NATIONAL
FOODS

6 October 2009

Committee Secretary
Senate Select Committee on Agriculture and Related Industries
P.O. Box 6100
Parliament House
Canberra ACT 2600

RESPONSE TO THE INQUIRY INTO FOOD PRODUCTION IN AUSTRALIA

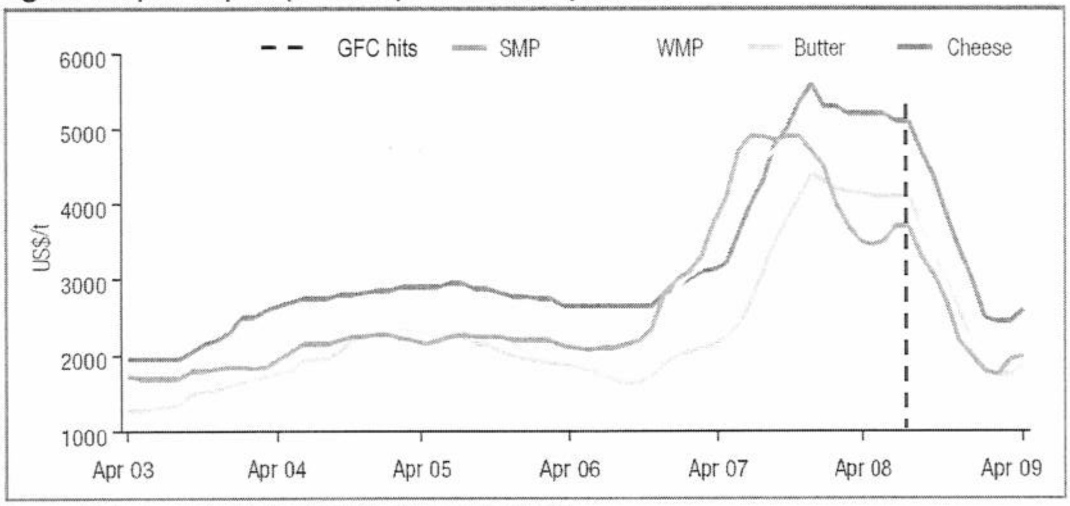
National Foods Limited welcomes the opportunity to provide input into the Senate Select Committee on Agricultural and Related Industries' inquiry into food production in Australia. We note that the terms of reference for the Committee have been broadened to include the issue of prices paid to Australian dairy farmers, in particular in Tasmania, and it is in this context that we are responding to the inquiry.

National Foods is also in the process of preparing its submission for the Senate Economics Reference Committee inquiry into competition and pricing in the Australian dairy industry.

The farm gate price for milk

The global financial crisis had an immediate impact on the global trade in dairy commodities. As insurance and credit markets froze, bank insolvency fears grew and currency fluctuations became more volatile, dairy prices went into free fall. This led to a sharp reduction in the price being paid internationally and in Australia for farm gate milk, as the graph below illustrates.

Figure 4: Spot export prices April 2003 to April 2009



(source: Dairy Australia: Dairy 2009, Situation and Outlook)

To remain competitive in the domestic market place, National Foods has to adjust the price it pays to farmers if there is a fall in global dairy prices. This is because of the direct link between the Australian and world markets for dairy products.

To explain this link it is important to understand the dairy market in Australia. Around 24 percent of the milk produced in Australia is consumed in the form of fresh drinking milk, with the remainder being manufactured into processed dairy products like butter, cheese and milk powder. Over 60 percent of these manufactured dairy products are exported, so in total Australia exports nearly half of the milk it produces. These manufactured export products basically become commodities which are sold on the world market; meaning Australian exporters have to accept the world market price with little opportunity for price differentiation.

The direct link between the Australian and world markets for dairy products is generally accepted in the dairy industry and is recognised by the Australian Competition and Consumer Commission (ACCC). For instance, in its 2008 report into the competiveness of retail prices for standard groceries the ACCC stated "... because milk products are internationally traded, the prices domestic milk processors offer are primarily set by international factors. The best evidence of this was the recent surge in farm gate price in response to rising international demand. Accordingly, the ACCC considers that the market for fresh milk at the farm gate is competitive."[1] A copy of National Foods response to that inquiry is attached (Attachment B).

[1] Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries, 2008, p.221

The world market price for milk feeds back through the supply chain and influences the returns dairy farmers can achieve. Australian dairy farmers will not sell to drinking milk processors for a price lower than they can achieve through having their milk manufactured and sold on world markets. This was National Foods experience in 2007 and 2008 when commodity prices were at record highs and National Foods paid farmers above the contractual price in order to secure supply of milk.

National Foods also has to be conscious of its competitive position against sales of processed milk by other processors. We cannot pay a price to farmers for milk that is so high that it becomes unprofitable and uncompetitive for National Foods to process and sell that drinking milk. This applies throughout Australia including in Tasmania, where concerns have been raised about milk pricing.

As Dairy Australia notes in its Dairy 2009: Situation and Outlook Report "...due to the transparency of world market prices, the open market for dairy imports, and the structure and practices of the retail grocery sector, there is no effective sustainable premium over time for sales into the domestic market compared to export returns, when all costs are considered. **As a result, farm gate prices - particularly in the regions of Victoria and Tasmania where the majority of milk is used in the manufacture of dairy products - are closely aligned to returns from exported products.**"[2] The report goes on to say that in 2007/08, around 90% of the raw milk produced in Victoria and Tasmania was used in the manufacture of dairy products.

Contracts

National Foods has a major commitment to milk processing in Australia and we require supply to keep our factories at full capacity. As a drinking milk processor we pay a market price for milk sufficient to attract supply from farmers and we compete with other processors to secure milk supplies from farmers.

In order to secure greater certainty of milk supply, in recent years National Foods has offered contracts to farmers of varying duration. These contracts have begun and ended at different times and this explains the differences in contract pricing being paid to farmers in different regions of Australia. Some contracts still include prices prevailing at periods when the world market price was very high, and as a result of the global financial crisis more recent contracts have been progressively reset. This reflects the realities of world market prices and the way in which they flow through to prices offered to farmers through the competitive marketplace here in Australia.

[2] Dairy 2009: Situation and Outlook, 2009, p.12

Dairy farmers

With the fall in the global price for dairy products, dairy farmers in Australia are facing some major challenges aside from the normal battles with climatic conditions. Many have increased debt servicing obligations as a result of decisions to expand their farming operations or working capital in the lead up to the global collapse of credit markets - when prices were at historic highs.

The appreciation of the Australian dollar continues to have a negative impact on the farm gate price. Dairy Australia in its 2009 Situation and Outlook Summary Report (Attachment A p.2) estimates that each 10 cent rise in the dollar reduces the farm gate price by approximately 6.5 cents.

The European and United States' governments have re-introduced export subsidies to deal with the over-supply in their markets. The use of these export subsidies has made it harder for the Australian dairy industry to compete in major dairy export markets in Asia. Export subsidies also artificially lower the global price for dairy products because they do not let the market deal with the issue of over-supply in the European Union and the United States.

National Foods has honoured all contracts with our dairy farmers

National Foods remains committed to working with our farmers through the global financial crisis. **National Foods pays, on an annualised basis, 3 cents/litre more than our raw milk competitors in south eastern Australia and our contracts include a minimum price guarantee that ensures the average price we pay is higher than that paid by our major dairy co-operative competitors.**

National Foods continues to honour contracts that were signed before the milk price collapse and this will not change. We have not sought to re-negotiate these contracts even though they now come at a significant commercial cost to the company.

Dairy Australia notes that farmers supplying domestically-focused processors have been insulated from the immediate impact, as supply contracts remain in force (Attachment A p.1).

Contracts that have come up for renewal this year in Victoria and South Australia have been finalised. There are currently contracts up for renewal in Tasmania and Western Australia. A majority of dairy farmers in NSW and Queensland will have their contracts renewed next year. As these contracts come up for renewal, dairy farmers will face reduced prices unless there is a major improvement in global dairy prices. Unfortunately, no commercial business wanting to remain sustainable in the dairy industry can afford to ignore fluctuations in the international commodity price.

On the positive side, however, if there is an upward movement in world dairy prices (and the market has been strengthening in the last few months), this upward movement will be passed on through the National Foods minimum price guarantee for contract milk which ensures our dairy farmers in south east Australia, which includes Tasmania, receive 3 cents/litre more, on an annualised basis, than the price offered by our major dairy co-operative competitors.

<u>Tasmania</u>

National Foods is committed to the Tasmanian dairy industry. We have been involved in the industry for nearly twenty years and have five hundred employees across five manufacturing sites in Tasmania. We inject over $50 million into the Tasmanian economy each year and promote iconic Tasmanian brands including King Island Dairy, Tasmanian Heritage and South Cape.

