Murray Goulburn Co-operative Co. Limited

Submission to the
Senate Economics References Committee

Inquiry into the Dairy Industry

October 2016

Contents

1. Introduction

Murray Goulburn[1] (MG) welcomes the opportunity to make a submission to the Senate Economics References Committee inquiry into the dairy industry.

This submission examines the key facts around our actions to address the impact of a very rare set of international market imbalances during FY16 and includes a chronology of the events and disclosures the Co-operative made in response to difficult global conditions, including the introduction of the Milk Supply Support Package (MSSP).

The MSSP was developed to provide immediate support to farmer supplier cash flows without applying loans against individual suppliers or applying retrospective terms and conditions. The support package was designed to assist suppliers by spreading the impact of the FY16 milk pricing shortfall across the three years after FY16. However, after consultation with our farmers, it became clear that the MSSP was not considered by many suppliers to have addressed their most significant concerns. We are now actively reviewing all options to further reduce the impact of the MSSP on future supplier income.

Our submission addresses the following key points:

- A brief overview of MG and our position in the Australian dairy industry, including a summary of our investment and growth strategy in Australia;
- The role of co-operatives in agriculture, and specifically the benefits observed globally when there is a strong co-operative operating in the dairy sector;
- An overview of farmgate milk pricing, the influence of global commodity markets and foreign currency on the Australian dairy industry, MG's major review of milk pricing in 2012 and our standard contract terms and conditions;
- The history of farmgate price revisions, specifically the impacts of global conditions that led to MG's price revision in April 2016 and the events leading up to that decision;
- The consideration of options by the MG Board in managing the price reduction, including the establishment of the Milk Supply Support Package (MSSP), which was introduced due to the lateness in the season and in recognition of the difficult seasonal conditions being experienced;
- The future of the Australian dairy industry, and the medium to long-term outlook for the sector, including MG's commitment to work with other supply chain participants on issues relating to supplier terms and conditions and pricing transparency; and
- MG's response to the Inquiry Terms of Reference.

MG acknowledges that the April 2016 profit revision and farmgate milk price (**FMP**) reduction had a significant impact on suppliers and that what transpired was unacceptable to them. The Board is very disappointed and sorry that suppliers were put in this position so late in the season.

MG was very disappointed that the business could not support the payment of the FMP that had been forecast prior to April 2016. MG Directors and management understand that 2015 / 2016 was a very difficult season due to low rainfall and this led to higher costs. A late season milk price drop meant suppliers had no time to adjust spending to the lower forecast. The primary objective of MG is to deliver the highest possible FMP to farmer-suppliers and consequently higher dividends / distributions to shareholders / unitholders, and the Board regrets the lateness in adjusting the FY16 forecast to reflect market returns.

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[1] Murray Goulburn (also MG, the Company or the Co-operative) includes Murray Goulburn Co-operative Co. Limited ABN 23 004 277 089 and subsidiaries. Murray Goulburn's Annual Report is available at http://www.mgc.com.au/media/40795/murray-goulburn-annual-report-2016-web-.pdf.

MG's Board and management remain committed to a strategy of pursuing value-added dairy products, to achieve a premium over and above the commodity return for our products. We will continue to take a disciplined approach to investment to support future growth and implement a range of initiatives designed to reduce costs.

As Australia's largest dairy foods company, 100 percent controlled by our farmer-suppliers (approximately 2,200), the nation's largest dairy foods exporter, and a major employer in regional Australia, MG is a significant contributor to rural economies. We believe we have an essential role to play in the future of Australia's dairy industry and will work with all members of the dairy industry supply chain to explore ideas for improving pricing transparency, including the introduction of the proposed commodity milk price index. It is our view that an independently managed and tailored commodity milk price index would be beneficial to all participants in the Australian dairy industry.

2. *About Murray Goulburn*

2.1 Murray Goulburn Co-operative Co. Limited

MG is Australia's largest dairy foods company and is 100 percent dairy farmer controlled by approximately 2,200 farmer-suppliers, with all suppliers holding shares in MG.

In FY16 MG received approximately 3.5 billion litres or 36.6 percent of Australia's milk and generated sales revenue of approximately $2.8 billion. Sixty percent of revenue was generated from the Australian market and 40 percent in international markets. As the country's largest dairy foods exporter, MG is responsible for approximately 50 percent of Australia's dairy exports and we sell to the major markets of Asia, the Middle East and North Africa, and the Americas. MG has played a significant role in developing export markets for Australian dairy producers.

MG produces a full range of dairy foods, including drinking milk, milk powder, cheese, butter and dairy beverages, and a range of ingredient and nutritional products, such as infant formula. We supply the retail and food service industries globally with our flagship Devondale, Liddells and MG Ingredients brands.

MG is a major employer in regional Australia and a significant contributor to rural economies. The Co-operative employs approximately 2,350[2] people based at 10 processing plants, ancillary businesses (including MG Trading stores) and corporate offices located across Victoria, New South Wales, South Australia and Tasmania. After the milk payments to suppliers, our corporate income tax contribution in Australia in FY15 was $12.4 million. In FY16 we paid payroll tax of approximately $13.0 million. Salaries and wages in FY16 amounted to approximately $253.5 million and employees contributed PAYG tax of approximately $72.2 million.

A map of MG's milk collection regions and processing facilities is provided at Attachment A.

2.2 MG's Vision and Strategy

MG's vision is to be a 'first choice dairy foods company' for farmers, customers and consumers.

[2] Employee numbers are expressed on a Full Time Equivalent (FTE) basis (as at 11 October 2016).

Our strategy focuses on two key areas[3]:

Operational excellence – invest in modern, flexible and globally competitive dairy foods manufacturing and supply chain infrastructure to deliver and sustain business efficiency and cost leadership.	**Innovation** – drive the ongoing shift to value-added products in the key growth categories of nutritional powders, consumer cheese and dairy beverages.

2.3 MG's Capital Restructure

At MG's Annual General Meeting (AGM) in 2013, supplier shareholders were updated on the outcome of a capital structure review for MG. The outcome of that review was to propose to supplier shareholders a funding model that maintained 100 percent farmer control, but allowed external investors to invest into MG. This was deemed to be a more effective and efficient capital structure for MG to pursue because it diversified MG's funding mix away from traditional bank debt, which had historically been the co-operative's primary source of funding[4].

The purpose of the capital structure was to enable MG to fund its growth and value creation strategy in order to become the first choice dairy foods company for its suppliers, customers and consumers, and specifically to fund investment in planned capital projects in the nutritionals, dairy beverages and cheese product segments. In addition, the Capital Structure enabled MG to simultaneously meet the following key objectives:

- retaining 100 percent supplier control of MG;
- reducing MG's reliance on debt funding;
- creating a market value for supplier's shares through the operation of the Shareholder Trading Platform as opposed to the $1 value that had historically existed prior to the capital structure;
- strengthening suppliers' balance sheets by facilitating the recognition of the value of their shares as an asset (prior to the capital structure, banks did not recognise the value of the shares);
- helping to fund MG's growth strategy of operational excellence and innovation to deliver over time a sustainably higher FMP; and
- ensuring MG not only remained competitive with other processors, both domestically and internationally, but became the first choice dairy foods company for its suppliers, customers and consumers[5].

At an Extraordinary General Meeting (EGM) of MG on 8 May 2015, 92.31 percent of shareholder votes cast were in favour of implementing the capital structure, with a participation rate in the poll of 50.37 percent[6]. On 3 July 2015, the MG Unit Trust was successfully listed on the Australian Stock Exchange (ASX), raising $500 million to fund capital investments as part of its growth and value creation strategy to sustainably maximise

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[3] MG's Annual Report 2016, page 5. Available at www.mgc.com.au
[4] MG Supplier Shareholder letter, 22 November 2013. http://www.mgc.com.au/media/13141/2013-AGM-supplier-shareholder-letter.pdf
[5] MG Unit Trust, Product Disclosure Statement, page 9. http://www.mgc.com.au/media/23437/mg-unit-trust-product-disclosure-statement-29-may-2015.pdf
[6] MG Supplier Letter, 8 May 2015. http://www.mgc.com.au/media/23066/mgs-extraordinary-general-meeting-supplier-letter-final.pdf

farmgate milk prices and future earnings[7]. Of the $500 million, approximately $438 million was raised from the Unit Trust[8], and the balance from supplier shareholders as part of the Supplier Share Offer (SSO).

An important feature of the model is the Profit Sharing Mechanism (PSM). MG's PSM aligns unitholders and suppliers' economic interests by linking the dividend rate to FMP. In summary:

- when the FMP is relatively high, MG will allocate a higher proportion of the Milk Pool to Net Profit After Tax (NPAT) available for dividends to Shareholders and distributions to unitholders; and
- when the FMP is relatively low, MG will allocate a lower proportion of the Milk Pool to NPAT available for dividends to Shareholders and distributions to unitholders[9].

Therefore, our primary objective is to maximise farmgate returns for farmer-suppliers via our FMP and dividends. In FY16, MG paid 96.5 percent of the milk pool to milk payments and income tax and 3.5 percent to dividends/distributions.

In FY16 the NPAT attributable to shareholders and unitholders was $40.6 million, with supplier shareholders receiving approximately two-thirds, which recognises the value of the capital that suppliers have invested in MG over many years, and unitholders in the MG Unit Trust the remaining third[10].

