

**Independent Witness Report
For
Australian Competition Tribunal
in relation to
Application by Murray Goulburn Cooperative Co. Ltd
for Authorization of Merger with
Warrnambool Cheese and Butter Factory Company Holdings Ltd**

November 2013

Prepared by

Christopher Phillips

**Director
Chris Phillips Consulting
Melbourne**

List of Common Abbreviations Used In This Report

Products		Company	Country or Organization
AMF	Anhydrous Milk Fat	ABS	Australian Bureau of Statistics
BMP	Buttermilk Powder	ADC	Australian Dairy Corporation
FY	Financial Year ending June	ABARES	Australian Bureau of Agricultural Resource Economics and Sciences
GOS	Galacto-oligosaccharide	ANZCERTA	Australia and New Zealand Closer Economic Relations Treaty
Kt	Kilotonne (1,000 tonnes)	DA	Dairy Australia
n.p.	Not published	EU	European Union
SMP	Skim Milk Powder	HSF	Herbert Smith Freehills
SNF	Solids non Fat	Lion	Lion Dairy and Drink Ltd
UHT	Ultra High Temperature	NDFS	Dairy Australia National Dairy Farmer Survey
	Treated milk	NZ	New Zealand
SNF	Solids non Fat	MG	Murray Goulburn Cooperative Company Ltd
WMP	Whole milk Powder	UK	United Kingdom
		WCB	Warrnambool Cheese and Butter Factory Holdings Ltd
		WTO	World Trade Organization

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Introduction

1. I have been engaged by Herbert Smith Freehills (HSF) to provide independent expert advice in relation to Murray Goulburn Cooperative Company Ltd's (MG) application for approval to acquire all the shares of Warrnambool Cheese and Butter Factory Company Holdings Ltd (WCB) as part of a proposed merger of the two companies and their operations.
2. Attachment 1 to this report is a letter listing the questions which HSF have asked me to answer. In particular, HSF has sought my opinion on:
 - a. The key drivers of milk production, pricing and dairy exports in recent decades; and
 - b. The potential impact of the proposed MG/WCB merger on dairy production and exports from Australia, both absolutely, and in comparison to the potential impacts of concurrent, competitive takeover proposals for WCB.
3. The findings and opinions I have set out in this report derive substantially from my specialised knowledge and understanding of the operation of the Australian and international dairy markets and policy regimes. I developed this knowledge and understanding over the past 25 years working as a senior market and policy analyst and strategist for the national dairy industry service body - the Australian Dairy Corporation (ADC) and its successor from 2003, Dairy Australia (DA). In particular:
 - a. I managed the Strategic Knowledge and Industry Data Groups within DA from 1995. These groups undertake detailed dairy market and policy analyses for local industry and maintain a comprehensive industry data base service for companies;
 - b. I chaired the Dairy Trade Committee from 2003 to 2012, and acted as industry negotiator on major trade agreements from 1993 to 2012;
 - c. I managed the ADC's wind up of national price support arrangements in FY1999 and managed its oversight of the Dairy Structural Adjustment Program from 2000.
4. I have also undertaken recent private consulting to dairy groups and farmers on future dairy demand scenarios and previously undertook dairy-related work with Federal government agencies. I include my Curriculum Vitae as Attachment 2.
5. In completing this report I have received statistical assistance from current staff of the DA Trade and Strategy Group and Library and was provided access to certain confidential industry analyses. I also had discussions with ex-dairy industry colleagues and reviewed a range of relevant

documents and web sites. A list of these documents is set out in Attachment 3. Where I have relied on a document for any finding I have cited this in the body of the report. However, all the opinions set out in this report are my own.

6. I was given no operating assumptions to incorporate into my analysis by HSF. Nor did they provide any documents relating to the takeover or dairy industry operations.
7. I acknowledge that I have received, read, understood and complied with Federal Court Practice Note CM7 in compiling this report. This note is included as Attachment 4.

Summary Opinion

8. Based on my detailed answers to the specific questions asked by HSF, I present the following summary of my report.
9. Australian dairy is relatively unique in world terms due to its traditional export focus and open approach to domestic market access. However, after a decade of declining (and more recently stable) milk production, the Australian dairy industry is at a cross roads.
10. Demand for dairy remains firm. Domestic per capita consumption is trending upwards, especially for cheese and yogurt. There is scope for significantly increased usage of dairy components in a wide range of health, sports and nutritional applications. Internationally, dairy is entering a renewed phase of dynamism, driven by the growing global demand and consumer expectations on food safety, health and sustainability. This should see international dairy consumption and trade grow strongly for some years, particularly in milk-deficit areas of Asia and the Middle East.
11. Australia is a logical supply source for this growing global demand. International firms see Australia as a potential supply base for their growth into Asia and nearby regions. But DA expects the recovery in local milk production and export volumes will be slow in the next few years. Farmers in many regions of Australia appear reluctant to invest substantially to grow milk supply.
12. Many of Australian dairy's international competitors are going through rapid adjustments as farmers and companies prepare for expected changes in the international supply / demand balance. This changing world is favouring both increased scale and supply integration among dairy processors.
13. Australia faces some risk in this situation. Reduced milk flows have constrained Australian company capacity to invest in new technologies and factory operational scale in a period when many international competitors are aggressively pursuing such outcomes.
14. Australia's small scale of operations has reduced its cost competitiveness in global dairy commodity markets and affected local firms' ability to integrate themselves into customers' growing businesses. A range of regional trade agreements to which Australia is not a party has reduced Australia's access rights relative to some major dairy competitors in important markets

like China and Korea. Buyers increasingly are asking whether Australia can regain its previous export position or if it will slip down among a group of new emerging exporters.

15. Without production and scale increases, there is a real risk that Australia will miss this wave of dairy demand growth. While domestic demand for dairy remains solid, local firms operating in the local market will continue to face serious competitive pressures due to the open access provided to imports, the active competition from larger scale global dairy suppliers and the tight retail market.
16. In this situation Australian dairy processors are working to structure and position themselves so they can effectively and profitably participate in the growing world dairy market and generate sustainable income flows and investment returns at farm and company level. The alternative takeover proposals for WCB reflect different potential approaches to this challenge.
17. The likely impact of the different takeover proposals on individual company exports and regional milk production is not straightforward. It will depend on several factors including:
 - a. The takeover's impact on farmer confidence and willingness to invest and grow milk supply,
 - b. The operational and market synergies achievable by the new firm and how it translates these into higher, ongoing supplier returns,
 - c. The extent to which the combined business can adjust current product mixes and plant utilisation to generate new/ more profitable domestic and export sales channels, and
 - d. The reaction of existing WCB business partners to a change in ownership.
18. Of the three takeover options my analysis leads me to believe that the MG/WCB proposal is the one that is most likely to enhance Australian export returns and lead to increased milk production with the associated positive flow on effects for local regions. On balance, the MG proposal looks to be the option that will best:
 - a. Underpin export competitiveness by maintaining globally competitive operating scale,
 - b. Support greater product mix flexibility and value-adding export opportunities, and
 - c. Maintain local farmer ownership, control and integration over the longer term.
19. A merged MG/WCB could generate plant throughput efficiencies and will have a better bargaining position with domestic supermarkets. Internationally it can consolidate supply of high value ingredients like Lactoferrin and reduce Australian supply competition in export markets

such as Japan and the USA. These add up to strong potential gains in sales returns and industry production incentives.

20. After an MG/WCB merger farm gate milk prices in West Victoria will continue to be set largely by international market returns. But processing efficiency and a greater capacity to develop and pursue added-value product sales should benefit the company's export sales returns and flow on to higher farm gate and regional incomes

Detailed Answers to Questions

Question 1. Industry Summary

Provide a brief summary of the dairy industry. In particular please describe:

- (a) Where dairy producing regions are located
- (b) The size of farms/volumes of milk produced in those regions
- (c) Who are the main milk purchasers / dairy producers and the locations they collect or otherwise acquire milk from
- (d) The arrangements under which milk is acquired from farmers and the mechanisms by which prices are set
- (e) The supply chain in the dairy industry
- (f) The products made from milk, and
- (g) The regions in which the products are generally manufactured

21. The dairy industry is an important rural industry in Australia with 6,400 dairy farms producing 9,200 Million litres of milk annually. The farmgate value of this milk (\$ 4 Billion p.a.) ranks dairy third nationally in terms of agricultural production value behind meat and wheat production. However, both milk production and farm numbers have declined over the past decade.
22. Dairy farming and manufacturing processing are closely integrated as raw milk must be processed (at a minimum undergo pasteurisation or a similar thermodynamic process) before it can be sold for human consumption. While modern freight, refrigeration and concentration technologies allow for the safe long-distance transport of raw milk, most dairy processing occurs near the farmgate point of production. As a result, the dairy processing sector is broadly dispersed across Australia and generates significant economic activity and employment in regional Australia¹. Local processing of milk into finished food products and ingredients adds significant value to dairy farmgate returns. The ABS has estimated the annual ex-factory value of Australian dairy production at \$13 Billion².
23. Dairy farming and processing is estimated to directly employ 43,000 people across Australia and close to 100,000 when related service industry employment is included³.

¹ WestVic Dairy, for example, estimates that dairying accounts for one third of all activity in the Greater South Coast region.

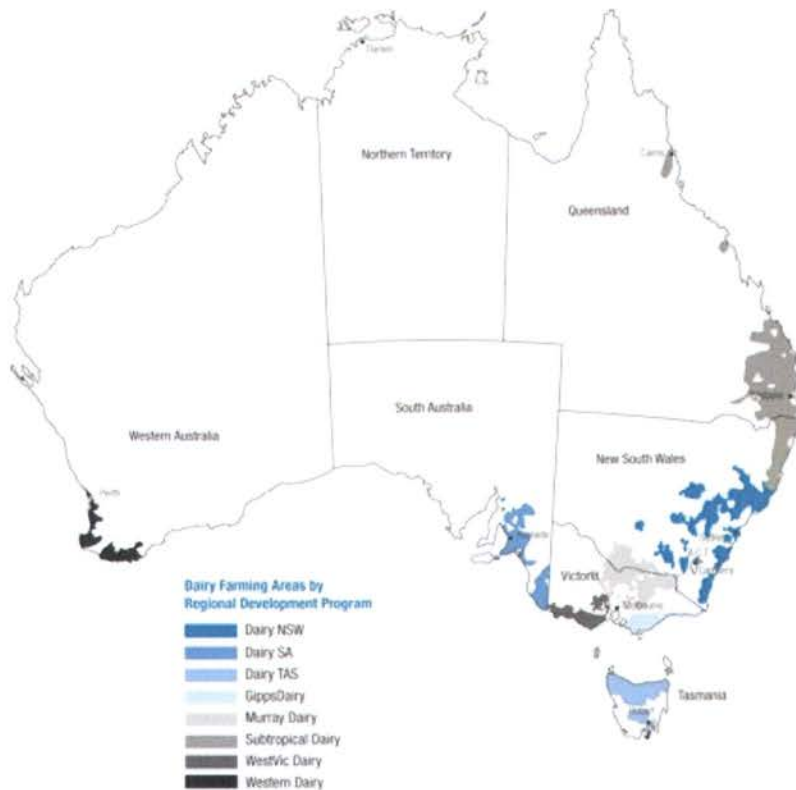
² Australian Bureau of Statistics *Publication 8159.0 Experimental Industry Statistics 2011*

³ DA – *Australian Dairy in Focus 2013*

Where dairy producing regions are located

24. Dairying is well established in all temperate and some subtropical areas of Australia, with dairy farms and processing plants operating in all states. Figure 1 provides a graphical representation of the location of Australian dairy farms based on the production regions defined by DA.

Figure 1: Australia's Dairy Production Regions



Source: DA - Dairy Australia In Focus 2013

25. Over time, a range of climatic, policy and commercial factors has seen a steady southward shift in milk production. Victoria accounted for 66 per cent of national milk supplies during the FY2013 production season (which runs from July to June). Table 1 below sets out a detailed breakdown of state contributions to national milk production. South Eastern Australia, which comprises Victoria, Tasmania, South Australia and southern NSW, produces over 75 per cent of Australia's milk.
26. Within Victoria, dairy farming is split fairly evenly across three production regions - Gippsland, the Northern Irrigation zone (which stretches from Shepparton to the Murray) and Western Victoria. Each of these regions produced around 2,000 Million litres of farm milk in FY2013. In recent years there has been more integration between the Victorian processing sector and farm supply from South East South Australia and the Riverina district in NSW. As a result, dairy factories in the

North and West of Victoria process several hundred million litres of milk that is originally sourced from interstate farms.

The size of farms/volumes of milk produced in those regions

- 27 As Table 1 shows, the average dairy farm in FY2013 produced 1.44 Million litres of milk from a herd of 258 cows. Average farm milk production has more than doubled since the early 1990s. Despite a steady growth in average farm size and herds, most farms remain owner-operated sole traders and partnerships. DA's National Dairy Farmer Survey (NDFS) indicates that corporate farms comprise only 3 per cent of all dairy farms in Australia, but account for a larger share of national milk production. Even with family-run operations there is a trend to running much larger 1,000 cow plus herds. Based on NDFS data the largest 20 % of dairy farms produce half Australia's milk, while 50 % of farms produce less than 1 million litres of milk annually.

Table 1: Australian Dairy Farm Facts and Figures FY2013

	Unit	NSW	Vic	Qld	SA	WA	Tas	National
Farm Numbers		731	4,284	518	268	160	437	6,398
Dairy Cows	000 head	196	1,079	93	90	56	137	1,650
Ave. Milking area	Hectares	147	162	186	229	239	179	171
Average Herd Size	Cows	268	252	178	336	350	314	258
% of herds < 150	%		27	52			14	30
% of herds > 300	%		28	9			47	28
Milk Production	Mill. Litres	1,071	6,039	458	536	337	760	9,200
(share of National)	%	11.6	65.6	5.0	5.8	3.7	8.3	
Average Farmgate	\$/kg milk solid	6.45	5.05	7.33	5.42	6.37	5.16	5.41
Milk price	(c/litre)	(46.4)	(37.8)	(53.6)	(38.3)	(45.0)	(40.2)	(40.2)
Farms producing	%	84	10	95	43	40	4	28
Year Round								
Milk Utilisation								
Drinking Milk	%	69	10	100	41	82	8	27
Dom Man	%	20	38		56	6	22	31
Export	%	11	52		3	12	70	42

Source: Dairy Australia In Focus 2013 and 2013 NDFS.

The main milk purchasers / dairy producers and the locations they collect or acquire milk from.

27. Australian dairy processing has undergone a steady process of rationalisation over the past 20 years. Currently, six firms collect and process over 500 million litres each year and account for 85-90 per cent of all farmgate milk collections. Table 2 describes the main milk processors, the

volumes of milk they collected in FY2013 and the regions in which they actively collect milk off farm. Australia's remaining milk is collected by a number of medium size regional processors such as Burra Foods and Longwarry Park Foods in Gippsland, Norco in NSW and Betta Milk in Tasmania. A large number of small niche firms operate in the fresh product and specialty cheese sectors. In recent years milk broking firms have become more common. These firms collect milk off farm either under contracts or opening price arrangements and then on-sell the milk before processing to local or national manufacturers. Recently, one large milk broker, United Dairy Power expanded its operations to include the direct manufacture of cheese in SA.

Table 2: Main Milk Purchasers/ Dairy Producers in Australia

Company	Milk collected FY2013 Bill. litres	Collection Regions
Murray Goulburn	2.990 (a)	Vic (Gippsland, Northern, West), SA, NSW, Tas
Fonterra	1.700 (b)	Vic (Gippsland, Northern, West), NSW, Tas
Lion Dairy	1.000 (c)	Vic, (Gippsland, Northern, West), Qld, NSW, Tas, WA
Parmalat	0.800 (d)	Qld, NSW, Vic (Gippsland, Northern)
Warrnambool	0.890 (e)	West Victoria, SE South Australia
Bega Cheese	0.650 (f)	Vic (Northern, Gippsland, West), NSW

Notes

- (a) MG Annual Report October 2013
- (b) Fonterra Australia website (www.fonterra.com.au)
- (c) Lion Dairy website (www.lionco.com).
- (d) Parmalat do not publicly disclose their milk collection volumes. This is an estimate based on observed industry sales.
- (e) WCB Annual Report October 2013
- (f) Bega Cheese Annual Report October 2013

Arrangements under which milk is acquired from farms, mechanisms by which prices are set.

28. Milk is acquired from farms under two types of commercial arrangement - direct contracts or informal "opening price/step up" payment systems.
29. Under direct contract arrangements firms typically enter into annual or multi-year contracts with farmer suppliers. These contracts set out the volume of milk that a farmer must deliver over the course of a year; allowable variations in daily milk supply volumes and the specific prices that will be paid for milk deliveries (either on a fat and protein content basis or cents per litre). Contracts also set out various price penalties/incentives that will apply in relation to milk quality and the under/oversupply of agreed milk volumes. Contracts often identify a fixed volume of milk deliveries for which farmers will receive a higher (Tier 1) payment and a lower Tier 2 price for any

milk delivered in excess of this amount. This reflects the alternative uses that milk processors can put additional milk volumes to.

30. The two large drinking milk processors (Lion and Parmalat) use contract arrangements in order to balance their daily milk intakes with their relatively stable downstream end use requirements.
31. Under opening price/ step up payment arrangements:
 - Firms implicitly agree to pick up all milk produced by supplier farms during a season if it meets agreed quality standards,
 - Before each production season commences in July, companies announce their opening price - effectively a monthly schedule of the prices they will pay for the fat /protein components of delivered milk over the year. The price offered varies between months with higher payments offered for milk deliveries in the traditional low production months of autumn/winter,
 - The schedule also sets out the potential premiums⁴ that will be paid to farmers if milk reaches certain quality standards, if supply exceeds certain seasonal volumes, other seasonal incentives and the deductions firms will charge in relation to milk collection and freight costs,
 - During the course of a season companies announce additional amounts (step ups) that they will pay for fat and protein deliveries. The higher prices are applied retrospectively to any milk already delivered during the season as well as any subsequent milk deliveries.
32. The larger dairy product manufacturers (including Murray Goulburn, WCB, Bega and Fonterra) all operate "opening price and step up" payment arrangements.
33. Companies base opening prices on their expected average returns on all product sales in all markets – local and export – over the coming financial year. They tend to set opening prices conservatively as milk payments to farmers are often made in advance of actual product sales (up to 12 months or more in the case of cheese). Companies announce and pay step ups as the season evolves and they have better data on actual production volumes, product mix, sales volumes, market developments and return and currency movements. Step ups can account for 10 – 20% of total farm gate receipts for milk in any season.

