



Dairy Situation and Outlook

February 2017

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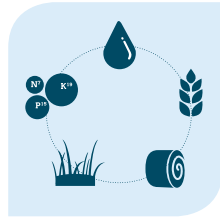
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Six key drivers of the Australian Dairy Industry

Inputs



Situation: ▲
Outlook: ■

Seasonal conditions have improved, with high rainfall and good pasture growth conditions. Cheap and abundant grain and fodder, as well as low fertiliser prices and cheaper water have also trimmed input costs. However, the rest of summer and early autumn are expected to be hotter and drier than average.

Global supply



Situation: ▲
Outlook: ■

The global milk supply picture remains cautiously optimistic for sellers, with only the US currently showing growth amongst the major exporters. Risks of resurgent growth exist in New Zealand and the EU as prices recover, but for now, milk flows are likely to remain constrained.

Global economy



Situation: ■
Outlook: ■

The IMF has again downgraded expectations for global economic growth, with ongoing uncertainty surrounding post-'Brexit' trade relationships and a weaker-than-expected US economy cited.

Australian market



Situation: ▲
Outlook: ■

Supermarket sales of Australian dairy products are showing volume growth in every major category. Growth in sales value is notably strong in the dairy spreads and drinking milk categories.

Global demand



Situation: ▲
Outlook: ▲

Global demand has picked up, lifted by strong growth in China and southeast Asia, though exports to Japan have eased and Middle Eastern demand is sluggish. Overall value remains down, however the marked improvement in prices in the last few months looks set to persist.

Exchange rates



Situation: ■
Outlook: ■

Currencies of most major dairy commodity exporters have remained fairly weak, supporting relative competitiveness. The AUD averaged 0.74 AUD/USD during October quarter, down from the previous average of 0.75 AUD/USD.

▲ Positive ■ Neutral ▼ Negative

Executive summary

- › **Better balance in global dairy markets and lower input prices are positive signs for the Australian industry**
- › **Despite market improvements and better seasonal conditions, many farmers are still dealing with tight margins and strained balance sheets**
- › **Robust sales growth is evident in the domestic market, along with significant consumer shifts within categories**

The Australian dairy industry has seen the beginnings of a recovery in recent months, as some of the drivers of farm profitability return to more favourable settings. Costs of major inputs continue to fall, with big grain and hay harvests bolstering supplies – although quality is likely to be an issue with conserved fodder. The global dairy supply and demand balance is better than it has been for some time, and prices for most products are back above five year average levels.

Milk price step-ups have also helped improve the cash flow situation for many southern farmers, but production margins remain tight or negative, and many face a significant task rebuilding their equity position after the past 12 months. Trust and relationships along the supply chain are also in need of further repair, and a number of external enquiries and industry-led initiatives launched in the wake of the late 2015-16 season step-downs, are ongoing. Domestic, fresh milk-focused regions are facing emerging challenges, with milk price reductions flagged for a number of producers as protracted negotiations continue.

Nonetheless, as the season has progressed, the year on year drop in Australia's milk production has narrowed, from over 10% for the first four months, to 8.5% for the season to December. Dairy Australia's expectation

is that this gap will narrow further but remain significant, with full season production totalling between 6 and 8% lower than the 9.5 billion litres produced in 2015-16.

Lower total milk intakes pose a challenge for many processors; one that is not distributed evenly, given the success of some in growing their share of the milk pool and filling the volume gap through supplier recruitment. Most processors have also experienced some form of post-farmgate setback in the past year, with the broader market downturn, and intricacies of the Chinese market the most cited factors. Downstream players have also had their share of setbacks, with Bellamys, Viplus, Camperdown Dairy International and Camperdown Dairy Company amongst those cutting sales forecasts, encountering trade restrictions, or abandoning ventures.

Despite this, the significant amount of new manufacturing capacity coming online over the next few months will likely maintain competition for milk at the farm gate.

In the wider international market, the balance between supply and demand pressures is keeping commodity prices stable in the short term, after a steady recovery during the second half of 2016. Sentiment drove the recovery, and the fundamentals have since caught up.

The question is: what next? A period of consolidation around current commodity pricing seems likely.

In short, the global milk supply picture remains cautiously positive for sellers, with only the US currently showing growth amongst the major exporters. New Zealand and the EU warrant close watching, but for now, milk flows in both regions are likely to remain constrained. In New Zealand, wet conditions early in the season caused extensive pasture damage and pugging in some areas and delayed maize planting. The weather has since improved, however damage to pasture stands from the earlier wet conditions is reportedly limiting actual growth. A 3% fall in milk volumes is forecast for the season to May.

Europe remains a myriad of conflicting signals, with some processors passing on higher commodity prices while the European Commission is funding a program to pay farmers to cut milk production. In addition, the Netherlands is grappling with the need to reduce phosphate output to meet EU limits, and may see as much as 10% of its dairy herd culled (or relocated across borders) to achieve this. Thus far, the sum total has been a slowdown in milk production growth from around 7% for the first quarter of 2016, to an expected 0.6% for the full year, and the Commission is currently forecasting a very modest 0.2% growth for 2017.

Ongoing economic and geopolitical uncertainty remains a significant risk, as does resurgent supply growth in Europe and New Zealand.

Ongoing economic and geopolitical uncertainty remains a significant risk, as does resurgent supply growth in Europe and New Zealand. With the southern hemisphere production season winding down, and the northern hemisphere heading for spring, EU and US price indicators are taking centre stage, with some falls noted in recent weeks. Whether this translates to a problematic trend will largely depend on how the production season continues to shape up in those regions. For now, tight Oceania supplies and reasonable levels of demand are providing some market support.

Global dairy demand presents a mixed, but overall positive picture. The volume of dairy products traded over the past twelve months to the end of October 2016 rose by just over 7%, with a recovery in demand from Greater China accounting for around a third of that growth. The value of global exports was down by 14% though, with falls across all major markets except Greater China, reflecting the lower global prices for key dairy commodities for much of the year.

In addition to robust export demand, dairy sales in the Australian supermarket channel outgrew the rate of population increase (1.4%) for each of the major categories except yoghurt, according to the most recent data. Total liquid milk sales volumes grew by 2.4% to 1,372 million litres over the 12 months to January, while the category's sales value grew 5%, reflecting the recent shift in favour of branded products. Full cream milk also remains a favourite, up 9% in volume terms, while modified (low fat) milks saw volumes drop 6%. Despite some drift back to private label product, branded milk has maintained much of the market share gained in mid 2016; comprising 43% of supermarket fresh white milk sales by volume. Cheese has grown steadily (up 3% by volume), though price pressure has meant values have not kept pace (increasing by 1.3%). Private label cheese is making inroads, up from 36% of market volume in the 12 months to October 2014, to 43% by October 2016. Within the yoghurt category, the trend of consumers adopting traditional

unsweetened varieties of yoghurt in preference to sweetened of yoghurt continues, with traditional dairy yoghurt sales growing 12%, whilst sweetened yoghurt sales volumes fell by 5% over the 12 months to October 2016.

Calendar year 2017 has started on a more positive note for the industry, but the overhanging issues from the events of 2016 will not be erased overnight. For farmers in domestic-focused regions, the prospect of lower farmgate prices signals renewed financial pressure in the months ahead. Elsewhere, margins are still tight but seasonal and market developments are encouraging. These headline improvements highlight the challenges surrounding other key factors such as confidence and trust.* Improved farmgate profitability will help, and the current market settings look conducive to delivering this, albeit not without risk given the threats posed by resurgent supply growth internationally and broader political and economic disruption.

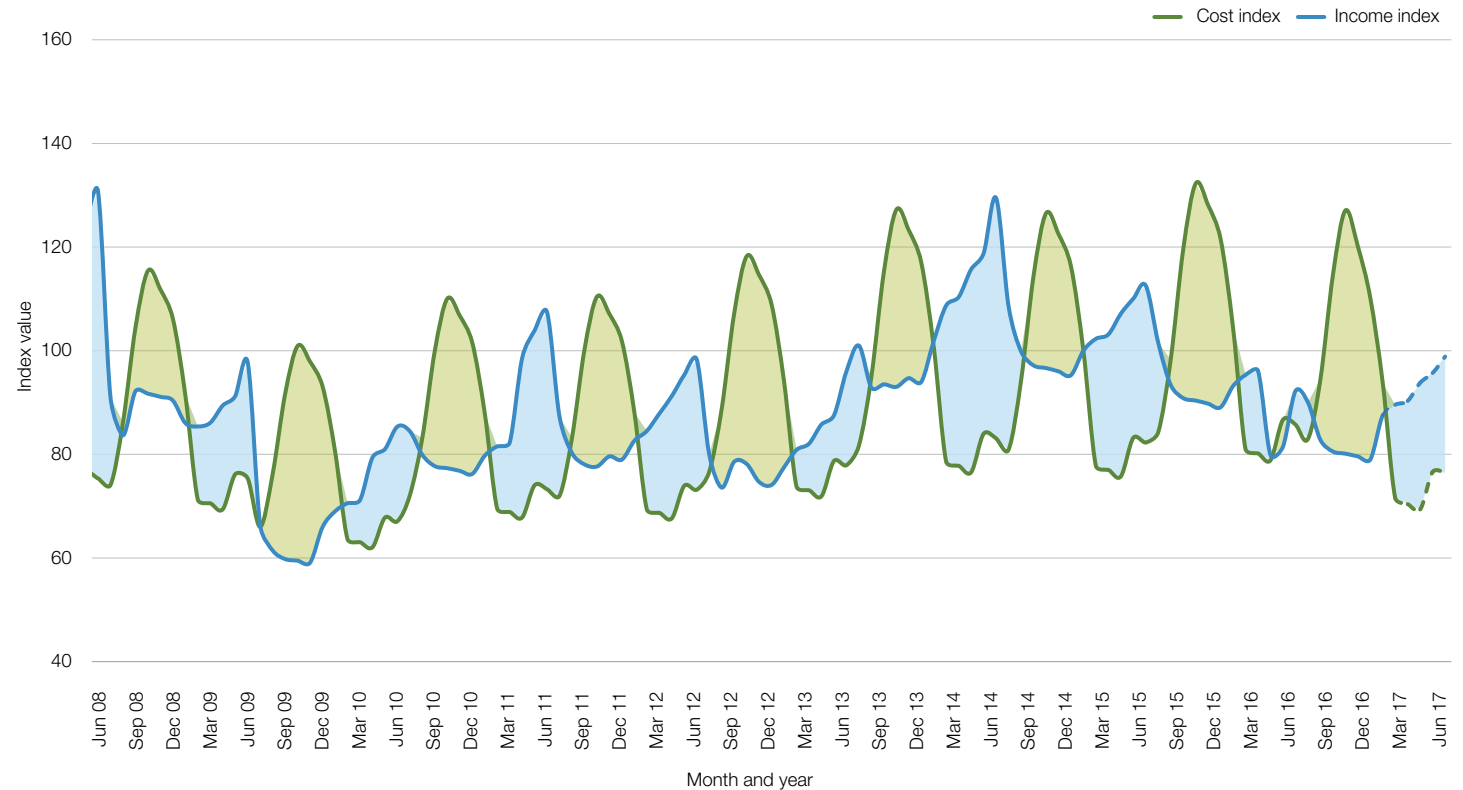
* Dairy Australia's annual National Dairy Farmer Survey is currently being undertaken, and will inform a comprehensive analysis of farmer confidence in the June Situation and Outlook report.

Export region weighted cost and income indices

The weighted cost and income indices consider the near-term outlook and highlight the net impact of market changes. The latest update suggests:

- › The margin squeeze from late 2015–16 through early 2016–17 was the most severe of recent years.
- › Earlier than expected milk price step-ups and rapid falls in feed costs have begun to ease the pressure for many southern farmers, but recent months have left significant catching up to do.
- › The base case outlook assumes a continuation of current input cost trends through the remainder of the season, and modest ‘tweaks’ to milk prices as the gap between processor offerings narrows.

