



Dairy 2010

Situation and Outlook

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This report has been prepared for the Australian Dairy Industry to provide participants and stakeholders with a comprehensive and objective assessment of the industry's position and outlook, as a resource to the dairy industry for information and planning purposes. The work has been funded by Dairy Australia.

The report has been written by Dairy Australia's Strategic Analysis team with assistance from Freshlogic. The project has benefited from the input from dairy farmers, management of Australia's major dairy companies, ADF Limited and Dairy Australia management.

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Executive Summary

Purpose of this report

- The Situation & Outlook report provides a clear, timely picture of what is happening in the Australian dairy industry and expectations for the future. The report is produced by Dairy Australia, with support from industry organizations – an example of collective industry activity.
- As well as informing farmers, the report aims to provide factual insights into dairy for banks, governments, regional communities, and suppliers of products and services to the dairy industry.
- The Situation & Outlook report is part of ongoing activity to build a comprehensive knowledge base on the Australian dairy industry, its operating environment and the factors affecting its future.
- The current uncertain and volatile operating environment for this industry underlines the need for all industry participants to have access to timely, credible intelligence on which to base decisions.
- In response, Dairy Australia is now augmenting this major annual report with regular quarterly Situation & Outlook updates on the key drivers of industry profitability.

The industry in 2010 – riding the rollercoaster

- Operating conditions for the Australian dairy industry have improved dramatically in 2010. In 2009, the industry was facing a crisis, with the global economic downturn cutting milk prices, and continued dry conditions placing many farm businesses at risk.
- In 2010, the industry's position has changed significantly for the better. Economic recovery has underpinned renewed demand growth in key markets, while reduced supplies have seen dairy commodity prices rise sharply in US dollar terms. This has seen a return to the fundamentals of the dairy market – without the overlay of a financial and economic meltdown.
- While the benefit of the international market recovery for Australian exporters has been constrained by the strong Australian dollar, farmgate prices for southern producers have improved in the second half of the 2009/10 season from relatively low opening prices compared with the previous two seasons.
- Improved milk prices, combined with low grain prices and generally favourable seasonal conditions see southern farmers enjoying the best production conditions for several years. Nevertheless the negative cash flow conditions of

2009 are still weighing heavily on farm businesses – with debt estimated to have increased by an average of 20% over the two years to 2009/10. Increased debt loads and higher interest rates will maintain pressure on farm finances.

- The 2010/11 opening farmgate milk price announcements will again be important signals for farmers assessing their short-term decisions and their longer term future in the industry. While uncertainty remains, particularly around currency, opening prices will be considerably higher than last year. Dairy Australia's forecast range for opening price of around \$4.40-\$4.60 per kg of milk solids (kgMS), implying a full year price range of \$5.00 and \$5.40 per kgMS. This is assuming dairy commodities trade at around current levels and the Australian dollar remains between 90 and 95 US cents. Dairy market fundamentals support this price outlook – however, the wider global economic situation remains the greatest threat to a sustained market recovery.
- Market and margin volatility has undermined confidence for many dairy producers, in particular younger farmers and those with low equity. Caught by the sudden downturn in milk price, they are financially stretched and uncertain of their ability to withstand future volatility in their returns.
- The low growth situation and outlook resulting from this uncertainty is intensifying the contest for sustainable regional supplies. Competition for milk between dairy manufacturers remains strong, due to increasing export demand, the need to fill factories and support future expansion plans.
- In northern states, conditions for dairy farmers have been relatively benign over the past year, with contract prices remaining in place for most dairy producers, and seasonal conditions remaining generally favourable. As a result, milk production has expanded beyond the requirements of fresh milk processors in the region. This adds to margin pressures being experienced due to the lack of wholesale price improvements in the retail market. As a result, processors are building in sharper signals designed to limit further growth into new supply contracts.
- While the turnaround in external operating conditions for most farmers is remarkable, confidence levels are unchanged. The volatility of the industry is undermining confidence in the outlook for many farmers who are seeking reliable returns on which to build a longer term future.
- Others are quickly adapting their production systems and responding to the changeable environment - confident in the ongoing demand for dairy products and their ability to sustain and grow their own business.

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Australian market Situation & Outlook

- The Australian economy has emerged relatively unscathed from the economic downturn. Household incomes have continued to grow steadily over the past couple of years - having directly benefited from government payments and sharply lower interest rates, as well as the effect of these measures in keeping unemployment relatively low.
- As the international market downturn hit, the Australian dairy market proved resilient, providing volume and value growth throughout 2009.
- However, households have responded to the uncertain economic conditions in 2009 by tightening their food spending, reducing eating out and opting for cheaper grocery options. Retailers have sustained aggressive price-based strategies.
- There has been a volume shift towards the grocery channel, contributing to growth in supermarket sales across most dairy categories, with some reversal of the trend toward private label products resulting from improved consumer confidence and aggressive brand promotion.
- As production has contracted in recent years, the local market has accounted for an increasing proportion of the industry's production – around 55% of annual output. The Australian market will continue to represent a relatively “safe haven” of steady sales growth for the industry with neither the extreme highs nor lows of the international commodity market. Companies supplying the domestic market are positioned to push for margin recovery, given the tight supply situation and improved export opportunities.

World market

- The international dairy market has become increasingly volatile over the past three years. Drivers of this instability include:
 - global economic environment which impacts demand and affordability;
 - structural changes in the global market with emerging suppliers and lower structural surpluses of stocks in the Northern Hemisphere;
 - highly variable weather impacting on exporting regions;
 - variable input costs impacting on farmers production intentions;

- the reaction of the market to new price indicators such as *globalDairyTrade* online auction results;
- changed buyer behaviour due to uncertainties caused by a combination of these factors.
- Spot international dairy commodity prices have increased by 80% in US dollar terms, since their February 2009 low, reflecting improved economic conditions and tight supply. This has taken commodity prices back to the levels of two years ago, suggesting the worst of the global financial crisis effects may be over. While retail demand appears healthy, buyers remain cautious – buying “hand to mouth” rather than rebuilding stocks, and adding to ongoing volatility.
- The demand recovery has been led by China, indirectly as a major driver of the global economy, and directly as a significant and growing importer of whole milk powder. Many retail markets in developing countries are segmented, and with limited supplies, Australian exporters are concentrating on higher value segments to maximise returns – for example, infant formula for China.
- Powder demand from South East Asia has remained resilient, as has Middle East demand for cheese and other products. Japanese cheese demand remains weak and internal supply and demand issues are limiting imports.
- As dairy prices rise and volatility increases, substitution of dairy ingredients for non-dairy fats and proteins becomes a greater risk – particularly as grain and soybean prices have been slower to rise in this current cycle. This poses a longer term threat for dairy demand, as once reformulation has occurred, ingredient buyers are reluctant to return to dairy products.

World supply

- World milk supply grew by just 1% in 2009, below the longer term average of 2%, as farmers responded to cut in milk price and profitability. With higher commodity prices being passed through the supply chain gradually, and farmer confidence and finances under pressure, a significant supply response is unlikely in 2010.
- After re-instating market support measures in 2009 and re-building government stocks, the US and EU are no longer intervening in the global dairy market. Government stocks did not reach historical levels and are largely committed to domestic programs, limiting their impact on international trade.
- US milk production finally contracted in 2009, with higher mid-west production offset by falls in Californian output. With the US milk price to feed grain ratio

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approaching expansion levels once again, milk production is expected to grow slightly in 2010 – however the significant financial pressure felt by larger farmers is likely to constrain their ability to respond.

- In the European Union, cold and wet conditions have delayed the spring flush of production, adding to shortages in fresh supplies and limiting growth in 2010. Increased internal cheese consumption and strong Algerian demand for milk powders is likely to limit production of butter and SMP for export. However, the debt issues plaguing a growing number of member states may limit consumption growth and weaken the Euro, enhancing the competitiveness of EU exporters.
- New Zealand milk production growth will be less than 1% in 2009/10, due to drought conditions affecting the North Island. Production is expected to return to the longer term average of 2 to 3% in 2010/11 as farmers respond to higher payouts.
- Despite a slow start, milk production is expected to expand in Brazil and Argentina in 2010. However, increasing domestic consumption is likely to limit the availability of product for export.

The farm sector in 2010

- The 2009 Situation and Outlook report highlighted the polarization that was occurring based on the nature and security of milk supply arrangements – in particular pricing and the seasonal conditions farmers were facing.
- The conditions of the past 12 months have increased the polarisation of farm businesses dependent on their region and their exposure to the international market. Looking forward to the 2010/11 improving prices and seasonal conditions in the south are likely to see greater convergence with the northern and far western fresh milk regions.
- Confidence in the future of the national industry, as measured by the National Dairy Farmer Survey, was unchanged in 2010 at 65% of respondents positive about the future of the industry. This is despite improving conditions for many producers. Those with a positive outlook cited demand for dairy products and adequate or improving prices as the basis for their views.
- Confidence in the future of the industry locally, was similar to that for the national industry across the survey at 64%, but with significant regional variations. From a high 85% of farmers expressing confidence in the future of their immediate western Victorian region to a low of 32% in South Australia.
- Milk price remained the greatest challenge farmers are seeing currently and into the future, while climate issues have receded in farmers' minds. While the second half of 2009/10 saw a significant increase in prices to southern farmers, and grain prices are at their lowest point for four years, 50% of farmers surveyed did not believe they would make a margin over costs for the January to June period. Farmers in Tasmania and western Victoria were the most likely to report a loss for the period.
- The residual impact of low 2009 prices is evident in ABARE farm income estimates. The ABARE survey estimates indicate a dramatic drop in national average farm cash income in 2009/10 to \$50,000 – down 43% from last year's \$88,000 figure. The regional variations around this average are significant, and the percentage of farms with a negative cash income lifted from 26% to 44% in 2009/10.

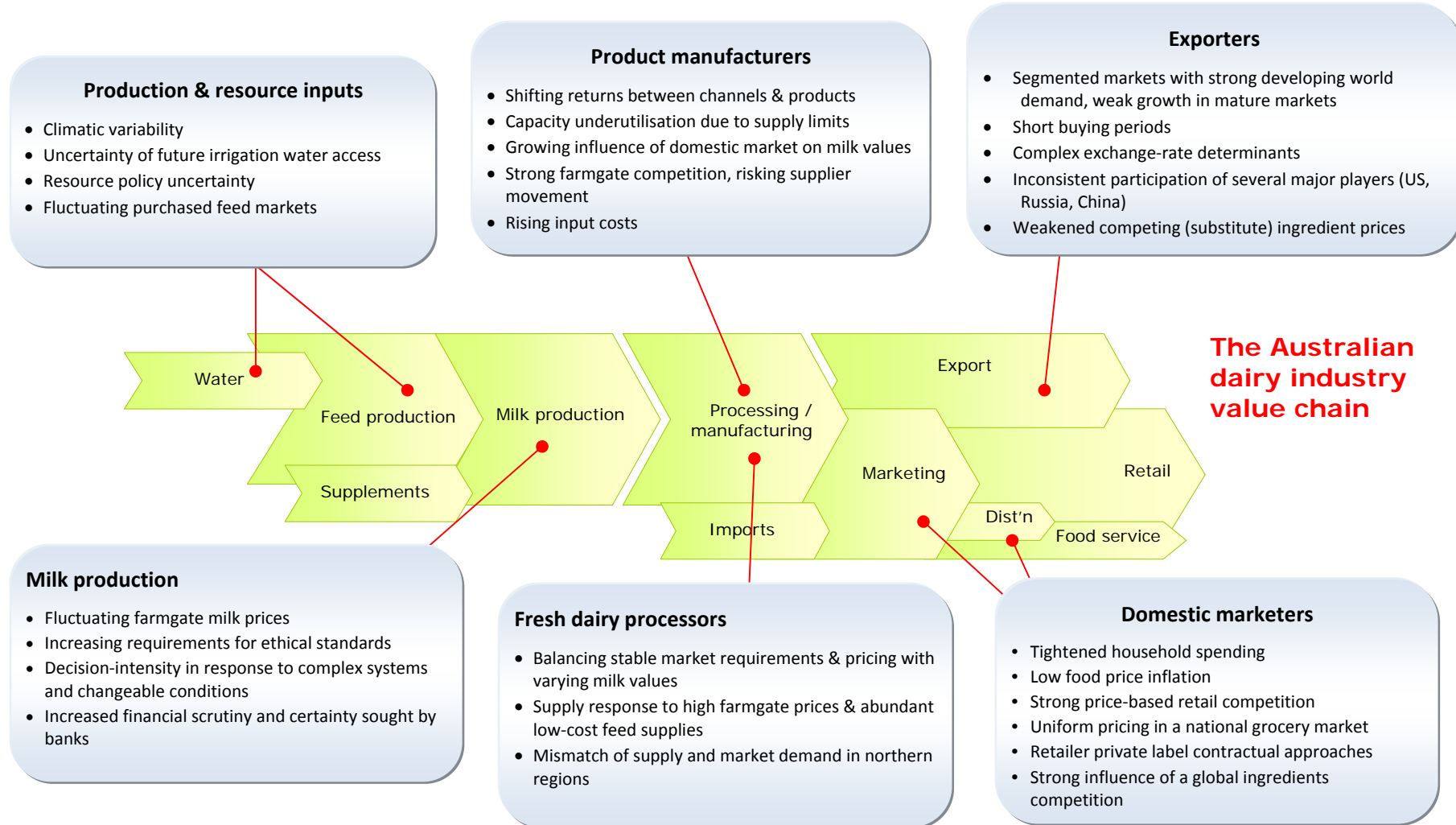
Milk production outlook

- Milk production contracted in 2009/10 as a result of sharply lower milk prices and a poor start to the season in southern states, which prompted many farmers to reduce herd numbers. With the lower peak production, and despite an end of season recovery, total national output is forecast to fall to 8.95 billion litres.
- The 2009/10 season offers significantly better prospects with the likelihood of higher farmgate prices for southern farmers, lower grain costs and a better autumn in most areas. In northern Victoria irrigators are enjoying their best water allocation for four years.
- However, the financial position that many farmers in southern Australia find themselves in is limiting their ability or willingness to expand production, in light of the volatility they have experienced over the past few years.
- At this stage the forecast for 2010/11 is for 9 billion litres, however, with National Dairy Farmer Survey respondents indicating a 2 to 3% increase in cows milked in spring 2010. However, there appears to be some upside in this forecast, should seasonal conditions continue to be favourable in most regions.
- Looking further ahead however, three year production intentions from the 2010 survey showed a significant decline in growth expectations compared with the 2009 survey. Based on these expectations and assuming reasonable seasonal conditions and prices, milk production could range between 8.9 and 9.2 billion litres by 2012/13. However, with a sustained improvement in both milk price and climate for the majority of producers, there is potential for stronger growth into the medium term

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Volatility driving pressure points in the value chain

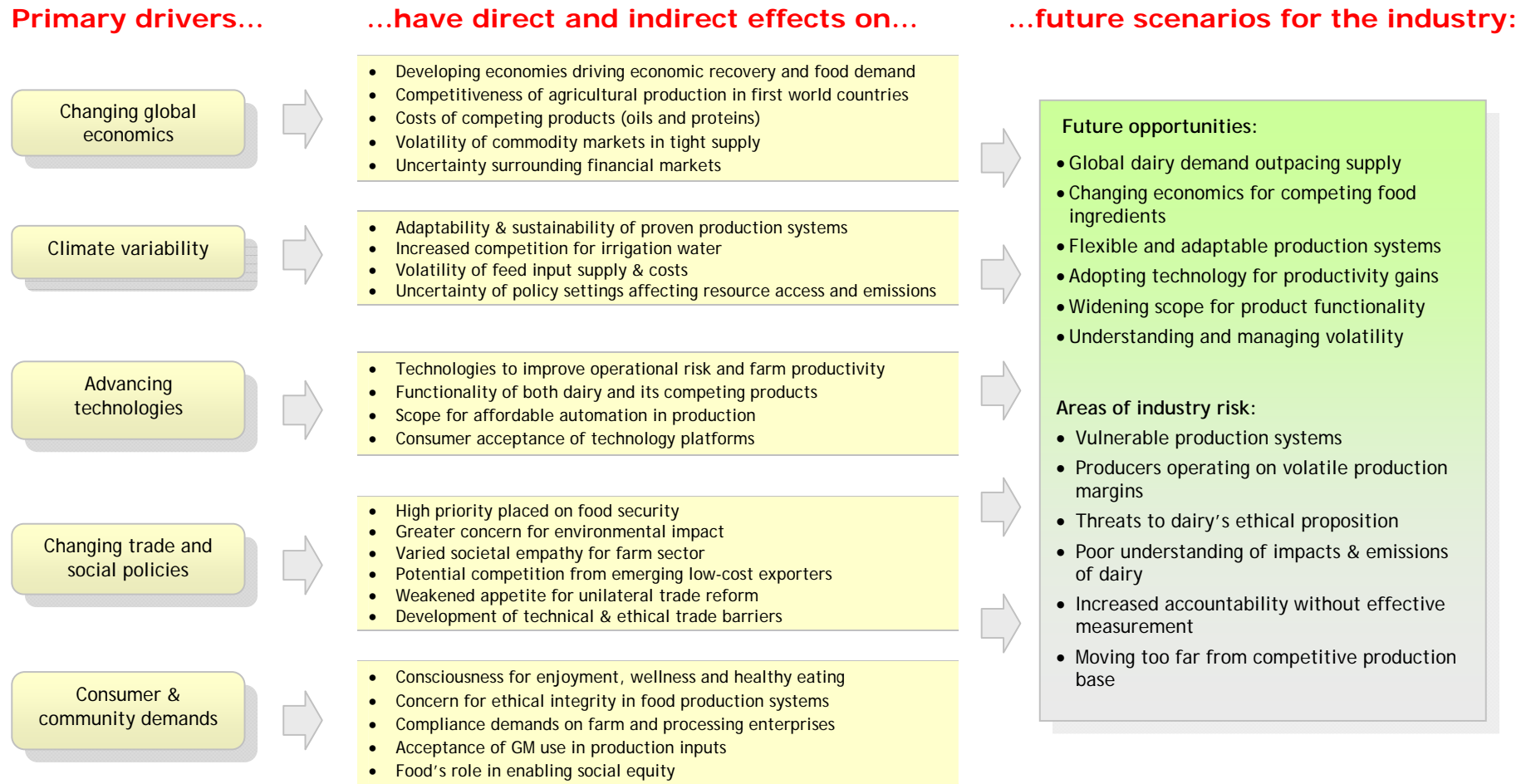
This map of the Australian dairy industry value chain reflects the pressure points being felt by participants – with greater influence of volatility on all sectors.



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Fig E.1 - Drivers of the industry's future

The scenarios for the future size and structure of the Australian Dairy Industry in the medium to long term will be shaped by a number of major primary drivers of change over time. The ultimate outcomes will be based on how well the Australian dairy industry responds to such future opportunities and risks affecting the industry's competitiveness and sustainability. Outcomes are also determined by how well the sectors of the value chain align and respond, affecting its capacity to adopt, innovate and differentiate.



Overview

What drives the returns to the industry?

- The domestic dairy market has consumed approximately 55% of Australia’s milk production in recent years. The export share of milk use remains just under 45% in 2009/10.
- In 2009/10 the product split from expected total milk production of 8.95 billion litres is estimated to be 24% in drinking milk and 76% in manufactured products such as cheese, dairyspreads and yogurt. However the product mix varies significantly between regions across Australia’s industry.
- The Australian industry is open to imports of dairy products, with imported product contributing an estimated 22% of domestic cheese consumption and 15% of domestic butter consumption in 2008/09. New Zealand is the major source of imports – contributing 73% of total cheese imports and 95% of butter imports. These figures have remained consistent over recent years.
- The majority of wholesale dairy product prices in the domestic retail, foodservice and industrial products markets are directly influenced by prevailing international prices and world market conditions.
- 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.
- Returns for drinking milk and fresh dairy products are less directly affected by returns for traded commodities; however, the extent of this influence varies from region to region.

