SUBMISSION TO

PRODUCTIVITY COMMISSION

ON

THE AUSTRALIAN PIG INDUSTRY

OCTOBER 2004

QAF MEAT INDUSTRIES PTY LTD

Background

QAF established it's first piggery near Albury NSW in 1971. Over the last 33 years the Company has grown to be the largest producer of pork in Australia. QAF is an integrated producer encompassing the following business sectors.

- Stock feed mills producing 450,000 tonnes per year.
- Company owned sites and contract pig farms produce approximately one million pigs annually. This equates to approximately twenty percent of Australia's pig production.
- All pigs are slaughtered at Company owned abattoirs.
- QAF boning rooms process 130,000 pigs per year.
- QAF accounts for twenty-five percent of Australia's farmed pig meat export value.

QAF Meat Industries is not about being protectionist and has a history of exports. However over the last two years we have suffered significant losses, which we attribute largely to imports. We welcome the opportunity to participate in this latest inquiry.

1. Recent Profitability of QAF

Figure 1 details the EBIT figures for QAF over the last 10 years. 2003 was the worst trading year in the history of QAF with 2004 estimated to follow a similar trend. Losses such as these are obviously unsustainable.

Figure 1: QAF Profitability vs Imports
Source: QAF Management Accounts and APL

The following events played a significant part:

- Pre 1997 imports were of insignificant volume;
- Moderate industry exit tightening supply 1998;
- 1999/2000 Nipah virus outbreak in Malaysia opening up opportunity to export to Singapore, ameliorating effect of increasing imports;
- Outbreak of FMD beginning 2001 stopped imports from Denmark, triggering price recovery;
- Denmark re enter market 2001/02;
- All manufacturers now using imports (up to 60% of supply);
- One in hundred year drought in 2003. Significant increase in feed costs but unable to pass on costs due to suppression of price by import manipulation of supply.

2. Factors Affecting Profitability

Outlined below are the key factors QAF views as the main drivers of its profitability.

2.1 Cost Factors

The major production costs for QAF are outlined in Table 1.

Table 1: Cost of Production/Percentage of Total Costs
Source: QAF

2.1.1 Feed

The cost of feed has the largest impact on cost of production. The cost of feed as a percentage of total costs over time is given in Figure 2.

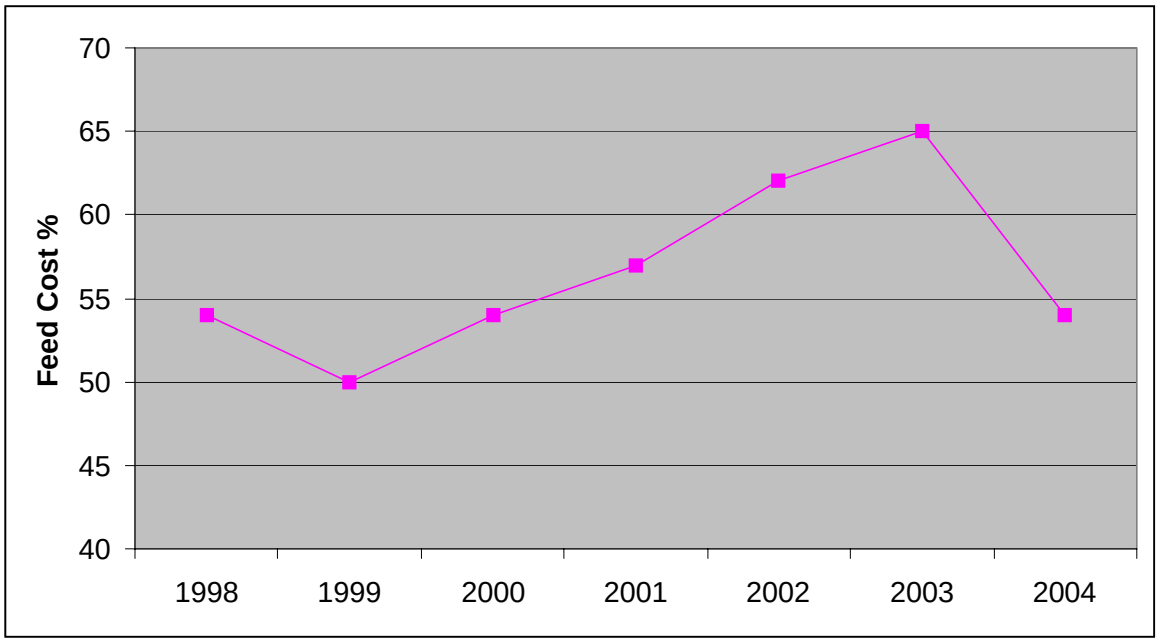

Figure 2: Feed Cost As A Percentage of Total Cost
Source: QAF

The impact of feed cost on profitability at an EBIT level for QAF on the last ten years is presented in Figure 3. Normalised feed cost is $254 per tonne over the period.