In certain abnormal circumstances the Board can decide that, for the benefit of all stakeholders, including suppliers (as supplier of milk and as shareholders) and unitholders, the PSM should be deviated from when allocating the milk pool to milk payments, income tax and NPAT. Examples of abnormal circumstances may include extreme prolonged drought conditions, prolonged levels of materially increased competition for milk supply or other circumstances determined with the unanimous consent of MG's Special Directors to warrant deviation to protect MG's milk supply and profitability and support its supplier base. The process for a deviation is outlined in MG's Product Disclosure Statement of 29 May 2015[11].

An illustration of the PSM is provided at Attachment B.

3. *Importance of Co-operatives*

Given MG's manufacturing footprint and scale in Victoria, the Co-operative is in some instances the only dairy processor able to collect and process milk from suppliers in the more remote areas of the State.

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[7] MG media release (2015), *MG Unit Trust Lists on the ASX.*
http://www.mgc.com.au/media/25039/mg-unit-trust-listing-media-release.pdf
[8] MG media release, *MG Unit Trust Lists on the ASX.* 3 July 2015.
http://www.mgc.com.au/media/25039/mg-unit-trust-listing-media-release.pdf
[9] MG Unit Trust, Product Disclosure Statement, page 9.
http://www.mgc.com.au/media/23437/mg-unit-trust-product-disclosure-statement-29-may-2015.pdf
[10] MG ASX Announcement (2016), *Murray Goulburn announces results for the Full Year ended 30 June 2016,* page 4.
http://www.mgc.com.au/media/39102/murray-goulburn-announces-results-for-the-full-year-ended-30-june-2016.pdf
[11] MG Unit Trust, Product Disclosure Statement, page 140.
http://www.mgc.com.au/media/23437/mg-unit-trust-product-disclosure-statement-29-may-2015.pdf

Following the completion of the Inquiry into Co-operatives and Mutuals in March 2016[12], the Committee would appreciate and understand the important role that co-operatives play in the Australian economy, and particularly in the agriculture supply chain. Along with Norco on the north coast of NSW, MG is the only Australian dairy farmer-controlled processor operating in Australia.

The presence of strong co-operatives is common in successful dairy industries around the world. A European Commission report published in 2012 found that in "EU countries where dairy cooperatives have a large market share, farmers receive a higher milk price than in countries where cooperatives cover a small share of the dairy market"[13]. Their econometric analysis of different milk price data demonstrated that moving to a co-operative market share of 20-50 percent increases the relative milk price by more than 15 percent when compared with a 20 percent and below co-operative market share[14].

An important distinction can be made between co-operatives and a fully listed company, or privately owned company, around the drivers influencing the business priorities. This is summarised in the following comment by Mick Keogh (2013)[15]:

> *"A cooperative exists for the benefit of its members, while a company exists for the benefit of its shareholders. So while a dairy cooperative might pay a quite high price for milk and forego some cooperative profits in order to bring benefits to dairyfarmer members, a company is, by law, required to maximise its returns for shareholders. This means it will try to maximise the net margin between the price it pays dairyfarmer suppliers, and the price it receives when it sells products to consumers."*

Although MG listed a unit trust on the ASX in July 2015, it should be recognised that this was a capital raising to support the Co-operative's investment strategy. MG itself is not a listed company and continues to operate on the co-operative principles enshrined in our constitution, with the supplier shareholders retaining 100 percent control. As outlined in Section 2.3 of this submission, MG aligned the interests of supplier shareholders and unitholders through the PSM, whereby the dividend payable is higher when the FMP is high.

4. *Murray Goulburn pricing*

4.1 Influences on the Farmgate Milk Price (FMP)

As a result of MG's exposure to export markets, commodity prices and their impacts on value-added product pricing (such as UHT) are the largest external influence on our performance. As Australia's largest dairy exporter, we are more exposed to movements in global dairy commodity prices and exchange rates than any other Australian processor.

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[12] Senate Economics References Committee (2016), *Final report on the Inquiry into Co-operative, mutual and member-owned firms,* March.
http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Cooperatives/Report

[13] European Commission (2012), *Support for Farmers' Co-operatives*. DG Agriculture and Rural Development report, pages 76-78.
Source: http://ec.europa.eu/agriculture/external-studies/2012/support-farmers-coop/fulltext_en.pdf

[14] European Commission (2012), *Support for Farmers' Co-operatives*. DG Agriculture and Rural Development report, pages 76-78.
Source: http://ec.europa.eu/agriculture/external-studies/2012/support-farmers-coop/fulltext_en.pdf

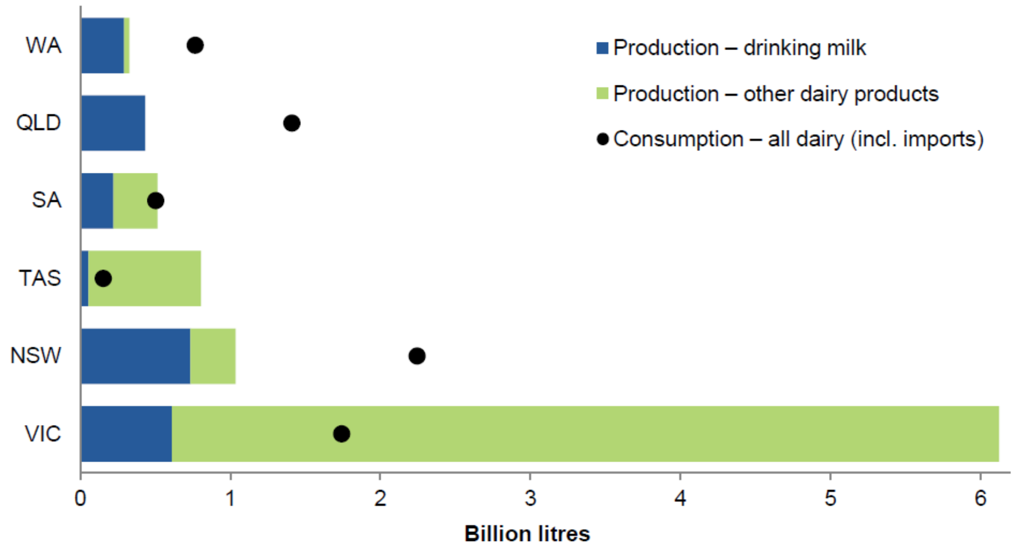
[15] Keogh, M. (2013). *Australian farmers generally refuse to be cooperative.*
http://www.farminstitute.org.au/ag-forum/australian-farmers-persistently-refuse-to-cooperate (as at 6 October 2016).

MG's strategy, as summarised in Section 2.2, does not remove exposure to global commodity prices but delivers a return that flattens the peaks and troughs in commodity pricing.

More broadly in Australia, given this strong interplay with world markets, domestic dairy product prices, and therefore the resulting FMP, are strongly influenced by international markets and prices[16].

Attachment C provides a comparison between MG farmgate prices and the commodity price.

It is important to recognise the diverse manufacturing footprint that exists in the Australian dairy industry. Approximately 25 percent of Australia's milk production is used to manufacture drinking milk (both chilled and long-life), while the remaining volume is used to manufacture other dairy foods[17]. As demonstrated in Figure 1, the majority of the raw milk produced in Victoria, Tasmania and South Australia enters the manufactured dairy food sector (cheeses, powders and other non-dairy beverage products), with production far exceeding domestic consumption.



[a] Production estimates assume all raw milk is used for manufacture in the state in which it is produced. Consumption estimates assume dairy consumption is 301 litres per capita (milk equivalent) in all states.

Figure 1. Production and consumption of dairy goods, by state (Milk equivalent terms, 2013-14)[18]

As the Productivity Commission identified[19], Australian dairy processors will not sell into the domestic market at a lower price than can be obtained in export markets. In addition, competition amongst domestic processors, and from imports, will ensure that Australian customers generally do not pay more than the world price (notwithstanding there will be

[16] Productivity Commission (2014), *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing*, Research Report, Canberra, September 2014, page 10
[17] Productivity Commission (2014), *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing*, Research Report, Canberra, September 2014, page 34.
[18] Source: Productivity Commission (2014), *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing*, Research Report, Canberra, September 2014, page 47.
[19] Productivity Commission (2014), *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing*, Research Report, Canberra, September 2014, page 60.

some divergence in prices due to transport costs). In relation to Australian dairy product imports, total imports are more than 100,000 tonnes per annum, which is dominated by cheese, with most total imports coming from New Zealand[20].

As a co-operative the mechanism of best delivering the distribution of payments from the milk pool will always be a topic for discussion and refinement. MG's objective is to maximise the FMP paid to suppliers. MG typically announce a forecast full year final FMP and then pay 90-92 percent of the forecast final FMP as the opening price to support supplier cashflows. Traditionally this has been common practice for other Australian processors operating in the Southern Milk Region. The balance of the milk pool is paid to suppliers throughout the year as backdated step-ups (effectively increasing the total full year price). The level of the opening price does come with risk when there is increased volatility in either global commodity markets or foreign exchange rates, particularly given MG's exposure to export markets.