⁴ In some cases quality payments can be set out as penalty deductions for failure to meet agreed standards

The supply chain in the dairy industry

34. As noted above, most milk is processed relatively close by the farms from which milk is collected. This reflects both milk's perishable nature and its high water content. Modern refrigeration, transport and concentration technologies do allow raw milk to be safely collected, transported and processed hundreds of kilometres away from its original point of production. While there are no public data on inter-company milk swaps, they are a standard part of industry operations with both manufacturers and drinking milk processors using them to balance plant throughputs, reduce milk collection costs and facilitate logistical efficiency.
35. Companies collect milk from farms regularly via bulk tankers (taking test samples on-farm to ascertain fat and protein content). Farm size and seasonal milk flows will determine if tanker pick-ups occur daily or on a more or less frequent cycle. Once collected, milk is transported from farm to a designated factory for separation, standardisation and pasteurization. It is then processed into various products onsite or on-sold to other firms under contract.
36. The resulting products are then transferred to on-site or external storage, repackaging or distribution centres until sale after which they are transported either directly to domestic customers (or in the case of major supermarkets their centralised warehousing systems) or to export customers (generally by containerised sea freight).

The products made from milk

37. Reflecting its versatility and functionality milk is processed into many forms of liquid, semi-solid and solid consumer products and food ingredients. Some of these products are processed directly from standardised whole milk (for example cheese). Others are produced by applying different technologies to the fat, protein and solid non-fat elements of raw milk to produce joint products (e.g. butter and skim milk powder) or specialty ingredients (whey protein isolates, lactoferrin). Table 3 sets out a list of the main dairy products produced in Australia. Products shown in the right hand column are generally regarded as joint products (i.e. one that is produced from the same raw milk input used to make the product listed in the left hand column, either in a separate process or as a by-product of the manufacture of the first product).

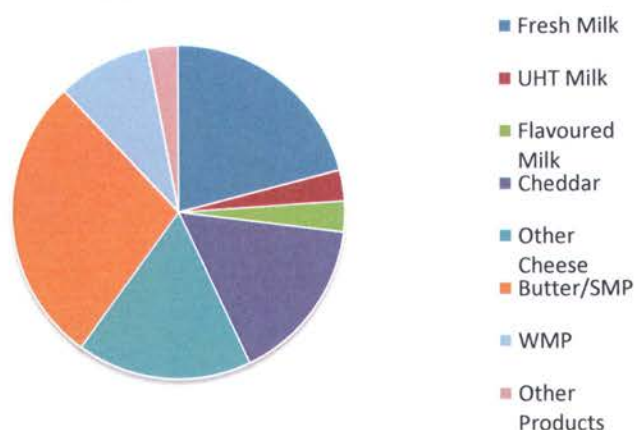
Table 3: A List of Common Australian Dairy Products

Fresh Milk – regular and modified. Ultra Heat Treated (UHT) Milk Flavoured Milk Dairy based breakfast drinks	Cream
Butter Dairy Spreads Anhydrous Milk Fat	Skim Milk Powder (SMP) Buttermilk, Buttermilk Powder (BMP) Casein / Caseinates
Cheese	Whey Powder Whey proteins
Wholemilk Powder(WMP)	Infant formula Nutritional Powders Dairy based powder blends
Yogurt Drinking Yogurt Custard Ice Cream Dairy Desserts Lactose, Protein isolates, Lactoferrin	

38. Figure 3 shows that, on a milk equivalent input basis⁵, in FY2013 Australian milk was processed primarily into cheese (33%), drinking milk (27%) and butterfat/skim milk powders (28%). The most common cheese produced was cheddar. This variety accounted for 16% of total milk supplies. For drinking milk, packaged fresh milk lines account for 21% of all farm milk while flavoured and UHT milks each account for a further 3%.

⁵ The amount of milk required to produce a specific product (e.g. it takes 10 litres of milk to produce one kilogram of cheddar cheese). Joint products (such as butter and Skim milk powder) can take differing amounts of raw milk (e.g. it takes over 20 litres to make a kilo of butter, but the same volume will produce 2 kg of SMP)

Figure 3: Australian Milk Utilisation % Shares FY2013



Source: DA Dairy Industry in Focus 2013

The regions in which products are generally produced

39. Australian dairying can be divided into two regional sub-categories. In three states - Queensland, NSW (particularly northern areas), and WA - milk production and processing is geared to the year round supply of drinking milk and fresh products (such as yogurt) to local cities and towns. This requires farmers to operate production systems that deliver consistent daily volumes of milk throughout the year. These year-round systems involve higher production costs, which need to be reflected in higher average farm gate prices for milk. Processor infrastructure in these three states is designed to handle stable year round intake volumes.
40. South Eastern Australia's production is much more centred on the manufacture of finished dairy products and food ingredients like cheese. Farms in these states can follow lower-cost seasonal production systems (with a significant milk production peak occurring in late Spring). This has implications for the type and scale of processing infrastructure needed in these states. Companies must be able to effectively process significantly higher volumes of milk across the Spring peak than they do during Autumn/ Winter.⁶
41. DA maintains detailed data on regional factory and farm level production, but does not publish detailed breakdowns of these data. Based on my industry knowledge I can state that:

⁶ In NSW and Qld the seasonal peak milk flow in Spring is between 1.2 and 1.3 times the winter production low point. By comparison the peak to trough ratios in Victoria and Tasmania range from 1.8 to 2.2.

-
- Fresh drinking milk production roughly aligns with each state's share of national population. So NSW, Victoria and Queensland are the major production regions for this product⁷;
 - Victoria and Tasmania are major UHT milk production states;
 - Victorian factories generate over 80 per cent of all manufactured dairy products in Australia. The percentage is higher for milk powders but slightly lower for cheese;
 - Some of recorded product output for Victoria is made with milk (several hundred million litres) that is sourced from cross border farms in southern NSW and SE South Australia;
 - Each of the Victorian production regions has factory facilities that produce significant volumes of core products like milk powder, butter, UHT milk, nutritional powders, cheese and yogurt;
 - Firms transfer considerable volumes of natural cheese and milk powders interstate and inter-regionally after initial processing. For cheese this relates to product re-cutting, re-packaging and re-processing. For milk powders it reflects re-blending and recombining of standard powder ingredients into various nutritional formula and mixture products.

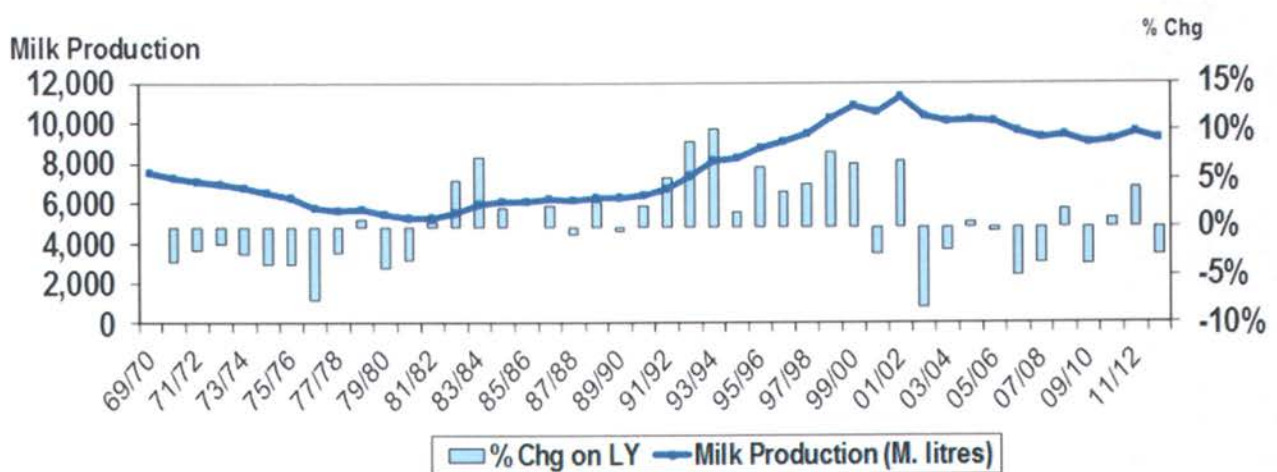
⁷ In recent years, factory rationalisation and increased use of both inter-regional milk flows and inter-company milk transfers by the major milk processors means that the correlation between state-level production and consumption of drinking milk has dropped slightly from the levels of 10 years ago.

Question 2. Milk Production, Key Influencers of Production

Between 1970 and 2013 what has been the total production of milk and what factors contributed to increasing and falling production from time to time

- 43 Figure 4 presents a timeline of Australian milk production from 1970 to 2013. This shows that national milk output fell from 7,551 to 5,432 Million litres over the 1970s. Production then stabilised in the 1980s, before expanding strongly over the 1990s and reaching a peak of 11,271 Million litres in FY2002. Milk production has since declined by more than 15% to its current level of 9,200 Million litres.

Figure 4: Australian Milk Production Timeline - 1970 to 2013



Source: DA - Dairy Industry in Focus, Dairy Compendium (various editions)

- 44 In terms of the factors that have shaped milk production levels over the past forty years, four groups of key drivers stand out. These are:
- Natural resource availability and major climatic events,
 - Government pricing policies for milk (before 2000),
 - Other domestic government policy developments, and
 - External shocks that affected industry returns, profitability and confidence.
- 45 Like all agricultural industries, Australian milk production has been affected periodically by major climatic events including droughts (in 1981, 2003, 2004, 2006 and 2007), floods and cyclones (in the Northern production regions).
- 46 Before 2000 Australian government regulation of farm gate milk prices was a major influence on dairy farm profitability and milk supply. Production quotas specifically shaped output growth in some states (see Box A below).

Box A: Government Roles in the Setting of Farmgate Milk Price in Australia Before 2000

Historically, Australia's drinking milk and dairy manufacturing sectors operated under different jurisdictions. Drinking milk was subject to state government control while dairy manufacturing was covered by Federal legislation.

Up to 2000 a complex system of state pricing regulations determined the farm gate price that was paid for milk consumed as drinking milk in Australia. Under these regulations farmers were paid different prices for their milk depending on whether it was consumed in regular, UHT or flavoured formats and also whether it was consumed within, or outside, its original state of production or exported.

State authorities determined the share of each farm's milk that fell under different price tiers. NSW operated a tradable drinking milk quota system. Victoria annually set the percentage of state milk production that farmers would be paid for as drinking milk regardless of its actual usage and imposed rules on company transfers of milk to ensure drinking milk processors received appropriate raw milk supplies over the course of a season.

For milk used in manufacturing, before 1986, farm gate prices were determined by the interaction of company market returns and federal price support structures. The latter included:

- Minimum wholesale prices for product sold in both domestic and export markets⁸
- The industry level pooling and equalisation of all company returns from domestic and export sales making returns independent of actual market sale prices, and
- Federal government commitments to underwrite industry returns in specific circumstances.

The Kerin Plan in 1986 terminated product pooling and minimum prices. From this company milk payments were determined by actual market returns on product sales. Kerin did provide a small (and declining over time) premium payment to export manufacturers, the Market Support Payment (MSP).

This MSP was funded by a levy on drinking milk production and effectively produced an intra-industry transfer from regulated drinking milk producers to deregulated manufacturing milk producers.

All domestic price regulation of milk was ended in July 2000.

- 47 Beyond direct dairy industry policy, economic and trade policy decisions by the Australian government had important influences in shaping milk production, including decisions not to pursue continued access for dairy to the UK market when that country joined the EU in 1973 and the floating of the Australian dollar in 1983.⁴⁸ External shocks like the 2008 GFC have also had major impacts on local dairy profits, market returns and prices and so ultimately have helped

⁸ Under the International Dairy Agreement, Australia and most of its major competitors (other than the US) agreed to enforce international price floors on all export sales of major dairy commodities.

shape national and regional milk production. The impacts on production of these different drivers of change are set out in more detail below.

The 1970s and early 1980s

48. This was a difficult period for Australian dairy, which experienced several major shocks including:
- The uncompensated loss of access to the UK in 1973 when that country joined the EU⁹
 - A major drought in the early 1980s¹⁰.
 - Major expansions in EU and US milk production that outstripped their internal market growth and resulted in massive government product stockpiles and a large rise in subsidised EU dairy exports and US food aid programs. These programs depressed and distorted world market prices throughout the 1980s.
 - The signing of the ANZCERTA free trade agreement and associated phase in of free access for NZ dairy products to the Australian market from 1984.
 - A government requirement¹¹ for the ADC, which was acting as an industry-level exporter, to sell several Asian dairy processing joint ventures it had developed as export outlets for Australian milk powder and butterfat.
49. Dairy farm profits were continuously low in the 1970s so, not surprisingly, milk production fell. Debates over state-level drinking milk regulations added to industry turmoil especially in Victoria. Nationally the operation of price equalization pools¹² for manufactured products reduced individual company incentives to develop new markets, products and systems. Despite the emergence of Murray Goulburn as a major player, these rules encouraged the continuation of many smaller, regionally based manufacturers with limited “brand” positions.
50. In the early 80s government saw dairy as an inwardly focused, high cost, highly supported sector¹³. The industry was not given priority in policy reform debates (UK entry to EU or ANZCERTA) and was viewed as a target for further cuts in government support.

⁹ Australia had exported over 50,000 tonnes of butter to the UK in 1972 (which represented almost 14% of national milk solids production). Exports fell to zero in 1974 and subsequent years. By contrast, NZ retained ongoing access to the UK for over 100,000 tonnes of butter. These export sales delivered major premiums to the NZ industry for the next 30 years.

¹⁰ A (drought related) decision not to supply contracted export cheese to Japan in 1981 led to an “unofficial” sanction and reduced export volumes from Australia to Japan throughout the 1980s

¹¹ Resulting from a Senate review of the activities of one ADC joint venture in Indonesia

¹² For most products, returns from domestic and export sales were pooled and largely equalised across all firms.

¹³ Dairy was regularly reported as the most assisted sector of Australian agriculture, largely due to the Industry Commission’s assistance methodologies for measuring support to drinking milk.

The 1985 to 2000 Growth Phase.

51. The combined effects of ANZCERTA and the 1986 Kerin Plan were expected to see Australian dairy progressively shrink back to a domestic fresh milk and product industry. Instead, from 1990 the industry entered an extended production and export growth phase. While farm numbers declined (15,396 to 12,896) between 1990 and 2000¹⁴, as Figure 4 shows, national milk output rose 60% from 6,262 to 10,847 Million litres. Every state recorded solid milk growth in the 1990s. The export share of production doubled over the decade peaking at 60% in FY2001.¹⁵
52. This growth was not based substantially on higher international prices or farmgate milk prices. In most states the regulated farm gate prices for drinking milk rose (and no doubt encouraged production of greater volumes of marginally costed "insurance" ¹⁶ milk in states like NSW and Qld). But, apart from a couple of good seasons (notably 1993 and 1996) farm gate manufacturing milk prices were fairly static over the decade and dropped in real terms. Even so, farm cash incomes were relatively stable across the decade (averaging from \$40-65,000 per annum according to the ABARES Farm Survey¹⁷). So growth, particularly in the southern states, was built on a combination of reasonable seasons, adequate milk returns, confidence around expanding world markets, increased production intensity and a growing internal belief that Australia could profitably be a low cost supplier to world markets.
53. The 1992 extension of the core Kerin Plan support arrangements to 2000¹⁸ underpinned industry stability. International developments also tended to confirm Australia's export competitiveness and growth potential. These included:
- a. The 1991 US Farm Bill (with its Dairy Herd Termination Scheme);
 - b. Japan firms lifting the "informal" limit on Australian cheese exports in the early 1990s;
 - c. The 1994 WTO Uruguay Round outcome (which assisted world prices by cutting export subsidies and tariffs and expanded Australian access to some premium markets).
54. Australian dairy export sales are generally contracted in US dollars. The \$A:\$US cross rate through the 1990s generally favoured local currency returns from export sales.

¹⁴ DA - *The Australian Dairy Industry in Focus 2013* (November 2013).

¹⁵ DA - *The Australian Dairy Industry in Focus 2006 edition*

¹⁶ Production in excess of known, or likely, drinking milk quota volumes for which farmers received a lower price and which firms essentially used for manufacturing purposes.

¹⁷ ABARES – *Financial Performance of Dairy Producing Farms* (various editions)

¹⁸ The extended arrangements were retitled the Crean Plan, after the responsible Minister for Agriculture

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55. There were negative policy developments later in the decade such as resurgence of EU export subsidies and a new subsidised dairy exports from the US. But by and large the Australian industry remained in reasonable shape. Farm returns and confidence were sufficiently high to encourage continued industry investment and herd growth. This growth was also backed, at farm level, by increased intensification of dairy farming systems across Australia, particularly in Southern regions. This intensification covered both herd rationalisation (larger farms) and changed feed regimes (a shift away from pure pasture to increased use of purchased feed). This saw a rise in both aggregate and per-cow milk production. Sometimes this growth in milk supply was confused with increased productivity in the industry (ignoring the extra inputs being used), but it did add to industry confidence about Australian dairy's positive future.
56. The 1990s also saw a steady stream of company rationalisation as firms sought to generate production scale in order to compete effectively in world markets. Bonlac had emerged as a second large Victorian co-op in the late 1980s. Bonlac and MG each accounted for 20-25% of Australian milk supplies at this time. Over the decade Dairy Farmers Group /Australian Cooperative Foods (DFG) emerged as a third major co-operative (and the first, major multi-state producer) through a series of co-op amalgamations in NSW, Qld and SA. Some decisions made by these three firms in the early 2000s have significantly shaped more recent industry developments (these issues are discussed further in answers to Questions 3 and 11).

2000 Onwards

57. The dairy industry reached 2000 expecting continued growth at a national level. But clear signs were emerging that this growth potential varied widely across different production regions. National milk output did rise in 2001/2, based on a good season and a strong world market, but then fell back. Only recently is national milk production showing signs of consistent recovery.
58. Two key drivers of the past decade's production trends were the deregulation of milk pricing in 2000 and the comprehensive mid-decade droughts. Both were important catalysts of industry change.

The 2000 Deregulation

59. In the late 1990s, National Competition Policy reviews placed significant doubt on the long term future of state-based regulation of drinking milk production and prices. After long internal debate, the major dairy industry bodies reached agreement with the Federal government to support the

full deregulation of all milk pricing arrangements (state and Federal) in return for a broad industry restructuring package. Price deregulation came into effect in July 2000. At the same time the Federal government introduced the \$1.6 Billion Dairy Structural Adjustment Program (DSAP)¹⁹.

