



Outlook for Australian Agriculture – The Five Year Plan

Review of the ABARES' March 2011 Australian Commodities report.

The outlook for Australian agriculture is extremely optimistic in the eyes of Australia's official commodity forecaster. ABARES medium-term view for the sector includes the favourable mix of strong production and strong prices.

The positive outlook for the Australian farm sector follows a dynamic recovery in the domestic sector during 2010/11. The value of farm production jumped 17% to \$48.5 billion in 2010/11, due mainly to a 26% surge in the value of crop production. By 2015/16, the gross value of farm production is forecast to grow further to \$51.4 billion, representing growth of 1.2% per annum. Prospects for the livestock industry over the coming 5 years support the robust growth forecasts for the entire agriculture industry (Figure 1).

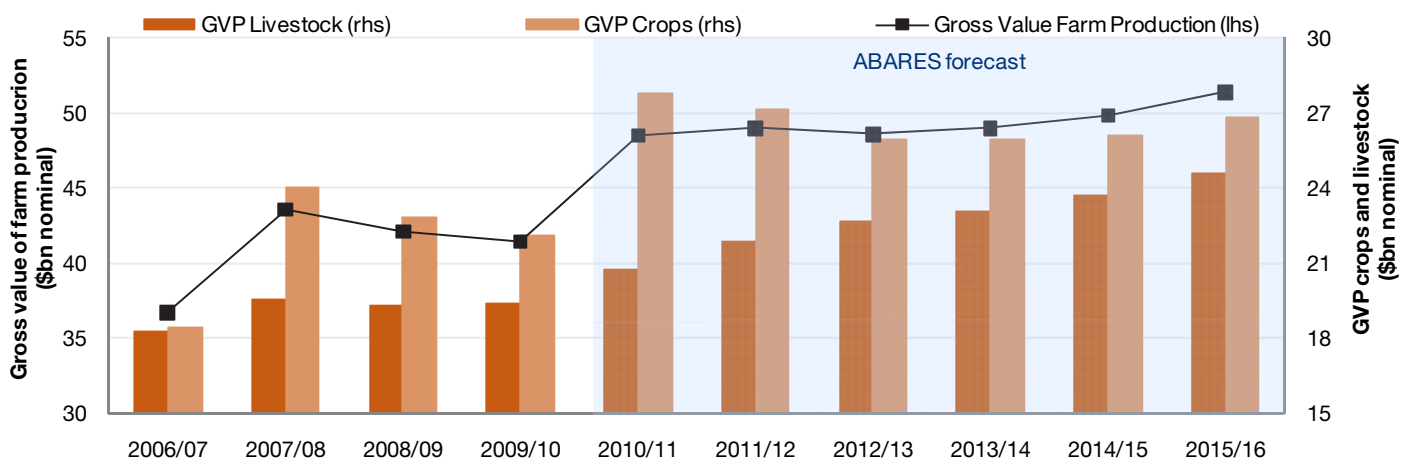
ABARES optimistic outlook for the livestock industry is due to forecast favourable seasonal conditions, herd-rebuilding activities and exceptionally strong prices. Although the Australian economy is not expected to be "riding on the sheep's back" anytime soon, ABARES outlook for the livestock industry is as bright as at anytime in recent history. However, in our view, ABARES livestock price forecasts appear a little too optimistic. Current east-coast seasonal conditions can arguably be regarded as near-ideal for herd-rebuilding activities. Therefore, in our view, the balance of risks is for seasonal conditions to moderate from here-on-in, which may cool restocker demand and prices.

The 17% surge in the value of crop production in 2010/11 was the result of record large production volumes and a rally in global grain markets from July 2010. Crop failures in key overseas production areas caused the 2010 global price spike. While ideal weather during the east-coast growing season supported record local crop production, despite the negative impact of excessive rainfall and quality downgrades during the 2010/11 summer. In the coming 5 years, ABARES forecast the value of Australia's crop production to moderate as both output and prices subside from this year's exceptional result. Australian grain prices, in particular, are forecast to moderate in accordance with world markets as global production recovers from the 2010 weather-affected result.

Report purpose and structure

This report reviews ABARES 5 year outlook for Australian and global agriculture. In particular, we review the key trends and forecasts for commodity production, use and prices for the major agriculture industries. This includes the grains, oilseeds, sugar, fibres, meat and dairy industries. Unless otherwise stated, the views expressed in this report are that of ABARES.

Figure 1: Gross value of Australian farm production forecast to rise strongly



Source: ABARES and CBA



Macro-economic backdrop

In framing the commodity sector forecasts contained in this report, ABARES make the following assumptions concerning the global and domestic macro-economic environment.

Global economy

- The global economy is forecast to grow by 4.1% in 2011, following growth of 4.8% in 2010. Growth will be modest in advanced countries but more robust in emerging economies.
- Fiscal consolidation in OECD countries and a Chinese slowdown are the key risks to the outlook.
- Inflationary pressures have become an issue in many emerging, and, to a lesser extent, advanced economies. Central Banks in many nations have acted to rein-in inflation.

Domestic economy

- Australia's economy is assumed to grow by 2.8% in 2010/11, before strengthening to 3.9% in 2011/12. Medium term domestic growth is forecast at 3% per annum.
- Adverse weather in Q4 2010 and Q1 2011 has dampened economic activity. However the necessary reconstruction effort will ensure the adverse impact is short lived.
- ABARES estimated that rainfall and flooding reduced agricultural production by around \$2.3 billion in 2010/11, with large impacts on winter crops, fruit, vegetables, cotton and horticulture. Cyclone Yasi caused a further \$300 million in damage, principally to banana and sugarcane crops.

