

**Simmonds, Martine**

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**From:** Philp, Susan  
**Sent:** Friday, 6 January 2006 8:52 AM  
**To:** Simmonds, Martine  
**Subject:** FW: Submission in reply to Dairy WA Draft Determination  
**Attachments:** 060105 Cover Letter to ACCC with submission on Draft Determination.doc; Submission in response to Draft Determination on Dairy Western Australia.doc

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**From:** Jenni Mattila [mailto:JenniMattila@bigpond.com.au]  
**Sent:** Thursday, 5 January 2006 10:46 PM  
**To:** O'Gara, Siobhan; Philp, Susan  
**Subject:** Submission in reply to Dairy WA Draft Determination

Please find attached covering letter and Submission in response to WA Dairy Draft Determination taking into account changed ACCC policy as reflected in the ADF Draft Determination. We confirm our clients continue to request that their revised application be dealt with formally. As previously agreed supporting documents will be sent by Express Post.

**Jenni Mattila**

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5 January, 2006

Mr Scott Gregson  
Adjudication Branch  
Australian Competition & Consumer Commission  
PO Box 1199  
**DICKSON ACT 2602**

Your ref: A90961/A90962

Dear Mr Gregson

**Applicant Response to Draft Determination of Dairy WA Application for Authorisation nos. 90961 and 90962**

Please find attached the Applicant's response to the ACCC's Draft Determination dated 17 October 2005. Supporting documents will be forwarded by Express Post as agreed with Ms Philp.

The Applicant has previously agreed to withdraw the application for boycott powers. The Applicant has revised its submission in the light of the ACCC's change in policy reflected in the Australian Dairy Farmers Limited Draft Determination dated 15 December, 2005 (the ADF Draft Determination).

The ADF Draft Determination indicates a significant change in ACCC policy that clearly impacts upon the WA Dairy Draft Determination. The Applicant has as far as possible adopted an approach consistent with this revised policy.

The Applicant requests that the final Dairy WA Determination take into account these changes and the adjustments made as a consequence to the Dairy WA Application.

As a number of issues in the ADF Draft do not specifically deal with issues arising in the Dairy WA application for Authorisation we confirm that we believe that it continues to be necessary to provide Dairy WA with a specific authorisation so that Dairy WA may proceed with confidence with its amended proposal with a clear understanding of specific conditions that would apply to it.

The applicant therefore has responded to the WA Dairy Draft Determination by specifically dealing with the proposed conditions included in the ADF Draft Determination.

Dairy WA has also previously provided survey data from November 2005 to the ACCC in relation to the WA dairy industry to support our consistently held point that the WA dairy industry is indeed in crisis.

The WA dairy industry has been severely damaged by the interpretation of the original ADF Authorisation that compounded the existing monopsony situation. The Applicant also wishes to reconfirm that two processors control 70% of the WA dairy supply and pay a similar average price of 28cents per litre resulting in a continuing lack of competition for dairy farmers' milk in the WA market.

We would be happy to discuss any further questions the ACCC may have in relation to the attached submission or the impact any proposed conditions would have on the Applicant's proposal prior to the ACCC's final Determination.

Yours faithfully,

*Jenni Mattila*

**Jenni Mattila**

## **Submission in response to Draft Determination on Dairy Western Australia's application for Collective Bargaining Authorization no.90961**

### **Summary**

The Application by Dairy WA and the Draft Determination of Application 90961 has been overtaken by a change in ACCC policy as expressed in Draft Determination A90966 of the Australian Dairy Farmers Limited.

Dairy WA requests that this change in ACCC policy be taken into account in reviewing the draft determination but requests that the clarification sought in this submission be included in the Dairy WA authorization response.

- Please note that as a result of Proposed Condition 3 and 7 of the Draft ADF determination Dairy WA seeks to amend its response to Question 12 of the Questions and Answers provided on 11 May 2005. Dairy WA accepts that subject to meeting the requirements of the Privacy Act Dairy WA is willing to provide dairy farmer personal details to "interested parties" and will if required allow for processors to nominate that milk only be supplied by nominated suppliers .
- Dairy WA notes clause 11.6 where the ACCC notes that as a factual matter all dairy farmers in WA will not join the Milk Negotiating Agency and that a number of farmers have directly indicated to the ACCC that they will not join.
- Dairy WA also acknowledges that as a result of Condition 3 Challenge Dairy Co-operative may choose not to enter negotiations with the Milk Negotiating Agency and therefore many concerns it has raised may as a result be unfounded. Dairy WA's application should not be refused on the basis of Challenge's objections as they may simply refuse to deal with the Milk Negotiating Agency. We have however responded to the issues raised by Challenge in the hope that they will enter into meaningful negotiations with the Milk Negotiating Agency.

Dairy WA requests that the ACCC take into account that 70% of the industry is controlled by two processors who both pay an average price of 28cents per litre, with the result that there is no practical competition at the present time for the supply of 70% of the milk in Western Australia.

Dairy WA believes that it can meet the obligations imposed on Collective Bargaining Groups under the changed ACCC policy and requests that the authorization 90961 be approved and that clarification of the outstanding issues are included in the Dairy WA authorization.

### **Background**

Dairy Western Australia (Dairy WA) applied for authorization to form a collective bargaining group to negotiate on behalf of dairy farmers in Western Australia who authorised it in writing to do so.

The key attributes of the application were:

1. The proposal was purely voluntary – dairy farmers needed to authorize Dairy WA in writing to act on their behalf. They were under no obligation to do so.
2. The terms and conditions of the agreements between Dairy WA and dairy farmers were individually negotiated they were not standard unlike the contracts with processors.

3. The terms and conditions including price were to be negotiated between Dairy WA and processors.
4. If dairy farmers wished to toll milk to retailers and engaged Dairy WA to negotiate on their behalf those arrangements again were not standard and were to be negotiated.
5. As is currently the case the contracts would be for a certain period of time and the normal contractual provisions would apply to dairy farmers or processors wishing to exit contracts prior to their termination date. This is of course normal commercial practice. If a dairy farmer wished to exit a contract prior to the termination date the processor linked to that contract would suffer economic loss if the milk could not be sourced from elsewhere. Alternatively if the processor wished to exit a contract prior to the termination date the dairy farmers linked to that contract would suffer damage if they could not find an alternative processor willing to take the milk on similar or better conditions. As previously stated this is merely normal sound commercial practice and is the current situation with enforceable processor /dairy farmer contracts.
6. Current pricing structures and the existing ADF Authorisation noA90782 worked to the detriment of dairy farmers and different alternative methods of negotiating price structures needed to be considered. It was of course subject to negotiation with processors. Logic indicates that it was unlikely that a similar price for milk would be reached. As, the current price paid by the two major processors (covering approximately 70% of the WA market) is basically similar it was hoped that Dairy WA would be able to introduce more competition for the price paid for milk to dairy farmers in WA.
7. Current arrangements for transport are inefficient and costly. It was anticipated that greater efficiency would be available if dairy farmers could chose their own transport companies rather than being required by processors to contract with third party transport companies as part of their milk supply contract.

## RESPONSE TO STATEMENTS MADE IN DRAFT DETERMINATION

### EXECUTIVE SUMMARY

#### Page i ACCC ASSESSMENT OF PROPOSED ARRANGEMENTS paragraph 1

**“The ACCC notes that despite request made to Dairy WA, aspects of material provided by the applicant are lacking in detail which may otherwise have assisted in the assessment of the Proposal”**

The Applicant was concerned at the disparity between what was treated as confidential as it related to processors and supermarkets and the refusal of confidentiality accorded to commercially sensitive information prepared or being prepared by Dairy WA. In particular concerns arose when the details of the proposed arrangements (the Questions and Answers dated 11 May 2005) with dairy farmers were denied confidentiality.

The ACCC indicated that the information would not be considered in their deliberations, to the detriment of the proposal, unless the Applicant agreed to it being published. The Applicant reluctantly agreed to do so and stressed that whilst there was a general approach many key provisions were of course subject to negotiation and no definitive response was possible or appropriate as such arrangements could not be finalised without an Interim Authorisation from the ACCC.

Shortly afterwards the ACCC requested copies of documents including:

- The research on the impact of different pricing structures on the dairy market (the basis for understanding market impact on different arrangements and undertaken to assist in the negotiating process). A single price model or pooling had been discarded as a concept prior to the research being commissioned because of the detrimental effect on the market and the need to encourage higher prices for quality milk ;
- The business plan for the negotiating agency (including Dairy WA’s contribution to start up and subsequent break even budget).

The Applicant was unable to obtain confirmation that this information would be treated as confidential in spite of the extremely sensitive commercial nature of the documents. The Applicant does not believe that similar documents, including financial projections, held by processors would have been published in the circumstances.

The ACCC refused the interim authorization the same week that they refused to confirm that the documents would be treated as confidential.

The Applicant subsequently cancelled the contract to complete the price modeling as the ACCC had caused concern that the information would be provided to the processors to the detriment of dairy farmers.

It was confirmed to the ACCC that Dairy WA proposed to assist in the start up arrangements for the negotiating agency and that over time it was intended to be self funding after the industry had financially recovered. The intention was to provide a low cost organization run by a small number of staff, contracted professional negotiators on an as needs basis in accommodation provided by Dairy WA. The Applicant believed that

making detailed financial projections, marketing plans and break even figures available to processors and supermarkets would be extremely detrimental to dairy farmers in their attempts to obtain an improved bargaining position and may result in attempts to undermine the Milk Negotiating Agency prior to its establishment and on an ongoing basis.

The writer was subsequently informed that the processors (in particular Challenge) had requested that the ACCC obtain this material from Dairy WA for the benefit of the processors.

The Applicant remains concerned at the disparity in the treatment of information confidential to dairy farmers compared to confidentiality granted to processors and supermarkets.

**Page i ACCC ASSESSMENT OF PROPOSED ARRANGEMENTS paragraph 2**  
**“Generally, the ACCC considers that collective bargaining agreements, WHICH SET UNIFORM TERMS AND CONDITIONS (INCLUDING PRICE), are likely to lessen competition relative to the situation where such collective arrangements do not exist.) (emphasis added)**

The Applicant was criticized because the proposed arrangements between Dairy WA and dairy farmers and Dairy WA and processors and supermarkets indicated on a number of occasions that the information that the ACCC had requested in relation to the contract would of course be subject to negotiation.

The Applicant was criticized for not having standard terms and conditions available in response to the ACCC’s questions. Please see comments above.

Again it is necessary to reiterate that the two major processors Peters and Brownes Foods (PBFoods) and National Foods (Nationals) pay a similar average price of 28 cents per litre. The price paid to the Nationals/Challenge suppliers is averaged at an overall price of 28 cents per litre. Comparatively few dairy farmers have 100% of their milk supplied to Nationals. The average price paid by Nationals taking into account the price it pays to Challenge (for National/Challenge milk) is therefore 28cents per litre in the hands of farmers and in the accounts of Nationals. They also do not compete with one another, for a number of reasons, for the supply of dairy farmer’s milk and control 70% of the raw milk in WA. Dairy farmers needless to say have no incentive to switch between the two major suppliers as the average price paid is similar.

We also refer to the ACCC to the summary of the Dairy WA proposal at page 12 items iv and v where it clearly states that proposal is for voluntary arrangements with individually negotiated contracts – contrary to the implication made in the Executive Summary by the ACCC and the acknowledgement included in clause 11.6 of the ADF Draft Determination.

**Page i ACCC ASSESSMENT OF PROPOSED ARRANGEMENTS dot point 1**  
**“The arrangements have the potential to significantly depress competition between dairy farmers on matters such as price”**

WA dairy farmers have no impact on price and have little or no capacity to compete with one another because of the lack of average price differential paid by the two processors controlling 70% of the WA market. The only significant processor paying a consistently higher price for milk controls approximately 10% of the market and has approximately 34 suppliers. There are therefore only a small number of opportunities for the majority of dairy farmers to be paid a higher price and they can only do so if they change processors. Historically only Harvey Fresh has been willing to take on new suppliers. PBFoods and Nationals have to date not taken on new suppliers with Nationals and more recently PBFoods preferring to source additional milk from Challenge.

We further note at clause 7.51

**“ The ACCC considers that the proposed milk negotiating agency has the potential to restrict or limit the current level of competition existing between collective bargaining groups”**

We find it surprising that the ACCC is of the view that at the date of the draft determination there was any competition between collective bargaining groups, given the previous advice of the ACCC that such behaviour was not permitted under the ADF Authorisation. There was in fact no competition between the only two existing collective bargaining groups as they had been advised that they could not negotiate with anyone other than their existing processor. Please see comments below in relation to the ADF Draft Determination and the ACCC acknowledgement that there was a belief that such competition was prohibited.

**Page ii ACCC ASSESSMENT OF PROPOSED ARRANGEMENTS dot point 2  
“the arrangements have the potential to unduly restrict the ability of dairy farmers to deal directly with processors”**

This statement assumes that dairy farmers have the ability to engage in meaningful negotiations with processors. The four major processors operate with standard form contracts - there is little or no capacity to influence terms and no capacity to negotiate price. Challenge in particular does not appear to involve members in the consideration of changes in milk prices see comments on Challenge revised milk pricing policy announced in December 2005 below.

The only significant variable over which dairy farmers have control is the volume of milk they produce and to exit the industry on the expiration of notice under their existing contracts.

We again draw the ACCC's attention to Clause 11.6 of the ADF Draft Determination where it is noted that

***“a large proportion of dairy farmers align themselves to a specific processor and it is unlikely that all farmers will show an interest in negotiating with other processors.”***

In short dairy farmers who wish to do so will continue to deal directly with processors.

**Page ii ACCC ASSESSMENT OF PROPOSED ARRANGEMENTS dot point 3  
“the arrangements have the potential to introduce industry wide pricing arrangements.”**



The Applicant finds this a perplexing statement by the ACCC as this is already the case - 70% of the raw milk volume sold in WA is sold to the two major processors at a similar average price of 28cents per litre. The Applicant believes that the proposal would require the two major processors to actively compete for the supply of milk in WA increasing the possibility of true competition between those two processors.

We also note that condition 3 of the ADF Draft determination provides that processors cannot be compelled to negotiate with collective bargaining groups – there are grounds to believe that Challenge would not enter negotiations with the Milk Negotiating Agency and it is believed that Harvey Fresh will continue to pay the best price for milk in WA. We therefore reiterate that for 70% of the market for dairy farmers milk industry wide pricing is already in place.

**Page ii ACCC ASSESSMENT OF PROPOSED ARRANGEMENTS dot point 4  
“the arrangements are likely to significantly limit the input of dairy farmers into contracts negotiated with processors.”**

The Applicant has previously provided evidence regarding the lack of input by dairy farmers in the negotiating process. It is already accepted by the ACCC that this is the case. The failure of the National Foods Collective Bargaining Group is well documented. Evidence of the control of the PB Foods Negotiating Committee by PB Foods itself has also previously been provided. We note that a number of PBFoods suppliers that stridently supported the PBFoods case have either left the industry in the last 6 months although a small number have transferred their supply to Harvey Fresh. We anticipate that further exits of PBFoods suppliers will take place in the New Year based on survey results and the failure of PBFoods to increase the price for milk prior to Christmas (as mistakenly anticipated by some PBFoods suppliers).

**Page ii ACCC ASSESSMENT OF PROPOSED ARRANGEMENTS dot point 4  
“ The arrangements may have significant detrimental impact on Challenge and existing surplus milk arrangements”**

The important issue of Challenge and their financial circumstances and the reason for the financial difficulties will be dealt with below. A discussion of the impact of Challenges arrangements for surplus milk will also be dealt with and its impact on the industry. We would however request the ACC to take into account Proposed Condition 3 of the ADF Draft Determination and acknowledge that Challenge may choose not to enter into negotiations with the Milk Negotiating Agency.

The Dairy WA Application should not be refused on the basis of Challenge’s objections as Challenge has the option of refusing to deal with the Milk Negotiating Agency.

**Page ii ACCC ASSESSMENT OF PROPOSED ARRANGEMENTS dot point 5  
“the arrangements are likely to artificially increase the barriers to entry and exit for dairy farmers and may also artificially increase barriers to entry and expansion for processors”**

**Barriers to entry by dairy farmers** would be no greater than currently exist in fact it may encourage new entrants who would enter the market as others exit the negotiating agency or at a time when there is an increasing demand for milk. New entrants may also negotiate

separate arrangements with processors if they believe they can negotiate a better arrangement than that offered to them by the negotiating agency.

**Barriers to exit by dairy farmers** whilst this is subject to negotiation and not a standard term under normal circumstances it would be necessary to match dairy farmer supply arrangements to the contractual obligations with the processors.

At present processors all have provisions covering the exit of dairy farmers from contracts. The ACCC appears to believe under the current situation dairy farmers can exit at will possibly because the ACCC did not request copies of exiting processors standard term contracts. In brief the existing standard exit term is as follows:

PB Foods – 3 month notice

Nationals – annual contract provides for 6 months notice

Harvey Fresh – by negotiation

Challenge – in theory Challenge suppliers can only exit if they assign their Delivery Rights Units (DRUs) to another Challenge member. We understand in practice that Challenge members are required by the board to give three months notice of the intention to assign their DRUs and the DRUs are pooled for assignment to other Challenge members or proposed members. There is currently no market for the assignment of DRUs *see Comments on Challenge below.*

**Entry and Expansion of Processors** Unlike dairy farmers we do not believe that processors would accept a negotiated price that would significantly impact on their business. We note that PBFoods, Harvey Fresh and Challenge are all undertaking expansion at the present time. We also note that processors in the Eastern States have continued to pay an improved price for milk without significantly limiting new entrants to the market or the expansion of existing processors.

We note that no information has been provided as to why the ACCC has accepted this argument and it makes it difficult to respond without the basis for the statement.

We also note that this argument was treated to the contrary in the ADF Draft Determination at clauses 8.29-8.36.

## **BACKGROUND**

### **Page 8 Western Australia Clause 2.44**

**“Production has remained in line with pre-deregulation levels, as farm sizes have grown on average by more than 33%....”**

The figure of 33% increase in farm size relates to Australia not WA. The figures for WA production provided by Dairy Australia are unaudited unverified figures. Dairy Australia now qualifies these figures for milk volume by acknowledging that the figures are provided by the dairy processors.

Independent Survey information provided to the ACCC indicates that the figures for WA have fallen significantly since the lodgement of the Application for authorization in March 2005.

It is anticipated that there will be shortages of raw milk to some processors over the summer 2005-2006 and that there will be pressure upon remaining dairy farmers to increase supply. See comments below on the impact of Challenge on the WA Dairy Industry. The survey information indicated that at current prices there was little remaining capacity amongst dairy farmers to increase production to meet this shortfall.

**Page 8 Western Australia clause 2.46**

**“Dairy 2005 Situation and Outlook Report that milk flows from the region exceed requirement for fresh product processing by 25-30%.”**

It should be noted that at the date of the Dairy WA draft determination the figures for Dairy 2005 had been collected over 9 months before in January 2005.

No audited or verified figures have been collected by Dairy Australia, survey results taken by Dairy WA in June 2005 showed an anticipated reduction in milk supply by 15% by December 2005. These figures were subsequently confirmed by an independently conducted survey in November 2005. It is anticipated that there will be an additional significant reduction in milk volumes in the first half of 2006 due to farmer exits, sale of heifers and cows on the international market and ongoing slaughter of existing stock. The impact on PBFoods suppliers of the failure to increase price prior to Christmas as anticipated and the subsequent sourcing of milk from Challenge by PBFoods is still uncertain but is probably significant.

**Page 8 Western Australia Clause 2.47**

**“Approximately 47% of Western Australian dairy farmers are members of Challenge.”**

Challenge only has 35 suppliers who provide 100% of their milk to the company. Survey figures indicate Challenge has between 105(confirmed) and possibly up to 115 members in total. The remaining members supply most of their milk to Nationals under annual contract with the balance to Challenge.

In March 2005 there were approximately 290 dairy farmers in WA survey results indicate there are currently approximately 243 as at November 2005.

The risk that Challenge faces in the current climate was addressed in Ms Marino’s opening address at the Pre-Determination Conference. Challenge subsequently reduced its price to the Nationals/Challenge dairy farmers whilst increasing the price to the 35 members who are 100% Challenge suppliers (including all member directors of the Challenge board). A number of these National/Challenge suppliers do not hold DRUs and are in a more flexible position than those members who do.

It is reasonable to anticipate that these members may re-think their relationship with Challenge as a result.

**Page 9 Related Authorisations Clause 2.54**

**“Under this arrangement the ADF, or another common agent is not permitted to represent farmers in price/supply negotiations.”**

The Applicant notes this comment by the ACCC. Ms Marino the Chairman of the Applicant has confirmed that she was previously advised by Vern Gardem of the ACCC in Perth that collective bargaining groups were only permitted to negotiate with one processor

that those dairy farmers currently supplied. Mr. Gardem insisted that dairy farmers who supplied other processors were prohibited from being members of another collective bargaining group. This advice was provided to the processors and was the reason for the Application made by Dairy WA, as it was seen as the reason for the plight of the WA dairy farmers.

We note Mr. King's comments at the Pre-determination Hearing that this interpretation in his view is not correct and that Collective Bargaining Groups can negotiate with more than one processor.

This revised approach was included in the Draft Determination A90966 for Australian Dairy Farmers Limited dated 15 December 2005 at clause 11.5 second sentence:

**“While the ACCC is of the view that the authorization does not permit multiple processors from participating in the same negotiation, it does not see why the conditions would prevent a collective bargaining group from negotiating with more than one processor provided members of the group have a shared community interest”**

#### **Australian Dairy Farmers Ltd Draft Determination A90966 dated 15 December 2005 (ADF Draft)**

The ADF Draft indicates a change in ACCC policy since ADF Authorisation A90782 and the Dairy WA Draft Determination.

The response to the Dairy WA Draft Determination must be dealt with in the light of the changed policy in the ADF Draft as this is the most relevant of current ACCC policy documents.

The Dairy WA Determination should be dealt with in the context of this new policy and should take into account statements made in relation to the Dairy WA proposal included in that draft.

The ADF Draft has seven proposed conditions:

##### ***Proposed Condition 1***

Collective bargaining groups may be represented by a member (or members) of the collective bargaining group or by (one or more) third parties. However, a collective bargaining group must not be represented by the ADF or by a third party who represents or has represented another collective bargaining group.

##### ***Proposed Condition 2***

Collective bargaining groups can only be formed by dairy farmers that each has a reasonable expectation of being able to supply the dairy processing company's plant, or each of the dairy processing company's plants, that will be the subject of the collective negotiations. Condition 7 requires groups to provide the ADF with details of how this condition is satisfied.

##### ***Proposed Condition 3***

Dairy processing companies are able to choose whether or not to negotiate with collective bargaining groups. Dairy processing companies are able to negotiate with one, or some, of the dairy farmers within a particular group based on their own commercial requirements.

***Proposed Condition 4***

Dairy farmer participation in collective bargaining groups is voluntary. Dairy farmers retain the right to negotiate and enter into individual contracts. Dairy farmers can leave collective bargaining groups on giving reasonable notice.

***Proposed Condition 5***

Collective bargaining groups, individual dairy farmers or dairy farmer representatives, may not attempt to prevent or restrict other farmers from supplying particular dairy processing companies.

***Proposed Condition 6***

Members or third party representatives of a collective bargaining group may not disclose, other than to members of the same group, information which was obtained by them in the course of collective negotiations with a dairy processing company and which the dairy processing company has advised them is confidential.

***Proposed Condition 7***

Any new collective bargaining group must, within 28 days of it first forming, provide the following information to the ADF:

- the names of the dairy farmers and the names of locations of the farms comprising the group
- the name and contact details of the party(s) nominated by the group to represent the group in collective negotiations
- with respect to each dairy processing company that the group intends to negotiate with, the name of the dairy processing company and the location of its relevant plant(s)
- with respect to each dairy processing company that the group intends to negotiate with, details of how each member of the group satisfies Condition 2. This could include information as to group members' histories of supplying the processor and , where the group members have not previously supplied the processor, information regarding the distance between those members' farms and the relevant plant(s) of the dairy processor.

Furthermore, the group must advise the ADF of changes to the composition of the group or to the party(s) representing the group within 28 days of such a change(s) being made.

The ADF must keep an up-to-date register which includes this information and must, on request by an interested party, provide access to the register free of charge during normal business hours.

### **Dairy WA proposal compared to ADF Draft Proposed Condition 1**

It is submitted that the Milk Negotiating Agency is a third party representative of a Collective Bargaining Group. The Milk Negotiating Agency will not represent another Collective Bargaining Group.

### **Dairy WA proposal compared to ADF Draft Proposed Condition 2**

Members of the Milk Negotiating Agency will be in a position where there is a reasonable expectation that they could supply any processor in South West of Western Australia. This reasonable expectation would be on the basis that the Milk Negotiating Agency with the consent of those dairy farmers could arrange for the transport of their milk to the dairy processor's plant thereby improving the available markets for each dairy farmer member's milk. Condition 7 is noted.

### **Dairy WA proposal compared to ADF Draft Proposed Condition 3 (amendment of response to Question 12 in Questions and Answers 11 May 2005)**

It is acknowledged that it is not legally possible to force dairy processing companies to negotiate with anyone.

In particular we note that Challenge itself may chose not to deal with the Milk Negotiating Agency as they believe that they can obtain sufficient milk under their existing DRU arrangements. Should Challenge itself wish to negotiate with the Milk Negotiating Agency we strongly believe that the issue of DRUs can be easily resolved through negotiations undertaken in good faith.

We note that as part of this Condition 3 dairy processing companies will have the ability to "pick and choose" which dairy farmers are included as a subset of the collective bargaining group.