Figure 1 Export region weighted cost and income indices



Source: Dairy Industry Farm Monitor Project, Dairy Australia analysis

Inputs

Fertiliser

Urea (granular Middle East)

242 US\$/t

▲ +5% LY ▼ -29% 5Y

DAP (US Gulf)

320 US\$/t

▼ -21% LY ▼ -34% 5Y

MOP (granular Vancouver)

215 US\$/t

▼ -27% LY ▼ -39% 5Y

Price is December 2016 average, compared to the 2015 December average (LY) and 5 year average (5Y).

Source: Bloomberg

Water and weather

Northern Victoria

160 \$/ML

▼ -12% LY ▲ +47% 5Y

1,603,119 ML

▼ -20% LY ▼ -0% 5Y

Murray Irrigation System

118 \$/ML

▼ -35% LY ▲ +29% 5Y

121,242 ML

▼ -3% LY ▼ -28% 5Y

Price of water traded is 12 month average and volume of water is 12 month total, both to January 2017, and compare to year prior (LY) and last 5 years (5Y).

Source: Victorian Water Register, Murray Irrigation Ltd

Cows

Cull cows

464 c/kg

▲ +13% LY ▲ +29% 5Y

106,279 head

▲ +16% LY ▲ +42% 5Y

Dairy cattle exports

67,192 head

▼ -9% LY ▼ -15% 5Y

Price is January 2017 average, compared to December last year (LY) and 5 year averages (5Y). Number of head is last 12 months (cull cows to December, dairy cattle exports to December 2016) compared to year earlier (LY) and 5 year averages (5Y).

Source: NLRS, ABS



Weather

Rainfall for spring 2016 has been 26% above average for Australia, with much of the rainfall concentrated in southeastern Australia, while northeastern and southwest Australia recorded below average rainfall. The bulk of this spring rainfall fell in September and October, with November drier than average for all states, except Tasmania. In Tasmania, heavy rainfall led to severe localised flooding in the northeast around the Esk and Macquarie rivers in mid-November. Victoria and Tasmania both recorded their tenth wettest spring on record, while spring rainfall in the Murray-Darling Basin was 64% above average. High rainfall has in some cases delayed harvests, and whilst providing almost ideal growing conditions and high yields, has also reduced the feed quality of fodder crops.

Temperatures during spring 2016 were broadly in line with Australia's long-term average, with slightly cooler than average days and warmer than average overnight temperatures prevailing around the country. December has seen slightly higher than average temperatures across Australia, particularly in NSW, which experienced its second hottest December on record. December 2016 was also the 5th wettest on record, with South and Western Australia enjoying their highest and third highest December rainfalls on record. The outlook to March 2017

points to below average rainfall and above average temperatures for much of the east coast of Australia, between Wilson's Promontory in Victoria and Townsville, Queensland. Lower than average temperatures are expected for much of Tasmania and parts of southwest Victoria.

Water

Widespread winter and spring rains have contributed to increased dam storage levels throughout southern Australia; with the Dartmouth, Hume and Eildon dams sitting at 78%, 85% and 76% of capacity in early February, 2017. This compares to 46%, 38% and 43% at the same time in 2016.

The high rainfall has led to steady declines in the price of temporary water across northern Victoria, with average prices across northern Victoria falling from \$107/ML in November, to \$101/ML in December and then dropping significantly in January to \$70/ML. In January 2016, temporary water prices averaged \$255/ML in northern Victoria.

Farmers have taken advantage of these lower prices, with 157,000 megalitres of water traded in January 2017, compared to 67,700 in January 2016. The biggest increase has been in the Zone 6 (Hume to Barmah) trading zone, where volumes of water traded in January 2017 were up almost 1200% on January 2016.

Southern NSW has also seen considerable improvements in water trading, with temporary water prices falling from \$83/ML in November 2016, to \$74/ML in December, and then trading at \$60/ML in January 2017. This compares to \$244/ML in January 2016. Similarly, trading volumes increased from 9,000 megalitres in January 2016 to 19,500 megalitres in January 2017. Over the 12 months to January prices averaged \$118/ML, compared to \$180/ML over the period to January 2016.

Fertiliser

International fertiliser prices remain well below long run average prices, with muriate of potash (MOP), diammonium phosphate (DAP) and urea down 39%, 32% and 29% below their respective five year averages. Potash and phosphate prices have both declined consistently throughout 2016, and are now down 26% and 14% on the same period in January 2016.

Global demand for potash is subdued, with low global crop prices reducing incentives to spend more on additional fertiliser inputs, at the same time that major importing countries such as China and India still have significant stockpiles to draw down. The looming merger of two of the largest fertiliser producers, Agrium Inc. and Potash Corp., is in part a response to lower global prices and a desire to consolidate in a market currently suffering from excess capacity.

Widespread winter and spring rains have contributed to higher dam levels throughout southern Australia, and steady declines in the price of temporary water.

A smaller US beef herd, strong demand for Australian beef and tighter dairy margins have seen a 16% increase in the number of cows culled.

The USDA is predicting the largest global grain crop on record, which will see global stocks increase by around 3.8% to 626 million tonnes.

DAP prices have also been pressured by a global supply-demand mismatch, with notably low demand from major importer India, as well as key South American purchasers such as Argentina. Some indicators suggest that DAP prices may be firming in early 2017, with reduced Chinese export volumes and lower plant throughput. However, availability remains high and producers have significant spare capacity that can be brought online rapidly.

Urea, whilst below 5 year average prices, has actually gained ground on last year, up 28% on the same time in 2016. Permanent reductions in Chinese capacity, with the closure of a number of coal-based plants, as well as increases in natural gas prices (the main input cost) have seen prices rise since around July 2016. With new productive capacity set to come online in the US in the second half of 2016/17, the recent upward trajectory in prices may yet change.

Cows

The combination of a smaller US beef herd, strong foreign demand for Australian beef and the need to support farm incomes through culling has seen 106,279 head of dairy cull cows sold to slaughter in the 12 months to January 2017, up 16% on the number sold in the prior 12 month period. Prices over the same period were 13% higher, with the weighted average carcass price sitting at 451 cents/kg. Despite easing somewhat from their highs in August

2016, cull cow prices remain elevated, with January carcass prices averaging 464 cents/kg, 25% higher than January 2015. At the same time, the number of dairy cull cows in saleyards has fallen the last four consecutive months to January 2017, with the sales volumes down 16% in January compared to January 2016. This may reflect the cushioning effect of cheaper input costs for dairy farmers in the southern, export-oriented regions of eastern Australia, as well as expectations of better farmgate milk prices, given falls in production and higher global commodities prices.

While Meat and Livestock Australia has flagged the possibility of Australian cattle prices easing by between 20%-40% in its Industry Projections 2017 Report, MLA considers this to be more probable to occur from 2018 onwards. Taking a cue from US cattle markets MLA is also optimistic that even after substantive easing, Australian cattle prices will remain significantly above the long-term average. In the short term, cattle prices are likely to be supported by restockers rebuilding beef herds in the southern regions, with producers looking to retain cows.

Live dairy cow exports for the 2016 calendar year totalled a little over 67,000 head, down 9% on the 2015 volumes, and 15% below the 5 year average. The fall in live dairy cow exports is due to lower demand from China, the main destination for Australian dairy cows, reflecting challenging business conditions for the Chinese dairy industry.

Lower global milk prices and higher feed costs have resulted in over half of China's dairies operating at a loss in 2016, with many large scale corporate dairies in China extensively culling herds. Going into 2017 there is some uncertainty over Australian live dairy cow exports to China, with new pedigree requirements coming into effect, but no clear pathway to satisfy them.

Grain

Following favourable growing conditions in most major grain producing regions, the USDA's January World Agriculture Supply and Demand Estimate report has revised its world production estimate for all grains (wheat, coarse grains) downwards by around 2 million tonnes since December, to 2,059 million tonnes. This will be the largest global crop on record, and will also see global stocks of grain grow by around 3.8% to 626 million tonnes.

Global wheat production is projected to be around 753 million tonnes, with large harvests in Canada, Argentina, and the European Union, and record Australian and Russian wheat harvests. Within the US, markets had effectively priced in bumper global wheat harvests, with Chicago Mercantile Exchange (CME) wheat futures declining by around 26% since June 2016. While concerns about winterkill affecting US yields have provided some price support, so far these concerns are yet to be borne out. However, given that the USDA has recorded the lowest US wheat acreage

on record, any reduction in yields could have a considerable effect on total US production and thus global prices.

In terms of coarse grains, large harvests are expected, particularly of maize, with the International Grains Council (IGC) forecasting a global harvest of 1,045 million tonnes of corn, and global production for barley of around 147 million tonnes. IGC puts total world coarse grains (also including sorghum, millet oats and rye) production at 1,320 million tonnes. While the amount of grain allocated to feed is expected to increase, much of this year's extraordinary harvest will enter stocks, which are projected to reach 272 million tonnes.

In Australia, ABARES' December crop report forecasts the 2016-17 winter wheat crop at 32.6 million tonnes, up 35% on 2015-16, and also a new Australian record. This has pushed local wheat prices lower in all states, with ASX Jan 17 wheat futures following a similar pattern to CME futures, falling by 22.5% since June 2016. Australian feed barley prices have also dropped considerably.

In Australia, ABARES forecasts barley production to increase 24%, to a record 10.6 million tonnes, and canola production to rise by 22% to 3.6 million tonnes. As with wheat, this large crop has seen local prices for barley and canola meal come down, particularly in the eastern states.

Hay

The local hay market has been slow moving as of January 2017, as the abundance of pasture and big stocks of on-farm fodder and silage mean farmers are in no hurry to buy in at the moment. The large fodder harvests in most regions have also contributed to the lack of urgency from farmers to buy. Market participants are not expecting much improvement in traded volumes until March or April.

A generally wet spring in eastern Australia has provided excellent growing conditions and yields for fodder, however, rainfall throughout the harvest has meant much of it is weather-damaged and of generally lower quality than in previous years. Hay baled earlier in the new season was also rain damaged in Western Australia as well.

In many parts of the south, demand for fodder remains relatively low. Milk price cuts have had a detrimental impact on dairy farmers' ability to purchase in large volumes, and the addition of good rain and pasture availability has slowed the fodder market.

This rainfall has had mixed results for crops with some producers reporting difficulty when spraying. As mentioned above, tight cash flow could see more farmers try and focus on home grown fodder this season with variable quality, depending on good curing conditions.

As is the case for a number of regions around the country, the north has experienced a real slowdown in hay trading. Good pasture availability from consistent rainfall and a promising season ahead have created less urgency for purchasing fodder. The main buyers in the market continue to be feed-lotters and farmers weaning cattle. Beef producers are having limited impact as good beef prices have seen a number of farmers destock. However, ongoing dry conditions and high temperatures in Queensland are likely to see demand pick up in the coming weeks.

In Western Australia, there are large volumes of export quality feed which cannot be utilised by exporters, causing a glut on the domestic market. This has resulted in a number of growers having difficulty selling hay. Farmers continue to prioritise home-grown feed with good pasture still available in most areas, keeping demand low as well. Reports indicate that quality of fodder is much higher than the majority of the eastern states. However, hay baled earliest in the season was almost all rain damaged so care should be exercised when purchasing.



For ongoing information and updates on farm inputs, subscribe to Dairy Australia's monthly **Production Inputs Monitor**, or the weekly **Hay and Grain Report**, found on the Dairy Australia website at: dairyaustralia.com.au/Markets-and-statistics/Farm-inputs-and-costs.aspx

Grain and hay prices

Australian dairy regions – Grain and hay



The relevant stockfeed wheat available in a region: ASW, AGP, SFW1 or FED1.



Shedded cereal hay: mid-range product without weather damage, of good quality and colour.

Prices are estimates in \$/tonne at December 2016. GST exclusive but including delivery and (for grain) an allowance for storage and marketing costs.

Percentage price change compares to the equivalent date December 2015.