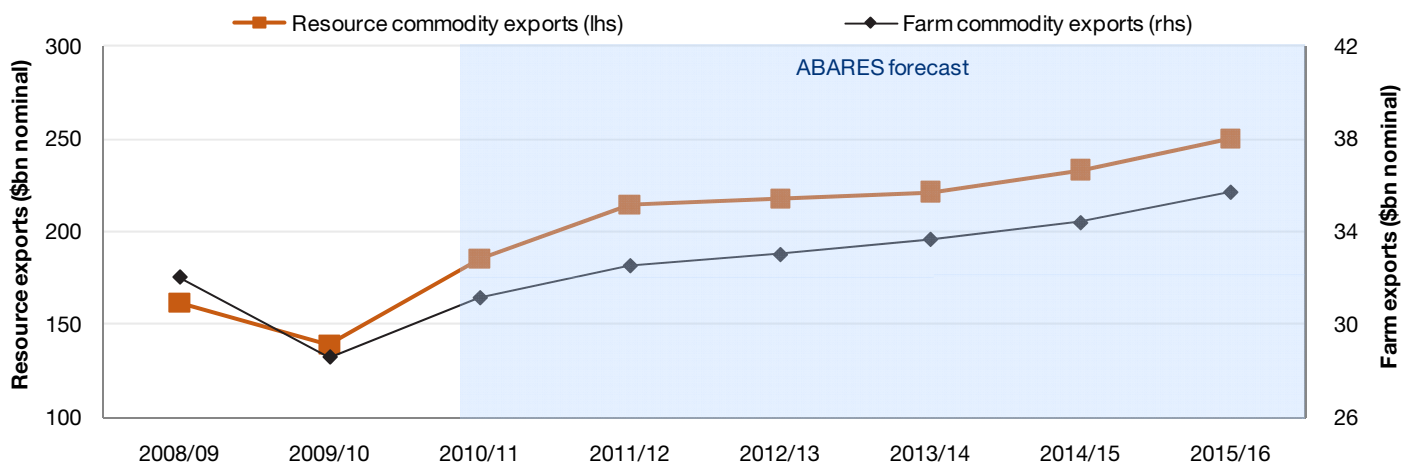
Commodity Sector Outlook

Australia's commodity export opportunities are bright

Australia's commodity export returns (per unit) are expected to increase 6% in 2011/12 following a strong 24% increase in 2010/11. The 2011/12 increase largely reflects higher energy and mineral commodity prices. Farm commodity export returns are expected to decline 3.5% in 2011/12 after rising 9% in 2010/11. Longer run unit export returns are expected to moderate from current levels.

The value of Australia's commodity exports is forecast to increase 14% in 2011/12 (yoy) while the value of exports in 2015/16 is expected to be 15.5% higher than 2010/11 levels (real terms). The medium term increase in commodity export earnings reflects higher resource commodity volumes.

Figure 2: Value of Australia's commodity exports forecast to rise.



Source: ABARES

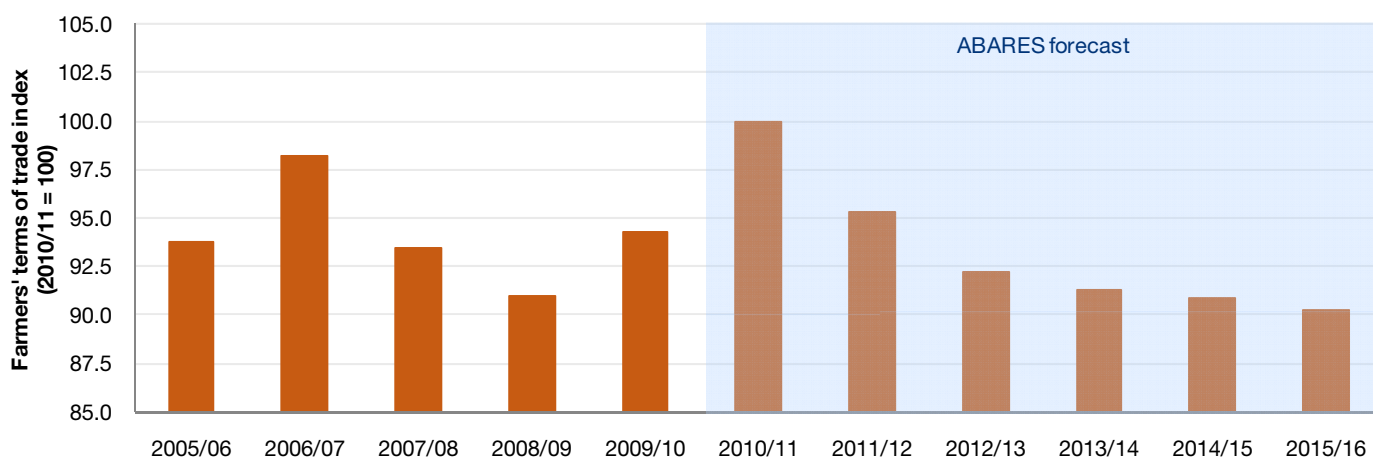


Australian farm performance in 2010/11 improves strongly.