Figure 3: Effect of Feed Price on Profitability (calendar year)
Source: QAF Management Accounts

Figure 3 clearly demonstrates that feed costs will impact on absolute profitability in any given year. It is however by no means the only factor which affects profitability.

A further critical issue on feed costs is the effect of current quarantine regulations in relation to grain importation. Current regulations effectively restrict movement of imported grain further than 50 kilometres from the port of entry. In times of limited supply in Australia, such as in the 2003 drought, this places companies such as QAF with feed milling operations outside this radius at a distinct disadvantage. We are not able to access opportunity buys of raw material from overseas.

2.1.2 Labor and Other Costs

Over the last five years all other costs have only differed by a total of 12 cents per kilogram in any one year. They tend to be of a fixed nature, the per unit cost will vary with production volume fluctuations. The variation in this cost component hasn't significantly affected our recent lack of profitability.

2.2 Price Factors

The key determinant of the profitability variation independent of feed price outlined in Figure 3 is pig price. Over the last two years we have traded at a severe loss because, simply the price we have received for our product has not covered our cost of production. The basic determinants of price are supply and demand. We would argue that imports influencing supply are having the major impact on current and more importantly future profitability.

2.2.1 Markets

The pork market can be divided into three segments: retail, manufacturing and export. The specifications and QAF's approach and involvement in each market are given in Table 2.

	Carcase Weight Specifications (kg)	Percentage of QAF Sales (%)
Retail	50 to 70	
Manufacturing	70 to 90	
Export (Japan)	90 to 110	

Table 2: Pork Markets

The market segments are differentiated essentially by the carcase weight of the pig. Pigs can be easily diverted into any of the three markets by simply altering the age and therefore weight they are marketed at. The easy transfer between markets, especially the first two, means that the relative prices track each other. Any difference between the prices is related to the variance in cost of production relating to the lighter pigs, i.e. the fixed production and slaughter costs are spread over fewer kilograms. This price difference tends to be fixed, with the retail market generally 40 to 50 cents higher per kilogram carcase weight.

A significant percentage of QAF's carcase sales are direct to manufacturers or wholesale boning rooms. The manufacturing sector is a major customer of the wholesalers, especially for leg meat and boneless middles for ham and bacon, respectively.

An important point to note for the Japanese export market is that it does not take all cuts. This market takes the loin, belly, collar butt and tenderloin, leaving the leg muscles and shoulder picnic which are directed to the manufacturing market for ham production. Import price for legs and shoulders therefore influence significantly the value that can be returned for an export carcase.

2.2.2 Effect of Imports on Price

Total supply into the market is a combination of domestic production and imports. Imported product is restricted to frozen bone out material, which must be cooked prior to sale. The majority of the product comprises leg muscle from Canada for ham production and boneless middles from Denmark for bacon production. Based on the previous section we would argue that although imports are restricted to one segment of the market, they effectively determine prices in all segments because of the unrestricted movement of pigs between market segments.

2.2.3 Death of the Hog Cycle

Prior to imported products entering Australia, a relationship between price and supply existed which was described as the 'hog cycle'. This described the effect of an event such as a drought would have on subsequent supply and price. If we use last year's drought as an example, during this period the cost of production rose dramatically due to the cost of feed. Usually this results in producers either exiting the industry or reducing mating numbers. The resultant drop in supply will not be immediate. There will be a lag period of 40 weeks, which is the time from when a sow is mated until her progeny are marketed. With the drop in supply, a period of higher prices would occur, until producers either re-entered the industry or increased mating numbers. This phenomenon allowed producers to recover from periods of low profitability such as experienced in 2003.

Access to imported product has killed off the hog cycle.