Historically there have been problems of overt intimidation in the WA dairy industry. This lead Dairy WA to request confidentiality of the membership of the Milk Negotiating Agency, Dairy WA had provided documentary evidence of threats and intimidation of dairy farmers who supported the Dairy WA proposal. However changes in recent months give reasonable grounds to believe that this may be less of a problem in the future.

It is reasonable to believe that under normal circumstances the dairy processors would require:

- agreed volumes including flexibility supply
- agreed milk quality (including components)

Whilst some processors may prefer supply from specified dairy farmers who may or may not continue in the industry over time, the dairy processor who chose that option would need to bear the risk of the uncertainty of supply over time.

The logical extension of Condition 3 from the Milk Negotiating Agency's perspective is that some dairy farmer members may supply one processor whilst another supplies other processors. Over time it is reasonable to believe that dairy farmers will move towards a milk volume, quality and component basis possibly supplying a range of processors.

### **Dairy WA Proposal compared to ADF Draft Condition 4**

Membership of the Milk Negotiating Agency is voluntary, if the dairy farmer is not contracted to the Milk Negotiating Agency they retain the right to enter into individual contracts. It is acknowledged that the intention is that dairy farmers may terminate the

contract with Milk Negotiating Agency on reasonable notice. What is reasonable will vary from case to case and will take into account existing processor contracts, if that dairy farmer is specifically contracted to a particular processor the “reasonable notice” clause will need to be included in the agreement with that processor. If possible the Milk Negotiating Agency in the case of these individuals would attempt to include a termination clause based on hardship. Clearly volume and quality contracts would have more flexible termination clauses as the milk could be more readily replaced.

We note that at the present time notice of termination under the Nationals contracts is the six months, with the contracts being for a period of twelve months. Challenge does not have a termination clause under the Challenge Delivery Right Agreement in favour of the supplier. The Agreement only allows members to exit if they assign their rights with the board’s consent under the contract. There is as previously stated no market for the assignment of DRUs.

A supplier may assign Delivery Rights Units to a third party subject to amongst other things the approval of Challenge.

The ACCC is requested to confirm if the current Nationals and Challenge arrangements represent “reasonable notice” for the purposes of Condition 4. The Milk Negotiating Agency would need to be aware whether existing processor notice provisions would be considered unreasonable if they were reflected in the Collective Bargaining Agreements.

#### **Dairy WA proposal compared to ADF Draft Condition 5**

Noted. We assume that this would not include dairy farmers currently under contract with the Milk Negotiating Agency, as this would make contracts unenforceable. Condition 5 would appear to apply to dairy farmers who were not members of the Collective Bargaining Group under contract or where they were negotiating a new contract on the conclusion of existing arrangements..

The analogy would be that a processor could enforce contracts with its existing dairy farmer suppliers but could not prevent a dairy farmer from changing processors at the conclusion of the contract.

Logically dairy farmers who were not members of the Milk Negotiating Agency could not be prevented or restricted by the Milk Negotiating Agency from supplying which ever processor they chose, in the same way that a processor that the dairy farmer was not contracted to could not restrict someone who was not their supplier from negotiating with another processor.

#### **Dairy WA proposal compared to ADF Draft Condition 6**

Noted. However we believe that this clause should include the standard provision included in commercial contracts that the clause only applies if the information is not in the public arena. Whilst processors are not bound by the ACCC’s authorization a comment should be included that confidentiality should also be the right of Collective Bargaining Groups.

The Australian agricultural sector has continuously been denied the right of confidentiality by various governments over the years and this has done irreparable harm upon industry deregulation. This refusal of confidentiality is in stark contrast to the insistence on the right of confidentiality provided by various governments to all other members in the supply chain. If confidentiality is to be applied it should be applied consistently to farmers, processors and supermarkets.

Specifically, in the case of the dairy industry in Western Australia the publication of dairy farmers' costs of production will continue to disadvantage dairy farmers in their negotiations with processors for years to come.

The position at present appears to be that farmers business is everyone's business – and that processors' and supermarkets' business is no-one else's business.

#### **Dairy WA proposed ADF Draft Condition 7**

Condition 7 is based on the original conditions 8, 9 and 10 of Authorisation 90782. We note the comments that this is so that dairy farmers' information is open and transparent. We reiterate our comments above.

We also comment that this clause under normal circumstances would be a breach of the Privacy Act as the information is not merely to be provided to other negotiating parties but "on request to an interested party".

The Milk Negotiating Agency would need to obtain consent from each member that this information be released under the Privacy Act. We would propose if this was a condition of a successful authorisation to do so as part of the Milk Negotiating Agency contract.

Whilst all information is of a commercial nature and would normally fall within the provisions of the Privacy Act dot point 4 makes information about a dairy farmers business and provides easily accessible financial information about that farmer available for practical purposes to anyone who asks for it.

It is difficult to imagine a circumstance where processors themselves would be required to place the history of the details of their supply arrangements on the public record. No doubt they would refuse. Interestingly enough this information would by default provide much of this information to their competitors.

#### **CHALLENGE**

The draft determination raised three main issues in relation to Challenge:

- Challenge's inability to raise funds purportedly as a result of the possibility of the establishment of the Milk Negotiating Agency; and
- The impact on Delivery Rights Units if Challenge members chose to join the Milk Negotiating Agency.
- The detrimental impact on Challenge in its management of the surplus milk market.

#### **Challenge Comment 1**

##### **Challenge's inability to raise funds purportedly as a result of the possibility of the establishment of the Milk Negotiating Agency**

Challenge has indicated in its only publicly available letter to the ACCC undated but received by the ACCC on 14 November, 2005 that the establishment of the Milk Negotiating Agency:

***"may well be detrimental to our current operation and will restrict any future investment in our business"***



No other information is available to us to support this statement or why Challenge takes this view. To respond to this statement and the ACCC's belief that the Milk Negotiating Agency would harm Challenge's existing capacity to raise funds it is necessary to look at the history of Challenge and whether at the present time it would meet commercial lending criteria.

Commercial lenders normally require loans to be secured by real property and be supported by a history of sound management and steady profits.

In some circumstances commercial loans will be made on the basis of cash flow but this is for comparatively small amounts and the criteria for lending are again steady profits and sound management.

### **Challenge Background**

Challenge Dairy Co-operative was established shortly after the deregulation of the dairy industry in 2000. The then Western Australian Government provided Challenge with loan funds of \$10 million to provide start up capital and purchase George Weston facilities at Boyanup and Capel. (see attachment 1 Press Release of the Hon. Monty House date 12/12/00).

The purchase price for the George Weston facilities was over \$6.26680 million based on the figures on 2001 annual reports the agreement also included a non compete clause preventing Challenge from selling milk on the fresh milk market in WA in competition with National Foods however Nationals would purchase a portion of its milk from Challenge (see attachment 2 advice to Challenge Members undated but presumably September 2001.)

In July 2003 Challenge entered into a joint venture with Beijing Sanyuan Food Co Ltd, Sanyuan provided \$5.5million in funds for the first stage. (see attachment 3 Press Release Hon. Kim Chance dated 23 July 2003). The joint venture was dissolved in March 2004.

Sanyuan's funds were subsequently repaid "at a discount" (see attachment 4 Challenge Annual Report 2004 Chairman's Report) however the failure of the joint venture created severe financial pressures on Challenge with the Chairman stating:

***"The board and management have managed to tread a fine line between saving a business as well as pay a milk price at will ensure supply for the future."***

The Annual Report also noted that the insurer would no longer provide some parts of Directors Liability insurance (see attachment 4 Chairman's Report).

Challenge repaid its loan to Rabo in the 2004 year and entered into a new joint venture (Challenge Australian Dairies) with QAF of Singapore.

The Capel and Boyanup facilities purchased for \$6,26680 were transferred to CAD however the ownership appears to have been transferred to QAF. The value of Challenge's property, plant and equipment transferred to CAD as shown as \$1,981,561 (Attachment 4 page 13).

Challenge had also shown a series losses since its first year of operation (see annual reports 2004 and 2005).

### **Challenge approach to Dairy WA for commercial loan**

Mr. Peter Giddy informally approached Dairy WA CEO Leslie Chalmers for loan funds in August 2005. Ms Chalmers indicated that Dairy WA would be willing to consider a formal application for a loan to Challenge. She also indicated loans are subject to Dairy WAs commercial lending criteria. Challenge did not formally apply for a loan from Dairy WA.

Dairy WA has approximately \$5.8 million in cash part of which had been earmarked for the establishment of the Milk Negotiating Agency subject to the authorization being granted by the ACCC.

### **Conclusion**

Challenge's difficulty in raising commercial loans is primarily due to its lack of real property assets. Challenge's financial history would also create difficulty in its attempts to obtain commercial loans or seek further investors.

We understand there is currently no market for DRU's and that the Nationals/Challenge suppliers have consistently received a lower price than 100% Challenge suppliers. In December 2005 for the summer months the price differential increased from 2 cents per litre to 4 cents per litre.

Challenge's financial problems are unrelated to the Milk Negotiating Agency and are of an historic nature. Financiers make decisions based on sound management and balance sheets and factual industry profiles.

### **Challenge Comment 2 The impact on Delivery Rights Units if Challenge members chose to join the Milk Negotiating Agency.**

The Delivery Rights Agreement provides at Clause 7:

*“In the event that in any year of the term of this Agreement the Supplier fails to supply the Annual Supply Quantity for that year, the only remedy available to Challenge for such default will be the right, at Challenge's election, to act as the Supplier's agent for the purposes of obtaining the shortfall in milk in the name of the Supplier and charge the supplier all expenses, including but not limited to, the price of the shortfall in milk, transport and all other incidental costs incurred by or on behalf of Challenge in obtaining and delivering the shortfall of milk to Challenge.”*

Clause 8 provides that a breach of clause 7 does not give rise to the right to terminate the Agreement

At the present time there is no market for the sale of DRUs and to our knowledge, there is no legal possibility of a dairy farmer exiting the Agreement without Challenge amending the current Agreement. If the farmer wishes to exit the industry for hardship reasons the farmer must first assign the obligation to supply under the Agreement to a third party. Failure to supply milk to Challenge under the Agreement may impose high and ongoing costs on the farmer for the purchase of replacement milk - theoretically in perpetuity.

This creates an untenable situation for both dairy farmers and Challenge in the current climate of dairy farmer exits.

As previously acknowledged Challenge cannot be forced to negotiate with the Milk Negotiating Agency. However Challenge members may wish to receive an improved price for their milk as some receive as little as 14.9 cents per litre.

### **The Approach Proposed to Challenge in Discussions prior to Lodging the Application**

The Delivery Rights Agreement members could meet their commitments arising under clause 7 by entering into arrangements with the Milk Negotiating Agency to provide milk to Challenge compliant with Clause 7. Discussions with Challenge about the obligation to meet the DRU requirements (i.e. the need to meet the supply commitment at the DRU agreed price) was the basis for discussions prior to the application being lodged with the ACCC. Challenge has not been significantly affected by dairy farmer exits on the information available under the survey, however this is likely to change as the industry continues to contract over the next 12 months.

As previously stated Dairy WA is of the view that Challenge may chose not to enter negotiations with the Milk Negotiating Agency and that Dairy WA's request for authorization should not be refused on the basis of Challenge's comments.

### **The detrimental impact on Challenge in its management of the surplus milk market.**

This comment is based on the underlying assumption that there is an ongoing amount of surplus milk. Survey information provided to the ACCC indicates that at current average price of 28 cents per litre the surplus milk market is significantly diminishing.

Challenge's position in the market encourages the production of surplus milk with the consequence of holding milk prices down to dairy farmer producers. The availability of milk from Challenge leads processors to believe that they will be unaffected by falling milk volumes as milk will always be available from Challenge. Challenge under cuts the price of milk received by its National/Challenge members by selling the balance of Nationals requirements (we understand approximately 35 million litres of milk per annum) at a price lower than Nationals pays for direct suppliers. Historically Challenge's role encouraged its suppliers to over produce. Challenge then sells "surplus milk" in competition with its own members and other dairy farmers thereby driving prices down. As a consequence processors believe there is no need to respond to market signals from the exit of their own suppliers.

A recent case in point was PBFoods review of its own supplier's positions. Anecdotal evidence indicated that there was a critical need for a price increase before Christmas if significant numbers of PBFoods suppliers were not to exit the industry. Many PBFoods suppliers mistakenly believed that PBFoods would indeed increase price before Christmas and continued in the industry as a result. We understand PBFoods subsequently sourced additional supplies from Challenge. As a result, PBFoods own suppliers were not given the price increase they had mistakenly expected. We are concerned that the result of this action may be the accelerated loss of existing PBFoods suppliers over and above that indicated in the survey results.

At the Challenge Annual General Meeting on December 1, 2005 Challenge announced an increase in price to its 35 "100%" suppliers (including the 5 member directors on the Challenge Board) and a lesser increase in price to its approximately 70-80 National/Challenge suppliers none of whom are represented on the board.(see attachment 5). The price differential in the summer of 2005-6 is now 4 cents per litre. The impact of this decision may potentially result in the loss of some milk supply to Challenge from these Nationals/Challenge suppliers who do not hold DRUs.

As Ms Marino stated at the Pre-Determination Conference Challenge is at significant risk in the current market and unfortunately the recent price change may merely have aggravated that risk.

We do not believe that the Milk Negotiating Agency would place Challenge at any greater risk than it currently faces due to the acknowledged and reiterated willingness of the Milk Negotiating Agency to meet DRU commitments of Challenge dairy farmers wishing to join the Milk Negotiating Agency.

# Jenni Mattila & Co

Lawyers

Australian Competition and Consumer  
Commission,  
PO Box 1199,  
DICKSON. A.C.T. 2602  
Attention: Ms. S. Philp

FILE No
DOC:
MARS/PRISM:

PO BOX 1685 Double Bay NSW 1360  
AUSTRALIA  
ph: 61 2 9252 7177  
fax: 61 2 93864055  
mob: 0418 650 555

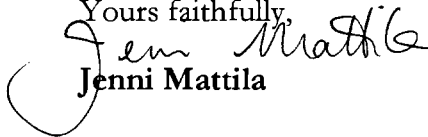
January 6, 2006

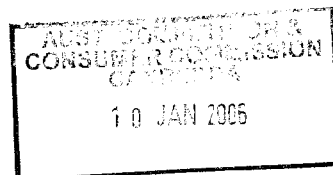
Dear Sue,

## **Dairy WA Application for Authorisation**

Please find included supporting documents for the Dairy WA submission on the Draft Determination. As agreed we have included a copy of Dr Watson's Report from 1 December, 2005 on the WA Dairy Industry.

Yours faithfully,

  
**Jenni Mattila**



<sup>12/12/2000</sup>  
Press Release Hon M. House - \$10m Grant to Challenge

1

3 July 2001  
Press Release Hon. K. Chance - \$10m Challenge confirmed

2

September 2001? Challenge announce purchase of Boyanup and Capel Plant

June 30, 2001? Property Plant Eq \$6,266,880

3

<sup>23/7/2003</sup>  
Press Release Hon. K. Chance - Sanyan JV  
payment of \$5.5m.

4

Challenge Annual Report 2004

5

5 December 2005  
Challenge letter to members announcing  
increase in price - 4cpl differential between  
100% challenge and National  
Challenge members

6

Challenge Annual Report 2005

7

Copy Deliver Right Agreement

8

Report on Milk Pricing in WA  
- DR Alistair Watson (Economist)  
December 2005.

9

10



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Attachment 1

3

Government of Western Australia

**Prior Government Media Statement**

**The Hon. Monty House JP, MLA**

Released by the then:  
Minister for Primary Industry; Fisheries.  
Statement Released: 12-Dec-2000  
Portfolio: Primary Industry



Government announces aid package for dairy industry

Not the current Minister

12/12/00

Primary Industry Minister Monty House today announced an \$11.2 million financial assistance package for the Western Australian dairy industry to encourage growth and development of the capability and competitiveness of the processing sector.

Mr House said that processing industry funding was part of a \$27 million State Coalition Government dairy industry assistance package announced in July to help dairy farmers in the transition from a regulated to deregulated market.

"It is essential that support for dairy farmers is maintained to see an increase in price to farmers and stimulate milk production to allow for a revitalised dairy industry in the future," he said.

The Western Australian dairy industry currently produces 403 million litres of milk per annum, with 158 million litres consumed as fresh milk and the remaining 245 million litres available for processing.

"WA has considerable potential to increase production levels from existing landholdings and, provided on-farm efficiencies are gained, an economic scale processing industry is achievable," Mr House said.

"This funding has been a priority for the Government to provide the incentive for farmers and companies to take charge of their industry and secure their financial future.

"The projects funded have wide ranging impacts on regional development providing positive impacts for milk producers and flow-on benefits to businesses providing goods and services to the dairy industry."

Companies to benefit from the funding include:

**Challenge Dairy Co-operative - \$10 million**

The co-operative currently comprises in excess of 90 farmer members and seeks to provide a more secure future. The co-operative's funding aims to acquire the Boyanup and Capel facilities to produce a variety of dairy products including milk powders, butter and cheese.

**Harvey Fresh - \$500,000**

Harvey Fresh is a WA-owned and operated business processing milk and fresh fruit juices at facilities near Harvey. Funding will provide for the purchase and installation of a refurbished UHT packaging machine that will improve export



④

capacity.

**Manassen Foods/Margaret River Cheese Company - \$500,000**

The factory is based in Margaret River, a region that is expanding rapidly and is internationally recognised. The company proposes to capitalise on this and use funding to expand its Margaret River cheese production at Metricup, focussing on white and blue mould cheeses.

**Swan Valley Cheese Company - \$100,000**

This company is a boutique producer of continental cheeses operating in the Swan Valley. Currently it is unable to meet demand with production and funding will allow for the purchase of processing equipment to meet market demands.

**A J and M H Green - \$75,000**

This is a family partnership producing milk and beef at Boyanup and Waterloo. Funding will allow the establishment of a processing, packaging and distribution system based on supplying farm fresh organic and Jersey milk.

Applicants for funding underwent a two-stage strict selection process with external consultants assisting with the assessment process.

"All successful applicants recognise the importance of their proposal in leading to substantial growth of the industry and increased returns to farmers," Mr House said.

He said the funding was a positive step forward for the dairy industry and had targeted innovation and adoption of world best practice for dairy processing plants.

In addition new product development and the improvement of the industry knowledge base in technology, management and marketing skills would provide a solid foundation for the dairy industry in WA to move into the future with security and prosperity.

Media contact: Peter Jackson 9481 2044

[Back to Statements list](#)

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Government of Western Australia

**Media Statement**



**The Hon. Kim Chance M.L.C.**

Minister for Agriculture, Forestry and Fisheries; the Midwest, Wheatbelt and Great Southern;  
Leader of the Government in the Legislative Council



Statement Released: 3-Jul-2001  
Portfolio: Agriculture

**Dairy co-operative venture's push for bigger market praised**

3/7/01

Agriculture Minister Kim Chance has praised the initiative shown by dairy farmers involved in a new venture seeking a bigger slice of the world market.

Mr Chance said the Challenge Dairy Co-operative venture represented an important opportunity for Western Australian dairy farmers to take charge of their industry's future and share in the benefits to be gained from a buoyant international market for dairy products.

The Minister was speaking at the WA Farmers' Federation's dairy industry conference held in Busselton today.

The WA industry has received a boost with the honouring of a \$10 million grant provided by the previous State Government to the new Challenge Dairy Co-operative.

The grant was the largest provided to businesses under the Dairy Processing Incentive Scheme and will allow Challenge to purchase the Capel and Boyanup dairy processing facilities, owned by George Weston Foods and National Foods.

The Challenge Dairy Co-operative now has close to 120 dairy farmer members, representing about one third of all WA dairy producers.

The Dairy Processing Incentive Scheme was part of a \$27 million State restructuring package, which included grants to processors to increase WA's capacity to produce a diverse range of specialty products, especially for the export market.

"The scheme demonstrates Government commitment to supporting the dairy industry during the difficult adjustment period following deregulation last year," Mr Chance said.

"It also illustrates faith in the industry's ability to adapt to new challenges and to capture a bigger share of the growing world market for dairy products."

Media contact: Mike Marren 9213 6700

[Comment](#)

[Back to Statements list](#)

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Government of Western Australia



Attachment 2

(21)

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**

Dear Member,

Your directors are pleased to confirm that a Memorandum of Understanding (MOU) with George Weston Foods Limited (GWF) and National Foods Limited (NF) has been signed.

**The MOU proposes that:**

- a.) Challenge will buy NF's Boyanup facility and GWF's Capel facility on a "going concern" basis.
- b.) NF will purchase a portion of its milk requirements from Challenge.
- c.) GWF will enter into a product supply agreement to purchase its requirements for both butter and cheese at a price, which includes a premium to world commodity prices.
- d.) Premiums received from the NF and GWF supply agreements will be applied to the current Capel suppliers, which will increase their current average prices and partially restore the premiums they previously received under milk regulation.
- e.) All NF and GWF suppliers will be able to join Challenge. (as will Peters & Brownes suppliers)

**The MOU is subject to:**

- a.) Final contract negotiations between Challenge and GWF and Challenge and NF.
- b.) Challenge being successful in winning support from the Western Australian Government by way of funding from the deregulation package.

Owing to exceedingly tight timing constraints relating to the release of details of the signing of the MOU, your directors were unable to provide normally acceptable notice of the informal meeting held on the 1<sup>st</sup> of September.

A meeting will be held within four weeks to explain the MOU and its proposed implementation by Challenge, co-operative membership and pricing and rebate policies for delivery rights, because membership of the co-operative is open to all producers your directors have decided that invitations to attend the meeting will, in addition to being sent to members, be sent to all non member milk producers.

Your directors acknowledge and appreciate the time, effort, support and willingness of NF and GWF in achieving this first step in resolving the critical industry problems of retention and then growth of the milk supply.

Your directors consider that the reported proposed acquisition of equity in Peters & Brownes by Kiwi Dairy Co-operative should be complementary to the initiative developed by the signatories to the MOU and we look forward to the stability and subsequential growth in the milk supply provided by a revitalised manufacturing sector which will be owned by the producers.

Larry Brennen  
Chairman  
Challenge Dairy Co-operative Limited

CHALLENGE DAIRY CO-OPERATIVE LIMITED

35-39 McCombe Road, Bunbury WA 6230. Postal Address: PO Box 5404, Bunbury WA 6231. Telephone (08) 9726 4222. Facsimile (08) 9726 2120.

(22)

***NATIONAL FOODS SIGNS MEMORANDUM OF UNDERSTANDING***

National Foods Limited announced today that it had signed a Memorandum of Understanding with George Weston Foods and Challenge Co-operative, which is owned by Western Australian dairy farmers.

The Memorandum of Understanding is subject to funding from the Western Australian Government, and final contract negotiations, however is a significant step towards establishing a stable manufacturing sector for the Western Australian dairy industry.

It is proposed that NFL's Boyanup facility and George Weston's Capel facility will be sold to the Challenge Co-operative as going concern.

It is further proposed that NFL will enter into a milk supply agreement with Challenge to purchase a portion of its milk requirements from the Co-operative. George Weston will enter into a product supply agreement to purchase its Watsonia brand cheese and butter requirements from Challenge.

"This is a very good result for the West Australian dairy industry", NFL MD Mr Max Ould said today, "It is a step forward to providing a solution to the problem of a large section of the dairy industry being severely disadvantaged by deregulation, and I congratulate Challenge and Weston's for their willingness in seeking a solution. I also thank the West Australian Government for its support for the outcome achieved."

# CHALLENGE DAIRY CO-OPERATIVE LIMITED

STATEMENT OF FINANCIAL POSITION  
AS AT JUNE 30, 2001

	Notes	2001 \$	2000 \$
<b>CURRENT ASSETS</b>			
Cash	5	3,990,859	329,047
Receivables	6	942,456	1,748
Inventories	7	2,102,742	-
Other		498,021	-
<b>TOTAL CURRENT ASSETS</b>		<u>7,534,078</u>	<u>330,795</u>
<b>NON-CURRENT ASSETS</b>			
Property, plant and equipment	8	6,266,880	-
<b>TOTAL NON-CURRENT ASSETS</b>		<u>6,266,880</u>	<u>-</u>
<b>TOTAL ASSETS</b>		<u>13,800,958</u>	<u>330,795</u>
<b>CURRENT LIABILITIES</b>			
Payables	9	2,724,249	22,998
Provisions	10	1,126,424	-
<b>TOTAL CURRENT LIABILITIES</b>		<u>3,850,673</u>	<u>22,998</u>
<b>NON-CURRENT LIABILITIES</b>			
Other		2,312	-
<b>TOTAL NON-CURRENT LIABILITIES</b>		<u>2,312</u>	<u>-</u>
<b>TOTAL LIABILITIES</b>		<u>3,852,985</u>	<u>22,998</u>
<b>NET ASSETS</b>		<u>9,947,973</u>	<u>307,797</u>
<b>EQUITY</b>			
Capital	11	586,008	452,008
Non share capital	12	10,000,000	-
Accumulated losses		(638,035)	(144,211)
<b>TOTAL EQUITY</b>		<u>9,947,973</u>	<u>307,797</u>

The accompanying notes form part of these financial statements.