According to ABARES farm surveys:

- The average financial performance of Australian broadacre farms is projected to improve markedly in 2010/11. At the national level, average farm cash income for broadacre farms is projected to increase from \$58 900 a farm in 2009/10 to \$82 000 a farm in 2010/11.
- Farm cash incomes are projected to increase in all eastern states because of increased production and higher prices for broadacre commodities. The largest projected increase in farm cash income is in South Australia, driven in part by record winter crop production.
- In contrast, reduced farm cash incomes are expected for broadacre farms in Western Australia as a consequence of severe drought in southern Western Australia.
- High rainfall and flooding in some areas damaged fences, roads, irrigation structures and farm buildings and are expected to result in increased expenditure on repairs.
- Abundant pasture growth and higher sheep, lamb and wool prices have increased farm cash incomes for sheep farms. Farm cash income for sheep industry farms are projected to average \$80 000 a farm, the highest farm cash income recorded since 1989/90, in real terms.
- Farm cash income is projected to improve for dairy farms in southern regions in 2010/11 in response to a small increase in milk prices and increases in on-farm fodder production.
- Overall, broadacre and dairy farms had strong farm equity at 30 June 2010 and new investment in machinery, vehicles, plant and improvements was the highest recorded in more than 20 years in 2008/09 and 2009/10.

Figure 3: Australian farmers' terms of trade bounces in 2010/11 before subsiding.



Source: ABARES, (Terms of trade is a ratio of prices received by farmers (output) of prices paid by farmers (inputs))

Grain and Oilseed Market Outlook

- Global crop prices rallied because of adverse weather in 2010. Increased production in 2011 should weigh on global prices.
- Australia's grain and oilseed sector performed strongly in 2010, despite grain quality issues.

Grain and oilseed prices rallied in 2010 because of weather-induced production shortages in key regions. Global crop inventories, particularly for corn, have been drawn down sharply, supporting prices. This suggests that supply-side factors, such as droughts, have a more significant influence on year-on-year price changes than demand-side influences.



Consistent with the seasonal nature of supply, ABARES does not expect the rally in grain and oilseed prices to persist. The world's grain and oilseed producers are expected to respond to current high prices by increasing production in 2011/12, and this is forecast to put downward pressure on world prices. The global area planted to wheat, coarse grain and oilseeds are all forecast to rise by roughly 3% in the coming season. A normalisation in global yields will further boost global grain and oilseed production in 2011/12.

Global wheat view

ABARES expect the global wheat balance sheet to swing back into surplus in 2011/12, following the 2010/11 deficit, because of increased area planted and improving yields. The forecast 5 million tonne production surplus will cause the global wheat stock-to-use ratio to increase to 29% in 2011/12. And over the 5-year projection period, ABARES expect wheat production growth to outpace demand, resulting in further modest gains in global wheat inventories. Consequently, ABARES forecast world wheat prices to decline 19% over 2011/12 to US\$250/t (US HRW wheat, fob Gulf), before declining further to US\$219/t in 2012/13.

In our view, the largest risk to ABARES 2011/12 wheat price forecast is production uncertainty. 2011/12 production prospects are vague at best because the northern hemisphere winter wheat crop is yet to emerge fully from dormancy, and spring wheat planting has not commenced. A repeat of the 2010 crop failures would tighten world wheat supplies and support prices.

Global coarse grain view

Global coarse grain plantings are forecast to rise strongly in the coming season because of attractive prices, and yields are forecast to improve sharply from last season's weather-affected result. Overall, global coarse grain production is expected to lift 6% to 1,149 million tonnes in 2011/12, resulting in a 2 million tonne production surplus. However, despite the forecast production surplus, global coarse grain stocks will remain tight, thereby supporting prices.

World feed grain prices are forecast to fall modestly (10%) to US\$216/t (US corn, fob Gulf), but still remain 33% above 2009/10 levels. A further, gradual, moderation in nominal prices is anticipated through 2013/14. Strong demand, particularly from the ethanol market, will keep a reasonably solid footing under medium-term prices.

Global oilseed view

Global oilseed production is forecast to lift 5% in 2011/12 to 467 million tonnes, driven a strong increase in area planted and improving yields. Meanwhile, consumption growth is forecast to increase 2% to 461 million tonnes, largely because of the expansion and global biodiesel production and increasing Chinese vegetable oil/meal demand.

Over the medium term, ABARES expect further strong growth in South American soybean production because of an expansion in area planted. ABARES forecast the Argentinean and Brazilian soybean area to increase by 12% (5 million hectares) over the coming 5 years.

Reflecting increased production, ABARES forecast world oilseed prices are forecast to fall 8% to US\$474/t (Soybeans, cif Rotterdam) in 2011/12, with a further 15% fall in prices in 2012/13.

Australian grain and oilseed outlook

Australia's wheat area is forecast to rise 3% in 2011/12 because of favourable prices and a full soil moisture profile. However despite the higher planted area, ABARES forecast domestic wheat production to decline by 2.3 million tonnes from last year's record to 24 million tonnes in 2011/12 because of a normalisation in yields. In particular, east-coast yields are forecast to moderate from the last year's record levels, while Western Australia's yields should improve from last year's drought-affected result. Australian wheat exports are forecast at 16.5 million tonnes in 2011/12.

Favourable prices are presumed to result in a 6% lift in Australian canola area planted, resulting in a 4% lift in production. But, barley area planted is expected to fall 3% because of 'crowding-out' from other crops, and output is likely to fall 5% because of a normalisation in east-coast yields.