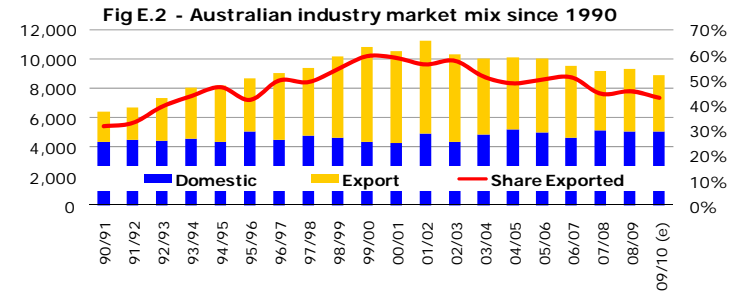


Fig E.3 - Australian industry product mix 2008/09

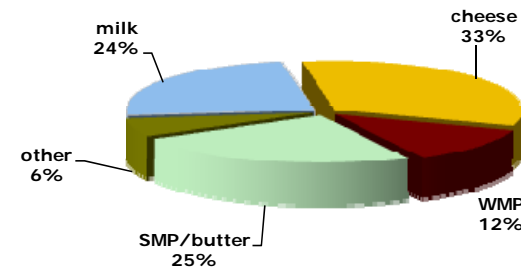
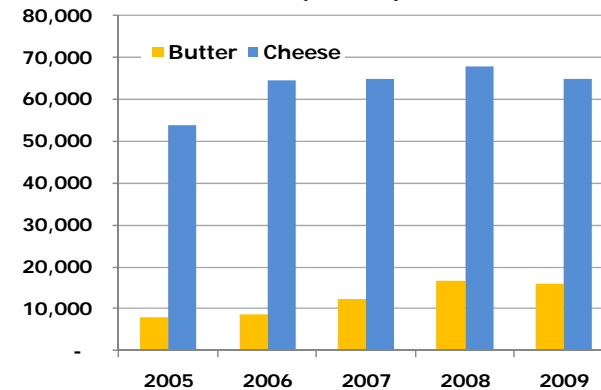


Fig E.4 - Australian imports of dairy products (tonnes)



Glossary of terms

<i>ABARE</i>	Australian Bureau of Agricultural and Resource Economics
<i>ABS</i>	Australian Bureau of Statistics
<i>ACCC</i>	Australian Competition and Consumer Commission
<i>ADF</i>	Australian Dairy Farmers Limited
<i>ASEAN</i>	Association of South East Asian Nations
<i>AUSFTA</i>	Australia and US free trade agreement
<i>BSC</i>	Bonlac Supply Company
<i>CAP</i>	EU's Common Agricultural Policy
<i>CPRS</i>	Carbon Pollution Reduction Scheme
<i>CWT</i>	Cooperatives Working Together
<i>DEIP</i>	Dairy Export Incentive Program
<i>Doha Round</i>	The round of negotiations of the WTO commenced in 2001
<i>EU</i>	European Union
<i>FAO</i>	Food & Agricultural Organisation of the United Nations
<i>FAPRI</i>	Food & Agricultural Policy Research Institute
<i>FNQ</i>	Far North Queensland
<i>FTA</i>	Free Trade Agreement
<i>GCC</i>	Gulf Cooperation Council
<i>gDT</i>	Global Dairy Trade online auction platform
<i>GED</i>	Global Economic Downturn
<i>GFC</i>	Global Financial Crisis
<i>Gipps</i>	Gippsland
<i>IDFA</i>	International Dairy Foods Association
<i>Intervention</i>	a process whereby a government buys products from the market to reduce commercial availability

<i>Mercosur</i>	A trade alliance between a number of South American countries including Brazil, Argentina and Uruguay
<i>NatFoods</i>	National Foods
<i>MPC</i>	Milk Protein Concentrate
<i>NSW</i>	Central and Southern NSW (including the Hunter Valley)
<i>NV</i>	Northern Victoria and Riverina
<i>NZ</i>	New Zealand
<i>OECD</i>	Organisation for Economic Cooperation and Development
<i>OPEC</i>	Organisation of Petroleum Exporting Countries
<i>PACER</i>	Pacific Agreement on Closer Economic Relations
<i>PDA</i>	Pauls Daily Access, a supply management scheme
<i>QSR</i>	Quick Service Restaurant eg McDonalds, KFC
<i>SA</i>	Central South Australia and Murraylands
<i>SEQ</i>	South East Queensland and Northern NSW
<i>SMP</i>	Skim milk powder
<i>Survey</i>	National Dairy Farmers Survey conducted as part of the preparation of this study
<i>TAFTA</i>	Thailand-Australia Free Trade Agreement
<i>TPP</i>	Trans-Pacific Partnership agreement
<i>TRQ</i>	Tariff Rate Quota
<i>US</i>	United States
<i>USDA</i>	United States Department of Agriculture
<i>WCB</i>	Warrnambool Cheese & Butter Factory
<i>WMP</i>	Whole milk powder
<i>WTO</i>	World Trade Organisation
<i>WV</i>	Western Victoria

The Markets for Dairy Products



Chapter 1

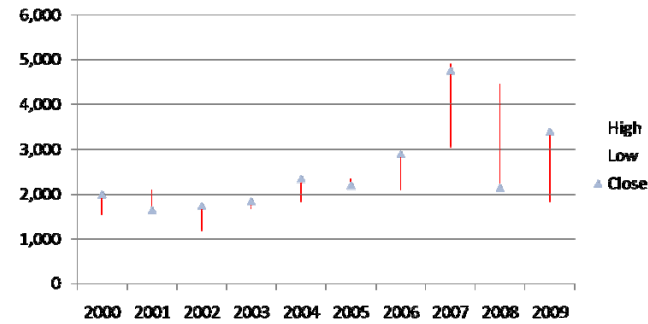
The international dairy market

Current market developments

Volatility in the market

- Volatility has become a key feature of the global dairy commodity market with shorter and sharper price swings. This is drawing increasing attention and many industries around the world are looking at ways to manage this volatility. In the past 3 years, the volatility in dairy prices has been far greater than in the past for the major commodities.
- The challenge for the world's dairy industries is that the global market will continue to be volatile in the future. There are a number of reasons for this. Firstly, the global dairy market is very thin. Annually less than 8% of all the milk produced each year is traded between countries as milk and dairy products. As a result, the global market is susceptible to price swings even when there are small shifts in supply and/or demand conditions.
- In addition, new factors in the market are leading to volatility and will see the range and frequency of price cycles intensify. Key factors at play include:
 - Highly variable weather impacting on production systems
 - Variable input costs impacting of farmers production intentions
 - Changing structure of the global market with emerging suppliers and lower structural surpluses of stocks in Northern Hemisphere
 - New market indicators such as *globalDairyTrade (gDT)* - and soon dairy futures
 - Volatile global economic environment which impacts demand and affordability
- Dairy is not alone when facing volatility. Many other agricultural commodity markets are exhibiting severe price swings. This includes grains and oilseed markets; which in turn can have a bearing on input costs for dairy farmers. There has been a greater range of commodity spot prices in the past 3 years compared to previously.
- The sources of dairy market volatility
 - Wider economic uncertainty
 - Low structural stocks and surpluses
 - Swinging players (US, Latin America , Russia)
 - New ways of interacting (eg *gDT*)

Fig 1.1 – Spot price ranges for WMP per year since 2000



- Shortening of buyer commitment – just in time purchasing and low stocks
- Climatic variability and its effect on supply
- Sensitivity of developing world demand to price and income changes

Supply weakened by lower milk prices

- 2009 was a year of lower than normal growth in global milk production. Traditionally global milk production grows around 2% each year but was constrained to less than 1% in 2009, reaching more than 560 billion litres. The slowdown in growth was driven by farmers around the world facing low farmgate price and high costs of production.
- 2010 will see a period of ongoing correction in the milk supply with improving, but still low, farmgate prices. Improving commodity pricing conditions should flow through to the farmgate by the end of the year, but this can be delayed by various factors along the supply chain. Whether this translates into a strong recovery in production in 2011 will depend heavily on farmer confidence and the situation with input costs.
- With supply growth likely to be more constrained in low cost regions such as the Southern Hemisphere, the market will be dependent on securing product from higher cost suppliers such as Europe and the US. This underpins expectations that the global commodity market will trade above traditional levels in the short term.

Global economic settings

Economic recovery

- Recovery from the recession caused by the global financial crisis (GFC) and its effects is underway, but still fragile. The GFC has accelerated the shift in the balance of economic power from west to east, with each facing very different growth prospects. The IMF predicts that from for the period from 2007 to 2011, the output of the “rich” countries will rise 1.9%, while developing countries up 22.1% - a two-speed world economy.
- In 2010, world output is expected to rise by about 4.25%, and again in 2011. This follows a 0.5% contraction in 2009. In most advanced economies, fiscal and monetary policies should maintain a supportive thrust in 2010 to sustain growth and employment.
- It is expected there will be a slow and steady recovery of US and EU. The issues surrounding sovereign debt in Greece and other member states present a significant risk to recovery. The US appears to be stabilising, but sustained high unemployment and excess capacity will slow economic recovery.
- The EU meanwhile is recovering more slowly, suffering rising unemployment, concerns over high public debt in some member states and tight credit conditions.
- Japan’s economy is recovering slowly, but suffers persistent risks of deflation and difficulty in passing on increased costs of food. The economy is improving slightly at the business level, but is yet to show any significant recovery in private demand.
- In both China and India, strong domestic demand will support the recovery. Stimulus measures have played a major role in the recent strength of domestic demand, which is expected to have positive spillovers for other Asian economies.

Financial markets remain troubled

- The timing and coordination of the withdrawal of stimulus packages is one of the major future threats to stability facing the global economy. Premature exits could choke off recovery, while unwinding too late could trigger inflation and further asset bubbles.
- The challenges amount to managing a rebalancing of global demand from public to private sectors; away from economies with excessive external deficits toward those with excessive surpluses; while supporting economies still struggling to recover.

- Financial risks to individual countries and the banking systems remains a concern, in view of the mounting debt of the developed world. The key concerns are centred on the EU – in particular Greece and neighbouring countries where sovereign debt has reached a crisis point.

Currency movements

- The Australian dollar (\$A) has risen in value against most major currencies reflecting Australia’s quick recovery from a relatively mild recession.
- Factors that are currently influencing the relative value of the \$A
 - Better performance of the economy
 - Commodity demand
 - Relative interest rates (between Australia and the US)
 - Weak recovery in the US and EU
 - Financial risks facing US, Europe and Japan
- The growing interest rate differential between Australia and the USA, in addition to increasing commodity prices have driven the \$A to its current levels. Official rates are likely to push up to 5%-5.25% by the end of the year. Depending on the bank, could peak between 5-5.5%. Strong resources sector and recovery in housing construction are supporting higher interest rates.
- More recently the Greek crisis saw investors seek the safe haven of the US dollar, resulting in it strengthening against major currencies. This, combined with increased concerns of an economic slowdown and reduced commodity demand saw the \$A fall below 90 US cents in May before recovering on assurances from the European Central Bank and EU finance ministers of a safety net package for troubled Eurozone members
- By the end of the year major Australian banks have a forecast range for the \$A of 90-97 US cents. A Bloomberg survey of 32 financial institutions for the same period forecasts the \$A will be somewhere between US\$0.87 and US\$0.89.
- Those with low forecasts believe the US will recover sooner. Meanwhile many of the Australian banks have confidence the commodity boom, continued Chinese growth and an expanding interest rate differential will support the \$A.

Global market outlook

Mitigating volatility

- A number of initiatives are being implemented to assist participants to manage volatility in the dairy market.

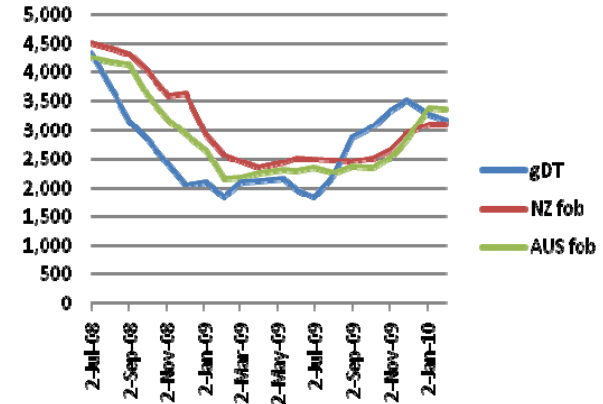
globalDairyTrade

- The advent of the *globalDairyTrade* (gDT) online auction platform has allowed forward buying and selling of Fonterra product, and provided greater price transparency for whole and skim milk powder sales. The platform has also changed buyer behaviour. Purchasing activity is active immediately after the latest results. After a few weeks, sales slow down as the focus then switches to the next auction.
- From May gDT is publishing a dairy price index, the gDT-Trade Weighted Index. The index will show the percentage change in the average price of the basket of products currently traded at the monthly auction, weighted by total international dairy product trade flows.
- The significance of the gDT for world trade is increasing. In the 2009 calendar year 214,000 tonnes of New Zealand-origin WMP were sold through the auction system. This represented about 30% of all WMP produced in New Zealand and 12% of world trade in WMP for that year.

Futures markets

- In response to increasing volatility a number of exchanges have seen an opportunity to launch dairy futures products. As a result, markets are being established in the US, Europe and New Zealand.
- While the underlying dairy market will still be exposed to the risk of volatility due to the influence of demand and supply factors over time. These products will allow participants to manage the extent of their exposure to the price effects of these changes. Futures offer opportunities to protect margins and profits, but are not without their own inherent risk.
- The facilities will also open dairy to a range of new participants and investors who don't deal in the physical product. Futures provide important reference pricing to set value, provided there is sufficient liquidity. The trading platforms will not replace or mirror the direct trade that occurs, in a market that is increasingly driven by specification and relationship, especially if there is an ongoing tight supply situation.

Fig 1.2 - WMP price gDT vs NZ and Aust fob



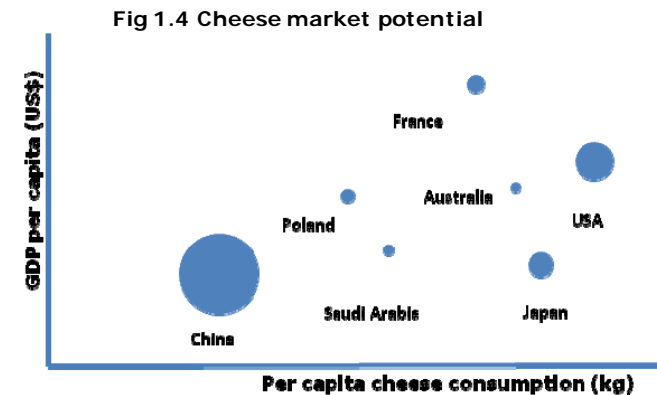
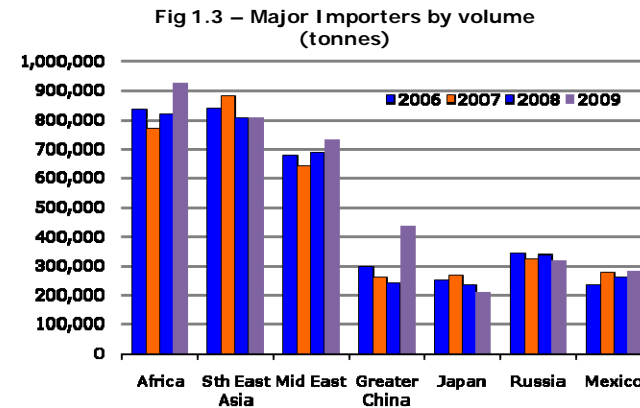
- The US proposal – to be operated on the Chicago Mercantile Exchange - is for physical delivery to specified ports. The European and New Zealand products are cash settled contracts, which allow participants to buy a financial product that derives its price from dairy commodities.
- Companies creating the futures market stand to profit from each trade. There is significant interest from potential users, but most would prefer to ‘wait and see’ how the trading platforms take off and what sort of liquidity is available. Despite the opportunities for dairy product manufacturers, exporters and importers, there is little scope for direct access by milk producers who wish to manage the milk price risk.

Operator	Starting date	Product	Unit of trading	Tick size	Specifications
NZX	June 2010	WMP	1t	US\$5	Cash settled to gDT
CME	May 2010	SMP	20t	US\$10	Physical delivery
NYSE Euronext	Mid-2010	SMP, butter and whey	n.a.	In Euros	n.a

Global market outlook

Demand factors

- Economic conditions, particularly in the developing world will be an important determinant of demand for dairy products. The key Asian economies have largely withstood the economic crisis – continuing to grow throughout 2009, and leading the global recovery.
- While much of the current demand in developing countries is for lower priced commodities, the development of internal production and distribution infrastructure will allow for increasingly sophisticated and differentiated dairy products to be made available to consumers.
- As economic growth in Asia and other developing nations gathers pace, increased incomes are expected to underpin the ongoing westernization of diets and increased demand for dairy products. The nutritional value of dairy products is a key driver for consumption in these markets, as households will increasingly seek to optimize their health and well-being through their expanded food choices.
- With rising incomes and improvements in household spending power over time, sensitivity of consumers to price and income changes for dairy products is reduced as food purchases constitute a smaller proportion of the household budget for the growing middle class.
- In Asia, Food and Agricultural Policy Research Institute (FAPRI) modelling suggests the projected boost in Asian dairy demand resulting from economic growth, population increases and changing diets will lead to increased production in India and China, with China becoming a net exporter after 2012.
- However, south-east Asia is expected to remain heavily dependent on imports, with FAPRI modeling indicating steady growth between 3.3 and 4.5% annually for dairy products. This represents a key opportunity for the Australian dairy industry which is well established in the region.
- Dairy demand from oil-dependent economies such as Russia and the Middle-Eastern bloc is expected to increase as economic recovery pushes oil prices higher. Despite moves toward increased self-sufficiency, Russia is expected to remain heavily dependent on imports – primarily from the European Union.



Global market outlook

Risks to the global economy

- While the acute phase of the financial crisis appears to have passed, and recovery is underway it remains fragile, and scenarios of a double-dip recession or further slow down are still a possibility. The key risks to the global economy include:
 - growing sovereign debt
 - withdrawal of government stimulus
 - integrity of financial systems
 - slowdown in Chinese growth
- Many countries entered the crisis with significant government debts. The International Monetary Fund (IMF) estimates the world's 20 largest economies, the G20, will have a total debt equal to 118% of their combined gross domestic product by 2014, meaning debt will have exploded by 50% in just seven years.
 - Britain has not run a budget surplus since 2001, Japan since 1992, and Italy and France even longer.
 - Japan presents the greatest worry in the medium term. The IMF expects government debt to exceed 246% of GDP by 2014.
- High public debt and fiscal deficits could lead to higher interest rates and slower economic growth in the medium term.
- While the global economy has stabilized over the course of 2009 and early 2010, the seriousness of the Greek debt situation that emerged in May highlighted broader concerns about sovereign debt. With neighbouring EU member states in a similar situation the "Greek contagion" has the potential to spread throughout the EU, destabilising the entire Eurozone. The IMF and other member states have moved to contain the crisis, offering Greece a €110 billion lifeline in exchange for austerity measures including reduced spending and increased taxes – a move not welcomed by Greek citizens.
- It is crucial, in the medium term, for governments around the world to exit from the high levels of public debt taken on in the stimulus effort. Timing and coordination of exit strategies is crucial. Premature exits could choke off recovery, while unwinding too late could trigger inflation and further asset bubbles.

- The IMF has indicated that fast-growing emerging markets can start withdrawing stimulus packages so that large public debt can be reduced.
- The OECD has predicted that economic growth is likely to slow in advanced nations in the first half of 2010, and governments should wait until 2011 to withdraw stimulus and curb deficit spending.
- In early May, the nervousness of the wider global markets was highlighted when an erroneous trade sent US share markets tumbling before being corrected. Confidence in the world's financial systems has not been restored, with investors still lacking trust in the integrity of markets and financial instruments.
- China remains critical to the economic recovery. The OECD puts Chinese growth at 10% for 2010, indicating it will contribute one third of global economic growth. The Chinese government is seeking to control a property bubble without a major collapse in asset prices. The leadership has opted for a series of specific measures designed to limit speculative lending.

	<i>Year on year % change in output (GDP)</i>		
	2009	2010	2011
Advanced economies	-3.2	2.3	2.4
US	-2.4	3.1	2.6
EU Area	-4.1	1.0	1.5
Emerging economies	2.4	6.3	6.5
China	8.7	10.0	9.9
ASEAN	1.7	5.4	5.6

Source: IMF World Economic Outlook April 2010

Global market outlook

Demand regions at a glance

Russia

- Import volumes rose steadily to 2008. Cheese is largest product category; with EU the major supplier
- Increasing commodity prices and the decline in value of the Rouble curbed imports in 2009 to 430,000 tonnes
- Dependent on imported cheese and butter
- Further expansion will be driven by expanding food service and hospitality sector as the economy expands, but there will also be support from increasing retail consumption
- Russia will continue to regulate dairy trade with Belarus and limit imports if they become excessive – however there is likely to a continued reliance on imported product

China

- Consumption per capita fell 6% following the melamine contamination
- Import volumes have risen sharply in 2010 as imported product replaces local milk powder production. Local WMP output fell 15% in 2009.
- Processors are investing heavily in their own supply chains to ensure quality of the raw milk they purchase, aiming to lift demand.
- Dairy herd expected to increase 3-5% in 2010.
- WMP import demand will remain strong for a period (2-3 years) while milk production restructures.

Middle East

- Region imported 1.2 million tonnes in 2009, with a temporary decline expected due to GFC effects.
- Consumption of milk drinks expected to rise more than 3% per annum over next 5 years as recovery continues.
- Consumption of cheese and other products expected to improve as consumers look to expand their diets and living standards improve.
- Saudi Arabia and UAE most important markets (45% of volume).
- Economic outlook is for steady demand growth as oil prices are expected to remain firm and drive economic activity.
- Strong demand for local product styles but this is widening with food service and retail diversity.

Africa

- Dairy consumption will continue to be supported by government social programs (i.e. price concessions) and trade will be assisted by credit guarantees.
- Algeria imported 272,000t, and Egypt 174,000t of dairy product in 2009.
- Sub-Sahara Africa collectively imports in excess of 250,000 tonnes of dairy products each year.
- Mix of low GDP per capita and hence little opportunity to consume dairy. Others have growing national incomes due to tourism or oil which has boosted consumption.
- Significant barriers to growth due to under developed cold chain infrastructure, or poor transport infrastructure.

