranges for Southern Queensland, Northern NSW, Central NSW and Northern Victoria and also cost ranges in cents per litre to transport milk from each region to be processed in Southern Queensland for that market. The table then provides a comparison of the landed cost of milk into Southern Queensland. As can be seen from the comparison of 2012/13 figures the landed cost of sourcing milk from Northern Victoria to fill supply gaps in Southern Queensland in more than the cost of sourcing milk within the region. This differential is highlighted to a greater degree when the increases in opening prices for 2013/14 in the Southern regions is taken into account, unless Northern farm gate prices increase significantly this year.

Landed cost comparison

	2012/13 average prices & freight costs in cents per litre				2013/14 forecast Nth Vic
	Sth Qld [1]	Nth NSW	Cent NSW	Nth Vic	
Farmgate	**48-53**	**46-52**	**45-50**	**38-41**	44-48
Freight	**3-4**	**5-6**	**8-10**	**17-20**	17-20
Landed cost	**51-57**	**51-58**	**53-60**	**55-61**	61-68

* This assumes milk prices on a year-round basis, given likely pricing by fresh milk processors in that region
The above price reflect Tier 1 pricing and do not include Tier 2 prices
The above price ranges may vary further depending on the allocation at farm level of the Tier 1 and Tier 2 volumes.

2013/14 price expectations

- The opening prices for Southern exporting regions have increased significantly for the 2013/14 year being up by over 25%, being driven by strong global demand, high world dairy prices and a lower Australian exchange rate. These price increases may over time force NSW and then Northern milk prices higher as processor compete for milk supply and security in a supressed milk supply environment. The timing of this affect will demand on many factors particularly the price structure of retail contracts in the domestic market.
- Current contract offers in the region have similar pricing offers to the previous year, however again processors are also placing more stringent quality and volume supply conditions and seeking flatter year round supply commitments from farmers. Some processors have further increased pick up charges, particularly for farmers in outlining production regions.
- Lion current initial offers do not offer any significant change in Tier 1 pricing (under negotiation at the time of this report).
- If major retailers allowed an increase in wholesale returns to the processing sector on both private label and branded milk sales, processors would be in a better financial position to be able to offer dairy farmer better price offers to try and stabilise regional production volumes.
- New longer term contracts announced by Coles with MG and Norco, which have been presented as having a cost plus approach to farm gate milk pricing, but they do not start until July 2014.

Survey Results

National Dairy Farmer Survey (NDFS) – Subtropical (STR) Results February 2013

(SAMPLE SIZE FOR SDP N=130)

Confidence Levels: Across the Subtropical Region (STR) confidence in the industry's future has fallen a significant 14 points since 2012 (now 31% positive; was 45%. This compares to national figures of 43% and 66%). Almost two thirds of dairy farmers in the STR (63%) are now negative. These are the lowest level of confidence recorded since the inception of the NDFS in 2004 – a year that followed a significant market downturn and a widespread, severe drought.

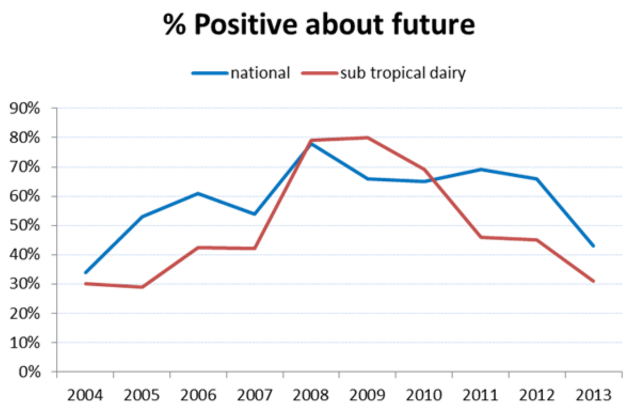


Figure 22 Survey Results of Positive Confidence Level Feb 2013

Drivers of Confidence: Milk price continues to be a key driver of farmer confidence and is raised consistently over time as the main challenge for farmers in terms of their own enterprise as well as for the industry as whole. Milk price is the main influencer of confidence in the region, mentioned by 51% and is nominated by 56% as the greatest future challenge for individual enterprises.

In general, farmers who are more positive about the future are less concerned by milk price and are more likely to be positive about the export demand for dairy

On average 59% of STR farmers are unable to see opportunities for the future of the industry. This is comparable with NSW which also relies on domestic market and are also significantly impacted by supermarket price wars.