Domestic production, imports and pig price are shown in Figure 4 starting July 2003 until now.

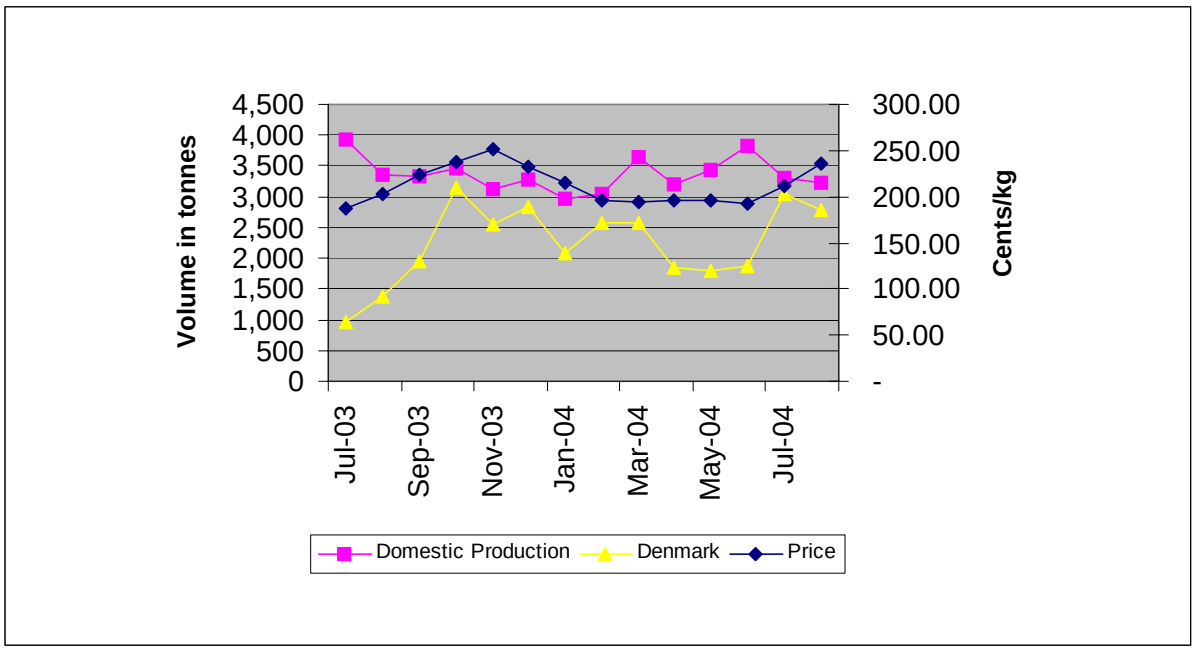

Figure 4: Relationship between carcase price, domestic production (divided by 10) and Danish imports
Source: APL

In Figure 4 we see that pig prices began to rise in July 2004. Anecdotal evidence suggested that the price rises were driven by a lack of supply which is supported by the slaughter data; which shows domestic production had dropped, again most likely in response to the adverse trading position in 2003. This price rally has been short lived with prices having stalled in early October and predicted to fall at a time of traditionally highest demand running into Christmas.

The major reason our wholesale customers are giving us is that they cannot pass on the required price rises to the manufacturing sector. The manufacturing sector has the opportunity to switch to imported product, which then sets the price for domestic sales. Unlike the relative slow changes we see in domestic supply, there is only a five to six week lag between ordering and delivery of imported product. In Figure 4 we see that the last few month's import figures show a significant increase especially in boneless middles from Denmark.

The current scenario mirrors the situation in late 2003 as seen in Figure 4, when prices began to decrease earlier than expected, again in response to a large surge in imports. Producers have little flexibility in manipulating supply due to the intensive nature of the production system, i.e. similar numbers of pigs need to be marketed on a weekly basis. In contrast the manufacturing sector has the ability to change the supply situation relatively quickly through imports and thus influence price at will.

2.2.4 Price recovery from wholesale manufacturing pig

Table 3 illustrates a typical product mix, yields and current prices a wholesaler will achieve from boning a manufacturing pig. If we subtract estimated processing costs i.e. slaughter, boning and packaging, the remaining figure is the break even price for the carcase.