*Horwath*

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**STATEMENT OF CASH FLOWS**  
**FOR THE PERIOD ENDED JUNE 30, 2001**

		2001 \$	2000 \$
	Notes	Inflows (Outflows)	Inflows (Outflows)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Receipts from customers		(734,017)	-
Interest received		12,748	6,161
Payments in the course of operations		513,649	(129,122)
<b>Net cash flows from operating activities</b>	(ii)	<u>(207,620)</u>	<u>(122,961)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Payments for property plant and equipment		(6,266,882)	-
<b>Net cash flows from investing activities</b>		<u>(6,266,882)</u>	<u>-</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Funds received from farmers		136,312	452,000
Proceeds from non share capital		10,000,000	-
Proceeds from the issue of shares		-	8
<b>Net cash flows from financing activities</b>		<u>10,136,312</u>	<u>452,008</u>
Net increase in cash held		<u>3,661,810</u>	<u>329,047</u>
Cash held at the beginning of the period		329,047	-
<b>CASH HELD AT THE END OF THE PERIOD</b>	(i)	<u>3,990,857</u>	<u>329,047</u>

**(i) Reconciliation of Cash**

For the purposes of the statement of cash flows, cash includes deposits at call which are readily convertible to cash on hand and are subject to an insignificant risk of changes in value. Cash at June 30, 2001 as shown in the statement of cash flows is reconciled to the related items in the balance sheet as follows:

Cash held in trust account	10,756	243,108
Cash at bank	3,980,101	85,939
	<u>3,990,857</u>	<u>329,047</u>

**(ii) Reconciliation of Cash Flows from Operating Activities to Operating Loss After Income Tax**

Operating loss after income tax	(493,824)	(144,211)
Changes in assets and liabilities:		
(Increase) in trade debtors	(940,708)	(1,748)
(Increase) / decrease in inventory	(2,102,742)	72,098
(Increase) in other operating assets	(498,021)	-
Increase in accounts payable	3,341,251	-
Increase / (Decrease) in provisions	486,424	-
<b>Net cash flows from operating activities</b>	<u>(207,620)</u>	<u>(122,961)</u>

**(iii) Non-cash Financing and Investing Activities**

None

*The accompanying notes form part of these financial statements.*

**Horwath**

## CHALLENGE DAIRY CO-OPERATIVE LIMITED

NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED JUNE 30, 2001

	2001 \$	2000 \$
<b>NOTE 8. NON CURRENT ASSETS- Property Plant and Equipment - (cont.)</b>		
Furniture and Fixtures - at cost	5,794	-
Less -accumulated depreciation	-	-
	5,794	-
Office Equipment at cost	203,935	-
Less -accumulated depreciation	-	-
	203,935	-
Motor Vehicle at cost	742,503	-
Less -accumulated depreciation	-	-
	742,503	-
Total property, plant and equipment	6,266,880	-

### NOTE 9. CURRENT LIABILITIES - Payables

General creditors	2,724,249	22,098
	2,724,249	22,098

### NOTE 10. CURRENT LIABILITIES - Provisions

Annual leave	170,145	-
Long service leave	267,492	-
Sick leave	24,444	-
Provision for stock discount	640,000	-
Rostered days off	24,341	-
Total provisions	1,126,424	-

### NOTE 11. EQUITY - Capital

Farmers voting shares	(i) 114,000	93,000
Farmers non recourse loans	(i) 472,000	359,000
B class ordinary shares	8	8
	586,008	452,008

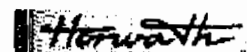
#### (i) Farmers Voting Shares and Farmers Non Recourse Loans

During the period ended 30 June 2001, a further 21, \$1,000 shares and 21, non recourse, interest free loans were issued. The loans have been convertible to part payment of delivery as the company has began to receive milk.

### NOTE 12. EQUITY - NON SHARE CAPITAL

Non - share equity interest	10,000,000	-
	10,000,000	-

The Non - share equity interest comprises a loan secured by a fixed and floating charge over the assets of the Challenge Dairy Co Operative Limited.  
The loan may become non renounceable subject to terms given by the Minister of State Development.  
An amount of \$4,000,000 is expected to be forgiven within the next financial year.



APR 11 2002



# CHALLENGE DAIRY CO-OPERATIVE LIMITED

NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED JUNE 30, 2001

	2001 \$	2000 \$
<b>NOTE 5. CURRENT ASSETS - Cash</b>		
Cash at bank and on Hand	5,980,102	5,29,047
Trust Account	10,757	-
	5,990,859	5,29,047

**NOTE 6. CURRENT ASSETS - Receivables**

Trade Debtors	640,000	-
Milk Debtors	227,159	-
	867,159	-
Other debtors	78,097	1,748
	945,256	1,748

**NOTE 7. CURRENT ASSETS - Inventories**

Raw materials- at cost	36,412	-
	36,412	-
Finished goods at cost	1,727,537	-
	1,727,537	-
Stocks other products	138,703	-
	138,703	-
Aggregate carrying amount of inventories	2,102,652	-

**NOTE 8. NON CURRENT ASSETS- Property Plant and Equipment**

<b>Land and buildings</b>		
Freehold Land		
At cost	63,128	-
	63,128	-
Buildings - at cost	800,925	-
Less - Accumulated depreciation	-	-
	800,925	-
Manufacturing plant at cost	4,397,500	-
Less- accumulated depreciation	-	-
	4,397,500	-
Manufacturing equipment at cost	12,825	-
Less- accumulated depreciation	-	-
	12,825	-



## CHALLENGE DAIRY CO-OPERATIVE LIMITED

NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED JUNE 30, 2001

	2001 \$	2000 \$
<b>NOTE 5. CURRENT ASSETS - Cash</b>		
Cash at bank and on Hand	3,980,102	329,047
Trust Account	10,757	-
	3,990,859	329,047

**NOTE 6. CURRENT ASSETS - Receivables**

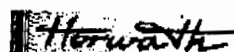
Trade Debtors	640,000	-
Milk Debtors	227,359	-
	867,359	-
Other debtors	75,097	1,748
	942,456	1,748

**NOTE 7. CURRENT ASSETS - Inventories**

Raw materials- at cost	36,412	-
	36,412	-
Finished goods -at cost	1,727,537	-
	1,727,537	-
Stocks other products	338,793	-
	338,793	-
Aggregate carrying amount of inventories	2,102,742	-

**NOTE 8. NON CURRENT ASSETS- Property Plant and Equipment**

<b>Land and buildings</b>		
Freehold Land		
At cost	103,128	-
	103,128	-
Buildings - at cost	800,995	-
Less - Accumulated depreciation	-	-
	800,995	-
Manufacturing plant at cost	4,397,700	-
Less- accumulated depreciation	-	-
	4,397,700	-
Manufacturing equipment at cost	12,825	-
Less- accumulated depreciation	-	-
	12,825	-

 Horwath

MEMBERSHIP

05-JAN-06 08:51



Government of Western Australia  
**Media Statement**



**The Hon. Kim Chance M.L.C.**

Minister for Agriculture, Forestry and Fisheries; the Midwest, Wheatbelt and Great Southern;

Leader of the Government in the Legislative Council

	Notification Service
	Statements Home Page

Statement Released: 23-Jul-2003

Portfolio: Agriculture, Fisheries, Forestry

Two new deals boost WA food exports

23/7/03

The Gallop Government's drive to increase Western Australian food exports was given a boost this week, with two new deals with companies based in China and the United Arab Emirates.

Agriculture Minister Kim Chance said the deals were an encouraging development for the agricultural industry, and for the Gallop Government's efforts to ensure sustainable and export-oriented agriculture, forestry and fishing industries.

Mr Chance said they indicated the success of the Government's work towards focussing international attention on the agricultural industry's impact on the supermarket shelf.

The Minister attended a dinner launching a joint venture alliance between a Chinese dairy firm and Challenge Dairy Co-operative in Capel, comprising an investment of more than \$50million.

Beijing Sanyuan Food Co Ltd handed over a cheque for \$5.5million for the first phase of the Sanyuan Challenge Australian Dairy Joint Venture.

"For the very first time, a Chinese dairy firm has formed a joint venture alliance with an overseas country," Mr Chance said.

"And it is also the first time an Australian firm has entered into an arrangement of this scale.

"The joint venture brings together the marketing skills, distribution network and local knowledge of one of China's most dynamic food companies with the production expertise and growth potential of WA's only farmer-owned dairy processor.

"This is quite remarkable, particularly as Challenge Dairy Co-operative is just two years old.

"The key selling point for the Chinese was WA's well-established reputation for clean and green produce."

Mr Chance said the formation of the joint venture provided the 100 WA dairy farmers comprising the Co-operative with direct access to one of the world's fastest-growing retail markets.

18

They would face less price uncertainty as the industry grew and became more dependent on exports - and Chinese consumers would have preferential access to quality products made from the world's cleanest and safest milk.

"This is a beneficial resolution to the long-term problems faced by the WA dairy industry, with our prices being 16-18 per cent lower than in China," the Minister said.

Mr Chance said this exciting development for the dairy industry occurred at the same time that a major United Arab Emirates retailer had placed orders with five WA food exporters and called for samples from a further nine companies.

The interest had resulted from a visit by UAE's largest retailer T Choithram and Sons, organised by the Department of Agriculture, Austrade and the WA Trade Office in Dubai.

The visit followed two successful food exhibitions held in Dubai recently - the WA Trade Exhibition last October and the Gulf Food Exhibition in February this year.

"WA agriculture has always been seen as a high quality and reliable supplier of raw materials," Mr Chance said.

"It has been the Gallop Government's policy to improve our market impact on the supermarket shelf, rather than be seen simply as suppliers of commodities.

"A Government initiative in this regard was October's WA Trade Exhibition in Dubai, led by Premier Geoff Gallop, the biggest trade mission ever to leave WA. It provided an opportunity for small companies which would not otherwise have had the capacity to explore Middle East export potential.

"It gave these companies the chance to meet the supermarket decision-makers and provide an appropriate forum to promote their produce. Many of the exhibitors returned to Dubai in February for the Gulf Food Expo, which I also attended.

"These two deals this week are welcome indications that the Government's policy is now beginning to bear fruit."

Minister's office: 9213 6700

[Comment](#)[Back to Statements list](#)

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Attachment H.

## **ANNUAL GENERAL MEETING**

**The Geographe Bayview Resort**

**555 Bussell Highway, Busselton**

**Wednesday 15 December, 2004, 10.30 am**

*The perfect balance!*



## CHALLENGE DAIRY CO-OPERATIVE LIMITED

### NOTICE OF ANNUAL GENERAL MEETING

Notice is hereby given that the Annual General Meeting of Challenge Dairy Co-operative Limited for the year ending 30 June 2004 will be held at the **Geographe Bayview Resort, 555 Bussell Highway, Busselton, on Wednesday 15 December at 10.30 am.**

Representatives of Corporate Shareholders must present an executed notice evidencing their appointment when they register at the Annual General Meeting.

Appropriately completed proxy forms must be lodged with the Secretary 24 hours before the meeting to be recognised as valid.

#### **Business**

1. Apologies
2. To receive and consider the report of the Chairman of Challenge Dairy Co-operative Limited for the year ending 30<sup>th</sup> June 2004.
3. To receive and consider the Profit and Loss Statement and Balance Sheet as at 30<sup>th</sup> June 2004 with the reports of the Directors and Auditors.
4. Appointment of Auditors

To consider and, if thought appropriate, pass the following resolution as an ordinary resolution:

That Horwath Perth be appointed Auditors of Challenge Dairy Co-operative Limited and that their remuneration be fixed by the Board of Directors.

5. To elect two member Directors

In accordance with Article 15.7 of Challenge Dairy Co-operative Limited's Articles of Association, the following member Directors retire at this meeting and, being eligible, have offered themselves for re-election:

Mr Larry Brennen

Mr Robert Poole

No other nominations have been received.

6. Special business

There has been no notification of any special business.

To consider any other business for which valid notice has been received.

By order of the Board

**Geoffrey C de Chanéet**  
**Secretary**  
**26 November 2004**



## CHALLENGE DAIRY CO-OPERATIVE LIMITED

### Minutes of the Annual General Meeting held on Wednesday 10 December 2003 at Geographe Bayview Resort 555 Bussell Highway, Busselton

**Present:** 65 Members signed the Register and another 5 were identified as present, a total of 60 members.

<b>In Attendance:</b>	Mr L Brennen	Member Director and Executive Chairman
	Mr N Haddon	Member Director and Deputy Chairman
	Mr R Poole	Member Director
	Mr G Jenkins	Member Director
	Mr S Scott	Member Director
	Mr G Shepherd	Non-member Director
	Mr D McIntyre	Non-member Director
	Mr G de Chaneeet	Secretary
	Mr R Kay	General Manager, Operations
	Ms S Thunder	Financial Controller
	Mr G O'Brien	Horwath Perth Partners, auditors

The Chairman opened the meeting at 10:38 am and welcomed members to the meeting.

#### BUSINESS

**1. APOLOGIES**

Mr R Blackburn

**2. MINUTES OF THE ANNUAL GENERAL MEETING OF CHALLENGE DAIRY CO-OPERATIVE HELD ON WEDNESDAY 11 DECEMBER 2002.**

The Chairman referred members to the minutes of the Annual General Meeting of Challenge Dairy Co-operative held 11 December 2002 that had been issued to all members attending the meeting.

Moved by Mr B Briney and seconded by Mr I McGregor, that the minutes of the Annual General Meeting of Challenge Dairy Co-operative Limited held on 11 December 2002 be accepted as a true and accurate record of proceedings of the meeting.

Carried by the meeting.

**3. CHAIRMAN'S REPORT**

The Chairman referred members to his written report, which had been circulated to members with the notice of the meeting.

The Chairman used his report as the basis for a short presentation on the year under review and on the future directions for the Co-operative. He reported that the Board had concentrated on its place in the Western Australian Dairy Industry for the first two years of operation of the Co-operative. This phase of the Co-operative's development was over and Board had now moved to a focus on the Co-operative and its commercial future.

Mr Brennen described some of the problems currently facing the Co-operative in relation to the Sanyuan Challenge Australia Dairy joint venture and the actions the Board was taking to address these.

The Chairman also advised the meeting that advice had just been received from the Co-operative's insurers that the insurer would no longer provide some parts of Directors' Liability insurance for Co-operative Directors. This was being addressed as an urgent issue.

**Item 5 - election of one Member Director.** As part of his address the Chairman advised the meeting that, as only one nomination for the vacant position of Member Director had been received, Mr Neville Haddon was elected as a Director for a term of three years.

#### **4. FINANCIAL STATEMENTS YEAR ENDED 30 JUNE 2003.**

The Chairman referred members to the Financial Statements for the Year ended 30 June 2003 that had been issued to all members. He invited Ms Sara Thunder, Financial Controller, to address the meeting on the financial statements.

Ms Thunder reported that the increase in value of the A\$ against other currencies resulted in prices for commodities sold by the Co-operative declining from about 13% to 31% over the year. This had a major impact on profitability. Ms Thunder answered questions on the financial data.

#### **4. APPOINTMENT OF AUDITORS FOR 2003 - 2004**

The Chairman advised that Horwath Perth Partnership, Accountants, were responsible for the audit of the 2002/2003 Financial Statements and the Board recommended the resolution that Horwath Perth Partnership be appointed as Auditors for the 2003/2004 financial year.

Moved by Mrs L Daubney seconded by Mrs J Leiper, that Horwath Perth Partnership be appointed Auditors of Challenge Dairy Co-operative for the 2003/2004 financial year and their remuneration be fixed by the Board of Directors. Carried by the meeting.

### **3. CHAIRMAN'S REPORT**

As a continuation of his report the Chairman invited Mr Roger Kay, General Manager Operations, to address the meeting. Mr Kay presented data on sales of products in terms of litres of milk and identified the need for Challenge to be producing more profitable commodities than at present. He pointed out the increase in sales of milk to Fraser and Neave (F&N) that was quite profitable and looked likely to increase given the recent negotiations between the Co-operative and F&N.

Mr Brennen then gave a presentation describing negotiations with F&N to form a joint venture to produce extended shelf life (ESL) milk at the Boyanup plant. F&N projections were for milk sales to increase from the present about 7 million litres to about 40 million

litres by 2005-2006. This would be as fresh milk sent to Singapore in bulk and as packaged ESL milk.

The Boyanup plant would be upgraded at a cost of about \$10 million and would be producing ESL by October/November 2004. Sales of bulk milk to Singapore would double immediately.

F&N would own 75% of the joint venture and Challenge the other 25%, with all financial deals being written in \$A so the Co-operative would be protected against currency fluctuations.

Discussion ensued on the proposal and the following motion was proposed by Mrs E Brand seconded by Mr B Briney:

*That the Board of Challenge Dairy Co-operative Limited progress the F&N proposal as presented at the meeting for the production and marketing of ESL milk and that the outcome of negotiations be presented to a shareholders meeting at the earliest opportunity for consideration of endorsement.*

Before the motion was put, Mr M Norton moved an amendment, seconded by Mr P Giumelli:

*That the words "subject to a review of the proposal being conducted by a third party other than KPMG" be added to the motion.*

This was agreed to by Mrs Brand and Mr Briney and then carried by the meeting.

The motion:

*That the Board of Challenge Dairy Co-operative Limited progress the F&N proposal as presented at the meeting for the production and marketing of ESL milk, subject to a review of the proposal being conducted by a third party other than KPMG, and that the outcome of negotiations be presented to a shareholders meeting at the earliest opportunity for consideration of endorsement.*

was then put and carried by the meeting.

## **6. TO CONSIDER ANY OTHER BUSINESS FOR WHICH NOTICE HAS BEEN RECEIVED**

The Chairman advised there were no other items of Special Business for which valid notice had been received.

The Chairman thanked all members for their attendance and declared the meeting closed at 12.55 pm.

Chairman .....

Date .....

# CHALLENGE DAIRY CO-OPERATIVE LIMITED

## Minutes of the General Meeting held on Friday 24 September 2004 at Geographe Bayview Resort 555 Bussell Highway, Busselton

**Present:** 23 Members signed the Register. 68 proxies were held by the Chairman and one was held by an attending member.

<b>In Attendance:</b>	Mr L Brennen	Member Director and Executive
Chairman	Mr N Haddon	Member Director and Deputy Chairman
	Mr R Poole	Member Director
	Mr G Jenkins	Member Director
	Mr S Scott	Member Director
	Mr G Shepherd	Non-member Director
	Mr P Giddy	Chief Executive Officer
	Mr G de Chaneeet	Secretary

The Chairman opened the meeting at 10:35 am and welcomed members to the meeting.

### 1. APOLOGIES

Mr B and Ms S Yates.

### 2. SPECIAL BUSINESS

The business of the meeting was to consider a resolution, notice of which had been given to Members. This was to consider, and if thought fit, to pass as an ordinary resolution the following:

"That for the purposes of Article 15.20 of the Articles of Association of the Company and for all other purposes, the Company's members approve the sale of the Company's Boyanup assets to Challenge Australian Dairy Pty Ltd and the issue of shares in Challenge Australian Dairy Pty Ltd (ABN 59 103 242 155) to QAF Limited (a company incorporated in the Republic of Singapore) on the terms described in the Explanatory Memorandum which accompanies and forms part of this notice of the general meeting or otherwise upon the terms and subject to the conditions which the Board of Directors determines."

The Chairman introduced the motion and briefly spoke about its purpose, which had been provided to Members in a previous information meeting and through the Explanatory Memorandum. He invited questions from the floor and in response to these he and Mr Giddy provided further information as follows:

- The deal would be written in A\$ and not US\$.
- Operations for the next three years or so would follow a business plan aimed at re-engineering the business using the approximately \$8 million that the joint venture would immediately inject into the business and the approximately \$5.3 million to

come from operation of the business plan. Further development would depend on profitability of the business at the time.

- Funds for future expansion would probably come from sale of delivery right units (DRU), retained earnings and borrowed capital.
- The Board intended that eventually there be one price for all milk supplied as DRU milk. Current differentials between prices paid to 100% suppliers and other were set by the Board as being in the best interests of the Company in the long term. Prices were under constant consideration.
- There would be additions to staff as the Company was re-engineered and production and sales became more technically complex. This would increase gross overheads, but the overall costs of production per quantum of product would reduce.
- Current capital expenditure would be on improvements that would be usable in a greenfields plant when one was developed.
- Environmental issues related to increased production were being addressed. One of the most pressing was water supply.
- The Board was currently focusing on diverting the 20 million litres of milk that was dried into production of higher value products. As prices are market driven, this should increase the price and/or dividends that could be returned to members in the long term and this would attract more members into becoming 100% suppliers. DRU's would be issued to match market demand.
- The deal with QAF did not affect dealing with Fraser and Neave, who were aware of the deal. The two did not compete. Similarly sales and dealings with Harvey Fresh should not be affected other than the fact that Cow Head UHT, the QAF brand, could be supplied by Harvey Fresh. All other milk sales to other industry players would be from the Co-operative and not the joint venture.
- A new business plan for the JV would be prepared to operate from 31 December to coincide with the Singapore financial year. Milk prices would be set in this. The Board would consider if it could set prices for 2005 before this date and make them available at the AGM.
- The assets at Boyanup were not included in the Sanyuan deal and were included in this deal because Sanyuan were not interested in them and QAF were and their inclusion made this a stronger JV. Duplication of some operations would be avoided thereby reducing overheads and the capital input to the JV would be maximised.
- The Board was unaware of what influence this JV would have on moves underway in the industry to develop another co-operative because the working group had not provided any detail of what was intended.
- National Foods did not appear yet ready to source all their milk from Challenge rather than directly from farmers and the Board did not think it was yet ready to present them with a case for this.

At the conclusion of this question and answer session the Chairman put the motion to the meeting.

A show of hands recorded 21 Members (included one proxy held by a member in attendance) in favour of the resolution and 2 against. The Chairman held 68 proxies in favour of the resolution, so he declared the resolution passed by a margin of 89 Members in favour over two against. .

The Chairman thanked all members for their attendance and declared the meeting closed at 11.50 am.

Chairman .....

Date .....

Chairman's Report  
Annual General Meeting  
2004

Dear Shareholders

This year was to be a year of consolidation with the promise of a solid future due to the Sanyuan Foods joint venture. Instead it turned out to be another battle for survival mid year. With the advent of a new CEO and management team and a clear change of focus we have finished the year in a sound position. Now with QAF as a new joint venture partner I believe we can look forward to a period of consolidation and progress for the next three years.

The formation of Sanyuan Challenge Australian Dairies in July 2003 and the dissolution in March 2004 dominated most of the year physically and financially. The intent of the joint venture was to develop products and brands for the Beijing market. Sanyuan Foods were going to be the distributors for the new products. By December unfavorable trading conditions, Sanyuan Foods being unable to act as distributors and Sanyuan not matching the required capital all led to the decision to dissolve the joint venture. This was achieved in March 2004. Challenge Australian Dairies and Sanyuan Foods are still working together under a memorandum of understanding to develop market opportunities in China.

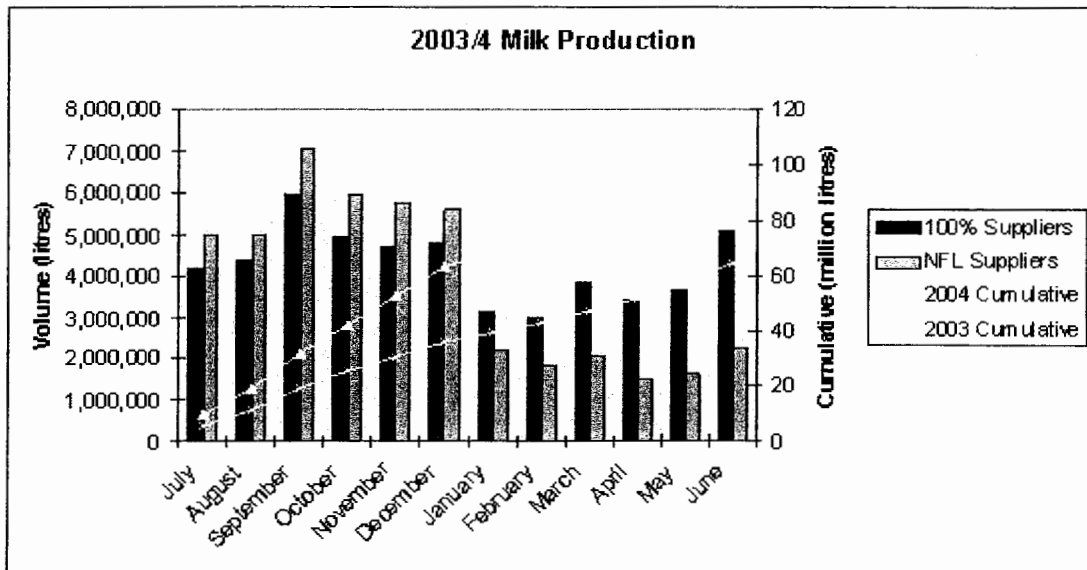
The financial position of the Co-operative, despite the difficult year, has improved. The trading position has changed from the \$3.8 million loss the previous year to return a profit of \$303,000 in 2004. This was achieved because of a number of factors.

- The Australian dollar leveled out against the US dollar, after it appreciated some 30% in the first half of the financial year.
- There was a significant improvement in world commodity prices, led by cheese and butter.
- Skim milk powder prices slowly but steadily improved over the same period.
- The appointment of a new Chief Executive in February saw many changes to the yields and productivity of the company that all contributed to the improved financial performance.

The improvement in the balance sheet was mainly due to negotiating a successful dissolution of the joint venture and a re-valuation of our assets at Boyanup.

## Milk Intake

Milk intake for the year increased by around 50% and sales of products has been strong in the second half of the year. This resulted in a sales revenue increase of \$12 million for the year. We received around 97m litres for the year, which was approximately 32.5m litres more than our annual intake last year. Challenge milk cost approximately \$22m for 2003/4, at an average overall farm gate price of 22.5 c/litre. Average prices were 23.7, 21.4 and 14.2 c/litre for 100% suppliers, NFL members and base suppliers respectively. 100% suppliers produced 51m litres compared to 46m litres from NFL members.