There has been discussion as to whether alternatives such as those systems in operation in New Zealand and Europe could apply in the Australian domestic context.

In New Zealand the opening price is traditionally a smaller percentage (between 60-70 percent) of the forecast final FMP. For example Fonterra New Zealand is currently forecasting a 2016 / 2017[21] season forecast of NZD5.25, with a cash payment (Base Advance Rate) in September 2016 to December 2016 of NZD3.60[22].

However, New Zealand is unique as Fonterra collects around 87 per cent of the total milk supplied and exports around 95 per cent of its milk production. As a result, there is no 'market price' set through competition for supply[23].

Whilst this approach might reduce the risk of a price reduction during the season, it also has downsides. If a New Zealand model were adopted dairy farmers would not receive the same level of cashflow at the start of the season as they currently receive under the MG model. Instead they would rely on the forecasted final FMP being held and then realising a price increase through the year (referred to in the industry as a 'step up').

In Europe farmers are quoted milk prices on a monthly basis, which reduces their ability to generate longer term forecasts across the full financial year.

MG remains committed to continuing to look at ways of improving price transparency, including the proposed introduction of a commodity milk price index discussed further in Section 7 of this submission[24].

4.2 MG's milk payment system

MG prices the FMP each season for each of the Southern Milk Region and NSW-Sydney Milk Region (NSW).

The Southern Milk Region covers suppliers in eastern South Australia and western dairy region in Victoria ('West'), the Gippsland dairy region in Victoria ('Gippsland'), the Murray dairy region in central and northern Victoria and southern NSW ('North'), and, from 1 July

[20] Dairy Australia, *Australian Dairy In Focus 2015*. Page 50. http://www.dairyaustralia.com.au/Industry-information/About-Dairy-Australia/Publications-2.aspx
[21] Note: Fonterra NZ operate on a 1 August-31 July Financial Year.
[22] Fonterra Advance Payment Rates, as at 21 September 2016.
[23] Source: http://www2.fonterra.com/our-financials/farmgate-milk-prices (accessed on 11 October 2016)
[24] MG Supplier letter dated 16 August 2016. http://www.mgc.com.au/media/38622/supplier-letter-post-canberra.pdf

2016, Tasmania. The Southern Milk Region represents the pricing for the majority of the milk supplied to MG and is processed into the wide range of products produced by MG.

The Southern Milk Region is quoted on a Weighted Average Price basis.

The NSW region comprises the South Coast of NSW, Southern Central Highlands, Central West, Northern Tablelands, Hunter Valley, and Manning Valley. MG has a different pricing model for this region to reflect the single end-use of this milk (daily-pasteurised) and the need to have a flatter supply curve for this product.

In FY16, the volume of milk collected by MG in each state, as represented as a percentage of the total production in each state, included approximately 50 percent in Victoria, 24 percent in Tasmania, 5 percent in South Australia and 17 percent in New South Wales.

4.3 Background to MG's milk payment system

In 2012, MG and the Boston Consulting Group (BCG) undertook a comprehensive review of the Co-operative's milk payment structure.

The primary objective of the review was to recommend a milk pricing system that was based on fairness and profitability for all MG suppliers across farm systems and regions and allowed MG to develop a sustainable business that maximised the farmgate price for all its members[25].

In undertaking this review MG considered a range of factors, including:

- Supplier opinions about the payment system and its interaction with their farm business decisions;
- Farm production costs across systems;
- The seasonality of milk supply and MG's supply needs;
- The net return to MG of its products across months;
- Competitor pricing and product mix; and
- MG's strategy going forward.

The review included a farmer survey with 580 responses, 16 farmer meetings and direct consultation with several of the industry's leading farm advisers.

The review also examined MG's growth strategy in areas including UHT, cheese, butters and spreads and plans to increase the footprint for Devondale in Australia and overseas. This included an examination of peak versus off-peak returns for MG (the value of milk across months) and the competitive landscape for milk in Australia.

The increasing emphasis of the Australian dairy industry on consumer-pack and value-added ingredients such as infant formula was also noted.

The headline outcomes of the review included:

- Base price and seasonal incentives
  - *A Simpler System* – moving from three base prices to a single base price.
  - *Improve cash flow and profitability* – raise the base price during peak months vs. off-peak months, creating a flatter price curve.
  - *Retain a flatter milk commitment to underpin markets* – retain a simpler flat milk incentive with an improved cash flow structure to ensure MG can supply key markets and increase the milk price for all suppliers.

[25] MG supplier letter re: 'Headline outcomes from MG's Milk Payment System Review', 13 March 2013. http://www.mgc.com.au/media/4830/MG-milk-payment-review-supplier-letter-FINAL.pdf

- *Balanced* – a milk pricing system that balances the profitability drivers of a range of farm systems and MG product mix objectives – maximising the milk price for all suppliers.
- Fat and protein ratio – a protein to fat ratio that better reflects the increase in market value of fat products, such as butters.
- Productivity incentive, pick-up and volume charges
    - *Fair market signals (milk handling costs)* – the review found that the existing productivity incentive and volume charge fairly reflected the true costs to the MG business and therefore apportioned milk handling costs fairly among suppliers. As a result these were maintained at similar levels but simplified. However, pick-up charges were amended to better reflect true costs.
- Quality – the review recommended changes to the milk quality system, particularly with increased regulatory and compliance changes being introduced globally.

The outcomes of the review were fully communicated to suppliers, and were aimed at providing farmers with improved cashflow at the start of the financial year.

4.4 Contractual arrangements

MG operates Standard Milk Payment Terms in each of the Southern Milk Region[26] and NSW-Sydney Milk region[27]. These set out the terms and conditions governing the supply to and purchase by MG of milk, including pricing arrangements, and are published annually.

The large majority of MG suppliers, representing approximately 76 percent of MG's milk, supply milk under the Standard Milk Payment Terms and do not have any fixed term contract. They are therefore free to leave the co-operative at any time.

The remaining approximately 24 percent of MG's milk is supplied under fixed term contract arrangements. Approximately 40 percent of these fixed term contracts arose as a result of supplier participation in the Supplier Share Offer (SSO) during the capital raising in 2015. As part of the SSO, new and existing suppliers were invited to purchase MG shares at a discount and in return signed agreements to supply MG for periods of between one and three years. The terms of those fixed term supply contracts were explained in the 2015 SSO prospectus. The remainder of the fixed term contracts arise as a result of commercial business arrangements. For example, certain suppliers receive payments from MG under MG initiatives to support expansion and growth in their farm businesses. The length of these contracts varies from one to five years.

MG is actively participating in a range of industry led discussions regarding contractual and pricing arrangements. These discussions are ongoing and MG is committed to working with its farmer suppliers and industry groups to continue to improve upon arrangements where possible.

This has included meetings with farmers groups such as the United Dairyfarmers of Victoria (UDV) and the Australian Dairy Farmers (ADF), and also through our attendance at the symposium chaired by the Deputy Prime Minister, the Hon Barnaby Joyce MP, in August 2016[28].

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[26] MG Supplier Handbook, Southern Milk Region 2016/17. http://www.mgc.com.au/media/36238/2016_17southernmilkregion_supplierhandbook.pdf
[27] MG Supplier Handbook, NSW-Sydney Milk Region 2016/17. http://www.mgc.com.au/media/36239/2016_17nsw_smr-supplierhandbook.pdf
[28] Deputy Prime Minister's media release, *Working together to tackle dairy challenges.* 26 August. http://minister.agriculture.gov.au/joyce/Pages/Media-Releases/working-together-to-tackle-dairy-challenges.aspx

MG was also represented at an ADF meeting on 27 September 2016 that brought together State Dairy Farming Organisations (SDFOs) and processors to discuss the development of a voluntary code of practice[29] to facilitate an improved business relationship between dairy farmers and processors. In addition, there was discussion at that meeting around the transparency and operation of supply contracts with processors[30].

MG will continue to play an active role in industry discussions relating to supplier contracts and pricing transparency to support Australian dairy farmers into the future.

5. Context to Farmgate Milk Price (FMP) revision

5.1 MG's milk payment system

As outlined in Section 4.1, MG typically pays 90-92 percent of the forecast final FMP as the opening price from 1 July each year to support supplier cash-flows through the season. While there is some risk to this arrangement when there is increased volatility in either global commodity markets and/or foreign exchange rates, MG has delivered a final FMP equivalent to or above the opening price for suppliers in 62 of the 65 years of MG's history.

The three exceptions to this are as follows:

- 1972 - prior to deregulation there was a FMP reduction applied due to prolonged drought in Australia.
- 2008 - Global Financial Crisis (FY09).
- 2016 – Sustained low commodity prices, and lower than forecast Adult Milk Powder (**AMP**) sales to China.

On the two occasions in the last 10 years we have had to adjust milk prices down to reflect market conditions, some of the other milk processors have followed.

5.2 Milk price reduction in FY09

In December 2008, MG informed supplier shareholders that the rapidly deteriorating world dairy market was far worse than initially anticipated as the full impact of the Global Financial Crisis was being felt by the world economy.

The extremely volatile market, fuelled by the unprecedented collapse in world financial markets, resulted in world dairy prices falling more than 60 percent for powders and 50 percent for cheese and butter in less than two months, with no clear view at that time as to whether they had bottomed or not.