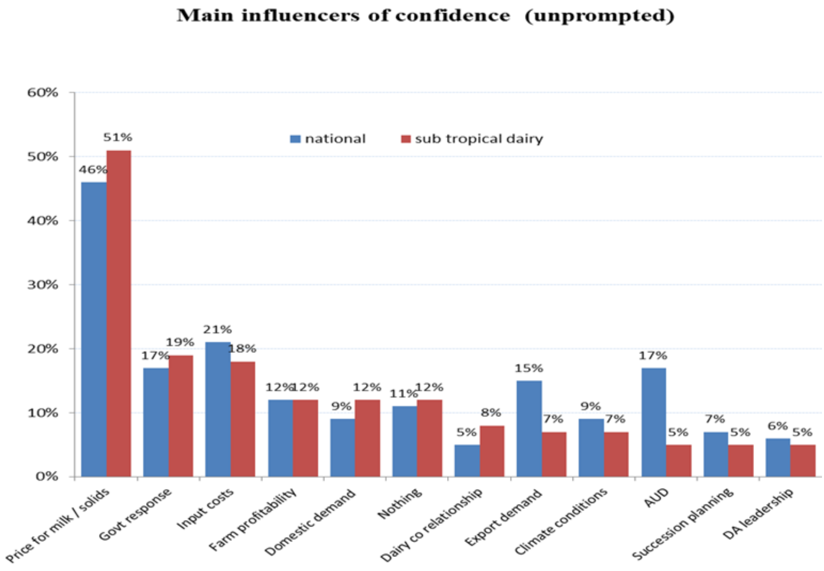


Figure 23 Survey Results on Main Influencers of Confidence Feb 2013

Only 6% of STR farmers expect to be more profitable over the 2012-13 year than the average of the previous five years. (on a par with national average) but a comparably high 17% are expecting similar profit to previous years.

Debt levels or the need to extend debt/refinance appears as well as supplementary feeding to be less of an issue in this region. This is despite the fact that hay and silage was purchased by 53% of farms over the past year – a significant 13 points higher than 2012.

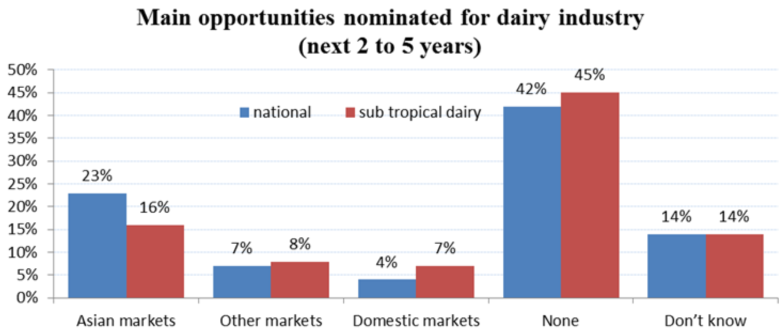


Figure 24 Survey results on main opportunities in next 2 to 5 years

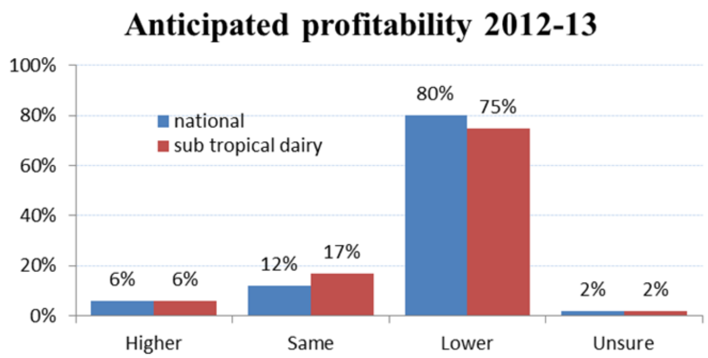


Figure 25 Survey results on anticipated profitability for 2012-2013

Across the STR 57% of farms reported being in a 'steady' phase, with 28% overall unable to expand, mainly due to financial pressures and having a set contract for milk. Only 13% reported being in an expansion phase and 17% reported that they were winding down their operations.

In 2013, there is a significant decrease in the proportion of farmers "where they want to be" being 29% now down from 45% in 2012. There are however a significantly proportion of farmers are rebuilding post floods.

Nationally there has been a significant increase in the proportion of farmers being steady and unable to expand and a decline in proportion who are expanding. Nationally, low profitability levels are prohibiting some dairy farms from expanding and consequently the proportion doing so has fallen a significant 6 points since 2012 from 22% to 16% while 25% now say they are in a steady phase, unable to expand - was 17%.