National Foods has also invested over $20 million of capital into the Tasmanian economy in the last five years:

- $7 million in Burnie
- $10 million in King Island (including a $3.5 million environmental investment)
- $3 million in the Lenah Valley.

In Tasmania, National Foods competes with Fonterra and Cadbury for the supply of milk and we purchase only 23 percent of the raw milk produced. The milk National Foods buys is processed and sold in competition with other manufacturers. There is currently a surplus of raw milk in Tasmania and National Foods is not immune to the current situation as we are currently purchasing 30 million litres of raw milk that is excess to our requirements. National Foods has continued to buy this surplus milk as part of our commitment to the Tasmanian dairy industry. This milk is processed into cheese and milk powder at a loss to National Foods as it is sold into the low-end, over supplied segment of the market.

To illustrate this point further (as it goes to the heart of why as a commercial business we must buy at or near the global market price in Tasmania), if we buy 145 million litres of raw milk this year, only 30 percent will be processed for the liquid drinking milk market in Tasmania with the rest being manufactured into products such as cheese, butter and milk powder.

National Foods contracts in Tasmania include a minimum price guarantee that ensures, on an annualised basis, that the price we pay is higher than that of our major dairy co-operative competitors. Using this formula, we pay 3 cents/litre more than Fonterra. We are also honouring all contracts entered into before the global financial crisis hit at a considerable cost to the company. For example, there are still dairy farmers in Tasmania who are receiving between 39 and 45 cents/litre for their milk. As our contracts come up for renewal, National Foods, in order to compete on a commercial basis, needs to adjust our pricing in line with the international commodity price.

Other facts about the Tasmanian dairy industry that may be relevant to this inquiry are:

- There has been an increase in production of 18.6 percent in the last five years.
- Approximately 10 percent of the raw milk produced in Tasmania is sold as drinking milk. This means the price paid for raw milk is closely aligned with the commodity price.
- Even though there is currently a surplus of milk in Tasmania there continues to be investment in increased production.

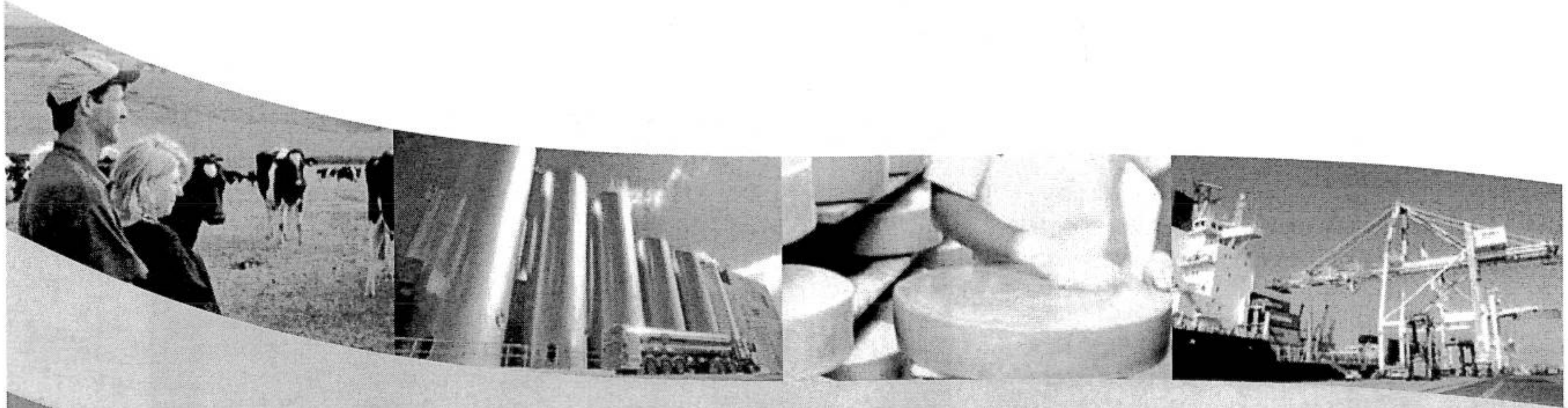
National Foods will appear before the inquiry in Canberra on Wednesday 7 October.

Yours sincerely

Ashley Waugh
Managing Director and Chief Executive Officer

Dairy Australia

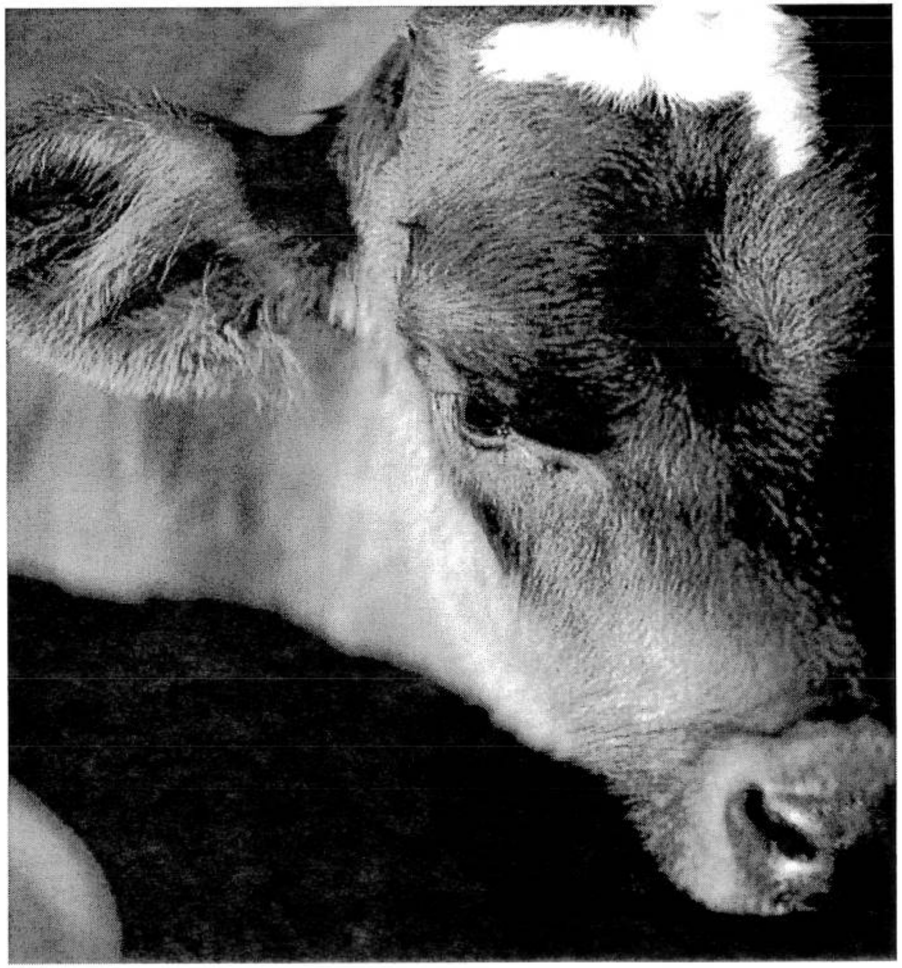
Your Levy at Work



Dairy 2009
Situation and Outlook

Summary Report

The industry in 2009

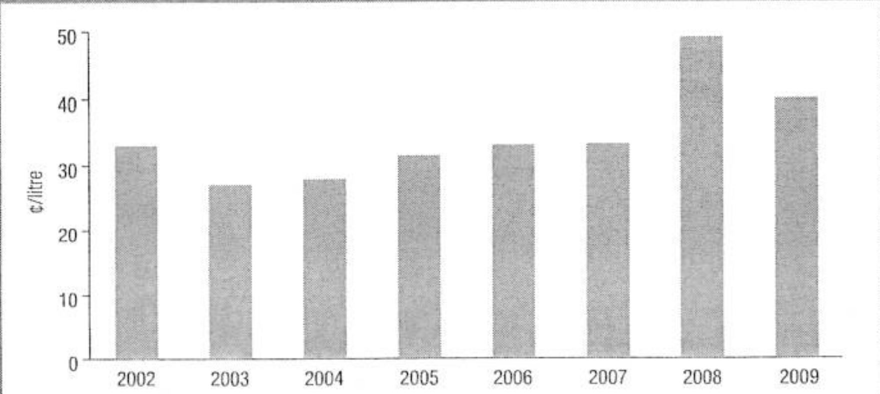


- Unprecedented volatility in the international market associated with the global financial crisis and resultant economic downturn, has had a severe impact on farmer confidence as well as finances.
- Falling commodity prices translated rapidly into lower farmgate prices with a 1 in 35 year step-down in milk price announced mid-year across southern dairying regions.
- The financial impact has been severe as many farmers, through climate-related necessity and facilitated by the previous higher farmgate prices, have found themselves locked into production systems with limited cost flexibility.
- Farmers supplying domestically-focussed processors have been insulated from the immediate impact, as supply contracts remain in force. In northern regions, higher milk price has combined with welcome improvements in seasonal conditions, to support higher levels of confidence.
- Milk price has re-emerged as the greatest challenge farmers are facing. The likelihood of a conservative opening price and slow recovery in returns limits the options available in the short term for dealing with adverse seasonal conditions and volatile input costs.
- The medium term outlook remains positive, as population growth, improved incomes in developing countries and likely constraints on production point to higher prices.
- While falling input prices may provide some relief, without a significant improvement in seasonal conditions, particularly in the Murray Darling Basin farmers will face severe difficulty trading through the current downturn.