South East Asia

- Region imported 1.5 million tonnes in 2009, up 38% in last 10 years. Australia supplied 18% (in 1999 was 34%).
- NZ has major share of powder trade.
- As education and economic prosperity spread throughout the region, there is also a steady increase in demand.
- Growing market for higher value powders and mixtures as base of consumption broadens. Higher levels of wealth allow consumers to move higher up the product value chain.

Global market outlook

Supply factors

- Common challenges due to climate and market volatility are putting production margins under pressure in many producing regions.
- Domestic dairy consumption for major producing regions with exportable supplies will be critical to global dairy market balance. This is because local markets are the primary focus and international markets are a secondary channel.
- Shifts in local demand in the US, Argentina, Brazil and most parts of Europe have a direct impact on the export availability of dairy commodities. In these markets the domestic market absorbs in excess of 80% of all milk produced.
- The South America region provides a good example. While milk production is likely to grow in both Argentina and Brazil in 2010, local consumption patterns are expected to outpace this growth and actually limit milk available for export markets this year. In contrast, both Australia and New Zealand are much more reliant on the export market and have been continuous net exporters for many decades.
- Farmgate milk prices in 2010 are generally more positive than last year, with an expectation that milk prices will continue to improve. Farmer confidence and margins over input costs will be critical influences over whether this converts to higher milk production.
- As economic conditions for dairying improve around the world, so will production intentions, yet there is likely to be a lagged impact on the world dairy market.
- Current Southern Hemisphere milk production season is winding down. For next season, production is likely to grow in most markets but growth is likely to be limited to lower than normal growth. Weather patterns over the remainder of the year will be critical.
- In the Northern hemisphere, the EU season has started poorly and milk production will remain flat as a result. This is despite having additional room under the milk quota. While US milk production has edged above in recent weeks, production growth will be constrained to less than 1%. This is below the average growth of 2% in the most recent expansion phase.

Fig 1.5 - Changes in milk supply from major exporters

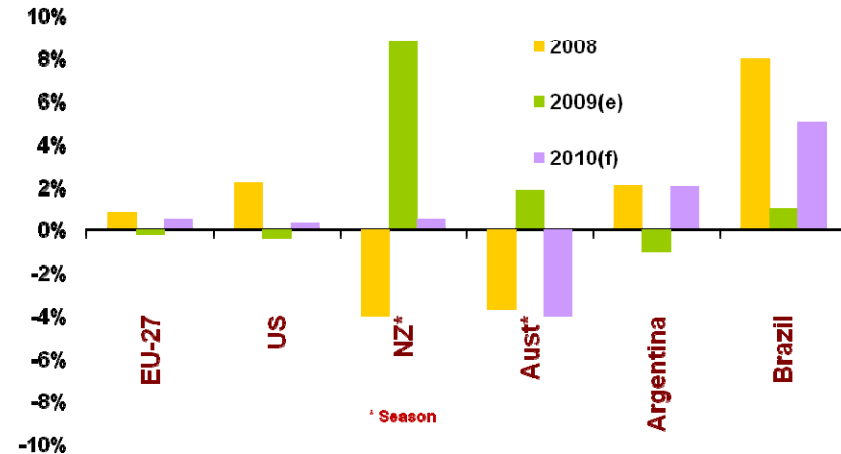
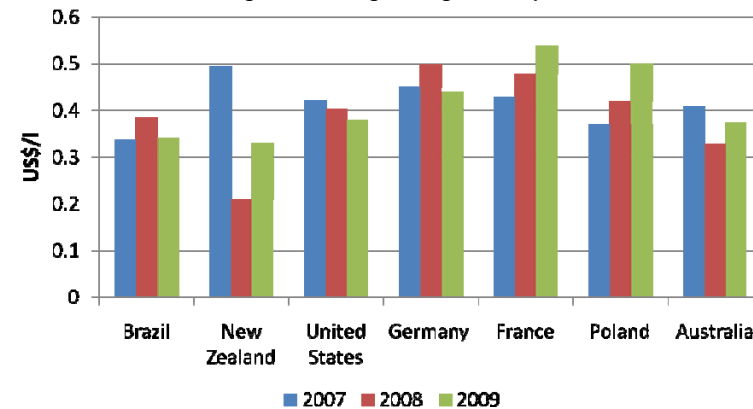


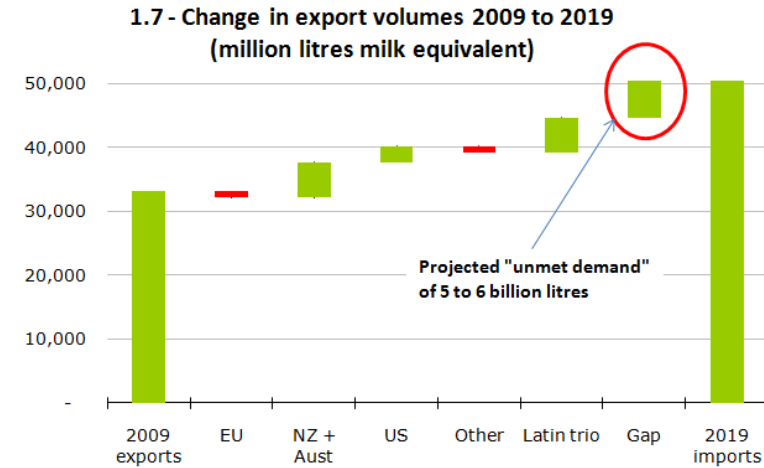
Fig 1.6 – Average farmgate milk prices



Global market outlook

Long term outlook

- The Australian dairy industry is an exporting industry with established customer relationships in markets and regions that will lead demand growth into the future.
- Global demand is likely to continue to rise in the long term with growing awareness of milk's nutritional value and functional diversity, and the improvement of living standards in developing economies.
- The outlook chart on the right describes a scenario for future trade in dairy products. In this scenario, the apparent gap in future world milk supply to meet projected demand, has been based on detailed demand and supply assumptions using available information and latest outlook projections.
- This outlook takes account of the trade in the world market in 2009, and reflects the following key assumptions:
 - Projected growth in milk production, export availability for a number of the major producers and exporters, as modelled by FAPRI in 2010 and adjusted based on latest information
 - The EU's outlook for milk production, dairy product manufacture and consumption
 - Assumed growth in production in Australia of 1% per annum and New Zealand of 2.5% per annum
 - Projected Chinese production in farm output and ingredient manufacture
 - Already low rates of self-sufficiency in dairy products of South East Asian countries will decline further
- This scenario is highly sensitive to the following factors :
 - Milk production and ingredient manufacture in China
 - EU trade balance
 - US trade balance
- This gap implies that there are opportunities for existing and new suppliers to increase their participation in a growing world market.



- With growth in supply lagging the expansion of demand, upward pressure on commodity prices will be maintained.
- The tight balance and sensitivity of the outlook to small changes in variables in key production and market regions lends itself to ongoing price volatility.

Global market outlook

Competitors at a glance

USA

- US milk production fell in 2009 by 0.1% to 83.4 billion litres. Current forecasts suggest production will recover slightly in 2010 by 0.3%.
- US exports of most dairy commodities weakened in 2009. Cheese exports were -17% to 109,000t, SMP exports - 34% to 264,000t and butter exports - 72% to 22,000t. Whey and lactose exports improved by 3% and 18%, respectively.
- Economic recovery will also help lift domestic dairy consumption
- High commercial cheese stocks overhang the market in 2010.
- Fully committed intervention stockpile of SMP – no expectation of additional purchases this year with wholesale prices likely to remain above trigger levels.
- No DEIP activity since late 2009 but CWT program in operation

South America

- Collectively the South American countries exported 720,000t of WMP beyond the local region. This was +40% on the previous year.
- 2010 domestic consumption is expected to grow (as economies recover) at similar rates to production; which will curtail export trade.
- The region has capacity to expand, but is hindered by economic, political and climate instability as well as strong competition for resources from other agriculture sectors.
- Import demand from oil-rich Venezuela will be an important factor in 2010. Imports reached 250,000t in 2008 but fell to 150,000 in 2009

EU

- Production volumes started 2010 below prior year, and remain well below quota levels. Limited production growth is expected in the medium term despite quota increases and planned removal of limits in 2015.
- In 2009 EU SMP exports were +28% at 227,000t, the highest for five years. Cheese exports in 2009 were 576,000t, +4% while WMP exports were -7% at 450,000t. Butterfat exports were -2% to 138,000t.
- Wholesale prices strong, driven by world trends, although internal consumption is mixed with consumers in several regions trading down due to poor economic conditions
- Retains high uncommitted intervention stocks of SMP (192,000t) equivalent to 20% of annual EU consumption.
- Export subsidies were set to zero in November 2009

New Zealand

- Milk production expected to finish up 0.5% in 2009/10, with drought affecting North Island output. South Island production will grow by about 8% due to continuing new investments
- 2009 was a strong year for New Zealand exports with all categories growing. WMP exports were 818,000t (+35), SMP exports were 408,000t (+69%), cheese exports were 290,000t (+17) and butterfat exports were 451,000t (+38%)
- For 2010/11 milk production growth expected within the range of 2-3% again. Longer term New Zealand does have potential to increase production based on its pasture based

	Australia	New Zealand	United States	Europe	Argentina	Brazil
Growing milk supply		x	x		x	x
Low cost production model	x	x			x	x
Processing sector economies of scale		x	x			
Large domestic market			x	x	x	x
Extensive product portfolio	x	x		x		
High quality products; food safety and traceability	x	x	x	x		
Established distribution networks	x	x		x		
Long term customer relations with commitment to market	x	x		x		
Geographical and preferential access to large import markets	x	x	x	x	x	x
Political and economic stability	x	x	x	x		
Government policy intervention			x	x	x	x

Global market outlook

Competitor products

- Dairy substitution in ingredient applications will continue to be a threat for the dairy franchise. Price volatility, and generally higher dairy prices, will encourage substitution and reformulation from some ingredient buyers.
- This factor represents a ceiling for dairy commodity prices which the market is nearing. While impossible to specifically identify, history suggests that once dairy commodities near US\$4,000/tonne, there is a heightened chance of demand backlash.
- During the last commodity price boom, substitutes were able to take some market share from dairy and this will need to be avoided in the future as once lost, this demand is difficult to entice back. Added to the pressure on the dairy franchise is market volatility which appears at times to be more severe than for alternative commodities.

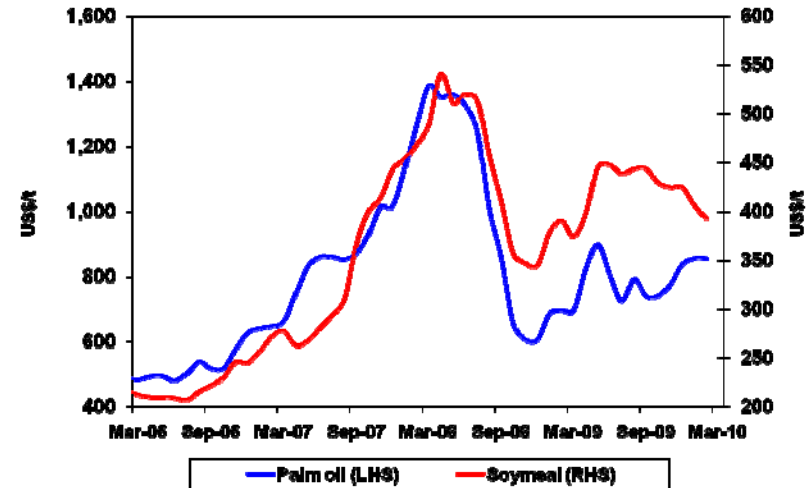
Vegetable oil

- Production of palm oil will probably remain below potential for the second year in a row. Lower than expected expansion of palm oil production are to be seen as the major reasons for the anticipated slowdown on the supply side.
- Palm oil production is expected to increase seasonally in Malaysia and Indonesia in the April/June quarter but, in our assessment, there is only limited scope for a replenishment of palm oil stocks. The recent drought in many parts of Malaysia has stressed palm oil supply.
- Palm oil fundamentals have changed considerably owing to a deterioration of production prospects for 2010, which will significantly curb exports and consumption. Palm oil prices may face some downward pressure as the year progresses, driven by a shift in consumer purchasing patterns in favour of cheaper soya oil.

Soy

- Market fundamentals are weighing heavily on soy product pricing. The market is carrying significant volumes of stocks. Compounding the situation is new South American crops which are increasing.
- The Argentine soybean crop for 2010 is expected to reach a record 53.3 million tonnes, up steeply from the drought-reduced crop last year. In the United States,

Fig 1.8 – Prices of vegetable oil products



the USDA says farmers intend to plant a record 78.1 million acres of soybeans this year.

- Meanwhile, world carryover stocks are expected to reach the second highest level on record. Strong supply is expected to keep soy product pricing under considerable pressure in the short term.

Policy drivers

Intervention policies

- A better balance in the marketplace, in addition to firmer prices and budgetary limitations, is expected to limit the use of these government intervention tools in future.
- Last year saw the re-introduction of market intervention tools, namely export subsidies and a build-up of intervention stock. In 2009, the European Commission used almost all measures at its disposal to intervene in the dairy market and had to find significant levels of funding from elsewhere in the budget.
- EU export subsidies were used until November 2009 when the market recovery allowed the EU commission to set them to zero. There is no immediate prospect of their use in 2010 because of the small gap between EU and world prices, but operators have begun tendering for subsidies for SMP. In the EU, 280,000 tonnes of SMP and 83,000 tonnes of butter were sold to intervention stores in 2009.
- In October 2009, the US ceased its dairy subsidies under the Dairy Export Incentive Program for 2009/10, after reactivating the subsidies in April 2009. In addition, the Commodity Credit Corporation purchased 125,000 tonnes of milk powder between October 1, 2008 and the end of July 2009 under the Dairy Product Price Support Program (DPPSP).

European Union

- All of the dairy reforms agreed in the Health Check of the 2003 CAP reform are now in place and it is unlikely that there will be significant changes to these in the period to 2013.
- The key dairy elements of the Health Check are:
 - Milk quotas are generally being increased by 1% every year between 2009/10 and 2013/14. Milk quotas are then programmed to expire in 2015.
 - Intervention systems for butter and SMP, and private storage aid (PSA) for butter, have been retained in their current form. Intervention stores open between March and August at a fixed price until annual volume ceilings are reached, at which point a tendering system may be introduced.
 - Obligatory PSA for cheese and the butter aid schemes (for pastries, ice cream and direct consumption) are being abolished.

- Some dairy farmers will be able to receive financial aid under a new 'Milk Fund', to be included under the Rural Development regulation, and 'Article 68' (the transfer of direct-payment funds to funding for specific cases).
- The European Commission set up a High Level Experts' Group on Milk (HLG) to consider long-term dairy policy directions. The Australian Government and the Australian dairy industry made submissions to the HLG in December 2009/January 2010 covering Australia's experiences with restructuring the dairy sector and the benefits of deregulation.

United States

- In June 2008 the US Congress enacted a new multi-year farm bill (the Food, Conservation and Energy Act of 2008). This Farm Bill expires on September 30, 2012. However, the chairman of the House Agriculture Committee plans to accelerate the debate on the next farm bill.
- Scrutiny on government spending, and the fact that support mechanisms in the existing Farm Bill failed farmers during the recent crisis are likely to drive change to the structure of the next piece of legislation. The government is also under pressure to hold down government spending.
- There has been renewed farm lobby pressure for the imposition of tariff rate quotas (TRQs) on milk protein (casein, casein and MPC) imports. Milk protein imports are viewed as contributing to the supply-demand imbalance which led to financial stress on all dairy regions in the US.
- The US is the largest importer of milk protein concentrates, casein and caseinates. A bill titled the 'Milk Import Tariff Equity Act' is before both the House and Senate to place a cap (quota) on imports. The potential for congressional enactment of the TRQ bills is uncertain at this stage.
- The Dairy Import Assessment (DIA) imposes a tax on the milk equivalent of imports to fund generic promotion of dairy products in the United States. The implementation of the DIA has been delayed by up to three months.
- The Australian dairy industry has been opposing the imposition of this tax for almost nine years. The extension of the domestic levy to the milk equivalent of imports was first legislated in the 2002 Farm Bill but has yet to be implemented.
- New laws enacting health reform pose some points of interest for the dairy industry. Firstly, fees are likely to be implemented in respect to certification of

Policy drivers

dairy processing plants, either by FDA or third parties. Also, political pressure is building to reduce the sodium content of food; including dairy products.

- Pressure to overhaul the food safety system has grown following several high-profile outbreaks. A US Senate committee unanimously voted to increase government oversight of food safety, with the first significant overhaul likely this year.

US Policy review

- The USDA had its first meeting of a newly established Dairy Industry Advisory Committee as it attempted to follow a similar path to Europe's use of its HLG think-tank.
- The Dairy Industry Advisory Committee, which had been chartered to review farm milk price volatility and dairy farmer profitability, will make recommendations to the secretary on how USDA can best address these issues to meet the dairy industry's short and long term requirements. In addition, it will also provide feedback on how the dairy industry has been affected by USDA's recent actions.

Food security and affordability

- After a period of significant focus on the impact of the global financial crisis there is likely to be a return in government policy attention to food security, food affordability and food self-sufficiency. While interrelated, they are separate issues and can involve different policy tools.
- Food security refers to the availability of food a country has access to, whether it be locally produced or imported. Food self-sufficiency is a measure of how much consumption is supplied by domestic production as opposed to imported goods. Finally, food affordability focuses on the cost of available food relative to incomes.
- The challenges for governments is sometimes locally produced food is more expensive than imported food hence the balance between ensuring enough low cost food is available for consumers without jeopardising self-sufficiency.
- There is a vast array of policy instruments at the disposal of government to achieve their respective goals. In the dairy franchise, there are numerous examples of dairy policy that impact on the market environment.

- **India** - the National Dairy Plan is aimed at meeting the projected national demand of 180 million tonnes of milk by 2021/22 hence maintaining self-sufficiency in dairy products.
- **Asia** - many of the local dairy industries have low self-sufficiency rates, which are likely to decline further, as growing demand outpaces domestic production into the medium term. Traditionally these countries have selectively allowed imports as well as supporting local industries.
- **Argentina** - government from time to time use export taxes to try to balance the attraction of the local market with export sales, and thus restrain price increases (at the cost of the profitability of the dairy industry).
- These issues are likely to become more important in future as growing populations place an increased strain on natural resources required to feed them. The impacts of climate change and variability are likely to lead to increasing price volatility and shortages.
- Governments will be under increasing pressure to guarantee food supplies that are safe and affordable, possibly increasing the risk of a return to protectionist policies that limit trade. However further liberalization of trade may be a more effective means of securing food supplies for many countries.

World Trade Organisation talks stalled

- Following a brief period of renewed activity in late 2009, World Trade Organisation (WTO) negotiations have entered a difficult period as members attempt to finalise the remaining issues in the agriculture negotiations.
- Senior officials met in Geneva in March 2010 to conduct a stock-take of progress in the Doha Round. The stock-take provided a frank assessment of the work remaining to bring the Round to a conclusion.
- It is unlikely that a formal Ministerial will take place this year. Hence, the goal of concluding negotiations and securing a global trade deal before the end of 2010 - an objective laid out by heads of state last year - is highly unlikely.
- The biggest challenge for concluding the round is that there are ongoing political and administrative changes. Political interests are invested elsewhere, namely in dealing with the immediate fallout from the financial and economic crisis.

Policy drivers

- With the Doha talks stalled, preferential trade arrangements continue to proliferate. Even countries that had traditionally opted for multilateralism have now begun to aggressively to pursue regional trade deals.
- For the Australian dairy industry, the real gains lie in both increased, quality market access as well as the elimination of trade distorting subsidies. Only a multilateral trade agreement can deliver this.
- The current WTO round of trade negotiations still represents the best opportunity for Australia to increase access to overseas markets and improve the competitiveness of Australian exports.

Directions for trade policy

- The simultaneous pursuit of Australia’s WTO and free trade agreement (FTA) agendas is mutually reinforcing. Given the slow pace in developments and future uncertainty of reform through the WTO, bilateral agreements provide an alternative means of securing continued growth in profitable export markets and maintaining competitiveness in existing markets.
- Australia is participating in negotiations for a Trans-Pacific Partnership Agreement (TPP). The TPP will expand on the current Trans-Pacific Strategic Economic Partnership Agreement between Brunei Darussalam, Chile, New Zealand and Singapore, which entered into force in 2006. The United States, Peru and Vietnam will also participate in the TPP negotiations.
- The agreement is facing stiff opposition to the inclusion of dairy, particularly by the US. The US farmer lobby group, National Milk Producers Federation, have demanded that New Zealand dairy products be excluded from the new trans-Pacific trade talks.
- Australia has an existing free trade agreement with the US which includes expanding quota access for some dairy categories. Likewise Australia has existing trade agreements with other participants negotiating this agreement.
- The TPP is potentially a significant addition to Australian trade policy. The agreement will provide a docking arrangement which would serve as the foundation for spanning free trade in the Asian region, which may include China and Japan.