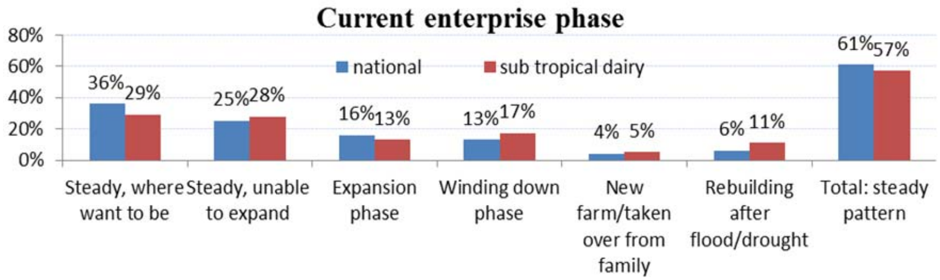


Figure 26 Survey results on current enterprise phase Feb 2013

Investment intentions: On farm investment is predicted on 24% of farms – slightly lower than 2012 (30%). 3 in four farmers will not be investing on farm in the next 12M. Only significant shift in investments is a reduction in intended investment in dairy plant, 5% in machinery and shedding, 4% in dairy plant and 3% in irrigation plant and tracks/laneways.

Average herd size is on par with 2012 being 197 cows calving down over the past 12 months compared to 201, but herd size range is substantial among SDP respondents from 40 to 1,000 cows. 25% planning to increase, 33% maintaining current levels, 38% planning to decrease and 4% unsure.

Overall, on farm investment is predicted to be less widespread over the next year and likely to be the lowest since 2009. Nationally, farmers are less likely to be planning investment in dairy plant, machinery, shedding, feed systems and fencing than previously.

In line with declining confidence and poor profit predictions, expectations of on farm investment over the coming year have fallen significantly. However more than a third of farmers are intending increasing their herd size, probably as a means to improve profit levels.

Queensland Dairy Farmer Survey (QDFS)

– May 2013 (48% of dairy farmers responded)

Expectations for 2013-14

In May 2013 the QDO and Premium conducted a survey of Queensland dairy farmers. The following statistics were obtained from 48 percent of the 518 suppliers registered at that time.

When asked about confidence in the future of the industry and in their particular business, 55 percent were not confident about the future of dairy industry with a further 35 percent unsure of the industry's future.

When asked about their future as a dairy farmer 44 percent were not confident, while a further 40 percent were unsure. Only 9 to 15% showed confidence in the industry and their future. This is a significant fall in confidence levels surveyed in 2012 with 33% having confidence in the future. Only 30 percent replied that they expected to be dairying in 5 years and 8% were unsure. This is a significant decline in confidence from the NDFS carried out earlier in the year in February and these where the worst results recorded in the history of the survey.

The major reason given for their uncertain future was a lack of profit, due to low farm gate returns. This reason was also highlighted in the prior 2012 survey along with –seasonal conditions, availability of labour, regulation and finances available.

In the month of the survey, 68 percent reported that they were unable to pay their accounts from the monthly milk cheque.

When asked to express their view on a milk return which would change their confidence level to perhaps remain in dairying, 46 percent believed they required 60+ cents per litre with a further 32 percent suggesting 65+ cents per litre.

Based on the limited information available at this time, 56 percent of farms indicated that they would not be interested in direct supply to supermarkets.

54 percent of respondents expect to produce less than 1 million litres in 2013-14 while the remaining farms expect to produce in excess of 1 million litres, 4 percent expect to produce in excess of 3 million litres per annum in 2013-2014.

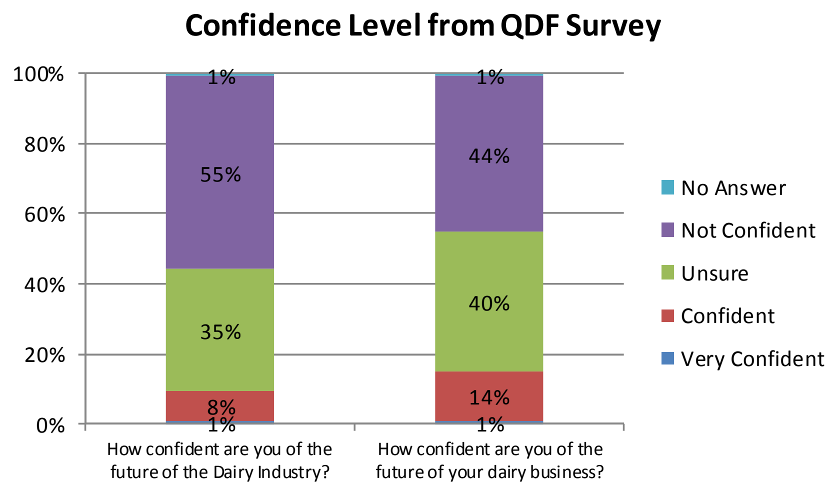


Figure 27 Confidence Levels from QDF Survey May 2013

Farm Costs of Production & Profitability

Review of 2011-12: The following review of 2011-12 is compiled from Queensland Dairy Accounting Scheme (QDAS). In 2011-12, 62 co-operators (12% of registered dairies) supplied data for analysis. Annual production (2011-12) in Queensland remained the same as the prior year at 485 mL, as shown in the Figure 28 below. Production declined in 2012-13 by 5.6% to 458 million.