PRODUCT	*KG/PIG*	*PRICE/KG*	*AUD/KG ex works*	*AUD*
Boneless Middle	17.8	4.40	4.30	76.63
Tenderloin	1.00	9.60	9.50	9.50
Collar Butt	5.30	6.05	5.95	31.30
Shoulder Picnic	11.20	3.40	3.30	36.83
Leg	10.70	5.40	5.30	56.71
Trims	3.70	3.30	3.20	11.78
Fats	1.30	1.30	1.20	1.56
Hock Meat	2.80	3.50	3.40	9.52
Other	1.40	1.20	1.10	1.54
TOTAL	55.20			235.37
Boning Fee				40.00
Packaging Cost				8.00
Slaughter Fee				16.75
	Carcase weight 78kg HSCW		*Sub Total*	64.75
Return/Pig				**170.61**
Return/kg HSCW				**2.19**

Table 3: Manufacturing Carcase Value
Source: QAF

Altering the prices for individual products, eg. leg muscles and boneless middles quantify the effect that changes in import price will have on potential carcase price to the producer. We contend that the leg and boneless middle prices will not exceed import price, but can be less. Currently industry sources are pricing domestic boneless middles at a discount to imported product, because of excess supply due to increased imports and expected future import volumes.

Prior to the 1998 Pig Meat Industries Inquiry, the Australian Industry was only contending with importation of effectively one third of the carcase. Since 2000, the increasing level of imports of boneless middles has increased this to two thirds, which obviously significantly increases the influence of imports on carcase price.

2.2.5 The Effect of Export Markets on Price

Exports over the last five years are presented in Figure 5. Exports have grown significantly in the last five years however over the last eighteen months total exports are on a decline. A major factor in this decline is rising exchange rates both in Singapore and Japan. Over the eighteen month period, the Australian dollar has appreciated 30% against the Yen and the Singapore dollar. This reduces the profitability in the respective markets directing product back onto the domestic market, again potentially lowering domestic price. However, the decline in exports of 10,000 tonnes for the first eight months of 2004, compared to the first eight months of 2003, has been matched by an increase in imports of 10,000 tonnes over the same period.