## Milk Supply

	2003/4 Litres	2002/3 Litres
CDC 100% Suppliers	51,144,205	47,220,331
CDC Members with NFML Contracts	44,211,940	16,264,652
NFML Suppliers Sending Base Milk	1,552,083	1,006,611
<b>Total</b>	<b>96,908,228</b>	<b>64,491,594</b>

In December the Board undertook a strategic analysis of the business. With the advent of a new CEO and management team in February, many



changes have been implemented in accordance with the long standing strategic objectives of the company.

The first clear change was to accelerate the process of turning the Co-operative into a stand-alone business in the West Australian dairy industry. This means we have to be more than just a milk balancing operation for the other companies in Western Australia. As a start we have introduced our Bannister Downs range of waxed cheese to the market. We have developed an association with Pinnacle Foods in Sydney to cut, package and distribute our products on the Eastern seaboard. Our waxed cheese is also being exported onto markets into Singapore, Hong Kong and Korea. A gourmet range of yoghurt is being developed for the domestic as well as export markets. Changes are being implemented to improve the front end of the business with a sales marketing and distribution team. Credit must go to all management and staff for lifting the level of the plant and products to achieve an AQIS A or B level rating for all parts of the plant. Our focus has been to cut overhead costs by improving yield and product efficiency and to move away from bulk commodity products to retail or value added products where ever possible. This will take time and capital and management.

The Board and management have endeavored to tread the fine line of saving a business as well as pay a milk price that will ensure supply for the future. This has been a most difficult process. As 53% of the Co-operative's milk supply comes from the 100% suppliers of the Co-operative, the Board considered it necessary to pay a premium to defend the majority of our milk supply. This premium represented 2.38 c/litre average for the whole year. The 100% suppliers to the Co-operative averaged 23.74 c/litre for the year. The Board is well aware of the issues some NFL farmers have regarding the premium to 100% suppliers. Whilst the 100% Challenge Co-operative suppliers remain the lowest paid in the state and there is a freight differential passed on by NFL the Board considers that this premium should remain at approx 2 c/litre. This is in order to protect and insure the majority of the Co-operative's supply base. It is the Board's clear goal that as soon as a sustainable milk price can be paid the premium will no longer be required.

During the year the Co-operative Board was challenged to be involved in the development of a single desk bargaining arrangement. Let me say the Board agrees totally with the principles of farmers owning and controlling their own milk supply. This is the fundamental reason the Challenge Dairy Co-operative was established in July 1999. The offer to use the current Co-operative structure and constitution was made to avoid

duplication and additional overhead costs to the industry. This offer still stands. For the Board to be any further involved would not only be perceived to be, but would be, a real conflict of interest. The Board is totally responsible to the 139 members to ensure the constitution and the day to day operations of the Co-operative are carried out.

### The Board

The Board held regular meetings during the year as well as many committee meetings all attended by the Board. David McIntyre resigned on the 11<sup>th</sup> December 2003. The Board has not filled this vacancy. Geoff Jenkins filled the vacancy on the Sanyuan Challenge Australia Dairy Board created by the resignation of David McIntyre from 11<sup>th</sup> Dec 2003 to 12 March 2004.

The Board requested that I fill the role as Executive Chairman of the Co-operative and acting Chief Executive of Sanyuan Challenge Australia Dairy (SCAD) from 11 Dec 2003 until Mr. Peter Giddy took up his appointment on the 28<sup>th</sup> January 2004.

With the completion of the new QAF joint venture, Challenge Australia Dairy (CAD), the vacant Board position will be reviewed by the Board during the current financial year. During this period the Board adopted a policy to use external expertise to cover a wide range of expertise required.

I would like to make special mention and note David McIntyre's contribution to the development and formation of the Challenge Dairy Co-operative. His broad knowledge, skill, experience and professionalism played a major role in the Co-operative achieving what it has today. The contribution to the Challenge Dairy Co-operative is only part of David's broader commitment to the WA Dairy Industry. Personally David's counsel and advice on many difficult issues was always and still is appreciated.

### Events Subsequent to 30<sup>th</sup> June 2004

QAF Ltd has subscribed to 51% of the operating assets of the Challenge Australia Dairy Pty Ltd. This has meant a much needed injection of capital. Management now has some of the resources needed to develop the retail range of products necessary and to spend capital on the plant to improve yield and production efficiencies. Through the association with Ben Foods, a Singapore-based sales, marketing and distribution company

that is owned and operated by QAF, the new Joint venture will have access to retail products and markets and this will hasten the move away from reliance on bulk commodity products.

The announcement of the proposed takeover of National Foods by Fonterra does present an opportunity for the Challenge Dairy Co-operative as well as Challenge Australia Dairy. Just what these opportunities are and what we make of them are the issues facing the Board and management this year. At the same time the Board is monitoring developments with the objective to overcome any detrimental outcomes that may impact on the Co-operative.

In summary, to weather the financial storm and return a profit for the year was particularly pleasing. To increase revenue by \$12 million, add \$2 million in value to the balance sheet and exit the Sanyuan JV without any financial damage are all positives for the company.

I am pleased to report that the management of the company is in very good hands. With that I would like to acknowledge the efforts of our CEO and senior management team and staff in turning a business around. With this team we can look forward to the future with confidence.

To my fellow Board members and their families and especially Graham Shepherd whose experience was invaluable on many occasions, I give thanks and acknowledge their efforts throughout the year.

Finally, the continued support of all the members, their acceptance of an unsustainable milk price in order to achieve the longer term objectives and the endorsement of the QAF joint venture have given the Board and management encouragement to strive harder for a better future for all.

Larry J Brennen

Chairman

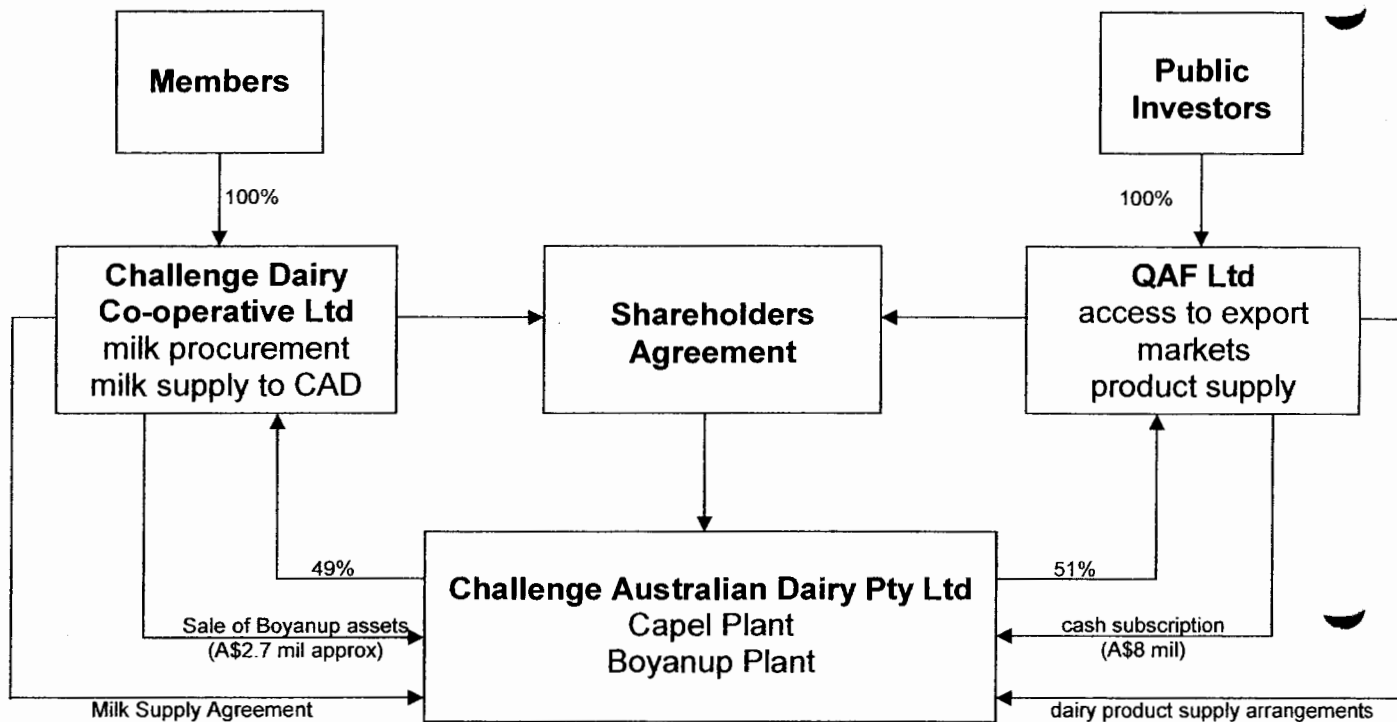
## CHALLENGE DAIRY CO-OPERATIVE LTD

The following extracts of the *Explanatory Memorandum* provided to members previously, which explained the QAF joint venture, have been included and attached to the Annual Report for Members' convenience.

The Co-operative remains 100% in control of Members as the following diagram demonstrates.

The Joint Venture commenced operations on 18<sup>th</sup> October 2004

### Position Now



### Background and objectives

CDC was established as an independent co-operative company to provide Members with a farm gate milk collection service and to purchase milk produced by Members at price levels which provided Members with an economically sustainable enterprise. In addition to providing Members with an economically sustainable milk price the objectives of CDC included providing additional financial returns to Members through appreciation in the value of their DRUs and dividends/rebates from any surplus profits of the CDC business.

From the outset it was recognised that the acquisition of two aged but operating processing plants using government funding was a first stage and that facilities needed to be upgraded significantly and profitable markets for dairy products established if the financial objectives were to be achieved. The existing facilities only permitted a limited production of essentially

commodity products. The margins derived from the sale of these products would not be adequate to enable CDC to deliver economic farm gate milk prices to Members nor to achieve the other financial objectives.

In order to upgrade facilities to create the capacity to rise above the commodity product trap, substantial additional capital would be required. From the outset it was recognised that CDC would be unlikely to be able to generate these substantial additional funds either through internally generated profit or from contributions from its Members. Having excluded these capital raising options (on the basis of the time frame available to achieve them), all that realistically remained was either debt funding or equity funding from another party. CDC did not have the balance sheet strength to secure the additional funding through debt. Accordingly, soon after the commencement of operations, CDC embarked on a worldwide search for a suitable joint venture partner to provide the additional funding and to provide access to additional markets for value added products.

In July 2003, CDC formed an incorporated joint venture with the Sanyuan Group of Beijing. Sanyuan introduced equity into the joint venture through a share subscription into Challenge Australian Dairy Pty Ltd ("CAD") (then named Sanyuan Challenge Australian Dairy Pty Ltd), to acquire a 50% interest in CAD. The Capel plant was transferred to CAD.

Members are aware the joint venture was not successful and it failed to deliver on its original expectations. There were a number of reasons for the lack of success - most of which were outside the immediate control of the partners. The joint venture was dissolved in March 2004 with CDC buying back the Sanyuan Group stake at a very substantial discount. Whilst the joint venture was not successful it was in fact the source of considerable benefit to CDC in that it provided much needed cash to continue operations and the trading losses were borne by the joint venture rather than incurred solely by CDC directly.

Notwithstanding the dissolution of the joint venture the commercial relationship with the Sanyuan Group has remained strong and it is anticipated that it will deliver substantial new market opportunities and commercial benefits.

## **CDC financial performance**

It is important to place in perspective the financial performance of CDC since commencement.

For the first year of operation (2001/2) CDC operated at a break even level - commodity prices were high.

In the second year (2002/3) substantial losses incurred - commodity prices were very depressed.

The CDC Board recognised whilst the loss position was unsustainable it needed to continue to operate at historical throughput given that the commencement of the joint venture with Sanyuan was imminent and there was a need to ensure continuation of the milk supply and Member support. The operations in the new joint venture continued to incur substantial losses. The joint venture bore the brunt of these losses and to a large extent the other operations of CDC offset its share of losses from the joint venture operations.

The last financial year (2003/4) has seen the CDC Group at break even level.

From early 2004, when problems with the Sanyuan joint venture began to emerge, the Directors and CEO of CDC began actively looking for a new joint venture partner. Over the past 6 months the CEO has been successful in restructuring markets and processing facilities within the extremely limited funding restrictions. The outcome is that the operations are in a much stronger position and capable of delivering substantial additional benefits from the opportunities introduced from any new joint venture partner with new market access.

## The proposal

### What is proposed?

The current proposal has two elements.

**Firstly, the Boyanup plant will be transferred from CDC to CAD for a cash consideration of A\$2.7 million (approx).**

**Secondly, QAF Limited ("QAF") a Singapore based listed public company, will contribute equity capital to CAD in an amount of approximately A\$8 million cash through a subscription for shares.** The subscription amount has been calculated to approximately match the value of the assets previously contributed by CDC to CAD.

In addition to the cash subscription QAF will provide any support, in addition to guarantees from CDC and QAF, that may be necessary to ensure CAD can secure additional debt funding of A\$5.3 million (approx.)

After the subscription, QAF will end up with a 51% stake in CAD with CDC retaining the remaining 49%. This raises some control issues, however, CDC believes these can be adequately managed through the terms of a Shareholders Agreement between CDC and QAF which incorporates a number of legally binding safeguards (more particularly detailed in paragraph 0). The principal safeguard comprises CDC's right to have an equal number of representatives on the CAD Board and for Board resolutions on major issues to require the approval of at least 2 of the directors appointed by each of CDC and QAF.

### How will the subscription funds be used?

The initial funding commitments from QAF will be sufficient, on current projections, to cover CAD's funding requirements for the next 3 years including working capital (including the maintenance of published farm gate prices) and the upgrading of facilities for Stage 1 (see paragraph 0 below).

A comprehensive Business Plan has been developed which shows how the Challenge Group will combine its raw milk supply capability, manufacturing facilities and existing marketing structure with the sales, marketing and distribution network of QAF (through its subsidiary Ben Foods) to build an international dairy company.

Part of the funds subscribed by QAF to CAD will be applied in satisfying the purchase price of the Boyanup facility from CDC of approximately A\$2.7 million. CDC will apply this money to satisfy monies still owing to Sanyuan Group for the buy back of its shares in CAD and discharge the existing Rabo Bank debt facility leaving adequate cash on hand for projected needs.

## Business Plan - CAD

The Business Plan outlines 3 stages of operations summarised below:

### Stage 1

- take control of the manufacturing activities of the Capel and Boyanup facilities;
- take control of the sales, marketing and distribution of all current Challenge products;
- appoint key staff to provide the executive capacity required for the joint venture;

- develop a broad range of value added products to enable CAD to derive adequate return on investment and pay a competitive milk price;
- the capital expenditure requirements at the Capel and Boyanup facilities for plant upgrades has been estimated at A\$12 million and will be funded through the QAF share subscription proceeds and additional debt funding provided by CAD with QAF's support;
- CAD operations will focus on developing the cheese range into waxed and retail products and the development of UHT and liquid milk opportunities; and
- plan and design Stage 2 which comprises a new "green field" manufacturing facility.
- to work with CDC to build milk supply to 200,000,000 litres over the next 4 years.

## Stage 2

- construct a new high technology "green field" powder and liquid milk manufacturing plant with retail cheese cutting and processing facilities;
- the plant will be designed to produce products suitable for the Asian and other selected markets; and
- obviously the ability to proceed with Stage 2 will be significantly dependent on the success of Stage 1. The method of raising the capital necessary will be a matter of further discussion between CDC and QAF. Any decision to proceed with Stage 2 and the methods used to raise necessary funding will require CDC approval.

## Stage 3

Stage 3 will involve the relocation of the cheese plant as well as the close down of the current plant.

## Who is QAF?

QAF and its group companies are a food based entity with interests in the meat, grain milling, baking and food service and distribution industries. It traces its origins to 1958 and it was publicly listed on the Singapore Stock Exchange in 1967. Its management is based in Singapore but the Group has significant interests within Australia, Indonesia, Malaysia and other ASEAN countries including China.

The rules of Singapore Stock Exchange have much in common with the requirements and disciplines imposed by the rules of the Australian Stock Exchange.

## Main Operations

QAF's December 2003 Annual Report discloses its main operations as including:

**primary production:** QAF Meats which is wholly owned and is the largest producer of pigs and pork meat in Australia (being 4 times larger than the next producer);

**food manufacturing:** the Gardenia brands in Singapore including bakery operations which have the largest market share in Singapore. Additional operations in other countries.

**Trading, distribution and logistics - Ben Foods:** This is QAF's wholesale distribution company and trades in a diverse range of products including dairy products. It is principally with this entity that CAD will interface and be instrumental in the growth of

its dairy division. The Business Plan adopted by CAD details how this is to be achieved which will include placing an executive in a Singapore office reporting directly to the CEO of CAD.

## **Financial status**

QAF reported a profit for the financial years ended December 2002 and 2003. The 2003 result was adversely affected by SARS and the drought in Australia (particularly major negative impact on Australian pig operations) and the rise in the Australian dollar - amongst other factors. Trading conditions have not improved as expected in the two quarters reported to date but QAF directors advise that they are confident that the position is improving.

The Group has assets in excess of SD\$500 million and shareholders funds of SD\$280 million.

QAF clearly represents a group of financial substance with a sound reputation.

CDC believes that QAF, through its Ben Foods operations, has the capacity to deliver the opportunities sought by CDC and CAD in relation to access to premium dairy product export markets. CDC is also encouraged through QAF's commitment to directly invest A\$8 million (approx) in equity and to provide whatever assistance is necessary to enable CAD to borrow a further A\$5.3 million.

## **Structure of CDC and CAD**

### **CDC**

Following the transfer of the Boyanup assets to CAD and the commencement of the joint venture with QAF, CDC will remain intact but have a reduced operational focus. It will retain its responsibility to manage raw milk procurement (in particular the DRU system) and organise milk collection. CDC will predominantly fund its operations through fees received from CAD. The Milk Supply Agreement expressly provides that to assist CDC in meeting its operating costs, CAD will for a period of 3 years (in addition to the price payable for raw milk) pay CDC an amount equal to its agreed budgeted costs to administer CDC. If an unexpected event beyond CDC's reasonable control increases the cost structure of CDC, the parties agree to negotiate in good faith a new rate payable by CAD so as to enable CDC to recover its budgeted administration costs.

CDC will have capacity to raise additional capital through the sale of additional DRUs, retention of dividends from CAD profits, etc.

### **CAD (joint venture)**

CAD will be responsible for and conduct all dairy product processing and manufacturing operations and discharge the sales, marketing and distribution function.

It is anticipated that sales will be bolstered through the Manufacturing and Supply Agreement to be executed between CAD and QAF. Pursuant to this agreement QAF, (through a right of first refusal arrangement with CAD) undertakes to offer CAD the rights to supply at competitive prices all dairy products required for its operations.

### **Shareholding and Board Representation**

Following QAF's share subscription it will hold 51% of the shares in CAD with CDC holding the remaining 49%.

Under the terms of a shareholders agreement to be executed between CDC and QAF each party will be entitled to nominate 3 representatives to the QAF Board. The Chairman of the



CAD Board will be appointed from the QAF representatives and the Chairman will have a casting vote on resolutions before the Board that do not require the approval of at least 2 of each of CDC's and QAF's representatives. The protection for CDC in this scenario is that the majority of substantive resolutions to come before the Board will require the approval of at least 2 of each of CDC's and QAF's representatives. **In other words, for such resolutions to be valid, at least 2 of the 3 CDC representatives on the Board must approve them.**

In addition, certain resolutions need to be put to shareholders. The Shareholders Agreement stipulates that certain of these resolutions can only be passed by a **special** resolution of shareholders (i.e., shareholders exercising more than 75% of voting rights).

The need for a special resolution gives CDC a veto right on these issues whilst it holds 25% or more of the shares of CAD.

### **Executive Management**

The existing CEO and senior management will remain in place. The appointment of a new CEO will require a unanimous Board decision.

### **Singapore Office**

In order to drive market opportunities in south-east Asia, CAD will establish a regional office in Singapore with at least one full time employee.

### **Reimbursement of CDC Administration Costs**

For a period of 3 years, CAD will make a contribution to CDC's administration costs in an amount equal to its budget costs to administer CDC.

## **Benefits of a joint venture**

From CDC's perspective, the participation by QAF in CAD in the manner described in this Explanatory Memorandum meets the original objectives and strategic plan set by CDC. The proposed joint venture structure:

- provides the capital required to develop modern manufacturing capacity (and potentially a new complete state of the art manufacturing facility);

- through the existing QAF presence in Asia, provides immediate access to additional overseas markets which show positive cash flows and generally provides opportunities for growing the export markets for value added products;

- establishes an association with a significant food marketing and distribution group in the ASEAN region which is of considerable substance and reputation;

- provides the opportunity for CDC to be a major force in the Western Australian dairy industry;

- enables CDC to maintain an autonomous existence and retain its milk supply rights through continued ownership of the DRUs; and

- the terms of the Milk Supply Agreement will define in a legally enforceable manner CDC's right to supply milk to CAD and CAD's obligations to take that milk.

From a QAF perspective, it creates the opportunity to develop its Ben Foods dairy division as a significant and integral part of its range of food products through access to a reliable and high quality milk supply and value added dairy products on cost effective terms.

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**CHALLENGE DAIRY CO-OPERATIVE LIMITED  
AND CONTROLLED ENTITIES  
FINANCIAL REPORT  
FOR THE YEAR ENDED 30 JUNE 2004**

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**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**AND CONTROLLED ENTITIES**  
**STATEMENTS OF FINANCIAL PERFORMANCE**  
**FOR THE YEAR ENDED 30 JUNE 2004**

	Notes	CONSOLIDATED ENTITY	PARENT ENTITY	
		2004 \$	2004 \$	2003 \$
<b>Revenue from ordinary activities</b>	<b>2</b>	<b>42,154,245</b>	<b>40,045,073</b>	<b>30,094,852</b>
Change in inventories of finished goods and work in progress		(677,418)	(3,009,113)	(352,869)
Raw materials and consumables used		(28,380,314)	(24,749,543)	(21,641,425)
Employee benefits expense		(2,142,678)	(1,181,959)	(4,512,519)
Depreciation expense	<b>3</b>	(399,476)	(241,756)	(760,517)
Carrying amount of non current assets sold		(5,810,182)	(5,770,476)	-
Gas, water and electricity expense		(599,504)	(102,058)	(1,431,776)
Repairs and maintenance expense		(575,563)	(222,223)	(1,453,510)
Borrowing costs expense	<b>3</b>	(123,498)	(115,479)	(186,599)
Other expenses from ordinary activities		(1,207,438)	(4,065,999)	(3,654,182)
Share of net loss of associates and joint venture		(1,934,488)	(1,934,488)	-
<b>Profit / (Loss) from ordinary activities before income tax expense</b>		<b>303,686</b>	<b>(1,348,021)</b>	<b>(3,898,545)</b>
Income tax expense relating to ordinary activities	<b>4</b>	-	-	-
<b>Profit / (Loss) from ordinary activities after related income tax expense</b>		<b>303,686</b>	<b>(1,348,021)</b>	<b>(3,898,545)</b>
<b>Net Profit/(Loss)</b>		<b>303,686</b>	<b>(1,348,021)</b>	<b>(3,898,545)</b>
Net increase in asset revaluation reserve	<b>18</b>	1,585,355	3,402,185	-
<b>Total revenues, expenses and valuation adjustments attributable recognised directly in equity to members of Challenge Dairy Co-operative Limited</b>		<b>1,585,355</b>	<b>3,402,185</b>	<b>-</b>
<b>Total change in equity other than those resulting from transactions with owners as owners</b>		<b>1,889,041</b>	<b>2,054,164</b>	<b>(3,898,545)</b>

*The above statements of financial performance should be read in conjunction with the accompanying notes.*

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**AND CONTROLLED ENTITIES**  
**STATEMENTS OF FINANCIAL POSITION**  
**AS AT 30 JUNE 2004**

	Notes	CONSOLIDATED ENTITY		PARENT ENTITY	
		2004	2004	2004	2003
		\$	\$	\$	\$
<b>CURRENT ASSETS</b>					
Cash	5	513,505	199,475		200
Receivables	6	4,988,026	4,303,206		4,683,861
Inventories	7	3,904,948	218,417		3,227,530
Other	8	40,524	21,008		12,565
<b>TOTAL CURRENT ASSETS</b>		<b>9,447,002</b>	<b>4,742,105</b>		<b>7,924,156</b>
<b>NON-CURRENT ASSETS</b>					
Property, plant and equipment	9	8,257,023	2,718,087		7,122,914
Other	10	-	8,448,001		172,001
<b>TOTAL NON-CURRENT ASSETS</b>		<b>8,257,023</b>	<b>11,166,088</b>		<b>7,294,915</b>
<b>TOTAL ASSETS</b>		<b>17,704,025</b>	<b>15,908,193</b>		<b>15,219,071</b>
<b>CURRENT LIABILITIES</b>					
Payables	11	6,059,870	4,727,290		5,393,565
Interest bearing liabilities	12	1,085,965	1,000,000		1,951,265
Provisions	13	475,586	169,703		537,419
<b>TOTAL CURRENT LIABILITIES</b>		<b>7,621,421</b>	<b>5,896,992</b>		<b>7,882,249</b>
<b>NON-CURRENT LIABILITIES</b>					
Interest bearing liabilities	14	141,919	-		213,456
Provisions	15	112,372	17,764		95,821
Other		2,312	2,312		2,312
<b>TOTAL NON-CURRENT LIABILITIES</b>		<b>256,603</b>	<b>20,076</b>		<b>311,589</b>
<b>TOTAL LIABILITIES</b>		<b>7,878,024</b>	<b>5,917,068</b>		<b>8,193,838</b>
<b>NET ASSETS</b>		<b>9,826,001</b>	<b>9,991,125</b>		<b>7,025,233</b>
<b>EQUITY</b>					
Capital	16	2,437,536	2,437,536		1,525,810
Non-share capital	17	10,000,000	10,000,000		10,000,000
Reserves	18	1,585,355	3,402,185		-
Accumulated losses	22	(4,196,889)	(5,848,598)		(4,500,577)
<b>TOTAL EQUITY</b>		<b>9,826,001</b>	<b>9,991,125</b>		<b>7,025,233</b>

The above statements of financial position should be read in conjunction with the accompanying notes.