- Australian continues to negotiate other free trade agreements. These agreements are all at various stages of negotiation. Under negotiation are:

<i>Partner</i>	<i>Rounds of negotiation</i>	<i>Next round</i>
China	14	Mid-2010
Gulf Cooperation Council (GCC)	4	
Japan	11	Not known
Korea	4	May 2010
Malaysia	6	April 2010
Pacific Agreement on Closer Economic Relations (PACER) Plus	None – initial meeting in 2009	April 2010

- Australia is also considering FTAs with India and Indonesia with feasibility studies underway for both markets. Australia and India completed a joint feasibility study on the merits of an FTA between the two countries in April. A study is still being considered by the Australian and Indonesian Governments with a view to possible commencement of negotiations toward an FTA.

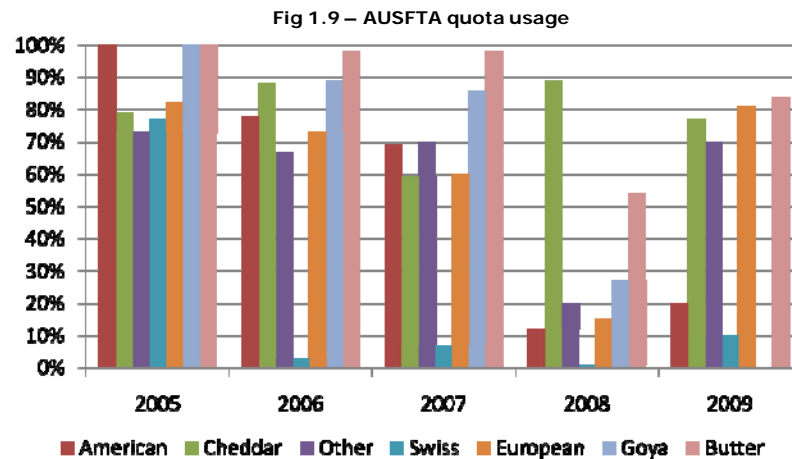
Actions by competitors

- The Australian dairy industry’s competitiveness will continue to face pressure from the establishment of trade agreements between our trading partners and competitors. An example is the pursuit of trade deals with Korea. New Zealand negotiations continue while the official signing of the Korea-EU FTA is expected this year. Meanwhile, the United States and the Republic of Korea signed the United States-Korea Free Trade Agreement (KORUS FTA); but is still pending Congressional approval.
- New Zealand is also in the process of negotiating trade agreements with the Gulf Cooperation Council.
- The European Neighbourhood Policy (ENP) is increasing in importance as a means of engendering closer political and economic relations between the EU and its near neighbours. The ENP members are those countries that do not have the prospect of early EU membership, but which share borders or close proximity with the EU and include large dairy markets such as Algeria and Egypt

Policy drivers

Performance of the US FTA agreement

- Commercial realities are hampering the ability of Australian dairy processors to take full advantage of preferential quota access into the US, under the Australia-United States Free Trade Agreement (AUSFTA).
- Firstly, there has been a convergence between US wholesale prices and global commodity prices in recent years. Secondly, the cost of exporting dairy products to the US is substantially higher per tonne than sourcing domestically because of sea freight and insurance.
- Also, from an Australian company strategic viewpoint the erosion of premiums from the US market-place comes during a time of milk shortage in Australia where processors are competing strenuously for available supply and the consequent need to pay a competitive farmgate price. Securing the highest



possible returns from the global market-place is therefore essential and will remain so for Australian processors.

- Quota fill was low in 2008. According to latest statistics from Department of Agriculture, Fisheries and Forestry figures, however quota fill for 2009 (compared with prior years) has improved.

Greenhouse gases

- In Australia, political support for the government’s Carbon Pollution Reduction Scheme (CPRS) weakened without a meaningful global agreement on tackling climate change.
- According to the United Nations (UN), a new legal agreement committing nations around the world to curb greenhouse-gas emissions is unlikely to be completed until the end of 2011.
- The Copenhagen summit in December 2009 ended with a ‘light’ agreement (Copenhagen Accord) of principles and a pledge of finance for poor countries most threatened by climate change. UN negotiations will continue with the next conference in Cancún, Mexico in November 2010. The sole aim is to get negotiations back on track.
- The Australian government decided against re-submitting its CPRS bill for the third time, citing the intransigence of the Coalition and Green parties and the lack of global progress on climate change.
- Despite this, there remains strong international and commercial support for reduction of emissions – led by retailers and major downstream branded food groups and manufacturers
 - In May 2009 Tesco has announced an expansion of its carbon labelling project, with the goal to eventually have a carbon label on all private label products. The UK’s largest supermarket chain now has 100 products with the label, which informs customers of the amount of CO2 and other greenhouse gases produced during the lifetime of the product including use and disposal
 - In 2009 Walmart stated it goal to create a universal rating system that encompasses carbon footprints and other issues, scoring products based on how environmentally and socially sustainable they are over the course of their production cycle – the green equivalent to a nutrition label. Wal-Mart plans to begin by asking its more than 100,000 suppliers world-wide to answer 15 questions about the sustainable practices of their companies.

Chapter 2

The Australian dairy market

Current market conditions

Economic recovery is underway

- The Australian financial system remained resilient through the global financial crisis of the past two years. Australian households and businesses have weathered the recent economic downturn relatively well with assistance from stimulus measures and are now benefitting from improved economic conditions.
- Household incomes have continued to grow solidly over the past couple of years - having directly benefited from the boost to incomes from government payments and sharply lower interest rates - as well as the support these measures have given to the economy more generally in keeping unemployment relatively low.
- While households have generally been more cautious in their borrowing behaviour than in the pre-crisis period, their demand for housing credit strengthened noticeably during 2009. While this has been associated with stronger growth in housing prices, household gearing remains at historically high levels.
- Unemployment estimates peaked at 8.5%. However, as 2009 unfolded, the impact of stimulus packages and the strength of the domestic economy, saw the rate decline to 5.5% by year's end. The turnaround in employment prospects provided the platform to lift consumer confidence.
- Underlying inflation is expected to continue moderating until the second half of 2010, before rising a little thereafter. Inflation expectations remain contained and the effects of the significant slowing in wage growth seen last year and the appreciation of the exchange rate have yet to fully work their way through.
- The National Australia Bank's latest Business Survey of March 2010 showed a slight dip in business confidence; but it remains at very robust levels and above long-term averages with the trend still moving upwards to levels not since seen early in the decade. Business trading conditions, profits and employment all improved in the latest survey as economic growth picks up and profits strengthen with activity readings at their highest levels in two years since January 2008.
- The easing of global demand for consumables, supported by an improving exchange rate eased the pressure on the costs of living for Australian households.

- Australia remains in a low food price inflation environment. General CPI - measured inflation has begun to move upwards as the economy picks up pace, while food and dairy inflation in particular are currently weak.

Fig 2.1 - Comparison of consumer sentiment & variable home loan interest rates

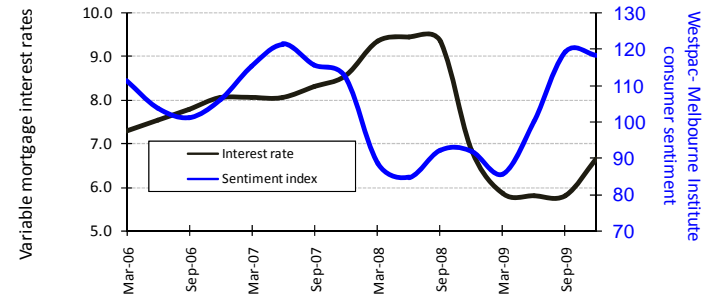
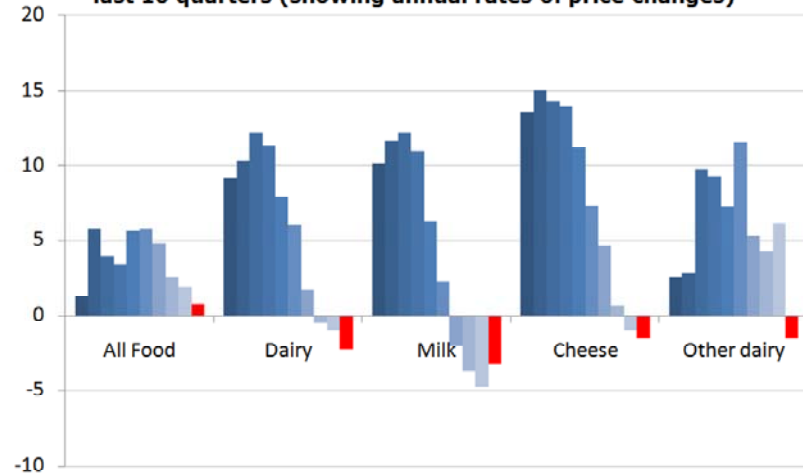


Fig 2.2 - Quarterly changes in Food and Dairy CPI over last 10 quarters (showing annual rates of price changes)



Current market conditions

Consumer trends

- The economic recovery has led to a gradual improvement in household spending in 2009/10. Australian consumers believe they have avoided the major impacts of the financial crisis which have affected the US and Europe, with consumer sentiment recovering sharply in early 2010 compared to a year earlier.
- The Westpac-Melbourne Institute is the most widely regarded barometer of consumer sentiment, although it does not specifically relate to the purchase of food or other household consumer goods. This gauge recorded a clear lift in sentiment in the last three quarters of 2009, after exhibiting a record low in 2008, a period when interest rates and fuel prices peaked.
- Consumer optimism about the sharemarket, house prices and jobs – with the aggregate financial position of the average household now only a little below its 2007 peak - has generally offset the negative impact of five interest rate increases in seven months since October 2009 at least up to this point.
- In 2008/09, there began a noticeable drift of household food spending towards the grocery channel, as consumers ought to cut food costs. Added to that, was a shift in product share towards private label due to strong price differentials. These effects have partially reversed in 2009/10, but caution remains.
- Food spending - according to Freshlogic’s analysis (using the Mealpulse consumer panel) has gradually improved in 2009/10 with the improvement in household incomes and confidence levels. The increase in total spending has been due to improved food service sales, whereas supermarket spending has remained relatively flat.
- This aligns broadly with ABS retail sales data which shows strong growth in the foodservice sector. In the six months to March 2010, retail rose 4% while food service expanded more than 13%.
- The proportion spent in each channel of the food market shifted away from eating out in 2008 according to Australian Bureau of Statistics and Freshlogic analysis. ABS data suggests that 2% of share has been won by the eating out channel, whereas Freshlogic’s data suggests a smaller change.

Fig 2.3 - Total Food: share of spending

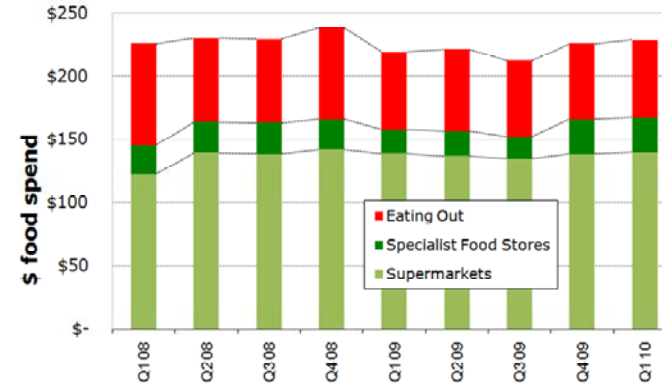
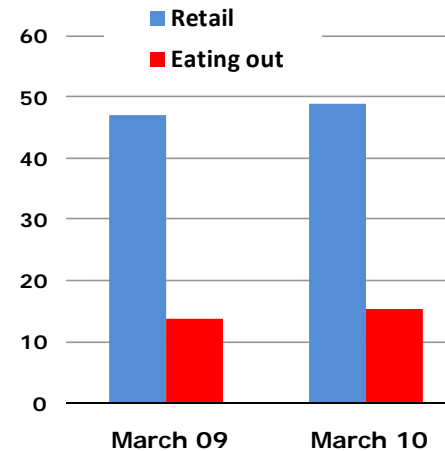


Fig 2.4 - Australian retail sales in \$bn (6 months to March 2010)



Current market conditions

Market segments

- The proportion of sales made through each channel (grocery versus non-grocery) varies considerably across product categories.
- Dairy Australia estimates for the key dairy categories indicated that domestic per capita consumption reached over 300 litres in milk equivalents in 2008/09 – with steady per capita consumption rates of milk offset by slight falls in the other dairy categories.
- Nevertheless strong population growth of around 2% has offset any easing in per capita consumption rates so that the local market has continued to expand – with milk, cheese and dairyspreads all increasing volume in 2009/10.
- Volume growth (in milk equivalents) in 2008/09 is expected to be at around 1% and wholesale value growth at 8% to an estimated \$6.3 billion for the four major consumer categories.

Domestic returns over time

- The domestic dairy market is generally more stable over time. However a more intensely competitive domestic market limits the effective differences in net returns after the costs of servicing the domestic market - including distribution and marketing costs - are taken into account.
- There is a relationship between domestic and export market returns from dairy product sales, with cheese providing an example. Due to the nature of grocery supply arrangements, wholesale prices for a manufactured product such as cheese tend to be smoother, whereas a lagged and subdued effect of export price movements can be seen in sales into the non-grocery segment, which is more directly exposed to import competition.
- There is however little or no relationship between export returns from dairy products and the wholesale price movements for fresh milk and dairy products.

Fig 2.5 - Dairy product sales volumes by channel 2008/09

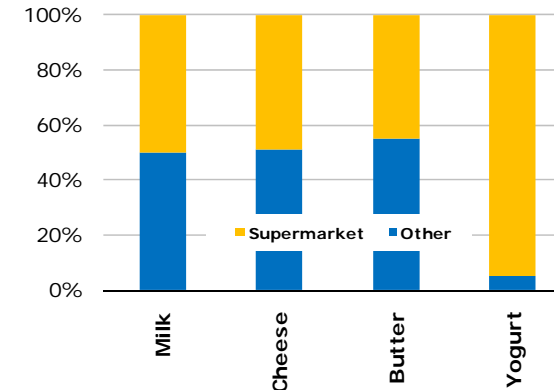


Fig 2.6 - Indicative cheese prices

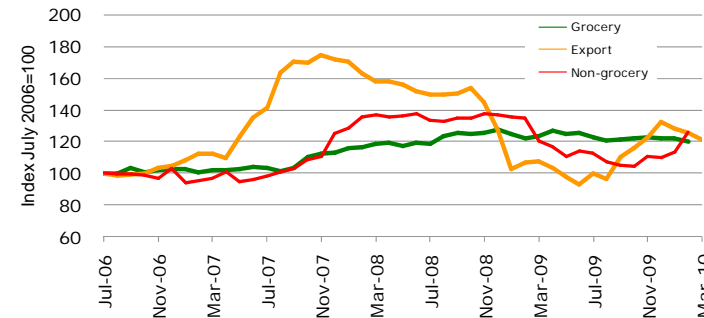
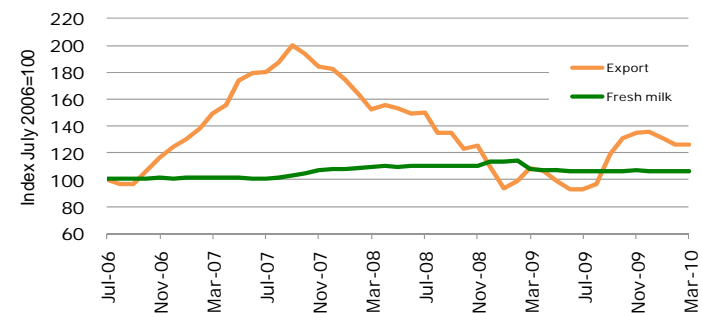


Fig 2.7 - Milk retail prices v export returns



Current market conditions

Competition in the retail market

- Competition between the two major supermarket chains has been strong on a number of fronts this year – as both major grocery chains Coles and Woolworths invest in network expansion, store refurbishments, discounting and promotional strategies to capture market share.
- Woolworths continues to outperform Coles on a number of performance measures but Coles has clawed back some market share with stronger underlying sales growth figures in 2009/10.
- Increased competition from Aldi (who continue to expand their presence along the east coast) has seen the two major chains roll out national pricing and price reduction plans during the first quarter of 2010. The entry of Costco into Melbourne and Sydney (proposed for 2010/11) will add further discounting pressure.
- It is estimated that new stores planned by Woolworths, Coles, Metcash, Aldi and Costco will capture more than \$2.1 billion in sales out of the market each year - comfortably accounting for the entire average annual rate of volume growth.
- This will make it harder for the existing store base to achieve same-store sales growth. With food price inflation also tipped to remain low and discounters putting pressure on the existing pricing structures, pressure exists for an ongoing margin squeeze for much of the 2010 year. This condition will persist while retail groups are (in total) adversely affected by low household income growth.
- A number of retailer initiatives have sustained the focus on “price” and “value” in the past year to retain the increased share of food spending that was won in 2008/09. These include:
 - Programs of deeper discounting of food prices
 - Consistency of pricing on a national basis, which has accompanied the roll-out of uniform pricing on labels
 - Continuing focus on “value” meal promotion with the recruitment of celebrity identities to improve the attraction of cooking more meals at home using ingredients bought at the supermarket
- Both retailers claim little or no food inflation in their overall food prices taking account of the effects of price promotions.

Fig 2.8 – Freshlogic estimated share of retail spending on food March Qtr 2010

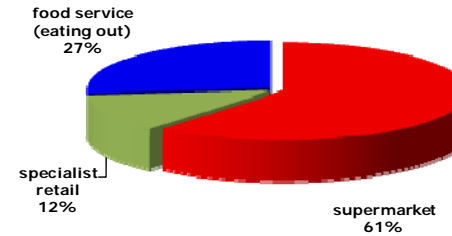
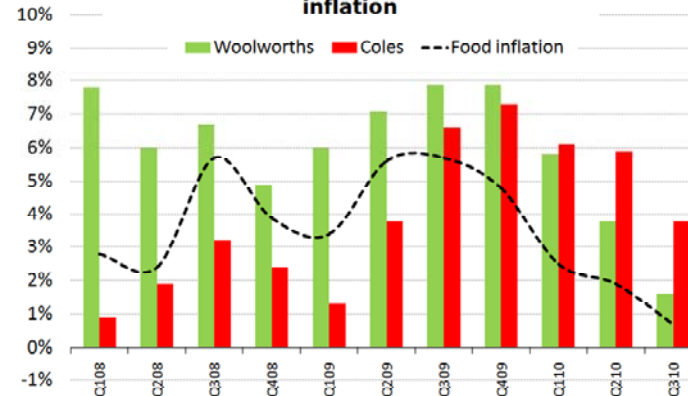


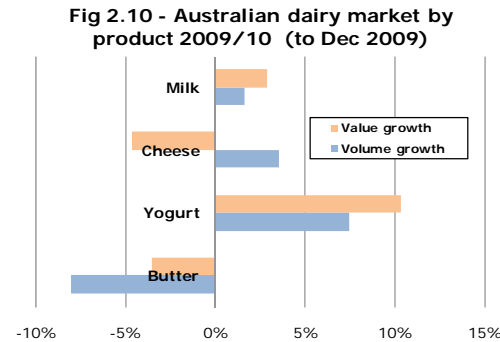
Fig 2.9 - Retailer "same store" sales v food inflation



Current market conditions

Dairy category growth

- The chart on the right shows a mixed performance for dairy categories for the first half of 2009/10.
- The drinking milk market grew by 2.1% to reach 2.27 billion litres in 2009. Strongest growth in 2009 came in UHT milks - up nearly 11% - thereby taking share from each of the other segments. Nevertheless, both modified milks and fresh flavoured milks returned to positive growth of just over 2% as consumers resumed their purchasing patterns from prior to the economic disruption of the last couple of years.



Supermarket channel

- Dairy Australia estimates that the supermarket channel accounts for 49% by volume (milk equivalents) and 59% by wholesale value of the total domestic market for the key categories of milk, cheese, dairyspreads and yoghurt.
- Milk, cheese, butter and yoghurt have displayed volume growth in the last six months; with dairy blends being the only exception. Blends have been a possible casualty of the aggressive 'anti-butter' advertising campaign currently being run by one of the major margarine brands. Interestingly, while butter sales volumes have eased from very high levels in recent months, they remain strongly positive.
- In the drinking milk category, UHT products have shown strongest growth due to heavier discounting by retailers. Analysis of retail prices for fresh milk shows some interesting regional trends, with Queensland and New South Wales average prices lagging those in Victoria. NSW the difference is attributable greater share of private label product (68% compared to 55-58%). However, in Queensland branded prices are on average 15% lower than branded products in the other states – reflecting the intensity of competition.
- In the supermarket cheese category, significant price promotional activity has pulled value growth into negative territory in the last six months. Nevertheless, sales of higher value non-cheddar cheese products in supermarkets have increased strongly in recent months, indicating some freeing up in consumer food spending. Indeed, the retail value of the supermarket cheese category is now estimated to be larger than the milk category – with both now above \$1.9 billion per year.