60. Deregulation was a major watershed for the local industry but its impact on national milk production is overstated. The larger manufacturing milk sector had been deregulated since the mid-1980s. In the “manufacturing milk” states of Victoria and Tasmania drinking milk represented only 7% share of production. Farmers in these states also received a significant share of the DSAP adjustment payments. Aided by rising world (and so local farm gate) prices, milk production in the southern states actually rose in the year after deregulation.²⁰
61. The end of milk quotas (and guaranteed prices for quota milk) had much more significant effects on farms in the three drinking milk states of NSW, Qld and WA. Dairy herds in NSW and Qld were often well below the national average²¹. Smaller farms that had been viable with quota struggled to adjust to a lower, deregulated milk price (especially given firms required continued year-round production). While DSAP package payments helped soften the blow, many small farms found themselves without the capacity (or willingness) to adapt to this deregulated pricing environment.²² Aided by non-dairy demand for their land, farmers left the industry which saw both farm numbers and milk production fall in the drinking milk regions. In NSW, Qld and WA total farm numbers collectively fell by over 15% in 2001²³. The fall in milk supply in these states was less pronounced but still significant at 170 M litres (6.5%) in 2001²⁴. Farm numbers and milk production have continued to fall in these states.

¹⁹ An additional \$150M Supplementary Structural Adjustment package was introduced in 2001.

²⁰ 2000 did see a sizeable (10%) drop in Tasmanian farm numbers, but Vic farm numbers only fell by 3% in that year (roughly in line with the historical trend rate).

²¹ DA- *Dairy Compendium 2001*

²² For example, in 2001, former ADC Deputy Chairman Reg Smith told me that, before deregulation, both he and his close neighbour ran viable farms with herds of around 125 cows. After deregulation he said neither farmer saw their business as viable unless they greatly increased production. But he said neither he nor his neighbour felt they could do this and so they would both likely leave dairying. Mr Smith subsequently did leave dairying.

²³ DA – *Dairy Compendium 2001* edition

²⁴ DA - *Dairy Compendium 2001*. Milk production in these states had expanded rapidly over the 1990s so while it fell in 2001, total output was still above the levels recorded in these states up to 1999. The dairy herd in the drinking milk regions stayed relatively flat in the years immediately after deregulation.

The Two “one in a hundred year” Droughts

62. The droughts of 2003, 2004 and 2006/7 are very important in explaining recent milk production trends in South Eastern Australia. The farmgate value of dairy production held up better than it did in other sectors of agriculture during these droughts due to dairy’s greater flexibility with feed inputs. But, DA data shows that Victorian milk production fell by 800M litres (nearly 12%) alone in 2003 while national milk declined by 940M litres in that year²⁵. The 2007 drought saw a further drop in milk output of around 500 M litres²⁶.
63. Cattle numbers were less affected by the 2003 drought as people worked hard to keep their herds intact (and different regional climate conditions allowed farmers to “park” herds in less affected areas). But the drought and feed fibre shortage of 2007 – which was more widespread - had a bigger impact. The industry lost 240,000 cows (13% of the herd) between 2006 and 2008. The national herd in 2008 at 1.641 million head was 23% smaller than it had been in 2002²⁷.
64. The drought impact on farm numbers was also delayed, quite likely because farms were originally well placed having had a very profitable FY2002. Many farmers had used their DSAP package money to lower debt and invest in their farm systems. But in the second year of drought, 1,000 farms (10% of all farms) exited the industry. FY2007 then saw another 800 farms depart as people struggled to cope with the second “one in a hundred year” event in 4 years²⁸.
65. Beyond the immediate physical challenges, the droughts had longer term impacts on farm systems and behaviours, which are still affecting industry milk production growth. Drought and associated public debates on water rights encouraged farmers to switch to more resilient production systems (which meant maximising long term sustainability rather than short term milk growth). Irrigated farmers learnt to farm with significantly less water rights, but this often came with a capital cost and more reliance on purchased feeds. Often the new systems have proved to be higher cost and more decision-intensive. In some cases farmers found the shift to increased scale operations and more intensive feeding regimes difficult, higher cost and less rewarding than planned.

²⁵ DA – *The Dairy Industry in Focus* 2006 edition

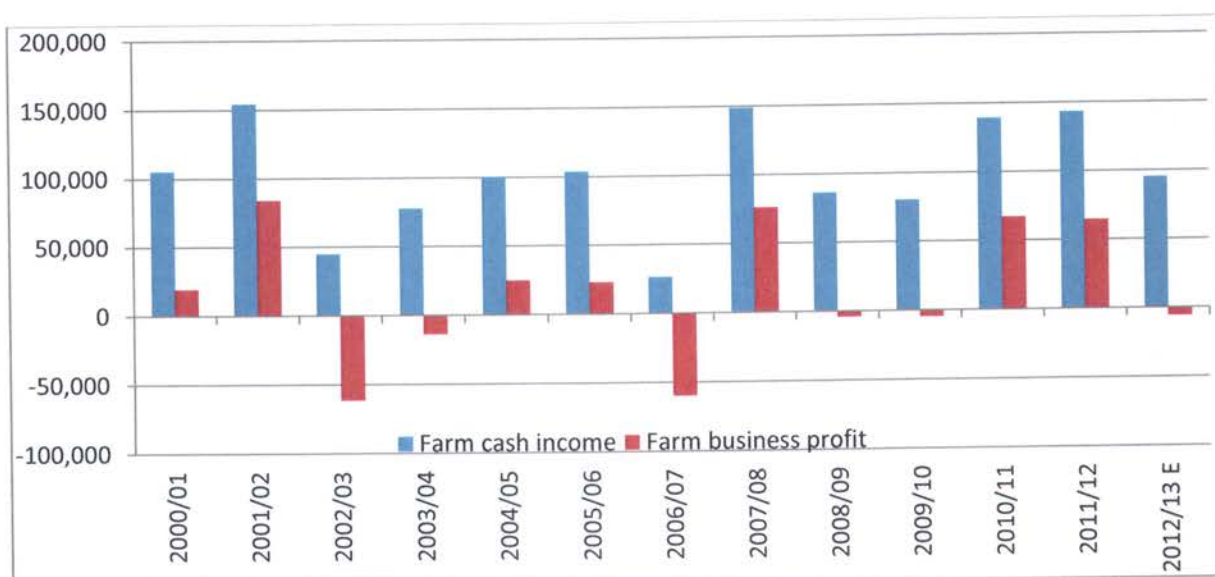
²⁶ DA - *The Dairy Industry in Focus* 2013 edition

²⁷ DA - *The Dairy Industry in Focus* 2006, 2013 editions Table 4

²⁸ DA - *The Dairy Industry in Focus* 2013 edition Table 3

66. Farm margins have been quite volatile. ABARES farm surveys have shown that farmers in many regions recorded negative farm business profits in six of the eleven years from 2002 to 2013 (Figure 7). This can be linked to a sharp build-up in farm debt and financing costs. Farmers consequently have sought new ways to generate reliable revenue streams. One of these has been the sale of dairy heifers to generate income, with sales helped by ongoing strong demand for live dairy heifers in Asia. The national dairy herd has subsequently remained relatively static in recent years.

Figure 7: Australian Dairy farm Cash Income and Business Profit 2001-2013



Source: ABARES Financial Performance of Dairy Producing Farms 2010-11 to 2012-13

The Global Financial Crisis (GFC) Step Downs

67. The impacts of the 2007 drought on farm income and production were offset partially by rising world dairy demand and prices. So 2008 offered farmers the hope of better seasons, better markets and better prices. The GFC-induced crash in international trade credit and sales, and ultimately export prices, was very untimely. In response, companies in SE Australia had to announce milk price “step downs” for the second half of the 2008/9 season (i.e. milk payments for February to June deliveries were cut substantially, not increased as farmers originally expected and budgeted for).
68. The step downs were clearly necessary given what had happened to world trade, particularly for a listed dairy company like WCB. But they were a major shock for farmers - having happened only once before in another industry crisis during 1973. The step downs forced farmers

(especially those calving in autumn) to run down equity and finance their second half farm operations on much lower than expected cash flows. As figure 7 showed farm profits fell below zero in both FY2009 and FY2010.

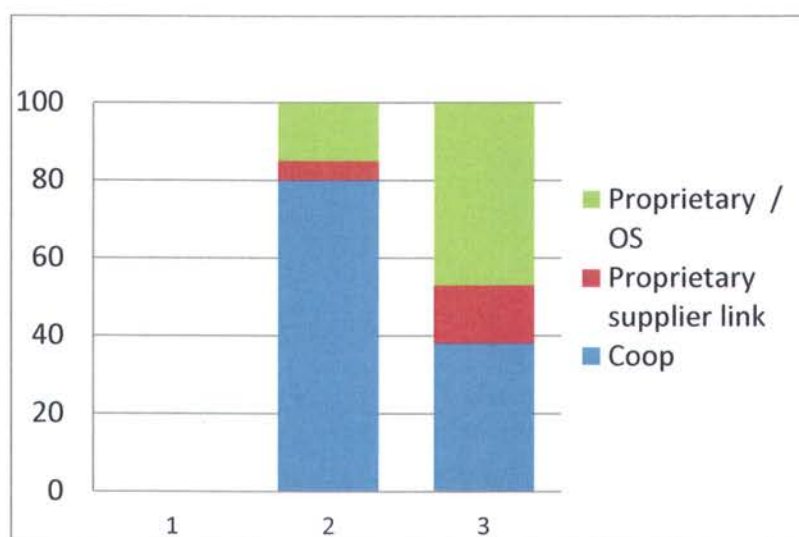
69. The step downs also affected industry confidence and, in some cases, greatly weakened farmer trust that companies were operating in their (farmer) interests.
70. In Queensland and Northern NSW two additional factors that have weighed on recent dairy production levels are:
 - (1) The significant physical and infrastructure damage caused by Cyclones Larry (in 2006) and Yasi (in 2011) and major flooding in 2012;
 - (2) The industry implications of widespread retail discounting of fresh milk (\$1 per litre) in 2011.
71. The post-Larry fall in farm and herd numbers and milk supplies, did see a rethink in company strategies in Northern Australia due to concerns that there may be a structural short fall in regional supplies of fresh milk. Firms offered higher priced multi-year contracts from 2008 and this did help slow the decline in local milk and farm numbers.
72. The impact of reduced retail pricing on the industry is discussed further in Question 11, but has been a factor in the continued decline of milk production in Northern Australia,

Question 3. Recent Company Acquisitions and their Impacts

What acquisitions have occurred in the Australian dairy industry during the past 13 years. What Impact if any have these acquisitions had on the dairy industry?

73. Like most countries, Australian dairy manufacturing was traditionally dominated by supplier-owned cooperatives. However, over the past two decades the structure of ownership of local dairy firms has altered considerably with the share of milk production that is processed by co-ops falling sharply (Figure 5).

Figure 5: Australian Milk Collection By Company Type 1992 v 2012



Source: DA- Confidential company milk intake data

74. There has been a steady stream of company mergers, acquisitions and change since 2000 including:
- 2003 Bonlac's full purchase by Fonterra (after progressively lifting its shareholding stake from 25% 2001).
 - 2004 San Miguel's purchase of National Foods.
WCB's stock exchange listing
 - 2006 National Food's purchase of specialty cheese firm, Lactos, in Tasmania.
 - 2007 Bega buying a 70% stake in Tatura Milk Industries.
Kirin's purchase of National Foods
 - 2008 DFG/ Australian Cooperative Foods demutualisation
Bega purchase of De Cicco Industries
 - 2009 National Foods purchase of DFG
 - 2010 The post-GFC share acquisitions in WCB by MG and Bega
 - 2011 The restructuring of National Foods into Lion Dairy and Drink
Bega's stock exchange listing and full purchase of Tatura
Lactalis' purchase of Parmalat
75. The detailed drivers of these company adjustments and acquisitions and their flow-on impacts on industry are discussed below.

-
- 76 Up to 2003 Bonlac was the second largest collector of milk off-farm in Australia. However, from 2001 the firm had faced significant operational issues due to the cumulative negative effects on its profitability and processing efficiency of:
- High company borrowings for major plant developments,
 - Agreements to align payments to Victorian and Tasmanian farm suppliers,
 - Losses arising from a major long-term currency hedge on export sales,
 - A self-reinforcing downward spiral in supplier numbers and milk intake.
77. As Bonlac's problems became public there was debate within industry about the merit of a merger between it and the other major co-op (MG). Many people argued that the creation of one very large Australian manufacturer would generate greater operational scale, better logistics and branding and increased market share. This would help Australia to remain competitive in world markets against existing and emerging large scale competitors (like Fonterra) and buyers (Nestle).
78. Murray Goulburn did not make a competitive bid during this period. This may have reflected concerns with the emerging drought and also the likely cost of a major corporate restructure. However, the absence of an MG/ Bonlac merger helped pave the way for Fonterra's entry into Australian manufacturing.
79. It brought a significant element of Australian dairy manufacturing within the ambit of Fonterra's global marketing system and strengthened Fonterra's global marketing position. Fonterra's presence, while commercially positive, has complicated Australian industry organisational politics and structures and some industry level trade dealings with Canberra. It has constrained industry-level information sharing on R&D and also reduced Australian ownership and, ultimately control, over major investments in regional dairy production²⁹.
80. The non-merger had consequences for MG. Due to the droughts and other factors discussed before, MG's recorded annual intake of farm milk fell by 800 million litres³⁰ from 2003 to 2010, a fall of 19% from its peak milk intake. While MG's milk intake has resumed slow growth in the last two years, at its current size, the company operates at a disadvantage to some major players in world markets in terms of plant scale /efficiency and brand positioning.

²⁹ An example of this is Fonterra's subsequent decision to close down a world class ice cream operation it had acquired in WA in preference to using its NZ plants and milk to supply international markets.

³⁰ As quoted in MG annual reports for the two years.

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81. Fonterra's takeover of Bonlac had more positive implications for Bega. A change of ownership clause required Fonterra to return its rights to the Bega brand – Bonlac's primary domestic cheese brand – to the Bega Co-op for \$1.00. Bega parlayed this into a very favourable arrangement including support to develop a new cheese plant and a long term cutting and packing contract with Fonterra. This has certainly facilitated Bega's subsequent development, its expansion into Victorian manufacturing via the purchases of Tatura Milk Industries and De Cicco, and its more recent company listing.
 82. In 2007 there was an opportunity for a Victorian cooperative merger when northern Victorian firm, Tatura Milk Industries, ran into major financial issues. As a regional competitor, MG seemed well placed to seek a merger given possible synergies in farm milk collections and factory operation.
 83. Ultimately, it was Bega that invested and took operational control of Tatura in a two stage process (a 70% stake in 2007 followed by full merger in 2011). This investment has significantly increased Bega's exposure to international dairy markets via milk powder and cream cheese.
 84. In the drinking milk states, two different sets of acquisitions have shaped regional industry development.
 85. In Western Australia prior to deregulation, there were no significant farmer-owned dairy manufacturers. The dairy firms had no incentive to maximise farm gate milk prices and set them at levels necessary to achieve consistency and continuity of local farmgate milk supply. After deregulation, farmer groups used WA government seed funding to establish an industry-owned co-operative processor - Challenge Dairies. The logic was that a co-op would generate improved pricing and greater supply security for farmers as an alternative outlet for milk. But the manufacturing facilities Challenge purchased were old and not world-class. This made it difficult for Challenge to compete in world and domestic markets or deliver a premium milk price.
 86. In practice, Challenge was unable to match the prices on offer from proprietary companies. The result was that Challenge did act as an industry price setter in WA but not as a strong one. This difficult situation for farmers was compounded when Challenge collapsed in early 2011 owing its farmer suppliers money. Other firms have since taken on most of Challenge's suppliers and some of its market outlets (like bulk milk exports to Malaysia). But, despite steady growth in regional

drinking milk sales (supported by the mining boom), milk production in WA has been stable in recent years. The previously noted closure of local ice cream operations by Fonterra will also have slowed milk production growth given the limitation this placed on alternative outlets for additional milk supply.

- 87 In the northern states, dairy cooperatives played a major role in drinking milk production and marketing both before and after 2000. Dairy Farmers Group (which operated as Australian Cooperative Food) was formed by a series of mergers between, NSW, Queensland and South Australian co-ops. DFG's business strategies had an important influence on the 2000 deregulation process³¹ and subsequent developments in house brand (i.e. supermarket label) milk contracts from the early 2000s. This is discussed further under Question 11.
- 88 As it lost milk supply and members post-deregulation DFG progressively wound back its Northern non-drinking milk manufacturing capacity. It demutualised in 2008 and was subsequently purchased by National Foods in 2009. This sale did allow regional dairy farmers to capitalise on their co-op ownership. But this purchase and the later purchases of National Foods by Lion Nathan (Kirin) and of Parmalat (by Lactalis) have reshaped the dynamics of the Australian drinking milk sector.
- 89 Parmalat and Lion have concentrated their businesses on drinking milk and short shelf products, with Lion also operating as a specialty cheese (i.e. non cheddar) producer. However, both firms have struggled to retain volume growth in supermarket sales of (their higher margin) company branded fresh milk lines in the face of strong house brand pricing and discounting by the major chains. They have also become vulnerable to the loss of individual supermarket house brand contracts given the potential disruption this can have on a firm's ability to balance contracted milk supply and commercial sales opportunities. In practice, Australia now has two major milk processors with low returning assets, who are locked into relatively low growth markets (albeit ones with long term expansion potential), who have little flexibility in terms of their potential product mix and operate in a very competitive retail environment.
- 90 This has seen both Lion and Parmalat move to rationalise plants and use greater inter-regional shifting and inter-company transfers of milk to lower costs, while winding back manufacturing

³¹ Southern processors support for deregulation reflected concerns that DFG could use drinking milk regulation to cross subsidise sales of cheese in domestic and export markets and anomalies in different state based treatments of UHT and flavoured milk pricing.

capacity in other areas (e.g. Lion has sold its cheese plant in Jervois in SA and is shifting cheese production to Burnie from other plants in Victoria (Simpson) and Tasmania (Kings Meadow). Unlike cooperatives, Lion and Parmalat have no incentive to guarantee long term milk prices for farmer suppliers beyond the level needed to secure enough milk to meet expected demand. In responding to their financial position the firms have put pressure back on farm suppliers via lower contract prices, smaller guaranteed Tier 1 volumes and forced exiting of small suppliers. With no large scale alternative processors seeking additional milk in Northern NSW and Qld this pressure on farm gate price is acting as a dampener on milk production in these regions. in the drinking milk states.