With planting still some months away, we have no major objection with ABARES 2011/12 crop production forecast. More refined production estimates, including our own, will become available

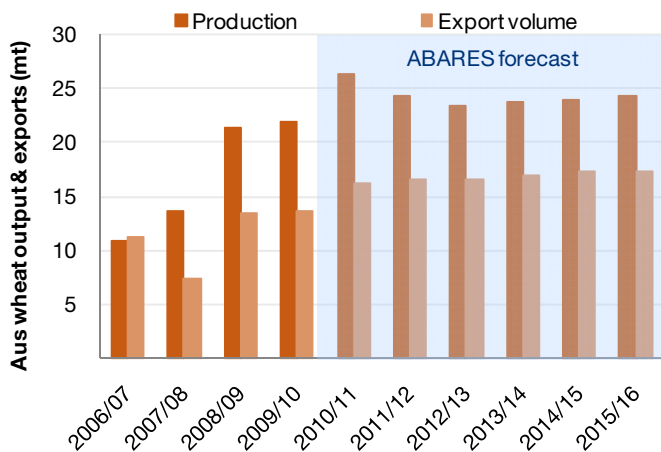


over the coming months.

Consistently strong wheat, barley and canola production is forecast for the medium-term. ABARES have assumed that Australian wheat yields will increase by 2% pa over the projection period, from an elevated starting base, citing technological progress. However, we are unconvinced the necessary yield-enhancing technologies will be commercially available in the near-term. So we don't subscribe to ABARES' view of 2% per annum yield growth. On the contrary, seasonal volatility appears to have increased over the past decade, and if this volatility persists in the future, ABARES production targets seem unrealistic.

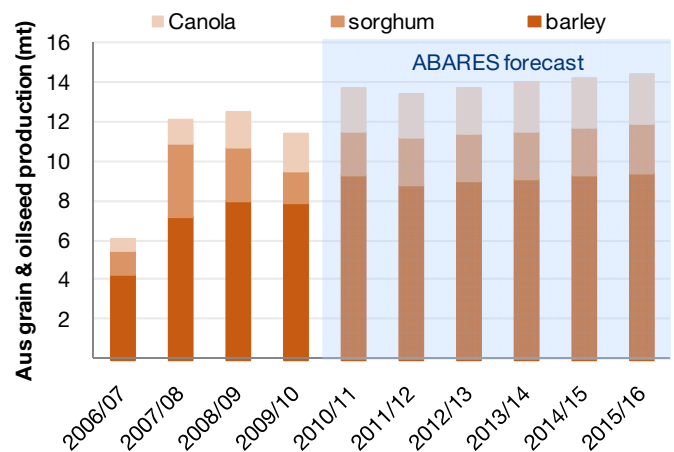
Australia's medium-term wheat exports are forecast to exceed 17 million tonnes by 2015/16, in line with production growth, according to ABARES. In our opinion, wheat exports consistently exceeding 17 million tonnes are unlikely for three reasons. Firstly, ABARES production targets appear optimistic. Secondly, rising domestic grain demand will slowly erode Australia's exportable surplus of wheat. And finally, even in the presence of a 17 million tonne crop, constrained upcountry-logistics will likely prevent a consistent 17 million tonne export program.

Figure 4: Australian wheat production and exports outlook



Source: ABARES and CBA

Figure 5: Australian barley, sorghum and canola outlook



Source: ABARES and CBA

Sugar Market Outlook

ABARES expect global sugar prices to remain favourable over the next few years, thereby allowing a recovery for the local industry from the effect of excessive 2010 rainfall and cyclone Yasi.

Global raw sugar prices are expected to average US\$28.50/lb in 2010/11, 19% above 2009/10 levels, supported by low global inventories and steady global consumption growth. Over the next few seasons, sugar prices are forecast to ease because of an increase in production, but even so, ABARES believe medium-term prices will remain above the past two-decade average.

The near-term increase in global sugar production is being driven by current strong prices, resulting in a forecast 6 million tonne production surplus in 2011/12. This is despite continuing adverse weather in many regions which has tempered the production response. Looking further forward, ABARES suggest that the current high prices may induce an excessive investment response by the world's cane farmers, which may in turn place additional pressure on prices. Such a response would be consistent with historic production and price responses to previous sugar-price spikes.

Strong income growth in developing regions is forecast to remain the most significant medium term influence on global sugar prices. World sugar consumption proves relatively resilient to higher prices, with changes in incomes a more important influence. Hence rising incomes in developing nations, especially China and India, is expected to cause an increase in per capita sugar consumption.



Australian sugar outlook

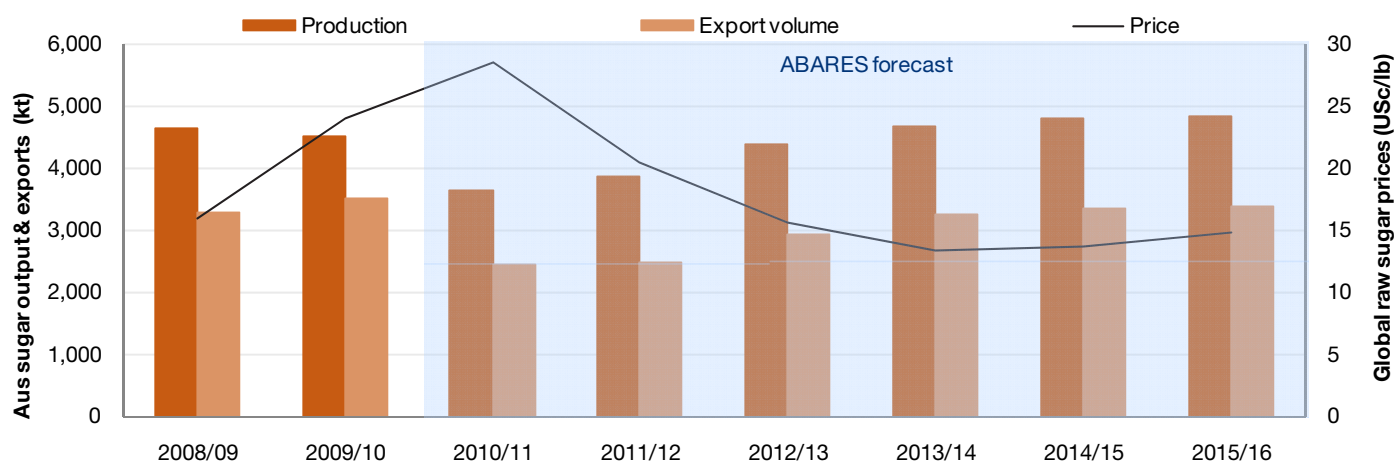
Australian sugar production is forecast to fall 1 million tonnes in 2010/11 to 3.6 million tonnes because excessive rains during the crushing season. An estimated 5.7 million tonnes of cane, roughly 20% of the total cane crop, could not be crushed. Therefore poor seasonal conditions constrained Australia's ability to take advantage of the elevated global sugar price during 2010/11.