Source: AFIA, Lachstock Consulting



The Australian market

Milk

Total milk sales volumes grew by 2.4% to 1,372 million litres over the 12 months to January, while the category's sales value grew 5% to over \$2,160 million. Fresh white milk is experiencing unusually strong growth, up 3% in volume, and 6% in terms of value. Of this, the full cream fresh white milk segment is growing particularly strongly, up by 9% in terms of volume and over 13% in terms of value. This strong growth in full cream milk shows consumers are still moving away from low-fat varieties of fresh milk, sales of which fell 6% by volume and 3% by value. This marks the fourth consecutive year-on-year decline in sales volumes of modified fat milk. In the 12 months to January 2013, 476 million litres of fresh modified fat milk were sold, compared to 397 million litres for the latest period. Over the same time frame, full cream white fresh milk grew from 543 million litres to 667 million litres. Full cream milk now constitutes 63% of the fresh white milk category, compared to 53% to the same time in 2013.

Branded fresh white milk has regained market share from supermarkets' private label fresh white milk category, with branded milk sales volumes increasing by 21% year-on-year to 439 million litres, while private label fell by 7% to 625 million litres. This compares to 362 million litres of branded milk and

672 million litres of private label milk sold in the previous 12 month period. Prior to the step downs in April 2016, the share of company branded fresh white milk was 34%, however, in response to prominent social media campaigns, this increased to 48% in June; since easing to 43% by December.

Sales of flavoured milk also continue to grow strongly, providing a valuable product stream for major processors. Sales volumes of flavoured milk grew 8.9% to around 131 million litres, retailing at an average of \$3.57/litre in supermarkets. Iced coffee is the most popular flavour, accounting for slightly under half of all flavoured milk sold in supermarkets.

Sales volumes of UHT product fell just over 4% to approximately 184 million litres for the 12 months to January 2017, although sales value of the category declined by slightly less, down around 3%. Most of this decline occurred in sales of company branded white milk, which fell nearly 8% to 109 million litres.

Sales of company branded lactose free milk grew over 9%, to 20.3 million litres, worth \$43 million. Within the company branded white UHT milk, lactose free milk accounts for around 18% of sales volumes but 28% of sales value, highlighting the importance of these higher-value specialist milk brands such as Liddell's and Zymil for processors'

Figure 2 Supermarket sales



Source: IRI

Note: Available data is taken from differing periods; milk and dairy spreads figures from MAT 08/01/2017; cheese, yoghurt and dairy snacks from MAT 04/10/2016.

revenue within the UHT category.

Cheese

Cheese sales volumes have grown steadily over the last 12 months to October 2016, increasing by 3%, while values are up 1.3%. Within the cheese category, sales of deli cheese have increased around 5% in terms of volume, to 22,450 tonnes. The value of deli cheese grew 3.5% to \$563 million, with average per kilogram price for deli cheese declining by 1.5%, to \$25.06/kg. Despite accounting for under 16% of all supermarket cheese volumes, deli cheese now represents over 25% of the cheese category's sales value.

Within the chilled cheese segment, sales volumes grew nearly 3% reaching 120,400 tonnes, whilst value increased by 0.5% to \$1.6 billion. Average per kilogram price for chilled cheese declined by 2%, falling from \$13.55/kg

to \$13.27/kg.

Sales of ingredient and cooking cheese types grew strongly, up 6%, however the value of this segment fell more than 4%, dragged down by a decline in average prices (-9.5%). The growth in sales of ingredient and cooking cheese is also reflected in the changing pack sizes consumers are buying. Sales of cheese in the 400g to 650g packsize range, which is the most popular at 46% of the market, have fallen by 1.6%. Meanwhile, larger bulk packs in the 650g to 1kg and 1 to 1.5kg weight ranges (mostly shredded mozzarella and cheddar) have grown strongly, by 18% and 6% respectively. Retailing at an average price of \$9.94/kg and \$7.91/kg respectively, these pack sizes represent the best value-for-money proposition for consumers, and suggest that consumers purchases have changed accordingly. Within

the chilled supermarket category, another noticeable feature has been the significant growth in the market share of private label cheese, which has expanded from 36% of the market volume in the 12 months to October 2014, to 43% by October 2016.

Yoghurt and dairy snacks

The yoghurt and dairy snacks category has seen a slight growth in volumes over the 12 months to October 2016, with growth in overall volumes of 1% from 206,000 tonnes to 208,000 tonnes. The value of the category eased slightly, dropping 1.3% to \$1.4 billion. Within the category, growth in yoghurt volumes of around 2% offset a 3% decline in dairy snacks (including custards, probiotics and dairy desserts). The 2% volume growth in the yoghurt sales, from 159,000 to 163,000 tonnes marks a return to growth for the yoghurt category, whilst sales value has remained relatively flat at around \$1.08 billion for the year to October 2016.

Within the dairy yoghurt category, consumers continue to adopt traditional unsweetened varieties of yoghurt in preference to sweetened of yoghurt, with traditional dairy yoghurt sales growing 12.4%, whilst sweetened yoghurt sales volumes fell by 5% over the 12 months to October 2016. In value terms traditional yoghurt sales increased 7.5%, or less than volume growth. This was due to a 4.4% fall in the average price of the traditional segment, from \$7.55/kg to \$7.22/kg.

Average prices for sweetened yoghurt also declined, but by less, from \$5.51/kg to \$5.44/kg. The ongoing transition to traditional yoghurt is also supported by data showing the continued growth in sales of bulk packs, at the expense of multipacks more commonly favoured for sweetened yoghurts.

Total dairy spreads

Total dairy spreads grew over 3% in volume, to 48,356 tonnes, and nearly 5% in value to \$453.8 million, in the 12 months to January 2017. Butter sales increased 3.8% by volume to 26,036 tonnes, and total sales value increased by 4.7% to \$220.2 million, with average price for butter growing around 1% to \$8.46/kg. The share of company branded butter sold has increased compared to private label butter, from 42% five years ago, to slightly over 50% in the latest 12 months. This is despite the fact that company branded butter retails for around twice the price of private label butter, with average prices of \$11.25/kg compared to \$5.62/kg. Sales volumes of low salt butter fell 20% over the last 12 months, while salted and unsalted butter sales volumes grew by 7% and 9% respectively. The strong growth in sales of 500g butter blocks (+7%), which are favoured for use in cooking, points to the ongoing change in consumer attitudes towards saturated fats.

Figure 3 Supermarket chilled cheese

Supermarket chilled cheese market					
Select Packsizes	Share of Market	Price	Price Growth	Kt	Volume Growth
100–199g	5.10%	\$29.70	-2.80%	6.9	14.60%
200–299g	21.90%	\$18.01	-0.60%	25.5	1.10%
400–649g	45.70%	\$11.71	-2.00%	52.7	1.60%
650–999g	9.70%	\$9.94	-4.10%	13.4	17.70%
1–1.49kg	17.00%	\$7.91	-5.30%	21.1	6.00%

Source: IRI

Chinese infant formula market

In the 12 months to October 2016, China has become Australia's most valuable export market for dairy products, with the value of exports jumping from \$US380 million to \$US660 million. The largest part of this growth is due to a single category - infant formula. Over the same period, Australian exports of infant formula to Greater China grew from almost 6,000 tonnes valued at \$US74 million to 19,000 tonnes worth more than \$US275 million, the overwhelming majority (more than 95%) of which was retail-ready, packaged formula. Australian exports of infant formula to other markets have been more-or-less stable over the same period. Hence, in size, rapidity and concentration, the growth of the infant formula category is singular.

Notably, these export statistics do not capture the large so-called 'grey-market', where private buyers often known as Daigou have created an informal sales channel into China, by buying formula in Australian retail outlets and then shipping or posting it to China. Given the nature of the market there are no reliable numbers around the extent of this market, however, data from Australian supermarkets suggest that sales

volumes cannot be explained by growth in domestic consumption, over a period in which Australian birth-rates were more-or-less stable. Indeed, looking at ABS figures for the Australian infant population (0-3 years old), we can see that between June 2010 and June 2016 the population grew from 1.17 million to 1.25 million, roughly 1.1% a year. Over the same period supermarket infant formula sales volumes grew from 7,180 tonnes to 18,250 tonnes, for an average growth rate of almost 17% per year.

Australian imports of infant formula and WMP have grown rapidly, even as Australian exports of both categories have grown. Most Australian imports of infant formula were from New Zealand, in the form of packaged, retail-ready tins for sale to Australian consumers and unofficial re-exporters. In fact, for most of the last six years, Australia has been a net importer of infant formula in volume terms. Interestingly, Australia has also been a net exporter in value terms over the same period, suggesting Australian companies have sought to establish themselves in the higher value Chinese export market, even as imports have grown to service domestic demand.

It is uncertain whether this trend of growing Australian imports to service demand from the re-export trade will continue.

Firstly, regulatory changes in the Chinese market, discussed in more detail below, have made the grey market trade in infant formula significantly more difficult, while the Chinese government has made a real effort to control unauthorised trading. Additionally, whilst Australian based companies may have seen Daigou as a valuable unofficial marketing channel for their products, this path presents risks for foreign infant formula brands in having no oversight or tracking of product distribution into a market where consumers are highly sensitive to issues of food safety, and where counterfeiting and adulteration can occur.

Further, it seems reasonable that Australian companies will seek to directly enter this market themselves, obviating the need for Daigou intermediaries. An example of this might be Woolworth's listing products directly on the Chinese e-commerce platform T-Mall to sell directly to Chinese customers. Several companies have invested in new or upgraded facilities to increase the

supply of base powders and infant formula for export. Australian exports of infant formula to China have increased substantially since 2015, and even more Australian companies are set to apply for licencing to export into China.

The continued viability of the Daigou-led infant formula re-export trade appears in doubt, squeezed between increased supply of direct exports from better-resourced companies, and more difficult regulatory conditions in China. This has obvious implications for Australian retail sales and imports of infant formula, excepting niche formula companies which will likely continue to rely on imported product and ingredients. The graph below shows a precipitous fall in infant formula sales in the last two quarters of 2016, and may indicate the beginning of a decline in the re-export business.

In response to a number of food safety incidents, the Chinese government and relevant agencies have made a concerted effort to improve food safety standards, as well as the traceability, accountability and trust in the entire food supply chain. The government seeking to establish a market for high quality, safe infant formula products with supply chain integrity.

In practice, this means reducing the number of brands and manufacturers of infant formula present in the Chinese market, leaving it concentrated amongst a smaller number of established, reputable and audited companies. Before May 2014, there were over 3,000 infant formula brands in China, with little to no oversight, and no clear understanding of supply chains. This was highlighted clearly with the Fonterra botulism scare in 2013. While ultimately found to be a false alarm, the process of tracing suspect shipments of WMP and then recalling potentially affected products including infant formula revealed just how complex and fragmented supply chains within China were.

One of the major regulatory initiatives towards this objective was the requirement to have manufacturing, blending and canning facilities of infant formula sold into the Chinese market registered and inspected by the China National Certification Accreditation Administration (CNCA). This came into effect May 1st 2014. Infant formula brands exported to China were legally required to originate from one of these approved facilities, and stamp their accreditation number on all tins exported to China. All tins are required to have identical Chinese and English labelling, which must be printed on the tin.

At present, there are eight establishments in Australia that have registered and been inspected by the CNCA. These are:

- › Camperdown Powder in Braeside, Victoria
- › Blend & Pack in Hallam, Victoria
- › Viplus Dairy in Toora, Victoria
- › Farmland Dairy in Auburn, NSW
- › Australian Dairy Park in Carrum Downs, Victoria
- › Sphere Healthcare (Asia) Pty Ltd, Moorebank, NSW
- › Bega/Tatura Milk in Derrimut, Victoria
- › Murray Goulburn Co-operative in Cobram, Victoria

Without certification from the CNCA, exports of Infant Formula into China are deemed non-compliant, and in violation of food safety standards laws. Given the value of the Chinese infant formula market, CNCA registration is obviously a highly valuable asset for manufacturers and blenders. There have been a handful of Australian companies who have applied for registration, which are awaiting an inspection from the CNCA. At present, only NZ has secured an agreement from the CNCA to delegate the inspections to a local authority, in this case the Ministry of Primary Industries.