MG's announcement on 18 December 2008 expressed deep regret for the actions that had to be taken in the circumstances. The resulting decision included:

- For milk delivered in December 2008 and January 2009 the existing milk price would be paid.
- For milk supplied from February 2009 to 30 June 2009 the base price was reduced by $1.35 / kg of fat and $3.38 / kg of protein, which represented over the 2008/2009 financial year a reduction of 13 percent to the opening price advised in June 2008[31].

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[29] UDV media release (2016). *Dairy farmers champion transparency in proposed industry Code.* http://www.vff.org.au/vff/Media_Centre/Latest_News/Media2016/Dairy_farmers_champion_transparency_in_proposed_industry_Code.aspx

[30] ADF media release (2016). *ADF held important meeting with dairy leaders*. 29 September. http://www.australiandairyfarmers.com.au/media-releases

[31] MG supplier letter dated 18 December 2008.

5.3 Milk price reduction in FY16

Dairy farmers and processors around the world have been hit by a series of unprecedented conditions that have seen the commodity price for dairy remain lower for longer than ever before (see Attachment C).

During FY16, a surge in European dairy production following the removal of dairy quotas for the first time in 30 years, a continuation of Russian trade bans and a slowdown in demand out of China converged to create a 'perfect storm', driving commodity prices down to historic low levels, where they have remained for a longer period than expected or predicted. Dairy returns are continuing to be affected by global over supply, which is estimated to be in excess of six billion litres of milk[32].

Forty percent of Australia's milk production is exported and therefore exposed to prevailing global dairy commodity prices. The domestic Australian market is also exceptionally competitive, with international dairy groups also able to access this market via free trade agreements.

Nationally, this has been further complicated by volatility in the Australian Dollar and its impact on FX rates.

Attachment D illustrates the commodity price and cost increase impacts on the FY16 FMP compared to FY15.

5.3.1 Chronology of events

The Board recognises and fully understands the depth of issues that have been faced by suppliers. MG has at all times taken its disclosure commitments seriously. The Board considers that it acted appropriately on the information before it and in the best interests of the suppliers/shareholders at all times.

August 2015

1. At the time of announcing its Full Year results for FY15 MG stated that the impact of commodity prices meant that the full year farmgate milk price was more likely to be in the range of between \$5.60 and \$5.90 unless there was a strengthening of commodity prices during the balance of FY16.

   At that time, MG said that it was confident that a global supply response was starting to emerge as a result of the low dairy commodity price environment. This statement was supported by third party analysts and forecasts[33].

February 2016

2. At the time of MG's Half-Year Results in February MG disclosed that its ingredients business sales had under-performed but that the dairy foods milk products business had materially out-performed, partially offsetting the ingredients revenue shortfall.

   As explained to the market at the time, the ingredients business segment revenue decline (-13 percent to \$517 million) was partially offset by the material

[32] Rabobank. Estimated excess global inventories of 4 billion litres of Liquid Milk Equivalent (LME) plus EU intervention stock of approximately 2 billion litres of LME.
[33] MG FY15 Full Year Results Presentation, Slide 12.
http://www.mgc.com.au/media/27870/Murray-Goulburn-FY15-results-presentation-31-August-2015.pdf

outperformance of the dairy foods business segment revenue growth (+27.2 percent to $694.7 million) during the first half[34].

3. MG also advised the market that the full year forecast of the farmgate milk price was now $5.60 (at the bottom end of the previous guidance range) due to weak commodity prices. MG advised that this was subject to there being no further material deterioration in dairy commodity prices or unfavourable changes to the current AUD:USD exchange rate[35].

4. MG also advised that the weakness in dairy commodity prices was expected to result in the Ingredients and Nutritionals segment materially underperforming what had been forecast for FY16, with this underperformance expected to be partially offset by the growth in the Dairy Foods segment resulting from the acceleration of production mix shift and the expected strong performance of domestic and international ready to consume dairy food product sales. The strong performance of AMP sales in China was making a significant contribution to offsetting the impact of the weak commodity prices.

5. At the time of MG's half year results, MG advised that growth in sales of outbound AMP had experienced significant growth from the previous half-year[36]. During FY16 MG had experienced capacity constraints in the production of AMP and had approved capital expenditure to increase its production capacity to allow it to meet the expected continued strong demand for these products. This occurred with the additional capacity coming on line in early 2016.

April 2016

7. On 7 April 2016, Chinese regulations changed unexpectedly, with various government bodies issuing a 'positive' list for products that could be sold in China via the 'cross border' channel. Products not included on the list were not permitted to be sold via the cross border channel. UHT and AMP were not included on the list although it was initially thought that they may have been permitted under an alternative category. MG's immediate view was this change would not materially impact on our business.

8. Ultimately, until additional regulatory clarity was provided Chinese traders chose to largely withdraw MG's products from most sites. On 15 April 2016, the government published a revised 'positive' list, which specifically included UHT and AMP. Our products were immediately restored to all channels.

April Board Meeting 2016

9. The Board had its first opportunity to consider the March 2016 sales of AMP at the April Board meeting and was concerned by the run rate for sales figures to date and the required sales of AMP for the remainder of the financial year. The Board requested management to investigate April's sales, and review expectations for the full year. Management requested that the Unit

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[34] MG FY16 Half Year Results presentation. http://www.mgc.com.au/media/31721/Murray-Goulburn-HY16-Results-Presentation-29-February-2016.pdf
[35] MG ASX Announcement, *Murray Goulburn announces First Half 2016 Results*. 29 February 2016. http://www.mgc.com.au/media/31841/Murray-Goulburn-HY16-Results-announcement-29-February-2016.pdf
[36] MG FY16 Half Year Results presentation. http://www.mgc.com.au/media/31721/Murray-Goulburn-HY16-Results-Presentation-29-February-2016.pdf

Trust be placed into trading halt while it undertook a review of the impact of market conditions on the FY16 outlook.

10. Over the ANZAC day long weekend, AMP forecasts were reassessed and lowered by management. Given the high margin on these products, this had a financial impact. The A$ had also risen approximately 10 percent from the time of the 1H16 results, further reducing revenue on international sales against budget[37].

11. On 27 April 2016, MG made an announcement to the ASX setting out a trading update and revised outlook for FY16. The announcement outlined the revised NPAT, the factors that had impacted performance and the need for reduced farmgate milk pricing[38]. Following the trading halt there were extensive senior management changes with an interim CEO[39] and CFO[40] being appointed.

The farmgate milk price reduction announced in April only applied to the Southern Milk Region. Milk pricing in MG's NSW region remained unchanged in FY16 and therefore the Milk Supply Support Package did not apply in this region (see Section 6).

6. *Introduction of the Milk Supply Support Package (MSSP)*

Due to the timing of the FMP reduction being announced so late in the year the MG Board considered all options around how to manage the opening price reduction to minimise the impact on all suppliers. The two major options for the Board were to reduce the opening price by the full amount required (from $5.60 / kgms to $4.75 / kgms) or to minimise the impact on suppliers by paying higher cash prices via the introduction of a support package for suppliers.

Under the first option - the full impact of the price reduction would have resulted in a weighted average price for the final two months of FY16 of $1.30 per kgms, or less than 10 cents per litre. For some suppliers this would have meant no financial returns in these months, which would have been particularly devastating for Autumn calving herds who would have been entering two of their higher milk production months.

It was the Board's view that it would not have been reasonable or fair to implement the full reduction in the opening price. As a result, the Milk Supply Support Package (MSSP) was introduced. The MSSP was designed to provide a milk support payment so that suppliers received payments during FY16 equivalent to an estimated weighted average available FMP of $5.47 per kgms[41] for the full year.

The Board was aware of the difficult conditions many MG suppliers faced at that time, particularly as the effect of very dry conditions (and water prices) from El Nino persisted into April across much of MG's Southern Milk Region. In light of this the MSSP was designed to:

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[37] MG ASX Announcement, *Trading update and revised outlook.* 27 April 2016. http://www.mgc.com.au/media/33306/1-asx-announcement-trading-update-and-revised-outlook.pdf
[38] MG ASX Announcement, *Trading update and revised outlook.* 27 April 2016. http://www.mgc.com.au/media/33306/1-asx-announcement-trading-update-and-revised-outlook.pdf
[39] MG ASX Announcement, *Murray Goulburn announces management changes*. 27 April 2016. http://www.mgc.com.au/media/33307/2-asx-announcement-management-changes.pdf
[40] MG Supplier Letter, 10 June 2016. http://www.mgc.com.au/media/34784/supplier-letter-appointment-of-interim-chief-financial-officer.pdf
[41] MG Supplier Briefing dated 27 April 2016. http://www.mgc.com.au/media/33308/chairmans-supplier-briefing-murray-goulburn-announces-revised-forecast-appoints-interim-ceo.pdf

- Support the sustainability of dairy businesses that underpin MG's milk supply in the long term;
- Support suppliers' cash flows in the near term while the difficult dairy conditions persisted by not requiring suppliers to incur a full reduction in the opening price for May and June 2016 to offset the higher FMP that had already been paid so far this year;
- Prudently manage MG's capital and balance sheet, and avoid permanent indebtedness arising from any support package (as well as ensuring that the financial cost of support was recovered over time from suppliers);
- Ensure that MG's strategy and growth investment program were not impacted; and
- Ensure that the support package did not distort the operation of the PSM to the disadvantage of unitholders and shareholders[42].