Tropical cyclone Yasi dealt another cruel blow the sector in February 2011, and will limit the sector's ability to rebound in 2011/12. The region that Yasi struck is home to around 20% of Australia's total cane, and the cyclone has reportedly reduced potential cane production in the region by one-third. Consequently, ABARES forecast that Australian sugar production for 2011/12 will be only 3.85 million tonnes.

By 2015/16 Australian sugarcane area is expected to increase modestly to 403 thousand hectares, 50 thousand hectares higher than 2010/11 levels. However, despite the increase, the future forecast area this is still 45 thousand hectares below the record area of 2002/03. Urban encroachment, competing crops and plantation forestry are expected to limit the future expansion.

Australian sugar production is forecast to rise to 4.8 million tonnes by 2015/16 from 3.6 million tonnes in 2010/11, supporting exports of 3.4 million tonnes (2.4 million in 2010/11). Despite the assumed 40% increase in export volumes forecast over the projection period, export value is forecast to decline 12% because of a lower prices. ABARES forecast 2015/16 world sugar prices will average USc14.70/lb, down from USc28.50/lb in 2010/11.

Figure 6: Australian sugar production, exports and prices



Source: ABARES and CBA

Cotton Market Outlook

High global prices and replenished irrigation supplies present a positive 3-year outlook for the Australian cotton industry, following a decade of trying conditions.

World cotton prices in 2010/11, at USc139/lb, are forecast nearly 80% above year ago levels because of tight supplies and strong demand. Nonetheless, prices are expected to ease gradually during 2011 because of increased supply availability, commencing with Australian and Brazilian supplies from March. ABARES forecast that the global market will average USc105/lb in 2011/12, down 25% from 2010/11 levels, but still an exceptionally strong cotton price.

ABARES forecast a global production surplus of 1.0 million tonnes in 2011/12, following the 2010/11 deficit of 0.9 million tonnes and the huge 3.7 million tonne deficit of 2009/10. Inventories are subsequently forecast to increase by 12% to 9.6 million tonnes in 2011/12, but this still remains well below the 13.2 million tonne inventory position of 2008/09. Inventories through to 2015/16 are expected to remain below the levels observed during the 2000's.

Global cotton consumption is forecast to expand modestly over the medium-term, albeit at a



slower rate than observed in the past. Population growth, income growth and the relative price of competing apparel fibres (primarily polyester) is expected to influence future cotton consumption. ABARES predict cotton will continue to lose market share to polyester over the medium term.¹ Improving synthetic-fibre quality, and growing consumer approval, has facilitated this trend.

Australian cotton outlook

The medium-term outlook for the Australian cotton industry is exceptional, according to ABARES.

Australian cotton production is expected to be the largest on record this season, despite the negative influence of the summer floods. At 839 thousand tonnes, this year's crop is 185% larger than the 2009/10 crop and 3% (23 thousand tonnes) larger than the previous record (2001/02). ABARES estimate that the summer floods destroyed around 7% of the cotton crop, and resulted in yield losses in other regions, however these negative impacts have been outweighed in strong yields in other regions and a large year-on-year increase in area planted. The increase in Australia's cotton area this year, up 2.8-fold to 590 thousand hectares, was facilitated by favourable planting moisture and exceptional prices.

Replenished irrigation supplies and expected strong prices over the coming few years is expected to support large cotton planting programs over the next few seasons. Improving yield potentials underline ABARES forecast for a record 1.106 million tonne season in 2011/12, followed by near-record 1.075 million tonnes lint production in 2012/13. By 2015/16, production is expected to fall back to 748 thousand tonnes, based largely on a moderation in area planted. Still, this remains more than 2-times larger than 2008/09 and 2009/10 production.

The value of Australian cotton exports is forecast to reach \$1.5 billion in 2010/11 before peaking at a record \$2.4 billion in 2012/13. By 2015/16, the value of exports is forecast to moderate back to \$1.9 billion, but this significantly more impressive than the 2008/09 result of \$500 million.

Wool Market Outlook

The outlook for Australian wool prices is positive because of tight wool supplies and an extremely buoyant global fibre market.

The Eastern Market Indicator (EMI) is forecast to rise to \$10.50/kg in 2011/12. A further gradual rise in wool prices is expected through to 2015/16, with ABARES forecasting a terminal price of \$11.17/kg. This substantially exceeds the 2008/09 average of \$7.94/kg, and the past decade average of \$8.60/kg. ABARES report that an increase in Australian shorn wool production, combined with a forecast moderation in global cotton prices is expected to exert some pressure on the market over the medium term.² In our view, ABARES' forecast for such sustained high prices appears optimistic.