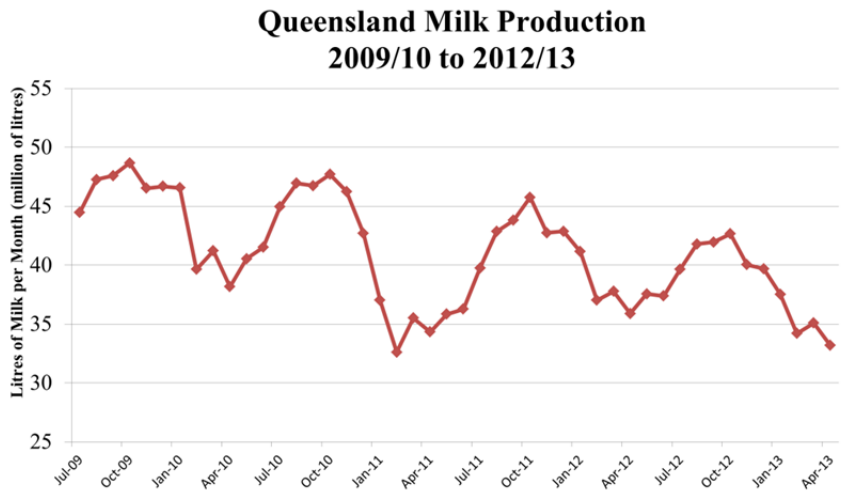


Figure 28 Qld monthly milk production 2010 to 2012

There was less variation in monthly supply in 2011-12, but a distinct spring peak.

QDAS reports on 3 production systems – grazing, farms (GRA), those with partial mixed rations (PMR) and those with total mixed rations (TMR) across 4 state regions.
In 2011-12 milk returns averaged 51.0 to 54.8c/L, while the margin over feed costs ranged from 24.7 to 30.0 c/L.

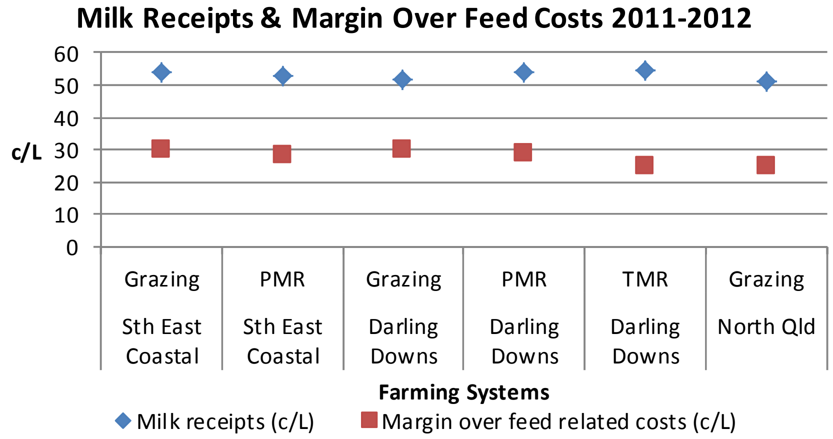


Figure 29 Milk returns and margin over feed costs in 2011-2012 by production system and region

Dairy operating profit (DOP) in dollars per cow ($/cow) is the key performance indicator (KPI) used to highlight the top 25% of farms. On average the DOP declined from $754 in 2009-10 to $482 in 2011-12. The top 25% of farms achieved $1 065 per cow.

Equity remains strong at 82%, while liabilities per cow is relatively constant at $2 937.

Other features contained in the report show- TMR farms with high production per cow (7 132 L), annual production at 1.78 mL and a DOP of $648 per cow. PMR farms on the Darling Downs had the highest DOP at $930per cow.

Return on assets managed is shown in the graph below, the top 25% attained 5.4%.

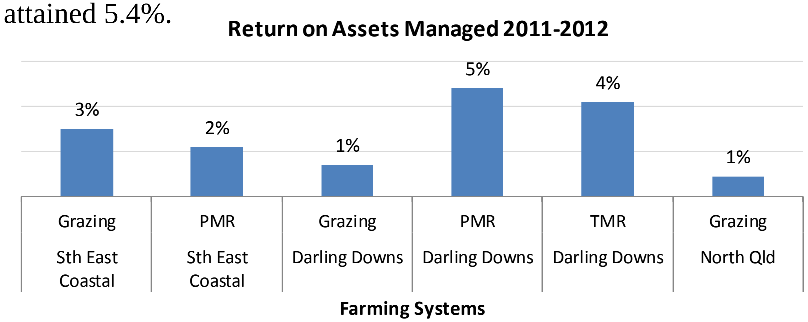


Figure 30 Return on assets in 2011-12 for all production systems by region.