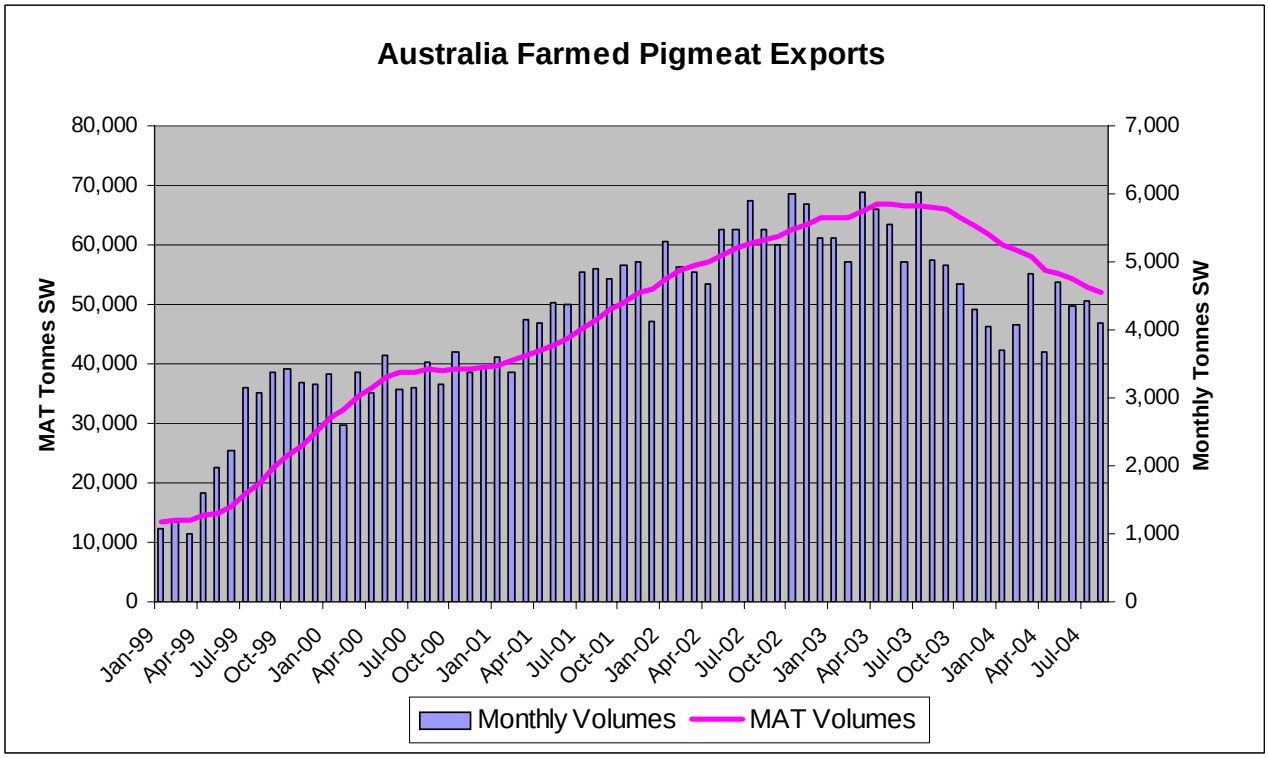

Figure 5: Australian Pigmeat Exports
Source: APL

3. International Competitiveness of Production Sector

The major factors, which influence the competitiveness of Australia's pig industry with our trading partners, are the biological efficiency of our systems, the input costs, plus the exchange rate. Outlined below is a discussion of how QAF compares with Denmark, Canada and the USA.

3.1 Biological Efficiency

The key factors, which effect profitability, are sow productivity, growth rate, feed efficiency and post weaning mortality. A comparison of these traits for the four countries is presented in Table 4.

	QAF	USA	Canada	Denmark
Feed Efficiency (30-100) (kg feed/kg L wt gain)		3.0	3.1	2.7
Pigs weaned/sow/yr		19.1	19.2	22.4
Growth Rate (grams/day) (30-100kg)		800	750	804
Post Weaning Mortality		6.8	6.0	7.0

Table 4: Comparison of Biological Efficiency Traits
Source: QAF, Pig Progress Vol 19, No.4, 2003

Clearly Table 4 demonstrates that QAF is competitive. This is not surprising as similar technology and production systems are used around the world, including genetics. QAF has in the past successfully exported genetic material to the United States.

3.2 Input Costs

The two major input costs, feed and labour, are presented in Table 5.

	QAF	USA	Canada	Denmark
Grower Feed (AUS $/ton)	250	210	205	290
Labour Costs (AUD $/hour)	17	14	15	31

Table 5: Relative Feed and Labour Costs
Source: QAF, Pig Progress Vol 19, No.4, 2003

The figures in Table 5 reflect 2004 feed costs. Feed costs vary significantly dependent on grain prices. Over the last 10 years feed costs for QAF has varied from $205 to $395, with an average of $254. The figures in Table 5 reflect reality, in that in most years North America will pay less for feed than Australia with European farmers paying the most. The labour cost differences reflect the generally significantly higher wages paid in Europe.

3.3 Exchange Rate

In any international cost comparison, the exchange rate can play a significant role. Over the last five years the Australian dollar has traded between 50 and 80 US cents. The feed and labour figures in Table 5 are calculated at the current exchange rate of 72 US cents. Exchange rates are a two edged sword, as the dollar appreciates, we have negative impacts via the price of exports and imports, but a positive in terms of feed price. A rising dollar generally reduces the cost of grain in Australia.

Exports to Japan are paid in Yen, while imports are paid for in Kroner or Canadian dollars. Grain prices will fall with an appreciating dollar, as the majority of Australia's grains are exported, with domestic price then linked to export price again as most export contracts are written in US dollars.

3.4 Competitiveness Post Farm Gate

QAF's slaughtering costs for the last five years are presented in Table 6.

	1999	2000	2001	2002	2003	2004*
Volume	520,000	700,000	910,000	943,000	893,000	897,000
Net Cost per pig ($)						

* 2004 is a forecast figure for the full year

Table 6: QAF Slaughtering Costs and Volumes
Source: QAF Management Accounts

Comparative data from overseas is difficult to obtain with little if any data published in the public domain. Industry sources put current slaughtering costs in the USA at US$16 /pig, which is above QAF's cost even at a dollar for dollar exchange rate. North America does however have an advantage in that they slaughter heavier pigs, 94kg carcass versus 72kg carcass, which lowers their slaughter price on a per kilogram basis.