A more recent major regulatory changes enacted to affect the informal trade were the new ecommerce laws

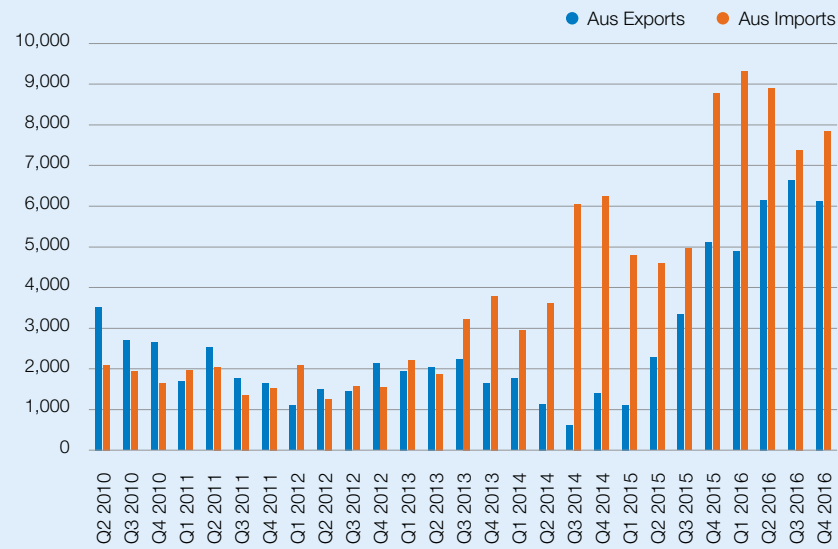
introduced in April 2016. Aside from imposing higher taxes on cross-border ecommerce, a so-called positive list for foodstuff items was established, which in effect made it illegal for online store-owners to import or distribute any product not pre-approved by the government. Furthermore, online platform owners are legally liable for the sale of any products through their platform that violate any food safety laws or market regulations, such as labelling requirements.

The most recent major regulatory change for infant formula exporters is in restricting manufacturers to at most three brands with three distinct and approved formulations. All infant formula brands exported to China must be registered with the China Food and Drug Administration before January 1st, 2018. Brands not registered with the CFDA can still be exported to China, and also sold in China after this date, provided they were landed in China before January 1st, 2018. There had been initial confusion relating to the registration deadline for IF brands, with the CFDA initially indicating a deadline of October, 2016. The CFDA have also indicated that they may also inspect and audit sites prior to a brand's registration, separate to any inspections or audits conducted by the CNCA of manufacturing sites. Dairy Australia and the Department of Agriculture and Water Resources advise manufacturers to complete

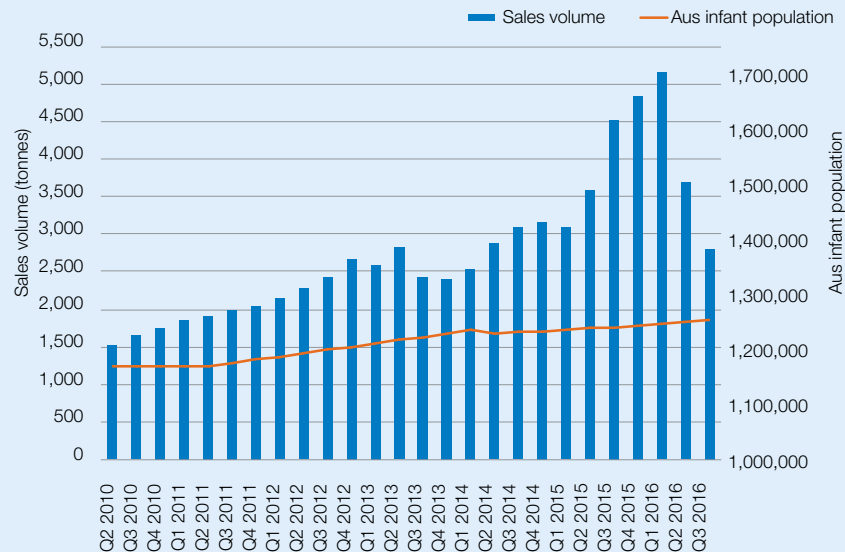
their brand registrations as soon as possible, and to notify the Australian authorities, so that they can assist and support the applications.

Ultimately, improved food safety within the Chinese market is likely to benefit reputable, high quality Australian companies exporting to China. However, remaining abreast of issues in this complex and evolving regulatory environment will be essential for ongoing success in any dairy product category. The combined effect of these regulations has been to drastically reduce the number of different brands of formula available in China, and gradually formalise and better regulate the Chinese food market. While these regulations may have the effect of halting some current trade, the Chinese market still presents immense opportunities for Australian dairy. Dairy Australia is managing a project, funded by the DAWR Package Assisting Small Exporters (PASE) program, designed to assist Australian companies looking to enter the Chinese market navigate and manage the regulatory requirements.

Australian imports vs exports (tonnes)



Infant formula sales – by quarter



Economic settings

The Westpac-Melbourne Institute Consumer Sentiment Index rose by 0.1 points, up from 97.3 in December 2016 to 97.4 in January 2017, representing some stabilisation from the large drop in consumer confidence between November and December 2016. The announcement in December that GDP had contracted 0.5% during the quarter to September 2016, combined with less favorable assessments of Australian economic conditions and a softer labour market were cited as the main reasons for the fall. A result below 100 indicates that pessimists outnumber optimists amongst consumers, and serves as an indicator of consumers' likely spending intentions and demand. With confidence now at its lowest level since April 2016, the latest consumer sentiment survey suggests that the generally more favorable view of the Australian economy and gains since April may now be wound back. Reports of lower retail revenues during the Christmas period appear consistent with these results, suggesting consumers were less comfortable making large purchases.

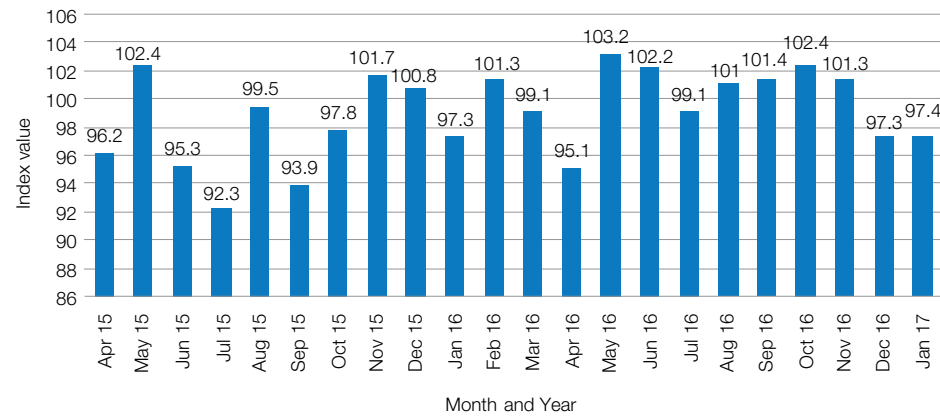
Dairy Australia's Food Service Index shows continued growth in the food services sector, with expenditure

growing by over 4% in the 12 months to November. The index reflects year-on-year growth in turnover of the food service channel, which aggregates hospitality turnover from takeaway food, cafes, restaurants and catering services. The Index shows that overall spending in food service has grown 4.3% in the 12 months to November 2016, compared to the same period a year ago. This compares to growth for the 6 month period to November 2016 of 5.1%, suggesting stronger growth in the second half of the year to November 2016 and more forward momentum. Conversely, slower growth in the latest six months compared to the 12 month period suggests a slowdown in growth for the category.

Although the headline figure for the Food Service Index is positive, further examination shows that two of the three components in fact show slowing (albeit positive) growth. Growth in the total value of supermarket sales appears to be slowing, as does turnover for cafes and restaurants. The standout category has been in takeaway food, which has seen exceptionally strong growth in the last 12 months, with the more recent 6 month growth figure of almost 10% suggesting the category may still be gaining momentum.

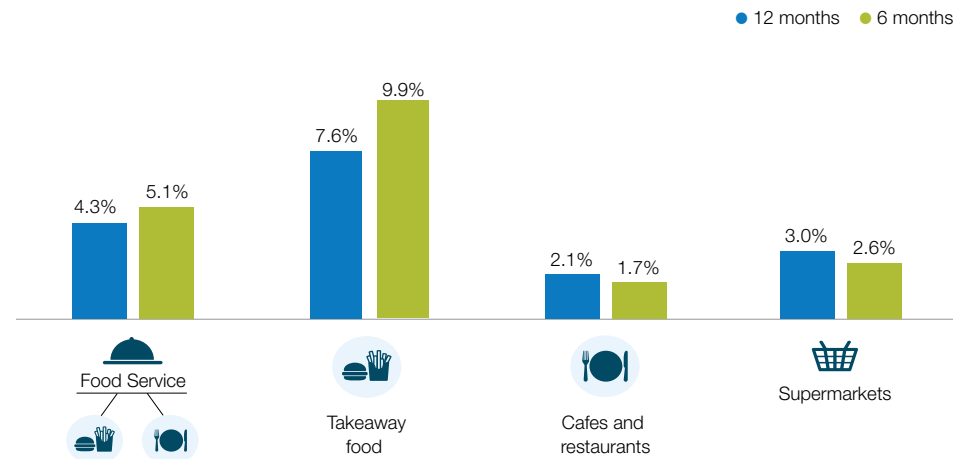
Dairy Australia's Food Service Index shows continued growth in the food services sector.

Figure 4 Australian consumer confidence



Source: www.tradingeconomics.com, Westpac Banking Corporation, Melbourne Institute

Figure 5 DA Food Service Index (YOY turnover growth to July 2016)



Source: Dairy Australia, ABS

Given that these numbers are from November and predate the fall in consumer confidence in December 2016, it will be interesting to see whether takeaway food expenditure, typically regarded as a discretionary outlay indicating consumer confidence, continues to grow. It may be that the rise of food delivery services for takeaway food is encouraging more eating-in, as an affordable indulgence alternative to evenings out.

The CPI now sits at 110.0 for the December Quarter, having gained 0.5% points since the September quarter 2016. Over the twelve months to the December quarter, this marks just a 1.5% annual increase in the CPI. While an increase on the 12 month inflation rate of 1.3% to the September quarter 2016, and expectations of continued low inflation, commentators were still generally surprised at the soft inflation results, which are the lowest in almost two decades. The most significant increases for the quarter were in tobacco and alcohol (+2.8%) and transport (+1.7%). Meanwhile furnishings, household equipment and services (-0.8%) and

telecommunications and services (-0.8%) saw the largest price level falls in the quarter to December 2016. Within the headline CPI figures, the food and non-alcoholic beverages category grew slightly, from 105.6 in the quarter to September to 106.2 in the quarter to December 2016. Over the last twelve months, the food and non-alcoholic beverages category has increased 1.2%, with decreases in two of the underlying indexes; milk (-0.1%), cheese (-4.1%), while ice cream and other dairy products increased 0.1%.

Inflation remains well below the RBA's mid-term target band of 2 to 3%, but broadly in line with its own forecasts. The RBA has been content to leave official overnight rates unchanged in its last three meetings, and while ongoing price weakness may yet prompt a changed stance in monetary policy, all indications are that the RBA is unlikely to respond with a rate cut any time soon. The RBA's February Statement on Monetary Policy indicated it sees annual inflation returning to the 2-3% target range by mid-2019.

Global economy and exchange rates

The latest update to the World Economic Outlook (WEO) from the International Monetary Fund (IMF) (October), projected a 3.1% global economic growth for 2016 and 3.4% economic growth in 2017, a minor reduction of 0.1% to previous forecasts. This revision is a result of the 'Brexit' vote and the lower-than expected growth in the United States. The original shock to the market after the 'Brexit' vote has ebbed, however future economic prospects are subdued due to the uncertainty surrounding future trade agreements between the UK and Europe. Ultra-low interest rates are forecast to persist longer than previously reported, limiting the effects of monetary policy and the risk of lower inflation, and deflation, has increase.

The low interest rates are generating greater capital inflows into emerging

markets. China's economic growth is slowly stabilizing and commodity prices are recovering, helping fuel a more positively economic outlook in developing countries. An economic recovery is predicted in 2017, driven by an increase in growth in the United States and emerging markets. The rise of protectionist and populist policies is posing a potential risk to this growth, through impediments to global trade.