Fig 2.11 - Average retail prices: fresh white milk (supermarket)

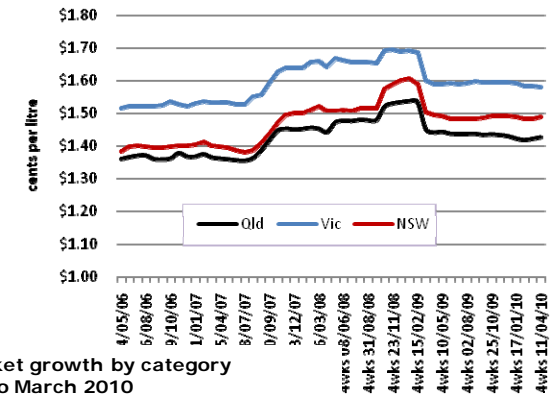
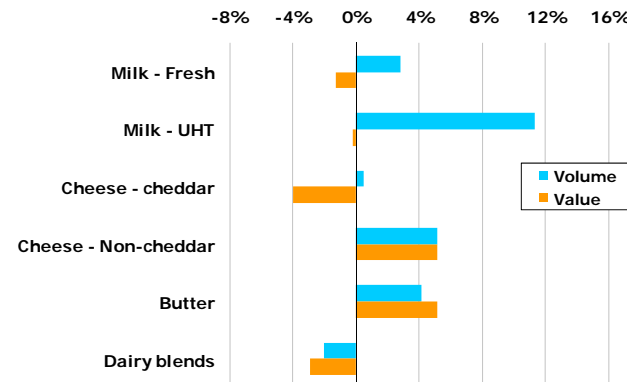


Fig 2.12 - Supermarket growth by category 6 months to March 2010



Current market conditions

Private label v brands

- The level of penetration of private labels varies across the dairy product categories – from 51% in total milk – and up to 71% in fresh regular white milk segment - to 30% in cheese, 28% in dairyspreads, and just 6% in the yogurt category.
- In a new and aggressively competitive development, the two major grocery chains launched marketing campaigns in late-2009 inviting comparison of their own private label products with leading retail brands.
- Such campaigns represent a major challenge to brand owners to maintain their market presence and share in the face of such direct competition from the companies that retail their products.
- The retail price differential between branded and private label milk products has continued to widen as the major retail chains use their own brand milk prices as a key traffic generator.
- However, the price chart for 1kg natural cheddar blocks shows a different picture. The entry of a major new branded player into the natural cheese sub-category during 2009 saw the aggressive use of price promotional activity to gain a foothold in the market – with the expected competitive response as the Australian market became increasingly attractive at a time of softer international commodity prices.

Food service

- Growth of the foodservice sector has lifted significantly above that of the supermarket sector over the last six months – reversing the trend of the previous eighteen months - reflecting consumers’ improving confidence levels and reduced concerns about the local economic and employment climate.
- Dairy Australia’s foodservice index indicates 13% growth on the corresponding period last year –compared to supermarket index growth of 5%. There has been improvement in both components - with takeaway food up 16% and cafes and restaurants up 11%.
- The sales volumes through takeaway and Quick Service Restaurants, which have gained increased household support as cheaper eating out venues, have assisted dairy with cheese sales. The importance of gaining a share of the growth in business through these outlets has led to stronger price pressures for cheese and spreads in these channels.

Fig 2.13 - Shares by supermarket dairy category

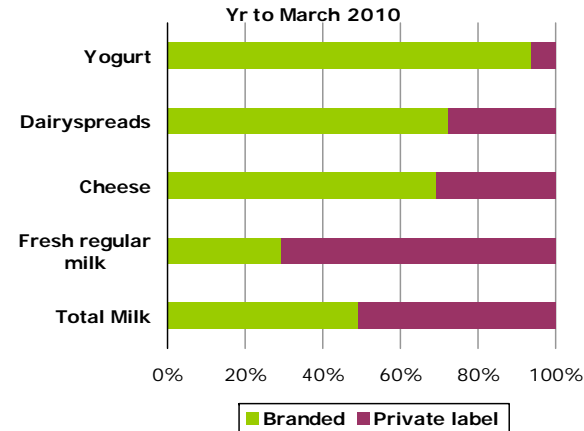
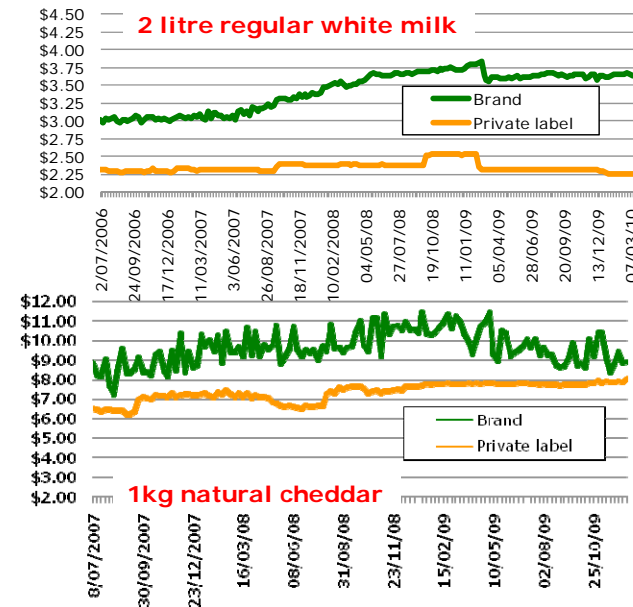


Fig 2.14 - Unit retail prices – July 2007 to March 2010



Australian market outlook

Overall

- The economic recovery is expected to continue in 2010/11, although the wind-down of effects of economic stimulus packages on the Australian economy may affect conditions in food retail markets.

Key economic indicators

	2010/11	Medium-term
Australian economic growth	3.0% to 3.5%	3.0% to 3.5%
RBA official cash rate	5.0% to 5.5%	5.0% to 6.0%
CPI	2.5% to 3.0%	2.5% to 3.0%
Per capita dairy consumption	+1.0%	+1.0%

- Consumers will remain cautious – the remainder of 2010 and 2011 may see steady recovery despite some risks.
- With interest rates rising steadily, and the effects of improving global demand on oil prices lifting fuel costs, disposable incomes may be constrained and this will likely have some impact on discretionary household spending. This effect was evident in the period prior to the outbreak of the GFC, and saw discernable changes in food spending patterns, and retailer responses in mid-2008.
- The overall consumption of dairy products is expected to continue to grow in response to population growth. Underlying any short-term variation in trends in dairy consumption in Australia is the fact that dairy products are available in a range of forms and applications, and are well placed to capitalize on on-going consumer lifestyle trends regardless of the sales channel to the consumer.
- While the cautious household sentiment is unlikely to affect the overall volume of dairy products consumed, it may impact on the preference for the channel in which consumers spend their food dollar. It will also be likely to continue to affect the unit value of sales as consumers are likely to seek value in their purchases. This will provide continuing support for private label products and price-promoted branded lines through the supermarket channel.

Challenges for the category

- The outlook in the short to medium term is for more intense retail and wholesale competition in the Australian grocery market.
- Pressure applied by retailers as a result of continuing to compete for the mantle of “cheapest for the consumer” will ensure sustained discount campaigns and an increased amount of shelf-space devoted to private label products. Expansion of the presence of Aldi will sustain pressure on the two major retailers to offset the loss in market share to new Aldi stores.
- These factors will threaten growth in the unit value of the dairy category over time, without corresponding investment in innovation, brand support and development.
- The challenge for fresh dairy processors and domestic dairy product manufacturers will be to improve brand share of retail sales to overcome the effect of private label sales on average wholesale prices and profit margins. This is especially the case in regions focused only on fresh milk processing.
- A potential increase in ethical requirements of retailers may affect the dairy category in future but to date change in this area has been slow compared to other categories. It is conceivable that retailers however may require product-label information to establish points of difference in response to consumer concerns in relation to “carbon footprints”, environmental impact, and animal welfare standards.

The Industry Value Chain



Ownership and consolidation

Industry ownership

- A core challenge for the southern Australian manufacturing sector is sustaining utilisation of factory capacity with the continuing decline in milk supply volumes since the pre-drought record production in 2001/02.
- A further decline in milk production in 2009/10 – to levels not seen since the mid-1990s - and the expected slow growth in 2010/11 - will increase that challenge and ensure that competition for raw milk from producers remains intense.
- Strong competition in the retail market in a price-sensitive economic climate also adds to the pressure for further consolidation of ownership of consumer brands, as well as manufacturing and processing capacity.
- The ownership of the Australian industry continues to change over time, with ever-growing proportions of the industry beyond the farm gate now owned by public and international interests.

Major changes of ownership

- Major domestic developments that changed the ownership of dairy businesses in the Australian industry are:
 - Parmalat completed the \$70 million purchase of Freshco in July 2009. This purchase included National Foods' (NatFoods) NSW and SA drinking milk assets – including the Lidcombe and Clarence Gardens milk plants. The sale of these assets was required by the ACCC following National Foods takeover of Dairy Farmers in 2008.
 - Japanese trading house Itochu purchased a 45% stake in Gippsland dairy processor Burra Foods for \$38 million. This will result in Burra commencing production of milk powders for the Asian market – with an upgraded plant due to start production in July 2010.
 - Kirin Holdings' takeover of Lion Nathan led to Kirin merging its Australian operations – which included NatFoods - into Lion Nathan National Foods with a turnover of \$5.6 billion.

Potential future foreign interest

- The rapid changes in the dairy sector has in recent years forced a number of dairy companies to investigate potential acquisition targets engaged in product manufacturer and milk production in low-cost dairy production regions.

- This ongoing interest from foreign groups in purchasing dairy assets is driven by:
 - Increasing concerns for food supply security, especially from Chinese and other Asian dairy processors. The tight world market supply situation has raised to concerns about availability of product with some companies looking to secure their supply chain through purchases of productive assets in diverse regions.
 - The availability of assets for purchase within the Australian industry
 - The existence of a number of acquisitive groups that are seeking a diversification of their geographic dependence on certain regions.
- The GFC has caused a slowing in that activity due to the difficulties in obtaining financial backing.
- The scope for Australian dairy manufacturers to be targets of these acquirers is limited, despite the fact that there exist a number of diverse businesses within the Australian industry. The perceived constraints on milk production growth in southern regions are a deterrent for potential buyers seeking secure access to a growing export competitive supply base.

Interest in WCBF

- In late December 2009 the WCBF board received unsolicited takeover offers MG and Canadian Saputo – who have long expressed interest in Australia. MG subsequently made a second offer, which was again rebuffed by WCBF. MG has since accumulated a 10% stake, which has taken its shareholding up to the current constitutional limit. The WCBF shareholding limit it due to be increased to 15% in May.
- In the meantime, the WCBF share price has more than doubled in response to the takeover interest – from around \$2 per share before the offers were revealed to as high as \$4.50 per share.
- The proposed merger of MG and WCBF was referred to ACCC for clearance by MG. In late April the ACCC released a Statement of Issues on MG's proposed acquisition/merger with WCBF which contained a negative view of the proposals based on the potential effects of farmgate competition in Western Victoria and South Australia.

Ownership and consolidation

Consolidation of capacity

- The ongoing effects of drought, limited irrigation water supplies compounded by low price on milk production have forced further rationalization of manufacturing capacity in Northern Victoria, with Murray Goulburn mothballing its cheese-making operations at Leitchville.
- Further changes will depend on regional milk production capacity, which in turn may be affected by changes in irrigation water availability under the Murray Darling Basin Authority's Basin plan due for release later in 2010.
- NatFoods continues to rationalise its processing capacity around Australia following the acquisition of Dairy Farmers with a series of announcements over the last year including the closure and sale of the Shepparton (VIC) plant (to UDP); and the closure of the Hexham (NSW) and Booval (QLD) plants over the next year or so. Further consolidation of processing and manufacturing facilities within the group may occur depending upon the group's dairy sector strategy.
- The proposed Australian Cheese Company joint venture between WCB and NatFoods – to facilitate a divestment of commodity product manufacture by NatFoods – did not proceed due to the loss of milk supply by WCBF in April 2009 which adversely affected the company's short-term profitability and financial position. While the company has since restored its milk supplies to prior levels, the joint venture has not proceeded. WCBF retains a simple supply agreement to provide bulk cheese to NatFoods.

Further market changes

- Further developments in the management of private label brand supply by major grocery retailers (including independents and Aldi) may have a significant influence on the medium-term outcomes of consolidation in the milk processing sector.
- Faced with two dominant processors, retailers may seek to reduce their sourcing risk and improve flexibility by seeking alternative supply arrangements – including regional private label packing contracts. Changes of this nature would have implications for processor facilities and milk sourcing, and could create some uncertainty for milk producers regarding their market access.

Company structures

- Farmer-owned dairy manufacturing businesses, including co-operatives, engaged in the dairy industry in Europe, the US, New Zealand and Australia face common challenges.
- These include:
 - **Accessing sufficient equity capital** for investment in processing assets, product innovation and marketing to remain competitive with publicly owned brand marketers
 - **Redemption risk**, regarding the potential drain on shareholders capital as a result of the exit of dairy farmers from the industry or their loss as suppliers to competitors
 - **Flexibility in dealings** with supplier-members regarding differentiation in milk payment systems

What is forcing change?

- A number of gradual changes in the world dairy industry are driving the boards of major farmer-owned businesses to assess ownership options. The principal drivers are:
 - Deregulation of dairy markets in the EU which is forcing dairy companies to evaluate competitive milk supply sources
 - Consolidation of the retail sector and global food businesses which forces dairy co-operatives to compete with larger brand owners
 - Greater competition between dairy companies at the farm gate vying for suppliers with less entrenched company loyalty and more internal focus than in the past
 - Further restructure in the UK where co-operatives have the opportunity of taking more involvement in the value chain
 - Greater consciousness of investment returns by dairy farmers, requiring stronger accountability for performance through milk prices
 - Greater volatility in dairy markets flowing back to the farm sector and putting pressure on traditional small-scale farmers to exit

Ownership and consolidation

Global precedents for change

- A number of changes have been actioned by farmer-owned businesses in the recent past to address these challenges. The responses include:

<i>Company</i>	<i>Corporate structure</i>	<i>Steps taken</i>
Fonterra (NZ)	<ul style="list-style-type: none"> Traditional co-operative model 	<ul style="list-style-type: none"> Restructure of shareholding rules, the introduction of share trading is being proposed to shareholders
Arla Foods (Europe)	<ul style="list-style-type: none"> Traditional co-operative model 	<ul style="list-style-type: none"> Proposing change in capital structure in 2010/11
FrieslandCampina (Europe)	<ul style="list-style-type: none"> Traditional co-operative model 	<ul style="list-style-type: none"> Co-operatives merged in 2008 and are exploring further changes in structure
First Milk (UK)	<ul style="list-style-type: none"> Unlisted public company with capital contribution requirements 	<ul style="list-style-type: none"> Restructure of capital structure and participation, share trading and performance dividends (took effect April 2009)
Glanbia (Ireland)	<ul style="list-style-type: none"> Hybrid public company with a farmer co-operative holding a controlling stake in a trading business 	<ul style="list-style-type: none"> Proposed sale of commodity manufacturing assets and operations to the farmer cooperative was rejected by shareholders

Fonterra restructure

- The changes being implemented by Fonterra are relevant to Australia's dairy industry, given its significant exposure to commodity manufacturing, and its share of global marketing and trade in dairy ingredients.
- The objectives of the restructure are to remove redemption risk; ensure the preservation of farmer control of the co-operative; and provide a structure to facilitate greater access to farmer capital for business requirements. Previous attempts at restructure have failed or been stalled due to a lack of comfort by shareholders of this latter outcome.
- Fonterra have already implemented a change in the payout structure to unbundle payments to farmers and make profits more explicit.
- In the Fonterra restructure, there are three stages of change
 - Strengthening the share structure, to allow farmers to hold shares up to 120% of their milk production (compared to the former limit of 100%)
 - Restricting the value of company shares to reflect the fact that they will not be freely traded in the market
 - Allowing the trading of shares between supplier-shareholders
- The first two stages were overwhelmingly passed by shareholder vote in November 2009. The strength of support for those stages has urged the Board and management of the company to hold a vote for the final stage. Fonterra is currently seeking industry feedback before proceeding with the third vote – which requires the support of 75% of farmer-shareholders. A successful result appears likely based on current reaction within the industry.

Farmgate market

How farm gate milk prices are set

- The traditional co-operative model plays a critical role in setting the farm gate value of milk in the Australian industry. The co-operative share of Australian milk collection has reduced in recent years due to ownership changes and reduced milk flows in regions where cooperatives operate.

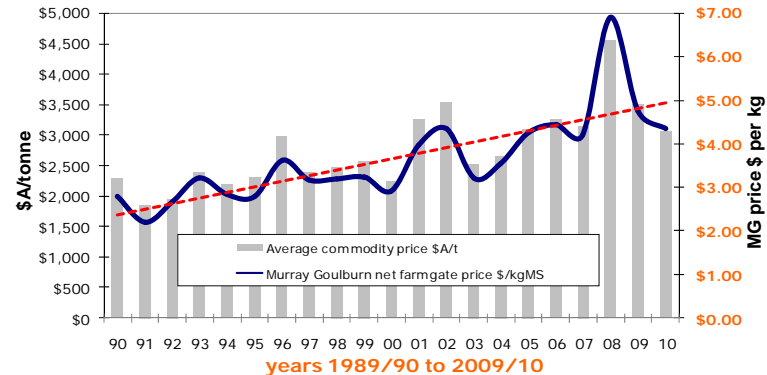
Farm gate prices in 2009/10

- Milk prices opened significantly lower in 2009/10 due to the sharp fall that occurred in export returns as a result of the GFC the resultant economic downturn and contraction in demand.
- While the benefit of the international market recovery for Australian exporters and farmers has been constrained by the strong Australian dollar, farmgate prices for southern producers have improved in the second half of the 2009/10 season. Southern milk prices are expected to close the season in the vicinity of \$4.30 to \$4.50 kgMS.
- Milk prices in NSW and Queensland have not changed significantly from the prior year as most producers supplying milk processors in these states have been on 2- to 3 year agreements. The majority of these contracts were struck when southern benchmark prices were significantly higher and milk supply shortages due to poor seasonal conditions were falling short of regional demand.

Sustained competition for milk

- Despite the fall in world market prices, there has been sustained supply competition between dairy companies which has been driven by the recovery in demand from export markets albeit at much lower prices than in 2008/09.
- Sustaining optimum milk throughput in plants remains a priority to ensure financial performance, including where reflected in milk prices.
- Fresh milk processors operating in southern regions are also seeking greater certainty of supply in all regions of their eastern Australian operations, through increased direct supply to their plants.
- Looking forward to 2010/11, a “two speed” milk intake situation has emerged in the industry, with southern exporting manufactures looking to increase intake to meet rapidly growing export demand, while domestic milk processors in fresh milk regions are focussed on matching slowly growing demand with secure year round regional supplies.

Fig 3.1 - Average export returns and Murray Goulburn milk price 1990 to 2010



Forecast milk prices in 2010/11

Southern regions

- The 2010/11 opening farmgate milk price announcements will again be important signals for farmers assessing short-term decisions and their longer term future in the industry.
- While uncertainty remains, particularly around currency, opening prices are forecast to be considerably higher than last year. Exporting manufacturers are likely to announce stronger opening milk prices due to improved market conditions. Opening prices are expected in the range of \$4.40 to \$4.60 kgMS, while full year prices are forecast to reach \$5.00 to \$5.40 kgMS.
- This outlook is based on the following assumptions:
 - Dairy product prices realising the spot price levels in early 2010, which sees all major commodities trading in the range \$US3,500 to \$US4,000/tonne
 - The \$A valued between 90 to 95 US cents
- The dairy market fundamentals support this price outlook through 2010/11. However the wider global economic situation remains the greatest threat to a sustained market recovery and stable currency environment.

Farmgate market

Northern regions

- Prices are under downward pressure in Queensland and NSW regions as regional milk flows exceed fresh market demand requirements, and intense retail competition has limited processing margins. Queensland retail prices for both branded and private label lines are in fact considerably lower than those in Victoria, yet processors face far higher milk input costs at present.
- Prevailing farmgate prices in effect in 2009/10 were largely struck in 2007/08 or earlier when seasonal conditions threatened the ongoing adequacy of local milk flows, and southern milk prices were significantly higher than those expected in 2010/11. A large percentage of Parmalat’s Queensland milk supply is contracted at firm prices until the end of the 2012 calendar year.
- With a major renegotiation of milk prices by other buyers in the region, downward revision of farmgate prices will occur. In addition to this, pressures to closely align milk supply with market demand have ensured there will be significant change for many suppliers supplying DFMC and NatFoods in NSW and Queensland with the implementation of a new milk supply arrangement, which is outlined below.

Changes in pricing arrangements

Murray Goulburn

- In view of the range of pricing arrangements offered by competitors, including those predominantly servicing domestic markets, MG proposes the introduction of optional pricing arrangements to its traditional uniform arrangements. These will include two new variants to provide suppliers with more options:
 - A “domestic market” supply arrangement with “flatter pricing” but which will require a commitment to a flat seasonal ratio that will earn a post-season bonus
 - A seasonal payment system that will increase the price offered in spring but reduce second half incentives, and also requires a full year commitment.
- These options mirror the features offered by MG’s competitors, but the change reflects a need for the co-operative to respond to the risk of loss of further milk to competitors following attrition in milk supply in 2009/10 and the need to align its production to market requirements.