The industry in 2009 continued

- Dairy farmers have taken on more debt in recent years to either fund expansion of farm operations, or additional funds for working capital. Balance sheets are now under pressure on many dairy farms as a result of increased liabilities and static or decreasing asset values – including land, cows and irrigation water.
- The ability or willingness of farmers to extend their debt, or to realise the value of their assets, as well as their personal and family commitment to continue dairying are the key factors being weighed up now and over the coming year. The opening price for 2009-10 will be a critical signal for farmers in southern regions. Dairy Australia's forecast range for opening price is between $3.50 and $4 per kg MS (24 to 29 cents per litre), implying a full year price range of $4.00 to 4.60 per kg MS 29 to 34 cent per litre. However, significant uncertainty remains.

Average Farmgate Milk Price to Australian dairy farmers (yr to June 30)

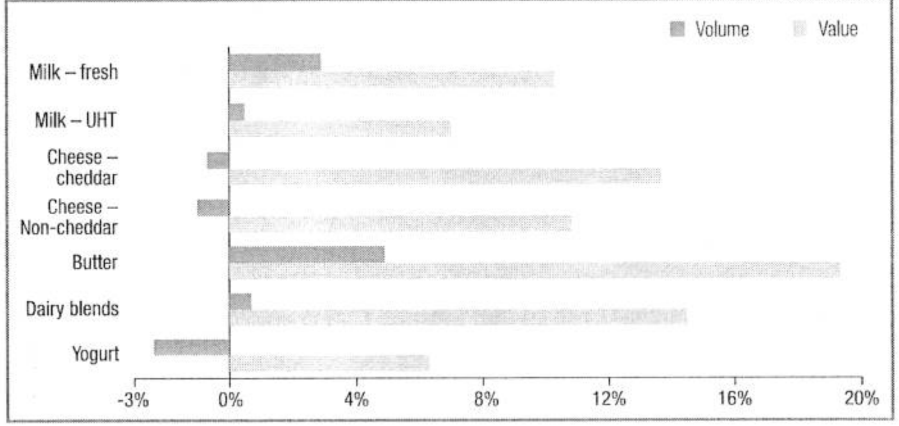


- While international commodity prices have stabilised, the appreciation of the Australian dollar has a negative impact, as each 10 cent appreciation reduces farmgate price by approximately 6.5 cents.
- Farmers supplying domestically-focussed milk processors under existing contracts have more certainty regarding milk price in 2009-10. This is reflected in their levels of confidence, as well as their intentions to employ and invest on farm.
- The results of this year's survey indicate that farmers remain largely confident about the future of the industry; however, the short term challenges on farm are significant.

Australian market Situation & Outlook

- In the context of the rapid downturn in export returns, the domestic market has been a bright spot for the industry. Accounting for 55% of annual milk production, the Australian market has offered good value and some volume growth, and underpinned industry returns.
- Higher retail prices have been largely maintained, as supply contracts limit the immediate passing on of lower commodity prices. This has driven category value growth, and volume impacts have been limited as consumers have adjusted to higher prices.
- The full impact of the global economic downturn is yet to be felt in Australia in terms of unemployment. However, lower fuel and interest costs, discounting activity from retailers, as well as the government's fiscal stimulus have actually improved the spending power of many consumers.
- Quick service restaurant sales have been boosted as a result, and cheese consumption is likely to be supported by this trend, as strong growth is being reported in pizza and burger outlets.
- While domestic prices have held, pressure is likely to build on wholesale prices if the downturn worsens, as consumers trade down to lower priced generic products, and contract negotiations reflect the international market situation and the increased focus of manufacturers on domestic opportunities.

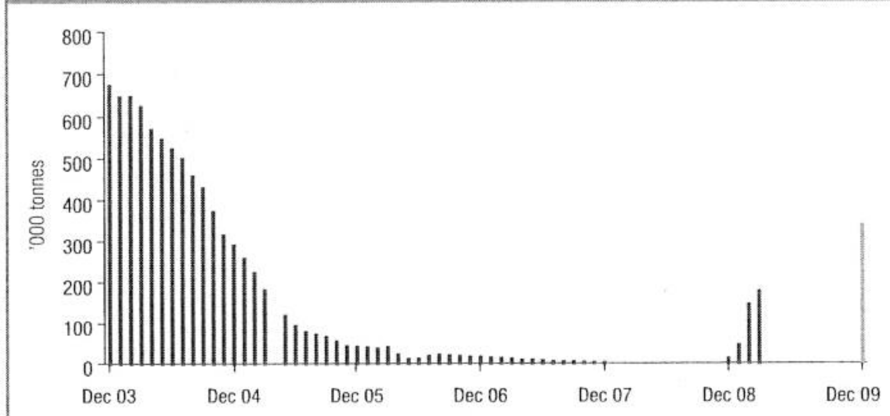
Supermarket sales growth by category (yr to February 09)



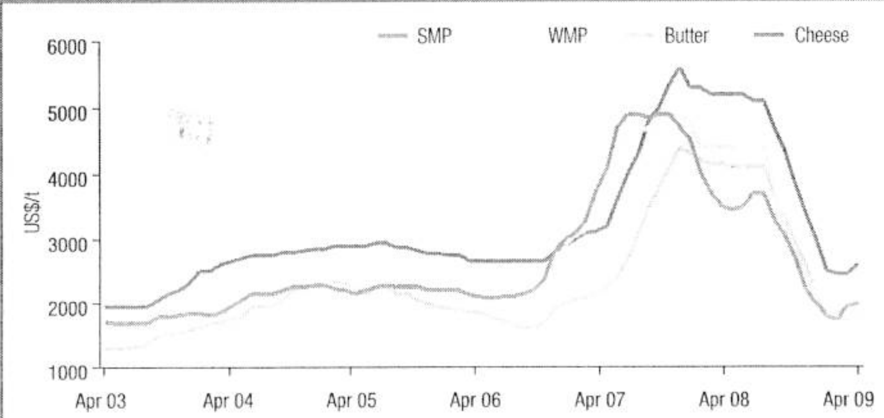
International market Situation & Outlook

- In 2008, after two years of sustained high prices, it seemed the international dairy market had reached a new plateau. However, there were already signs emerging that volatility would be a feature of the market outlook.
- Nevertheless, it would have been difficult to predict the impact of a global financial crisis which rapidly spread from the US to the developed and developing world. Trade in commodities was affected immediately, as insurance and credit markets were impacted by "toxic assets", bank insolvency fears, and increasingly volatile currency movements.
- Dairy commodity prices immediately went into a downward spiral, as buyers rapidly reacted to initial falls and the increasing financial and economic uncertainty. Supply pipelines were emptied as buyers ceased purchasing, preferring to run down high priced inventories, resulting in a build up of supplier stocks.
- Both the US and then EU governments are intervening in the market – the build up of surplus stocks has triggered the re-activation of export subsidies in Europe and now the US. This has added to the negative sentiment surrounding the international dairy market.
- With buyers re-entering the market to fulfil their immediate requirements, commercial stockpiles for powder in particular have been reduced. Import demand for powders is likely to recover at lower commodity prices. However, the outlook for cheese is less rosy with imports to Japan and Russia, two major cheese markets, constrained by economic conditions and a slow down in EU consumption growth.
- While the international market appears to have bottomed, prices are unlikely to move strongly upwards unless market perceptions alter significantly with a tightening in supply or a surge in demand associated with economic recovery.