Currencies of some major dairy commodity exporters have remained fairly weak, improving their relative competitiveness. New Zealand experienced a spike in its exchange rate during the third quarter of 2016, deteriorating its cost-competiveness, while the Australian dollar averaged 0.74 AUD/USD during October quarter 2016 – down from the previous quarter average of 0.75 AUD/USD.

The increase in the strength of the US dollar comes as a result of the US Federal Reserve increasing interest rates. The Federal Reserve's focus on the underutilised labour force is also creating further speculation about potential rate increases. The median consensus forecast is for the AUD to appreciate slightly against the USD in the first quarter of 2017 before stabilising around 0.72 AUD/USD for the remaining quarters. The New Zealand Dollar (NZD) is forecast to depreciate against the USD in 2017, producing an exchange rate of around 0.68 NZD/USD by the end of the year. The Euro has appreciated against the USD following the decreasing likelihood of additional monetary stimulus by the European Central Bank. It is expected to devalue against the USD during the first half of 2017, before stabilising around 1.05 EUR/USD.



Global supply and demand overview

The traded volume of dairy products increased 7% in the 12 months to October 2016, driven largely by resurgent Chinese and Southeast Asian demand.

United States

The US domestic market is soaking up most of the country's extra milk production, especially cheese and butter. Sharper SMP/NDM pricing suggests exports of these will likely ramp up.

Export volume trends (Tonnes)
2,019,700

Total volume change:
▼ -1%

Significant product shifts

- ▲ Whey powder (4%)
- ▲ SMP/NDM (1%)
- ▼ Cheese (-12%)
- ▼ Butter and blends (-39%)

Mexico

Mexico's demand for dairy continues to grow, though given recent political developments in the US, Mexico's largest supplier, this may be disrupted.

Import volume trends (Tonnes)
695,170

Total volume change:
▲ +9%

Significant market shifts

- ▲ New Zealand (81%)
- ▲ North America (6%)
- ▼ European Union (-8%)
- ▼ South America (-34%)

European Union

The EU has continued to make its presence felt outside traditional markets. European sellers have a firm foothold in Asian UHT market, and its WMP is increasingly competitive.

Export volume trends (Tonnes)
4,192,409

Total volume change:
▲ +3%

Significant product shifts

- ▲ Liquid milk (+29%)
- ▲ Butter and blends (+29%)
- ▲ Cheese (+3%)
- ▼ Skim milk powder (-15%)

Russia

Russian imports have increased, driven by growth in exports from second tier exporters such as Belarus, Uruguay and Argentina. Most growth has been in SMP and WMP, much of which is for reconstitution.

Import volume trends (Tonnes)
146,784

Total volume change:
▲ +15%

Significant market shifts

- ▲ New Zealand (156%)
- ▼ South America (-14%)
- ▼ European Union (-15%)
- ▼ East Asia (-54%)

Greater China

Reduced domestic production and low global prices have led to a significant increase in imports. Liquid milk and WMP saw particularly strong growth.

Import volume trends (Tonnes)
2,429,685

Total volume change:
▲ +13%

Significant market shifts

- ▲ Australia (+29%)
- ▲ New Zealand (20%)
- ▲ European Union (16%)
- ▼ North America (-9%)

Southeast Asia

Southeast Asian demand for dairy products remains robust, with strong growth in most individual countries. Whey and casein increased sharply.

Import volume trends (Tonnes)
2,473,802

Total volume change:
▲ +7%

Significant market shifts

- ▲ European Union (17%)
- ▲ Australia (8%)
- ▲ New Zealand (5%)
- ▼ North America (-1%)

Middle East

Import volumes are up in the Middle East, with the European Union increasing its share at the expense of the United States.

Import volume trends (Tonnes)
1,722,880

Total volume change:
▲ +1%

Significant market shifts

- ▼ European Union (3%)
- ▼ New Zealand (-5%)
- ▼ North America (-20%)
- ▼ North Africa (-21%)

New Zealand

Lower milk production through spring gave Fonterra more manufacturing flexibility than usual. WMP shipments are expected to begin closing the gap with last year.

Export volume trends (Tonnes)
3,303,846

Total volume change:
▲ +8%

Significant product shifts

- ▲ Liquid milk (+42%)
- ▲ SMP (+14%)
- ▲ Cheese (+11%)
- ▼ WMP (-1%)

Australia

WMP has remained out of favour, as high fat prices and core cheese business absorb constrained milk supplies. The changing product mix partly explains why total tonnages continue to increase.

Export volume trends (Tonnes)
828,231

Total volume change:
▲ +7%

Significant product shifts

- ▲ Liquid milk (+25%)
- Cheese (0%)
- ▼ SMP (-3%)
- ▼ WMP (-18%)

Japan

Total Japanese imports were pulled down by large decreases in SMP and butter. Australian cheese exports to Japan also fell significantly.

Import volume trends (Tonnes)
481,168

Total volume change:
▼ -4%

Significant market shifts

- ▲ North America (22%)
- ▼ European Union (-8%)
- ▼ New Zealand (-8%)
- ▼ Australia (-13%)

Changes 12 months to October
Source: GTIS, Dairy Australia

 Four largest exporters

Global demand

The volume of dairy products traded over the past twelve months to the end of October 2016 rose by just over 7%, with a recovery in demand from Greater China accounting for around a third of this. Total dairy export volumes to Southeast Asia grew by around 4%, whilst export volumes to the Middle East and Japan eased slightly. The value of global exports was down by US\$4.2 billion, or 14%, compared to the same time last year, with falls across all major markets except Greater China, reflecting the lower global prices for key dairy commodities.

Greater China

Exports to Greater China (PRC, Macau and Hong Kong) grew by 13% in volume terms over the 12 months to the end of October 2016, totalling over 2.3 million tonnes. The value of exports grew by 1.4% to just under \$US 7.2 billion. Demand for milk powder was mixed; WMP import volumes were up 14.7% on the same period last year to 450,000 tonnes, with sales values growing 11% to over US\$1.6 billion, whilst imports of SMP declined significantly, down 8.2% to slightly over 200,000 tonnes. Sales volumes of liquid milk rose 36.2% to almost 680,000 tonnes with large increases in volumes of UHT milk from the European Union, particularly Germany, accounting for over half of the growth in this category. Infant formula remains the single highest value category of imports, totalling almost \$US 2.5 billion.

Australian export volumes grew by 29%, from around 138,000 tonnes to 178,000 tonnes while the value Australian exports increased by over 70% year-on-year, from \$US349 million to almost \$US600 million over the last 12 months. Most of this increase in value is due to the growth of a single category – infant formula. In a single year, Australian exports of infant formula have increased more than threefold from 6,000 tonnes worth \$US74 million, to over 19,000 tonnes in the 12 months to

the end of October, valued at \$US270 million. Australian exports of WMP also grew strongly, up 158% to over 12,000 tonnes, valued at \$US75 million. Volumes of liquid milk exported to China over the last 12 months grew by over 10,000 tonnes or 17%, to 85,000 tonnes.

Japan

Japanese dairy import volumes have fallen by 4% in the 12 months to the end of October. SMP import volumes have fallen from 48,000 tonnes to 25,000 tonnes representing a decline of 48%. Meanwhile cheese volumes, which represent over half of Japan's dairy imports, were down 3% to 228,500 tonnes compared to the same time last year, while the value of cheese imports fell by over 14%, to \$US783 million. Japanese butter imports have also fallen noticeably, down 22% to 17,000 tonnes, compared to almost 22,000 tonnes in the previous 12 month period. This is largely due to increased domestic butter and SMP production from Hokkaido, as well as softening demand from bakers and food manufacturers.

Over the same period the volume of Australian exports to Japan have fallen by almost 14,000 tonnes or approximately 13%, from 108,000 tonnes to 94,000 tonnes. This was largely due to an 8,500 tonne decline in total Australian cheese exports, which

account for over 85% of Australia's exports to Japan. Australian fresh cheese exports fell by 10,000 tonnes, which was only partially offset by increased exports of cheddar and other varieties of cheese. Declines in Australian SMP export volumes largely accounted for the rest of the decline. Moreover, this decline in the volume of Australian dairy exports to Japan, was compounded the problem of lower prevailing world prices during much of the period, with the value of Australian export falling by around 21% from \$US 383 million to \$US301 million over the 12 month period to the end of October.

Southeast Asia

Southeast Asian imports of dairy products grew strongly in the 12 months to October, increasing 7% on the prior 12 months to 2,470,000 tonnes. Notable category volume increases included casein (+205% to 62,000 tonnes) and whey powder (+12.5% to 412,000 tonnes). Nevertheless, strong volume growth was not enough to offset the effect of lower prevailing world prices, with declines in every major individual category leading to a decline in the value of dairy imports of 17%, from \$US5.6 billion to \$US4.65 billion. In particular, the lower world prices for SMP meant that despite volume growth of almost 4%, the value of SMP imports declined by almost 24%.

Exports to Vietnam grew by 21% with higher imports of SMP (+28%) and whey powder (+62%), while Indonesian imports grew by 10% and imports from the Philippines by 9%. Meanwhile exports to Thailand grew 7% due almost entirely to an enormous increase in casein shipments (+530% to 40,000 tonnes). Exports to Malaysia fell by 2%, pulled down by lower imports of WMP, while Singaporean imports grew by 2%.

Relative market shares have changed slightly over the last 12 months, with New Zealand's share of exports to Southeast Asia falling from 29% to 28%, whilst the US also saw its share fall, from 17% to 16%. The main beneficiary of this has been the European Union, which has seen its share grow over the last 12 months from 21% to 23%. Australia's share of the export market has remained at 11% over the last four years.

Australian export volumes to the region grew by 8%, from 256,000 tonnes to 276,000 tonnes in the last 12 months, despite a 13,000 tonne fall in SMP volumes, generally Australia's largest single export to the region. Meanwhile, the value of Australian exports fell by 18% from \$US 635 million to \$US 524 million. This fall in value was largely due to the weaker prices of SMP, with the value of Australian SMP exports falling from \$US 302 to \$US 196 million, a 35% fall in value while corresponding volumes for SMP fell only 11% over the same period. Australian exports to Singapore grew by 8% to 85,000 tonnes, exports to Malaysia were up 16% to 54,000 tonnes while Australian exports to Indonesia eased slightly, down 2.5% to 51,600 tonnes.

Mexico

Mexico saw strong growth in dairy imports, with import volumes up by 8.5% on last year to 695,000 tonnes, led by increases in butteroil (+112%) and WMP (+286%). Overall value of Mexican imports declined however, and fell by 6% to 1.6 billion. Butter oil imports grew from 27,000 to 48,600 tonnes, WMP imports grew from 13,000 tonnes to 49,000 tonnes, while SMP imports fell by 3% to almost 270,000 tonnes. Exports of whey powder fell by 17% to around 43,000 tonnes, whilst cheese imports have been relatively stable, growing slightly (+1%) over the last 12 months. It should be noted that these figures capture trade to the end of October 2016, and thus does not capture volatility in the Mexican peso and business uncertainty following the US election in November.

Middle East

Export volumes to the Middle East grew slightly over the 12 months to October, up 1% to 723,000 tonnes, compared to 710,000 tonnes in the previous 12 month period. Imports of WMP were down 8%, from 337,000 tonnes to 309,000 tonnes, while cheese volumes remained more-or-less unchanged at around 324,000 tonnes. Following the removal of production quotas and substantial production increases, the market share of exports from the EU has increased from 51% in 2013/14 to 57% in 2015/16. This has come at the expense of US market share, which has fallen from 11% to 4% over the same period.

Australia's dairy export volumes to the Middle East fell by 27% from 55,000 tonnes to around 40,500 tonnes in the 12 months to October 2016, and was down almost 42% in value terms over the same period, to \$US103 million. Australia's market share has declined slightly over the same period, from 3% to 2% of product sold in the Middle East. The largest declines were in SMP, where volumes declined some 31% to around 20,000 tonnes, whilst the value of these exports halved from \$US80 million to \$US40 million in the 12 months to October.