The MSSP is currently funded by the MG balance sheet. MG did not apply a loan against individual suppliers and did not apply terms and conditions (such as a required commitment to supply) retrospectively to suppliers. The MSSP was designed to assist suppliers by spreading the impact of the FY16 milk pricing reduction across the three years after FY16. The range of the MSSP at the time of this announcement was expected to be between $140 million and $190 million[43].

On 28 June 2016 MG announced a net opening FMP of $4.31 per kgms, after application of the MSSP repayment amount of $0.14 per kgms (one cent per litre). As FY16 was not yet complete and the final MSSP amount could not yet be determined, MG elected to reflect an initial MSSP repayment amount of $0.14 per kgms, with the balance to be recouped from future step-ups[44].

Following the announcement of MG's full year results for FY16, MG reported a final FMP for FY16 of $4.80 per kgms. As a result, the total support provided through the MSSP was $183 million and suppliers were delivered an average cash price for their milk in FY16 of $5.53 per kgms, not $4.80 per kgms. This payment followed two consecutive years of FMP above $6.00 per kgms[45].

Since the introduction of the MSSP it has become very clear that it is not considered by suppliers to have addressed their most significant concerns and is reducing MG's competitiveness whilst the sector continues to experience low commodity prices. This was not its intent and the MG Board is very mindful of continuing to do what it can to help address supplier concerns. As a result, on 5 September 2016 a review of all options was announced with a view to providing a better solution to support suppliers in the long-term interests of suppliers and MG. The Board is proceeding with this review in a timely manner and expects to be in a position to communicate further with suppliers by the end of October 2016[46].

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[42] MG Supplier Briefing dated 27 April 2016, page 4. http://www.mgc.com.au/media/33308/chairmans-supplier-briefing-murray-goulburn-announces-revised-forecast-appoints-interim-ceo.pdf

[43] MG supplementary supplier briefing, 29 April. Page 3. http://www.mgc.com.au/media/33536/supplementary-supplier-briefing-revised-forecast-and-introduction-of-mssp.pdf

[44] MG ASX Announcement, *Murray Goulburn sets farmgate milk pricing for 2016-2017*, 28 June 2016. http://www.mgc.com.au/media/36232/asx-announcement-murray-goulburn-sets-farmgate-milk-pricing-for-2016-17.pdf

[45] MG ASX Announcement, *Murray Goulburn announces results for the Full Year ended 30 June 2016,* 24 August 2016. Page 2. http://www.mgc.com.au/media/39102/murray-goulburn-announces-results-for-the-full-year-ended-30-june-2016.pdf

[46] MG Supplier letter, *Murray Goulburn actively reviewing options to support Suppliers*, 5 September 2016.

Given the structure of the MSSP, and that suppliers do not have any individual debt in relation to the MSSP, they are free to move to another processor, subject to any separate fixed term contract arrangements that may be in place.

In MG's FY16 full year results announcement on 24 August 2016 it was stated that the Board and management remained focused on mitigating the impact of the prevailing market conditions and were implementing a series of decisive actions, which included:

- Reductions in working capital by approximately $150 to $160 million, $51 million of which was achieved by the end of FY16, through lowering MG's receivables with the remaining $100 million to $110 million reduction in FY17 related to inventory.
- An organisational review to reduce MG's overheads of between $50-60 million on an annualised basis, primarily from reduced headcount (predominantly positions associated with head office and MG Trading), procurement benefits, and systems improvement. MG expects to deliver $10 million to $15 million of these savings in FY17, net of costs.
- Revisiting our capital projects initiatives and tailor plans to better suit prevailing market conditions. Changes to our planned dairy beverages investment will see a reduction in capital spend for growth, and protect the business from underwhelming investment returns[47].

Improvements in global commodity prices early in the FY17 season has enabled MG to offer a modest step-up in the full year weighted average available forecast FMP from $4.80 / kgms to $4.88 / kgms (before deducting the MSSP amount of $0.14 / kgms) on 13 September 2016 for suppliers[48], with MG committed to passing through any additional improvements in the market conditions to suppliers with future step-ups.

7. *Future of the Australian dairy industry*

Despite current market conditions MG considers that the long-term outlook for the industry remains positive.

Given the continued global oversupply in the dairy market, a continued contraction is forecast for the Australian dairy sector. Dairy Australia's current forecast for 2016 / 2017 is for a reduction in the national milk production of 5 percent to around 9.06 billion litres[49].

The latest Rabobank Dairy Quarterly reports that global milk production is tightening quickly, and, in the face of firm domestic demand, surplus for exports has reduced sharply[50]. However, at the moment the price recovery is being driven by a fall in supply so price increases will be limited given continued weak global demand at present and significant global stocks.

Longer-term outlooks still remain favourable for the dairy sector. Global dairy production is forecast to grow, on average, 1.9 percent from 2014-2023, which is lower than the growth rate experienced in the preceding decade (2.2 percent). However, global dairy demand is forecast to continue to grow over the next decade as higher economic growth will result in

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http://www.mgc.com.au/media/39741/supplier-letter-murray-goulburn-actively-reviewing-options-to-support-suppliers.pdf
[47] ASX announcement, *Murray Goulburn announces results for the Full Year ended 30 June 2016*, released 24 August 2016. www.mgc.com.au
[48] MG Supplier letter, *MG announces a step-up and increase in forecast FY17 Farmgate Milk Price*, 13 September. http://www.mgc.com.au/media/40329/supplier-letter-mg-announces-a-step-up-and-increase-in-forecast-fy17-farmgate-milk-price-final.pdf
[49] Dairy Australia (2016). *Dairy Situation and Outlook Report – October 2016.* Page 24.
[50] Rabobank (2016). *Dairy Quarterly Q3 2016 – September.* Page 1.

consumers looking for additional protein sources[51]. With the growth in demand for dairy in China and the ASEAN-6 nations (Indonesia, Thailand, Malaysia, Singapore, the Philippines and Vietnam) well above the global average, there is an opportunity for Australia to capture some of this demand.

As noted in Section 3, the presence of a strong dairy co-operative has a positive impact on the FMP when compared to markets without a co-operative[52]. As a major co-operative and the largest dairy food company in Australia, MG will continue to play an important role in the future of the Australian dairy industry.

MG is well positioned to capitalise on the growth opportunities for dairy products globally. There is no change in focus from MG toward a strategy that sees a focus on pursuing value-added dairy products (that is, achieving a premium above a commodity return for our products). This is a strategy that continues to receive the support from our supplier shareholders and investors. However, MG announced in our full year results for FY16 that the Board and management have refocussed on execution, encompassing operational excellence, innovation and maintaining a strong balance sheet position.

MG's Board and management will continue to address the poor market conditions and to position MG for the opportunities to capitalise on the projected growth in dairy demand globally. This is being achieved through the following measures:

- **Investment for the future** – MG is committed to investing across three key dairy growth categories: consumer cheese, nutritional powders and dairy beverages.
    - Consumer cheese cut and wrap facility - construction of MG's new state-of-the-art facility in Cobram (Victoria) is now complete and commissioning is underway. This investment will deliver a step change in MG's capability in this segment, while delivering substantial cost benefits of approximately $10 million per annum above operating margins.
    - Nutritionals investment – in March 2016 MG announced its intention to proceed with plans to build a new state-of-the-art nutritionals facility. Plans for this investment are underway with construction expected to commence in FY17, subject to Board approval.
    - Dairy beverages investment – MG is currently reviewing the optimal investment approach given the global over supply that developed in FY16 in fluid milk products, in particular, UHT. As a result, pricing in MG's key export markets for UHT reached very low levels. MG will be in a position to report on our findings in the coming months.
- **Decisive actions to address market conditions**
    - Reduced working capital by approximately $150 million to $160 million, with $51 million achieved in FY16 and the balance to be achieved in FY17.
    - Completion of an organisational review of MG's overheads, which will deliver between $50-60 million on an annualised basis ($10 million to $15 million of these savings are expected in FY17); and
    - Tailoring our investment plans to suit the prevailing market conditions.

[51] ANZ (2015). *Australian Dairy Industry*, September. Available at www.bca.com.au. Page 3.
[52] European Commission (2012), *Support for Farmers' Co-operatives*. DG Agriculture and Rural Development report, pages 76-78.
Source: http://ec.europa.eu/agriculture/external-studies/2012/support-farmers-coop/fulltext_en.pdf

- Considerable focus will continue in FY17 to ensure **MG's balance sheet remains strong** and with prudent levels of debt[53].

MG is committed to working with suppliers, State Dairy Farming Organisations (SDFOs), Australian Dairy Farmers (ADF) and other processors to improve the industry for all participants and to exploring ideas for improving Australia's national competitiveness and pricing transparency, including the introduction of the proposed commodity milk price index[54]. The commodity milk price index should be independently managed and tailored for the benefit of all participants in the Australian dairy industry.

8. Responses to the Inquiry Terms of Reference

MG provides the following specific responses to the Terms of Reference:

(a) the Australian dairy industry is facing an unprecedented crisis with the retail cost of bottled milk per litre often less than the retail cost of bottled water

Retail milk prices are determined by the supermarkets. Retail $1 per litre milk was first initiated by Coles supermarkets in 2011. Other major supermarkets soon followed by making similar cuts to the retail pricing[55].