EU and US SMP stockpile

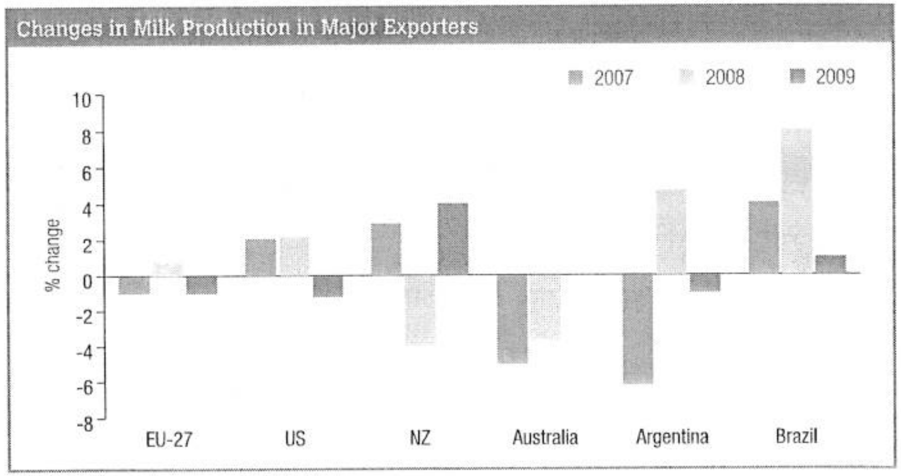


Spot export prices April 2003 to April 2009



World supply

- While world milk supply was expanding through much of 2008, the reversal in economic conditions and dairy commodity prices has been rapidly transmitted to farmers in milk price. In response, farmers have adjusted their production plans.
- Despite a 2% increase in the EU's milk production quota, output is expected to fall by 1% in 2009-10. Despite the Commission's interventions, farmer prices have been cut severely and farmers are responding by reducing production. EU exports are once again receiving subsidies in response to internal lobbying, and in an effort to maintain internal prices, and divert product from intervention stores.
- In the US, production is expected to contract by 1-2% in 2008-09 after growing steadily for a number of years. With milk returns falling more than grain prices, the milk to grain price ratio is at its lowest point on record, thereby discouraging growth.
- In Argentina, severe drought conditions have reduced milk production and will constrain future growth, as the national herd was heavily culled. While the export taxes which have severely hampered Argentina's participation in the world market, are not a factor at present, the low international prices provide little incentive for increased participation.
- In New Zealand, dry conditions in north island regions is hampering milk output. Credit constraints have slowed some conversions on the South Island. Nevertheless NZ production is expected to grow by 4%.

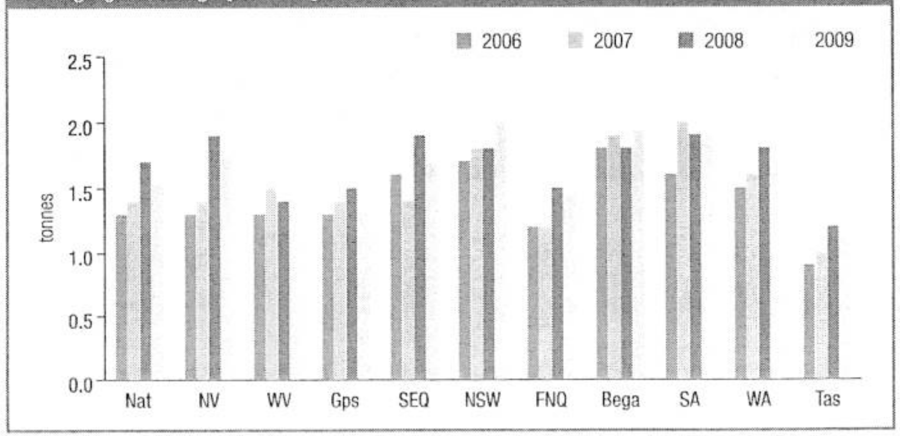


The farm sector in 2009

The National Dairy Farmer Survey results provide the following profile of the industry:

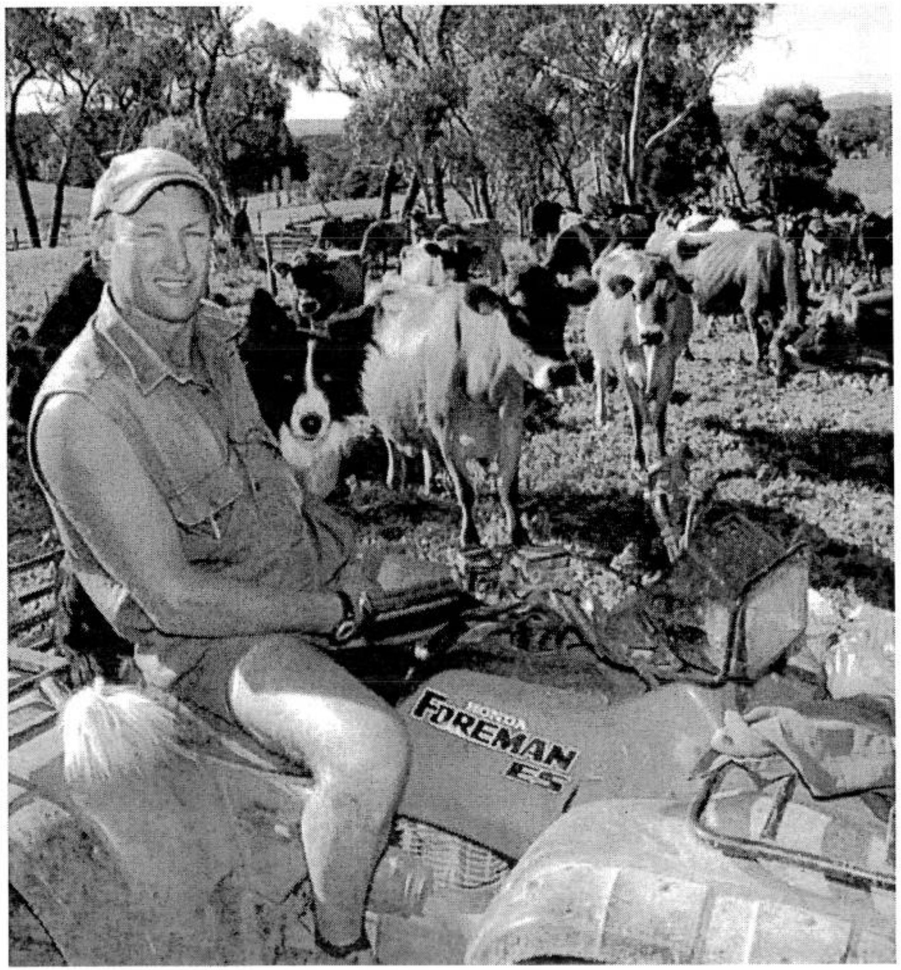
- Surveyed average herd size was 275 cows up from 247 milking cows in 2008, with the inclusion of several large herds in the NSW sample.
- Herds milking 600 or more cows account for 7% of farms, but 25% of national milk output.
- Average milk production per cow was 6,114 litres in this year's survey up from 5,702 litres in 2008.

Average grain usage per cow per annum



- An estimated 74% of farmers were operating a system which relied mostly on pasture, with light to moderate feeding of supplements in the bale, while 2% of farms operated a total mixed ration feedlot system. 30% of farms knew what their pasture utilisation was over the last 12 months.
- The average grain fed on surveyed farms was 1.5 tonnes per cow per year in 2009, down from 1.7 tonnes in 2008. 36% of farmers fed more than 1.5 tonnes, down from 42% in 2008.
- On average, 132 ha is set up for irrigation on irrigated dairy farms, however, just 58% of that area was watered during the last 12 months. On average, 51% of the total volume that would be available at 100% allocation was used 2008-09.
- Around 76% of farmers were impacted by a mid-season step down in farmgate price, with the majority reporting it had a major impact on their business.
- Seasonal calving featured on 36% of farms in 2009, compared with 35% in 2008. Split calving characterised 33% of farms, down from 36% in 2008. While year round calving dominates in regions with a high requirement for fresh product supply, it accounts for 32% of farms nationally.
- 28% of farms were staffed solely by the owner or ownership couple in 2009, compared with 34% in 2008 and 43% in 2007.
- 10% of surveyed farms were intending to hire staff over the next 12 months, while 5% of farms planned to lay off staff.

What did farmers say?

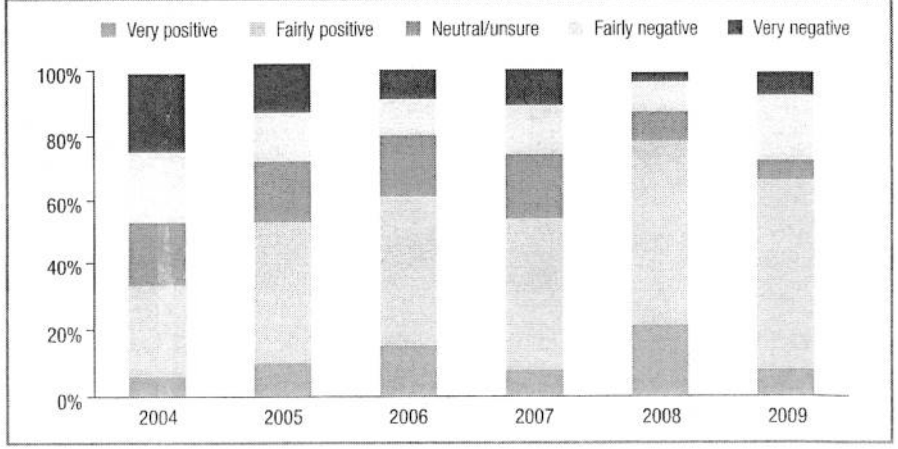


The National Dairy Farmer Survey results include the following key findings:

Attitude and Challenges

- 66% of farmers were positive about the future of the industry in 2009 compared to 78% of farmers in 2008. While farmers were less positive than last year, a higher proportion of farmers were optimistic than in all prior years of the survey. Positive sentiment was most often linked to a belief that there would always be demand for dairy products. Low milk price was the most common reason given for negative sentiment.