Care is needed in interpreting the results as individual skills, quality of resources and climate are variables determining profitability. Production per cow has risen by 550 litres to 5 871 litres on average over the period 2000-2001 to 2011-12.

Feed, labour and finance costs are 3 key areas for farmers to manage.

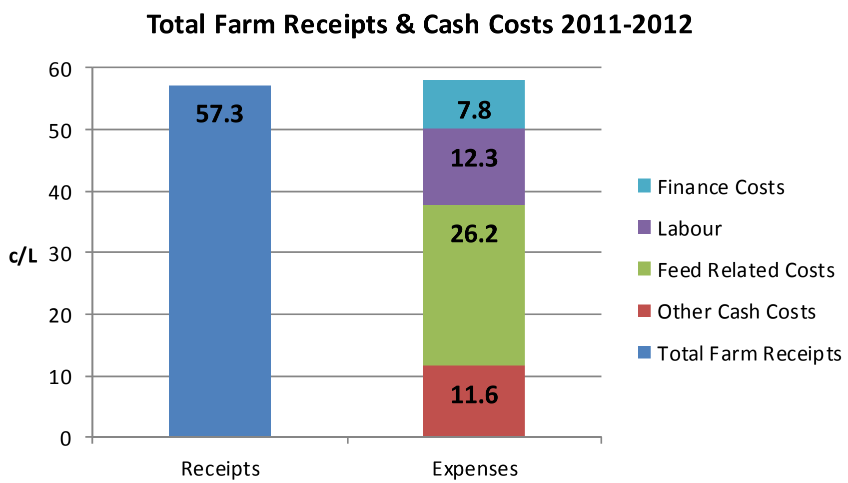


Figure 31 Feed, labour and finance costs in c/L for 2011-12.

Review of 2012-13: Early in the year there was concern about the range of prices for milk that may not be needed for the white milk trade. These ranged from 13 to 37 c/L as processors attempted to match demand with supply. The graph below shows that in 2012-13 milk intake was below sales in each month. Most farmers have received tier 1 prices all year.

The impact of the January floods can be seen in Figure 33. All processors have implemented stringent component and quality conditions on supply. Depending on the processor supplied, milk returns based on components vary from a high of 97% to as low as 3%.

Preliminary financial data indicates the following;
Milk returns (52.3 c/L) a similar to those of 2006 – 2007. Farmers have contained feed costs and hence variable costs, but when total costs are considered in a profit analysis, a cash deficit pre-tax of (4.2) c/L is

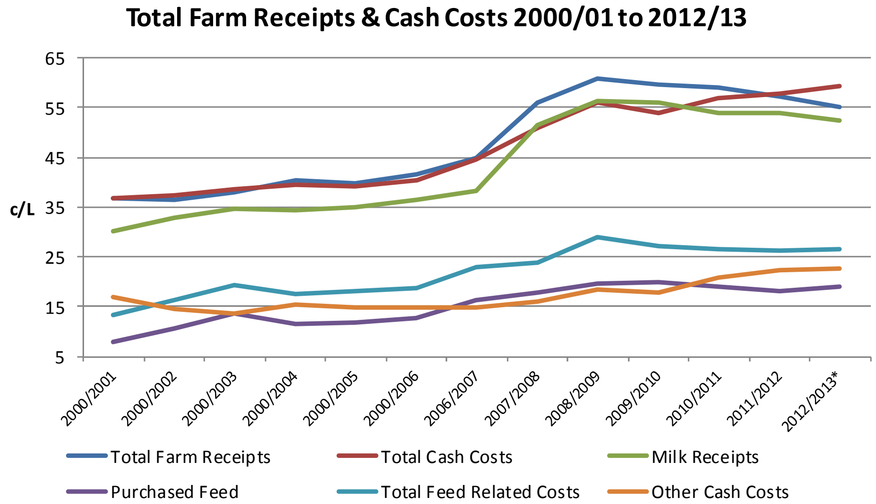


Figure 32 Milk returns, feed, labour and finance costs in c/L for the period 2000-01 to 2012-13.