It was not until April 2013 that MG signed a landmark 10-year agreement with Coles to supply private-label milk into their supermarkets in NSW and Victoria from July 2014[56]. The agreement also lead to Devondale milk and cheese being ranged in Coles supermarkets and enabled MG to invest $160 million into a state-of-the-art daily pasteurised factories in Laverton and Erskine Park[57]. Prior to this agreement MG did not have exposure to the domestic daily pasteurised market.

The milk price paid to MG by Coles locks in a margin that delivers additional profits to MG farmer-suppliers over the life of the contract. The margin is not affected by price fluctuations in international dairy markets or movements in the Australian currency and the contract contains rise and fall provisions to protect the margin farmers receive[58].

There is no link between Coles' shelf price and the price paid to MG farmers under our contract. Under competition law MG cannot dictate the retail prices that retailers charge. Of the 3.6 billion litres MG processes annually, approximately 170 million litres is directed to private label daily pasteurised milk, which is less than 6 percent of the total.

To clarify, MG has received a better return for the milk solids sold via daily pasteurised milk than it would have received if these solids were sold into many of our other dairy markets.

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53 MG ASX Announcement, *Murray Goulburn announces results for the Full Year ended 30 June 2016,* 24 August 2016.
http://www.mgc.com.au/media/39102/murray-goulburn-announces-results-for-the-full-year-ended-30-june-2016.pdf

54 MG Supplier letter dated 16 August 2016.
http://www.mgc.com.au/media/38622/supplier-letter-post-canberra.pdf

55 Dairy Australia (2016). *Dairy situation and outlook report – June 2016*. Page 16.

56 MG media release (2013), *Devondale enters daily pasteurised milk market to boost farmer returns.*
http://www.mgc.com.au/media/4827/130410-MG-Coles-release.pdf

57 MG media release (2014), *New $80 million Melbourne plant secures Devondale's place in daily chilled milk market*, page 3.
http://www.mgc.com.au/media/18594/ddbc-media-release-and-fast-facts-final.pdf

58 MG media release (2013), *Devondale enters daily pasteurised milk market to boost farmer returns.*
http://www.mgc.com.au/media/4827/130410-MG-Coles-release.pdf

(b) Australian milk production since deregulation over 15 years has decreased from approximately 11 billion litres per year to 9 billion litres per year – a 20 per cent decrease, while New Zealand milk production has almost doubled

There are multiple factors that have contributed to the reduction in milk production since the peak of 11.3 billion litres in 2001 / 2002[59]. These include[60]:

- The structural adjustment associated with industry deregulation. The removal of incentives for over-production in 2000 encouraged dairy farms to become more productive (to ensure viability in the absence of government assistance). In some cases, the land, capital and labour previously used in dairy farming was reallocated to more productive uses. These developments have led to fewer, but larger and more productive, dairy farms in Australia.
- The impact of severe droughts in the southeast of Australia (2002-03 and 2006-07), and cyclone and flood events in northern Australian (2006-07), on water availability, pastures and fodder.
- The resources investment boom, which resulted in an appreciation of the Australian Dollar and had a significant impact on the competitiveness of agricultural exports (including dairy). Moreover, strong competition for resources (such as labour) from the mining sector has implications for other domestic industries, including the dairy product manufacturing sector.
- The average age of Australian dairy farmers has been increasing: up from 48 in 1990 to 53 in 2014. There is some evidence that dairy farmers approaching retirement prefer to repay farm debt, which can contribute to lower levels of investment in herd numbers
- To a lesser extent, the relative attractiveness of exporting live dairy heifers.

Since economic integration with New Zealand in 1983, and particularly since deregulation in 2000, the Australian dairy industry has been exposed to global competition. Experience elsewhere, and Australia's own circumstances, suggest the dairy sector requires a strong, at-scale, cooperative to drive needed improvement.

(c) in 2011, a report of the Senate Economics References Committee recommended that producers' contracts with dairy farmers should offer a clear, consistent formula for milk pricing with unambiguous conditions

We undertake periodic reviews of our farmgate milk pricing structure. In 2012 this was comprehensively reviewed and significant changes were made at that time. These changes are summarised in Section 4.3 of this submission.

MG publishes its Standard Milk Payment Terms for milk supply on its website and discloses the milk pricing each season. In July 2016 all suppliers also received an income estimate for their farm business clearly showing the milk price forecast for their farm business.

As stated earlier in the submission most suppliers to MG are not contracted for a fixed term but are members of the Co-operative and supply under the Standard Milk Payment Terms.

The Standard Milk Payment Terms are approved by the Board as elected by the Co-operative members. The Board and management regularly have dialogue with suppliers about the milk supply terms and how they can be improved.

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[59] ANZ Study (2015), *Australian Dairy Industry*, page 11. September.
Source: http://www.bca.com.au/publications/reports-and-papers (accessed on 6 October 2016).
[60] Productivity Commission (2014), *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing*, Research Report, Canberra, September 2014, page 96.

MG will continue to have dialogue with suppliers about how to best design the milk payment system. Although MG's pricing mechanism has worked effectively for many decades and through many industry cycles, we do believe there is scope to improve the transparency of pricing for Australian dairy farmers and support the establishment of a commodity milk price index.

While the final milk price must reflect market conditions we are looking at our internal processes to ensure the market signals are reflected back to our milk price as early as possible. The Co-operative has to pay a FMP that reflects market conditions.

MG is already engaging with the dairy farming and processing sector on concerns raised about contractual terms and conditions, and will continue to proactively be involved in these discussions.

(d) five years later, the livelihoods of up to 40 per cent of Australian dairy farmers are under threat because of imposed, retrospective debt, helped by unclear, inconsistent milk pricing contracts with ambiguous conditions

Dairy farmers and processors around the world are struggling with a set of unprecedented conditions and a commodity cycle that has not been seen before; where prices have persisted at historical lows for a protracted period.

During FY16, a surge in European dairy production following the removal of dairy quotas for the first time in 30 years, a continuation of Russian trade bans and a slowdown in demand out of China converged to create a 'perfect storm', driving commodity prices down to historic low levels, where they have remained for a longer period than anyone expected or predicted. This has been made all the more difficult by a volatile Australian Dollar.

Dairy returns are continuing to be affected by global over supply, which is estimated to be in excess of six billion litres of milk[61]. With 40 percent of Australia's milk production exported, the dairy sector is therefore exposed to prevailing global dairy commodity prices. The domestic Australian market is also exceptionally competitive, with international dairy groups able to access this market via free trade agreements.

To be clear:

- MG has taken on the debt associated with the MSSP, currently records this against the milk pool and has not imposed debts on individual suppliers. Any supplier who leaves MG does not have any ongoing liability in respect of repayment of the MSSP. The review regarding the MSSP relates to the reduction of the MSSP total amount over the coming years.

- MG's opening price reflects the Available Southern Milk Region FMP. This is the average price available to the average supplier in the Southern Milk Region if they supply premium quality milk for the duration of the entire financial year. When MG announced its opening price reduction in April in accordance with its rights under the Standard Milk Payment Terms it announced a reduction in the average annual price payable. This was reflected in the amount paid over the final two months of the milk year.

Reductions in opening milk price are rare but not unprecedented.

[61] Rabobank. Estimated excess global inventories of 4 billion litres of Liquid Milk Equivalent (LME) plus EU intervention stock of approximately 2 billion litres of LME.

MG's Standard Milk Payment Terms are available on its website and set out a clear and comprehensive set of terms and conditions relating to the supply of milk. MG does not consider these terms to be ambiguous.

(e) Australia's largest dairy producer and milk price setter, Murray Goulburn, has been allowed to force onto its suppliers unprecedented milk contracts or agreements ensuring that dairy farmers are burdened with retrospective debts ranging from tens to hundreds of thousands of dollars

As stated above, MG's pricing structure was extensively reviewed in 2012, as summarised in Section 4.3.

The terms and conditions which apply to MG suppliers are explained in Section 4.4 of this submission. The events associated with the price reduction in April 2016, and the payment of FMP and support provided through the MSSP, is provided in Sections 5.3 and 6 respectively. MG reiterates that no debts have been imposed on farmers.

(f) Australian rural and regional communities face losing millions of dollars and thousands of jobs if a fair, long term solution to Australia's dairy crisis is not found

What is occurring in the dairy industry is a result of supply-demand dynamics that occur in a global trading environment. As an industry we are currently experiencing a trough in the typical business cycle. However, we recognise that this doesn't lessen the concern and difficulties faced by many dairy communities across Australia.

As a Co-operative member, suppliers receive a step-up to reflect an improvement in our FMP forecast when market conditions (increase in commodity price; decrease in exchange rates) improve, as was evidenced on 13 September 2016[62].

MG continues to play a significant role in regional and rural Australia. In addition to our approximately 2,200 farmer-suppliers located across Victoria, New South Wales, South Australia and Tasmania, we also have 2,350[63] employees at 10 processing plants and working in ancillary businesses including MG Trading stores.

We are currently implementing a range of initiatives to improve the profitability of MG and reduce costs so as to generate better returns for our farmer suppliers.