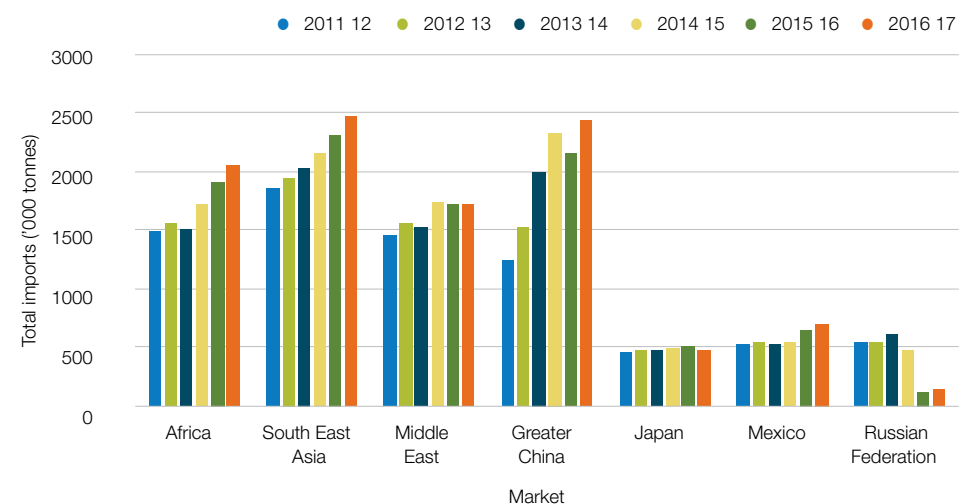
Russia

Russian dairy imports have increased by almost 20,000 tonnes to 147,000 tonnes in the 12 months to October 2016, boosted by increased imports of SMP and WMP. Russian embargoes remain in place on dairy imports

from United States, European Union, Australia, Canada and Norway. Consequently, Russia has turned to smaller, second tier dairy producers such as Argentina, Uruguay and Belarus for supplies, and also sought to encourage its own domestic production.

While recent political developments may see this situation change in the coming months, it is also worth noting that the combination of financial sanctions, stifled trade and lower resource prices will likely have lasting effects. As reflected in Dairy Australia's Dairy Import Affordability Index, even if embargoes were lifted in the next few months, it is unlikely that Russian purchasing power and appetite for more expensive imported foodstuffs would match pre-embargo levels, when Russia imported over 600,000 tonnes of dairy products.

Figure 6 Exports to key demand markets (twelve months to June)



Source: Dairy Australia, GTIS

Dairy affordability

Dairy Australia's Import Affordability Index has risen further in the wake of the October S&O report, reflecting reduced affordability as dairy commodity prices continue to recover. Although SMP has been one of the slower-recovering product lines, prices are up 12.5% compared to the October report, and are around 38% higher than the same time last year. This has lifted our index to 121.3, its highest point since March 2015, and signals the potential re-emergence of affordability concerns for dairy importers. In the longer term however, dairy protein remains affordable, with the index remaining 13% below the five year average.

A weakening of most currencies relative to the US dollar has pushed the index higher in local terms for many importers, with the Japanese Yen the biggest mover, reversing earlier gains and depreciating by 13% since September. This adds up to an almost 28% increase in the cost of importing SMP. Chinese buyers have been less affected, with a 3.5% currency depreciation and combining with commodity price movements to drive a 16% increase in the RMB-denominated index. Russia's currency has bucked the trend of recent months, strengthening by around 7% against the US dollar – and limiting the rise in SMP costs to 4.5%. That said, the Russian index remains 24% above the five year average; and with all else equal, affordability would prove a significant impediment to Russian dairy buying even if the current trade sanctions were removed.

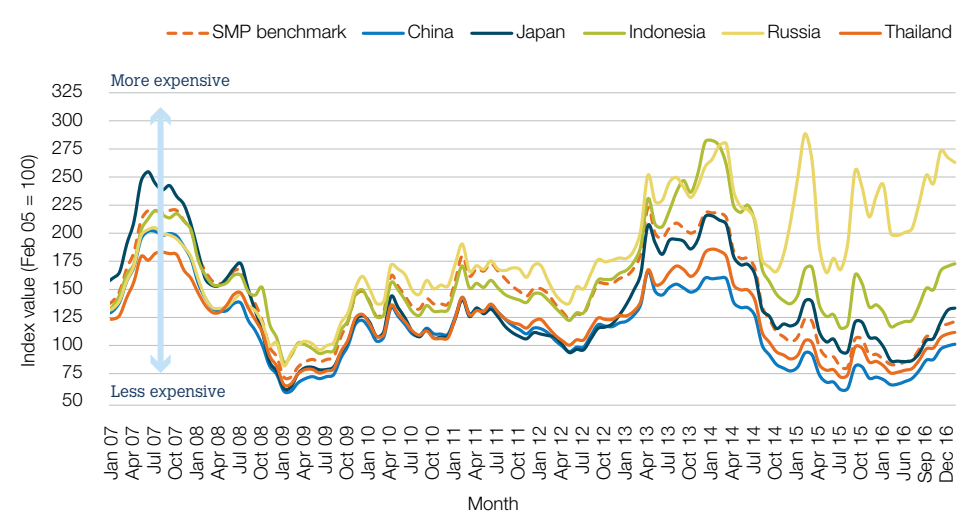
Dairy substitutes

An increasingly tight global market for dairy fats has pushed the premium relative to palm oil-based substitutes to near-record levels, reaching US\$4.83/kg fat in December 2016. This is 30% above the five year average, and 60% higher than the level reported in the October Situation and Outlook report. The phenomenal run in milk fat pricing has been driven by a combination of supply contraction and shifts in demand, with dairy fats finding renewed favour with consumers and food service businesses in many global markets.

Inevitably however, such elevated premiums will prompt some degree of substitution towards non-dairy fats in more price-sensitive (or flexible) segments of the market, which will curtail further growth in premiums. A likely supply response (either via increased milk production or redirection of manufacturing streams) will also dampen prices. Palm oil market dynamics are also at play; stocks remain constrained due to supply issues caused by the 2015 El Niño event, and market analysts suggest prices will continue to rise towards mid-2017. Thus, the dairy fat premium is likely to plateau or contract in the near term.

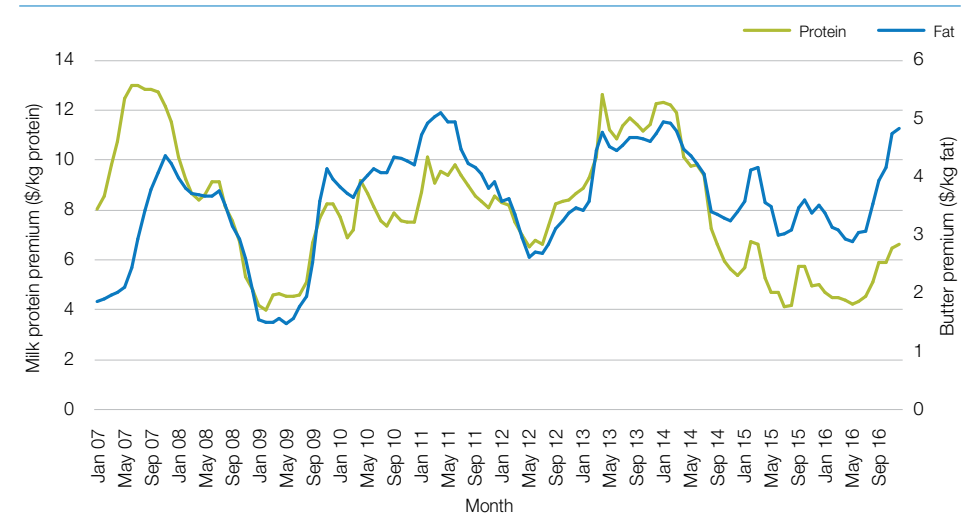
Dairy protein premiums have also increased in recent months, up 53% compared to the October Situation and Outlook report to US\$6.60/kg protein.

Figure 7 Dairy affordability



Source: Dairy Australia, Bloomberg

Figure 8 Dairy price premium vs palm/soy substitutes



Source: Dairy Australia, Oil World

Despite recent increases, the SMP market remains relatively subdued, and despite weak soymeal prices, the dairy premium remains 13% below its five year average. Recent flooding in Argentina is expected to severely curtail production in one of the world's largest soybean meal exporting countries, but record harvests are forecast in other South American producers (notably Brazil). Combined with a bumper US harvest, global supplies may not be overly affected. A continued, if moderating, recovery in dairy protein prices will thus most likely bump the dairy price premium back up to average levels over the next few months.

Brexit: An opportunity for Australian dairy?

Following the unexpected result of the UK's EU Referendum on 23rd June 2016, uncertainty has reigned as the UK scrambles to renegotiate its relationship with the EU. Over the course of Britain's four decades of membership, the EU has come to influence almost every aspect of UK agriculture, from animal welfare to food standards to trade deals. Negotiations over the formal separation of the two parties, and the future relationship between them will commence once the UK officially advises the EU of its intention to leave the EU, under Article 50 of the Lisbon Treaty. In an address on January 27th, British Prime Minister Theresa May has indicated her intention to trigger Article 50 by the end of March 2017, which means the UK will leave the EU by mid-2019. Prior to this, EU laws and agreements will still apply to Britain, including the UK's trade relations with the rest of the world.

While the final shape of a future EU-UK relationship remains unclear, Theresa May has indicated her preference for a so-called 'hard Brexit', stating 'Brexit means Brexit'. This effectively rules out a Norway-like relationship with EU, where the UK would remain within the single market and subject to EU regulations and free movement of people. Instead, the UK government appears to favour a so-called 'FTA-plus' arrangement

where the UK and EU have a deeply integrated bilateral trade agreement for goods and services, but with Britain controlling its own justice and immigration policies. However, a UK-EU FTA would almost certainly take more than two years to negotiate, which makes it unlikely there will be a bilateral trade agreement upon Britain leaving the EU.

This assumes that Britain can undertake separate negotiations regarding its exit under Article 50 and a future trade relationship with the EU in parallel, and while still an EU member. However, whether the EU will agree to this is unclear, as technically the EU members are unable to separately negotiate trade agreements. This would increase the time taken to finalise post-Brexit trade relations, and necessitate an interim agreement of some sort. The UK also has to re-establish its own customs schedule, tariffs and quotas with the WTO as a sovereign country, which would be necessary pre-condition for any future bilateral agreements. At present, under its WTO commitments the EU-28 has a quota for 4,211 tonnes of Australian cheese. It is unclear whether the UK and EU-27 will apportion this quota between them, or whether the UK will mirror the EU commitments, so that Australian access would be doubled, with two 4,211 tonne quotas for both the EU-27 and the UK. The UK faces difficult, complex negotiations with Article 50, an EU FTA and its WTO membership

commitments, and possesses hardly any experienced trade negotiators to conduct them. Given this, the UK is unlikely to be concluding bilateral FTAs with third parties within the next few years, despite informally exploring the possibility with a number of countries, including Australia.

It is unclear what approach a UK freed from the CAP will take towards agricultural policy, and whether Britain will trade off agricultural access to ensure better terms for its competitive service sector industries. For Australian dairy, Brexit is unlikely to present a 'back to the future' opportunity to regain the British market. 98% of the UK's dairy imports are sourced from the EU, mainly cheese and butter from Ireland and France, while 72% of British dairy exports are destined for the EU (AHDB). The UK shares a land border with the Republic of Ireland, a significant low-cost dairy producer, and a major trade partner of the UK. Considering the highly integrated agricultural supply chains and production systems between Northern Ireland and the Republic of Ireland, minimizing disruptions to these trade relationships will be a priority for both the EU and UK in future negotiations. Given this, a newly separate Britain may present new opportunities for Australian dairy exporters, but they will likely be limited, and take considerable time to eventuate.

Global supply

Overview

The global milk supply picture remains cautiously optimistic, with only the US currently showing growth amongst the major exporters. New Zealand and the EU warrant close watching, but for now, milk flows are likely to remain constrained.