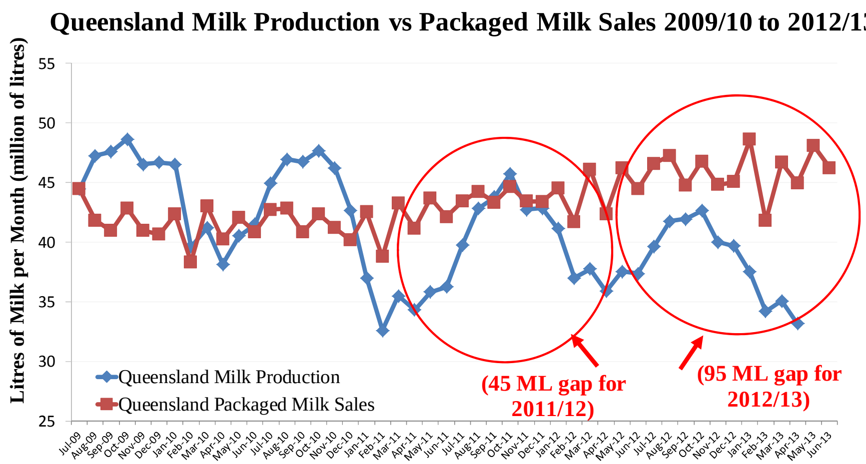


Figure 33 Queensland Milk Production and Milk Sales by month

Table 2 Milk returns, feed, labour and finance costs in c/L for the period 2000-01 to 2012-13.

	2000/2001	2001/2002	2002/2003	2003/2004	2004/2005	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012	2012/2013
Total Farm Receipts	36.7	36.6	38.1	40.3	39.8	41.5	45	56	60.8	59.5	59	57.3	55.2
Feed Related Costs	13.4	16.3	19.2	17.5	18.1	18.8	23	23.7	29.1	27.2	26.5	26.2	26.6
Labour	8.1	7.7	7.2	7.6	7.4	7.6	7.6	7.8	8.9	9.3	9.9	12.3	12.6
Finance Costs	6.2	4.6	4.4	5.6	5.4	5.2	5.6	6.3	7.2	6.2	8.3	7.8	7.8
Other Cash Costs	9	8.9	7.8	8.9	8.3	8.7	8.4	13.1	10.8	11.2	12.2	11.6	12.4
Total Cash Costs	36.7	37.5	38.6	39.6	39.2	40.3	44.6	50.9	56	53.9	56.9	57.9	59.4
Cash Surplus/Deficit*	0	-0.9	-0.5	0.7	0.6	1.2	0.4	5.1	4.8	5.6	2.1	-0.6	-4.2**

** These figures include the depreciation allowance*
*** Without depreciation the cash deficit was 1.8 c/L for 2012/2013*

Impacts on the cost of production

Current grain prices are not good news for dairy farmers. For the first time China imported large quantities of Australian sorghum pushing the price to $325 per tonne, increase from $180 per tonne last June 2012. Sorghum is in short supply, no relief in the price is expected till the new harvest arrives.

Corn is currently trading at $340 per tonne, an increase of $135 since the last July. Merchants don't expect an easing in price till February March 2014. Wheat is currently trading at $350 per tonne, up from $225 last June 2012. It is expected to drop by $80 to $270 at harvest.

There has been a gradual increase in all pellet prices over the year with June prices for 16% crude protein pellets reaching $385 per tonne. It is expected prices will increase to around $400 per tonne by December before falling in the New Year. Fourteen percent pellets are usually $8-10 per tonne cheaper than sixteen percent pellets.

Soybean meal will continue to trade at $700 - $720 a tonne till September, a drop of $70 per tonne would be expected with the new crop. Canola is expected to trade at $535 per tonne through till September, prices should ease by December.

Fertiliser prices have eased by $100-$120per tonne through the last year. Urea currently trades at $600-620 per tonne**.** As the Australian dollar falls against the US dollar over the next few months, estimates suggest about $10 per tonne increase in fertiliser costs per tonne with each fall of one cent in the AUD**.**

Electricity -price rises and changes to tariffs have had substantial impacts on cost of production. Substantial rises in the cost of electricity were seen from 1 July 2012, with another round of rises being implemented from 1 July 2013 which saw increases of approximately 20% or more. Although some reprieve was provided, after lobbying from industry groups, for irrigation and farming tariffs for 2013-2014, increases of more than $10,000 per annum will be seen, which followed price increases of more than $5,000 per annum the previous year.

The decline in feeder cattle prices were reflected in feeder cattle turnoff numbers due to dry conditions in many parts of western and northern Queensland. Cattle numbers are increasing in the short term despite high grain prices. Feedlots were running at 71 percent capacity in March but this has climbed to 90 percent capacity at present.

The two components of labour costs are paid and unpaid labour. Unpaid labour in the profit calculation is called imputed labour, this is the real value of the unpaid labour. A realistic calculation can be made by observing the following;

The average wage in Australia at November 2012 was $1 492 per week, based on a 38.25 hour week this equates to $39 per hour. The median wage is more likely to be $1 150 or $30 per hour. It is generally accepted that an average work rate on farms is more likely to be 55- 60 hours.

Based on this calculation a farm imputed labour figure could be $85 800 to $93 600, much more than the average farm draws in living costs. Table 2 below has used 6.9 c/L or $85 070 as the labour cost. Family members usually also contribute to running the operation as unpaid staff.