91 Two other recent acquisitions that may affect future domestic production and competition trends are:

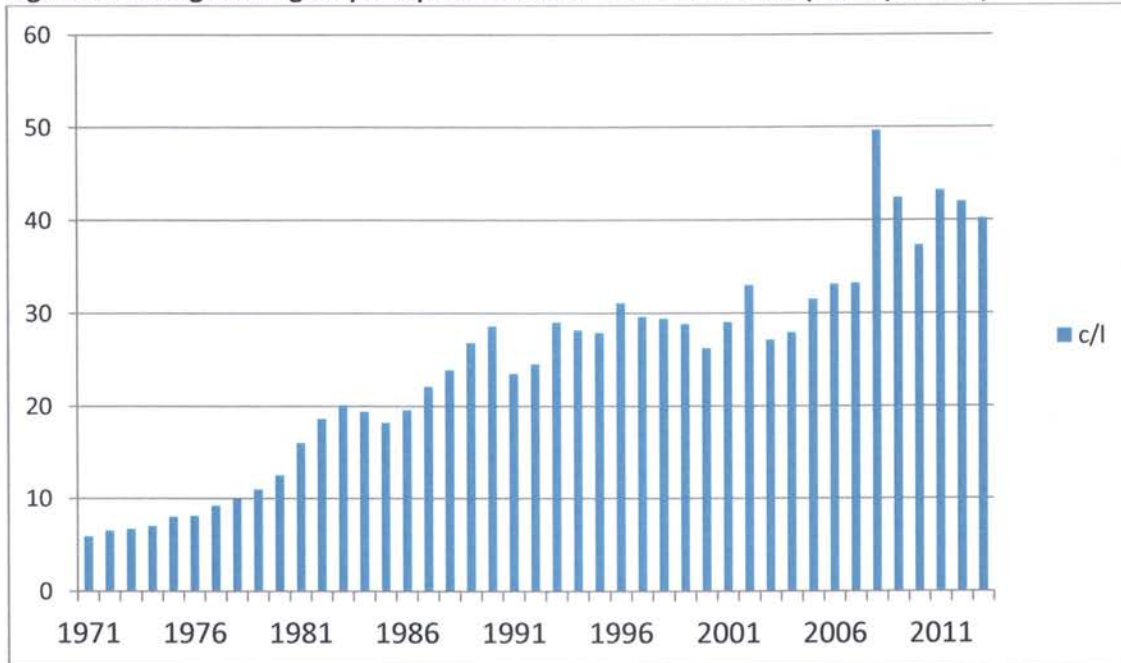
- The establishment of Tasmanian Dairy Products (TDP) - a consortium between Murray Goulburn (55%), Mitsubishi Japan (25%) and local dairy farmer investors (20%) - to process a range of milk powders for export. The new plant will operate in competition to Fonterra which, up to now, has been the dominant dairy manufacturer and farm milk collector in that state.
- United Dairy Power (UDP)'s has acquired Lion - Dairy's Murray Bridge and Jervois cheese factories in South Australia and commenced production of "Caboolture Cheese". This brings a new processor into the competition for milk supply in some parts of that state.

Question 4. Farm gate Milk Pricing

Between 1970 and 2013 what has been the farm gate of milk and what factors have contributed to increasing or falling prices from time to time throughout this period?

- 92 Figure 6 sets out the average Australian farm gate price paid for milk deliveries from 1970 to 2013.

Figure 6: Average farm gate price paid for Milk FY1970 to FY2013 (cents per litre)



Source: DA – Dairy InFocus various editions

- 93 As this shows, farm gate milk prices have trended upwards over time, although in real (inflation adjusted terms) they have actually fallen over recent decades.
- 94 The historical drivers of farm gate milk prices were touched on in the Question 2 discussion. In summary though:
- Prior to 2000 government policy played a major role in setting observed farmgate prices of milk through state and federal pricing systems for drinking milk and manufactured products;
 - From 1986 to 2000 the government impact on farmgate prices reduced with the effective deregulation of manufactured product pricing in Australia and the opening up of the domestic dairy market to imports;
 - Since 2000, farm gate milk pricing in Australia has been completely deregulated, so payments reflect company commercial outcomes in the different market channels in which they operate. Milk purchases remain by far the largest single item in dairy company cost of sales (ranging upwards of 50 per cent annually).

95 For milk consumed domestically as drinking milk the key current drivers of farm gate prices are:

- Regional and (less importantly) national and international supply/demand balances for fresh milk;
- The impact of major supermarket pricing strategies on the dairy value chain and the pressures being imposed on milk processors to reduce the cost of their main input, milk.

96 For milk used in dairy manufacturing the key drivers of farm gate price now are:

- Domestic market demand and retail developments;
- International market developments, with particular reference to demand and income growth versus global supply capacity (the importance of this linkage is discussed further in Question 5);
- Company processing, milk collection and distribution efficiency;
- Company product mix, and the share of product they can sell outside more volatile bulk commodity markets;
- International exchange rate movements which have a dual impact on international demand and the local currency value of Australian dairy export sales;
- The impact of import competition on returns from larger volume supply contracts with domestic retail, food service and food processing customers; and
- The overall level of company competition for farmgate milk. In this context, the continued presence of efficient, supplier-linked firms that aim to maximise the transfer through to farm gate from generated sales revenue is important.

Question 5. The Impact of World Pricing on Farm gate Milk Prices

How are domestic prices for the supply of milk affected by the world prices for dairy products?

97. The linkage between world market prices and domestic farmgate milk prices depends on the market channel into which milk supplies are directed. Table 1 previously identified that:
- a. 27 % of Australian milk is consumed locally as drinking milk.
 - b. 31% of all milk is consumed as manufactured products in the domestic market, and
 - c. 42% of all milk is consumed in oversea markets.
98. In Victoria drinking milk sales account for a much lower percentage of milk intake (10%) while direct exports account for a higher share of milk intake at 52%.

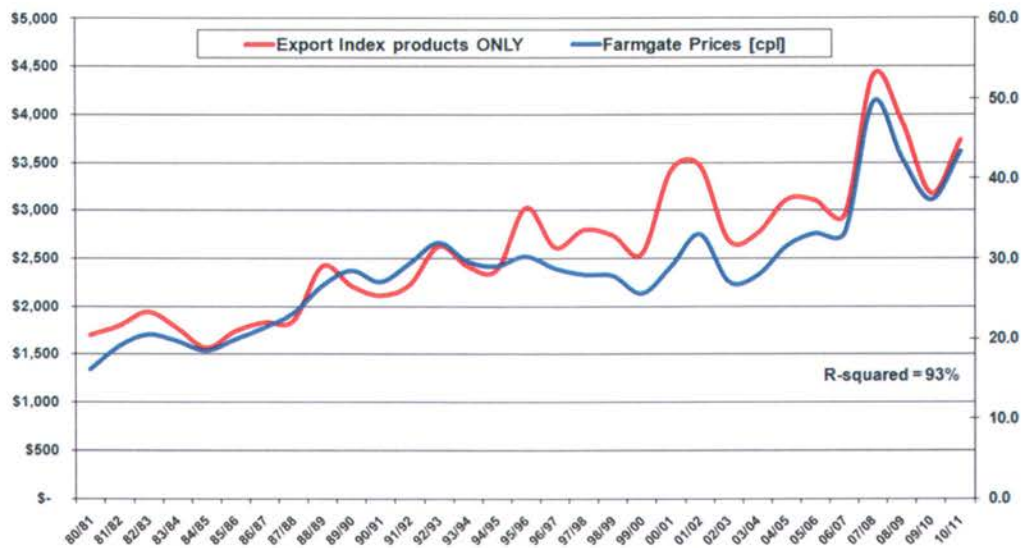
Drinking Milk and Short Shelf Products

99. As noted in Question 4, for the 27% of milk that is consumed locally as drinking milk, farm payments to producers are largely driven by the regional balance between milk supply and demand in states such as NSW, Queensland and WA. This is because there is limited international trade in fresh milk, product cycles are very short and store turnover is fairly rapid. So farm gate milk pricing reflects how much companies need to pay to secure consistent daily volumes of milk off farm.
100. In Eastern Australia, international market prices do have a limited influence on the regional farm gate pricing for drinking milk as world market conditions and outlook can affect the willingness of product manufacturers in southern states to transfer bulk milk to the fresh milk processors in competition with regional farm suppliers. However, geography and the cost of freighting milk up the Eastern seaboard influence the viability and attractiveness of long distance, inter-regional milk flows.
101. A larger share (20 per cent) of Australia's UHT milk is exported to Asia and the Pacific. In recent years some bulk milk concentrates have been exported to markets like Malaysia for local processing and sale as drinking milk. World market conditions affect returns on these product sales. But in practice, the milk embodied in UHT milk and concentrates is often counted as manufacturing milk rather than drinking milk for payment purposes.
102. A similar conclusion can be reached on how prices are set for the small share of farm gate milk that is used in the manufacture and sale of short shelf-life products like yogurt.

Manufactured Products

103. For the other 70% of Australia's milk (and closer to 90% in Victoria) world market pricing has a big influence on company and farmgate milk returns. A high proportion of all milk (42%) is sold directly as finished product or ingredients in export markets. Table 4 provides a split of domestic and export channels for major products and also shows the role that imports play in domestic consumption in key categories. This highlights that:
- a. Milk powders and whey products are predominantly produced for export.
 - b. Around half of Australia's butterfat and cheese production is exported.
 - c. Japan, as a major export destination for Australian cheese (over 100,000 tonnes) consumes over 10% of all the milk solids produced in Australia each year.
 - d. South East Asian markets would consume a further 15-20% of our production.
104. So, for these products, returns from international markets clearly affect local industry returns and, hence, potential farm gate payments for milk.
105. For the 31% of milk solids that are consumed domestically as manufactured products, international market pricing is also a strong influence on returns and farmgate pricing. The competitive access provided to the domestic dairy market is discussed further in Question 8, but the factors that highlight the capacity of import competition to affect local industry returns on these products are:
- a. Australia provides open access for dairy imports;
 - b. Imports account for 20-24% of domestic consumption of butter and cheese (Table 4);
 - c. Within the domestic market consumers do not strongly differentiate between local and New Zealand sourced product.
106. This International Market nexus is highlighted by Figure 7. This charts the comparative movement in Australian farmgate milk prices and international dairy market product prices. The two series have moved closely in step for many years. At a statistical level DA has estimated the R^2 coefficient of determination of world prices on local milk pricing over the past 25 years at 0.93 (i.e. changes in export market pricing explain 93% of the observed change in Australian farm gate prices for milk in that period).

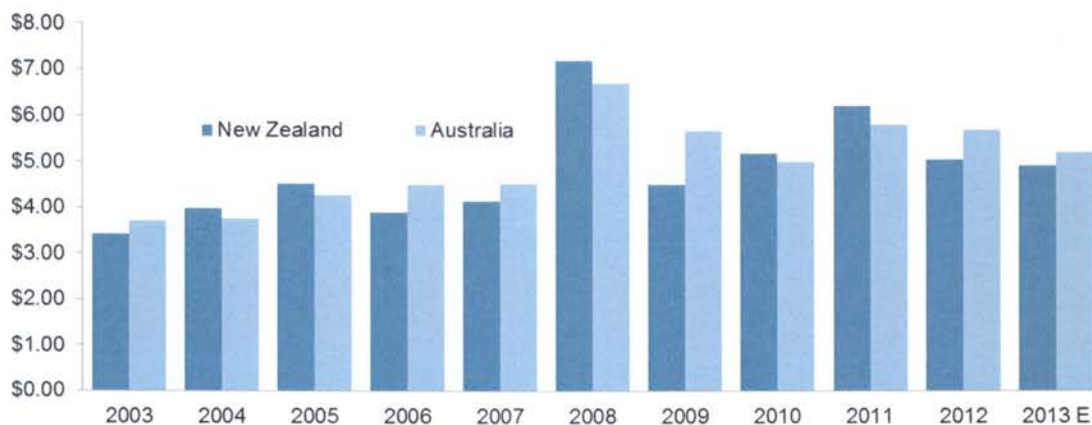
Figure 7 : Movements In Australian Farm Gate Milk and International Product Pricing



Source DA – Situation and Outlook 2012

107. Another indicator of the strong link between Australian farm gate prices and international dairy market returns is provided by a comparison of Australian and New Zealand farm gate milk payments. New Zealand exports the overwhelming share of its production so its farm gate pricing must be closely linked to world dairy market returns. As Figure 8 shows, Australian and New Zealand farm gate prices for milk have moved closely in line for the past decade.

Figure 8: Australian and New Zealand Farmgate Milk prices (in nominal \$A per kg Milk solids)



Source: DA Dairy Situation and Outlook report 2013

108. Year to year variation in farm payments between the two countries can be explained by differences in the market and product mixes of their major companies, different business and

currency hedging models and profit retention strategies.³² There are also differences in the dividend policies of export companies in the two countries, with New Zealand tending to pay a higher share of milk returns as dividends³³. But as Figure 8 shows, farm gate payments for milk in the two countries have tracked closely over the past decade, reflecting the strong linkage between world markets and domestic milk pricing in Oceania.

Table 4: Australian Dairy Product Sales by Channel and Imports FY2013.

Category	Unit	Australian		Product		Imports
		Grocery	Non-Grocery ¹	Total Dom.	Exports ¹	
Fresh Milk	Mill. Litre	1,028	933	1,961	31.0	...
UHT Milk	Mill. Litre	171	78	249	60.0	1.3
Flavoured Milk	Mill. Litre	95	146	241	-	...
Butter/Dairy Spread	'000 t	44.4	12.1	56.5	39.4	14.6
Anhydrous Milk fat	'000 t	...	4.8	4.8	11.5	3.0
Cheese	'000 t	117.1	131.2	248.5	174.7	73.7
Skim Milk Powder	'000 t	2.0	71.6	73.6	147.2	5.3
Whole Milk Powder	'000 t	5.6	5.6	11.2	103.3	15.4
Yogurt	'000 t	123.8	15.4	139.2	4.6	1.1
Cream	'000 t	56.3	51.5	107.9	11.9	2.1
Custard	'000 t	21.3	2.7	24.0
Dairy Desserts	'000 t	16.7	0.4	17.0
Whey Products	'000 t	...	20.0	20.0	41.1	13.5
Casein	'000 t	...	2.0	2.0	4.1	1.0
Lactose	'000 t	...	n.a.	n.a.	24.8	11.7

Definitions:

Source: *DA Dairy In Focus 2013*

Grocery covers dairy company sales to major supermarkets

Non-grocery covers sales to small retail outlets, food service and industrial food processing users

1. Total dairy exports will be above the figures recorded here as some recorded domestic non-grocery sales of products such as milk powder, whey powders, butter, casein and lactose are used in the manufacture of mixture products (such infant formulas, health powders, bakery mixes etc.) and subsequently exported under different tariff classifications (some of which are non-dairy). In FY2013 Australian exports of these mixtures exceeded 100,000 tonnes, New Zealand and Singapore are important primary destinations for these mixture exports although it is expected that many of them undergo blending and repackaging for sale in final third country consumer markets.

³² For example, NZ exports are more geared around WMP exports, while cheese and SMP are more important export categories for Australia. Fonterra also operates a longer-term rolling currency hedge on export sales compared to Australia, and sells more product through the on-line Global Dairy Trade auction platform.

³³ Fonterra's share dividend in FY2013 was of \$NZ0.32 (\$A0.27) per share compares to dividends paid by MG, Bega and WCB of 8, 7.5 and 11 cents per share respectively.

Question 6. Dairy Company Influencers of Farmgate Milk Price

Based on your experience over the past 10 years and in the various production regions in which milk is produced which dairy producers have been most influential in setting farmgate prices for milk?

109. I believe that Murray Goulburn has had a major role and influence on the setting of farmgate milk prices across Victoria (and nearby production regions in NSW and SA) for many years.
110. This view is based partly on MG's size and export orientation. The company picks up over 40% of the national milk supply that is subject to direct international competition and exports over 50% of the milk solids that it purchases. As a cooperative, I expect MG to try and maximise the milk price that it pays to its suppliers from available market returns over time.
111. Traditionally, firms using opening and step payment systems (as explained in Question 2) would often wait for MG (and, to some extent, Bonlac/Fonterra) to announce their opening price schedules for a season before they released their own. I have been told by executives of several firms in different years (most recently in 2012) that they aim to set their supplier prices around those announced and paid by MG.
112. Nowadays other firms may announce opening prices before MG. But in practice, if firms announce opening prices that differ substantially from MG's they will tend to make within-season step up adjustments to bring them in line. I believe competitive step up adjustments are common practice. Similarly, later in a season firms may not make additional step ups if they do not believe that MG will.
113. Over the past three production seasons, a comparison of MG's announced final payout for milk³⁴ with DA's recorded average Victoria farm gate price for milk³⁵ shows that the observed difference between the two was ± 6 cents per kilogram milksolids (or less than 1%). Some price differentiation between firms is logical given differences in product mix, hedging policies, their capacity to develop and market higher value product lines (like Lactoferrin) and their contracts (e.g. wholesale prices for supermarket cheese tend to be less volatile in the short term than international spot prices).

³⁴ Reported in MG Annual report 2011, 2012, 2013

³⁵ DA – Australian Dairy In Focus 2013 Table 6

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114. In Northern production regions the two national drinking milk processors, Lion and Pamalat, play the key role in setting farm gate prices through their contract offers.
115. In Tasmania, Fonterra, as the major milk collector, will dominate milk price setting.

Question 7. Export and Import Trade Volumes

What were the volume of exports and imports of the following dairy products between 1970 and current?

116. Tables 5 and 6 provide details of recent export and import volumes for major dairy products – covering the five years from FY2009 to FY2013. Tables 7 and 8 provide an historical snapshot of Australian dairy import and export trade over a forty year period from FY1971 to FY2011.