Figure 9 Farmgate price movements – four largest exporters

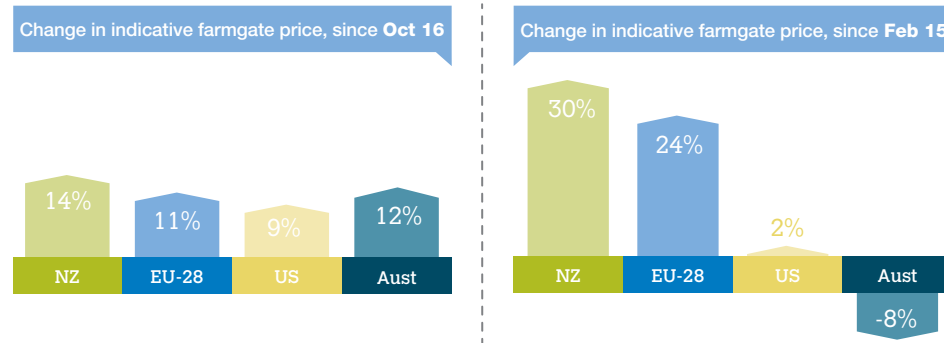
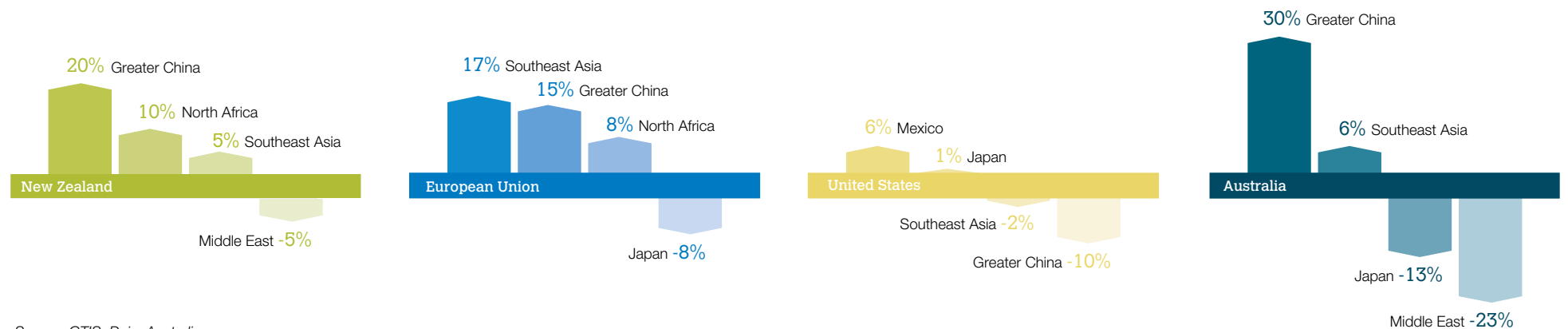
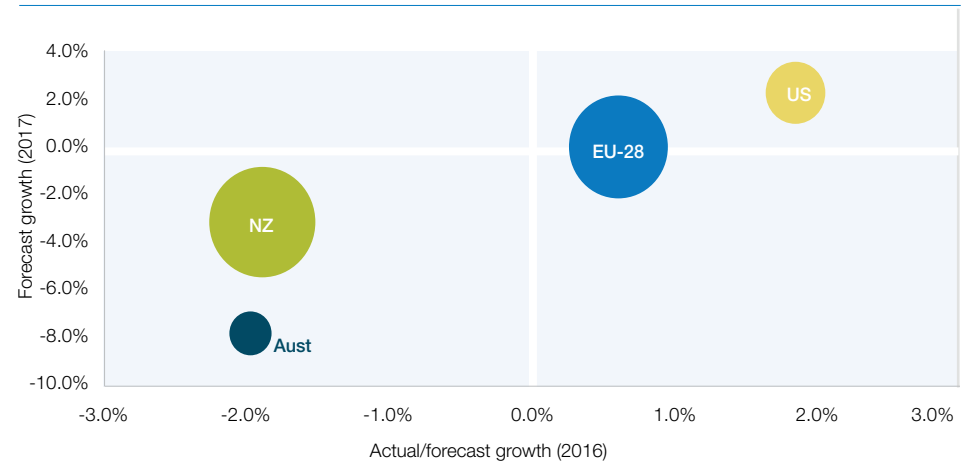


Figure 10 Significant market shifts – four largest exporters by volume



Source: GTIS, Dairy Australia

Figure 11 Actual and forecast milk production growth – four largest exporters



Note: Size of bubble represents share of global dairy exports.
Data covers production seasons for Aust and NZ, calendar years for US and EU.

European Union

Europe's milk production slowdown has been regarded as one of the key factors driving the recent recovery in dairy commodity prices. Having grown by 2.5% in 2015, the EU has produced only 0.8% more milk in the first 11 months of 2016 than the same period in 2015, driven largely by the Netherlands (up 8% YTD) and Ireland (up 5% YTD).

As of November, production in 19 of the 28 EU member states is slowing, with overall intakes down 4% for the month, compared to November 2015. Of the major producers the largest – France (down 8%), the UK (down 7%) and Germany (down 5%) – are tracking below the same time last year, while Italy notched up 4% growth and the Netherlands finally slowed to flat against November 2015.

Price signals are conflicted, with some processors passing on higher commodity prices as improved farmgate returns, while the European Commission is funding a program to incentivise farmers to reduce milk production.

The Commission's incentive package (around €150 million/A\$220 million, fully subscribed) pays around €14 cents per litre to reduce production, with major cooperative Friesland Campina offering its suppliers an extra €10 cents per litre to do so.

In addition, the Netherlands is grappling with the need to reduce phosphate output to meet EU limits. A combination of a significant (around 10%) reduction

in the national herd size, reduced phosphate levels in feed, production caps and manure exports is currently being pursued. Whilst milk production growth in the Netherlands (one of the biggest sources of extra milk since quotas were removed) is likely reverse as a result of this, the overall European impact is not yet clear, as some cows may be sold to farmers in neighbouring EU states.

Meanwhile, the average milk price across the 28 member states of the EU increased 3% in November, marking the fifth month of improvements since prices bottomed in June. The average farmgate price across the EU-28 is now around 26% higher than it was in November 2015.

The 2016 European Commission forecast for EU-28 milk production was sharply cut recently, and with only December data left to report, the expectation is that production will grow 0.6% for the full year. This would imply a total of just over 148 billion litres. Further modest growth of 0.2% is projected for calendar 2017.

United States

The US is the only major dairy exporting region where milk production continues to expand. Total intakes grew 2.2% in December 2016, compared to the same month in 2015, notching almost 2% growth for the calendar year. The national herd size has expanded to its largest since 1985, but the bulk of the increase has been in per-cow production, suggesting the combination

of cheap feed and good weather has driven yield increases in recent months. Local analysts report cull numbers were down around 1% for 2016, and suggest that further herd expansion may be in the works. Although there has been some convergence over the past year as California recovers from drought, the Midwest states (most notably Wisconsin) continue to grow at a generally faster rate. In volume terms, Wisconsin's milk production grew 1.7% in December, whilst California saw a 0.5% increase.

Although milk production is growing, US domestic demand is tracking at a similar pace and shows signs of further strength in the short term, based on the economic stimulation associated with the new President. Butter and cheese stocks have been drawn down as tighter supply of these products internationally has reduced the competitiveness of imports. Butterfat demand growth is tracking at double-digit levels relative to 2015, while cheese demand is growing too, albeit at a moderating pace. US exports have rebounded, largely in the form of protein-based products like SMP/NDM, plus extra sales of butter and cream to Canada, as that country's heavily protected dairy sector failed to keep up with growing milk fat demand.

The USDA expects further production growth of 2.5% in 2017 (an increase on earlier forecasts), for a total of almost 99 billion litres.

New Zealand

New Zealand milk production was hit by wetter than average conditions through spring, peaking lower than usual. The earthquake near Kaikoura (on NZ's South Island) in mid-November also impacted collections in that area. As at December, production for the 2016–17 season to date is around 3% below the comparable period in 2015–16. Cull cow numbers are significantly lower this season (coming off high levels last year) and the milk price outlook is more positive, but weather conditions have created some obstacles.

Wet conditions early in the season caused extensive pasture damage and pugging in some areas (especially in the main dairying regions of the North Island) and delayed maize planting. The weather has since improved, and pasture growth conditions have returned to average levels, however damage to pasture stands from the earlier wet conditions is reportedly limiting actual growth.

One positive associated with the reduced milk volume through the spring peak has been the increased manufacturing flexibility it has afforded Fonterra. Production of SMP tends to be favoured when plant capacity is stretched, due to the ability to run more skimmed milk through dryers per hour, compared to whole milk. This season, the lower peak has allowed an increased focus on better-returning WMP, which some suggest has subsequently weighed on prices at recent GlobalDairyTrade events.

New Zealand-based analysts AgriHQ are forecasting that the current 3% season-to-date drop will be maintained across the full season to May, implying a total milk production of around 21 billion litres. Fonterra is tipping a 7% drop in its collections, which includes a loss of market share to smaller rivals. It is unlikely that the lost volume through NZ's peak period could be made up for, though year-on-year growth is likely again towards the end of the season. Fonterra's current forecast of NZ\$6.00/kg MS is now considered 'easily achievable', with most analysts forecasting a further increase, and Fonterra's rivals variously forecasting within a \$5.50/kg MS to \$6.10/kg MS range. Combined with global downward pressure on feed prices, it appears likely that the financial pressure is likely to ease for virtually all New Zealand producers.

Australia

Australia's milk production has slowly begun to close the gap with 2015–16, after a very slow start to the season that culminated in a year on year decrease of 10% for the season to October. Since then, November milk production showed a 6.3% decrease compared to November 2015, and December volumes averaged 4.3% lower.

In southern regions, milk prices remain constrained for many farmers, confidence and trust in the supply chain has been shattered, and heavy culling has made a significant dent in the number of cows in lactation. Excessively wet conditions through much of spring

caused a range of issues, and the quality of conserved fodder is likely to emerge as an issue as feeding commences. However, the season has become more favourable moving into summer, with the pasture growth window for dryland farms extending well beyond the 'average' season, and lower prices for water providing more options for irrigators. As supplies of feed grains and hay have burgeoned, prices have continued to fall, providing further cost relief and improving a still-difficult profitability situation. The spring peak was significantly lower and flatter than 2015/16, but also later, and milk production on many farms has tracked above last season for at least some of the shoulder period.

Farmers in domestic-focused regions have experienced greater stability in farmgate prices, but are increasingly encountering their own issues. In Western Australia, uncertainty surrounds the outlook for farmers that do not have the security of an ongoing supply contract. Three farmers exited the industry in spring after their processor ceased milk collections, and several others are reportedly at risk of a similar outcome. In Queensland, proposed price reductions have been resisted by farmers who argue that domestic supply should not be influenced by international market movements.

Whilst unfolding developments in the domestic-focused regions present some additional downside risk, the improving situation in the southern states is likely to contribute to an overall

improvement in milk intakes towards the end of the season. In the context of significantly lower spring production and the ongoing constraints associated with cow numbers and milk prices, such improvements will be limited to narrowing the year on year gap, and a significantly lower full season total is still expected.

Dairy Australia's forecast for 2016–17 season national milk production remains a fall of between 6 and 8% compared to the 2015–16, implying a volume range of between 8.8 and 9.0 billion litres.

Latin America

For calendar year 2016 to November, Argentina's milk production fell over 12% compared to the same period in 2015. Flooding in early 2016 caused major setbacks, and although some improvement was evident in September, November saw a drop of over 18% compared to November 2015. Monthly year on year growth rates have fallen below the year-to-date trend for 9 of 11 months reported for 2016. Severe flooding again from mid-December through January has caused further issues, with some of the country's biggest dairying regions receiving over half their annual precipitation in the course of a single month. Local contacts have suggested that the latest flooding may prove even more damaging, and milk intakes are likely to fall sharply again in 2017. Milk flows in neighbouring Uruguay have also continued to lag, down nearly 11% for the first 11 months of 2016. November saw a more modest drop of 7%.