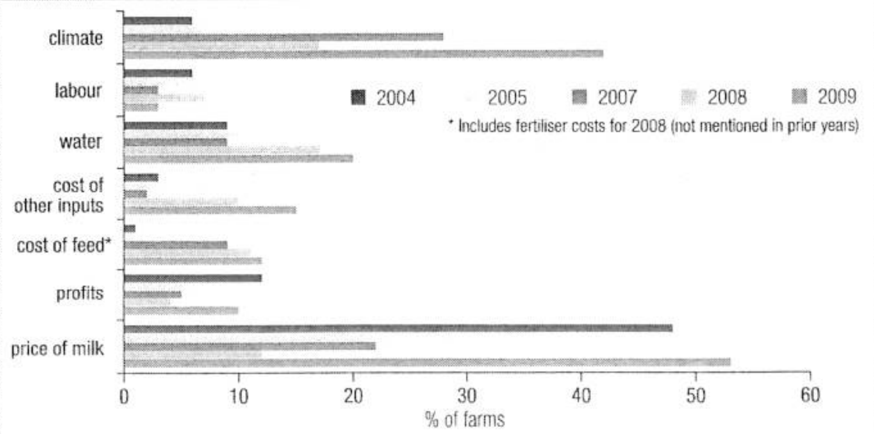
Attitude to the industry – comparing six surveys



What did farmers say? continued

- The most positive region was south east Queensland and northern New South Wales (81% of farmers positive), reflecting improved seasonal conditions and higher farmgate milk prices. The region has undergone a significant turn around since the survey was first conducted in 2004, and just 32% of farmers were feeling positive about the future.
- Continuing dry conditions and milk price cuts impacted northern Victoria and the Riverina sentiment in 2009, resulting in the lowest proportion of positive farmers (51%).
- Milk price was the greatest current and future challenge mentioned by farmers in 2009, overtaking climate and the availability and cost of inputs. Climate and the cost and availability of irrigation water were the next most often mentioned challenges, both for 2009 and the future.

Greatest future challenge



Investment

- 67% of dairy farmers made on farm capital investments in the previous 12 months, in line with 2008. However, there was a significant increase in the proportion of those investing on farm in both South Australia (79% compared to 67% in 2008) and New South Wales (70% compared to 63% in 2008).
- Machinery remained the largest area of investment, although less dominant than in previous years. Small increases were made in expenditure on milk harvesting and irrigation plant, as well as shedding.
- 32% of farmers were planning on-farm investment over the next 12 months, down significantly from 55% in the 2008 survey. Farmers in far north Queensland, New South Wales and Bega bucked the trend, taking the opportunity offered by improved farmgate milk prices to renew infrastructure.

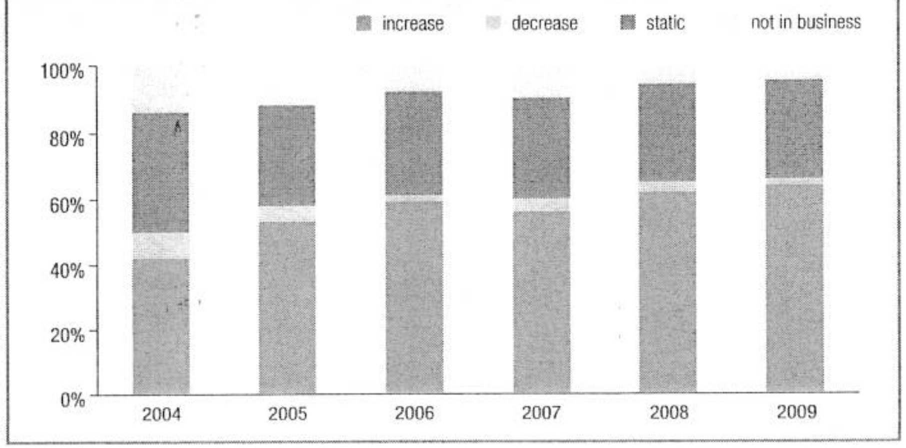
Dairy farm finances

- The Australian Bureau of Agriculture and Resource Economics (ABARE) conducts an annual survey of dairy farmers across Australia. While Dairy Australia's survey canvasses the attitudes and intentions of 1,000 farmers across Australia, the ABARE survey collects detailed financial and physical information from approximately 300 farm businesses. In 2009 estimates for 2008-09 were collected and updated.
- The survey projects a significant fall in farm cash income in 2008-09, reflecting the cut in milk price, with an average of $74,000 (compared to $139,500 in 2007-08). At the same time, cash costs are expected to be reduced by 10% due to lower grain and hay costs and interest payments.
- Average farm business profit is estimated to fall from $74,100 to a loss of $6,000.
- Analysis by Dairy Australia found increases in farm debt of between 7-9% on the average farm in regions such as Northern Victoria.
- The NDFS indicated that, of the 76% of farmers impacted by the milk price step-downs, 24% have extended their debt and a further 24% have refinanced or deferred their debt to manage their cashflow.
- Equity ratios continue to remain very high for farms across the dairying regions. While debt levels have generally risen steadily since the early 1990s, land values have kept pace, keeping estimated average equity ratios relatively high and constant in the range of 80-85%.
- Analysis by Dairy Australia, based on a range of regional data sources found dairy farm equity levels to be in the range 65-75%. This analysis also showed that debt servicing costs have risen significantly on many dairy farms as dairy farmers have taken on more debt. However, ABARE estimates the capital value of the average dairy farm at $3.3 million in 2007/08, with equity ratios remaining at a very high 84% on average.
- In the past, rising capital values have kept farm equity levels at a "safe" level (e.g. above 60% equity) and increasing equity has enabled increased borrowing ability for dairy farmers. Balance sheets are now under pressure on many dairy farms as a result of increased liabilities and static or decreasing asset values (including land, cows and irrigation water).

Milk production outlook

- Milk production in 2008-09 has been constrained by reduced cow numbers and unfavourable climatic conditions, as well the mid-season milk price cut, which prompted many farmers to reduce both herd numbers and supplementary feeding rates during the second half of the season. As a result, milk production is forecast to remain in line with 2007-08 at 9.2 billion litres.
- The 2009-10 season hangs in the balance with the prospect of lower farmgate prices requiring a significant improvement in climatic conditions to reduce production costs and support farm margins.
- While early signs have been encouraging, a comprehensive autumn break remains elusive. In lower Murray Darling basin, inflows will need to be at least average to ensure irrigators receive a water allocation to support spring pasture production, and reduce their heavy reliance on purchased feeds.
- With the economics around milk production changing so dramatically over the last 12 months, forecasting is particularly difficult. While production intentions stated in this year's survey were not significantly different from 2008, the 2009-10 season hinges on an opening price that can sustain a margin above feed costs. In turn, feed costs hinge on the rainfall received in dairying regions over the next six months. Both factors remain highly uncertain.
- At this stage the forecast for 2009-10 is for little growth in milk production to 9.0 to 9.2 billion litres, with the risks more on the downside in this forecast.
- Looking further ahead, three year production intentions from the 2009 survey were also in line with the intentions recorded in 2008. With reasonable seasonal conditions and prices, milk production could range between 9.7 and 10.1 billion litres by 2011-12. However, with the possibility of increased farm and cow exits over the next 12 months, this increase may be difficult to achieve.