Table 5: Australian Dairy Exports FY2009 to FY 2013 (tonnes)

Product Group	FY2009	FY2010	FY2011	FY2012	FY2013
Butter	42,144	39,460	31,010	32,596	38,004
Butter Blend	2,606	3,187	3,420	1,437	1,840
Butter Oil	21,358	25,756	18,065	12,057	11,525
Buttermilk	453	436	565	419	
Buttermilk Powder	9,551	11,178	10,081	8,927	9,368
Casein	7,634	9,623	4,725	4,185	4,158
Cheese	144,664	168,114	162,997	160,863	174,061
Condensed Milk	17,355	18,157	12,957	12,653	11,928
Ice Cream	6,218	6,877	7,597	8,311	6,686
Infant Powder	17,606	12,293	9,551	5,989	7,597
Lactose	7,112	18,746	21,867	23,495	24,872
Milk	69,132	71,915	77,159	91,295	106,477
Mixtures	46,671	72,147	97,103	104,231	113,257
Protein	169	585	341	240	275
SMP	162,081	125,623	155,336	141,318	146,916
Whey Powder	65,161	53,721	37,814	41,738	40,916
WMP	140,427	104,456	116,302	110,120	96,215
Yogurt	3,375	3,132	4,018	4,517	4,688
Grand Total	763,715	745,406	770,907	764,392	798,782

Table 6: Australian Dairy Imports FY2009 to FY2013 (tonnes)

Product Group	FY2009	FY2010	FY2011	FY2012	FY2013
Butter	12,047	18,201	16,209	20,617	14,583
Butter Oil	1,350	1,545	2,063	2,063	3,047
Buttermilk Powder	1,951	1,851	1,323	2,080	1,770
Casein	998	630	855	855	857
Cheese	58,841	71,525	72,873	76,24	73,706
Condensed Milk	1,995	1,487	1,562	1,650	2,228
Cream	1,765	1,483	1,594	1,970	2,165
Ice Cream (000 ltrs)	14,282	17,887	20,090	20,367	20,743
Lactose	11,371	10,785	15,285	16,584	11,653
Milk	5,329	7,606	8,485	5,981	1,330
SMP	3,830	3,900	3,820	4,963	3,617
Whey Powder	13,829	12,801	13,943	15,056	13,468
WMP	14,722	17,422	18,191	16,645	15,364
Yogurt	718	425	619	1,263	1,128

Source for Tables: ABS data quoted in DA- Australian Dairy in Focus various editions

Table 7: Australian Dairy Exports FY1971 FY2011 (Tonnes)

Product	FY71	FY76	FY81	FY86	FY91	FY96	FY01	FY06	FY/11
Milk	n.p.	1,000	12,300	10,700	34,586	72787	82,574	86,151	70,917
Butter	68,750	55,535	7,820	26,593	29,487	22584	56,871	35,526	33,602
AMF	18,500	22,738	2,510	22,720	21,131	42067	53,176	37,687	18,064
Cream (1)	9,230	7,991	18,700	10,700	13,800	13498	24,351	18,627	12,957
Cheese	34,433	34,533	54,100	68,441	62,872	118872	214,644	201,702	162,997
SMP	49,079	95,108	14,995	100,039	125,690	167215	217,704	217,087	155,355
WMP	16,727	23,966	53,920	40,804	44,606	87747	184,845	152,558	125,853
Whey Products			3,000	7,500	16,127	39207	43,408	76,181	37,815
Other powders	16,505	6,184	20,900	18,000	27,200	28100	62,600	94,800	108,200
Casein	26,516	15,446	10,600	7,130	3,190	4894	11,074	8,280	4,725
Yogurt	n.p.	n.p.	n.p.	n.p.	965	2251	3,053	3,402	4,018

Table 8: Australian Dairy Imports 1970/71 to 2010/11 (tonnes)

Product	FY71	FY76	FY81	FY86	FY91	FY96	FY01	FY06	FY/11
Milk					867	1,379	2,691	1,365	8,485
Butter				47	1,050	5,674	9,902	7,518	16,209
AMF					0	0	1,490	2,444	2,063
Cream (1)				0	19	54	788	1,163	1,594
Cheese	5,809	9,663	16,830	20,264	22,537	33,129	42,145	60,352	72,873
SMP				523	213	1,350	2,091	6,529	3,820
WMP				530	1,961	1,710	2,202	10,375	18,191
Whey Products				769	972	2,058	915	1,841	13,943
Other powders				239	1,662	2,691	1,269	4,097	n.p.
Casein				4,415	9,202	9,100	13,067	1,108	855
Yogurt					299	126	756	723	619

(1) Historical cream data may include condensed milk products

Sources for both import / export tables are: ABARES *Australian Commodity Statistics* various years
ADC Annual Reports various editions and DA – *Australian Dairy in Focus* (various editions)

117. While not specified in these Tables, most of Australia's internationally trade liquid milk is in UHT formats. DA data indicate that before 2000, UHT milk accounted for 70-75% of recorded milk exports³⁶ with the remainder being fresh milk that was air freighted to specific destinations in Asia and the Pacific. In more recent years the advent of new air freight routes, and the development of bulk milk exports to Malaysia will have seen the UHT share of the export milk trade fall slightly in percentage terms, even though the actual volume of trade has been maintained.

118. I believe that only small volumes of dairy desserts are traded internationally.

³⁶ DA – Dairy compendium 2001.

Question 8. Dairy Importers and Import Barriers

Based on your expertise and experience please provide details of:

- (a) The current importers of dairy product to Australia, their relevant products and suppliers
- (b) Any barriers to the importation of dairy products to Australia and
- (c) the facilities and distribution arrangements necessary for importation of dairy products, their capacity and who has ownership or control over these facilities and arrangements

To answer this question it is better to first address the market access barriers for imports.

Barriers to the importation of dairy products to Australia

- 119. Unlike many countries, Australia provides essentially free access to its market for dairy products. Tariffs on almost dairy product imports are set at zero, and this situation is reinforced by free trade commitments under agreements with major producers such as New Zealand (ANZCERTA 1983) and the USA (AUSFTA 2004).
- 120. Under WTO rules, Australia does apply a tariff rate quota (TRQ) on certain cheese imports from the European Union³⁷. However, the TRQ is not binding. Due to steadily growing domestic demand for specialty cheeses, importer companies regularly enter cheese volumes from the EU in excess of the TRQ limit.
- 121. As with all food products, imported dairy foods are required to meet jointly agreed Australian-NZ food and documentation standards (or recognised third country equivalent standards).

The current importers of dairy product to Australia, their relevant products and suppliers

- 122. I cannot provide specific detail of relevant importing firms, their products and their suppliers. This is because the ABS does not publish trade data at a level that will allow the identification of specific product importers, their domestic customers or their overseas supplier.
- 123. As Tables 4, 6 and 8 showed, imports account for a significant (and growing) share of Australian dairy consumption in key dairy categories. In FY2013 Australia imported over 73,000 tonnes of cheese (about double the amount it imported in 2000). Imports now account for about a quarter of local cheese consumption. Firms also entered 17,000 tonnes of butterfat products, 30,000 tonnes of milk powder and whey powders and over 20 million litres of ice cream in FY2013. So imports accounted for 20, 40 and 5 per cent of local consumption of these products respectively last year. These high import penetration levels mean that, even if Australian dairy were to shrink

³⁷ A tariff rate quota does not set an absolute limit on the volume of product that may enter a market. Rather it identifies a threshold volume, in this case 11,000 tonnes p.a. Imports entering below this threshold attract a minimal duty (10c per kg). Imports that entering above the threshold must pay a higher duty rate (currently \$1.22 per kg).

back to focus purely on domestic outlets, there is no commercial guarantee that it will have the market to itself. Imports are a fact of life in Australian dairy consumption. Anecdotally, it is difficult for Australian firms to differentiate themselves from New Zealand product in the local market.

124. In terms of Since New Zealand is the dominant import source of dairy product entering Australia it is logical to assume that Fonterra has a major role in this trade.
125. Major supermarkets are significant outlets for branded New Zealand cheese lines but I cannot identify whether these purchases are organised directly from Fonterra or via third party import agents.
126. Australia has a well-established network of cheese importer/distributor firms that enter and distribute cheeses and other dairy ingredients for sale to local supermarkets, restaurants and specialty retail outlets. Much of the EU cheese that is sold in Australia would enter through these distributors. These firms often distribute imported lines in conjunction with local products. The large Chinese dairy company, Bright Foods, recently secured a 75% stake in Manassen Foods, one of the larger importer/distributors of local and imported cheese brands.
127. There are a range of companies who use imported milk powder and butterfat. These include:
 - a. Firms who dry blend product with local ingredients to make health and nutritional supplements for domestic sale and/or re-export
 - b. Domestic manufacturers of products including bakeries, biscuit, desserts, ice cream etc.
 - c. Local dairy manufacturers adding imported ingredients to blended nutritional products or processed cheese manufacturing.
128. Some of these firms will import product directly from overseas dairy manufacturers. Others buy product from a broad range of international trading houses that operate in Australia and overseas such as Hoogwegt.
129. The emergence of the US as a supplier of bulk ingredients in recent years reflects the ongoing price competitiveness of this segment of the Australian food processing market (and the importance of exchange rate movements in the direction and volume of dairy trade).

The facilities and distribution arrangements necessary for importation

130. The import trade for dairy essentially requires importer/distributors to have the capacity to handle containerised sea cargo and to warehouse and distribute products via refrigerated road transport. There appears to be well established infrastructure and capacity in these three areas in all major capitals. Given the open access provided to Australia I have no reason to believe that there are any significant hurdles to this trade expanding in future years.

Question 9. Dairy Exporters and Export Constraints

Based on your expertise and experience please provide details of

- (a) Current exporters of dairy product to Australia, their relevant products and their markets
- (b) Any barriers to the exportation of dairy products to Australia and
- (c) the facilities and distribution arrangements necessary for exportation of dairy products, their capacity and who has ownership or control over these facilities and arrangements

Current exporters of dairy product to Australia, their relevant products and their markets

129. Of the six major dairy companies listed in Table 2, four are significant exporters - Murray Goulburn, Fonterra, WCB and Bega. Other regional firms like Burra Foods, Longwarry and Harvey Fresh export a significant part of their annual output. Australian dairy exporters employ a mixture of distribution channels into export markets including direct customer contracts, sales through local and international trading houses and the placement of product on the international *Global DairyTrade* on-line auction system.
130. While their importance will vary by channel the key markets for Australia by volume and value are Japan, China, the nations of ASEAN, New Zealand, the United Arab Emirates, Korea and Taiwan.
131. As with import trade, detailed company level data on exports of dairy products and export customers is held confidentially but not released by the ABS and or DA.
132. Among Australian companies MG is the largest dairy exporter, with sales to over 50 countries. It operates sales offices in 3 countries. According to its 2013 Annual report, export sales account for 48 per cent of the firm's annual sales revenue. While they account for a slightly lower proportion of the company production by volume (45 per cent), it is likely that exports will account for over 50 per cent of MG's milk solids intake³⁸.
133. 75 per cent of MG's export sales are consumed in Asia, followed by the Middle East and the USA. Key export products and markets are:
- a. Cheese –Japan, North Asia and the Middle East
 - b. Milk powders and butterfat - ASEAN, China
 - c. Infant formulas, specialty ingredients – China, USA, South East Asia.

³⁸ For example, many export sales for products like cheese and milk powder will be large scale units (20 kg) compared with domestic sales that may be for 250-1 kg packages that have a higher per unit wholesale price.

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134. Export sales account for a similar proportion of WCB sales revenues. By product, WCB exports:
- a. 40 per cent of cheese production to Japan, the Middle East, Korea and USA
 - b. over 90 per cent of its SMP to the Middle east, Japan, China
 - c. over 90 per cent of its Whey products to Japan, China and the USA
 - d. a smaller percentage of butter to Japan, Korea and the Middle East
 - e. most of the Galacto-oligosaccharide ingredient produced with its Great Ocean Ingredients joint venture, while its planned lactoferrin specialty ingredient will be sold to China.
135. The percentage of Fonterra's Australian production that the company exports has varied over time, subject to internal company decisions about the sourcing of product for Fonterra's global supply network. In recent years recorded powder mixture exports from Australia to New Zealand have risen sharply. Given New Zealand's small population, my assumption is that much of this trade would involve Fonterra product (and also other firms) that will be re-blended with other ingredients in that country before being re-exported to third countries.
136. Exports account for around 25 per cent of Bega's overall sales revenue. However, the export orientation of its different processing facilities varies widely. Most of the output of its plant in Tatura, Victoria – milk powders, infant formula and cream cheeses - is destined for export sale in North Asia and the Middle East.
137. Other milk powder manufacturers like Burra Foods sell a high percentage of their output to customers in North and South East Asia and the Middle East.

Barriers to the exportation of dairy products to Australia

138. There are many barriers to the successful export of Australian dairy products. At a policy level these include widespread government restrictions on dairy access to specific dairy markets and the emerging impact on international trade flows of bilateral and regional trade agreements

Trade Policy and Dairy Trade

139. Dairy production is widespread, and almost every country has a domestic dairy industry. Most dairy products are consumed in their country of production. So despite a steady growth in world dairy consumption, the international dairy market still represents only a minor fraction of world dairy production/consumption (under 10%). Milk production in large dairy producing countries

such as the EU, USA, India and Russia all substantially exceed the international traded dairy market on a milk equivalent basis. Australia is a very small player in world dairy (just over 1 per cent of production).

140. A corollary of most countries having a domestic dairy industry is that many governments have acted to protect local milk production from import trade (regardless of the local industry's global cost competitiveness or efficiency). As a result, dairy exports to many countries face explicit bans, binding import quotas, or very high tariffs (+100% rates of landed import value are common)³⁹. A significant share of current world dairy trade is conducted under bilateral quota arrangements (e.g. EU cheese exports to the US, New Zealand exports of butter to the EU). These quotas exclude competition from third country export suppliers.
141. Countries also impose technical barriers to restrict import entry or reduce the commercial viability of export sales to their market. These range from local content schemes (Malaysia, Japan)⁴⁰, specified end user requirements (Japan), extended factory inspection and registration systems (Russia) or restrictive food testing regimes (Thailand). In the absence of substantial WTO reforms, this situation is likely to remain in force for a considerable time.
142. The recent rapid expansion in regional and bilateral trade agreements (the WTO has registered over 400 of these in the last 20 years) also acts as a potential barrier to exports. Under these agreements, importers provide preferential access to exporter signatories in the form of exclusive quotas or significantly lower tariff rates on dairy imports relative to the rates applied to product from other countries. In most cases these preference deals outweigh the commercial competitiveness of exports from non-signatory countries and so reduce export trade.
143. Australian dairy exports to growth markets of North Asia are at increasing risk from the progressive implementation of recent trade agreements to which we are not a party, including:
- a. The China New Zealand Free Trade agreement that allows NZ to enter milk powders, butter and cheese to that market at considerable duty discounts to Australian supplies (6-10%).
 - b. The NAFTA agreement gives US firms preferential access to Mexico's drinking milk, powder and butterfat markets

³⁹ Japan imposes a tariff on butter imports above a very small volume threshold of over 300%, Korea applies a tariff of 180% on the entry of certain milk powders.

⁴⁰ Malaysia allows fresh milk entry but not in consumer packs, and only issues licenses to import milk to competing local milk processors.

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- c. Korea's Free Trade Agreements with the EU and USA will see an increasing gap arise in the duty imposed on Australian exports to Korea versus their US and EU counterparts.

144. Commercial factors also interact with the above policy barriers to influence current and future Australian dairy exports. These include;
- a. The strength of the Australian dollar and its dampening (or positive) effect on export returns,
 - b. The small size of the world market relative to major dairy producer countries, and
 - c. The increasing scale/ globalisation of Australian dairy's export competitors and customers.
145. The impact of exchange rate movements on exports will be touched on in Question 9. The issue of scale and imports will be addressed later in Question 11.

The facilities and distribution arrangements necessary for exportation of dairy products

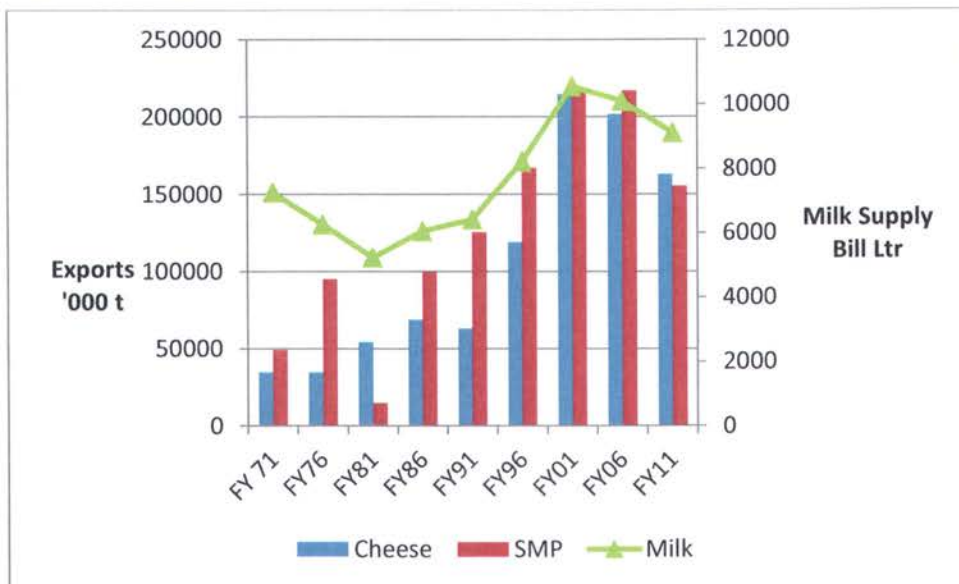
146. Most Australian dairy products are exported as containerised sea freight. Reflecting Victorian dairy's heavy export focus, Melbourne is the predominant export shipment point for local dairy. Conversely dairy is the most significant containerised export from the port of Melbourne. All local dairy exporter firms have well established networks and systems to facilitate this trade.
147. Obviously, as an industry or individual firms, Australian dairy has limited control over international shipping lines, routes and costs. However, there is ongoing investment at government level (e.g. dredging of Port Philip Bay channel) to try and ensure that there is sufficient suitable transport infrastructure to facilitate future Australian export growth.
148. Very limited volumes of high value, consumer products such as drinking milk are air freighted overseas. However, this trade is heavily linked to niche market opportunities in a range of Asian city locations. New carbon dioxide based preservation technologies may assist the industry's future flexibility in shifting the nature of products that are freighted overseas by allowing more processing to be carried out offshore. But this remains subject to more commercial testing.

Question 10. Factors Affecting Export Trade

Between 1970 and 2013 what factors contributed to increasing or falling exports from time to time throughout the period?

149. Export volumes from Australia have, and will continue to be, driven by a combination of macro (industry) and micro (company) level factors.
150. In general companies have only limited capacity to alter the mix of products they produce from milk within a season (especially during peak production periods). But over the longer term they can adjust their product mix to respond to changes in the level of import competition or variations in the absolute and comparative margins achievable from specific products and markets. Such responses will influence the observed level of export sales over time.
151. Company level investment decisions also have affected observed export flows from Australia (e.g. Fonterra's decision to supply international ice cream markets from New Zealand rather than WA, or DFG's decisions to shut its export-oriented mozzarella and casein plants in Queensland in favour of supplying domestic drinking milk markets).
152. At a macro industry level, the essential driver of export volumes from Australia over the past 40 years has been the level of local milk production and the extent to which local milk supply has exceeded the available commercial domestic demand for fresh milk and manufactured products.
153. The market for dairy products in Australia has ranged between 4,500 and 5,300 Million litres (on a milk equivalent basis) over this period, so industry has always been in a position where it has needed to find an alternative outlet for a substantial proportion of milk production (25 to 60%).
154. Unlike producers in some other countries (e.g. the US and EU), Australian dairy firms have had no recourse to government stockpiling or food aid regimes as a means of disposing of surplus production. Also the functionality of some dairy products (notably whole milk powder and cheese) alters over time. Coupled with high storage costs because of refrigeration requirements, local firms simply cannot store product indefinitely. So when production expanded, Australian firms have looked to increase export sales. When production has fallen, as in recent years, firms have carefully considered which market channels will generate the most value and return from a given intake of milk solids (after also taking account of factory utilisation and long term customer relationship issues). This close relationship between milk production and exports is clearly shown in Figure 9.