**CHALLENGE DAIRY CO-OPERATIVE LIMITED  
AND CONTROLLED ENTITIES**  
STATEMENTS OF CASH FLOWS  
FOR THE YEAR ENDED 30 JUNE 2004

	Notes	CONSOLIDATED ENTITY		PARENT ENTITY	
		2004		2004	2003
		\$		\$	\$
		Inflows (Outflows)	Inflows (Outflows)	Inflows (Outflows)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>					
Receipts from customers		41,991,084	37,538,974	32,059,760	
Interest received		27,306	22,853	31,862	
Payments to suppliers and employees		(40,071,310)	(35,836,224)	(33,582,073)	
Borrowing costs		(123,498)	(115,479)	(186,599)	
<b>Net cash flows from operating activities</b>	27 (ii)	<b>1,823,582</b>	<b>1,610,124</b>	<b>(1,677,050)</b>	
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>					
Payments for property plant and equipment		(190,082)	(186,782)	(624,452)	
Proceeds from sale of property plant and equipment		-	-	20,000	
Costs incurred to establish JV		(348,488)	(348,488)	-	
Payments for controlled entity net of cash	27 (iii)	(706,903)	-	-	
Payments to buy out JV partner		-	(903,527)	-	
<b>Net cash flows from investing activities</b>		<b>(1,245,473)</b>	<b>(1,438,797)</b>	<b>(604,452)</b>	
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>					
Proceeds from issue of equity instruments		911,726	911,726	398,560	
Proceeds from borrowings		-	-	500,000	
Repayment of borrowings		(805,765)	(713,013)	-	
<b>Net cash flows from financing activities</b>		<b>105,961</b>	<b>198,713</b>	<b>898,560</b>	
Net increase / (decrease) in cash held		<b>684,070</b>	<b>370,040</b>	<b>(1,382,942)</b>	
Cash held at the beginning of the period		(170,565)	(170,565)	1,212,377	
<b>CASH HELD AT THE END OF THE PERIOD</b>	27 (i)	<b>513,505</b>	<b>199,475</b>	<b>(170,565)</b>	

*The above statements of cash flows should be read in conjunction with the accompanying notes.*

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**AND CONTROLLED ENTITIES**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2004**

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

This general purpose financial report has been prepared in accordance with Accounting Standards, other authoritative pronouncements of the Australian Accounting Standards Board, Urgent Issues Group Consensus Views and statutory requirements.

The financial report is prepared in accordance with the historical cost convention, except for certain assets which, as noted, are at valuation. Unless otherwise stated, the accounting policies adopted are consistent with those of the previous year.

**(a) Principles of consolidation**

The consolidated financial statements incorporate the assets and liabilities of all entities controlled by Challenge Dairy Co-operative Limited as at 30 June 2004 and the results of all controlled entities for the year then ended. Challenge Dairy Co-operative Limited and its controlled entities together are referred to in this financial report as the consolidated entity. The effects of all transactions between entities in the consolidated entity are eliminated in full. Outside equity interests in the results and equity of controlled entities are shown separately in the consolidated statement of financial performance and statement of financial position respectively.

Where control of an entity is obtained during a financial year, its results are included in the consolidated statement of financial performance from the date on which control commences. Where control of an entity ceases during a financial year its results are included for that part of the year during which control existed.

Investments in associates are accounted for in the consolidated financial statements using the equity method. Under this method, the consolidated entity's share of the post-acquisition profits or losses of associates is recognised in the consolidated statement of financial performance, and its share of post-acquisition movements in reserves is recognised in consolidated reserves. The cumulative post-acquisition movements are adjusted against the cost of the investment. Associates are those entities over which the consolidated entity exercises significant influence, but not control.

**(b) Income Tax**

The company adopts the liability method of tax-effect accounting whereby the income tax expense shown in the statement of financial performance is based on the operating profit before income tax adjusted for any permanent differences.

Timing differences which arise due to the different accounting periods in which items of revenue and expense are included in the determination of operating loss before income tax and taxable income are brought to account as either a provision for deferred income tax or an asset described as future income tax benefit at the rate of income tax applicable to the period in which the benefit will be received or the liability will become payable.

Future income tax benefits are not brought to account unless realisation of the asset is assured beyond reasonable doubt. Future income tax benefits in relation to tax losses are not brought to account unless there is virtual certainty of realisation of the benefit.

The amount of benefits brought to account or which may be realised in the future is based on the assumption that no adverse change will occur in income taxation legislation and the anticipation that the company will derive sufficient future assessable income to enable the benefit to be realised and comply with the conditions of deductibility imposed by the law.

**(c) Acquisition of Assets**

The purchase method of accounting is used for all acquisitions of assets regardless of whether equity instruments or other assets are acquired. Cost is measured as the fair value of the assets given up, shares issued or liabilities undertaken at the date of acquisition plus incidental costs directly attributable to the acquisition. Where equity instruments are issued in an acquisition, the value of the instruments is their market price as at the acquisition. Transaction costs arising on the issue of equity instruments are recognised directly in equity.

Where settlement of any part of cash consideration is deferred, the amounts payable in the future are discounted to their present value as at the date of acquisition. The discount rate used is the incremental borrowing rate, being the rate at which a similar borrowing could be obtained from an independent financier under comparable terms and conditions.

A liability for restructuring costs is recognised as at the date of acquisition of an entity or part thereof when there is a demonstrable commitment to restructuring of the acquired entity and a reliable estimate of the amount of the liability can be made.

# CHALLENGE DAIRY CO-OPERATIVE LIMITED

## AND CONTROLLED ENTITIES

NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2004

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### NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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#### **(d) Revenue Recognition**

Amounts disclosed as revenue are net of returns, trade allowances and duties and taxes paid.

#### **(e) Receivables**

All trade debtors are recognised at the amounts receivable as they are due for settlement no more than 120 days from the date of recognition.

Collectibility of trade debtors is reviewed on an ongoing basis. Debts which are known to be uncollectible are written off. A provision for doubtful debts is raised when some doubt as to the collection exists.

#### **(f) Inventories**

##### *(1) Raw materials and stores, work in progress and finished goods*

Raw materials and stores, work in progress and finished goods are stated at the lower of cost and net realisable value. Cost comprises direct materials, direct labour and an appropriate proportion of variable and fixed overhead expenditure, the latter being allocated on the basis of normal operating capacity. Costs are assigned to individual items of stock on the basis of weighted average costs.

#### **(g) Recoverable amount of non-current assets**

The recoverable amount of an asset is the net amount expected to be recovered through the net cash inflows arising from its continued use and subsequent disposal.

Where the carrying amount of a non-current asset exceeds its recoverable amount the asset is revalued to its recoverable amount. Where net cash inflows are derived from a group of assets working together, recoverable amount is determined on the basis of the relevant group of assets. To the extent that a revaluation decrement reverses a revaluation increment previously credited to, and still standing to the credit of the asset revaluation reserve, the decrement is debited directly to that reserve. Otherwise the decrement is recognised in the statement of financial performance.

The expected net cash flows included in determining recoverable amounts of non-current assets have not been discounted.

#### **(h) Investments**

Interest in listed and unlisted securities, other than controlled entities and associates in the consolidated financial statements, are brought to account at cost and dividend income is recognised in the statement of financial performance when receivable.

#### **(i) Depreciation of property, plant and equipment**

Depreciation is calculated on a straight line basis to write the net cost or revalued amount of each item of property, plant and equipment (excluding land) over its expected useful life to the entity. Estimates of the remaining useful lives are made on a regular basis for all assets, with annual reassessments for major items.

#### **(i) Leased non-current assets**

A distinction is made between finance leases which effectively transfer from the lessor to the lessee substantially all the risks and benefits incidental to ownership of leased non-current assets, and operating leases under which the lessor effectively retains substantially all such risks and benefits.

Finance leases are capitalised. A lease asset and liability are established at the present value of minimum lease payments. Lease payments are allocated between the principal component of the lease liability and the interest expense.

The lease asset is amortised on a straight line basis over the term of the lease, or where it is likely that the entity will obtain ownership of the asset, the life of the asset.

# CHALLENGE DAIRY CO-OPERATIVE LIMITED

## AND CONTROLLED ENTITIES

NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2004

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### NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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#### **(k) Trade and Other Creditors**

These amounts represent liabilities for goods and services provided to the company prior to the end of the financial year and which are unpaid. These amounts are unsecured and are usually paid within 30 days of recognition.

#### **(l) Employee entitlements**

##### *(i) Wages and salaries, annual leave and sick leave*

Liabilities for wages and salaries, annual leave and sick leave are recognised, and are measured as the amount unpaid at the reporting date at current pay rates in respect of employees' services up to that date.

##### *(ii) Long service leave*

A liability for long service leave is recognised, and is measured as the present value of expected future payments to be made in respect of services provided by employees up to the reporting date. Consideration is given to expected future wage and salary levels, experience of employee departures and periods of service. Expected future payments are discounted using interest rates on national government guaranteed securities with term to maturity that match, as closely as possible, the estimated future cash outflows.

#### **(m) Maintenance and repairs**

The costs of maintenance are charged as expenses as incurred, except where they relate to the replacement of a component of an asset, in which case the costs are capitalised and depreciated in accordance with note 1 (i). Other routine operating maintenance, repair and minor renewal costs are also charged as expenses as incurred.

#### **(n) Foreign currency translation**

Foreign currency transactions are initially translated into Australian currency at the rate of exchange at the date of the transaction. At balance date amounts payable and receivable in foreign currencies are translated to Australian currency at rates of exchange at that date. Resulting exchange differences are recognised in determining the profit or loss for the year.

#### **(o) Borrowing costs**

Borrowing costs are recognised as expenses in the period in which they are incurred, except where they are included in the costs of qualifying assets.

Borrowing costs include:

- interest on bank overdrafts and short term and long-term borrowings;
- amortisation of discounts or premiums relating to borrowings;
- amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
- finance lease charges; and
- certain exchange differences arising from foreign currency borrowings.

#### **(p) Interest bearing liabilities**

Loans and debentures are carried at their principal amounts which represents the present value of future cash flows associated with servicing the debt. Interest is accrued over the period it becomes due and is recorded as part of other creditors.

#### **(q) Revaluation of non-current assets**

Subsequent to initial recognition as assets, land and buildings, including those classified as investment properties, are measured at fair value being the amounts for which the assets could be exchanged between knowledgeable willing parties in an arm's length transaction. Revaluations are made with sufficient regularity to ensure that the carrying amount of each piece of land and each building does not differ materially from its fair value at the reporting date. Annual assessments are made by the directors, supplemented by independent assessments at least every three years.

Revaluation increments are credited directly to the asset revaluation reserve, except that, to the extent that an increment reverses a revaluation decrement in respect of that class of asset previously recognised as an expense in net profit or loss, the increment is recognised immediately as revenue in net profit or loss.



**CHALLENGE DAIRY CO-OPERATIVE LIMITED**

**AND CONTROLLED ENTITIES**

NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2004

	CONSOLIDATED ENTITY		PARENT ENTITY	
	2004		2004	2003
	\$		\$	\$
<b>NOTE 2. REVENUE</b>				
<b>Revenue from operating activities</b>				
Sales of Goods	35,446,328		33,981,396	29,945,101
Services	597,759		15,601	7,563
	<u>36,044,087</u>		<u>33,996,997</u>	<u>29,952,664</u>
<b>Revenue from outside the operating activities</b>				
Cartage	33,033		33,033	757
Interest	27,306		22,853	31,862
Rental income	10,800		10,800	11,701
Proceeds on sale of non-current assets	5,950,478		5,918,350	20,000
Other	88,541		63,040	77,868
	<u>6,110,158</u>		<u>6,048,076</u>	<u>142,188</u>
Revenue from ordinary activities	<u>42,154,245</u>		<u>40,045,073</u>	<u>30,094,852</u>

**NOTE 3. PROFIT FROM ORDINARY ACTIVITIES**

**a) Net gains and expenses**

Profit from ordinary activities before income tax expense includes the following specific net gains and expenses:

**Net gains**

Net gain on disposal			
Property, plant and equipment	140,296	147,924	20,000

**Expenses**

Cost of sales of goods	32,756,543	31,311,893	26,692,667
Depreciation			
Buildings	71,520	25,843	117,625
Plant and equipment	327,956	215,912	642,892
Total Depreciation	<u>399,476</u>	<u>241,756</u>	<u>760,517</u>
Bad debts	-	-	195
Forgiveness of debt to controlled entity	-	2,197,983	-
Borrowing costs			
Interest and finance charges paid/payable	123,498	115,479	186,599
Other Provisions			
Employee Entitlements	(45,282)	(445,774)	50,100

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**

**AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 30 JUNE 2004**

	CONSOLIDATED ENTITY		PARENT ENTITY	
	2004		2004	2003
	\$		\$	\$

**NOTE 4. INCOME TAX**

The aggregate amount of income tax attributable to the period differs from the amount calculated on the operating profit. The differences are reconciled as follows:

Prima facie tax benefit on operating profit/(loss) before income tax at 30%	91,106	(404,406)	(1,169,564)
Add tax effect of:			
<b>Permanent differences</b>			
Non deductible entertaining	5,492	1,070	4,569
Non deductible travel	-	-	10,000
Non deductible fines	-	-	100
Other non deductible expenses	-	-	4,575
Income tax adjusted for permanent differences	96,598	(403,336)	(1,150,320)
- future income tax benefit in respect of tax losses and timing differences not brought to account	(96,598)	403,336	1,150,320
	-	-	-

The directors estimate that the potential future income tax benefit at 30 June 2004 in respect of tax losses not brought to account is

	1,258,518	1,758,452	1,355,116
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This benefit for tax losses will only be obtained if:

- (i) the co-operative derives future assessable income of a nature and sufficient amount to enable the benefit from the deductions for the losses to be realised
- (ii) the co-operative continues to comply with the conditions for deductibility imposed by tax legislation, and
- (iii) no changes in tax legislation adversely affect the co-operative in realising the benefit from the deductions for the losses.

**NOTE 5. CURRENT ASSETS - Cash**

Cash at bank and on hand	513,505	199,475	200
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**NOTE 6. CURRENT ASSETS - Receivables**

Trade debtors	4,114,559	3,644,252	3,948,934
Other debtors	873,467	658,954	734,927
	4,988,026	4,303,206	4,683,861

**NOTE 7. CURRENT ASSETS - Inventories**

Raw materials - at cost	221,162	-	36,083
	221,162	-	36,083
Finished goods			
- at net realisable value	3,656,109	203,588	2,941,053
	3,656,109	203,588	2,941,053
Stocks materials / engineering stores	27,677	14,829	250,394
	27,677	14,829	250,394
Aggregate carrying amount of inventories	3,904,948	218,417	3,227,530

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**AND CONTROLLED ENTITIES**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2004**

	CONSOLIDATED ENTITY		PARENT ENTITY	
	2004	2004	2004	2003
	\$	\$	\$	\$
<b>NOTE 8. CURRENT ASSETS - Other</b>				
Prepayments	40,524	21,008	12,565	
<b>NOTE 9. NON-CURRENT ASSETS - Property, plant and equipment</b>				
<b>Land and buildings</b>				
Freehold Land				
At fair value	1,462,824	862,320	585,296	
	1,462,824	862,320	585,296	
Buildings				
Less - Accumulated depreciation	2,118,011	791,982	1,336,720	
	(127,155)	(19,502)	(197,593)	
	1,990,856	772,480	1,139,127	
<b>Plant and equipment</b>				
At cost				
Less - accumulated depreciation	4,129,727	871,474	4,679,262	
	(377,516)	(129,908)	(542,571)	
	3,752,211	741,566	4,136,691	
Plant and equipment in the course of construction				
	146,683	12,027	113,303	
Total plant and equipment				
	3,898,893	753,592	4,249,994	
Office Equipment at cost				
Less - accumulated depreciation	228,850	31,778	490,318	
	(152,764)	(21,156)	(314,743)	
	76,085	10,621	175,575	
Plant and equipment under finance lease				
Less: Accumulated amortisation	493,049	-	548,897	
	(33,555)	-	(49,322)	
	459,494	-	499,575	
Motor Vehicle at cost				
Less - accumulated depreciation	736,991	668,876	729,252	
	(368,121)	(349,803)	(255,905)	
	368,870	319,073	473,347	
Total property, plant and equipment				
	8,257,023	2,718,087	7,122,914	

Reconciliations of the carrying amounts of each class of property, plant and equipment at the beginning and end of the current financial year are set out below.

	Freehold Land	Buildings	Plant & equipment	In course of construction	Office equipment	Motor vehicles	Leased Assets	Total
Opening (01/07/03)	585,296	1,139,127	4,124,543	113,303	175,574	473,348	511,723	7,122,914
Reclassification	-	-	-	-	-	30,062	(30,062)	-
Carrying amount of JV assets at 12 March 2004	490,600	1,076,155	3,311,249	156,405	43,660	56,038	434,597	5,568,704
Additions	-	3,676	95,452	11,944	41,864	-	37,147	190,083
Revaluation	755,927	994,159	-	-	-	-	-	1,750,086
Discount on acquisition	(17,381)	-	(147,725)	-	-	-	-	(165,106)
Disposals	(351,618)	(1,150,742)	(3,468,033)	(134,969)	(158,180)	(66,994)	(479,646)	(5,810,182)
Depreciation	-	(71,520)	(163,276)	-	(26,833)	(123,584)	(14,263)	(399,476)
Closing (30/06/04)	1,462,824	1,990,855	3,752,210	146,683	76,085	368,870	459,496	8,257,023

**CHALLENGE DAIRY CO-OPERATIVE LIMITED  
AND CONTROLLED ENTITIES  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2004**

	CONSOLIDATED ENTITY		PARENT ENTITY	
	2004		2004	2003
	\$		\$	\$

**NOTE 10. CURRENT ASSETS - Other**

Cost of joint venture establishment	-		-	172,001
Investment in CAD	-		6,466,440	-
Revaluation of investment	-		1,981,561	-
	-		<u>8,448,001</u>	<u>172,001</u>

**NOTE 11. CURRENT LIABILITIES - Payables**

Trade creditors	3,450,909		2,438,352	4,752,599
Other creditors and accruals	847,210		527,187	640,966
Amount owing to SAETC	1,761,750		1,761,750	-
	<u>6,059,870</u>		<u>4,727,290</u>	<u>5,393,565</u>

**NOTE 12. CURRENT LIABILITIES - Interest bearing liabilities**

**Secured**

Bank overdraft	-		-	170,765
Bank Loan	1,000,000		1,000,000	1,700,000
Lease liabilities (note 26)	85,965		-	80,500
	<u>1,085,965</u>		<u>1,000,000</u>	<u>1,951,265</u>

**Bank Loan**

The bank loan is secured by a first registered fixed and floating charge over all assets and undertakings of Challenge Dairy Co-operative Limited.

**NOTE 13. CURRENT LIABILITIES - Provisions**

Annual leave	239,937		76,125	253,833
Long service leave	187,921		76,688	233,150
Sick leave	20,493		8,047	15,603
Rostered days off	27,234		8,842	34,833
Total provisions	<u>475,586</u>		<u>169,703</u>	<u>537,419</u>

Average number of employees during the financial year	85		25	83
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**NOTE 14. NON-CURRENT LIABILITIES - Interest bearing liabilities**

**Secured**

Lease Liability (note 26)	141,919		-	213,456
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**NOTE 15. NON-CURRENT LIABILITIES - Provisions**

Long service leave	112,372		17,764	95,821
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**NOTE 16. EQUITY - Capital**

Farmers voting shares		(i)	133,000	133,000
A class shares		(ii)	2,304,536	1,392,810
			<u>2,437,536</u>	<u>1,525,810</u>

**(i) Farmers Voting Shares**

During the period ended 30 June 2004, a further 8, \$1,000 shares were issued and 8 were repurchased. During the period ended 30 June 2003 a further 19, \$1,000 shares were issued and 7 were repurchased.

**(ii) A class shares**

During the period ended 30 June 2004, 8,608 "A" class shares were issued. During the period ended 30 June 2003, 756 "A" class shares were issued.

# CHALLENGE DAIRY CO-OPERATIVE LIMITED

## AND CONTROLLED ENTITIES

### NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 30 JUNE 2004

	CONSOLIDATED ENTITY		PARENT ENTITY	
	2004	2004	2004	2003
	\$	\$	\$	
<b>NOTE 17. EQUITY - Non share capital</b>				
Non - share equity interest	10,000,000	10,000,000	10,000,000	
	<u>10,000,000</u>	<u>10,000,000</u>	<u>10,000,000</u>	

The non-share equity interest comprises a loan secured by a fixed and floating charge over the assets of the Challenge Dairy Co-Operative Limited.

The loan may become non-renounceable subject to terms given by the Minister of State Development. Up to 30 June 2004 a total amount of \$8,500,000 had been forgiven and subsequent to year end the remaining loan has been forgiven upon satisfaction of the conditions of the loan.

#### NOTE 18. RESERVES

Asset revaluation reserve	1,585,355	3,402,185	-
<b>Movements:</b>			
Asset revaluation reserve			
Balance 1 July 2003	-	-	-
Increment on revaluation of freehold land and buildings at the end of the financial year	1,585,355	1,420,624	-
Increment on revaluation of investment in associate at the end of the financial year	-	1,981,561	-
Balance 30 June 2004	<u>1,585,355</u>	<u>3,402,185</u>	<u>-</u>

#### NOTE 19. FINANCIAL INSTRUMENTS

##### (a) Net Fair Values

The aggregate net fair value of financial assets and financial liabilities approximate the carrying amount of the financial assets and liabilities as indicated in the balance sheet. There are no unrecognised financial assets or financial liabilities at 30 June 2004.

##### (b) Credit Risk Exposures

The company's exposure to credit risk at 30 June 2004 in relation to each class of recognised asset is the carrying amount of those assets indicated in the statement of financial position.

##### (c) Interest Rate Risk Exposure

The company's exposure to interest rate risk is considered minimal. Cash balances earn interest at the banks' benchmark rate which is within the vicinity of 4%.

	Fixed interest maturing in:					Total
	Floating Interest Rate	1 year or less	Over 1 to 5 years	More than 5 years	Non-interest bearing	
<b>2004 (Consolidated entity)</b>						
<b>Financial assets</b>						
Cash and deposits	513,505	-	-	-	-	513,505
Receivables	-	-	-	-	4,812,564	4,812,564
	<u>513,505</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,812,564</u>	<u>5,326,069</u>
Weighted average interest rate	3.5%					
<b>Financial Liabilities</b>						
Bank overdrafts and loans	1,000,000	-	-	-	-	1,000,000
Trade and other creditors	-	-	-	-	6,059,870	6,059,870
Other loans	-	-	-	-	2,312	2,312
Lease liabilities	-	85,965	141,919	-	-	227,884
	<u>1,000,000</u>	<u>85,965</u>	<u>141,919</u>	<u>-</u>	<u>6,062,182</u>	<u>7,290,066</u>
Weighted average interest rate	8.0%	9.0%	9.0%			
Net financial assets (liabilities)	<u>(486,495)</u>	<u>(85,965)</u>	<u>(141,919)</u>	<u>-</u>	<u>(1,249,618)</u>	<u>(1,963,997)</u>

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**

**AND CONTROLLED ENTITIES**

**NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2004**

**NOTE 19. FINANCIAL INSTRUMENTS (Continued)**

	Fixed interest maturing in:					Total
	Floating Interest Rate	1 year or less	Over 1 to 5 years	More than 5 years	Non-interest bearing	
<b>2003 (Parent entity)</b>						
<b>Financial assets</b>						
Cash and deposits	200	-	-	-	-	200
Receivables	-	-	-	-	4,683,861	4,683,861
	<u>200</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,683,861</u>	<u>4,684,061</u>
Weighted average interest rate	2.0%					
<b>Financial Liabilities</b>						
Bank overdrafts and loans	1,870,765	-	-	-	-	1,870,765
Trade and other creditors	-	-	-	-	5,393,565	5,393,565
Other loans	-	-	-	-	2,312	2,312
Lease liabilities	-	80,500	213,456	-	-	293,956
	<u>1,870,765</u>	<u>80,500</u>	<u>213,456</u>	<u>-</u>	<u>5,395,877</u>	<u>7,560,598</u>
Weighted average interest rate	9.60%	6.25%	6.25%			
Net financial assets (liabilities)	<u>(1,870,565)</u>	<u>(80,500)</u>	<u>(213,456)</u>	<u>-</u>	<u>(712,016)</u>	<u>(2,876,537)</u>

**NOTE 20. RELATED PARTIES**

**Directors**

Directors of the consolidated entity during the period were:

**Challenge Dairy Co-Operative Ltd**

Mr Larry Brennen  
Mr Neville Haddon  
Mr Steven Scott  
Mr Robert Poole  
Mr David McIntyre (resigned) 11/12/03  
Mr Geoffrey Jenkins  
Mr Graham Shepherd

**Challenge Australian Dairy Pty Ltd**

Mr Larry Brennen  
Mr Neville Haddon  
Mr David McIntyre (Resigned) 11/12/03  
Mr Geoffrey Jenkins (Appointed) 12/12/03  
Mr Xing, Chunhua (Resigned) 19/11/03  
Mr Zhao, Jifeng (Resigned) 19/11/03  
Mr Chen, Lijun (Resigned) 12/3/04  
Mr Guo, Weijian (Appointed) 19/11/03 (Resigned) 12/3/04  
Mr Bao, Zongye (Appointed) 19/11/03 (Resigned) 12/3/04

**Transactions with directors and director related entities concerning shares**

Aggregate numbers of shares of the company acquired from the company and held at 30 June 2004 by the directors of the company or their director-related entities:

	PARENT ENTITY		PARENT ENTITY	
	2004	2003	2004	2003
	shares	shares	\$	\$
Farmers voting shares	5	5	5,000	5,000
A class ordinary shares	1,746	221	167,400	96,475
B class ordinary shares	-	-	-	-

**Other transactions with directors and director-related entities**

During the year Mr Graham Shepherd was paid \$15,244 for the performance of consultancy services over the prior two years to the company, and \$1,725 for services to Challenge Australian Dairy Pty Ltd

During the year, S&L Scott, an entity associated with Mr Steven Scott, leased land to Challenge Australian Dairy Pty Ltd at normal commercial terms.