Expected production in three years time – comparing six surveys



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Dairy Australia
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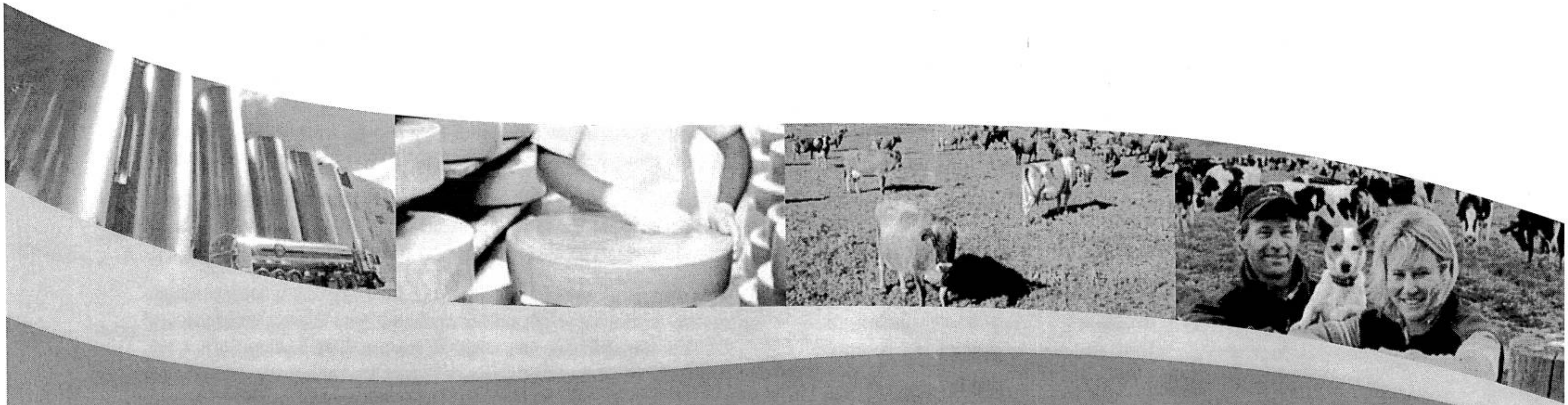

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Submission

Public submission to the ACCC Grocery Inquiry by National Foods

14 March 2008

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Submission

1 Introduction

1.1 National Foods

National Foods' core activities in Australia are the manufacture and wholesale of drinking milk, fresh dairy foods, cheese and fruit juices.

National Foods is not a participant in the grocery retail sector. However, it is pleased to provide information to assist the ACCC understand the Australian dairy industry supply chain and the factors that have influenced prices in recent years.

Further relevant dairy industry information and statistics are publicly available at the following website: http://www.dairyaustralia.com.au

1.2 The Australian Dairy Industry

The dairy industry is one of Australia's major rural industries. In 2006/2007 it was valued at around $3.2 billion at the farmgate.

The Australian dairy industry is open (with high levels of trade in manufactured dairy products) and the setting of prices and the terms of supply is unregulated. This is reflected in the fact that around half of Australia's total milk production is exported to more than 100 countries.

2 Key dairy industry trends

Continuing drought conditions across some of Australia's major water catchments (such as in the Southern Murray Darling Basin) has led to lower milk production, particularly in irrigation dependent areas. This has resulted in substantially higher input costs for dairy farmers, who either need to pay high prices for scarce water or feed their herds with high cost grain/hay. This significant negative impact of the drought for farmers is in part being offset by high international dairy commodity prices and drought payments to farmers by the co-operatives and milk processors as well as other drought assistance by governments.

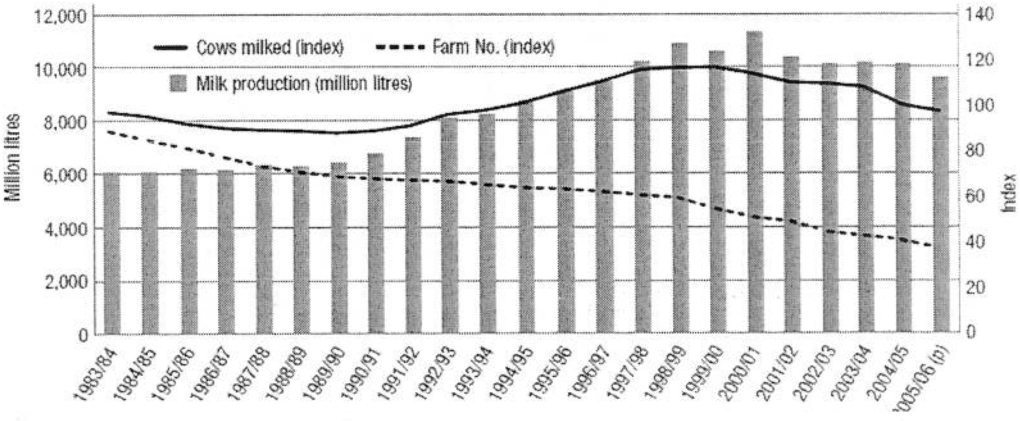
For domestic drinking milk processors (like National Foods), the convergence of reduced domestic milk production, high dairy commodity prices and increased costs for feed necessary for year around production of raw milk, has led to significantly higher milk acquisition prices. This situation, combined with increasingly complex logistics around variable regional milk flows, pressure on margins at the wholesale level, and plant overcapacity exacerbated by reduced raw milk supply, has put pressure on processors to rationalise and achieve greater efficiencies in all aspects of their operations.

3 Raw milk production and supply

Australia's dairy industry is predominantly pasture-based with efficient, low-cost, high-quality milk production. However, in the present drought conditions most farmers must supplement pasture feeding, which adds considerably to the cost of production.

The number of dairy farms has more than halved over the last 25 years, reflecting the need for farmers to shift to larger, more efficient operating systems. Over the same period herd size and average annual milk production per farm has more than doubled.

Australian milk production vs indices of farms and cows milked



Source: Australian Dairy Industry in Focus 2007, Dairy Australia

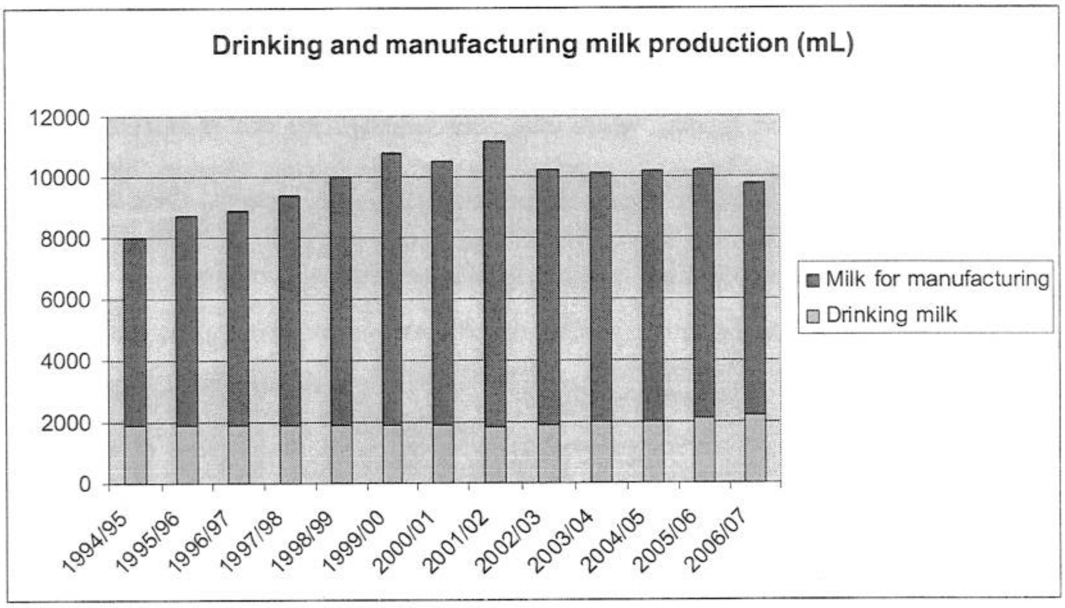
Milk production is concentrated in the south-east corner of Australia, with Victoria, Tasmania and South Australia accounting for almost 80% of national output.

Milk production (million litres)

	NSW	VIC	QLD	SA	WA	TAS	AUST
2004/05	1,218	6,613	619	679	398	600	10,127
2005/06	1,1,97	6,651	597	646	377	622	10,089
2006/07	1,105	6,297	534	655	349	642	9,582

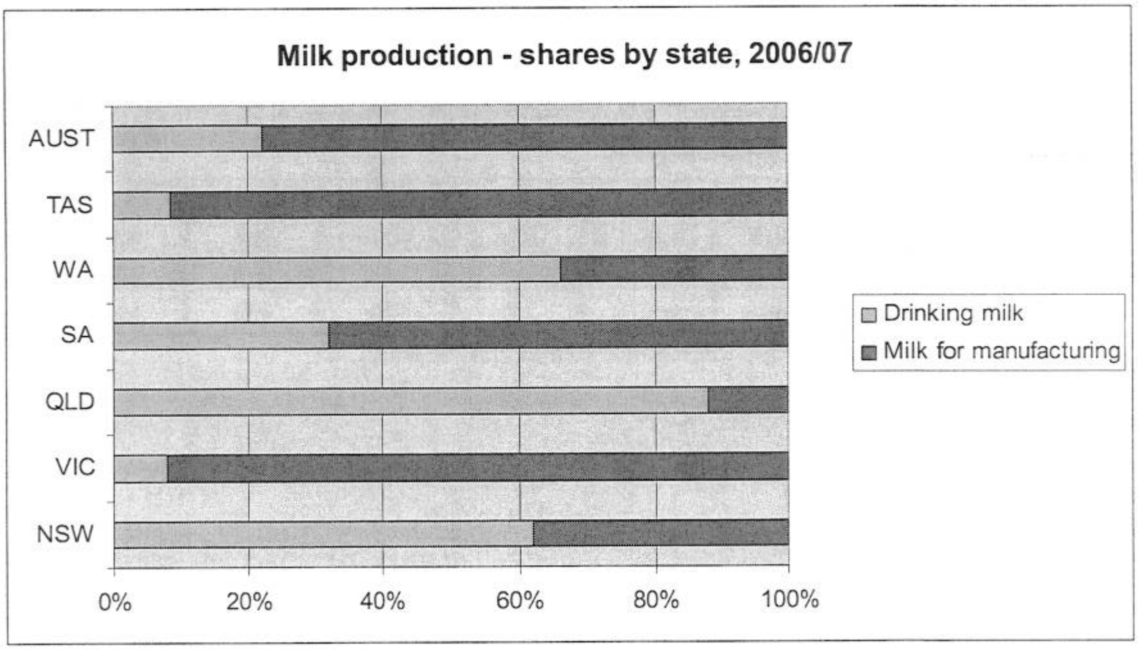
Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Around 80% of raw milk is manufactured into dairy products (such as cheese), with the remainder used for fresh drinking milk.



Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Australian milk production remains strongly seasonal. However, this is less pronounced in Queensland, Western Australia and New South Wales, due to the greater focus on drinking milk in the product mix of those states (which requires year around production).



Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Raw milk prices are ordinarily linked to milkfat and protein content levels. However, international prices for traded dairy products are the most significant factor in determining the price received by farmers for their raw milk.

Typical factory paid prices

		2004/2005	2005/2006	2006/2007
NSW	cents/ litre	32.9	34.3	35.7
	$/kg milk solids	4.62	4.80	5.02
VIC	cents/ litre	31.5	32.9	32.0
	$/kg milk solids	4.23	4.44	4.32
QLD	cents/ litre	35.0	36.6	38.8
	$/kg milk solids	4.84	4.99	5.38
SA	cents/ litre	30.1	32.0	32.6
	$/kg milk solids	4.19	4.49	4.57
WA	cents/ litre	27.2	29.0	32.0
	$/kg milk solids	3.89	4.09	4.49
TAS	cents/ litre	30.9	33.6	36.5
	$/kg milk solids	4.05	4.39	4.79
AUST	cents/ litre	31.5	33.1	33.2
	$/kg milk solids	4.28	4.50	4.51

Source: Australian Dairy Industry in Focus 2007, Dairy Australia

It is noteworthy that prices paid by processors to farmers in 2007/08 have increased significantly since 2006/07 (typically around 40% higher), for the reasons outlined above.

4 Processing of milk and dairy products

The milk processing sector is undergoing continued rationalisation, reflecting the need to achieve improved factory capacity utilisation, greater efficiency and economies of scale. This rationalisation is of particular importance given the current drought conditions in many parts of Australia which have constrained the supply of milk to processing facilities. The total production of milk in 2007/08 is forecast to be 15% below the level achieved in 2001/02.

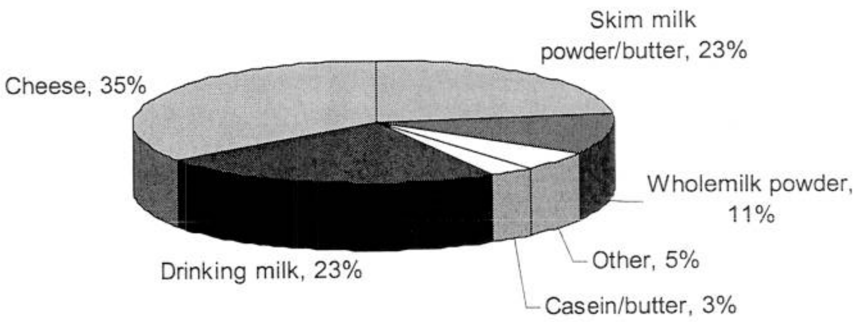
The Australian dairy manufacturing sector is diverse and includes farmer-owned cooperatives as well as public and private companies. The largest cooperative (Murray Goulburn) accounts for almost 40% of Australia's dairy production.

The major manufactured dairy product streams are:

- drinking milk – fresh and UHT;
- butter / skim milk powder;
- butter / casein;
- cheese;
- whole milk powder;

- fresh dairy products, such as yoghurt, dairy snacks, dairy desserts and cream; and
- specialised ingredients.

The utilisation of Australian milk in 2006/07



Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Around 68% of manufactured product (in milk equivalent terms) is exported. This contrasts with drinking milk, which is predominantly consumed in the domestic market.

5 Drinking milk

Whole milk, which is packaged for drinking, is standardised to a minimum milk fat content of 3.2%, as required under the Australia New Zealand Food Standards Code. Modified, reduced and low-fat milks are standardised to other relevant specifications and have varying milk fat and solids non-fat levels.

Drinking milk sales by State (mL)

	NSW	VIC	QLD	SA	TAS	WA	AUST
2004/05	641	486	429	200	215	53	2,024
2005/06	656	495	445	198	218	53	2,065
2006/07	684	509	475	207	230	55	2,160

Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Drinking milk sales by type (mL)

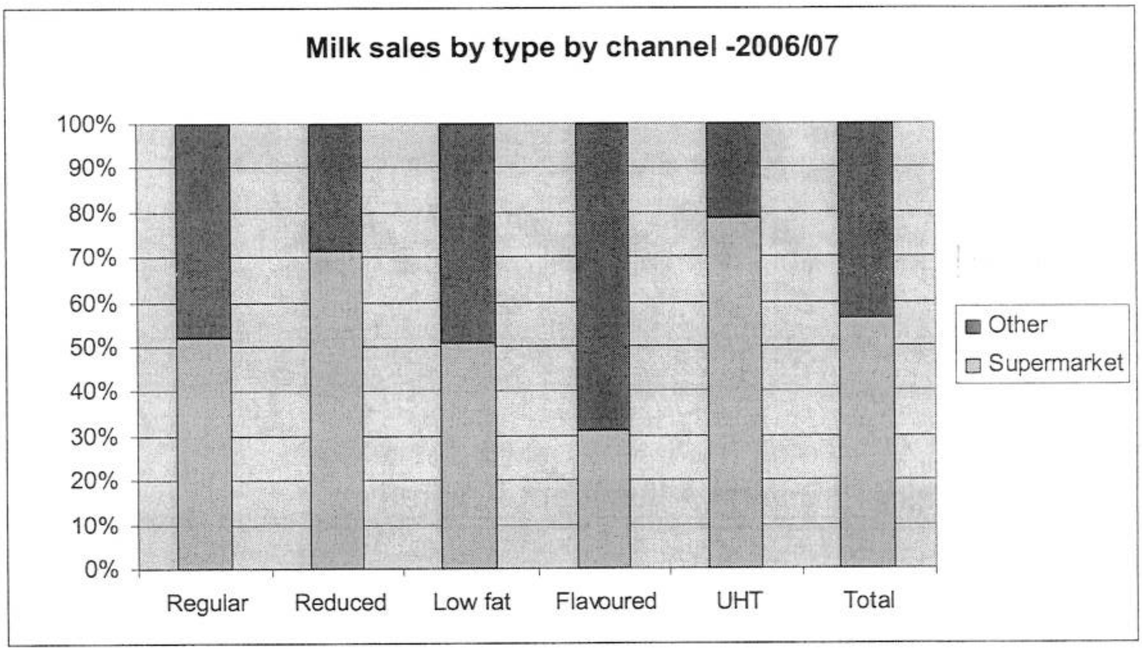
	Regular	Reduced	Low fat	Flavoured	UHT	Total
2004/05	1,078	457	138	200	152	2,024
2005/06	1,088	478	140	204	156	2,065
2006/07	1,111	511	147	216	175	2,160

Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Due to its perishability, milk processors require access to raw milk supplies within reasonable proximity to milk processing factories. In turn, these factories are usually located in areas from which major consumer markets can be easily serviced with packaged fresh milk products. Drinking milk processing facilities are therefore generally situated in the dairying districts located nearest to metropolitan cities and large regional centres.

In most areas the majority of drinking milk is produced by large scale processors, along with a range of smaller regional players. Since deregulation, a number of micro-processors have also developed niche markets by bottling milk on-farm for sale under their own brands.