Figure 9: Comparative Movements in Australian Milk Supply, Exports 1971 to 2011



Source: ABARES Agricultural Commodity Statistics various editions

155. International factors also affect the profitability of Australian milk production and hence export availability.

156. Movements in exchange rates play a two part role here. They affect the local currency amount firms receive from US dollar denominated export sales. They also alter the affordability of dairy imports in many emerging consumer markets. Both these effects pass back into local company revenue from their milk intake and so, ultimately shape the longer term trend in local farm milk prices, profitability, farm confidence and milk production.

157. A general indication of this is Australian dairy's export performance post GFC. In practice, the GFC's direct effects on world dairy prices and markets have passed. International major commodity prices in US dollar terms have recovered to, and in some cases exceeded, their pre-GFC levels.

158. But the GFC's impact for Australia lingers because of the resulting re-alignment of international economies, banking and exchange rates. In particular, the recent relative strength of the Australian dollar has reduced Australian dairy profitability. Almost all dairy export trade is conducted on a US\$ contract basis. So, while world prices in US dollar prices have recovered, in Australian currency terms they have not. The divergence in US dollar and local currency returns from exports in recent years is highlighted in Figure 10 below.

159. The high dollar is no doubt a factor behind the increased entry of US origin whey and cheese into more price sensitive sectors of the Australian domestic market.
160. More importantly the weaker \$A return from export markets has put pressure on the price that Australian dairy exporter companies can pay for farm gate milk. Victorian farm gate milk prices in recent years remain 20 per cent below their 2007/08 level.

Figure 10: Index of World Dairy Prices (US and Australian Dollar Basis)



Source: DA - Dairy Situation and Outlook report 2012

Question 11. Other Significant Events Shaping Local Industry

Between 2000 and 2013 what events or changes in circumstances occurred which had a major impact on the Australian dairy industry? To what extent have these events or changes had lasting or permanent negative effects on Australian dairy production and exports?

161. I have touched on many of the events and changes in circumstances that have affected Australian dairy over the past decade such as:
- a. Deregulation's effects on farm numbers and milk supply in different regions,
 - b. The impact of major climatic disturbances in many production regions,
 - c. The reduction in the national cow herd,
 - d. Increased farm debt and reduced farm profits
 - e. An upward movement in the Australian dollar, and its impact on export and domestic market pricing and competition
 - f. The effect of certain trade agreements on Australian competitiveness in key export markets
162. Of the above changes the reductions in farm numbers appears to be permanent shift. The others are all having ongoing effects on industry confidence and production but their impacts could be reversed in future, often for reasons outside Australian dairy's control (e.g. a decline in the Australian dollar based on slower Chinese growth, or changed US financial policy).
163. Some additional changes that warrant further discussion in terms of their longer term effect on future Australian milk production and exports are:
- a. Local farmer responses to climate variability;
 - b. The increased role of house brand milk and products in the Australian retail market; and
 - c. The evolving structure of overseas dairy competitors and customers.

A Shift in Farm Thinking

164. Australian dairy farmers have traditionally relied on home grown pasture as their primary feed-base. Feed lot operations remain rare in this country. Pasture feeding has been a cornerstone of Australia's international supply cost competitiveness.
165. However, over the past decade farmers have responded to greater climatic variability by adjusting their farm production systems to maximise long-term resilience and sustainability rather than maximising milk production. The supplementary feeding of cows with grains and other crops to boost per-cow production is one response. Over 95% of farms fed their cows an

average of 1.6 tonnes of feed (grain, hay or silage) in the FY2013 production season⁴¹. Farmers have also adjusted their operations to deal with reduced long-term access to irrigation water and increased customer traceability demands. Changes in company milk payment systems and the wider adoption on farm of more integrated pasture, feed and herd management techniques have reinforced these shifts in local production systems.

- 166. The increased use of purchased feed adds to per cow yields. But supplementary feeding, and other sustainability related practices has increased the underlying cost base of Australian dairy farming.
- 167. Australia remains competitive, but is no longer an extremely low cost milk producer by world standards. DA farm surveys suggest many farmers believe that milk returns have not risen sufficiently to cover their increased cost of production. In DA's 2013 National Dairy farmer Survey (NDFS), 61 per cent of all farms and 51% in West Victoria listed milk price and low profits as their major enterprise challenges.
- 168. Public debate on carbon pricing and water rights in various production regions has no doubted added to this emphasis on prices / cost pressure. The psychology of operating for extended periods for little perceived return (in an ambiguous policy environment regarding climate change and agriculture) no doubt has dampened farmer willingness to invest to expand milk production.
- 169. It has reduced farmer confidence that export market growth will deliver them sustainably higher prices and profits. If sustained, reduced farmer confidence and low farm profitability will slow local milk production growth and ultimately future export availability. A relevant statistic here is that over 40% of surveyed farmers in the 2013 NDFS indicated that they had no plan to expand milk supply in the next three years⁴².

House Brand Milk and Products

- 170. In the early 2000s Australia's liquid milk sector had three major processors competing to supply two dominant supermarkets. The supermarkets, in turn, were seeking to expand their sales of own label house brand lines. An early outcome of this competition was that one firm, DFG, in order to protect a NSW supermarket contract, massively discounted their offer price for plain white milk to secure the ongoing contract and associated milk volumes. Their success set a new lower benchmark price for future contracts and took a significant chunk of value out of the dairy

⁴¹ DA - *Australian Dairy in Focus* 2013

⁴² A further breakdown of these farms showed that roughly half the respondents were happy with current production levels while the other half felt they were unable to expand because of the state of their business.

chain in the drinking milk states that industry has never recovered. It also marked the shift away from company-branded lines to generic house brands in major local supermarkets.

171. As an example, supermarket sales of generic plain white milk jumped from 121 M to 260 M litres between FY2000 and FY2001⁴³. The average selling price for this milk also fell from \$1.23 to \$1.04 per litre. Company branded plain white milk sales in the same period fell by 122 M litres (and unit prices also fell by 6c per litre as firms discounted to hold market share). So dairy sold more drinking milk immediately after deregulation but achieved lower sales revenue. Since then, house brand sales have continued to grow.
172. Subsequent decisions by firms to extend house brand contracts to include modified skim milks etc. put further pressure on domestic milk processing margins and ultimately farm gate returns in the drinking milk states. Supermarkets sold only 17 M litres of house-brand modified milk in FY2000. This jumped to 150 M litres by FY2005 (at a retail price below the FY2000 level) and now stands at 240 M litres (at even more discounted prices)⁴⁴.
173. The introduction of \$1.00 per litre pricing for their house brand lines by all major supermarkets in 2011 has reinforced the position of house brand milk in local consumption. These lines now account for 59 per cent of fresh white milk sales and over half of all domestic milk sales⁴⁵.
174. Accordingly, house brand contracts, and the serious potential disruption caused by their loss, have become a major factor in domestic drinking milk processor business thinking - especially as they have wound back their alternative non-drinking milk manufacturing capacity. The entry of MG into a long term house brand supply arrangement with Coles will add to the competitive pressures in this sector, and have flow effects for regional milk supplies in different states.

International Commercial and Policy Developments

175. The scale and structure of major dairy companies and buyers and shifts in policy direction in major producer countries are important in determining whether Australian dairy processing will continue to have the size and scale of operation needed to remain a globally competitive supplier of safe dairy products and ingredients.

⁴³ DA – *Dairy Situation and Outlook Report 2004*

⁴⁴ DA – *Dairy in Focus 2006*

⁴⁵ DA – *Dairy Situation and Outlook Report 2013*

176. The size of large dairy producers like the EU and US mean that relatively small production shifts in these countries can significantly alter the international supply demand balance for dairy and fundamentally affect export pricing and market returns. In this context, the EU is planning to remove domestic milk production quotas after 2015 which will likely see a substantial lift in export availability from that region from 2016/17. The Irish government has announced plans to support a 50% expansion of local milk production post-2015.
177. Most large dairy firms in the US and EU are gearing up for export growth. Some of these firms are very large and can use their large domestic market bases to cross-subsidize marginal growth in export sales, at the expense of smaller export competitors like Australia.
178. As a company level, world dairy has also become increasingly concentrated over the past two decades with some 400-500 dairy company mergers and takeovers having occurred. Table 7 below lists the current 20 largest dairy companies in the world (as defined by RaboBank) and their turnovers compared to the local participants in the WCB takeover process.

Table 7: Major Global Dairy Companies 2012

Company	Business Structure	Headquarters	Dairy Turnover FY2013 (US Billion)	<u>RaboBank</u> 1999	<u>Ranking</u> 2012
Nestle	PLC	Switzerland	30.1	1	1
Danone	PLC	France	19.4	3	2
Lactalis	PLC	France	18.0	8	3
Fonterra	Coop	NZ	16.0	(a)	4
Freisland/Campina	Coop	Netherlands	12.1	(a)	5
Arla Foods	Coop	Denmark	10.8	(a)	7
Dean Foods	PLC	USA	8.8	16	8
Saputo	PLC	Canada	8.4	(b)	9
Meiji	PLC	Japan	7.7	15	10
Unilever	PLC	Netherlands	7.5	11	11
Yili	PLC	China	6.5	(b)	12
Morinaga	PLC	Japan	5.8	17	13
Mengniu	PLC	China	5.7	(b)	15
Australia					
Murray Goulburn	Coop		2.4	(b)	(b)
WCB	PLC		0.5	(b)	(b)
Bega	PLC		1.0	(b)	(b)

Notes

Source Company reports, Rabobank Global Dairy Top 20 Aug 2013

(a) Current company structure did not exist in 1999

(b) Revenue insufficient to make RaboBank list

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179. Table 7 is instructive in several ways. According to RaboBank the trend to consolidation in world dairy continues. 19 of its listed top 20 dairy firms in 2012 had undertaken new acquisitions, joint ventures or some form of capital restructure since 2010. Nestles' dairy turnover more than doubled from \$US 13 to \$US 30 Billion between 1999 and 2012.
180. The emergence of large Chinese dairy companies also highlights the organic growth of the Chinese market and the importance of exporters having the capacity and size to deal effectively with them in this major growth market.
181. Table 7 also highlights that cooperatives have achieved global scale of operation through amalgamation in a number of Australia's current export competitors.
182. Three of the Rabobank list are co-operatives.
183. **Fonterra** resulted from the 2001 merger of the Kiwi and NZDG cooperatives and the injection of the international business assets previously held by the NZ Dairy Board. The merged business accounts for over 90% of NZ milk supplies (and required a government over-ride of Competition Commission objections to commence operations).
184. **Arla Foods** was formed from the amalgamation in 2000 of Arla (which processed 60% of Sweden's milk) and MD Foods (which following several previous mergers processed 90% of Denmark's milk). It now processes over 10,000 Million litres of milk annually.
185. **Freisland/Campina** was formed in 2007 following a progressive series of mergers of Dutch, German and Belgian cooperatives and dominated dairy collections in that country.
186. Outside the top 20 are other cooperatives such as Ireland's Glanbia, where the farmer cooperative retains significant ownership of the merged downstream processor - Glanbia PLC - the dominant dairy firm in that country.
187. All these companies now operate in multiple countries via a range of joint venture and subsidiary operations. In each case, the company's farmer owners have traded off having multiple competitors for their farm gate milk in order to secure processing and marketing scale and synergies needed to compete in an increasingly deregulated world dairy market.

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188. A number of the listed dairy companies (including Nestle, Unilever, Danone, Meiji, Morinaga and Mengniu) are not only major producers. They are major international buyers of dairy products in their own right. While difficult to confirm, Nestles global dairy purchases of dairy inputs, in volume terms, must rival the total consumption of dairy products in Australia.
189. This internationalisation is not confined to dairy buyers, with global players emerging in many sectors of food service, pharmaceutical, health and infant formula distribution. The pressure for more global contracting by these buyers highlights the importance of export oriented producers having appropriate structures and capacities in place that allow them to deal effectively with major buyers and their integrated procurement and distribution systems.

Question 12. Dairy Consumption Opportunities

In your opinion is there potential for

- (a) increased domestic sales of dairy products
- (b) growth of domestic sales of dairy products by individual dairy producers
- (c) increased exports and/or imports for any dairy products?

190. From a demand perspective, there is some disconnect between recent the slowdown in Australian dairy production trends and available market opportunities , both domestic and international.

Scope for increased domestic sales of dairy

189. While Australians see many dairy products as “staple” foods (e.g. milk, cheese, yogurt and butter) there is scope for increased domestic sales of most products. Aggregate domestic consumption of dairy foods has grown fairly steadily over the past two decades from 4,500 to 5,300 Million litres (on a milk equivalent basis). Underlying per capita consumption trends for most dairy foods remain strong, based on a range of variables including taste, cultural influences on diet, positive health perceptions around dairy, community attitudes on sustainability, new product developments, out of home consumption etc. DA has estimated the movements in per capita consumption of major dairy products from 2007 to 2013 were:

- Drinking milk rose from 100 to 107 litres (+7%)
- Cheese rose from 12.2 to 13.5 kg (+11%)
- Butter and dairy spreads dropped from 3.9 to 3.7 kg (-5%)
- Yogurt rose from 6.8 to 7.6 kg per head (+12%)
- Ice cream was stable at 18 litres per head

190. Australia’s emerging coffee culture, and lower retail pricing has underpinned the rising demand for drinking milk. Within the milk category there has also been a shift to increased consumption of reduced fat, flavoured and UHT lines at the expense of traditional full cream milk.
191. New product offerings, dietary and cooking changes and out of home consumption trends will continue to favour rising per capita consumption of yogurt and cheeses. In the case of cheese these trends should favour products sold as specialty food lines ahead of traditional supermarket sales of cheddar, which will probably grow in line with population growth. The growing demand for health foods and formulas offers scope for continued rising consumption of specific dairy components such as whey proteins, whey powders, isolates, lactose, lactoferrin etc.

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192. Research findings on milk's potential as a high performance exercise recovery drink and in the promotion of muscle growth also offer scope for a possible quantum step up in demand in this core category in coming years.
193. While the demand outlook is positive, on balance, the domestic dairy market is relatively mature in most categories. So, as with many other developed Western economies, dairy consumption in Australia is likely to trend slightly ahead of population growth rates.

Growth of domestic sales of dairy products by individual dairy producers

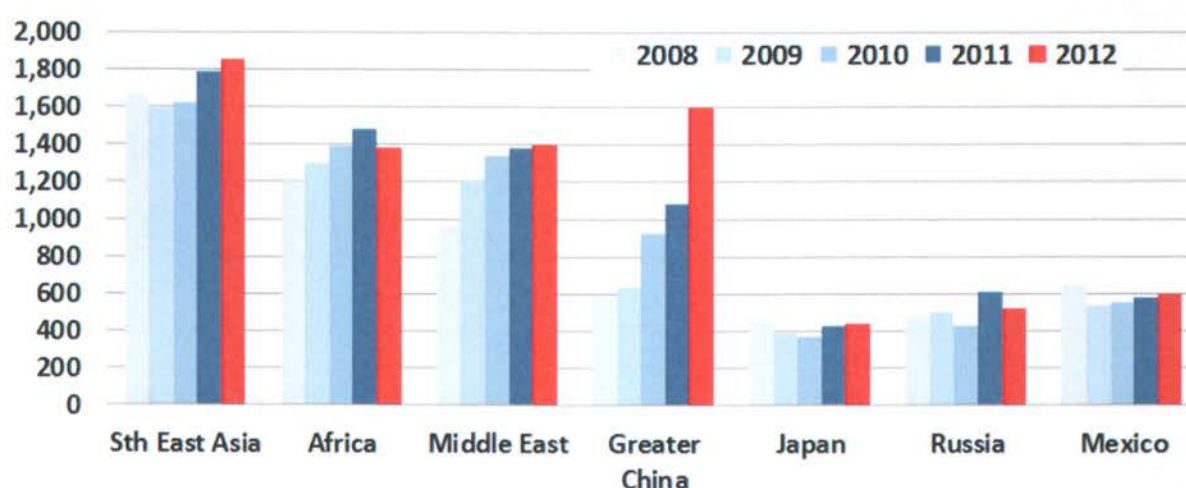
194. With its new production facilities MG appears well placed to position itself to participate in the likely growth in demand for both fresh and UHT milks.
195. All major firms are engaged in domestic cheddar market sales, so there should be substantial ongoing competition in this sector. Lion Dairy appears well placed to take advantage of the continuing growth in demand for specialty cheeses, especially given the potential it has to secure logistics and processing efficiencies through its centralised factory location.
196. New niche players such as A2 and Chobani appear well placed to secure significant growth in retail yogurt sales built on innovative products and market positioning.

Scope for increased exports and/or imports for any dairy products

197. As Tables 6 and 8 showed, imports of dairy product have continued to rise over the past decade. Given the open, price sensitive nature of the local food service and industrial food processing segments this trend could continue. In part, the rate of future import growth will depend on the viability, competitiveness and growth of domestic dairy ingredient production, which in turn is linked to the scale and relative processing efficiency of local firms.
198. The potential for export sales growth remains very real, provided Australian firms retain their international cost efficiency. Numerous bodies (FAO, ABARES, World Bank, Rabobank, Dairy Australia) have concluded that the growth potential for international dairy consumption and trade in the coming decades is extremely strong, particularly in milk-deficit areas of Asia, the Americas and the Middle East). International demand has been, and is likely, to continue to be driven by a range of factors including:

- a. Population and income growth. The World Bank estimates world population will rise by a further 1 billion by 2020 and exceed 9 billion by 2030, while the number of middle class consumers in Asia will treble from 2010 to 2030,.
- b. Increasing consumer awareness of dairy's strong health and nutritional platform
- c. Changing dietary demands and tastes, linked to income and rising urbanisation,
- d. Dairy's functionality as a food and pharmaceutical ingredient, and.
- e. The difficulty many countries have found in meeting local consumption growth with local milk sourcing.