(g) the mental and physical health of dairy families and workers are being unnecessarily and unfairly placed in jeopardy as politicians, legal and industry experts argue about possible solutions to the dairy crisis.

We acknowledge this is a very challenging time for our suppliers. The health, safety and wellbeing of the MG's dairy farmer suppliers, their families and employees is of the utmost importance to us. MG is doing everything within its power to control and reduce cost, generate additional efficiencies and improve cashflow, with any savings achieved to be passed on to farmers in the form of a higher FMP.

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[62] MG Supplier letter, *MG announces a step-up and increase in forecast FY17 Farmgate Milk Price*, 13 September. http://www.mgc.com.au/media/40329/supplier-letter-mg-announces-a-step-up-and-increase-in-forecast-fy17-farmgate-milk-price-final.pdf

[63] Employee numbers are expressed on a Full Time Equivalent (FTE) basis (as at 11 October 2016).

In addition, MG has contributed up to $1 million toward the *Tactics for Tight Times* program as part of the work of the Victorian Dairy Industry Taskforce[64], which is providing a range of initiatives to support dairy farmers including financial and emotional wellbeing counselling. MG participated in the Federal Government's Dairy Industry Symposium and is committed to playing an active role in all initiatives aimed at improving the financial returns available for dairy farmers.

MG is also providing interest free and deferred payment finance to support suppliers. This includes extended terms for fodder, pasture re-sowing and stock water management.

8.1 Terms of Reference

The legality of retrospective elements of milk contracts

MG's Milk Supply Support Package was introduced as the best option to support farmers at the time of the FMP reduction in April 2016, with many already struggling with additional costs due to the exceptionally dry seasonal conditions. The MSSP was implemented via the rights MG has under its standard milk payment terms to set the opening price.

The reduction in the opening price was done by MG in compliance with the terms and conditions of the milk contract.

The behaviour of Murray Goulburn

As detailed in Section 5.3 of this submission MG's Board stands by the decisions made in the circumstances. The Board is of the view that the correct disclosure process and protocol has been followed with respect to all of its announcements.

Furthermore, MG has acted in accordance with its contract terms in reducing the opening milk price. MG's actions have been driven by legitimate commercial reasons and this situation has occurred in the past – as recently as 2008/2009. Reductions in milk price are very regrettable but sometimes unavoidable due to market conditions.

These matters are currently under review by both the ACCC and ASIC and MG is co-operating fully with these investigations.

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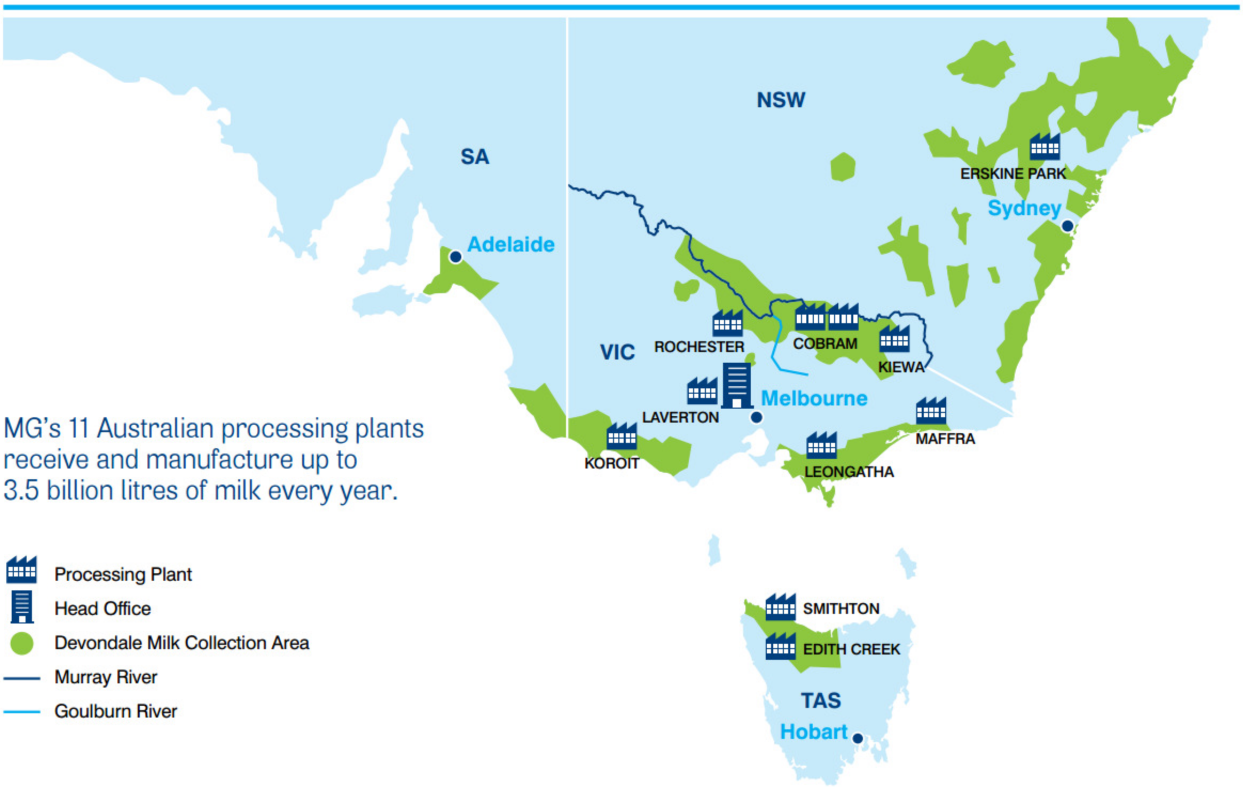
[64] Victorian Government media release, *Government and industry unite for dairy farmers, 24 May 2016.* http://www.premier.vic.gov.au/government-and-industry-unite-for-dairy-farmers/

Attachment A – MG's Australian manufacturing footprint and milk collection regions

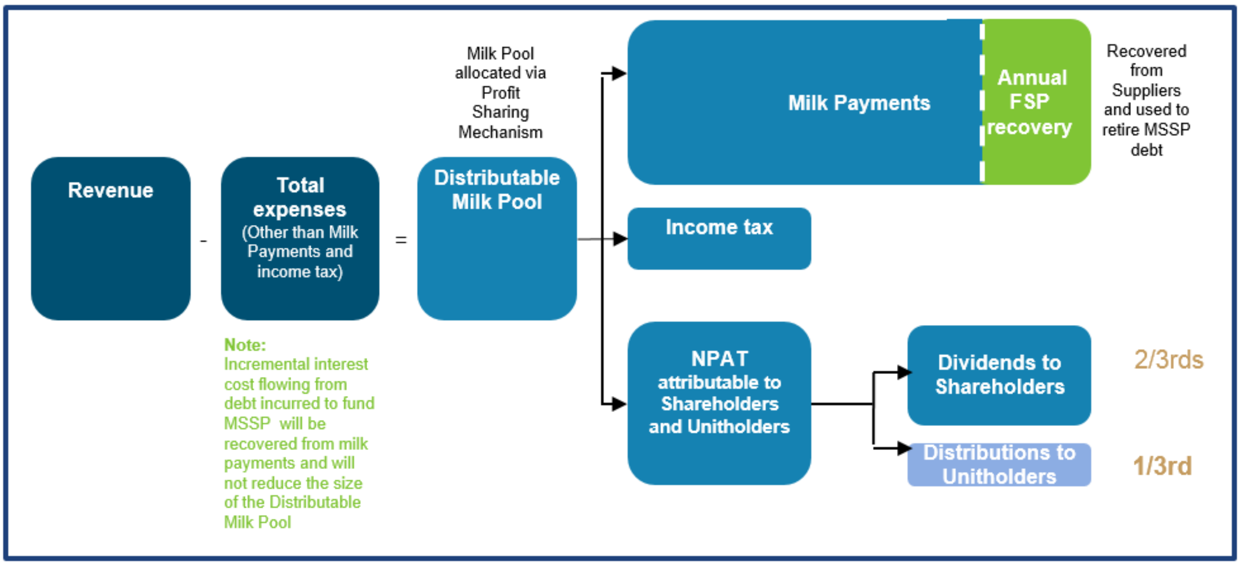
Dairy regions and processing plants



Source: MG's Annual Report 2016 (Page 9)[65]

65 http://www.mgc.com.au/media/40795/murray-goulburn-annual-report-2016-web-.pdf

Attachment B – Illustration of PSM including Farm Support Payment (FSP)



Note:

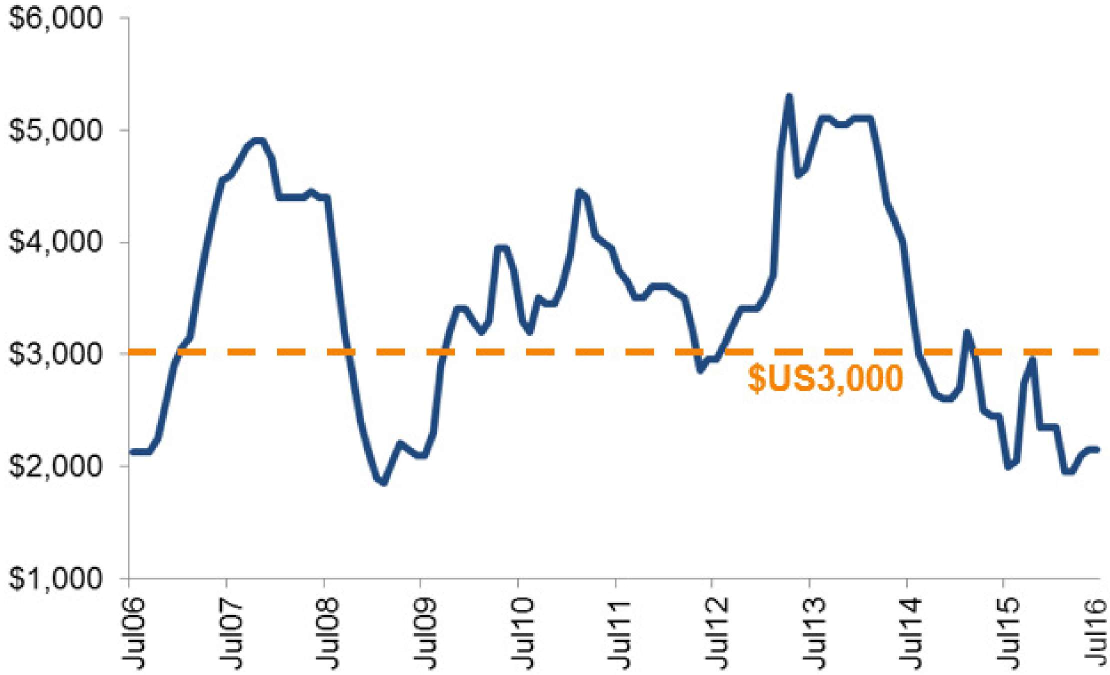
- The mechanism specifically retains smaller amount for investors when FMP is low
- The **minimum amount 3.5 percent** is forecast to be aside for NPAT in FY17
- This means 96.5 percent of the remaining pool is retained by farmers in the form of Milk payments.
- Investors accept this as an inbuilt support for suppliers.

Source: MG Supplier Information Session presentation (Slide 7)[66].

[66] http://www.mgc.com.au/media/38293/presentation-supplier-information-session-july-2016.pdf

Attachment C – Commodity pricing and FMP comparisons

Full Cream Milk Powder
(Oceania FOB USD / MT – 10 year to June 2016)

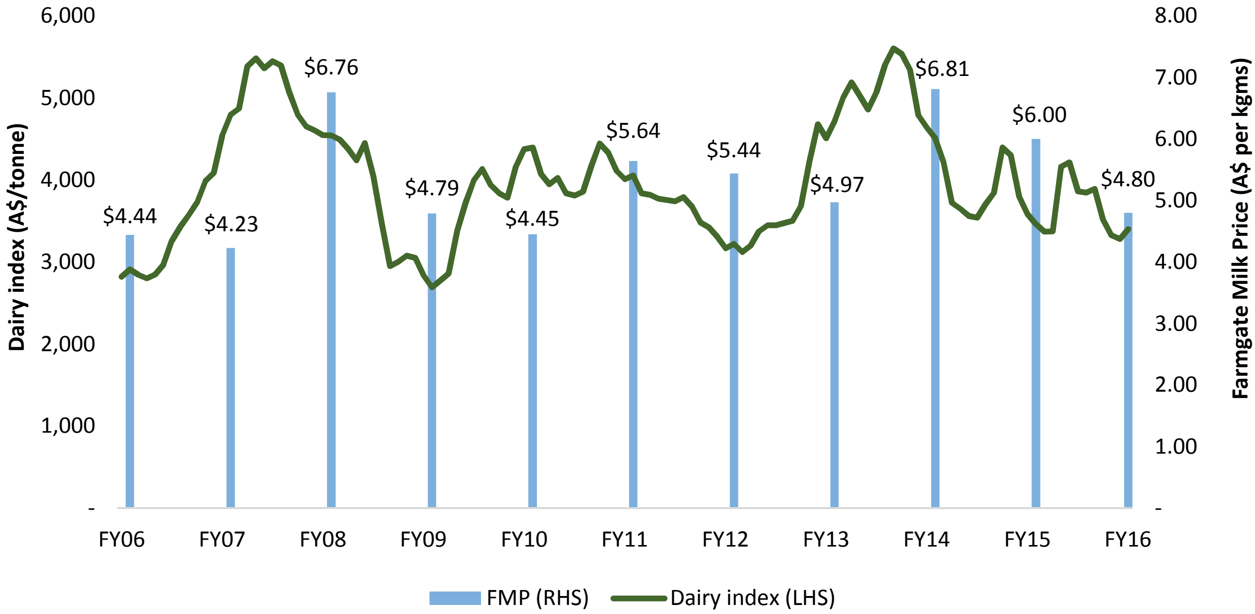


Source: US Department of Agriculture, Dairy Australia. Prices are observed, not MG's achieved prices[67].

Note: The orange dotted line is included to demonstrate the duration of time that Full Cream Milk Powder has not materially exceeded $3,000 US per metric tonne.

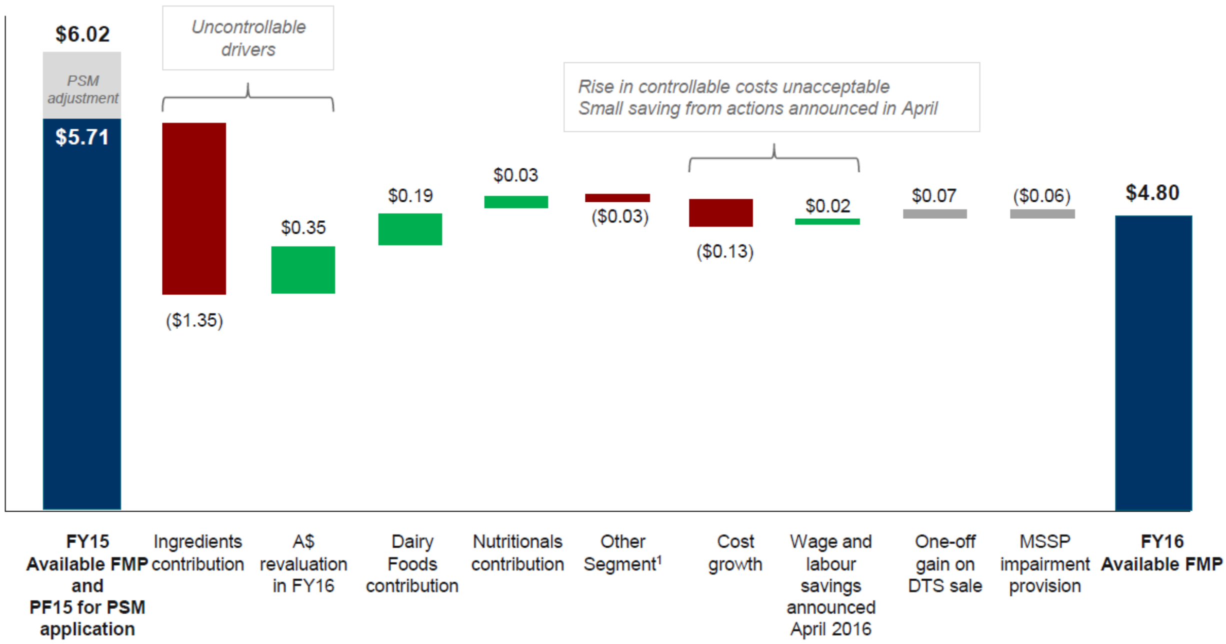
[67] MG's 2016 full-year results presentation (Slide 5), http://www.mgc.com.au/media/39103/fy16-full-year-results-presentation.pdf

Historical dairy commodity prices and MG milk prices (FY06 – FY16)



Note: Dairy index is calculated as the monthly average of Whole Milk Powder, Skim Milk Powder, butter and cheese pricing from Dairy Australia information, shown with three-month lag.

Attachment D – Available Southern Milk Region (SMR) FMP per kgms – FY16 vs FY15



Note: See appendix for FY15 and FY17 SMR milk solids, Distributable Milk Pool[68]. Segment price movements include milk revaluation expense.

1. Contains contribution from MG Trading, Milk Broking, and other one off costs.

The graph demonstrates the key factors contributing to MG's available FMP in FY16, both positively and negatively. In FY15 MG paid out an available FMP of $6.02 / kgms. The graph has included what the PSM adjustment would have represented if applied in FY15, noting that it was introduced following MG's capital raising completed in July 2016 (FY16).

The most significant impact on the FY16 available FMP was the low commodity price, resulting in a negative contribution from our Ingredients business against the budget. Like foreign exchange rates, the commodity price is outside MG's control.

The other more significant area was an increase in the cost growth, which is not uncommon for a business going through a growth phase. Measures announced in our FY16 Full Year results on 24 August 2016 will help to improve the value in FY17.

MG saw continued positive contribution from the Dairy Foods and Nutritionals business, but they were not enough to counter the negative impact of commodity prices.

[68] MG 2016 Full-Year Results presentation (Slide 4). http://www.mgc.com.au/media/39103/fy16-full-year-results-presentation.pdf