The average labour cost in Danish slaughter plants is 30% higher than QAF (Source: Danske Slagterier 2003)

No Danish data is available on total slaughter costs, however we would expect that their costs would be higher, due to their higher labour costs and similar carcase weights. Sixty-six percent of total costs to slaughter can be attributed to labour. The same figure with respect to boning is eighty percent. The plants and technology used around the world is again similar.

3.5 Competitive But Not Necessarily Profitable

Based on the data presented in the previous sections we believe QAF and the Australian Industry is cost competitive with North America and Europe. Whether we will be profitable in the future is less certain.

If QAF and the Australian Industry is cost competitive, why have imports achieved the high level of penetration. The explanation relies on two factors:

- marginal costing of the specific export cuts; and
- subsidisation of overseas producers via domestic government programs, allowing a lower overall carcase price to be paid to the producer.

Denmark has been able to price the boneless middle into Australia at relatively lower values. In Denmark, leg cuts attract a premium on their domestic market compared to cuts from the middle of the pig eg. loin chops. This is the opposite of what is seen in Australia.
The Danish middles are also plate boned, which allows the remaining component to be sold as loin and baby ribs. These products command a premium price in the US market. The US is the seventh most important export market for Denmark. In Australia rib prices are significantly less than the US market. Australia also string bones a number of middles, i.e. the meat is not left on the individual bones.

In Canada, the majority of the value of the carcase is derived from the middle. The highest value cuts are the ribs as described above, followed by the belly and then the loin. In the US market, the belly is used for bacon production. In Australia, bacon has traditionally been manufactured using the Wiltshire cure method, which comprises the loin as well as the eye.

The Canadians can then price their legs at a lower value, which is compensated for by the higher return they can extract from the middle of the pig.

The second part of the explanation involves subsidies paid to Danish and Canadian producers. Any form of subsidy will obviously allow the producer to sell the carcase under the 'true cost of production' and still remain profitable. A recent ABARE report in August of this year on the state of the Australian pig industry, noted that 26 percent of Danish farmers income was derived through government incentive programs.

The US pork industry has recently applied to its government for a safeguard action against Canadian imports on the grounds of unfair Canadian hog subsidies. The major claim is against a number of income stabilisation subsidies, which effectively eliminate normal economic risks for Canadian producers. The benefit received under the Quebec income stabilisation program is estimated to be as much as $US15 per pig produced.

The Australian industry has developed under a scenario of a fluctuating cost base due to varying grain prices matched against a reactive domestic pig supply, which resulted in a varying but at least a profitable industry.

***Imports at current levels no longer allow the traditional supply/demand/price relationship to operate*.**

4. For The Future

In the short to medium term we envisage that domestic production will continue to decline. The investment of new capital and repair and maintenance will also decrease reducing our international competitiveness. The rate of the decline will be dependent on import prices from Canada and Denmark, volumes imported and grain prices. The price of pigs will continue to be set by the import price.

A major concern is the subsidy that continues to be paid to Danish farmers. A recent ABARE Report stated that 26% of Danish producer's income came from Government payments. This indirectly allows Danish product to be sold at a lower price. If the imported price of boneless middles increased by 25% we estimate that domestic carcase price could potentially rise by 25 cents/kilogram.

Subsidies that are available to Canadian hog farmers fit into two general categories: preferential loans and income stabilisation programs. Dr Dermot Hayes of Iowa State University estimated that the average level of price subsidy in the Quebec province over the past ten years was as high as $US 15 per pig.

The timing of imports would appear to be being used as a sledgehammer to crush upward movements in pig prices thereby destabilising the market and creating a ceiling to the returns of pig farmers

If the industry is faced with another drought and concomitant higher grain prices there is potential for the industry to collapse seriously impacting on regional economies.

The last two years have substantially reduced producer's reserves and thus their ability to buffer against adverse trading conditions.

5. What Can The Government Do To Stabilise The Industry

Currently the continual and targeted increases in the supply of pig meat via imports is destabilising the industry. We believe it is essential that immediate action be taken both by Government and Industry to stabilise the industry. In further submissions and discussion we would like to explore different avenues that both parties can take to achieve this goal. Some examples include a tariff rate quota or price stabilisation schemes. These types of actions will allow the industry time to implement a restructure plan.