Fig 3.2 - Summary of the structure of milk supply arrangements offered by major dairy companies

	Milk volume direct supply 2009/10 (billion litres)	Step-up payments	Optional pricing structures	Full-year pricing or option	Use of individual contracts	Productivity incentive	Share deductions	Growth incentive
Murray Goulburn	2.9	Y	Y	Y		Y	Y	
Fonterra	1.8	Y	Y	Y		Y		Y
National Foods	1.7			Y	Y	Y		
(DFMC)			Y	Y	Y	Y		
Parmalat	0.6		Y	Y	Y	Y		
WCB	0.8	Y	Y	Y	Y	Y		
Tatura	0.3	Y	Y	Y		Y	Y	Y
UDP	0.2	Y		Y	Y	Y		

Notes:

1. Contracts are used by WCB for a portion of its supply base
2. National Foods refers to direct milk supply agreements milk supplied by DFMC, which offers separate milk pricing and incentive structures to the direct milk supply contracts offered by the company itself.
3. Fonterra offers a range of options to suppliers which include the use of full-year prices.

Farmgate market

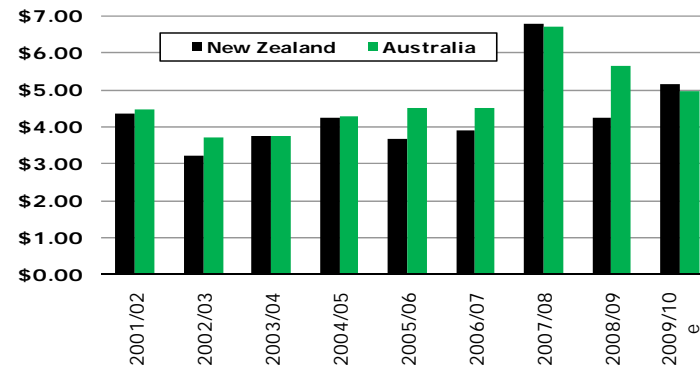
NatFoods and DFMC

- Following National Foods’ purchase of Dairy Farmers, an arms-length milk supply arrangements between the milk supply co-operative DFMC and National Foods took effect. DFMC provides a substantial portion of National Foods regional milk intake requirements, alongside direct supply contracts with individual suppliers (some of which are negotiated through collective bargaining groups) and third party bulk milk supply arrangements.
- NatFoods has indicated a need to more closely manage milk supply across all regions to align with monthly market demand. The proposed changes will affect DFMC suppliers in all east coast mainland regions, and involves more direct market signals to producers.
- From July 2010, NatFoods will apply Anticipated Full Demand (AFD) that equates to the total volume of bulk milk NatFoods requires from DFMC as a supplier in each region for its planned milk, fresh dairy and cheese processing.
- The features of the new arrangements will include:
 - Milk contracted to meet regional AFD will attract a Tier 1 price which will reflect the value of milk supplied on a flat year-round profile
 - The AFD volumes will be allocated by DFMC to individual suppliers, reflected in individual agreements between DFMC and its suppliers. The allocation will assume existing agreements as a starting point;
 - Tier 2 volumes will receive a milk price that will be benchmarked to the next best use of milk (in each region) to NatFoods;
 - DFMC contracts will be offered for periods of 1-3 years with varying precision as to future price guarantees.
- The regional percentage that AFDs represent of the volumes supplied by DFMC members in 2009/10 varies region to region. The effect on individual suppliers of a portion of their milk production achieving a lower marginal milk price will also vary significantly.
- Parmalat has foreshadowed it will apply similar supply management and pricing principles for its northern suppliers when existing contracts expire in 2012, and will consolidate the current differentiated supply pools into one.

NZ price outlook

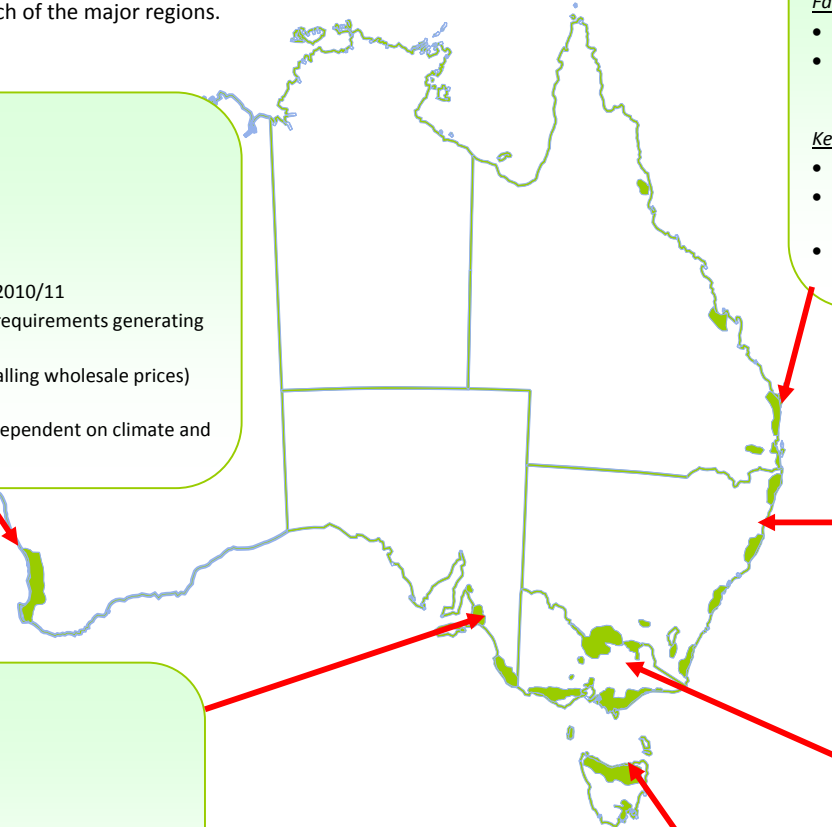
- Fonterra have announced an estimated full-year milk payout for the 2009/10 production season of NZ\$6.10 per kg MS (A\$4.83 kg MS based on average exchange rates for 2009/10 to date) – up 29% on last season’s final payment of NZ\$4.72 kg MS (the 2008/09 final NZ payout was actually NZ\$5.20 kgMS, which included a milk price component of NZ\$4.72 kg MS and a Value Return of NZ\$0.48 kgMS). In 2009/10 Fonterra will also make a separate profit distribution which at this time is forecast to be 40 to 50 NZ cents per share. The company has in 2009/10 changed the milk payment and profit distribution arrangements by introducing a discrete profit component.
- Fonterra is currently suggesting to its suppliers that the 2010/11 payout will be similar to the final 2009/10 amount, which would put the payout in the range of expectations contained in this report for Australian companies.
- Prices between Australia and New Zealand are different year-to-year because of:
 - Product mix between major commodity products and co-products
 - Market mix between domestic and export markets
 - Management of currency exposures
 - The different business models operated by dairy companies
 - Different profit retention practices by dairy companies
 - The extent of competition in each market

Fig 3.3 - Australia vs NZ farmgate milk prices in nominal \$A



Farmgate market

This map reflects the varying farm gate market prices and dynamics affecting milk supply and competition in each of the major regions.



Western Australia

Farm gate prices

- 2009/10: 35-45cpl
- 2010/11: up to 10% lower

Key dynamics

- Milk supply expected to grow 0.5% to 1% in 2010/11
- Milk production above domestic processing requirements generating pressuring returns
- Weaker dairy product margins (affected by falling wholesale prices) lowering milk value
- Volumes of production at lower milk prices dependent on climate and feed input costs

Queensland and North NSW

Farm gate prices

- 2009/10: 54-60cpl
- 2010/11: many suppliers are locked into agreements until 2013, yet others may see prices move below the bottom end of this scale

Key dynamics

- Milk supply expected to grow 3-5% in 2010/11
- Region is over-supplying local processing needs for several months of the year
- 2-3 year supply contracts addressing milk security addressing milk security

Central NSW

Farm gate prices

- 2009/10: 47-57cpl, with shorter agreements at lower end
- 2010/11: 45-50cpl for the majority of producers

Key dynamics

- Milk supply may grow further in 2010/11, but is weather dependent, and also affected by response to new milk supply agreement structure.
- Increasing influence of over-supply at times of year affecting milk value/returns
- Stronger southern milk prices will not reduce pressure significantly.

South Australia

Farm gate prices

- 2009/10: \$4.30 – 4.50/kgMS(32-34cpl)
- 2010/11: up around 15-20%

Key dynamics

- Milk supply expected to increase around 2-3% in 2010/11
- Lack of growth in Victorian regions sustains strong supply competition
- Volumes highly dependent on climate, water allocations and feed input costs

Tasmania

Farm gate prices

- 2009/10: \$4.20 – 4.40/kgMS (32-33cpl)
- 2010/11: up around 10-15%

Key dynamics

- Milk supply expected to decrease slightly by 3% in 2010/11
- Confidence returning but only sufficient to sustain production
- Volumes dependent on seasonal conditions and feed input

Victorian regions

Farm gate prices

- 2009/10: \$4.30 – 4.50/kgMS (32-34cpl)
- 2010/11: up around 15-20%
- Higher payments by fresh processor prices

Key dynamics

- Milk supply expected to increase by 1% to 2% in 2010/11
- Volumes highly dependent on Nth Vic season, irrigation allocations and feed input costs
- Lack of supply growth sustains farmgate competition

The Production Sector



Production trends

The production sector in 2010

- The production sector continued to polarise during 2009, as negative cashflow conditions impacted the southern, export-exposed industry (Victoria, South Australia and Tasmania). Low 2009/10 opening prices and dry conditions saw many farm businesses stretched to breaking point early in the season – particularly in the Northern Victoria and Riverina region.
- In 2010, good rains and improving market conditions have seen a significant turnaround in operating conditions, with margins for many producers currently more favourable than in the high milk price environment of 2007/08.
- In contrast, contracted milk prices and low feed costs have maintained confidence and production in domestically-focussed regions (northern NSW, Queensland and Western Australia). However, with the imminent renewal of contract supply arrangements, many farmers in these regions are likely to be brought into greater alignment with the southern industry, as well as being given sharper signals about fresh market requirements.

Current production trends

- Milk production is forecast to reach **8.95 billion litres in 2009/10 – down 5% on 2008/09 output.**
- Milk production in 2009/10 has been primarily affected by the low prices that prevailed for the southern industry during much of 2009. While seasonal conditions improved, water allocation increases have come too late to significantly affect 2009/10 production in the key northern Victorian/Riverina region, which will finish 9% behind last year.
- In other southern regions production has been held back by limitations on feeding and reduced cow numbers. Tasmania’s spring production was severely impacted by floods which affected pastures and cow productivity. The need to re-sow pastures has added to the financial pressures felt by some Tasmanian producers
- In northern states, seasonal conditions have been generally favourable – although some regions have experienced flooding. Low grain and fodder prices have supported production, as have contracted milk prices. In Western Australia rainfall has been low for the early part of 2010, however milk production is likely to finish close to the previous season.

Fig 4.1 - Monthly national milk production

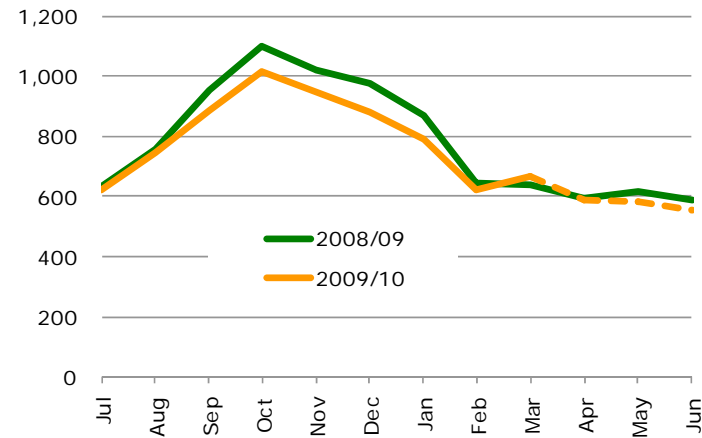
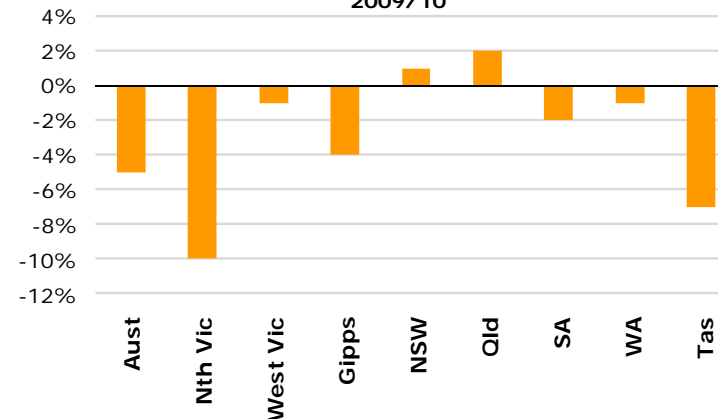


Fig 4.2 - Changes in regional production expected in 2009/10



- Nationally, production was 6% behind for the six months to December 2009. Southern production was most affected, with many farmers reducing cow numbers and seeking to limit feed costs. As seasonal conditions and pricing improved in the second half of the year, milk production strengthened, with January to June production estimated to be 4% below the same period in 2009.

Production trends

Industry confidence

- Overall confidence as measured by the National Dairy Farmer Survey was unchanged, with 65% of farmers surveyed indicating they felt positive about the future of the industry.
- There were differences in sentiment across dairying regions, but this narrowed in 2010 to a band between 48% and 71% of farmers who felt positive about the future of the industry.
 - The proportion of farmers who were positive increased in Northern Victoria and Gippsland, but decreased in all other regions compared to 2009.
- Those respondents with a positive outlook attributed their view on the ongoing demand for dairy products and adequate or improving milk prices. Low milk prices and rising input costs were most associated with negative views.
- This year respondents were also asked to comment about the future of the industry in their local region, and the outlook for their own farm business.
- A similar proportion of farmers nationally were positive about the industry in their region - at 64%. However, there was a much larger spread across the regions.
 - In western Victoria, 85% of farmers were positive about the future of their region. Tasmania had the highest proportion of farmers who were very positive about their region's future at 23%.
 - Just 37% of Western Australian respondents were positive about the future of the industry in their region.
- Farmers were significantly more confident about their farm than either the national or regional industry, with 70% of farmers positive about the future of their own business.
 - While more positive about the future of their own business than the national average -at 75% of respondents, farmers in western Victoria were significantly less confident about their farm's outlook than for the region.
 - Farmers in northern NSW and southern Queensland were the most confident about the future of their own business.

Fig 4.3 - Attitude to the industry – comparing 7 surveys

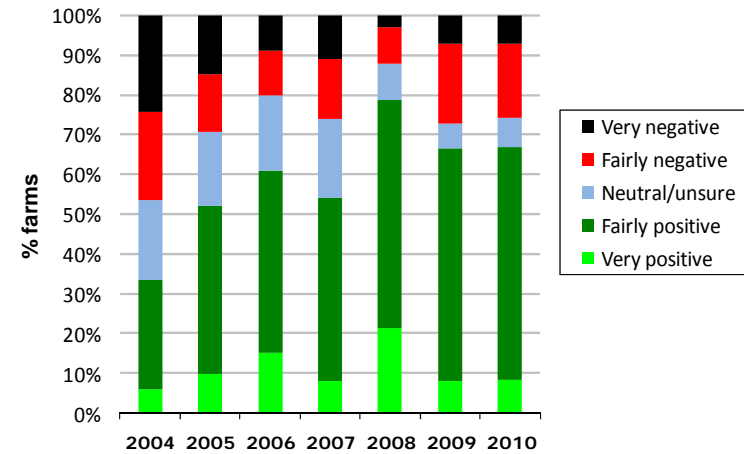
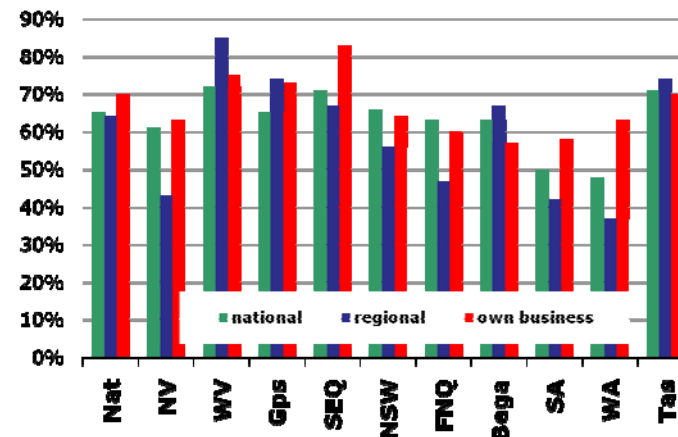


Fig 4.4 - Comparing positive attitudes to national and local industry and own business (% farms)



Production trends

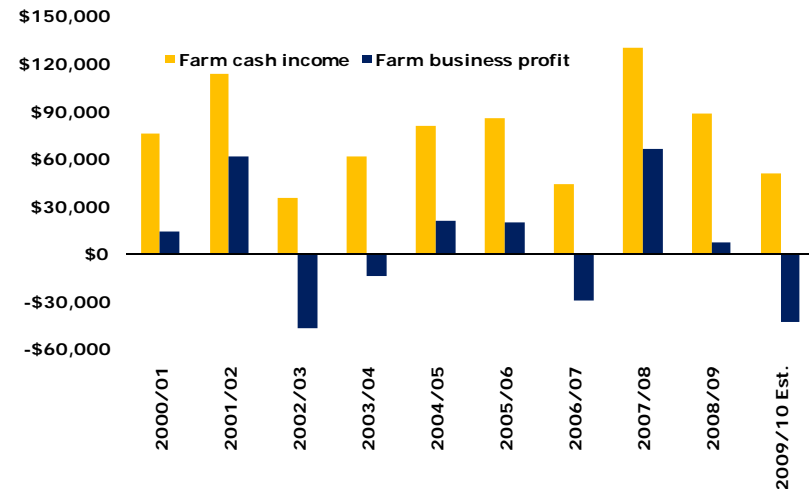
Profitability

- The ABARE 2010 Farm Survey reports that while milk prices have now lifted above break-even levels to deliver positive farm cash incomes on average, they are not at 'financially sustainable' levels, with the average farm business projected to return a loss for the 2009/10 season.
- In southern regions, farm margins have improved in recent months, with milk price step-ups and additional second half production incentives in place; grain prices at three-year lows; and oil prices relatively steady – although fertiliser prices are just starting to move upwards again. Irrigation allocations are also the most favourable for some years, lowering water prices.
- Average farm cash incomes for 2009/10 are projected at \$50,000 – down 43% from last year's \$88,000. The percentage of farms with a negative cash income has lifted from 26% to 44%.
- When build up trading stocks, depreciation and imputed labour costs are included, ABARE estimates an average loss of \$44,000 compared to last year's marginal \$6,700 farm business profit. Meanwhile, the percentage of farms with a farm business loss has lifted to 68%.
- Responses from the 2010 NDFS tend to confirm the above picture; with 50% of dairy farmers saying that they will make a margin over input costs during the January to June 2010 period; and a further 25% saying that they will just break-even.

Financial position

- The ABARE survey reports that average farm debt lifted again this season – up to an estimated \$683,000 per farm – an increase of 20% over two years ago.
- Interest payments are the second largest expense item for dairy farmers – representing an estimated 11% of average of dairy farm cash costs in 2009/10 according to ABARE analysis – increasing from 9% two years ago.
- The next financial challenge looming for dairy farmers will be dealing with increasing interest rates – the price of a strong local economy. While small business financing costs did not fall to the record lows enjoyed by domestic mortgage borrowers - for a few months anyway - they have been quick to rise in the past two quarters.

Fig 4.5 – ABARE's survey of cashflow and profit 2001 to 2010



- Added to higher interest rates, the increased short-term debt incurred by many farmers to cover cash flow shortfalls in 2009 mean increased financing costs will maintain pressure on margins into 2010.
- Department of Agriculture Forestry and Fisheries data on Farm Management Deposits (FMDs) shows significant use of these funds during the first half of the current season in those states most affected by the low opening prices. The other states showed a much lower rate of drawing down of these funds.
- While the total value of FMDs has fallen from a record high of \$240 million in June 2009 to an eighteen-month low at just over \$200 million in December 2009; they remain well above the average value of \$160 million for the three years prior to June 2008.
- It appears that dairy farmers are increasingly using FMDs to manage the income volatility they have experienced in recent years. Indeed, the rate of growth in dairy FMDs has been greater than that for agriculture as a whole since 2003.

Production trends

Challenges faced

- Farmers surveyed in the 2010 National Dairy Farmer Survey overwhelmingly cite low milk price as their major current challenge. Fewer farmers felt milk price would be their greatest challenge in future, with the proportion of farmers naming low milk price falling from 52% now to 41% for the future.
- The proportion of farmers naming climate as their main current challenge has fallen significantly compared to 2009, from 18% of respondents to 13% in 2010. This reflects the improved seasonal conditions most regions have experienced.
 - The exceptions were Queensland (40%) and Bega, where 47% of farmers understandably cited climate as their greatest challenge – given the flooding that was occurring around the time of the survey.
- The effects of climate were nominated as the major future challenge by fewer respondents in 2010 compared to the previous survey – 12% compared to 20% in 2009.