During the year the directors listed below supplied the Co-operative with product which was acquired at normal commercial terms and conditions no more favourable than those available to other members.

Mr Larry Brennen  
Mr Neville Haddon  
Mr Steven Scott  
Mr Robert Poole  
Mr Geoffrey Jenkins

# CHALLENGE DAIRY CO-OPERATIVE LIMITED

## AND CONTROLLED ENTITIES

### NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED 30 JUNE 2004

	CONSOLIDATED ENTITY	PARENT ENTITY	
	2004	2004	2003
	\$	\$	\$

#### NOTE 20. RELATED PARTIES (Continued)

Transactions between related parties are on normal commercial terms and conditions no more favourable than those available to other parties.

#### NOTE 21. EVENTS OCCURRING AFTER BALANCE DATE

On the 8th October, CDC signed a Joint Venture Agreement with QAF Ltd, a substantial Singapore company listed on the Singapore stock exchange. Members have previously agreed to the joint venture at a meeting of members held on 24th September. On 18th October, QAF contribute \$7,875,000 to subscribe for 51% of the shares of Challenge Australian Dairy Pty Ltd. On 18th October, Challenge Australian Dairy Pty Ltd purchased from Challenge Dairy Co-operative Ltd, the Boyanup operations for a sum of \$2,450,000. In addition to subscribing for capital, QAF has also made undertakings to assist in raising further funds. On receipt of the monies, Challenge Dairy Co-operative Ltd has extinguish all loans from banks. At the date of this report, Challenge Dairy Co-operative Ltd is in a cash positive position. As a result of the subscription for capital in Challenge Australian Dairy Pty Ltd, Challenge Dairy Co-operative Limited will now equity account its investment in Challenge Australian Dairy Pty Ltd and will no longer consolidate the entity.

#### NOTE 22. RETAINED PROFITS

Retained profits at the beginning of the financial year	(4,500,577)	(4,500,577)	(602,032)
Net profit attributable to members of Challenge Dairy Co-operative Limited	303,688	(1,348,021)	(3,898,545)
Retained profits at the end of the financial year	(4,196,889)	(5,848,598)	(4,500,577)

#### NOTE 23. SEGMENT INFORMATION

The company operates in the dairy industry within Western Australia.

#### NOTE 24. REMUNERATION OF DIRECTORS

Income paid or payable, or otherwise made available, to directors by the company and related parties in connection with the management of the affairs of the company:

Executive directors	104,448	38,150	31,416
Non-executive directors	243,338	126,573	119,948
	347,786	164,723	151,364

Details of the remuneration of each director of the company, including their personally-related entities, is set out in the following table:

2004

Name	Primary			Post-employment		
	Cash, salary and fees \$	Cash Bonus \$	Non-monetary benefits \$	Super-annuation \$	Retirement benefits \$	
<b>Directors of CDC</b>						
<b>Executive</b>						
Mr Larry Brennen	35,000	-	-	3,150	-	38,150
<b>Non-executive</b>						
Mr Larry Brennen	26,176	-	-	2,356	-	28,532
Mr Neville Haddon	16,514	-	-	1,486	-	18,000
Mr David McIntyre (Resigned 11/12/03)	8,042	-	-	-	-	8,042
Mr Geoffrey Jenkins	16,514	-	-	1,486	-	18,000
Mr Steven Scott	16,514	-	-	1,486	-	18,000
Mr Robert Poole	16,514	-	-	1,486	-	18,000
Mr Graham Shepherd	-	-	-	17,999	-	17,999
	100,274	-	-	26,299	-	126,573
<b>Directors of CAD</b>						
<b>Executive</b>						
Mr David McIntyre (Resigned 11/12/03)	61,424	-	-	4,874	-	66,298
<b>Non-executive</b>						
Mr Larry Brennen	34,645	-	-	3,118	-	37,763
Mr Neville Haddon	17,323	-	-	1,559	-	18,882
Mr Geoffrey Jenkins	10,303	-	-	927	-	11,230
Mr Xing Chunhua (Resigned 19/11/03)	9,778	-	-	-	-	9,778
Mr Zhao Jifeng (Resigned 19/11/03)	9,778	-	-	-	-	9,778
Mr Chen Lijun (Resigned 12/03/04)	9,778	-	-	-	-	9,778
Mr Guo Weijian	9,778	-	-	-	-	9,778
(From 19/11/03 - 12/03/04)	-	-	-	-	-	-
Mr Bao Zongye	9,778	-	-	-	-	9,778
(From 19/11/03 - 12/03/04)	-	-	-	-	-	-
	111,161	-	-	5,604	-	116,765

**CHALLENGE DAIRY CO-OPERATIVE LIMITED  
AND CONTROLLED ENTITIES**

Total	307,859	-	-	39,927	-	347,786
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# CHALLENGE DAIRY CO-OPERATIVE LIMITED

## AND CONTROLLED ENTITIES

NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2004

	CONSOLIDATED ENTITY	PARENT ENTITY	
	2004	2004	2003
	\$	\$	\$
<b>NOTE 25. AUDITORS REMUNERATION</b>			
Amounts received, or due and receivable by the auditors for:			
- Auditing the financial report	32,000	12,000	22,000
- Other services	90,380	77,911	7,200
	122,380	89,911	29,200

### NOTE 26. COMMITMENTS FOR EXPENDITURE

#### Operating leases

Commitments for minimum lease payments in relation to non-cancellable operating leases are payable as follows:

Within one year	24,696	-	17,292
Later than one year but not later than 5 years	49,392	-	51,876
Later than 5 years	-	-	-
	74,088	-	69,168

#### Finance leases

Commitments in relation to finance leases are payable as follows

Within one year	103,075	-	105,093
Later than one year but not later than 5 years	154,468	-	220,796
Minimum lease payments	257,543		325,889
Less: Future finance charges	(29,659)		(31,933)
Recognised as a liability	227,884		293,956

Representing lease liabilities

Current (note 12)	85,965	-	80,500
Non-current (note 14)	141,919	-	213,456
	227,884	-	293,956

#### Capital Commitments

Commitments for the acquisition of plant and equipment contracted for at the reporting date but not recognised as liabilities, payable:

Within one year	-	-	-
Later than one year but not later than 5 years	-	-	-
	-	-	-

### NOTE 27. NOTES TO THE STATEMENTS OF CASH FLOWS

#### (i) Reconciliation of Cash

For the purposes of the statements of cash flows, cash includes deposits at call which are readily convertible to cash on hand and are subject to an insignificant risk of changes in value. Cash at 30 June 2004 as shown in the statement of cash flows is reconciled to the related items in the statement of financial position as follows:

Cash at bank	513,505	199,475	200
Less: Bank overdraft	-	-	(170,765)
	513,505	199,475	(170,565)

#### (ii) Reconciliation of Cash Flows from Operating Activities to Operating Loss After Income Tax

Operating profit/(loss) after income tax	303,686	(1,348,021)	(3,898,545)
Changes in assets and liabilities:			
Depreciation and amortisation	399,476	241,757	760,517
Net gain on sale of non current assets	(140,296)	(147,874)	(20,000)
Share of associate loss	1,934,488	1,934,488	-
Change in operating assets and liabilities, net of effects from purchase of controlled entity			
(Increase) / decrease in trade debtors	(304,165)	380,655	(528,345)
(Increase) / decrease in inventory	(677,418)	3,009,113	352,869
(Increase) / decrease in other operating assets	(27,959)	(8,443)	(103,118)
Increase / (decrease) in accounts payable	381,052	(2,406,811)	1,709,472
Increase / (decrease) in provisions	(45,282)	(44,740)	50,100
Net cash flows from operating activities	1,823,582	1,610,124	(1,677,050)

# CHALLENGE DAIRY CO-OPERATIVE LIMITED

## AND CONTROLLED ENTITIES

NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2004

	CONSOLIDATED ENTITY	PARENT ENTITY	
	2004	2004	2003
	\$	\$	\$
<b>NOTE 27. NOTES TO THE STATEMENTS OF CASH FLOWS (CONTINUED)</b>			
<b>(iii) Outflow of cash to acquire controlled entity, net of cash acquired</b>			
Cash consideration	903,527	-	-
Less: Balances acquired			
Cash	196,624	-	-
Outflow of cash	706,903	-	-

**(iv) Non-cash financing and investing activities**

Challenge Dairy Co-operative Limited purchased 50% of Challenge Australian Dairy Pty Ltd in consideration for the transfer of net assets and liabilities of \$5,215,212.

**NOTE 28. INVESTMENT IN CONTROLLED ENTITIES**

Name of entity	Country of Incorporation	Class of Share	Equity Holding %	
			2004	2003
Challenge Australia Dairy Pty Ltd	Australia	Ordinary	100	-

On the 12 March 2004 the parent entity purchased the remaining shares of Challenge Australia Dairy Pty Ltd for \$2,610,000 plus associated acquisition costs of \$55,277. As at 30 June 2004 an amount of \$1,761,750 is still owing to Sanyuan Australian Economic and Trade Co. Pty Ltd (SAETC).

**NOTE 29. WORKING CAPITAL**

During the year the company and consolidated entity experienced poor trading conditions that resulted in losses in the first half of the year. In the second half of the year the trading conditions improved resulting an overall profit for the consolidated entity of \$303,686.

As disclosed in Note 21, subsequent to the year end, QAF Limited has subscribed for shares totalling \$7,875,000 in Challenge Australian Dairy Pty Ltd and Challenge Dairy Co-operative Limited has sold the Boyanup operations to Challenge Australian Dairy Pty Ltd. This has resulted in the entities having surplus working capital subsequent to the year end.

**NOTE 30. INTERNATIONAL FINANCIAL REPORTING STANDARDS**

The Australian Accounting Standards Board (AASB) is adopting the International Financial Reporting Standards (IFRS) for application to reporting periods beginning on or after 1 January 2005.

This financial report has been prepared in accordance with Australian accounting standards and other financial reporting requirements (Australian GAAP). The differences between Australian GAAP and IFRS identified to date as potentially having a significant effect on the economic entity's financial performance and financial position are summarized below. The summary should not be taken as an exhaustive list of all the differences between Australian GAAP and IFRS. No attempt has been made to identify all disclosure, presentation or classification differences that would affect the manner in which transactions or events are presented.

The Company has not quantified the effects of the differences discussed below. Accordingly, there can be no assurances that the consolidated financials performance and financial position as disclosed in this financial report would not be significantly different if determined in accordance with IFRS.

The key potential implications of the conversion to IFRS on the consolidated entity are as follows:

**(a) Income Tax**

Income tax will be calculated on the "balance sheet" approach, which will result in more deferred tax assets and liabilities, as tax effects follow the underlying transaction, some tax effects will be recognised in equity.

**(b) Equity-based comp**

Equity-based compensation in the form of shares and options will be recognised as expenses in the periods during which the employee provides related services.

**(c) Comparatives**

Changes in accounting policies will be recognised by restating comparatives rather than making current year adjustments with note disclosure of prior year effects.

The above should not be regarded as a complete list of changes in accounting policies that will result from the transition to IFRS, as not all standards have yet been analysed as yet and some decisions have not yet been made where choices of accounting policies are available. For these reasons it is not yet possible to quantify the impact of the transition to IFRS on the Company's financial position and reported results.

## Independent audit report to members of Challenge Dairy Co-operative Limited

### Scope

#### *The financial report and directors' responsibility*

The financial report comprises the statement of financial performance, statement of financial position, statement of cash flows, the directors' declaration and accompanying notes to the financial statements for both Challenge Dairy Co-operative Limited (the co-operative) and the consolidated entity for the year ended 30 June 2004. The consolidated entity comprises both the company and the entities it controlled during that year.

The directors of the company are responsible for the preparation and true and fair presentation of the financial report in accordance with the Companies (Co-operative) Act 1943. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report.

#### *Audit approach*

We conducted an independent audit in order to express an opinion to the members of the co-operative. Our audit was conducted in accordance with Australian Auditing Standards in order to provide reasonable assurance as to whether the financial report is free of material misstatement. The nature of an audit is influenced by factors such as the use of professional judgment, selective testing, the inherent limitations of internal control, and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

We performed procedures to assess whether in all material respects the financial report presents fairly, in accordance with the Companies (Co-operative) Act 1943, including compliance with Accounting Standards and other mandatory financial reporting requirements in Australia, a view which is consistent with our understanding of the co-operative's and the consolidated entity's financial position, and of their performance as represented by the results of their operations and cash flows.

We formed our audit opinion on the basis of these procedures, which included:

- examining, on a test basis, information to provide evidence supporting the amounts and disclosures in the financial report, and
- assessing the appropriateness of the accounting policies and disclosures used and the reasonableness of significant accounting estimates made by the directors.

While we considered the effectiveness of management's internal controls over financial reporting when determining the nature and extent of our procedures, our audit was not designed to provide assurance on internal controls.



**Horwath**

**Independence**

In conducting our audit, we followed applicable independence requirements of Australian professional ethical pronouncements and the Companies (Co-operative) Act 1943.

**Audit opinion**

In our opinion, the financial report of Challenge Dairy Co-operative Limited is in accordance with:

(a) the Companies (Co-operative) Act 1943, including:

- (i) giving a true and fair view of the co-operative's and consolidated entity's financial position as at 30 June 2004 and of their performance for the year ended on that date; and
- (ii) complying with Accounting Standards in Australia and the Companies (Co-operative) Act 1943; and

(b) other mandatory financial reporting requirements in Australia.

Dated the 3<sup>rd</sup> day of November 2004.

**HORWATH PERTH**  
*Chartered Accountants*

HORWATH PERTH

*Glyn O'Brien*

**GLYN O'BRIEN**  
Partner

# CHALLENGE DAIRY CO-OPERATIVE LIMITED

## PROXY FORM

To: The Secretary  
Challenge Dairy Co-operative Limited  
PO Box 57  
CAPEL WA 6271

I/We .....  
(full name in block letters)

of .....

being a member of Challenge Dairy Co-operative Limited hereby appoint:

.....  
(name of proxy in block letters)

or in his/her absence, the Chairman of the meeting as my/our proxy to vote on my/our behalf at the General Meeting of the Company to be held at 10.30 am on 15 December 2004 and at any adjournment thereof.

### Resolutions

4. Appointment of auditors

FOR

AGAINST

In the absence of specific instructions the proxy may vote as he/she thinks fit, or abstain from voting.

Dated this ..... day of ..... 2004

Signature of member/s.....  
.....

### Or if a company

The common seal of )

Was affixed in the presence of, )

And the sealing is attested to by: )

Secretary..... Director .....

**Note: a member may only hold two (2) proxies. Therefore it is important that you ensure your proxy holder does not already hold two (2) proxies apart from yours. If the proxy holder has submitted two (2) other proxies then your proxy will not be considered.**

**Completed proxy forms must be lodged with the Secretary 24 hours before the meeting.**

Challenge Dairy Co-operative Limited  
60 Roe Road Capel WA 6271 Telephone 97270000 Fax 97272634

# **CHALLENGE DAIRY CO-OPERATIVE LIMITED**

## **ANNUAL GENERAL MEETING**

Please note that the meeting will start at 10.30 am. However, tea and coffee will be available from 10.00 am.

A light lunch will be provided at the conclusion of the meeting.



**EXCLUDED FR  
PUBLIC REGIST...**

**CONFIDENTIAL ATTACHMENT**

**EXCLUDED FROM  
PUBLIC REGISTER**





Attachment 6

**ANNUAL GENERAL MEETING**

**ADDENDUM TO PAPERS SENT WITH NOTICE OF MEETING**

The third page of the Chairman's report was omitted from the papers sent out with the notice. A complete copy of his report is enclosed as a replacement.

I regret any inconvenience this omission may have caused.



G. de Chaneeet  
Secretary



## **Chairman's Report Annual General Meeting December 2005**

### **Fellow Members**

The first four years of our brief history have been totally devoted to establishing and then consolidating the company as a permanent part of the West Australian Dairy industry. A major part of this establishment process has been to attract capital, put a management team in place and develop a strategic plan for the short medium and long term. The next phase is to put the plan into action. This will be just as challenging as the past four years, but infinitely more rewarding because there will be increases in milk prices for the shareholders.

The basis of the strategic plans that the Boards of Challenge and Challenge Australian Dairy adopted have not altered. What we have now is the detail behind the enactment of the plans and a definite capital expenditure program. We are moving away from bulk commodity cheese to enter the value added retail market with our cheese. This year has seen the introduction of our "Capel Valley" and "Capel Cut" brand of cheddar and its entry to the retail market in Western Australia. Our Gouda and Edam cheese is also available with Capel Mozzarella, Capel Romano and Capel Parmesan soon to follow. We have also introduced our "Cracker Round" product into Woolworth stores with excellent sales results so far. Our "Capel Supreme" yoghurt has also been introduced to the retail market on a small scale, but with encouraging results. Capel shredded and Capel sliced cheddar cheese have also been introduced to the market mainly for the food service industries in Australia and Singapore.

A new cutting, wrapping and packaging plant at Capel will be completed in December 05 to fully service the markets for our products. This project comprises the first significant capital expenditure program at Capel for many years.

The second key strategy was to reduce our reliance on skim milk powder and butter. The re-development of Boyanup is well under way to produce frozen cream, high fat cream and eventually cream cheese. This also represents the first of several upgrades for this plant.

There has been a frustrating 6 month delay in the progress of this capital expenditure, but I am pleased to report that the whole project will be fast tracked over the next 12 months.

The other side of developing a cream business is to develop an alternative to our skim powder. A frozen skim concentrate plant is being refurbished. This option will give the company far greater returns than skim powder.

### **Finance**

The year saw the Co-operative sell a 51% share of its interest in Challenge Australian Dairies to QAF of Singapore. The Co-operative traded profitably for the year. The financial report reflects the results of the Co-operative trading on a consolidated basis for the first 3 months of the financial year and de-consolidated for the remainder of the year.

The Co-operative is in a sound financial position with a strong cash position and no debt. This cash position, as well as an improvement in the balance sheet, put the company in a sound position to maintain our equity in Challenge Australian Dairies in the future.

### **Management and Staff**

The CEO of Challenge Australian Dairies, Mr Peter Giddy, is continuing to build a competent team of senior managers. This is evidenced by several key appointments; a qualified engineer to take over the role of operations manager, a qualified experienced national sales and marketing manager to develop the retail market for the products that the company is developing and the contracted services of an experienced technical advisor to assist with business analysis and strategy. The results of these key appointments have already seen a large range of new retail products being developed and ranged in stores across Australia. There have also been significant reductions in the cost of operating and maintaining our manufacturing facilities and a clear benchmarking of the levels we need to achieve to be more competitive into the future.

### **Milk Price**

The Co-operative was able to increase milk price by 13% this year in line with price increases on the eastern seaboard and New Zealand. This has meant the Co-operative has added approximately \$4M to the farm sector this financial year. Our pricing is still behind the Murray Goulburn price for milk. If we look at the past 25 years the Western Australian milk price for manufacturing milk has averaged 7 to 10 cents /litre behind the Victorian and New Zealand milk price. The Co-operative actually paid the same price

*John - this was missing from  
the chairman's letter*

in Western Australia as the Victorian price in 2003. The differential currently is 4 cents/litre. It is the clear goal of the company to close this differential as soon as possible. The strategies mentioned earlier of moving from bulk commodity products to more value added retail products, to improving yields within the plant, to cutting costs by adopting more efficient procedures and practices and growing milk volumes will help us improve returns and get closer to the benchmark set by Murray Goulburn.

To derive full value from the domestic market two key events need to happen. Firstly we must get the manufacturing milk price to equal Murray Goulburn's price and secondly all farmers join the Co-operative and put a large portion of their milk supply through it. This year we have seen milk prices move significantly upwards across Australia and New Zealand and yet the Co-operative was the only company in WA to increase price.

We have seen the debate over the move to establish a single desk and the blocking by the ACCC. This confirms the only real option for the industry is a strong Co-operative to leverage full value from the domestic market. Our pricing will be governed more and more by the milk price in Victoria. The Australian dairy industry needs a strong Murray Goulburn to set a world market price and Western Australia needs a strong Challenge Dairy Co-operative to set a strong domestic price for raw milk.

#### **QAF**

The business relationship with our Singaporean partners is strong and healthy. The access to Ben Foods has added a UHT market to our business, access to the food service market for shredded cheese in SE Asia and the development of other fresh milk products. The solid financial support has meant management could implement the necessary changes that have added to the milk price increase this year. The JV has given us the ability to deliver on the strategies outlined that will build a strong future for all of us.

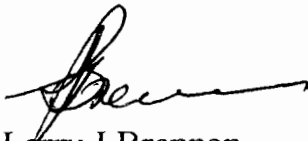
#### **Board Issues**

The Board took notice of the last AGM message that the Co-operative needed to replace former director David McIntyre to maintain the necessary Board strength to take into the future. It has been a difficult task to firstly identify the skills knowledge and expertise that would complement the strengths of our current commercial director and farmer directors and add strength to the business. Then we had to find someone to fill that requirement.

The Board is very pleased to announce the appointment of Dr Jon Hauser to the Board of the Challenge Dairy Co-operative. This appointment will be ratified by the new Board at the first Board meeting in December. Dr Hauser brings to the Co-operative a wealth of technical knowledge as well as experience managing a business similar in size to the Challenge group of companies as well as a network of international market contacts.

On behalf of the Board and many members I offer a profound vote of thanks to Steve Scott who has decided to step down as a Director. As a foundation Director, Steve's levelness, fairness and vision for the future has played a critical role in the establishment and the stability of the Co-operative.

Again I recognize the efforts of all the Board, Management and Staff for implementing the many changes and the many improvements that have helped consolidate the company and ensure a solid, sound future.



Larry J Brennen  
Chairman

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**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**FINANCIAL REPORT**  
**FOR THE YEAR ENDED 30 JUNE 2005**

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**CHALLENGE DAIRY CO-OPERATIVE LIMITED  
DIRECTORS' DECLARATION**

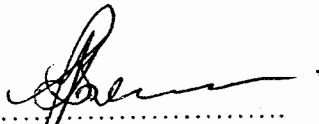
The directors declare that the financial statements and notes:

- (a) comply with Accounting Standards, other mandatory professional reporting requirements and statutory requirements; and
- (b) give a true and fair view of the company's financial position as at 30 June 2005 and of their performance, as represented by the results of their operations and cash flows for the year ended 30 June 2005.

In the directors opinion there are reasonable grounds to believe that Challenge Dairy Co-operative Limited will be able to pay its debts as and when they fall due and payable.

This declaration is made in accordance with a resolution of the Board of Directors and is signed for and on behalf of the directors by:

Dated at Capel this 31<sup>st</sup> day of October 2005.



.....  
Director



**CHALLENGE**

CO-OPERATIVE LTD

**ANNUAL GENERAL MEETING**

**The Geographe Bayview Resort  
555 Bussell Highway, Busselton  
Thursday 1 December, 2005, 10.30 am**



## CHALLENGE DAIRY CO-OPERATIVE LIMITED

### NOTICE OF ANNUAL GENERAL MEETING

Notice is hereby given that the Annual General Meeting of Challenge Dairy Co-operative Limited for the year ending 30 June 2005 will be held at the **Geographe Bayview Resort, 555 Bussell Highway, Busselton, on Thursday 1 December at 10.30 am.**

Representatives of Corporate Shareholders must present an executed notice evidencing their appointment when they register at the Annual General Meeting.

Appropriately completed proxy forms must be lodged with the Secretary 24 hours before the meeting to be recognised as valid.

#### **Business**

1. Apologies
2. To receive and consider the report of the Chairman of Challenge Dairy Co-operative Limited for the year ending 30<sup>th</sup> June 2005.
3. To receive and consider the Profit and Loss Statement and Balance Sheet as at 30<sup>th</sup> June 2005 with the reports of the Directors and Auditors.
4. Appointment of Auditors

To consider and, if thought appropriate, pass the following resolution as an ordinary resolution:

*That Horwath Perth be appointed Auditors of Challenge Dairy Co-operative Limited and that their remuneration be fixed by the Board of Directors.*

5. To elect two member Directors

In accordance with Article 15.7 of Challenge Dairy Co-operative Limited's Articles of Association, the member Directors Mr Geoffrey Jenkins and Mr Steven Scott retire at this meeting.

Mr Jenkins is eligible, and has offered himself, for re-election.

Ms Jacqueline Biddulph has been nominated for election to the position of Member Director

6. Special business

There has been no notification of any special business.

To consider any other business for which valid notice has been received.