Determining a competitive sustainable return for milk

A fair return for milk has been discussed over the last year. The following flowchart shows the way DOP or earnings before tax and interest (EBIT) is calculated. After calculating EBIT a farmer has to make the following choices of how to spend the remaining dollars. They include spending on – interest, principal, leases, superannuation, education, provision for future droughts/floods, investment in new technology. A substantial EBIT is required if farms are to remain viable and the industry retains a critical mass. EBIT is also the basis on the return on asset calculation.

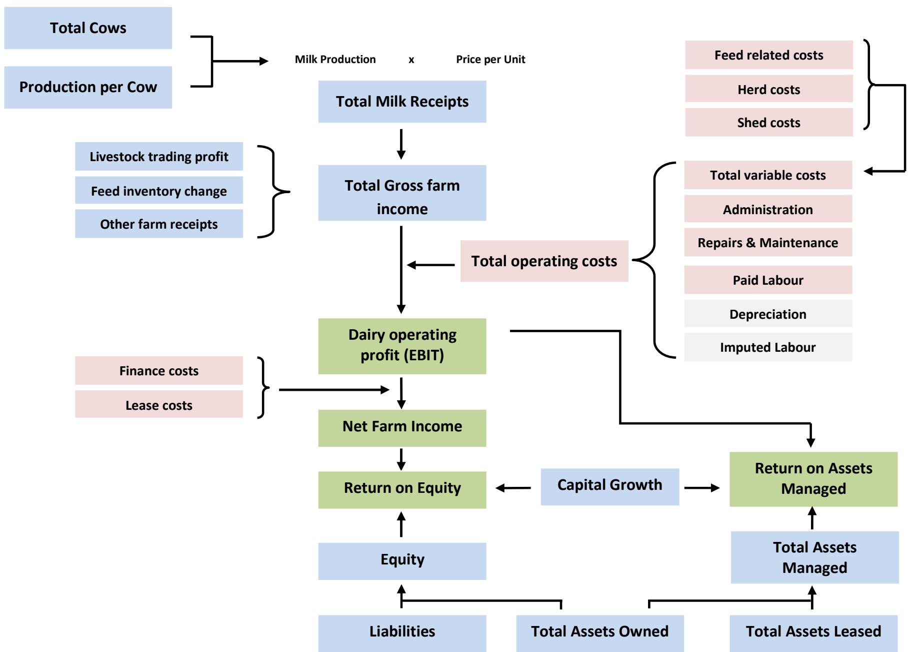


Figure 34 Flowchart showing the steps involved in calculating EBIT.

Table 3 Estimated returns and costs for 2012-13.

Cash Receipts	Estimated 2012-13 data (c/l)
Milk	52.3
Less cartage & levies	-0.5
Other receipts	3.4
Total farm receipts	**55.2**
Production costs	
Feed related costs	26.6
Herd & Shed costs	3.7
Total variable costs	**30.3**
Gross margin (milk)	**21.5**
Gross margin (farm)	**24.9**
Fixed & Overhead costs	
Administration	2.5
Repairs & maintenance	3.9
Paid labour	5.7
Depreciation	2.3
Imputed labour*	6.9
Total operating costs	**51.6**
Dairy operating profit (EBIT)	**3.6**
Finance Costs	7.8
Net Farm Income	**-4.2**
Estimated asset value	$3 995 489
Estimated production(L)	1 232 939
Return on assets (RoA EBIT)	**1.1%**

* Unpaid labour is imputed management allowance
** Refer to Figure 34

The analysis in Table 4 shows that at current milk prices farmers are earning a rate of return well below industry standards, this is reflected by the numbers exiting the industry. Going forward a substantial change in payments is required. Also note a cash deficit of (4.2 c/L) is recorded in Table 2.

Table 4 Milk returns calculated to match equivalent industry figures.

Milk price	2012-13 estimated RoA	Industry data
50 c/L	0.4%	
52.3 c/L	1.1%	Current estimated return
55 c/L	2.0%	Low Bank deposit rate
60 c/L	3.5%	6 month FMD 3.75%
65 c/L	5.1%	3-5 yr term 4.25 – 4.45%
70 c/L	6.6%	
75 c/L	8.1%	Wesfarmers share return 3yr average Aust shares

ABARES Dairy Survey Report 2012/13: ABARES Farm Survey estimates for 2012/13 for Northern NSW and Queensland dairy farmers;

- average farm cash incomes fell by 40% from the 2011/12,
- average farm business profit declined from $14,100 to a loss of ($39,000).
- a drop in milk receipts of 3 cents per litre from 2011/12, and
- fodder costs increased by over 13% from 2011/12.