Figure 10: Recent Trends in Dairy Imports In Major Markets (000 tonnes)



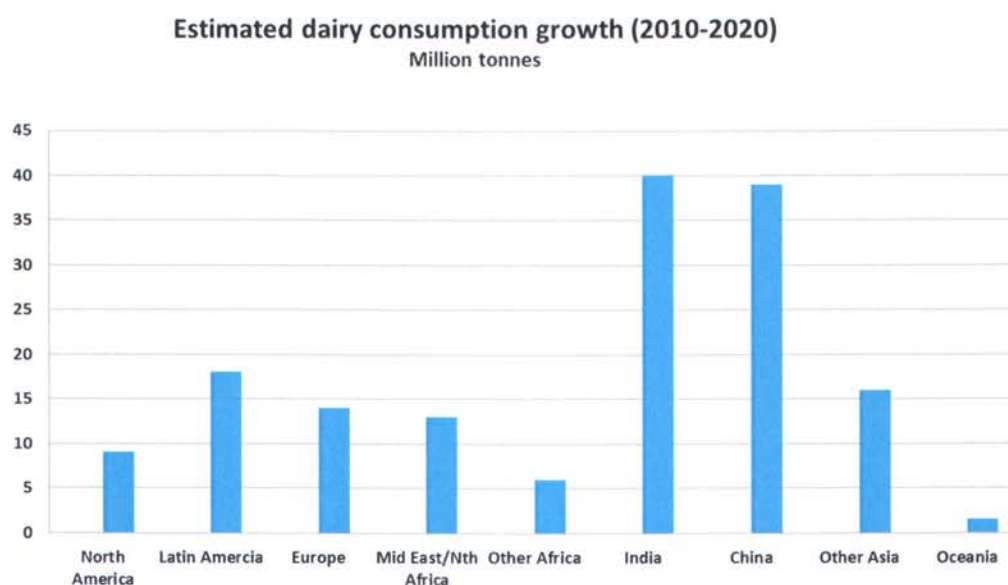
Source: DA - Dairy Situation and Outlook Report May 2013

199. As Figure 10 shows in the past decade Greater China (i.e. including Hong Kong) has emerged as a major player in world dairy trade. While China has a significant domestic dairy industry that annually produces 34,000 Million litres of milk (over 3 times Australia's recent output) it has been unable to maintain production in line with its booming domestic consumption. China's dairy imports have risen from about 400,000 tonnes in 2005 to over 1.6 million tonnes in 2012 making it the world's largest single import market. Imports now account around 20 per cent of Chinese dairy consumption and RaboBank⁴⁶ and others estimate that China's demand for imports will continue to grow over the next decade based on:

⁴⁶ China's Raw Milk Supply - Still dreaming of A White River - H Moynihan October 2013

- A restructuring of farm level production (from very small to large scale operations) that is slowing internal milk supply growth
- An ongoing active consumer preference for imported infant formulas and milk following earlier local food contamination scandals
- Rising incomes driving dietary changes (and demand for Western cheese and milk⁴⁷)
- Improved import and refrigerated freight distribution networks, and
- A planned relaxation of the national “one-child” policy.

Figure 11



Source : International Dairy Federation forecasts

200. Figure 11 indicates that India, with a strong history of dairy consumption, is expected to be another centre of world dairy consumption growth in coming years (driven by rising incomes and favourable demographics). An October 2013 Dairy Reporter study⁴⁸ (conducted by Mintel) predicts Indian dairy sales will grow at a compound annual rate of 14% p.a. over the next five years, making it the leading growth market in the world. However, India’s dairy lobby and several regional governments maintain a strong commitment to local self- sufficiency, so the growth potential for imports will depend on the success or otherwise of recent Indian initiatives to rapidly expand their cow herd.

⁴⁷ For example Australia exported 14,500 tonnes of cheese and 21 Million litres of milk to China in FY2013.

⁴⁸ Dairy Reporter –Worldwide Dairy Market Growth –October 13 , 2013

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201. Japan has long been a major import market for dairy, particularly cheese and skim milk powder. Japan's per capita consumption of dairy is very high relative to other Asian countries (75 kg per head compared to 15-30 kg), and has stabilised in recent years. This combined with the country's slow rate of population and economic growth will limit the rate of future Import demand growth for dairy.
202. The countries of ASEAN are strong potential growth markets driven by combinations of income and population growth, product innovation and health perceptions for dairy plus input requirements for emerging processed food export industries. The Dairy Reporter study identified four ASEAN countries (Malaysia, Thailand, Vietnam and Indonesia among the fastest growing dairy markets to 2020. These countries already rely heavily on imports to meet local demand so continued market growth should underpin international trade and prices. The caution on South East Asia is that some national markets are quite segmented with relatively small premium price consumer segments at this stage. Other market segments can be quite price-competitive and trade volumes can be subject to exchange rate induced movements in import affordability.
203. Other major import markets which are expected to continue to grow include Russia, Brazil, Mexico, Algeria and Nigeria. Australian firms, however, will have difficulty prioritising these regions because of ongoing freight disadvantages against other export competitors.

Question 13. Factors Affecting Future Australian Dairy Exports

Based on your expertise and experience:

- (a) What constraints are there on exports from Australia?
- (b) What factors will promote growth in Australian dairy production and exports?
- (c) What impacts would likely result from growth in dairy product exports?

204. Given its location, its open export-oriented industry structure and successful track record as a producer of safe, high quality dairy foods Australia has been seen as a logical supply source to meet this growing global demand, particularly in Asia. International dairy, food and pharmaceutical firms (like Mead Johnson, Nestle, Snow Brand) are using Australia as one supply base for their market growth in Asia and nearby regions. Others like Saputo, Bright Foods and Wabasha of China have been exploring the scope to invest in Australia as an export base.

What constraints are there on dairy exports from Australia?

205. The pathway to Australia sharing in the international dairy market growth outlined in the previous answer is not totally straightforward. There are real and potential constraints to Australia's export growth arising from:
- a. The trade diversion effects of existing trade agreements and their capacity to restrict commercial Australian access and supply competitiveness in key markets such as China
 - b. The small scale of Australia's processing operations relative to overseas competitors;
 - c. Rising buyer concern of Australia's capacity to integrate into their business growth plans given the slow rate of observed milk production growth in this country;
 - d. Potential reductions in long term water availability for irrigated agriculture and competition for land for alternative environmental uses.

What factors will promote growth in Australian dairy production and exports

206. A range of factors could promote an increase in Australian dairy exports in coming years. The most basic of these are the steady growth in world dairy demand, the difficulties countries like China are having in meeting this growth through domestic farm gate milk expansion and the very positive attitudes many Asian buyers have to sourcing product from safe and reliable production regions like Australia. Other outcomes that will assist Australian dairy export growth (either by themselves or in tandem with other factors) are:
- a. The successful conclusion of trade agreements between Australia and key countries such as China, Korea, Japan and the Gulf Cooperation Council. These are important to maintain our competitiveness in, and returns, from these key markets;

-
- b. Stable or rising world market pricing for dairy supported by continued economic growth in Asia and limited expansions in supply in Northern hemisphere producer countries,
 - c. Farmers and companies successfully applying emerging farm and factory technologies (e.g. robotic milking systems) and improvements in dairy farm business systems to boost business margins.

207. To rebuild and retain farmer confidence and returns and so generate the willingness needed to expand local milk production and exports:
- a. local processors must retain the production efficiency and scale needed to effectively compete with major companies from other dairy export nations,
 - b. Local manufacturing must retain the production flexibility needed to be able to adjust product mixes and shift greater volumes of milk into more value added consumer products and ingredients, rather than basic bulk commodity lines;
 - c. The Australian community must continue to hold favourable attitudes to dairy's sustainability performance and production ethics; and
 - d. Preferred overseas buyers must continue to believe that Australia remains a relevant business partner who they can reliably integrate into their business growth and sustainability plans.

What impacts would likely result from growth in dairy product exports

208. Export success, particularly if associated with a rising proportion of value added exports and hence higher unit returns on the milk solids embodied in products, will have positive flow on effects for both Australian companies and their farm suppliers.
209. There will be immediate benefits in many regions such as West Victoria where dairy is a major driver of local economic activity and employment, not just at farm level but also through its integrated production chain.

Question 14. Effect of an MG / WCB Merger

Based on your experience and expertise what effect would a merger between Murray Goulburn and WCB be likely to have on the level of :

- Exports by MG and WCB
- Other exports from Australia
- Australian dairy production

210. Before assessing the specific elements of this question I feel it is important to make several general comments which also apply to my answers for Questions 15 and 16.

211. Faced with growing domestic and world market opportunities but a relatively small scale of operation it seems to me that two key questions facing Australian dairy manufacturers and their farmer suppliers are:

- Does Australia see itself as an ongoing player in the growing world dairy market?
- and,
- If so, how should the industry structure and position local production and processing to maximise Australia's chances of effectively and profitably participating in a growing market for dairy, while generating sustainable income flows, investment returns and employment across regional Australia?

212. All three takeover proposals for WCB appear to answer to the first question as yes. They take alternative approaches to addressing the second of these questions, namely:

- a. Linking Australian production into a global firm's sales and marketing platform (Saputo)
- b. Consolidating two smaller proprietary firms to generate marketing synergies and form a smart, but niche, operator that sells (limited) branded product and ingredients to major global players under long term supply arrangements (Bega)
- c. Establishing a larger, supplier-owned operator that can maintain a globally competitive cost structure and use increased scale of operations and product mix flexibility to underpin a growth strategy based on pushing milk towards higher value growth markets and customers and reducing the impact of market volatility on returns (MG)

213. The likely impact of the different takeover proposals on individual company exports and regional and national milk and production is not straightforward. It will depend on several, as yet unknown, reactions and outcomes including:

-
- a. The impact of the takeover on farmer confidence in the region and beyond and, hence, farmer willingness to invest and grow local milk supply (recognising that milk pricing, low farm profits, input costs and access to suitable skills are the most common “enterprise challenges” listed by West Victorian and Australian dairy farmers);
 - b. The operational synergies achievable by the new firm and the extent this would translate into higher, ongoing supplier returns and milk payments;
 - c. The extent to which the combined business can vary current product mixes and plant utilisation to generate new or more profitable domestic and export sales channels;
 - d. The extent to which the merger strengthen Australia’s collective market reach and position in key export markets, and any flow effects for other Australian suppliers resulting from this; and
 - e. The reaction of existing WCB business partners (Kraft, Freisland and Lion) to a change in ownership and whether the change triggers relevant change of ownership clauses and diversions in existing production patterns and locations.

Exports by MG and WCB

- 214. MG can use the proposed merger to generate operational synergies in areas such as administration, finance, marketing and exports (both MG and WCB have sales offices in Japan). Bega has estimated such saving publicly at \$8M per annum so there is reason to expect that MG can make at least similar gains.
- 215. Since it has significant milk collections and processing plants of its own in Western Victoria, MG would have considerable scope (certainly MORE than the other bidders) to generate logistical efficiencies and savings in its milk collection and product transport.
- 216. MG should also be able to more quickly adjust current factory throughputs and product mixes to improve plant profitability and maximise the combined firm’s potential to produce more high- value, higher margin products for export. This would help the firm more effectively target its integration with preferred export growth customers. This flexibility could come early on in relation to alternative uses for the 50-150 Million Litres of farm milk that WCB now collects and on-sells with minimal processing. It may come from some of the milk and cream volumes that WCB now has processed under toll manufacturing arrangements.

-
217. The merged entity's improved bargaining position with domestic supermarket chains should assist returns over time and it can consolidate the supply of high value ingredients like Lactoferrin to export markets like China. A merger would also reduce supply competition in specific export markets such as Japan and the USA.
218. A merged MG/WCB would process around 4,000 Million litres of milk. In volume terms this would give it reasonable global scale (although competitors like Fonterra and Arla would process considerably larger volumes)⁴⁹. But the merged company would remain well outside the world's top dairy companies in turnover terms.
219. These factors suggest that the MG/WCB merger would have a positive effect on both aggregate company exports and export unit values.

Impact on other exports

220. The aggregate impact of this merger on other Australian exports should be limited, but depends on the resulting farmer responses (in terms of milk supply and switching between companies. In export markets, there could also be some export adjustments as different buyers respond to the changed commercial structure in Australia.

Impact of dairy production

221. If the MG/WCB merger achieves the possible operational synergies and product mix gains, this should flow through into higher farm gate returns and (over time) higher milk production in South Eastern Australia. How significant this production response is, will be difficult to quantify or isolate as it will occur in parallel with other market, climate and exchange rate developments.
222. An MG/WCB merger would see a reduction in the number of companies seeking to milk at farm gate in Western Victoria and South East South Australia. I do not expect this would reduce milk prices (and hence milk production) in the region for several reasons.
223. Firstly, farm gate milk prices in the region will continue to be determined largely by three factors - international market returns, the processing and marketing efficiency of local firms and their capacity to develop and pursue added value product sales. The merger would have little

⁴⁹ Fonterra processes over four times this volume within its Oceania operations alone, while Arla processes in excess of 10,000 Million litres annually.

impact on the first, and major, price driver. The merged firm will remain essentially a price taker on world markets as were the two independent operations.

224. Secondly, there would still be solid regional competition for farm gate milk from firms such as Fonterra (which has recently invested to expand capacity at its Cobden and Dennington plants) and from UDP which has cheese manufacturing operations in SA. Smaller fresh product players like Aussie Farmers Direct, who are targeting the growing non-retail home delivery trade, would also provide alternative outlets for farm supply. Bega could continue to compete for milk supply to transport to its Tatura operations, as could newly emerging milk brokers.
225. The new firm has the capacity to improve operational efficiency and increase sales returns from all markets. As it will remain a co-operative it should continue to seek to maximise both potential milk intakes and farm gate returns for suppliers. This suggests a positive effect on dairy farm gate prices and production.
226. As noted before in Question 13, farmer owner suppliers of major cooperatives overseas have agreed to trade off competition for farm gate milk in order to invest in processing businesses that can build larger, world-scale processing and marketing platforms. They have seen this as a legitimate, and necessary, response to the increasing internationalisation and concentration of dairy producers, customers and markets.
227. One issue relating to the production effect of an MG/WCB merger could be the impact on farmer confidence of a rise in expected company gearing to achieve the merger. Gearing issues have been addressed successfully by overseas cooperatives such as Fonterra and MG have announced strategies to do likewise. In the interim, debt may be an issue affecting farmer perceptions and attitudes, and hence production responses, to a MG/WCB merger.

Question 15. Effect of a Bega Cheese / WCB Merger

Based on your experience and expertise what effect would a merger between Bega Cheese Limited and WCB be likely to have on the level of:

- (a) Exports by MG and WCB
- (b) Other exports from Australia
- (c) Australian dairy production

Exports by MG and WCB

228. Given the geographic locations and milk intakes and operations of their respective plants, a Bega takeover of **WCB** should have limited regional production and export effects.
229. Bega is a company that is much closer in scale of operation to WCB. Like WCB it also undertakes a higher proportion of toll manufacturing under long term contracts than the other potential takeover partners (e.g. WCB produces cheese for both Lion and Kraft domestically, Bega produces powders, formulas for firms like Mead Johnson, Snow Brand).
230. The firm would remain relatively small by world scale (processing up to 1,500 Million litres per annum). As Bega has very limited milk collection in South West Victoria this merger should have minimal impacts on farm gate supply competition.
231. Bega has stated it would use the takeover to generate around \$8M annually in operational synergies (most likely in administration, marketing, domestic and export sales and finance). It has also said it would use the consolidated structure to create extra value and returns across its broader supply chain. This suggests Bega would seek to leverage the combined operation's higher production volumes to improve long term supply arrangements with the firm's larger domestic and international buyers.
232. Bega may be able to generate supply and export marketing synergies in those product categories where it and WCB's product mix overlaps - cream cheese, SMP and lactoferrin. Before this can happen, however, Bega would have to address contractual issues relating to WCB's lactoferrin licensing arrangements with Tatua (NZ) and its two way toll manufacture arrangement with Kraft Foods for the production of cream cheese and low fat cheddar lines.
233. As MG is engaged in SMP, cream cheese and Lacttoferrin production and export a Bega merger would have market implications for it. But these should not dramatically affect aggregate MG's export sales or returns.

Impacts on Australian Dairy production

234. Bega's shareholding structure and individual shareholding limit should help ensure the, relatively limited, financial benefits of a merger flow on to support farm gate prices, milk production and incomes within the relevant catchment communities in West and Northern Victoria and Southern NSW (at least until 2016 when the shareholder limit is open for shareholder removal).
235. On balance I expect that the milk production response to this merger would be small in national industry terms.

Question 16. Effects of a Saputo / WCB Merger

Based on your experience and expertise what effect would a merger between Saputo Inc. and WCB be likely to have on the level of:

- (a) Exports by MG and WCB
- (b) Other exports from Australia
- (c) Australian dairy production

Exports by MG and WCB

236. Saputo's entry to Australia would continue a long trend of overseas investment in existing Australian dairy operations. I see Saputo using the WCB plant to supply local and overseas markets and expand its corporate presence in Australia and the Asian region.
237. The ultimate outcome for WCB exports would depend on current WCB partner responses. There are questions over the Great Ocean Ingredients joint venture as this has specific provisions relating to WCB's sale to a Rabobank Top 20 competitor of its current partner Friesland (which Saputo is).
238. Saputo's extensive US food service links through its Morningstar and Fairmont Cheese subsidiaries could see it expand WCB cheese sales to the US. In the absence of new milk intake any such sales would potentially involve a redirection of trade from other existing WCB export markets.

Impact on Other Exports from Australia

239. In terms of milk flows, product mix and market outlets this proposal appears to be largely a continuation of existing business operations. There would be no obvious change in either WCB's export supply and market positioning (or that of local competitors like MG) unless Saputo seeks to use its financial scale to aggressively pursue more branded product positioning in designated markets.
240. While Saputo has a strong regional presence in the Americas I do not know how strong a branding and sales platform it has in Asia and the Middle East, where WCB now sells. Ultimately Saputo will seek to use Australian supply as part of building its global corporate position.

Impact on Australian dairy production

241. Assuming Saputo can generate a suitable return on its investment, its takeover of WCB should have very limited effect of regional competition for farm gate milk supply.

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242. In practice a Saputo takeover would link a smaller-scale Australian processor to a large global firm's international production, marketing and sales network (like Fonterra's earlier takeover of Bonlac's interests). There could be a positive short term production response to a new entrant to the market, especially if there is aggressive targeting of farm supply. But, a continued expansion in production is not guaranteed, without steady gains in farm gate pricing .
243. Ownership of WCB will transfer to Canada, and its future growth will become linked to how it performs relative to other divisions of the company. In this context Saputo has shown in recent years that it is prepared to withdraw from overseas dairy investments and plants if they do not reach "critical mass" or generate sufficient rates of corporate return - as evidenced by its closure of purchased plants in Wales and Germany in the past two years.

Declaration

I declare that in compiling this report I have made all the inquiries that I believe are desirable and appropriate and that no matters of significance that I regard as relevant here have to my knowledge been withheld from the Court

Signed



Christopher Phillips

26 November 2013

Attachments

1 List of Questions provided by Herbert Smith Freehills



HERBERT
SMITH
FREEHILLS

Chris Phillips
cljp@me.com

11 November 2013
Matter 82230139
By Email

Dear Mr Phillips

Murray Goulburn – merger authorisation application – expert report

1 Instructions

We refer to our letter sent earlier today in which we set out the terms of your retainer to act as independent expert.

Below we provide the list of questions that you are retained to provide an opinion on.