By order of the Board

**Geoffrey C de Chanéet**  
**Secretary**  
**10 November 2005**

4. **FINANCIAL STATEMENTS FOR YEAR ENDED 30 JUNE 2004.**

The Chairman referred members to the Financial Statements for the Year ended 30 June 2004 that had been issued with the notice of meeting to all members. Moved Mr L Henderson, seconded Mr I McGregor, that the financial statements as presented be accepted.

A question and answer session followed in which detailed points in the statements were clarified. Of particular interest was the revaluation of assets that was made at about the time of the dissolution of the joint venture with Sanyuan, and the nature of the joint venture with QAF.

The Boyanup property had not been part of the Sanyuan Challenge JV (SCAD) and had been owned in full by Challenge. Upon dissolution of SCAD, Boyanup was re-valued by independent valuers. When it was sold into the Challenge Australian Dairy Co Ltd (CAD) JV with QAF this increase in value was realised by Challenge.

5. **APPOINTMENT OF AUDITORS FOR 2004 - 2005**

The Chairman advised that Horwath Perth Partnership, Accountants, were responsible for the audit of the 2003/2004 Financial Statements and the Board recommended the resolution that Horwath Perth Partnership be appointed as Auditors for the 2003/2004 financial year.

Moved by Mr J Kitchen and seconded by Mr M Blake, that Horwath Perth Partnership be appointed Auditors of Challenge Dairy Co-operative for the 2004/2005 financial year and their remuneration be fixed by the Board of Directors. Carried by the meeting.

6. **CHAIRMAN'S REPORT**

The Chairman referred members to his written report, which had been circulated to members with the notice of the meeting.

The Chairman used his report as the basis for a short presentation and accentuated that the Co-operative was now debt free with funds in the bank. However, with a clear focus on increasing milk prices to members, the Board recognised that major changes were needed in the manufacturing and marketing activities of the joint venture businesses that processed the Co-operative's milk. These changes would require capital investment to improve both the Capel and Boyanup facilities.

**Item 5 - election of two Member Directors.** As part of his address the Chairman advised the meeting that, as only two nominations for the vacant positions of Member Directors had been received, he Mr L Brennen and Mr R Poole were elected as Directors for terms of three years.

The Chairman thanked his fellow Directors for their work over the year and paid particular tribute to Mr David McIntyre who retired in late 2003. Mr McIntyre had been a Director of the Co-operative since its commencement and had contributed much to its development.

The Chairman then introduced Mr Peter Giddy, the CEO of CAD, who presented an outline of the strategic direction that the CAD joint venture would be taking. The two major strategies were joint ventures with QAF and Burra Foods that would bring capital, market chains and technological expertise into CAD. The joint ventures planned to be manufacturing and selling products of higher value than at present, including frozen skim

# CHALLENGE DAIRY CO-OPERATIVE LIMITED

## Minutes of the Annual General Meeting held on Wednesday 15 December 2004 at Geographe Bayview Resort 555 Bussell Highway, Busselton

**Present:** 54 Members, including Member Directors, signed the Register.

<b>In Attendance:</b> Mr L Brennen	Member Director and Executive Chairman
Mr N Haddon	Member Director and Deputy Chairman
Mr R Poole	Member Director
Mr G Jenkins	Member Director
Mr S Scott	Member Director
Mr G Shepherd	Non-member Director
Mr G de Chaneet	Secretary
Mr P Giddy	CEO, Challenge Australia Dairy
Mr G O'Brien	Horwath Perth Partners, auditors

The Chairman opened the meeting at 10:42 am and welcomed members to the meeting.

### BUSINESS

#### 1. APOLOGIES

Messrs B Oates, M Norton and C Elson.

#### 2. MINUTES OF THE ANNUAL GENERAL MEETING OF CHALLENGE DAIRY CO-OPERATIVE HELD ON WEDNESDAY 10 DECEMBER 2003.

The Chairman referred members to the minutes of the Annual General Meeting of Challenge Dairy Co-operative held 10 December 2003 that had been issued to all members attending the meeting.

Moved by Mr I McGregor and seconded by Mr O Negus that the minutes of the Annual General Meeting of Challenge Dairy Co-operative Limited held on 10 December 2003 be accepted as a true and accurate record of proceedings of the meeting.

Carried by the meeting.

#### 3. MINUTES OF THE SPECIAL GENERAL MEETING OF CHALLENGE DAIRY CO-OPERATIVE HELD ON FRIDAY 24 SEPTEMBER 2004.

The Chairman referred members to these minutes that had been circulated with notice of the AGM.

Moved by Mr K Stewart and seconded by Mr I McGregor that the minutes of the Special General Meeting of Challenge Dairy Co-operative Limited held on 24 September 2004 be accepted as a true and accurate record of proceedings of the meeting.

Carried by the meeting.

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**STATEMENT OF FINANCIAL PERFORMANCE**  
**FOR THE YEAR ENDED 30 JUNE 2005**

	NOTE	2005 \$	2004 \$
Revenues from ordinary activities	2	30,919,766	40,045,073
Change in inventories of finished goods and work in progress		(544,398)	(3,009,113)
Raw materials and consumables used		(27,911,428)	(24,749,543)
Employee benefits expense		(420,436)	(1,181,959)
Depreciation expense	3	(75,591)	(241,756)
Carrying amount of non current assets sold		-	(5,770,476)
Gas, water and electricity expense		-	(102,058)
Repairs and maintenance expense		(67,840)	(222,223)
Borrowing costs expense	3	(49,490)	(115,479)
Other expenses from ordinary activities		(1,021,955)	(4,065,999)
Share of net loss of associated accounted for using the equity method	9	<u>(757,262)</u>	<u>(1,934,488)</u>
Profit / (Loss) from ordinary activities before income tax expense		71,366	(1,348,021)
Income tax expense relating to ordinary activities	4	<u>-</u>	<u>-</u>
Profit / (Loss) from ordinary activities after related income tax expense		<u>71,366</u>	<u>(1,348,021)</u>
Increase in asset revaluation reserve	17	-	3,402,185
Increase in retained earnings on adoption of new Accounting Standard	18	<u>1,192,360</u>	<u>-</u>
Total revenues, expenses and valuation adjustments attributable to members of the parent entity and recognised directly in equity		<u>1,192,360</u>	<u>3,402,185</u>
Total changes in equity other than those resulting from transactions with owners as owners		<u>1,263,726</u>	<u>2,054,164</u>

The accompanying notes form part of these financial statements

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**STATEMENT OF FINANCIAL POSITION**  
**AS AT 30 JUNE 2005**

	NOTE	2005 \$	2004 \$
<b>CURRENT ASSETS</b>			
Cash	5	3,278,161	199,475
Receivables	6	3,659,254	4,303,206
Inventories	7	-	218,417
Prepayments		-	21,008
<b>TOTAL CURRENT ASSETS</b>		<u>6,937,415</u>	<u>4,742,106</u>
<b>NON-CURRENT ASSETS</b>			
Investments accounted for using the equity method	8	7,093,027	-
Property, plant and equipment	10	269,713	2,718,087
Other Financial Assets	11	-	8,448,001
<b>TOTAL NON-CURRENT ASSETS</b>		<u>7,362,740</u>	<u>11,166,088</u>
<b>TOTAL ASSETS</b>		<u>14,300,155</u>	<u>15,908,194</u>
<b>CURRENT LIABILITIES</b>			
Payables	12	3,486,983	4,727,290
Interest bearing liabilities	13	-	1,000,000
Provisions	14	26,941	169,703
<b>TOTAL CURRENT LIABILITIES</b>		<u>3,513,924</u>	<u>5,896,993</u>
<b>NON-CURRENT LIABILITIES</b>			
Interest bearing liabilities	13	-	-
Provisions	14	2,859	17,764
Other		2,312	2,312
<b>TOTAL NON-CURRENT LIABILITIES</b>		<u>5,171</u>	<u>20,076</u>
<b>TOTAL LIABILITIES</b>		<u>3,519,095</u>	<u>5,917,069</u>
<b>NET ASSETS</b>		<u>10,781,060</u>	<u>9,991,125</u>
<b>EQUITY</b>			
Capital	15	3,945,306	2,437,536
Non-share capital	16	10,000,000	10,000,000
Reserves	17	-	3,402,185
Accumulated losses	18	(3,164,246)	(5,848,596)
<b>TOTAL EQUITY</b>		<u>10,781,060</u>	<u>9,991,125</u>

The accompanying notes form part of these financial statements

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**STATEMENT OF CASH FLOWS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

	NOTE	2005 \$	2004 \$
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Receipts from customers		32,377,809	37,538,974
Interest received		183,884	22,853
Payments to suppliers and employees		(31,124,606)	(35,836,224)
Borrowing costs		(49,490)	(115,479)
Net cash flows from operating activities	26(b)	<u>1,387,597</u>	<u>1,610,124</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Proceeds from sale of property plant and equipment		2,637,232	-
Purchase of property, plant and equipment		(264,448)	(186,782)
Costs incurred to establish JV		-	(348,488)
Payments to buy out JV partner		-	(903,527)
Purchase of investment		(191,492)	-
Net cash flows from investing activities		<u>2,181,292</u>	<u>(1,438,797)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Proceeds from issue of equity instruments		509,797	911,726
Proceeds from borrowings		-	-
Repayment of borrowings		(1,000,000)	(713,013)
Net cash flows from financing activities		<u>(490,203)</u>	<u>198,713</u>
Net increase / (decrease) in cash held		3,078,686	370,040
Cash held at the beginning of the period		199,475	(170,565)
<b>CASH HELD AT THE END OF THE PERIOD</b>	26(a)	<u><u>3,278,161</u></u>	<u><u>199,475</u></u>

The accompanying notes form part of these financial statements

CHALLENGE DAIRY CO-OPERATIVE LIMITED  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2005

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**NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

This general purpose financial report has been prepared in accordance with Accounting Standards, other authoritative pronouncements of the Australian Accounting Standards Board, Urgent Issues Group Consensus Views and statutory requirements.

The financial report is prepared in accordance with the historical cost convention, except for certain assets which, as noted, are at valuation. Unless otherwise stated, the accounting policies adopted are consistent with those of the previous year.

**(a) Income Tax**

The company adopts the liability method of tax-effect accounting whereby the income tax expense shown in the statement of financial performance is based on the operating profit before income tax adjusted for any permanent differences.

Timing differences which arise due to the different accounting periods in which items of revenue and expense are included in the determination of operating loss before income tax and taxable income are brought to account as either a provision for deferred income tax or an asset described as future income tax benefit at the rate of income tax applicable to the period in which the benefit will be received or the liability will become payable.

Future income tax benefits are not brought to account unless realisation of the asset is assured beyond reasonable doubt. Future income tax benefits in relation to tax losses are not brought to account unless there is virtual certainty of realisation of the benefit.

The amount of benefits brought to account or which may be realised in the future is based on the assumption that no adverse change will occur in income taxation legislation and the anticipation that the company will derive sufficient future assessable income to enable the benefit to be realised and comply with the conditions of deductibility imposed by the law.

**(b) Acquisition of Assets**

The purchase method of accounting is used for all acquisitions of assets regardless of whether equity instruments or other assets are acquired. Cost is measured as the fair value of the assets given up, shares issued or liabilities undertaken at the date of acquisition plus incidental costs directly attributable to the acquisition. Where equity instruments are issued in an acquisition, the value of the instruments is their market price as at the acquisition. Transaction costs arising on the issue of equity instruments are recognised directly in equity.

Where settlement of any part of cash consideration is deferred, the amounts payable in the future are discounted to their present value as at the date of acquisition. The discount rate used is the incremental borrowing rate, being the rate at which a similar borrowing could be obtained from an independent financier under comparable terms and conditions.

A liability for restructuring costs is recognised as at the date of acquisition of an entity or part thereof when there is a demonstrable commitment to restructuring of the acquired entity and a reliable estimate of the amount of the liability can be made.

**(c) Revenue Recognition**

Amounts disclosed as revenue are net of returns, trade allowances and duties and taxes paid.



CHALLENGE DAIRY CO-OPERATIVE LIMITED  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2005

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NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

(d) **Receivables**

All trade debtors are recognised at the amounts receivable as they are due for settlement no more than 120 days from the date of recognition.

Collectibility of trade debtors is reviewed on an ongoing basis. Debts which are known to be uncollectible are written off. A provision for doubtful debts is raised when some doubt as to the collection exists.

(e) **Inventories**

(i) Raw Materials and stores, work in progress and finished goods

Raw materials and stores, work in progress and finished goods are stated at the lower of cost and net realisable value. Cost comprises direct materials, direct labour and an appropriate proportion of variable and fixed overhead expenditure, the latter being allocated on the basis of normal operating capacity. Costs are assigned to individual items of stock on the basis of weighted average costs.

(f) **Recoverable Amount of Non-Current Assets**

The recoverable amount of an asset is the net amount expected to be recovered through the net cash inflows arising from its continued use and subsequent disposal.

Where the carrying amount of a non-current asset exceeds its recoverable amount the asset is revalued to its recoverable amount. Where net cash inflows are derived from a group of assets working together, recoverable amount is determined on the basis of the relevant group of assets. To the extent that a revaluation decrement reverses a revaluation increment previously credited to, and still standing to the credit of the asset revaluation reserve, the decrement is debited directly to that reserve. Otherwise the decrement is recognised in the statement of financial performance.

The expected net cash flows included in determining recoverable amounts of non-current assets have not been discounted.

(g) **Investments**

Interest in listed and unlisted securities, other than controlled entities and associates in the consolidated financial statements, are brought to account at cost and dividend income is recognised in the statement of financial performance when receivable.

(h) **Investments in Associates**

Investments in associate companies are recognised in the financial statements by applying the equity method of accounting.

(i) **Depreciation**

Depreciation is calculated on a straight line basis to write the net cost or revalued amount of each item of property, plant and equipment (excluding land) over its expected useful life to the entity. Estimates of the remaining useful lives are made on a regular basis for all assets, with annual reassessments for major items.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

(f) Leased Non-Current Assets lessee substantially all the risks and benefits incidental to ownership of leased non-current assets, and operating leases under which the lessor effectively retains substantially all such risks and benefits.

Finance leases are capitalised. A lease asset and liability are established at the present value of minimum lease payments. Lease payments are allocated between the principal component of the lease liability and the interest expense.

The lease asset is amortised on a straight line basis over the term of the lease, or where it is likely that the entity will obtain ownership of the asset, the life of the asset.

(k) Trade Creditors These amounts represent liabilities for goods and services provided to the company prior to the end of the financial year and which are unpaid. These amounts are unsecured and are usually paid within 30 days of recognition.

(i) Employee Entitlements (i) Wages and salaries, annual leave and sick leave as the amount unpaid at the reporting date at current pay rates in respect of employees' services up to that date.

(iii) Long service leave A liability for long service leave is recognised, and is measured as the present value of expected future payments to be made in respect of services provided by employees up to the reporting date. Consideration is given to expected future wage and salary levels, experience of employee departures and periods of service. Expected future payments are discounted using interest rates on national government guaranteed securities with term to maturity that match, as closely as possible, the estimated future cash outflows.

(m) Repairs and Maintenance The costs of maintenance are charged as expenses as incurred, except where they relate to the replacement of a component of an asset, in which case the costs are capitalised and depreciated in accordance with note 1(i). Other routine operating maintenance, repair and minor renewal costs are also charged as expenses as incurred.

(n) Foreign Currency Translation Foreign currency transactions are initially translated into Australian currency at the rate of exchange at the date of the transaction. At balance date amounts payable and receivable in foreign currencies are translated to Australian currency at rates of exchange at that date. Resulting exchange differences are recognised in determining the profit or loss for the year.

(o) Borrowing Costs Borrowing costs are recognised as expenses in the period in which they are incurred, except where they are included in the costs of qualifying assets.

Borrowing costs include:  
 - interest on bank overdrafts and short term and long-term borrowings;  
 - amortisation of discounts or premiums relating to borrowings;  
 - amortisation of ancillary costs incurred in connection with the arrangement of borrowings;  
 - finance lease charges; and  
 - certain exchange differences arising from foreign currency borrowings.

CHALLENGE DAIRY CO-OPERATIVE LIMITED  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 30 JUNE 2005

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NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)

(p) **Interest Bearing Liabilities**

Loans and debentures are carried at their principal amounts which represents the present value of future cash flows associated with servicing the debt. Interest is accrued over the period it becomes due and is recorded as part of other creditors.

(q) **Revaluation of Non-Current Assets**

Subsequent to initial recognition as assets, land and buildings, including those classified as investment properties, are measured at fair value being the amounts for which the assets could be exchanged between knowledgeable willing parties in an arm's length transaction. Revaluations are made with sufficient regularity to ensure that the carrying amount of each piece of land and each building does not differ materially from its fair value at the reporting date. Annual assessments are made by the directors, supplemented by independent assessments at least every three years.

Revaluation increments are credited directly to the asset revaluation reserve, except that, to the extent that an increment reverses a revaluation decrement in respect of that class of asset previously recognised as an expense in net profit or loss, the increment is recognised immediately as revenue in the net profit or loss.

(r) **Cash**

For the purposes of the statement of cash flows, cash includes cash on hand and at call deposits with banks or financial institutions, net of bank overdrafts.

(s) **Goods and Services Tax (GST)**

Revenues, expenses and assets are recognised net of the amount of GST, except where the amount of GST incurred is not recoverable from the Australian Taxation Office. In these circumstances the GST is recognised as part of the cost of acquisition of the asset or as part of an item of the expense. Receivables and payables in the statement of financial position are shown inclusive of GST.

(t) **Impact of Adoption to Australian Equivalents to International Financial Reporting Standards**

The company is preparing and managing the transition to Australian Equivalents to International Financial Reporting Standards (AIFRS) effective for the financial years commencing from 1 January 2005. The adoption of AIFRS will be reflected in the company's financial statements for the year ending 30 June 2006. On first time adoption of AIFRS, comparatives for the financial year ended 30 June 2005 are required to be restated. The majority of the AIFRS transitional adjustments will be made retrospectively against retained earnings at 1 July 2004.

The company's management, with the assistance of its auditors, has assessed the significance of the expected changes and is preparing for their implementation. An AIFRS committee is overseeing and managing the company's transition to AIFRS. The impact of the alternative treatments and elections under AASB 1: First Time Adoption of Australian Equivalents to International Financial Reporting Standards has been considered where applicable.

The directors are of the opinion that the key material differences in the company's accounting policies on conversion to AIFRS and the financial effect of these differences, where known are as follows. Users of the financial statements should note, however that the differences as shown could change if there are any amendments by standard-setters to the current AIFRS or interpretation of the AIFRS requirements changes from the continuing work of the company's committee.

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

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**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont'd)**

**(i) Impairment of Assets**

Under AASB 136: Impairment of Assets, the recoverable amount of an asset is determined as the higher of fair value less costs to sell, and value in use. In determining value in use, projected future cash flows are discounted using a risk adjusted pre-tax discount rate and impairment is assessed for the individual asset or at the "cash generating unit" level. A "cash generating unit" is determined as the smallest group of assets that generates cash flows that are largely independent of the cash inflows from other assets or groups of assets.

The current policy is to determine the recoverable amount of an asset on the basis of undiscounted net cash flows that will be received from the asset's use and subsequent disposal. It is likely that this change in accounting policy will lead to impairments being recognised more often.

**(ii) Income Tax**

Currently, the company adopts the liability method of tax-effect accounting whereby the income tax expense is based on the accounting profit adjusted for any permanent differences. Timing differences are currently brought to account as either a provision for deferred income tax or future income tax benefit. Under AASB 112: Income Taxes, the company will be required to adopt the balance sheet approach under which temporary differences are identified for each asset and liability rather than the effects of the timing and permanent differences between taxable income and accounting profit. The directors are of the opinion that there will be no material effect on the adoption of change in accounting policy.

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

	2005	2004
	\$	\$
<b>NOTE 2: REVENUE</b>		
<b>Revenue from operating activities</b>		
Sales of Goods	30,569,808	33,981,396
Services	-	15,601
	30,569,808	33,996,997
<b>Revenue from outside the operating activities</b>		
Cartage	31,237	33,033
Interest	183,884	22,853
Rental income	800	10,800
Proceeds on sale of non-current assets	-	5,918,350
Management fee income	-	-
Other	134,037	63,040
	349,958	6,048,076
<b>Revenue from ordinary activities</b>	<b>30,919,766</b>	<b>40,045,073</b>

**NOTE 3: PROFIT FROM ORDINARY ACTIVITIES**

**(a) Net Gains and Expenses**

Profit from ordinary activities before income tax expense includes the following specific net gains and expenses:

**Net gains**

Net gain on disposal		
Property, plant and equipment	-	147,924
	-	147,924

**Expenses**

Cost of sales of goods		
	27,911,428	31,311,893
<b>Depreciation</b>		
Buildings	22,666	25,843
Plant and equipment	52,925	215,912
Total Depreciation	75,591	241,756

**Bad debts**

	-	-
	-	-

Forgiveness of debt to controlled entity	-	2,197,983
	-	2,197,983

**Borrowing costs**

Interest and finance charges paid/payable	49,490	115,479
	49,490	115,479

**Other Provisions**

Employee Entitlements	(157,666)	(445,774)
	(157,666)	(445,774)

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

2005                      2004  
                                  \$                                      \$

**NOTE 4: INCOME TAX EXPENSE**

(a) The primaefacie tax on profit from ordinary activities before income tax is reconciled to the income tax as follows:

Primaefacie tax payable on profit from ordinary activities before income tax at 30% (2004: 30%)

21,410                      (404,406)

Add tax effect of:

**Permanent differences**

Non deductible entertaining

-                                      1,070

Non deductible travel

-                                      -

Other non deductible expenses

-                                      -

Share of equity accounted losses

227,179                                      -

Income tax adjusted for permanent differences

248,588                      (403,336)

Tax benefit in respect of tax losses and timing differences

(248,588)                      403,336

-                                      -

(b) Future Income Tax Benefit

The directors estimate that the potential future income tax benefit at 30 June 2005 in respect of tax losses not brought to account is

1,509,864                      1,758,452

This benefit for tax losses will only be obtained if:

- (i) The co-operative derives future assessable income of a nature and sufficient amount to enable the benefit from the deductions for losses to be realised.
- (ii) The co-operative continues to comply with the conditions for deductibility imposed by tax legislation, and
- (iii) No changes in tax legislation adversely affect the co-operative in realising the benefit from the deductions for the

**NOTE 5: CASH**

Cash at bank and on hand

3,278,161                      199,475

**NOTE 6: RECEIVABLES**

**CURRENT**

Trade debtors

2,289,318                      3,840,096

Other debtors

1,369,936                      463,110

3,659,254                      4,303,206

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

	2005	2004
	\$	\$
<b>NOTE 7: INVENTORIES</b>		
At Cost		
Raw materials	-	-
Stocks materials / engineering stores	-	14,829
	-	14,829
At Net Realisable Value		
Finished goods at net realisable value	-	203,588
	-	203,588
	-	218,417

**NOTE 8: INVESTMENTS ACCOUNTED FOR  
USING THE EQUITY METHOD**

Associated Companies	7,093,027	-
	7,093,027	-
	7,093,027	-

**NOTE 9: ASSOCIATED COMPANIES**

Interests are held in the following associated companies

<u>Name</u>	<u>Principal Activities</u>	<u>Carrying Amount</u>	<u>of Investment</u>
Challenge Australian Dairy Pty Ltd	Dairy Industry	7,093,027	-
		7,093,027	-
		7,093,027	-

**(a) Movements During the Year in Equity Accounted Investment in  
Associated Companies**

Balance at beginning of the financial year	-	-
Add Investments accounted for using the equity method	7,850,290	-
Share of associated company's reserve increments arising during the year	-	-
Les: from ordinary activities and extraordinary items after income tax	(757,262)	-
Balance at end of the financial year	7,093,028	-

CHALLENGE DAIRY CO-OPERATIVE LIMITED  
 NOTES TO THE FINANCIAL STATEMENTS  
 FOR THE YEAR ENDED 30 JUNE 2005

2005                      2004  
 \$                                      \$

**NOTE 9: ASSOCIATED COMPANIES (cont'd)**

**(b) Retained Earnings Attributable to Associate**

Share of associate's profit/(loss) from ordinary activities before income tax expense	(757,262)	-
Share of associate's income tax expense	-	-
Share of associate's profit/(loss) from ordinary activities after income tax	(757,262)	-
Share of retained earnings at beginning of the financial year	-	-
Share of retained earnings at end of the financial year	(757,262)	-

**(c) Summarised Presentation of Aggregate Assets, Liabilities and Performance of Associates**

Current Assets	5,037,921	-
Non-current Assets	4,191,138	-
Total Assets	9,229,059	-
Current Liabilities	2,083,356	-
Non-current Liabilities	52,675	-
Total Liabilities	2,136,031	-
Net Assets	7,093,028	-
Net profit from ordinary activities after income tax of associates	(757,262)	-

**NOTE 10: PROPERTY, PLANT & EQUIPMENT**

Freehold Land		
At fair value	-	862,320
	-	862,320
Buildings at cost	-	791,982
Less - Accumulated depreciation	-	(19,502)
	-	772,480
Plant and Equipment at cost	34,672	871,474
Less - accumulated depreciation	(113)	(129,908)
	34,559	741,566
Plant and equipment in the course of construction	228,448	12,027
Office Equipment at cost	20,952	31,778
Less - accumulated depreciation	(17,294)	(21,156)
	3,658	10,621



**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

	2005	2004
	\$	\$
<b>NOTE 10: PROPERTY, PLANT &amp; EQUIPMENT (cont'd)</b>		
Motor Vehicle at cost	25,676	668,876
Less - accumulated depreciation	(22,628)	(349,803)
	3,048	319,073
 Total property, plant and equipment	 269,713	 2,718,087

**(a) Movements in Carrying Amounts**

Movement in the carrying amounts for each class of property, plant and equipment between the beginning and the end of the current financial year.