Investment

- On-farm investment has remained stable over the past 12 months, with 65% of respondents making an investment, in line with the 2009 survey. As in previous years, machinery was the predominant category of investment, followed by dairy and irrigation plant.
 - Respondents from New South Wales, Western Australia and Queensland were the most likely to have invested on their farm during the previous 12 months.
- A larger proportion of farmers from the 2010 survey are intending to invest on-farm in the coming year compared to the 2009 survey.
 - Intentions in the 2010 survey were weaker in Queensland New South Wales where a higher proportion of farmers had made investments in the previous 12 months.
 - Investment intentions were stronger in the Victorian regions and Western Australia compared to the 2009 survey.
- Not surprisingly, farmers who were making a margin over production costs for the January to June period were significantly more likely to have invested over the previous 12 months. This group was also more likely to be planning on-farm investments for the coming year.

Fig 4.6 - Main challenge faced in the future (% farms)

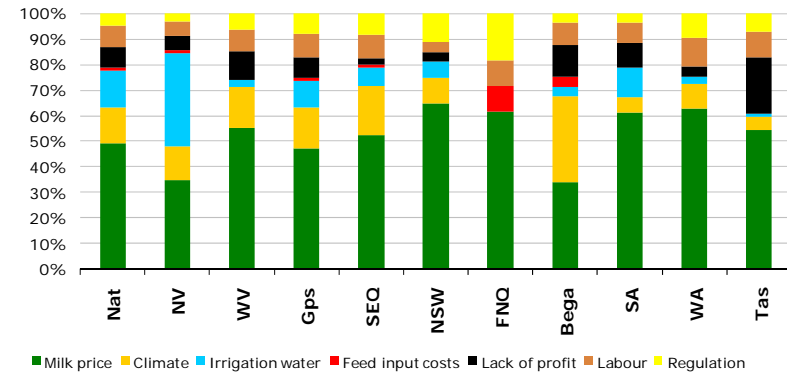
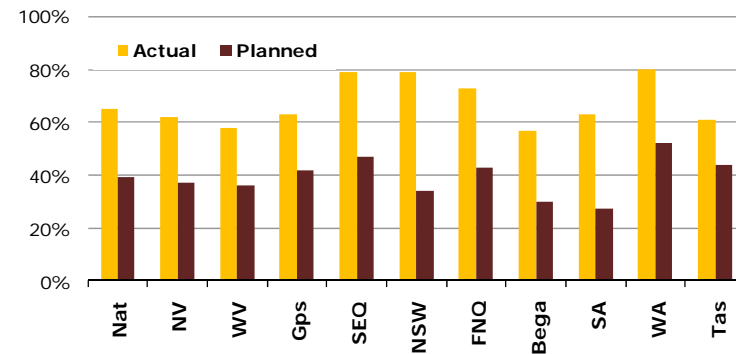


Fig 4.7 – Actual v planned on-farm investment in 2009 (% farms)

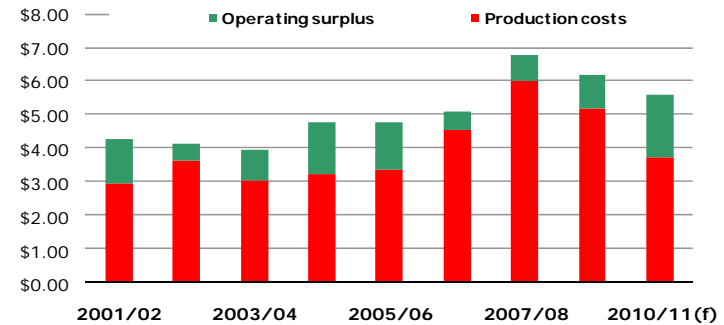


Production outlook

2010/11 production outlook

- The settings for the 2010/11 season are mostly positive – particularly when compared to the previous year. Favourable autumn conditions in most dairying regions, combined with low feed prices and the prospect of improving milk returns for most producers are all positives for milk production.
 - In northern Victoria/Riverina, water allocations are currently the best they have been for several years. Many producers have taken the opportunity to start pastures with irrigation, which have benefitted from mild autumn conditions. The late announcement of the allocation increases means that a large percentage of water will probably be carried over to the 2010/11 season, augmenting spring allocations.
 - Analysis by Farmanco of farms in the northern Victoria/Riverina - or Murray Dairy - region indicates that the improved water allocation will benefit farmers in two ways. It has allowed many farmers to start larger areas of pasture than in previous years – and those areas have been irrigated earlier. Secondly, the large proportion of this water likely to be carried over into the 2010/11 season will allow for improved spring growth – regardless of the winter conditions. Combined with more reasonable feed prices – estimated at 40% lower than 2008/09 for the coming year and there is potential for farmers’ terms of trade in 2010/11 to the best it has been since 2001/02.
 - Farmers in southern regions are receiving strong signals from exporting companies about the need for increased intake. There is strong completion for milk to satisfy market demand.
- On the negative side, farmers are still dealing with the effects of the poor 2009 conditions. Anecdotally, low in calf rates are likely to result in more cows being carried over into the new season, and this will reduce average productivity.
- Many southern farmers are also dealing with the financial impacts of the negative cash flow conditions in 2009, and the continuing market and economic uncertainty. For this reason, many are likely to take a conservative approach to the 2010/11 season, in an effort to avoid extending themselves financially, and determine whether the margin recovery can be sustained.
- In addition, farmers in northern regions are receiving stronger signals from milk processors that production is exceeding market requirements during period of the year.

Fig 4.8 – Terms of trade for average farm in Murray Dairy region (\$/kgMS)



Source: Farmanco analysis

- New National Foods contracts will build in sharper signals on supply with fixed contract prices for a proportion of production, while the rest will receive a variable “market” price.
- The Dairy Australia forecast for milk production in 2010/11 is for a modest increase to **9.0 billion litres**. This forecast is based on the views of each of the major dairy companies across Australia as provided to Dairy Australia
- However, if the favourable seasonal conditions are maintained and the expected improvement in milk prices for southern regions is realised with a strong opening price, there could be some upside to this forecast. This is reinforced by the surveyed intentions of farmers gathered from the National Dairy Farmer Survey.

Production outlook

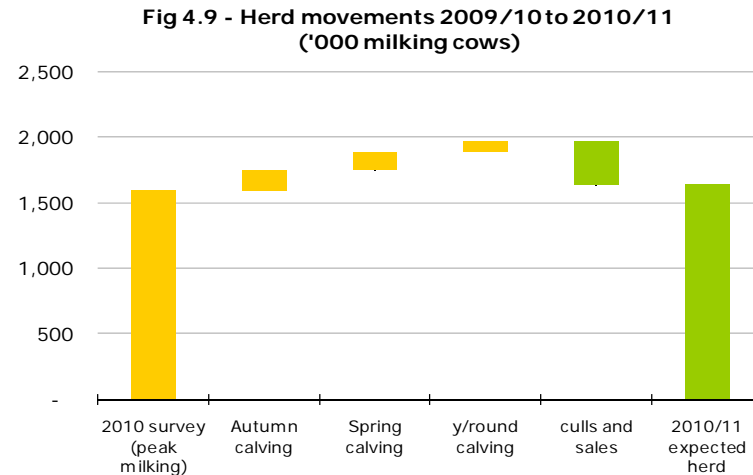
Herd numbers

- Changes in the national dairy herd based on survey responses and ABS data suggests that the number of cows milked at the peak in the 2010/11 season may be 2-3% more than that in the 2009/10 season.
- The analysis combines regional estimates of heifer replacement rates, sales and cows milked with the national estimate of cows in milk and dry at 30 June, as published by the Australian Bureau of Statistics.
 - Regions planning the largest increases in cows milked were northern Victoria/Riverina, South Australia and Gippsland.
 - Regions expecting to milk fewer cows in Spring 2011 included far north Queensland, central New South Wales, Bega,

Medium term outlook

- While operating conditions in 2010, the lingering uncertainty surrounding the world's recovery from the 2008 global financial crisis and an uncertain climate are weighing on the industry.
- In 2009, the industry was facing a significant downturn compounded the impacts of ongoing dry conditions in the industry's major dairying regions. It seemed regions reliant on irrigation from the Murray Darling Basin in particular were facing a massive shakeout.
- A year on and the shakeout appears to have been largely averted with improving market and seasonal conditions offering farmers a significant opportunity.
- Yet despite the remarkable turnaround in operating conditions across much of the industry, the three year production intentions measured in the National Dairy Farmer Survey– which had remained steady in the crisis conditions of 2009 have been lowered significantly in 2010.
- The increasingly complex challenges facing the adaptation of production systems to climatic uncertainty and volatile market conditions, policy uncertainty with respect to carbon and water, and the difficulty for many in sourcing skilled labour and managing expansion affects the overall industry outlook.
- Assuming a return to reasonable seasonal conditions, three year intentions from this year's survey indicate a scenario for milk production in 2012/13 of **between 8.9 and 9.2 billion litres**.

- This outlook reflects the significant reduction in the proportion of survey respondents intending to produce more milk in three years time, from 65% in 2009 to 50% in 2010. In fact this proportion represents the lowest production intentions recorded in the survey since 2004.
- With 40% intending to keep production at current levels, this is the largest proportion of farmers planning to keep production static in three years time recorded in the seven years of the survey.
- While the 2010 survey indicates a fairly conservative outlook for milk production growth, sustained milk prices and favourable seasonal conditions could see production increase further over the next three years.

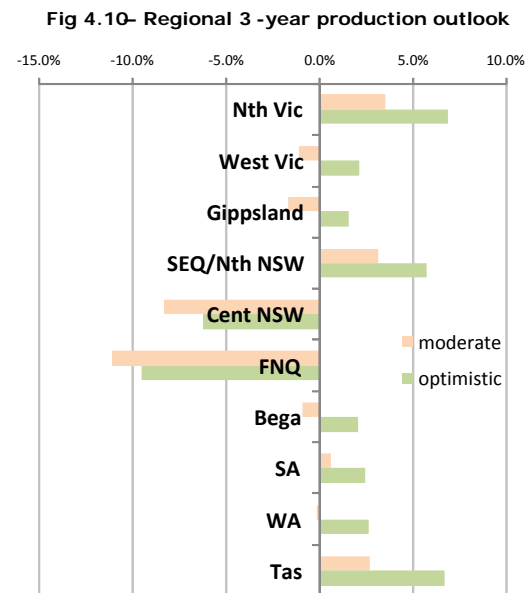


Production outlook

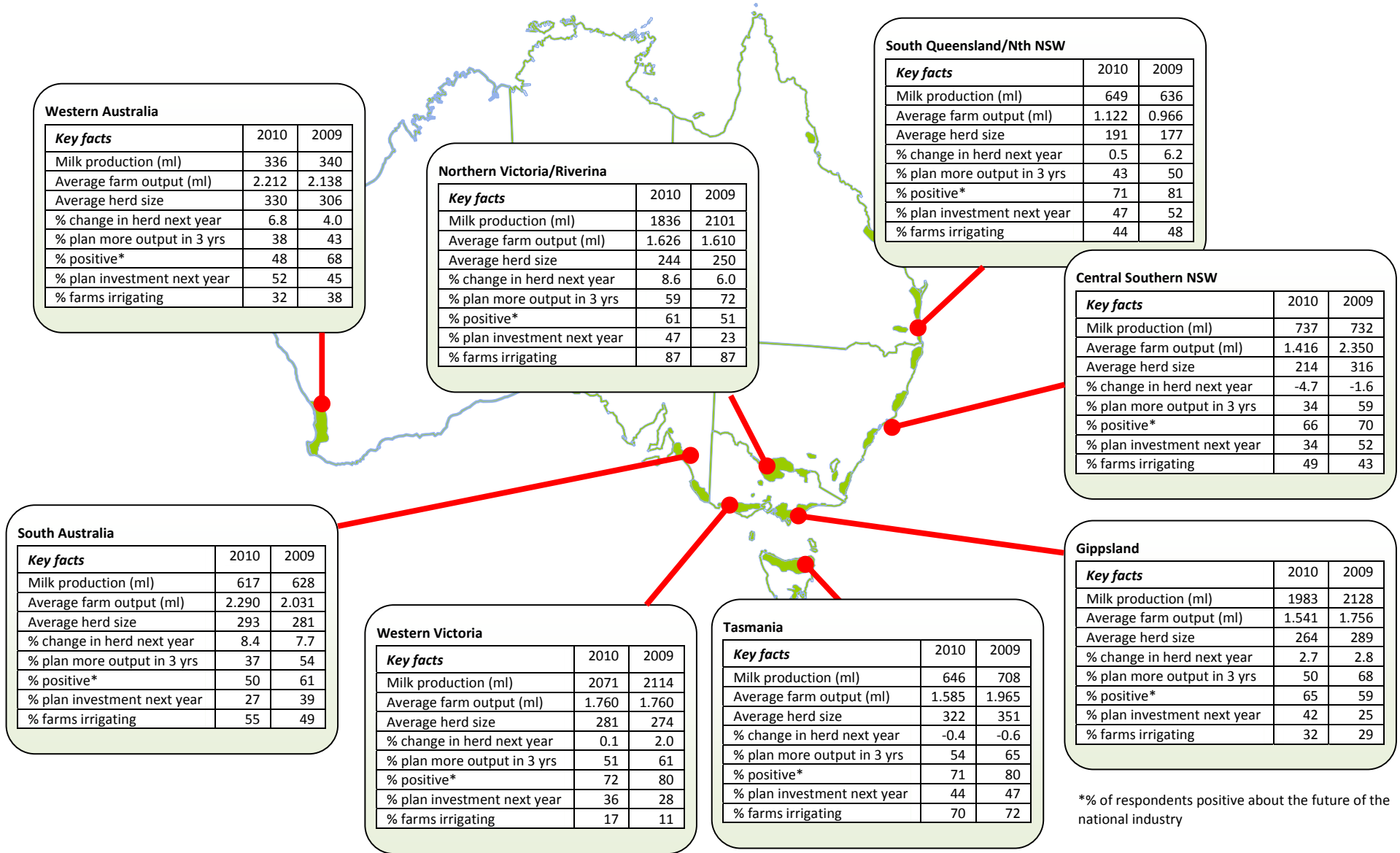
Scenarios for future medium term growth in milk production to 2012/13

This page provides some possible scenarios for medium term Australian milk production based on indicators of future intentions that have been provided in the 2010 survey. It is important however to view survey inputs as indicators of intention and sentiment towards future farm production, rather than an aggregation of firm commitments or plans, and to recognise the potential variability in the production outlook. The scenarios provided show the difference in outlook between moderate and optimistic outlook views, based on the capacity of producers who intend to grow their business over the coming three years.

Segments* of production sector (based on Survey)		Range of outcomes in 2012/13 billion litres
Growing Production on farms that state they will be increasing production over next 3 years	50% of production grows by 4-6% per annum	5.0 to 5.3
Static Production is on farms that will have static output over next 3 years	42% not changing	3.6
Declining Production is on farms that will decrease output over next 3 years	3% decreasing	0.3
Leaving Production is on farms that will exit over next 3 years	5% exiting	-
Total 2012/13		8.9 to 9.2



Key regions at a glance



Sustainability of systems

Systems under pressure

- There are a range of typical production systems in use across the industry which involve differing intensity of cattle stocking, different reliance on pasture feeding and use of supplementary feed, The role of irrigation will also vary across the systems depending on the specific region and the reliability on irrigation that is appropriate and available.
- In recent years, traditional approaches to milk production in a number of regions have come under pressure due to the unreliability of seasonal conditions and volatility in pricing of milk and feed inputs.
- What is more apparent is that:
 - Traditional seasonal operations are more vulnerable to cycles in milk price and bought in food costs.
 - Intensive high-cost operations have been exposed when there is little rainfall and irrigation.
- The industry has invested considerable resources in recent years in better understanding the vulnerability and adaptability of the most commonly-used systems, so as to assist producers with tools and know-how to better support holistic farm risk management and decision-making.
- Volatility in season-to-season milk prices, feed costs and weather has placed greater pressure on the performance of production systems.

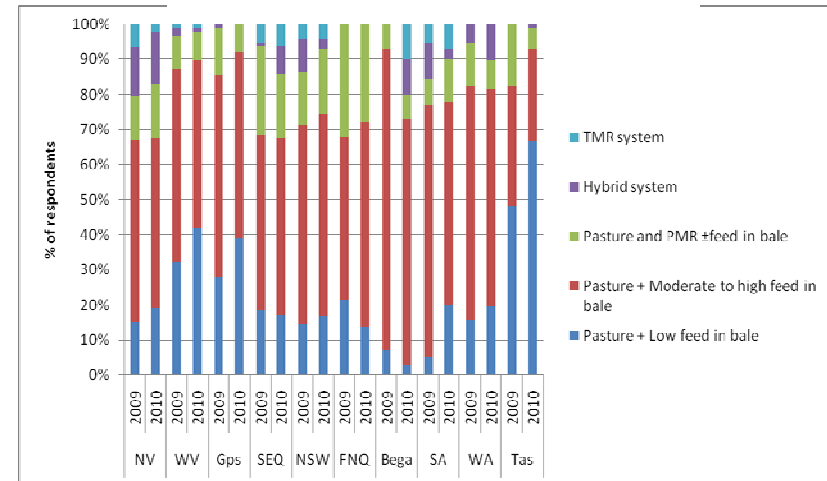
Analysis of performance over time

- It is misleading to generalise about the performance of production systems or different sized farms in volatile climate and market conditions. The realities of dairy farming are significantly more complex than simple assertions about the easy to categorise physical attributes of production.
- Analysis of the performance of different systems under fluctuating conditions has been carried out for Dairy Australia in 2009/10. The key points from this work are as follows:
 - Increasing intensity of milking operations is not necessarily more profitable in itself—this strategy is potentially riskier due to the significantly higher skill

levels required for effective management and the greater capital investment at stake.

- Comparisons of bought-in and home grown feed costs generally omit true costs of water and pasture investments.
- When evaluating returns on investment, significantly better returns are achievable by leasing feed producing land and water assets rather than through ownership.
- Seasonal conditions are not the sole driver of fortunes – the ability of a manager to adapt the system to cope with different conditions is more relevant in determining vulnerability. Skills in feed production, feeding cows and managing people are the critical definers of success in dairy enterprises regardless of the seasonal conditions.

Fig 4.11 – Trend in feeding systems – between 2009 and 2010



Production Inputs and Resources



Cow and heifer markets

Cow and heifer trade

- Dairy heifer export data available for the twelve months to March 2010 indicates that the total number of animals exported increased very strongly by 64% over last year to 82,600 - for a value of some \$A140 million. With the national herd at approx 1.6 million cows, live export heifers would now account for nearly 4.5% of milking cows - a record high level.
- Export volumes were at record highs in the first three months of 2010 – up from 6,700 last year to 31,000 this year. Nevertheless, export volumes are notoriously lumpy in nature.
- The largest markets over the last twelve months have been China with 54% [up from 19%]; Indonesia with 28% (new to the market this year); the Middle Eastern countries with 5% (down from 24%). Russia’s share has fallen from 34% last year to 10% this year and Mexico is out of the market this year after capturing 15% share last year.
- According to the 2010 NDFS, the proportion of heifers sold for export increased from 3.0% last year to 4.4% in 2009/10. While Victoria is the largest source of export dairy heifers in absolute numbers – due to the size of the industry - the proportion is traditionally highest in WA [reaching 6% this year].
- However difficult seasonal conditions in winter and spring and low milk prices in Tasmania and SA prompted dairy farmers in these two states to use the export market more heavily this season selling 11% and 7% respectively of their heifers in this way.
- Cull cow sales volumes decreased 24% in the six months to March 2010 – after increasing by 28% in the six months to September 2009 – the reversal of trend reflecting the positive changes in short-term conditions and outlook over the last six months.
- Over the full twelve months to March 2010, cull cow sales volumes were just 3% above the previous corresponding period. Results from the 2010 NDFS indicate 15% of the milking herd was culled – the same level as last year.
- As the national herd has contracted over the past decade, continued culling and exports of live cattle means that exiting stock represent a greater proportion of the herd. As a result, it is increasingly difficult to turnaround the decline and to increase cow numbers.