Australian shorn wool production is forecast to fall to a modern day low of 335 thousand tonnes in 2010/11, before increasing 2% to 342 thousand tonnes in 2011/12, and 367 thousand tonnes in 2015/16. Nonetheless, this remains below the 371 thousand tonne clip produced in 2008/09.

The increase in wool production next year largely reflects a weather-induced improvement in fleece weights. The number of sheep shorn is also expected to increase, albeit gradually, over the forecast period, reflecting improved seasonal conditions and improved returns. By 2015/16 the Australian sheep flock is expected to grow to 73 million head, up from 67 million head currently, reflecting average annual growth of 2%. ABARES do note that the expansion of the flock is likely to be biased toward meat and dual purpose sheep breed, meaning growth in wool production will lag the expansion of the flock.

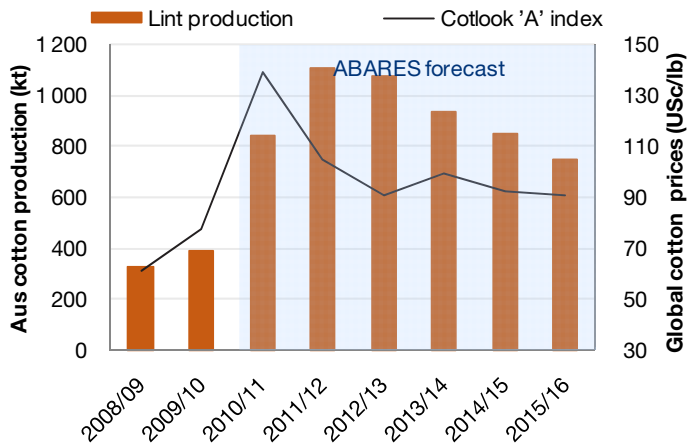
Global wool demand, particularly for fine supplies, is forecast to remain robust, and ABARES noted that wool demand rebounded strongly following the GFC lull. Reflective of robust demand and increasing supplies, Australian wool exports are expected to rise from 414 thousand tonnes (\$2.5 billion) in 2010/11 to 446 thousand tonnes (\$3.0 billion) by 2015/15. ABARES highlight that higher Chinese rates of per capita wool consumption is the key driver of global demand growth.

¹ This will be a continuation of the past 20-year trend which seen polyester's share of the apparel market rise from 10% to 60%.

² Evidently however, such downward pressure does not show up in ABARES nominal price-forecast profile.

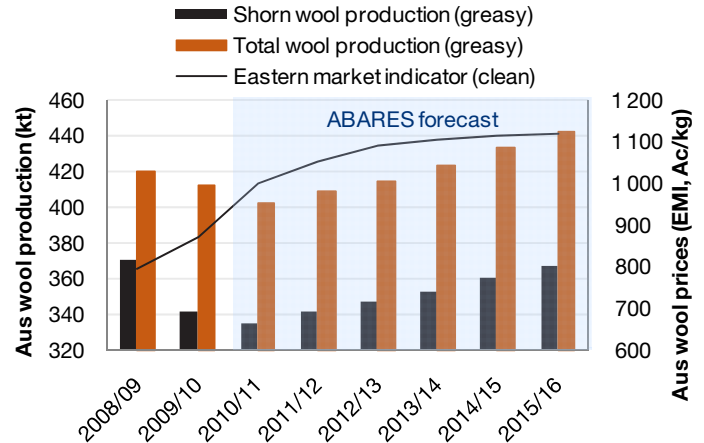


Figure 7: Australian cotton market outlook



Source: ABARES and CBA

Figure 8: Australian wool market outlook



Source: ABARES and CBA

Meat Industry Outlook

ABARES has an optimistic medium-term outlook of the global and domestic meat industry.

Beef and Veal Outlook

Current high Australian saleyard prices, and the expectation that these high prices will persist in the short term, reflect strong competition between the restocker and export markets. Saleyard prices are forecast to average \$3.20/kg in 2010/11, which is 11% higher than year-ago levels. Prices are expected to firm another 5% to \$3.35/kg in 2011/12 before remaining in a \$3.40-50/kg range for the remainder of the forecast profile. If achieved, ABARES forecast represents an improvement on the average saleyard price of the past decade (\$3.30/kg).

Improved profitability and seasonal conditions are expected to drive another 2% herd expansion in 2011/12 to 27.9 million head, following the 2% expansion in 2010/11. By 2013/14, the herd is expected to reach 28.8 million head which exceeds the most recent peak set in 2005/06. The forecast represents an 2 million head (8%) increase on the drought affected 2009/10 herd.

ABARES suggest Australian beef exports will expand in line with the increased production. Exports are forecast to increase from 910 thousand tonnes (\$4.12 billion) in 2010/11 to 1.025 million tonnes (\$5.04 billion) by 2015/16. Developing markets, including Russia and South East Asia, forecast to become increasingly important.

Sheep Meat Outlook

ABARES has an extremely optimistic view on the medium-term outlook for the Australian sheep-meat industry. This optimism is influenced by:

- The existing drought-reduced size of the Australian sheep flock;
- Strong restocker demand for breeding sheep; and
- Strong domestic and export demand for mutton, lamb and live sheep.