2 Questions for opinion

You are asked to provide an opinion on the following questions:

- 1 Provide a brief summary of the dairy industry, in particular please describe:
 - (a) where dairy producing regions are located;
 - (b) the size of farms / volumes of milk produced in those regions;
 - (c) who the main milk purchasers / dairy producers are and the locations they collect or otherwise acquire milk from;
 - (d) the arrangements under which milk is acquired from farmers and the mechanisms by which prices are set;
 - (e) the supply chain in the dairy industry;
 - (f) the products made from milk; and
 - (g) the regions in which the products are generally manufactured.
- 2 Between 1970 and 2013, what has been the total production of milk and dairy products in Australia, and what factors contributed to increasing or falling production from time to time throughout that period?
- 3 What acquisitions have occurred in the Australian dairy industry during the past five years? What, if any, impact have these acquisitions had on the dairy industry?

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- 4 Between 1970 and 2013, what has been the farm gate price of milk, and what factors contributed to increasing or falling prices from time to time throughout that period?
- 5 How are Australian domestic prices for supply of milk affected by the world prices of dairy products?
- 6 Based on your experience, over the last 10 years, and in the various regions in which milk is produced, which dairy producers have been most influential in setting farm gate prices for milk?
- 7 What were the volume of exports and imports for the following dairy products between 1970 and current:
 - (a) white milk;
 - (b) flavoured milk;
 - (c) UHT milk;
 - (d) dairy desserts and yogurt;
 - (e) cheese (bulk / cut);
 - (f) milk powder;
 - (g) cream (bulk / packaged);
 - (h) butter;
 - (i) whey; and
 - (j) other dairy products?
- 8 Based on your expertise and experience, please provide details of:
 - (a) the current importers of dairy products to Australia, the relevant products and their suppliers;
 - (b) any barriers to the importation of dairy products to Australia; and

- (c) the facilities and distribution arrangements necessary for importation of dairy products, their capacity and who has ownership or control of these facilities and arrangements.

- 9 Based on your expertise and experience, please provide details of:
 - (a) the current exporters of dairy products to Australia, the relevant products and their markets;
 - (b) any barriers to the exportation of dairy products from Australia; and
 - (c) the facilities and distribution arrangements necessary for exportation of dairy products, their capacity and who has ownership or control of these facilities and arrangements.

- 10 Between 1970 and 2013, what factors that contributed to increasing or falling exports from time to time throughout that period?

- 11 Between 2000 to 2013, what events or changes in circumstances occurred which had major impact on the Australian dairy industry? To what extent have these events or changes had lasting or permanent negative impacts on Australian dairy production and exports?

- 12 In your opinion, is there potential for:
 - (a) increased domestic sales for dairy products;
 - (b) growth of domestic sales of dairy products by individual dairy producers;
 - (c) increased exports and/or imports for any dairy products?

- 13 Based on your expertise and experience:
 - (a) what constraints are there on exports of dairy products from Australia;
 - (b) what factors would promote growth in Australian dairy production and dairy product exports; and
 - (c) what impacts would likely result from growth in dairy product exports?

- 14 Based on your expertise and experience, what effect would a merger between Murray Goulburn and WCB be likely to have on the level of:
- (a) exports by Murray Goulburn and WCB;
 - (b) other exports from Australia; and
 - (c) Australian dairy production?
- 15 Based on your expertise and experience, what effect would a merger between Bega Cheese Limited and WCB be likely to have on the level of:
- (a) exports by Murray Goulburn and WCB;
 - (b) other exports from Australia; and
 - (c) Australian dairy production?
- 16 Based on your expertise and experience, what effect would a merger between Saputo Inc and WCB be likely to have on the level of:
- (a) exports by Murray Goulburn and WCB;
 - (b) other exports from Australia; and
 - (c) Australian dairy production?

If you have any queries, please contact Myles Brown on 9288 1817.

Yours sincerely



Alan Mitchell
Partner
Herbert Smith Freehills

+61 3 9288 1401
+61 409 003 519
Alan.Mitchell@hsf.com

Herbert Smith Freehills LLP and its subsidiaries and Herbert Smith Freehills, an Australian Partnership, are separate member firms of the international legal practice known as Herbert Smith Freehills.

Brown, Myles

From: Brown, Myles
Sent: Tuesday, 26 November 2013 9:15 AM
To: cljp@me.com
Cc: Mitchell, Alan; Comino, Petria
Subject: Murray Goulburn

Dear Mr Phillips

I refer to our letter dated 11 November 2013 which contains a list of 16 questions.

Question 3 states:

"What acquisitions have occurred in the Australian Dairy industry during the past five years? What, if any, impact have these acquisitions had on the dairy industry?"

● responding to this question, please consider any acquisitions that have occurred between 2000 and today, rather than just the last five years.

If you have any questions, please do not hesitate to contact me.

Kind regards

Myles Brown
Senior Associate
Herbert Smith Freehills

T +61 3 9288 1817 M +61 408 612 702 F +61 3 9288 1567

www.herbertsmithfreehills.com

Please consider the environment before printing this email

2. Curriculum Vitae – Chris Phillips

CURRICULUM VITAE CHRISTOPHER PHILLIPS

PERSONAL DETAILS

Born: Wollongong Australia, 1956

Current Address: 6 Bunalbo Avenue South Yarra, 3141

Contact Details Mobile 0418104709 Landline (03) 98279160
Email: cljp@me.com

RELEVANT EXPERIENCE

Since September 2012

Chris Phillips Consulting

Providing independent strategic advice on market and policy issues and their commercial implications for Australian firms and industries. Recent work includes advice on:

- Potential key drivers shaping global food demand to 2020
- The potential impacts of animal disease on Australian dairy trade flows and profitability
- The future prospects for Australian live cattle exports

September 1988 to 2012

Dairy Australia (was Australian Dairy Corporation to 2003)

I have spent twenty-four years in multiple senior management roles with the national farmer-funded service body for the Australian dairy industry. My work significantly focused on the successful delivery to industry and government stakeholders of strategic planning advice, domestic and international market analysis, public policy analysis and advice and international trade development. From 1995 to 2012 I was a member of the organization's Executive Management team. Key Positions held within DA/ADC over this period were:

- Group Manager Trade and Strategy (2005–12)
- General Manager International Trade Development (2001-05)
- General Manager Planning and Information (1994-2001)
- Manager International Policy (1990 -1994)
- Research Manager (1988 -1990)
- ADC Board Secretary (1993 – 1999) concurrent role

Some major milestone achievements and involvements in these different areas of work over the last two decades include:

Strategic Planning

I have been a key coordinator of strategic planning processes for a range of industry organizations and companies for the past decade. This has included liaising with stakeholders on issues and priorities, developing Discussion papers on looming issues, organizing planning workshops, drafting planning documents and managing feedback and

validation loops. Linked with this I have overseen the planning and implementation of annual Cooperative Leaders Forums (jointly with New Zealand industry). Other major one off projects include:

- 2012 Project managed and was (ex-officio) Working Group member of *Horizon 2020 Future Scenarios for the Australian Dairy Industry* project
- 2011 Independent advisor to GippsDairy R&D strategy development processes.
- 2010 Participant in Northern Dairy Industry Strategic Plan *task force*
- 2009 Co-author of *Dairy Moving Forward – Future Research, Development and Extension Priorities* – which set out an agreed long term industry-level strategy for dairy research and innovation and was adopted under the National Primary Industries Standing Committee RD&E Framework in 2010.
- 2004 Chaired *Dairy Drought Response taskforce*, which dealt with both short term support and information needs of regional farm and processing sectors (and external stakeholders and customers) and helped develop a range of specific planning and on-farm advisory tools such as *Taking Stock/ Taking Action* to improve farm business ability to deal with increasing volatility.
- 2001 Member of *Dairy 2010 Strategic Visioning* task force
- 1999 ADC member of successful *Advancing Dairy Australia* strategic review

Market Analysis

From 2004 to 2012 I oversaw the annual development and production of *Dairy Australia's Situation and Outlook Report (and online Updates)*, including identifying and analysing key themes and commissioning additional external research where necessary such as the National Dairy Farmer Survey. S&O is consistently regarded as a pre-eminent source of advice on the key drivers of international and domestic dairy markets and policy and their implications for local milk production, trade, farm gate prices and company returns.

S&O itself developed from the successful implementation in 2004 of the *Clearing the Fog* initiative, which we used to explain the reality of Australian dairy's current and future prospects after the 2003/4 droughts to a range of internal and external audiences.

From 1998 to 2012 I was Australia's representative to the International Dairy Federation Standing Committee on Policy and Economics and regularly presented Australian views on market and policy issues to World Dairy Summits and national congresses of IDF member countries (such as the EU, USA, NZ, Chile, Brazil, China and Japan).

Trade Policy

As a member of the National Farmers Federation Trade Reference Committee I have represented dairy interests at all major strategic trade liberalisation negotiations since 1993. This included both strategy and position development with Australian government negotiators, presenting Australian positions to overseas industries and governments and participation/ support at Ministerial meetings such as:

- Conclusion of GATT Uruguay Round in 1995
- WTO Doha Round Ministerial in 2003, 2005, 2006, 2008 and 2010.
- Australia US Free Trade Agreement 2004

- Thailand Australia FTA 2005
- APECANZFTA 2010.
- Cairns Group farm leader meetings

Following completion of the above agreements I took a lead role in overseeing internal industry processes for allocating new market access entitlements achieved for Australian exporters. I also regularly represented Australian dairy interests in bilateral trade meetings whenever overseas government actions adversely affected Australia's existing or expected access rights in key export markets.

Public Policy Advice

- 2008-2012 Carbon Pricing – took primary carriage for analysing the potential impacts of alternative Emissions Trading Scheme / carbon tax options on Australian dairy farming and processing and, with the Australian Dairy Industry Council, coordinated public dairy industry responses to reviews such as Garnaut Inquiry, Green Paper, senate Inquiries etc. In 2009-10 I was selected to be one of the dairy representatives on the Department of Climate Change's Technical Options Development Group for Agriculture.
- 2009-2012 Water Entitlements – As member of Dairy Industry Water taskforce I coordinated industry analyses and public submissions in relation to Federal and state based reviews of future water allocation and management policy including the draft Murray Darling Basin Plan and various state Strategic Water Initiatives.
- 2010-2011 I was the Dairy representative to Sustainable Agricultural Initiative (Australia) which is examining the implications of changing public and private positioning on sustainability for the viability and direction of future food production.

Industry Support

- 1999-2002 Dairy Deregulation
I was a member of the initial industry task force that developed the original \$1.8 Billion restructure package proposal for industry and government agreement (including individual entitlement rules and processes) and helped secure industry approval of the planned package. Subsequently, following Ministerial agreement I led the ADC's management of a number of large scale projects associated with deregulation including:
- Developing the necessary legislative and regulatory elements of the core Dairy Structural Adjustment Payment Scheme
 - Establishing entitlement (and dispute settlement) rules / matrixes for farm businesses and individuals, designing and implementing application systems and building computer systems to manage entitlements and payments
 - Setting up the Dairy Structural Adjustment Fund and organizing a \$400M commercial loan facility of \$400M to finance the operations of the fund
 - Facilitating development and implementation of a separate Regional Adjustment Program
 - Winding up the Domestic Market Support Levy and Payment Scheme

-
- Establishing offices, funding and support for the Dairy Adjustment Authority
 - Repeating arrangements for Supplementary Adjustment program announced in 2001

Because of my understanding of the deregulation process, in 2010 I was asked by the Australian government to present Australian dairy views on how to deal with structural reform to the European Commission's High Level Group on Reform of the Common Agricultural Policy post 2015.

Pre-1988 Experience

- | | |
|-----------|--|
| 1987 | World Bank Project team – for Centre of International Economics
Development of Industry Assistance Measurement and Reporting
Infrastructure for Indonesia Department of Treasury (7 months) |
| 1982-1988 | Assistant Director Industry Commission (now Productivity Commission)
Undertaking independent reviews of federal and state government assistance
to local and international industry. From 1985 oversaw Commission's internal
Nominal and Effective Rates of Assistance estimation program. In this role
provided IC input to 1985 and 1988 Taxation reviews. |
| 1975-1980 | Completed Bachelor of Economics degree at University of Sydney |

3 List of documents /websites reviewed

Publications	
ABS	
Australian Dairy Corporation	<i>Dairy Compendium 2001, Nov 2001</i>
ABARES	<i>Agricultural Commodity Statistics, June 2013</i>
ABARES (2)	<i>Australian Dairy - financial performance of dairy farms 2010/11 to FY2013 Research report 13.9 Jul 2013</i>
ABARES (3)	<i>Prospects for Australia's Rural Industries –Outlook Conference presentation P Morris, Mar 2012</i>
Arla Foods	<i>Strategy 2017, 2009 .</i>
Bega Cheese Ltd	<i>AGM Presentation, Oct 2013</i>
Bega Cheese Ltd (2)	<i>FY2013 Annual Report Oct 2013</i>
Dairy Australia	<i>Dairy Situation and Outlook June 2001,2012, 2013 editions</i>
Dairy Australia (2)	<i>Australian Dairy in Focus 2013, Nov 2013</i>
Dairy Australia (3)(a)	<i>Horizon 2020 Final Report, Apr 2013</i>
Dairy Australia (4)(a)	<i>National Dairy Farmer Survey, Apr 2013</i>
Dairy Reporter	<i>World Dairy Market Growth report, Oct 2013</i>
Freisland Campina	<i>Route 2020 Strategy, Oct 2010,</i>
D N Harris	<i>Victoria's Dairy Industry – An economic history of recent Developments (Report for DPIV and DA) Oct 2011</i>
W Pritchard	<i>Current Global Trends in the Dairy Industry, Feb 2001</i>
Rabobank (1)	<i>Global Dairy Top 20 –Consolidation Accelerates, Aug 2013</i>
Rabobank (2)(a)	<i>China's Raw Milk – Still Dreaming of a White River, Oct 2013</i>
S Spencer	<i>Dairy's Challenging Horizon Australian Farm Policy Journal Vol. 10 No.1 pp.13-23</i>
UBIC Consulting(a)	<i>The World Lactoferrin and Lactoperoxidase Market 2013</i>
USDA Foreign Agricultural Service -	<i>Dairy World Markets and Trade, June 2013</i>
Warrnambool Cheese & Butter	<i>RBS Morgans Investor Presentation, Oct 2013</i>
Warrnambool Cheese & Butter	<i>Target's Statement, Nov 2013</i>
Websites	
ABARES	<i>Outlook Conference Programs</i>
Arla Foods	www.arla.com
Fonterra	www.fonterra.com
Freisland Campina	www.freislandcampina.com
Glanbia	www.glanbia.com
US Dairy Export Council	www.usdec.org

Note: Access to reports marked (a) were provided on confidential basis as they are not provided for general public release.

4. Copy of Federal Court Practice Note CM7



Attachment 1

Practice Note CM7 — Expert witnesses in proceedings in the Federal Court of Australia

Commencement

1. This Practice Note commences on 4 June 2013.

Introduction

2. Rule 23.12 of the Federal Court Rules 2011 requires a party to give a copy of the following guidelines to any witness they propose to retain for the purpose of preparing a report or giving evidence in a proceeding as to an opinion held by the witness that is wholly or substantially based on the specialised knowledge of the witness (see **Part 3.3 - Opinion** of the *Evidence Act 1995* (Cth)).
3. The guidelines are not intended to address all aspects of an expert witness's duties, but are intended to facilitate the admission of opinion evidence¹, and to assist experts to understand in general terms what the Court expects of them. Additionally, it is hoped that the guidelines will assist individual expert witnesses to avoid the criticism that is sometimes made (whether rightly or wrongly) that expert witnesses lack objectivity, or have coloured their evidence in favour of the party calling them.

Guidelines

1. General Duty to the Court²

- 1.1 An expert witness has an overriding duty to assist the Court on matters relevant to the expert's area of expertise.
- 1.2 An expert witness is not an advocate for a party even when giving testimony that is necessarily evaluative rather than inferential.
- 1.3 An expert witness's paramount duty is to the Court and not to the person retaining the expert.

2. The Form of the Expert's Report³

- 2.1 An expert's written report must comply with Rule 23.13 and therefore must
 - (a) be signed by the expert who prepared the report; and
 - (b) contain an acknowledgement at the beginning of the report that the expert has read, understood and complied with the Practice Note; and
 - (c) contain particulars of the training, study or experience by which the expert has acquired specialised knowledge; and
 - (d) identify the questions that the expert was asked to address; and
 - (e) set out separately each of the factual findings or assumptions on which the expert's opinion is based; and

¹ As to the distinction between expert opinion evidence and expert assistance see *Evans Deakin Pty Ltd v Sebel Furniture Ltd* [2003] FCA 171 per Allsop J at [676].

² The *"Ikarian Reefer"* (1993) 20 FSR 563 at 565-566.

³ Rule 23.13.



- (f) set out separately from the factual findings or assumptions each of the expert's opinions; and
 - (g) set out the reasons for each of the expert's opinions; and
 - (ga) contain an acknowledgment that the expert's opinions are based wholly or substantially on the specialised knowledge mentioned in paragraph (c) above⁴; and
 - (h) comply with the Practice Note.
- 2.2 At the end of the report the expert should declare that "[the expert] has *made all the inquiries that [the expert] believes are desirable and appropriate and that no matters of significance that [the expert] regards as relevant have, to [the expert's] knowledge, been withheld from the Court.*"
- 2.3 There should be included in or attached to the report the documents and other materials that the expert has been instructed to consider.
- 2.4 If, after exchange of reports or at any other stage, an expert witness changes the expert's opinion, having read another expert's report or for any other reason, the change should be communicated as soon as practicable (through the party's lawyers) to each party to whom the expert witness's report has been provided and, when appropriate, to the Court⁵.
- 2.5 If an expert's opinion is not fully researched because the expert considers that insufficient data are available, or for any other reason, this must be stated with an indication that the opinion is no more than a provisional one. Where an expert witness who has prepared a report believes that it may be incomplete or inaccurate without some qualification, that qualification must be stated in the report.
- 2.6 The expert should make it clear if a particular question or issue falls outside the relevant field of expertise.
- 2.7 Where an expert's report refers to photographs, plans, calculations, analyses, measurements, survey reports or other extrinsic matter, these must be provided to the opposite party at the same time as the exchange of reports⁶.
- 3. Experts' Conference**
- 3.1 If experts retained by the parties meet at the direction of the Court, it would be improper for an expert to be given, or to accept, instructions not to reach agreement. If, at a meeting directed by the Court, the experts cannot reach agreement about matters of expert opinion, they should specify their reasons for being unable to do so.

J L B ALLSOP
Chief Justice
4 June 2013

⁴ See also *Dasreef Pty Limited v Nawaf Hawchar* [2011] HCA 21.

⁵ The *"Ikarian Reefer"* [1993] 20 FSR 563 at 565

⁶ The *"Ikarian Reefer"* [1993] 20 FSR 563 at 565-566. See also Ommrod *"Scientific Evidence in Court"* [1968] Crim LR 240