	Freehold Land \$	Buildings \$	Plant & Equipment \$	Office Equipment \$	Motor Vehicles \$	In Course of Construction \$	Total \$
Balance at the beginning of year	862,320	772,480	741,565	10,621	319,073	12,027	2,718,086
Additions	-	-	33,951	4,781	-	225,716	264,448
Disposals	(862,320)	(749,815)	(719,570)	(8,833)	(287,398)	(9,295)	(2,637,231)
Depreciation	-	(22,665)	(21,387)	(2,911)	(28,627)	-	(75,590)
Carrying amount at the end of year	-	-	34,559	3,658	3,048	228,448	269,713

**NOTE 11: OTHER FINANCIAL ASSETS**

Investment in CAD	-	6,466,440
Revaluation of investment	-	1,981,561
	-	8,448,001

**NOTE 12: PAYABLES**

**CURRENT**

Trade creditors	3,109,274	2,438,353
Other creditors and accruals	377,709	527,187
Amount owing to SAETC	-	1,761,750
	3,486,983	4,727,290

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

	2005	2004
	\$	\$
<b>NOTE 13: INTEREST BEARING LIABILITIES</b>		
<b>CURRENT</b>		
Secured Liabilities		
Bank Loan	-	1,000,000
Lease liability (note 24)	-	-
	-	1,000,000
	-	1,000,000
<b>NON-CURRENT</b>		
<b>Secured</b>		
Lease liability (note 24)	-	-
	-	-
	-	-
(a) Total Current and Non-Current Secured Liabilities		
Bank loan	-	1,000,000
Lease liability	-	-
	-	1,000,000
	-	1,000,000
(b) The bank loan is secured by a first registered fixed and floating charge over all assets and undertakings of Challenge Dairy Co-operative Limited.		

**NOTE 14: PROVISIONS**

<b>CURRENT</b>		
Annual leave	13,482	76,125
Long service leave	13,459	76,688
Sick leave	-	8,047
Rostered days off	-	8,842
	26,941	169,703
	26,941	169,703
<b>NON-CURRENT</b>		
Long service leave	2,859	17,764
	2,859	17,764
	2,859	17,764
(a) Aggregate employee benefits liability	29,800	187,466
	29,800	187,466
(b) Number of employees at year-end	2	25

**NOTE 15: SHARE CAPITAL**

128 fully paid farmers voting shares	15(a)	128,000	133,000
11,700 A class shares	15(b)	3,817,306	2,304,536
		3,945,306	2,437,536
		3,945,306	2,437,536

**(a) Farmers Voting Shares**

During the period ended 30 June 2005, a further 2 shares at \$1,000 each were issued and 7 were repurchased. During the period ended 30 June 2004 a further 8 shares at \$1,000 each were issued and 8 were repurchased.

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

	2005	2004
	\$	\$

**NOTE 15: SHARE CAPITAL (cont'd)**

	2005	2004		
<b>(b) A Class Shares</b>	Number	Number		
Opening balance	11,700	2,995	2,304,536	1,392,810
Issued during the year	-	8,705	1,512,770	911,726
Closing balance	11,700	11,700	3,817,306	2,304,536

*Value? Cash*

**NOTE 16: NON-SHARE CAPITAL**

Non-Share equity interest	10,000,000	10,000,000
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**NOTE 17: RESERVES**

Asset revaluation reserve	-	3,402,185
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**(a) Asset Revaluation Reserve Movements During the Year**

Balance 1 July 2004	3,402,185	-
Increment on revaluation of freehold land and buildings at the end of the financial year	-	1,420,624
Increment/(Decrement) on revaluation of investment in associate at the end of the financial year	(1,981,561)	1,981,561
Transfers to/(from) reserves	(1,420,624)	-
Balance 30 June 2005	-	3,402,185

**NOTE 18: RETAINED PROFITS**

Retained profits at the beginning of the financial year	(5,848,596)	(4,500,575)
Net profit attributable to the members	71,366	(1,348,021)
Retrospective adjustment to investments accounted for using the equity method on adoption of Accounting Standard AASB 1016: Accounting for Investment in Associates	1,192,360	-
Transfers to and (from) reserves	1,420,624	-
Retained profits at the end of the financial year	(3,164,246)	(5,848,596)

**NOTE 19: FINANCIAL INSTRUMENTS**

**(a) Net Fair Values**

The aggregate net fair value of financial assets and financial liabilities approximate the carrying amount of the financial assets and liabilities as indicated in the balance sheet. There are no unrecognised financial assets or financial

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

2005                      2004  
 \$                              \$

**NOTE 19: FINANCIAL INSTRUMENTS (Continued)**

**(b) Credit Risk Exposure**

The company's exposure to credit risk at 30 June 2005 in relation to each class of recognised asset is the carrying amount of those assets indicated in the statement of financial position.

**(c) Interest Rate Risk Exposure**

The company's exposure to interest rate risk is considered minimal. Cash balances earn interest at the banks' benchmark rate which is within the vicinity of 4%.

	Fixed Interest Rate Maturing					Total
	Floating Interest Rate	Within 1 Year	Over 1 to 5 Years	More than 5 Years	Non-Interest Bearing	
	\$	\$	\$	\$	\$	\$
<b>2005</b>						
<b>Financial Assets</b>						
Cash and deposits	3,278,161	-	-	-	-	3,278,161
Receivables	-	-	-	-	3,659,254	3,659,254
<b>Total Financial Assets</b>	<b>3,278,161</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>3,659,254</b>	<b>6,937,415</b>

Weighted average interest rate                      5.00%

**Financial Liabilities**

Bank overdrafts and loans	-	-	-	-	-	-
Trade and other creditors	-	-	-	-	3,486,983	3,486,983
Other loans	-	-	-	-	-	-
Lease liabilities	-	-	-	-	-	-
<b>Total Financial Liabilities</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>3,486,983</b>	<b>3,486,983</b>

Weighted average interest rate                      0.00%

	Fixed Interest Rate Maturing					Total
	Floating Interest Rate	Within 1 Year	Over 1 to 5 Years	More than 5 Years	Non-Interest Bearing	
	\$	\$	\$	\$	\$	\$
<b>2004</b>						
<b>Financial Assets</b>						
Cash and deposits	199,475	-	-	-	-	199,475
Receivables	-	-	-	-	4,303,206	4,303,206
<b>Total Financial Assets</b>	<b>199,475</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>4,303,206</b>	<b>4,502,681</b>

Weighted average interest rate                      3.50%

**Financial Liabilities**

Bank overdrafts and loans	1,000,000	-	-	-	-	1,000,000
Trade and other creditors	-	-	-	-	4,727,290	4,727,290
Other loans	-	-	-	-	-	-
Lease liabilities	-	80,500	213,456	-	-	293,956
<b>Total Financial Liabilities</b>	<b>1,000,000</b>	<b>80,500</b>	<b>213,456</b>	<b>-</b>	<b>4,727,290</b>	<b>6,021,246</b>

Weighted average interest rate                      8.00%      9.00%      9.00%

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

2005                      2004  
                                    \$                              \$

**NOTE 20: RELATED PARTIES**

**(a) Names and positions held of directors in office at any time during the financial year are:**

Mr Larry Brennen	Executive Chairman
Mr Neville Haddon	Deputy Chairman
Mr Steven Scott	Non-Executive Director
Mr Robert Poole	Non-Executive Director
Mr Geoffrey Jenkins	Non-Executive Director
Mr Graham Shepherd	Non-Executive Director

**(b) Shareholdings**

Number of Shares held by Directors

	A Class Shares	Ordinary Shares
Mr Larry Brennen	251	1
Mr Neville Haddon	576	1
Mr Geoffrey Jenkins	235	1
Mr Robert Poole	418	1
Mr Steve Scott	431	1
Mr Graham Shepherd	-	-
	1,911	5

**(c) Other transactions with directors and director-related entities**

During the year Mr Graham Shepherd was paid \$7,875 for the performance of consultancy services to the company.

During the year, S&L Scott, an entity associated with Mr Steven Scott, leased land to Challenge Australian Dairy Pty Ltd at normal commercial terms. The value of the lease payments paid to Mr Steven Scott was \$18,445.

During the year the directors listed below supplied the Co-operative with product which was acquired at normal commercial terms and conditions no more favourable than those available to other members.

Mr Larry Brennen  
Mr Neville Haddon  
Mr Steven Scott  
Mr Robert Poole  
Mr Geoffrey Jenkins

Transactions between related parties are on normal commercial terms and conditions no more favourable than those available to other parties.

**NOTE 21: EVENTS SUBSEQUENT TO REPORTING DATE**

There were no transactions subsequent to report date that have a material effect on the financial report.

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

2005                      2004  
 \$                              \$

**NOTE 22: SEGMENT INFORMATION**

The company operates in the dairy industry within Western Australia.

**NOTE 23: DIRECTORS' REMUNERATION**

Income paid or payable, or otherwise made available, to directors by the company and related parties in connection with the management of the affairs of the company:

Executive directors	38,150	38,150
Executive chairman	62,887	-
Non-executive directors	109,538	126,573
	210,575	164,723

Details of the remuneration of each director of the company, including their personally-related entities, is set out in the following table:

	Salary & Fees	Super- annuation	Total	Consultancy Fees	Total
<b>Challenge Dairy Co-operative Ltd</b>					
<b>Executive</b>					
Mr Larry Brennen	35,000	3,150	38,150	-	38,150
<b>Non-Executive</b>					
Mr Neville Haddon	15,364	1,302	16,666	-	16,666
Mr Geoffrey Jenkins	13,761	1,239	15,000	-	15,000
Mr Steven Scott	13,761	1,239	15,000	-	15,000
Mr Robert Poole	13,761	1,239	15,000	-	15,000
Mr Graham Shepherd	15,387	1,277	16,664	7,875	24,539
	107,034	9,446	116,480	7,875	124,355
<b>Executive Chairman Salary</b>					
Mr Larry Brennen	57,694	5,193	62,887	-	62,887
	57,694	5,193	62,887	-	62,887
<b>Challenge Australian Dairy Pty Ltd</b>					
Mr Larry Brennen	-	-	-	-	-
Mr Neville Haddon	9,100	900	10,000	-	10,000
Mr Graham Shepherd	12,133	1,200	13,333	-	13,333
	21,233	2,100	23,333	-	23,333
<b>Total</b>	185,961	16,739	202,700	7,875	210,575

**NOTE 24: AUDITORS REMUNERATION**

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 30 JUNE 2005**

	2005	2004
	\$	\$
Amounts received, or due and receivable by the auditors for:		
- Auditing the financial report	18,438	12,000
- Other services	37,650	77,911
	56,088	89,911

**NOTE 25: COMMITMENTS FOR EXPENDITURE**

There are no commitments for operating or finance leases as at 30 June 2005.

**NOTE 26: NOTES TO THE STATEMENTS OF CASH FLOWS**

**(a) Reconciliation of Cash**

Cash at bank	3,278,161	199,475
	3,278,161	199,475

**(b) Reconciliation of Cash Flow from Operations with Profit from Ordinary Activities after Income Tax**

Profit/(loss) from ordinary activities after income tax	71,366	(1,348,021)
Non-cash flows in profit from ordinary activities		
Depreciation and amortisation	75,590	241,757
Net gain on sale of non current assets	-	(147,874)
Share of associate loss	757,263	1,934,488
Changes in assets and liabilities		
(Increase) / decrease in receivables	1,641,927	380,655
(Increase) / decrease in inventory	218,417	3,009,113
(Increase) / decrease in other operating assets	21,008	(8,443)
Increase / (decrease) in accounts payable	(1,240,307)	(2,406,811)
Increase / (decrease) in provisions	(157,667)	(44,740)
Cash flow from operations	1,387,597	1,610,124



## **Horwath Audit (WA) Pty Ltd**

ABN 79 112 284 787

Chartered Accountants

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### **Independent audit report to members of Challenge Dairy Co-operative Limited**

#### **Scope**

##### *The financial report and directors' responsibility*

The financial report comprises the statement of financial performance, statement of financial position, statement of cash flows, the directors' declaration and accompanying notes to the financial statements for Challenge Dairy Co-operative Limited (the co-operative) for the year ended 30 June 2005.

The directors of the company are responsible for the preparation and true and fair presentation of the financial report in accordance with the Companies (Co-operative) Act 1943. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report.

##### *Audit approach*

We conducted an independent audit in order to express an opinion to the members of the co-operative. Our audit was conducted in accordance with Australian Auditing Standards in order to provide reasonable assurance as to whether the financial report is free of material misstatement. The nature of an audit is influenced by factors such as the use of professional judgment, selective testing, the inherent limitations of internal control, and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

We performed procedures to assess whether in all material respects the financial report presents fairly, in accordance with the Companies (Co-operative) Act 1943, including compliance with Accounting Standards and other mandatory financial reporting requirements in Australia, a view which is consistent with our understanding of the co-operative's financial position, and of their performance as represented by the results of their operations and cash flows.

We formed our audit opinion on the basis of these procedures, which included:

- examining, on a test basis, information to provide evidence supporting the amounts and disclosures in the financial report, and
- assessing the appropriateness of the accounting policies and disclosures used and the reasonableness of significant accounting estimates made by the directors.

While we considered the effectiveness of management's internal controls over financial reporting when determining the nature and extent of our procedures, our audit was not designed to provide assurance on internal controls.

Directors: Glyn O'Brien CA Anthony Bevan CA

*Horwath Audit (WA) Pty Ltd conducts its practice independently of all other firms of chartered accountants who are members of Horwath International in Australia*





### **Independence**

In conducting our audit, we followed applicable independence requirements of Australian professional ethical pronouncements and the Companies (Co-operative) Act 1943.

### **Audit opinion**

In our opinion, the financial report of Challenge Dairy Co-operative Limited is in accordance with:

- (a) the Companies (Co-operative) Act 1943, including:
  - (i) giving a true and fair view of the co-operative's financial position as at 30 June 2005 and of their performance for the year ended on that date; and
  - (ii) complying with Accounting Standards in Australia and the Companies (Co-operative) Act 1943; and
- (b) other mandatory financial reporting requirements in Australia.

Dated the 1<sup>st</sup> day of November 2005.

**HORWATH**  
Audit (WA) Pty Ltd

HORWATH

GLYN O'BRIEN

**GLYN O'BRIEN**  
Director

## **CHALLENGE DAIRY CO-OPERATIVE LIMITED**

### **ANNUAL GENERAL MEETING**

Please note that the meeting will start at 10.30 am. However, tea and coffee will be available from 10.00 am.

A light lunch will be provided at the conclusion of the meeting.

**To facilitate catering please advise Leanne at the Capel office, telephone number 9727 0000, of your intention to attend and how many members will be coming with you.**

**CHALLENGE DAIRY CO-OPERATIVE LIMITED**

**PROXY FORM**

To: The Secretary  
Challenge Dairy Co-operative Limited  
PO Box 57  
CAPEL WA 6271

I/We.....  
(full name in block letters)

of .....

being a member of Challenge Dairy Co-operative Limited hereby appoint:

.....  
(name of proxy in block letters)

or in his/her absence, the Chairman of the meeting as my/our proxy to vote on my/our behalf at the General Meeting of the Company to be held at 10.30 am on 1 December 2005 and at any adjournment thereof.

**Resolutions**

4. Appointment of auditors

**FOR**

**AGAINST**

In the absence of specific instructions the proxy may vote as he/she thinks fit, or abstain from voting.

Dated this .....day of .....2005

Signature of member/s.....

.....

**Or if a company**

The common seal of )

Was affixed in the presence of, )

And the sealing is attested to by: )

Secretary..... Director .....

**Note: a member may only hold two (2) proxies. Therefore it is important that you ensure your proxy holder does not already hold two (2) proxies apart from yours. If the proxy holder has submitted two (2) other proxies then your proxy will not be considered.**

**Completed proxy forms must be lodged with the Secretary 24 hours before the meeting.**

**EXCLUDED FROM  
PUBLIC REGISTER**

**CONFIDENTIAL ATTACHMENT**

**EXCLUDED FROM  
PUBLIC REGISTER**



# Attachment 8

## **Milk Pricing in Western Australia**

(Comments prepared for Jenni Mattila & Co in the context of an investigation by the Australian Competition and Consumer Commission into pricing arrangements for the dairy industry of Western Australia – December 2005)

Alistair Watson, Freelance Economist, Melbourne, [aswatson@bigpond.net.au](mailto:aswatson@bigpond.net.au)

### **Background to the Western Australian Dairy industry**

The historical development of the dairy industry in Western Australia has special features that have made adjustment to the deregulation of the Australian dairy industry on 1 July 2000 even more difficult than in other Australian states. In one respect, this statement may seem counter-intuitive because the isolation of Western Australia shelters WA dairy farmers from interstate competition in the market for milk for direct human consumption.<sup>1</sup>

These features of the WA dairy industry are in addition to intrinsic economic features of the dairy industry that have resulted in near universal worldwide regulation of dairy farming, with associated assistance and regulation of market milk processing and dairy manufacturing. These interventions continue to disrupt world trade in manufactured dairy products.

The deregulation of the Australian dairy industry resulted in the breakdown of elaborate structures to regulate and protect the market milk and manufactured milk industries that had evolved over decades, although the policies were modified in various ways from time to time. These arrangements extended well beyond the farm-gate.

The most common instrument of dairy price and marketing policy was price discrimination; increasing revenue by taking advantage of differences between the demand for fresh milk and manufacturing milk, and the demand for manufactured products on the domestic and export markets. Successful price discrimination requires institutional arrangements to keep markets separate and to return the benefits to farmers. This was no easy task within the Australian constitutional framework. Supply management (production quotas) is an essential ingredient of fixing high prices for market milk, unless the benefits are shared with all producers through pooling. Pooling causes economic losses eroding the benefits of price support because further production is encouraged.

While the proximate cause of regulation and assistance to the Australian dairy industry in the past was low export prices for manufactured products, the weak market power of suppliers was also a major reason for assistance and regulation of the dairy industry. For similar reasons, cooperative processing and manufacturing facilities often emerged in most parts of Australia, and other countries, to guarantee farmers a market for their output.

The overriding reason for the weak market power of dairy farmers is the perishability of milk. Unlike other forms of agriculture and livestock production where there is some flexibility in the timing of sales, dairy farmers have no option but to sell their output (daily), at the going

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<sup>1</sup> Various described as market milk, fresh milk or fluid milk.

price. Western Australia was different from the rest of Australia in that cooperatives were not an important feature of milk processing and manufacturing. This is still more or less the case.

The deliberate encouragement of dairy farming in Australia through closer settlement was a major cause of the earlier difficulties confronted by the dairy industry. Sorting out the problems caused by this involvement helped ensure an ongoing role for government in all states of Australia.

While interstate transport costs protect the WA market milk industry, internal transport costs compound the adjustment difficulties of the geographically dispersed WA dairy industry with small numbers of farms scattered around various locations in the southwest of the state. The dairy industry evolved to service local as well as metropolitan communities with market milk. Hence the geographical scatter, and transport costs that continue to afflict the WA dairy industry.

It turns out that issues of location are at the core of the controversy over competition in the WA dairy industry.

Breaking down the separation of markets for milk used for direct consumption and short shelf-life products and milk used for the manufacture of storable products (butter, milk powders and cheese) was the major objective of dairy deregulation. There are no technical differences between fluid milk and milk for manufacturing, at the farm level. Higher on-farm costs are incurred producing milk for year-round consumption rather than seasonally for storable manufactured products. A premium is justified for market milk prices over the prices of milk for manufacturing to compensate farmers for the costs of supplying milk 365 days of the year.

The Australian states followed different strategies in response to the economic problems of the dairy industry, according to local differences in the underlying competitiveness of dairy farming on export markets, and settlement history. Immediately prior to deregulation, the Australian industry had evolved so that some states concentrated on market milk and others pooled the returns from production of market and manufacturing milk.

At the time of deregulation, the Western Australian dairy industry was essentially regulated by market milk quotas schemes akin to those of New South Wales and Queensland. (Market milk quotas had also been the case in Victoria, Tasmania and South Australia until around twenty-five years ago.) New South Wales and Queensland had large enough populations to support some domestic manufacturing. The Victorian and Tasmanian industries were on a different economic trajectory with the overwhelming proportion of milk used for manufacturing. With the impending end of price support for manufactured products, the markets of New South Wales and Queensland were even more tempting to Victorian farmers.

Regulation of market milk by the states generally involved setting farm-gate prices and regulation of processing and distribution margins, including home delivery in a much earlier epoch. Prices were established on the basis of costs, somehow determined.

Initially, there were strong public health reasons for governments to become intimately involved in controlling the market milk industry.

Transport costs in eastern Australia meant that the dairy industries could be more easily integrated once the separation of state markets for market milk was abolished. With deregulation, the price paid for manufacturing milk in Victoria based on world prices for manufactured products effectively set a floor from which all-year production of fluid milk could be priced in eastern Australia.

Surplus milk had been converted into short shelf-life products and manufactured products in Western Australia but the scale of operations was insufficient in manufacturing to allow competitive production of manufactured dairy products. When deregulation arrived as a result of escalating tensions between the eastern states over access to markets for fresh milk, as it happened coincident with the era of National Competition Policy, the basis for setting prices for market milk in Western Australia was undermined.

It would be gilding the lily to describe dairy deregulation as an orderly outcome from carefully crafted competition policy. More precisely, a long running commercial dispute between farmers in different states, and their cooperatives, was resolved in favour of Victoria, albeit with considerable assistance from taxpayers. The small WA dairy industry was caught up in national changes in response to conflicts in the dairy industry elsewhere, and is still trying to adapt.

Nevertheless, the changes following deregulation are essentially irreversible because compensation payments have been made to farmers, and to the states as part of National Competition Policy. The only potential remedies are with respect to strengthening farmers negotiating position, formally by action by the Australian Competition and Consumer Commission or informally through agreement between participants in the supply chain.

The early stages in the transition from a regulated dairy industry in Western Australia were unfortunately handicapped by grossly optimistic views of the potential for increased sales of high 'value-added' dairy products in Asian markets and actions by the WA State Government to pursue those aspirations. With about four per cent of national milk output, the WA government was well ahead of itself with its export ambitions for the local dairy industry. In any case, commercial firms are more than capable of making those judgements and exploiting any opportunities that genuinely exist.

### **Beyond the Farmgate**

While there are few small operations producing specialty products, there are effectively only four firms in Western Australia receiving milk for processing and packaging for the retail market for market milk. One of these is a recently formed cooperative that on-sells milk to the other firms, and has no retail presence. The four processors have distinct catchment zones and thus do not have to compete with one another for supplies of raw milk at the farmgate.

Dairy processors have a monopsony, as there is effectively only one local dairy processor to which a farmer can supply raw milk.



These processors also require farmers to use designated transport systems, another barrier to competition and a source of additional costs borne by farmers.

By default, the economic fortunes of suppliers of specialised services to dairy farmers are tied to this price-setting process.

Retailing in Western Australia also has different features to the rest of Australia. There is a stronger independent grocery-retailing sector alongside the two main players. Conceptually, this might make the industry more competitive in accessing milk but there are restrictions in shopping hours that probably make the sector less efficient than in the rest of Australia.

Dairy deregulation has brought about fundamental changes at the retail level. Generic milks that were around a quarter of sales in 1999 now have a market share of more than 70 per cent, Australia-wide. Branded milk is more important relatively in Western Australia, around 50 per cent, making price comparisons difficult with the eastern states. Making sense of supermarket pricing strategies and margin behaviour is perilous territory. The fact of the matter is that loss leadership in dairy products at retail is more prevalent in Western Australia than in the eastern states.

The market power of retailers and processors would seem at first sight to be evenly matched. Numbers of processors and supermarkets are around the same. Neither can do without the other, unlike the bargaining situation between individual farmers and processors. But the perishability of packaged market milk, and financial strength, stack the cards in favour of the large supermarket chains. In effect, raw milk processing for the retail market is like a toll manufacturing operation with the charges levied from milk suppliers. Most of the market risk in the supply chain has been passed back to farmers. Processors do not have strong incentives to negotiate vigorously with supermarkets, even if that were an easy proposition.

The Australian Competition Tribunal has acknowledged the unequal contest between farmers and processors with authorisation in August 2002 of collective bargaining between groups of farmers and their respective processors. The authorisation is however subject to conditions that compromise its intended purpose.

The collective bargaining group must:

- Have a shared community interest; and
- Have similar supply patterns (seasonal supply or all-year-round supply); and
- Be located at a distance where their product can be economically delivered to the processor's plant; or
- The dairy farmers must supply a specialty raw milk product.

Profoundly, the collective bargaining groups must operate independently of one another. Bargaining is in no sense transparent. This results in uneven access to information, a prerequisite for workable competition. Processors can know all about their farmer suppliers from publicly available sources but farmers have no access to information about processor's costs, or their relationships with supermarkets, or right to exchange any information that they might know from their own bargaining group.

If they choose, processors can ignore the existing collective bargaining provisions. Contracts can be altered unilaterally. The small local cooperative is in effect a supplier of last resort further weakening the collective bargaining groups with the other three major processors. Collective bargaining across the WA dairy industry would resolve this imbalance of market power and ease the transition to industry deregulation. Transaction costs of the existing bargaining process would be reduced. Transport savings could also be achieved, of benefit to farmers and consumers.

### **Concluding Comment**

The WA dairy industry has contracted since dairy deregulation and will contract further if the current imbalance in bargaining strength between farmers, processors and supermarkets is not curbed. The existing authorisation arrangements for collective bargaining permitted by the Australian Competition and Consumer Commission are flawed because the flow of economic information is impeded by tying farmers to exclusive negotiations with a single processor.