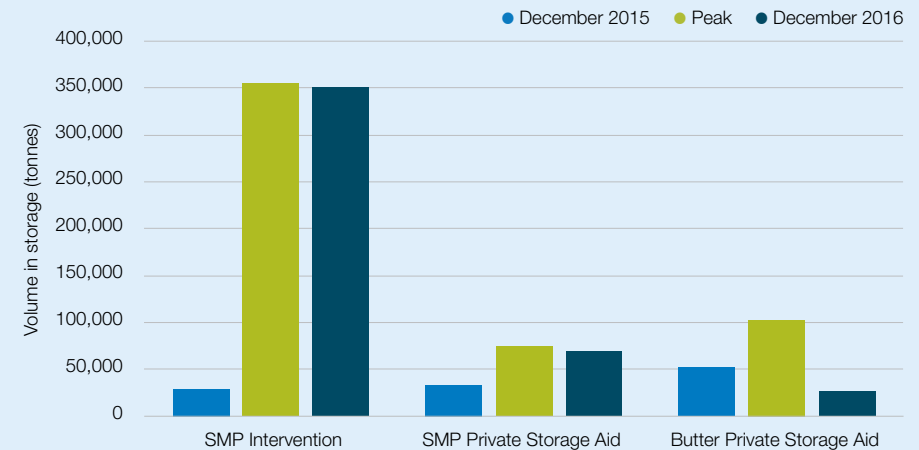
The improving situation in the southern states is likely to support some overall recovery in national milk intakes towards the end of the season.

EU stockpile

Much has been made of the huge stockpile of dairy product that has been built up in Europe, as a result of the European Commission's measures aimed at stabilising markets and supporting a floor in commodity prices. At its peak, around 350,000 tonnes of SMP was held in public intervention storages, while a further 50,000 tonnes was held in subsidised storage under the Private Storage Aid (PSA) program. Also in PSA stocks were around 100,000 tonnes of butter, and 25,000 tonnes of cheese. The SMP in particular represents over six months' worth of EU exports, and such a large accumulation of product naturally has the impact of overhanging the market and dampening any price recovery. Arguably, the increasing divergence between fat products such as butter, and protein products (in this case SMP) is evidence of this.

The mere presence of these stocks has an impact, but market players have increasingly considered the likely sale of this product to try and predict what the effect will be when it begins to actively compete with new supplies. With the first tenders on 20,000 tonnes of SMP in December, the European Commission came to market earlier than many had expected, but the emphatic rejection of bids on all but 40 tonnes of this offer signalled that the commission intends to dispose of the product as judiciously as possible. Little to no SMP has been sold since, and prices have not been affected; though questions are mounting concerning how the stockpile will be disposed of.

European Union product stockpiles



Source: European Milk Market Observatory

Corporate sector update

Whilst sluggish global markets combined with the ongoing effects of milk price reductions, weather challenges and ensuing milk production contraction have dampened the enthusiasm for major capital works, the corporate sector has seen continued activity during the last quarter.

Several companies have faced challenges associated with, or prompted by, market access issues. Most recently, ASX-listed Bellamy's Organic has experienced a turbulent time following a trading update that indicated projected sales of baby and infant formula in China would be much lower than previously forecast. Several contributing factors have been highlighted, including a shift in strategy away from the Daigou channel towards direct marketing for sales into China, loss of favour amongst Daigou shoppers, and changes to Chinese infant formula regulations. The company suspended trade of its shares on the ASX for roughly a month as it attempted to renegotiate supply contracts and determine how to manage an estimated \$105-\$110 million of inventory. Well-known CEO Laura McBain has resigned (as has the CFO) and terminated her position as director. The company's share price is down around 70% since trade resumed on January 11th. Negotiations are currently underway to reshape the company board and the company is facing two different legal actions concerning the forecasted profitability of the firm.

Toora (Gippsland, Victoria)-based infant formula producer Viplus Dairy had its import certification suspended by Chinese authorities for around a

month in November, in the midst of a \$10 million expansion project. Viplus has since resumed trade into China, estimating the cost of the suspension in the millions of dollars.

Camperdown Dairy Company (CDC), which had been one of a handful of companies exporting fresh milk to China, has decided not to re-apply for its Chinese export licence. The decision to quit the Chinese market came following a suspension imposed by the Australian Government attributed to milk quality issues.

The issues faced by some have not deterred all prospective new entrants however, with the new owners of Van Diemen's Land Company (Australia's largest milk producer) flagging plans to air freight milk to China. The plans, reaffirmed in January, envisage shipments from Hobart to Ningbo under the 'Van' brand.

Merger and acquisition activity has also continued, with Bega Cheese making headlines after announcing its purchase of the Mondelez International grocery business in Australia and New Zealand in January. Following the announcement, the Bega's share price increased around 12%, completing a recovery from record-low prices in the wake of sluggish sales of its Blackmores joint venture-produced

infant formula late last year. The \$460 million deal includes Vegemite (and its Port Melbourne factory), and a number of other grocery brands – but not the Philadelphia brand.

Freedom Foods has, in a joint venture with Chinese company Shenzhen JiaLiLe Food Co, established itself in the infant formula market. Together they plan to sell 'Australia's Own' branded formula directly in China. The milk will be acquired from Freedom's part-owned Australian Fresh Milk Holdings, which in turn owns Moxey Farms in Central West NSW. And in a \$50 million deal with Australian Consolidated Milk (ACM), Freedom have bought the remainder of Pactum Dairy Group in Shepparton, Victoria. Freedom Foods founded Pactum in a 50:50 joint venture with ACM in 2014, and now intend to expand the business from its current UHT focus to produce a variety of dairy products.

French food giant Lactalis has met resistance in its proposal to buy the remaining shares in Parmalat. Lactalis currently owns 87.74% of the company and offered to buy the remainder for €2.80 per share, noting that the share price has not exceeded €2.80 since 2011. Investor Amber Capital owns around 3% of Parmalat and has refused the tender, stating the "price is too low and does not reflect the real value of Parmalat".

The Canadian-based majority owner of Warrnambool Cheese and Butter has launched a bid to secure the remainder of the ASX-listed dairy manufacturer.

Lactalis mounted a hostile takeover of Parmalat in 2011, and intends to de-list the company from the Italian stock exchange if it secures more than 90% ownership. Its current offer runs from February 9th to March 10th.

Closer to home, the Canadian-based majority owner of Warrnambool Cheese and Butter (WCB) has launched a bid to secure the remainder of the ASX-listed dairy manufacturer. Saputo is offering \$8.85 per share in cash – around 25% above the pre-offer share price – in an attempt to complete its purchase and de-list WCB. At the commencement of the offer, Saputo holds 88.02% of the company's shares, with Lion Dairy and Drinks owning a 10.2% blocking stake (acquired during the 2013/14 takeover battle for WCB).

Murray Goulburn (MG) announced the mutually-agreed termination of the framework agreement with Mead Johnson Nutrition (MG) in early December. MG and MJN announced

the signing of the agreement in March 2016, through which the parties were negotiating a strategic supply alliance for the supply of nutritional products. Along with MG's continuing supply agreement with Indonesia's Kalbe Nutritionals, the MJN partnership had been regarded as a step towards MG's plans to invest in nutritional powder production at its Koroit, Victoria site. These plans are now under review.

Milk broker National Dairy Products (NDP) was placed into voluntary administration in mid-November, following and exodus of suppliers over unpaid milk proceeds. Negotiations concerning the future of the company continue, with the initial Deed of Company Arrangement (DOCA) rejected by creditors. Unsecured creditors (including dairy farmers, other milk companies and transport firms) have been told to expect between zero and five cents in the dollar, depending on whether a DOCA is agreed, or the company is liquidated.

Policy updates

NSW Healthy School Canteens revised strategy

As part of the revised NSW Healthy School Canteen strategy, the NSW Government are overhauling their school canteen guidelines. Previously known as Fresh Tastes@ School, the new Healthy School Canteen Guidelines are based on the 2013 Australian Dietary Guidelines. Key changes to the strategy include the following:

- › The Traffic Light System previously used to categorise healthy and unhealthy choices will be replaced by 'Everyday' and 'Occasional' food categories. Everyday foods are those recognised by the Australian Dietary Guidelines and includes foods from all five food groups such as milk, cheese and yoghurt. Occasional foods are discretionary, or junk foods, however these must meet a Health Star Rating score of >3.5 stars.
- › Three quarters of the school canteen menu must be Everyday foods and drinks (the remainder of the menu can be filled with Occasional items).
- › Portion sizes will be applied to some foods, including flavoured milk. Portions will be limited to 250mL for primary school students and 500mL for secondary school students.

Currently, the NSW Government are tweaking the strategy in response to public consultation, including a submission from Dairy Australia. The strategy is a step in the right direction toward a healthier school environment, particularly recognition that milk, cheese and yoghurt are Everyday foods which should not be limited in the diet, but rather encouraged.

Responses to milk price step-downs

A number of enquiries launched in the wake of the milk price step-downs continue to progress.

The Australian Competition and Consumer Commission (ACCC)'s investigation of Murray Goulburn and Fonterra's conduct in the lead up to the late 2015/16 price reductions is nearing its conclusion. ACCC agriculture commissioner Mick Keogh was quoted in early February suggesting that recommendations were likely to be made "in the next month or so".

The ACCC is also conducting a more extensive investigation into the industry as a whole, which is scheduled to deliver findings by mid-November. A significant feature of this investigation is the power to obtain pricing information, which is expected to provide an

opportunity to test assumptions about margins along the supply chain. Consultation forums are taking place across the country through February and March.

The Economic References Committee of the Australian Senate has also held several public hearings as part of its own enquiry. Initiated by crossbench senators and tasked with investigating the means to achieve 'a fair, long term solution to Australia's dairy crisis', the committee is expected to report its findings by February 24th.

The Australian Securities and Investments Commission (ASIC) continues to investigate MG, with a view to establishing whether the company fulfilled its continuous disclosure commitments as a publicly listed company in the lead up to the profit downgrade and step-down announcement in late April.

The Australian Small Business and Family Ombudsman is also progressing an inquiry into payment times and practices in partnership with the Small Business Commissioners in NSW, SA, Victoria and WA, as well as the Council of Small Business Australia and the Australian Institute of Credit Management. The inquiry is particularly concerned with the effect of power

Currently, the NSW Government are tweaking the Healthy School Canteen strategy in response to public consultation, including a submission from Dairy Australia.

imbalances between large corporations and smaller businesses on payment terms. The inquiry will examine the common practices and trends of payment terms when established between corporations and smaller businesses, the impacts of long payment times on small businesses and potential responses and remedies open to smaller businesses, including the recently amended Small Business and Unfair Contract Terms Act.

Review of Australia's Gene Technology Regulations

Australia's highly regarded Gene Technology Regulator regulates certain dealings with "genetically modified organisms" to ensure the health and safety of humans and the environment. In October 2016, the Gene Technology Regulator initiated a review focused on how to regulate new gene technologies. Modern scientific endeavour has led to the development of new breeding techniques that can mimic nature and are indistinguishable from changes that can occur in traditional breeding programs. The outcome of this review will be clarification of what constitutes a "genetically modified organism" and what is excluded from that definition.

The Australian Dairy Industry Council and Dairy Australia made a joint submission to the review, outlining the use of new gene technologies in the forage breeding R&D pipeline and arguing they be regulated in a manner commensurate with the risks they pose. Resolution of the way new breeding technologies are regulated is critical to ensuring new innovations can be adopted with confidence by the Australian dairy industry. These gains will only be realised where regulatory oversight is science-based, proportionate to risk and well-coordinated.

Trans-Pacific Partnership Update

The Trans-Pacific Partnership Agreement (TPP) is a regional free trade agreement.

The negotiating partners involved in the agreement are Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, Peru, New Zealand, Singapore, the United States and Vietnam. TPP negotiations were concluded in October 2015.

Despite the content of the Trans-Pacific Partnership agreement having been finalised by the 12 negotiating partner countries, the deal is still subject to final ratification by each of the partner countries before it can enter into force.

In January 2017 the incoming Trump administration advised that the USA would be withdrawing from the deal. Due to the conditions of the agreement this appears to limit any reasonable chance of TPP being implemented as it stands.

Other TPP member countries, including Australia, are currently assessing options for an alternative path forward for a revised agreement, or failing that for the agreed outcomes under TPP to be incorporated into other bilateral or regional agreements – such as the Regional Comprehensive Economic Partnership Agreement which is currently being negotiated.



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