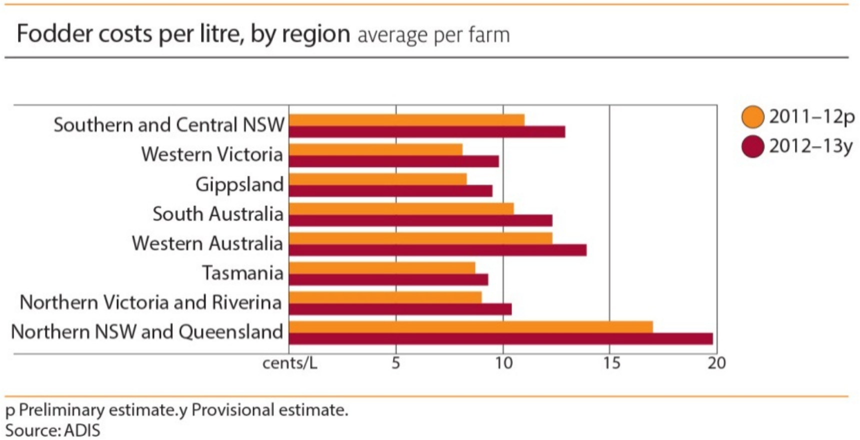


Figure 35 Fodder costs c/L per farm

Challenges, Issues and Options for the Future

A critical challenge for the region's future development is to maintain a balance in the supply chain where the milk supply will be contracted to a market requirement at prices which can ensure both, sustainability for producers and suitable margins for processors. The industry in the northern region faces a number of opportunities and threats in future. Industry development activities will in future be focused on balancing these in the interests of stabilizing and balancing the regional value chain. The following table provides opinions of strengths, weaknesses, opportunities and threats for the northern industry from a range of stakeholders, from an industry perspective.

Strengths	Weaknesses
The industry has a good understanding of production systems used and cost structures in the region as a basis to better manage future change. Prudent forward contracting of feed supplies will limit risk. Long term contract (5 years) will give a degree of certainty. Milk with higher milk quality standards will have priority in the market. Fresh milk is a dietary staple of a growing regional population. Sustained removal of permeate from main stream fresh milk brands will add to whole fresh milk requirements for the region's dairy farmers. The region has 'clean and green' and high quality reputation with interest from potential export markets. Regional consumers generally are supportive of local brands and dairy farmers.	Across the whole spectrum of production systems there are a limited number of farms with reasonable operating margins. In some sections of the industry, confidence of producers is weakened by continuous changes to volume and pricing signals. Current ability to compete for resources. Climate dependency and limited additional water supply opportunities. Rising feed costs and global competition for grain supplies driven by a growing population. Due to these mixed messages farmers report reduced margins which impact on investment and labour hiring intentions. Some costs (eg electricity) are rising at a rate well above inflation. Flattening the production curve will add costs for some farmers Investment opportunities for young well educated farmers are difficult to obtain Weak retail returns are a strong risk while consumer spending is cautious as major grocery chains and discounters are likely to continue to use milk as a "value" product to attract shopper traffic. Loss and now lack of dairy manufacturing capacity, throughput efficiency, diversification of product ranges and markets.

Opportunities	Threats
Future forecast population growth for the region equating the needing some 20% more fresh drinking milk by 2023. Increases in per capita consumption translating to higher market demand levels. Increasing evidence of a favourable weather patterns for the start of 2013-14 The slowdown in the mining sector may translate to advantages for agriculture Growth in population and living standards in Asia will continue to create export opportunities for high value dairy products Retailer and consumer interest in supporting niche milk products with clear ethical and health propositions (providing growth for a small number of enterprises) Sales of UHT milk may increase if supply cannot meet demand – especially in western areas, this is a product not requiring refrigeration for transport Diversified dairy businesses may be able to manage cost price squeeze more effectively Improved levels in water storages will reduce pressure on regional irrigation water supplies.	Community perceptions of farming – EPA and animal welfare issues For a viable northern dairy industry a critical mass of farms is required Continued retail pressure on branded milk sales Major retailers in direct negotiation with farmers Complex long term agreements indicated by some processors Uncertainties surrounding climate change, how to adapt and manage it is an issue Confidence of producers has been weakened due to falling milk values and changes in market access to the grocery channel affecting average returns. These have weakened investment & labour hiring intentions. A significant portion of milk is produced on dairy farms operating with slim margins, further pressured in 2012/13 with downward pressure on milk prices. Added costs and risks to dairy farming systems for flatter supply requirements from processors. Shorter term demands on suppliers and their farm systems by processors. Continuous changes to Tier 1 volumes and pricing disrupting confidence and investment at farm level. Community perceptions of intensification For the Northern dairy industry the combination of transport cost pressures such as diesel price and Carbon Tax, and large geographic distances will create added costs and competitive pressures in transporting inputs to farm and milk from farms to processors and to retailers.

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Dairy Manufacturers
You can find a listing of processors on Dairy Australia's website under "who makes what".