After falling to 68 million head in 2009/10, the lowest level since 1887, ABARES expect the national flock to stabilise in the near term before gradually rebuilding 7% to 73 million by 2015/16. Strong processor demand is expected to prevent the herd rebuilding program from evolving at a pace more consistent with other post-drought recoveries. These competing demand points will combine to ensure lamb and mutton prices remain elevated over the forecast profile. Following the 8% rise in the saleyard price of lamb in 2010/11, ABARES is forecasting a further 3% appreciation in prices over 2011/12 to \$5.17/kg. By 2015/16, lamb prices are expected to average \$5.60/kg, up 32% from 2008/09 levels.



Global mutton and lamb demand is expected to grow strongly over the medium term, despite higher prices. Significant growth is expected in emerging economies, including the Middle-East, North Africa and China, influenced by growing incomes and a pre-disposition to lamb and mutton in those regions. New Zealand is expected to remain Australia's primary export competition; however a recent decline in the NZ flock will limit the intensity of that competition.

In our view, ABARES sheep/lamb price forecast too optimistic. We believe the current exuberance in prices may temper as seasonal conditions moderate from current levels.

Pig Meat Outlook

ABARES outlook for the pig-meat industry is less bullish than for the other meats.

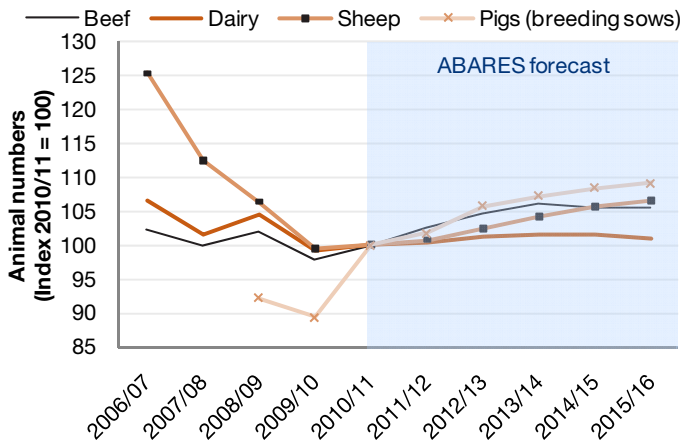
The saleyard price for pigs is forecast to dip 1% in 2011/12, to \$2.90/kg. This follows a 5% fall in 2010/11 and a 6% fall during 2009/10. By 2015/16 pig prices are forecast to rise to \$3.08/kg, but this terminal price is still 7% lower than the 2008/09 price of \$3.30/kg.

Continued import competition over the forecast period is expected to pressure local pig prices. Consequently, further productivity gains will be needed in the industry. Somewhat offsetting further import competition is the forecast that feed grain prices will moderate, easing input-cost pressure. The domestic breeding-sow herd is forecast to increase 22% by 2015/16 from 2009/10 levels, thereby supporting an increase in domestic pigmeat production and exports.

Poultry Outlook

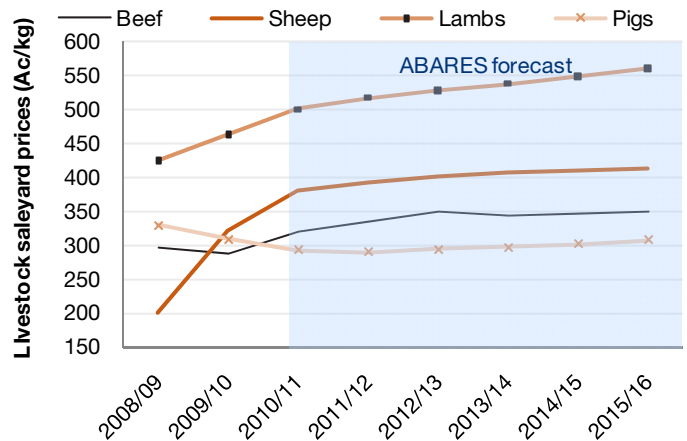
Consumer demand should continue to favour poultry over the forecast profile, largely influenced by continued strong red-meat prices. In addition to the favourable demand outlook, declining feed grain prices are expected to improve the performance of the poultry industry. Over the medium-term, Australia poultry production is expected to rise by 3% per annum.

Figure 9: Australian livestock herd rebuilding underway



Source: ABARES and CBA

Figure 10: Livestock prices forecast extremely high



Source: ABARES and CBA

Dairy Industry Outlook

Global dairy prices are forecast to remain strong through 2011/12, reflecting constrained milk production growth in key exporting nations, and sustained import demand, particularly from China, Russia, Middle East and developing Asia.

World skim milk powder prices are forecast to average US\$3,180/tonne in 2011/12, up 2% from the 2010/11 price, and 40% above the GFC-affected 2008/09 level. Further gains in milk powder prices are expected through to 2013/14, and thereafter prices are expected to moderate in-line with increasing global production, particularly in key exporting countries. However the influence of increased export supplies on prices will be largely offset by continued strong gains in emerging



market demand, reflecting income growth and changing diets. China will lead this demand growth.

Recovery in global dairy production

Global herd liquidation during the 2007/08 grain price spike and GFC has constrained dairy product production in recent years.

However strong dairy product prices are forecast to induce a positive global production response in 2011/12, although the planned growth in output may be tempered by current high grain prices. EU27, US and Oceania dairy production is forecast to increase in the coming season. Further increases in these regions is expected over the 5-year forecast period, while solid production gains in emerging regions, in particular South America and Asia (China and India), will contribute to medium-term production growth. An expansion in the NZ dairy herd, combined with higher yields, is forecast to drive a 2% per annum increase in NZ production over the forecast period. Most of this increased NZ production will be destined for the export market.