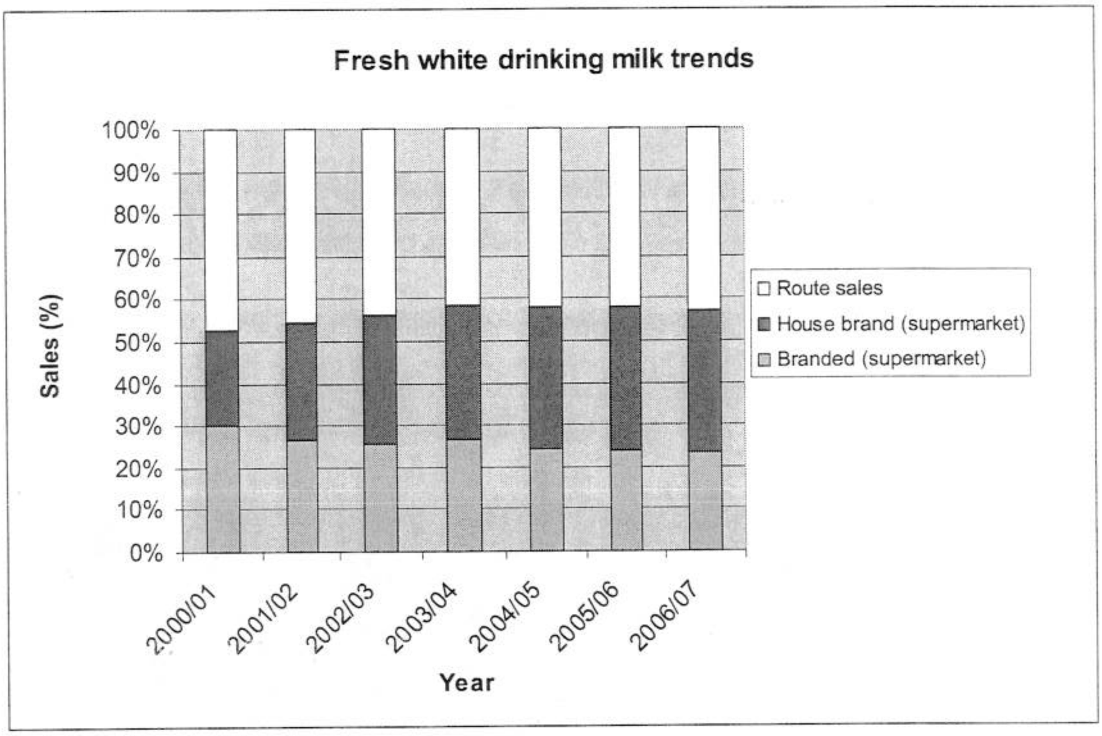
The major supermarket chains account for around 56% of drinking milk sales at the retail level.



Source: Derived from Australian Dairy Industry in Focus 2007, Dairy Australia

There has been strong growth of private label white milk sales in the grocery channel, at the expense of dairy company proprietary branded milk. Nationally, private lable sales of white milk in the grocery chains have grown by 65% in volume since 2000/01. This growth is demonstrated in the chart below.

National white milk drinking trends



Source: derived from Australian Dairy Industry in Focus 2003, 2004 and 2007, Dairy Australia.

6 Dairy Structural Adjustment Program

As part of the Dairy Structural Adjustment Program, the Dairy Adjustment Levy was imposed on domestic retail sales of products marketed as dairy beverages from 8 July 2000. The levy is set at 11c/L and payment is expected to continue to the end of the decade.

7 Cheese

Cheese is a major product for the Australian dairy industry, with domestic sales around 230,000 tonnes and export sales around 217,000 tonnes in 2007.

The basic process for making cheese takes the following path:

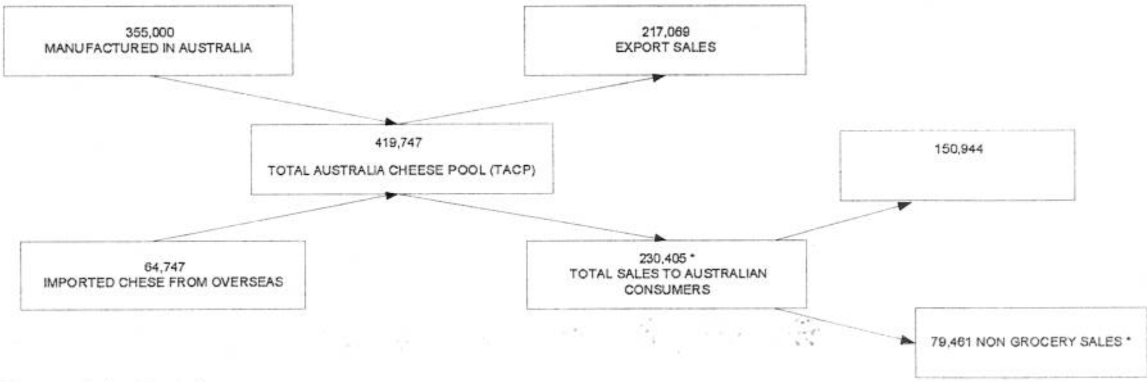
- raw milk is pasteurized. (White and Blue mould cheese have additional cream added whilst Fetta style cheeses have some of the cream removed);
- starter culture is added to warm milk to produce both acid and flavour;
- rennet is added to form curd and whey;
- the curd is cut and stirred to allow the whey to drain.

All the different varieties of cheese generally follow these primary steps. However, thereafter a range of processing techniques and skills are applied in order to produce the cheese varieties.

The Australian market for the manufacture and wholesale supply of cheese is characterised by high levels of international trade. The chart below provides an illustration of the cheese flows into and out of Australia. The chart shows:

- more than 50% of domestically manufactured cheese is exported;
- imported cheese forms a significant proportion of the domestic market (around 28%); and
- the majority of cheese is sold domestically through the grocery channel.

Estimated cheese flows in Australia for 2007 calendar year



Source: Dairy Australia.
*(includes 15,000 tonnes to reflect non-database contributors)

8 Dairy product distribution and retail

The major purchasers of drinking milk and dairy products from processors are generally categorised as either being in the grocery channel or the route trade.

8.1 The grocery channel

The grocery channel generally comprises supermarkets or independent stores which operate within buying groups as follows:

1. the major grocery chains (Woolworths and Coles), which sell their own private labels and processor proprietary brands;
2. other smaller chain supermarkets including:
   - Metcash's Action supermarkets which has stores in Queensland, northern New South Wales and in Western Australia;
   - Aldi, a growing participant in the Australian retailing sector.

Wholesale sales of dairy products to the grocery channel are often made pursuant to contracts that arise from a competitive tender process, particularly in relation to the supply of private label products.

8.2 The route channel

The route trade generally comprises smaller, independent supermarket stores and non-supermarket stores either in a convenience store format or the traditional corner store as follows:

1 independent grocery stores which have centralised purchasing arrangements, such as:

- Independent Grocers of Australia (IGA), a large group of over 1,100 retailers in New South Wales, Victoria, Queensland and South Australia, comprising a range of store types from large format supermarkets, mid-sized supermarkets and small format/convenience stores.
- Foodworks, a group of independent stores established in 1997 operating in Victoria, New South Wales and Queensland, comprising Foodworks supermarkets and FoodWise convenience stores.

2 petrol stations and convenience stores which purchase centrally, often on a national or state basis. These stores include those operated by the petrol retailers as well as chains such as 7 Eleven. It also includes the major grocery chains such as Woolworths and Coles, who have retail sites alongside major petrol retailers and are increasing their presence in the convenience sector;

3 corner stores who are serviced by milk vendors supplied by processors; and

4 foodservice providers including cafes, hospitals, hostels, restaurants, and coffee chains.

There are a variety of different contractual relationships that apply to wholesale sales of dairy products to the route channel. These include:

- contracts with individual retail outlets;
- contracts with dairy distributors that re-sell dairy products to retailers; and
- contracts to supply chains / groups of associated retail outlets that are negotiated centrally.

In each instance contracts are formed in a competitive environment.

9 Price changes for drinking milk and dairy products

In recent years there have been increases in the price of raw milk sold by farmers to processors as well as in wholesale prices for drinking milk and dairy products sold to retailers and internationally[1].

The key drivers of these price changes arise from both domestic and international factors.

1 Domestically, severe drought conditions in Australia have had the dual effect of increasing the cost of raw milk production for dairy farmers and reducing milk supply to processors. Both of these factors have driven up farmgate prices.

2 Strong international demand for dairy products combined with reduced supply from traditional exporting regions have pushed up dairy commodity prices. World prices in turn have a flow on effect at all levels of the domestic supply chain.

3 Milk processors, such as National Foods, are faced with higher input costs (particularly for raw milk and other goods such as petrol) as well as the costs of managing reduced milk supply (which adversely effects efficiency in logistics and plant utilisation).

In short, the recent price changes for the supply of raw milk and for the wholesale supply of drinking milk and dairy products are directly linked to increased domestic costs and

[1] As the ACCC is aware, price changes have also occurred at the retail / consumer level. However, National Foods is not a retailer and is not in a position to provide additional comment on the reasons for these adjustments.

increased world prices for dairy products. National Foods' experience suggests that the Australian dairy industry supply chain is highly competitive and efficient by world standards. This is reflected in the fact that half of Australia's total milk production is exported to more than 100 countries.