Fig 5.1 – Live dairy cattle sales by quarter since Sept 2005

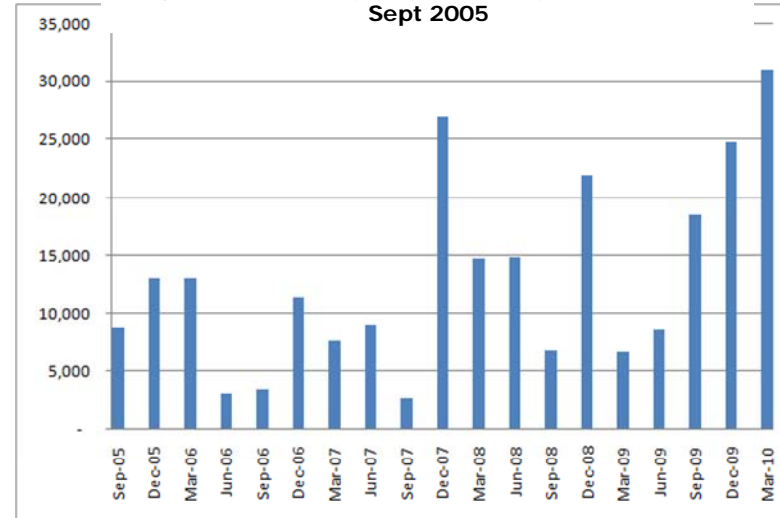
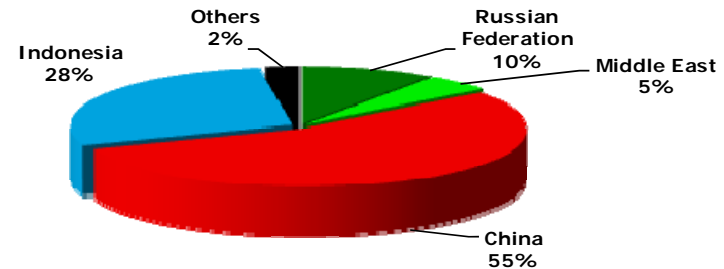


Fig 5.2 – Export destinations for live dairy cattle 12 months to March 2010



- Improving milk prices and signs of improving seasonal conditions have increased competition for autumn-calvers in recent months. Average prices are difficult to ascertain, but it would appear that current prices of around \$1,500 to \$2,000 – and upwards to \$2,500 - are well above prices being paid at this time last year when dairy farmers were facing the prospect of very low opening prices.

Cow and heifer markets

- Results from the 2010 NDFS suggest an average per farm of just 1.9% of heifers were sold domestically – up from 1.3% last year.

Beef market

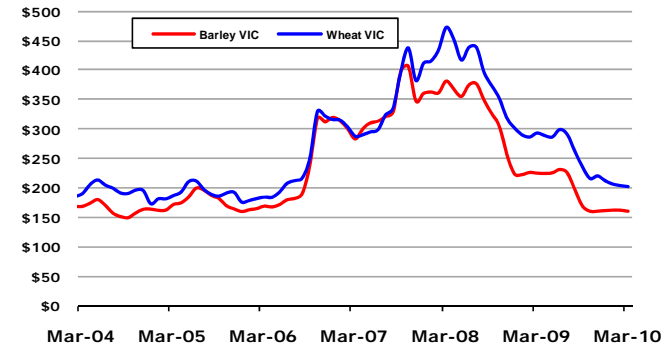
- The Australian beef herd has been declining since the middle of the decade due to less than favourable seasonal conditions.
- However, the significant rainfall across much of northern and eastern Australia during late-2009 and during the first three months of 2010 has led to reduced turn-off as transport became difficult in some areas and graziers withholding cattle in anticipation of improved pasture growth. Cattle prices have risen accordingly.
- The inland Queensland flooding and resulting improvement in deep soil moisture is seen as improving conditions for at least the next two seasons and ABARE is forecasting a gradually increasing herd size over coming years.
- Also supporting the increase will be stronger export demand as a result of income growth, and hence increased beef consumption, in Australia's major export growth markets of Chinese Taipei and Indonesia.
- However, export beef prices are forecast to be lower in the short term - reflecting increased competition for Australian beef [from the US with a weak USD] in the key export markets of Japan and Korea – and the strong \$A is also impacting on export demand.
- Consequently, the much improved pasture conditions and lower beef prices are expected to reduce the demand for feed grains from the feed lot sector – at least in the next season or two.

Outlook for feed inputs

Feed usage

- Purchased feed is the largest single cost item for dairy farmers – representing an estimated 30% of average of dairy farm cash costs in 2009/10 according to ABARE analysis – falling from 35% last season and over 37% the prior season.
- This figure has fallen in the current season due to better seasonal conditions; the fall in grain prices to four-year lows; and the lowest opening milk prices in southern regions several years which dramatically reduced the purchasing power of dairy farmers over the first half of the season.
- Analysis of the current season indicates a 'milk price to feed grain price ratio' increasing to 1.40 for feed wheat and 1.90 for barley – compared to 1.20 and 1.50 respectively last year – and up to the highest level in four seasons. More importantly, this ratio has improved significantly over the current season – from 1.20 for feed wheat during the first six months to an estimated 1.85 for the current six months. Similarly, barley has lifted from 1.60 to an estimated 2.35 over the season.
- An estimated 94% of Australia's dairy herd consumed an average 1.58 tonnes of grain, mixes and /or concentrates (according to NDFS 2010) in 2009/10 for a total feed grain requirement of around 2.4 million tonnes. National average usage per cow is up slightly on last year's 1.53 tonnes over 97% of the herd.
- The trend varies significantly around the dairying regions, with:
 - Similar usage in Victoria despite lower milk prices in the first half of season and improved pasture conditions.
 - Higher usage in NSW and south-east Queensland to take advantage of high milk returns and lower grain prices - and to combat drought in the far south-east of NSW.
 - Lower usage in SA and Tasmania as farmers managed difficult seasonal conditions in winter and spring and low milk prices.
- Better seasonal conditions – combined with low milk prices in the spring – meant a significantly lower proportion (35%) of dairy herds did not graze pasture for a period in the current season compared to last year's 45%.
- In an environment of falling grain prices during 2009 and into 2010, 85% of dairy farmers have purchased grain 'as required' – up from 78% last year – while the

Fig 5.3 - Grain price trends \$/tonne –Victoria



proportion buying on forward contract has correspondingly declined from 23% to 15%.

Feedgrains

Global

- Despite an expectation for a modest increase in global demand for wheat in 2010/11, relatively large global wheat supplies - production plus carry-in stocks - are expected to place downward pressure on grain prices.
- ABARE is therefore forecasting slightly lower world wheat production in 2010 – down 2% to 656 million tonnes - as a supply response to lower world grain prices [down 6%].
- Areas planted with winter wheat are down in the US and India, much the same in China and up slightly in the Black Seas region netting out to an overall lower area of plantings, plus an expected dip in Black Sea yields after two years of above average yields.
- World coarse grains production is forecast to increase 2% in 2010/11 – with expected higher corn production partially offset by lower barley production. This increase reflects greater utilisation of corn for ethanol production in the US to meet energy mandates - but is expected to be partially offset by an overall decline in demand for feed grains in the US and the EU with falling livestock numbers on feed.

Outlook for feed inputs

- World oilseed production is forecast to fall by 2 % because of reduced soybean production – which will not be offset by a rise in the production of other oilseeds such as canola.
- Over the medium term, increased demand for grains due of higher biofuels production and higher feed grain usage are likely to support world grain prices. Nevertheless, the peak prices seen in the commodity price boom of 2007/08 were an aberration and very unlikely to be seen again.
- The International Grains Council is also forecasting lower global wheat production – down 2% to 675 million tonnes in 2010 – but some 20 million tonnes higher than forecast consumption.
- Consequently world wheat stocks are expected to increase strongly again for a second consecutive year up to nearly 200 million tonnes - the highest level this decade.
- While Rabobank's forecast world wheat crop is slightly smaller at 652 million tonnes - due to lower planting expectations based on weakening gross margin from wheat production – the fundamentals remain the same and they expecting a third successive surplus in world wheat in 2010/11.
- Rabobank is also expecting further pressure on export prices in coming months as a number of export origins seek to reduce inventory levels and free up storage capacity ahead of the new crop harvest.
- The March-May period is critical for global grain crops as unfolding weather conditions will determine the size of the 2010 northern hemisphere harvest - and the area of southern hemisphere plantings - with resulting implications for stock levels and prices.
- We could usually expect volatility in grain prices during this period until crop prospects are firmed up. However, as each week passes with no major production problems to date, the uncertainty over the 2010 crop is steadily reducing and the risk premium is disappearing from the market.
- Global grain supply and demand fundamentals have not changed over the past month with the prospects of large northern hemisphere and South American crops putting longer term downward pressure on prices.
- The benchmark Chicago futures price for July 2010 wheat is down around 15% over the first four months of 2010.

Australian market

- Two consecutive good harvests, plus relatively high world grain stocks, has meant a steady decline in feed grain prices this season.
- The 2009/10 winter crop production was estimated at 35.2 million tonnes – 4% higher than last year's 'best in four years'. Of the major winter crops, wheat production is estimated at around 21.7 million tonnes – up 3%; barley production is estimated at 8 million tonnes – up 5%; and canola production at 1.9 million tonnes.
- There remains a high level of grain stored on-farm this season as grain growers hope for an improvement in prices and this has meant no autumn price premium as prices continued to drift lower in the early months of 2010.
- Lack of rainfall reduced grain sorghum plantings in northern regions this summer and the sorghum harvest will be the smallest in a number of years. However, major rains since that time have provided significant soil moisture and pasture growth, together with prevailing lower wheat prices, will offset potential feed gaps in northern regions in coming months.
- ABARE is forecasting the area planted to winter crops to marginally decline in Australia in 2010/11 as a result of lower grain prices.
- However, with a forecast marginal increase in yield, the wheat crop is forecast to increase slightly to 21.9 million tonnes. Barley volumes are forecast at around 8 million tonnes.
- However, excellent summer and early-autumn rains in virtually all eastern Australia's cropping zones may encourage larger areas to be sown with winter crops due to good sub-soil moisture levels.
- Rabobank's early forecast for the Australian wheat crop is currently at 21.8 million tonnes – with east coast winter crop prospects "looking outstanding". However WA is yet to see soaking autumn rains.
- The USDA is forecasting a local wheat crop of 22 million tonnes in the coming season; while the CBA is at the lower end of the range at 20 million tonnes.
- Australia's east coast 2010 winter crop prospects are off to a very good start with planting now under way after some of the best early-autumn rainfall in many years. West Australia is waiting for a decent autumn break to plant.

Outlook for feed inputs

- Nevertheless, while soil moisture is currently very good, the cropping season will ultimately hinge on spring rains.
- The wet conditions so far have increased the risk of plague locusts in some areas next spring – although these may pose more a risk to pasture than to developing crops by that time of year
- Local grain prices have also declined about 15% over the first four months of the year. Grain growers have held out hoping for a return to the harvest prices of late-2009 / early-2010; but the reality now seems to be hitting home for some as they seek cash flow for further planting of the next crop in May-June.

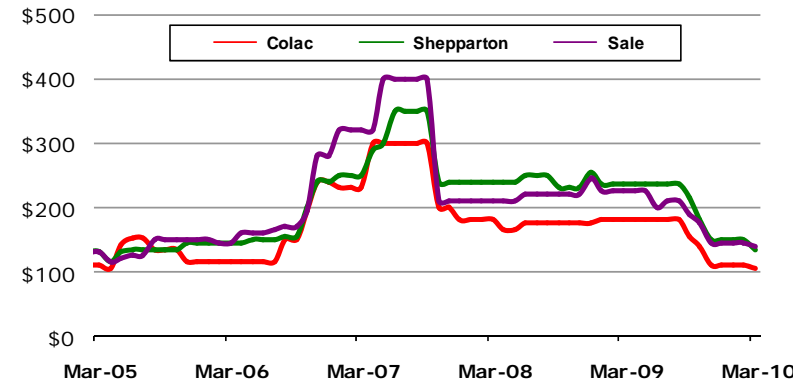
Fodder

- The large production on-farm of hay and silage last spring continues to sustain livestock in south-east Australia.
- With hay is now as cheap as it has been during the last four years in some areas, many hay producers are questioning the economic value of sowing paddocks this year for hay production.
- However this could change relatively quickly if next spring follows the pattern of recent years. In the event of another failed spring, the only hay available from the previous season will be weather damaged cereal and vetch.
- Hay producers will also be watching the development of the winter with much interest. A cold wet winter means solid hay demand and to clear high stocks of hay, winter consumption of fodder will need to be extensive. Consequently, it may now be a good time to purchase hay to shore up winter supplies in terms of both price and selection of quality.
- With hay prices as low as they are currently it may be worth considering the value of purchased fodder compared to home-grown fodder - when fully costed with the farmer's labour and on-farm fertiliser costs.
- ABS data indicates that hay exports increased 12% in 2009 – following a 20% increase last year -- to 869,000 tonnes in 2009. This volume is also 11% above the five-year average.

Medium term outlook

- Growth in the biofuels sector will continue to be a key driver of demand for grains and oilseeds – particularly in the US, the EU and China. Nevertheless, it may be changeable as governments fine-tune policies in this area to reflect

Fig 5.4 - Pasture hay price trends \$/tonne – Victoria



community attitudes to some of the unintended consequences of existing policies; such as environmental concerns and a wider 'fuel vs. food' debate.

- In Australia, the sheep meat industry is currently looking positive and there may also be some trade-off with grain growing in the wheat/sheep belt of eastern Australia in coming seasons.

Outlook for feed inputs

Fertiliser

- Fertiliser cost is a significant cost item for dairy farmers – representing an estimated 6% of average of dairy farm cash costs in 2009/10 according to ABARE analysis – falling from 6.8% last season and 7.2% the prior season.
- The global phosphate [DAP/MAP] market has seen considerable volatility in recent months. Softer demand in the northern hemisphere through 2009 lead to production cutbacks, and when combined with lower stocks across sellers and distributors burnt holding high priced inventory in the last price cycle, resulted in lower inventory levels across the supply pipeline by late-2009.
- Consequently, prices have jumped on US spring planting demand in recent months to levels 60% above those of November. However, unlike the price bubbles of 2007, once the period of peak demand eases, prices are expected to fall back.
- Local prices of around \$A 650 - 750 /tonne for the upcoming winter grain crop would be only \$A 100 – 150 / tonne below 2009 prices. However the difference this year is a much weaker outlook for wheat prices. January 2011 wheat is down around \$210 /tonne; whereas January 2010 wheat was at \$290 /tonne at time of sowing in May/June last year.
- Nevertheless, the [ANZ] view is that growers are more likely to reduce application rates below optimal levels to contain costs, rather than any large scale reduction in areas planted.
- Tight supply of ammonium phosphate fertiliser stocks through January and February [reportedly] eased off over March - with world supply catching up with solid international demand. Local supplier Hi Fert is forecasting there will not be the widespread supply issues for winter cropping programs that some within the industry had been predicting.
- X-cheque’s analysis is also that international nitrogen prices have eased in recent weeks; phosphate prices are also showing signs of stabilising after increasing 30% in the first quarter of 2010; while potassium prices to the Asian region have been steady but have continued to fall in product exported from Canada.
- Consequently, the international index for a dairy pasture fertiliser mix reached a recent peak in February at about 117% of the June 2006 benchmark. It has subsequently fallen back to 110%.

- It would also appear that the arrival of a new competitor to the market has also assisted in holding prices rises. Koch Fertiliser has leased a 150,000 tonne storage facility in Geelong from Grain Corp.
- The international price outlook is for continued weakness in nitrogen pricing and an associated fall in DAP; and stable prices for phosphate and potassium for the next quarter at least. China and India look like being the primary engine for demand with only tentative signs of improved economic conditions in Europe and the USA.
- In terms of local prices, weakening international nitrogen prices and more serious local competition should see reductions in urea and DAP prices and perhaps slight easing of superphosphate. Potassium is expected to continue its slow fall to some semblance of parity with international price indices

	Urea	DAP	Single super	Potash
Dec09	\$517	\$540	\$275	\$850
Mar10	\$555	\$825	\$325	\$715
Jun10 (f)	\$450 - \$500	\$650 - \$750	\$275 - \$325	\$650 - \$700

Source: X-cheque

- BHP has recently confirmed its entry into the fertiliser industry with its \$US320 million acquisition of Canada’s Athabasca Potash Inc – to combine with its own adjacent \$US 8 billion Jansen potash development which it believes has the potential to be a world-class low-cost project.

Water

The use of water

- Results of the 2010 NDFS indicate:
 - 61% of dairy land set up for irrigation was actually irrigated during the 2009/10 season – marginally up from 57% last survey.
 - 46% of respondents said they irrigated all of the land set up for irrigation, 5% did not manage to irrigate any land. The corresponding figures for northern Victoria / Riverina were 15% irrigating all their land and the same 5% irrigating none.
 - Despite water prices being much lower this season – peaking at \$420 /ML in August before falling below \$200 /ML two months later – only 7% of all irrigation water used was purchased water.
- The survey also reported that dairy farmers continue to invest in water use efficiency and security – 30% expect to change or upgrade their system – with 18% planning to introduce new irrigation technology; 15% change their method of irrigating; 21% increase the area of land irrigated and 19% buy water additional to their entitlement.

Water Availability in southern regions

- Water availability has improved significantly during the first quarter of 2010 with major rainfall events over much of the eastern half of Australia as the El Niño [warm] weather system has steadily broken down.
- The March quarter above average rainfall across eastern Australia meant that for the Murray-Darling Basin (MDB) averaged as a whole, it has been the seventh wettest start to the year since 1900; and in Victoria the wettest since 1974.
- Goulburn-Murray Water's final seasonal allocation for the 2009/10 season (announced on 1 April 2010) was that the Murray system finished on an allocation of 100% and the Goulburn system was 71%. The corresponding figures last year were 35% for the Murray and 33% for the Goulburn.
- Goulburn-Murray Water released the first outlook for 2010/11 seasonal allocations in mid-Feb10. Although the Murray and Goulburn systems have received their highest irrigation allocations in four years, inflows have remained well below average for another year; and there remain low system reserves by the end of this season. The July-Oct10 inflow period will again be critical to supporting irrigation allocations and delivery of carry over water next season.

- Even so, the position is likely to be better than the last couple of seasons with *average rainfall and inflows* forecast to deliver a 62% allocation on the Murray and a 65% allocation on the Goulburn by 15 October 2010 – rising to 100% on both systems by mid-February 2011.
- The Northern Region Sustainable Water Strategy [NRSWS] is providing greater flexibility in managing water entitlements by further relaxing the rules around carryover for the 2010/11 season.

Rainfall outlook

- The national outlook over the late-autumn to mid-winter quarter [May to July] shows a moderate to strong shift in the odds [65 to 75%] favouring a wetter than normal season over parts of north and eastern NSW and southern parts of Queensland. Contrasting this, the chances are between 35 and 40% for above average May to July falls in several small regions in southern Australia - mainly in parts of Western Australia and the west coast of Victoria.
- Furthermore, it is being reported in the rural press that Japanese climate scientists' computer models are forecasting a "fairly strong" La Nina developing across the Pacific Ocean this winter, which would suggest that "eastern Australia would have more precipitation than normal during May to August 2010".

Water policy developments

- The Murray Darling Basin Authority is releasing its first proposed Basin Plan in mid-2010 – which will provide for the integrated management of all the Basin's water resources. The stated objectives of the plan are to:
 - set and enforce sustainable diversion limits (SDLs) on surface and groundwater
 - set Basin-wide environmental, water quality and salinity objectives
 - develop efficient water trading regimes
 - set requirements that must be met by State water resource plans
 - improve security for all users
- As the major user of water in the Murray Darling Basin, the implementation of the Basin Plan will have a major impact on irrigated dairying regions which are reliant on the systems water resources, in particular the determination of SDLs based largely on environmental measures will necessarily reduce water available to irrigators

People

People in dairy farming

- The 2010 NDFS results indicate that farm management and labour structures continue to change over time.
- Hired labour cost is not really a significant cost item for dairy farmers – usually costing less than the amount spent of fertiliser in a regular season - representing an estimated 6.4% of average of dairy farm cash costs in 2009/10 according to ABARE analysis – but increasing from 5.4% last season and 4.7% the prior season.
- The number of dairy farms operated by a single person only or with a partner has been falling steadily from 43% in 2007, to 34% in 2008, to 28% in 2009; but lifted slightly to 31% now in 2010 as the economic climate reduced the number of paid roles on dairy farms.
- At the national level, some 61% of farms operate with paid roles – with the range from lows of 48% in western Victoria and 53% in far north Queensland to highs of 80% in Western Australia and 90% in the Bega region.
- Over the past twelve months, one in four dairy farms recruited staff - with over 90% being either farm hands or assistant farm hands. Furthermore, nearly half of the people recruited were new to the dairy industry.
- Approximately 100 farm supervisors and 100 production managers were recruited in the last year; with one third being recruited new to the industry.
- Over the coming 12 months, 17% of respondent farms are expecting to recruit approximately 1,800 staff. About 50% of these will be new positions and mainly farm hand or assistant farm hand roles. The offset will be staff cuts of around 300 people, for a net gain of around 1,500 roles.
- It is anticipated that approximately 50 farm supervisors and 100 production managers will be recruited in the next year.
- At the national level, 8% of farms had staff who participated in an apprenticeship or traineeship over the past year – with training participation highest in Tasmania at 14% and South Australia at 12%.
- At an on-going fundamental level, the skills and capability of farm owners and managers is critical to the sustainability and development of the dairy industry.

- In the on-going challenging and uncertain operating environment, management skill and emotional resilience of a significant proportion of the industry’s people is being severely tested.
- As the operating environment continues to develop in new and complex ways, farmers will need access to the information and support required to make effective decisions for their business and family.

Fig 5.4 - % of farms that plan employment changes in 2010/11



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