Growth in global dairy consumption and imports driven by China

Dairy consumption in China has risen dramatically over the past 15 years. Despite the recently rapid growth, further strong gains in Chinese dairy consumption are likely over the medium term. Higher disposable incomes, increasing health consciousness, a growing middle class and expanding retail outlets are the primary factors supporting growth in Chinese milk consumption. Per person dairy consumption in China remains well below the rates observed in other developed economies. ABARES believes that the continued expansion of Chinese dairy consumption, and increased import needs, will underwrite future dairy prices. We agree with this outlook.

Outside China, large gains in dairy consumption are expected in Russia (particularly cheeses), while Indian consumption is forecast to grow strongly because of population and income growth.

Outlook for the Australian dairy market

Improved irrigation water supplies and strong global dairy prices are assumed to boost Australian milk production by 2% in 2011/12 to 9.3 million litres. Further gains in local milk production are forecast over the next 5-years because of further herd-rebuilding and productivity improvements.

Australian farm-gate milk prices are forecast to average Ac38.8/L in 2011/12, up 4% from the 2009/10 lows. Farm-gate prices are expected to range around this level for the next 5 years.

Impact of supermarket price discounting for home-brand milk

ABARES provide an overview of the possible consequences of the current retail-milk price discounting. Some key facts, which help influence the current debate include:

- One-quarter of Australia's milk production is used domestically as market milk (drinking milk).
- Around half of Australia's drinking milk is sold through the supermarket channel (by volume).
- Home-brand milk and branded milk is not identical, but there is a high degree of substitution.
- The latest discounting by supermarket has widened the price discount of home-brand milk versus branded supplies. Coles Brand 2 Litre milk has been reduced to \$2, while the price of a certain branded milk (2 litre) was priced a \$3.89.
- QLD (94%), NSW (66%) and WA (70%) have a significant bias toward the local market milk industry. Only 9% of VIC milk and 8% of TAS milk is used as domestic market milk. The remainder is used in the manufacturing milk market.
- Around 60% of manufactured milk production is exported.
- VIC produces around two-thirds of Australia's farm-gate milk supply.

ABARES believe that lower home-brand milk prices will cause a decline in the market share of branded milk. However total drinking milk sales are forecast to increase because of lower prices.

The likely response by dairy processors – who supply retailers with both home-brand and branded product – will depend on the relative processor-margins across the various products. Under a



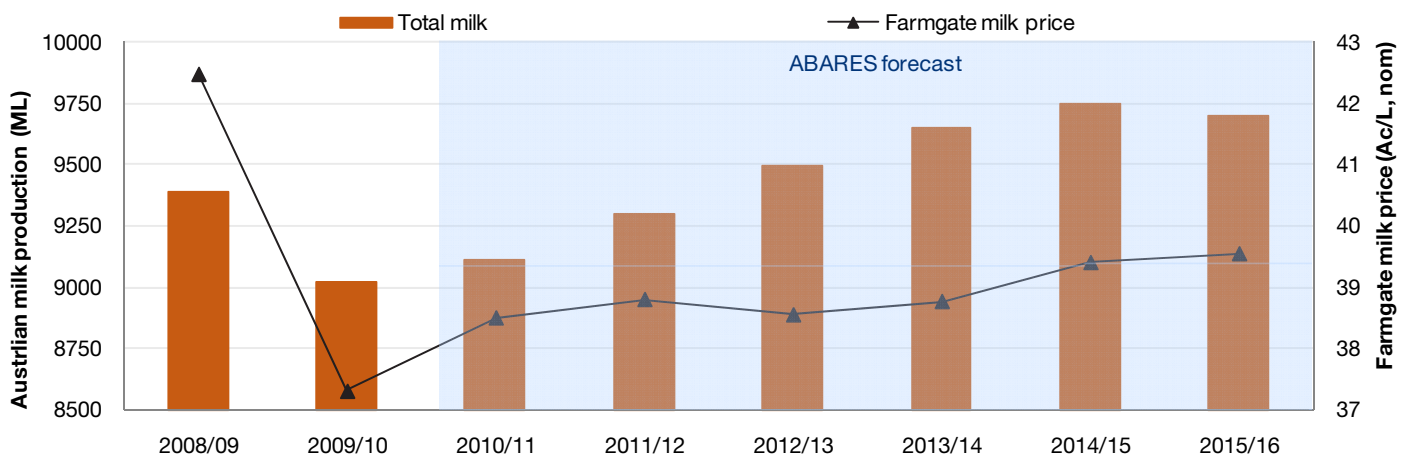
scenario where processor’s profit margins for branded supplies are higher than the home-brand product, the reduction in branded milk sales will reduce overall profit levels for processors. Under this scenario, processors could seek to protect profit margins by reducing the farm-gate milk price.

Should processors seek to offer lower farm-gate milk prices, the extent of the price declines would vary between regions:

- Regions that supply a greater proportion of their product to the manufacturing milk segment will observe a comparatively small decline in farm gate prices. The buoyant export market for manufactured milk products will place a floor under farm gate milk prices in those regions.
- However, for regions heavily exposed to the domestic drinking milk market, the potential downward pressure on farm-gate price could be significant. Thus the geographies most susceptible to farm-gate price pressure include QLD, northern NSW and WA.

However, ABARES noted that the current total cost of milk production in northern NSW and Qld is already near, if not at, the current milk price. This means that a decline in farm-gate milk prices would ultimately result in a rationalisation of dairy farms in those regions. Unless, of course, farm productivity improved. Therefore, outside VIC and TAS, dairy processors will be forced to absorb a greater proportion of the margin compression.

Figure 11: Australian milk production and farm-gate milk prices



Source: ABARES and CBA



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