PROPOSAL TO INTRODUCE

A

NEW MARKETING SYSTEM

FOR THE

QUEENSLAND SUGAR INDUSTRY

FROM THE 2006/07 SEASON

REPORT OF

THE INDUSTRY WORKING GROUP

APRIL 2005
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Background

In 2004 CANEGROWERS and the Australian Sugar Milling Council committed to a Heads of Agreement with the Queensland Government and provided a Statement of Intent to the Australian Government.

Key elements of the Heads of Agreement with the Queensland Government include:

- a commitment to supporting and promoting comprehensive reform and restructure;
- an acknowledgement the legislative impediments to reform must be removed;
- recognition that the future cannot simply be an extension of the past and that previous assumptions driving production and structural arrangements need to be changed; and
- Industry commitment to transformational change required to achieve sustainability.

Key elements of the Statement of Intent to the Australian Government include industry agreement that the industry will actively pursue long term economic, social and environmental sustainability by:

- undertaking significant reform across all sectors;
- comprehensively rationalising and restructuring its operations;
- diversifying its economic base; and
- adapting to its new operating environment.

Establishment of Industry Working Group

One element of the Heads of Agreement provided that:

“...the industry will establish a working group to develop voluntary marketing arrangements as soon as possible. The objective of this working group is to work towards a new system for marketing of raw sugar prior to the requirement for review in 2006.”

During 2004, a tri-partite Working Group was established in accordance with the Heads of Agreement comprising Messrs Ian Ballantyne, Rino Cargnello, Max Craigie, Alf Cristaudo, Paul Martyn, Bob McCarthy, Ian McMaster, Geoff Mitchell, Joe Russo, Paul Schembri and Eddie Westcott.

The Working Group operated on the premise that, at some future point in time, the Sugar Industry Act 1999 would be repealed. Given that a review was to commence in 2006, there is a possibility that all legislation specific to Queensland Sugar Limited (QSL) would be withdrawn, including vesting, schemes of payment, directions on deliveries, brand production, quality standards, Ministerial directions and Trade Practice Authorisations. Sublease arrangements with Sugar Terminals Limited would terminate in accordance with the terms of the lease agreement and would need to be renegotiated. Suppliers would have the ability to decide initially whether or not to join an industry-sponsored voluntary marketing arrangement.

During its deliberations, the Working Group sought the assistance of the Chief Executive of Queensland Sugar Limited (QSL) and the assistance provided was very much appreciated. The Working Group has periodically provided the Premier of Queensland with updates on progress being made.
New Marketing Arrangement

This paper is premised on the cooperation of the Board of QSL and the assumption that the direction and developments recommended will be largely embraced by the directors of that company.

The current Board of QSL, but later a potentially restructured body, will have carriage of those changes regarded as necessary to allow smooth transition from a regulatory base to a contractually based marketing structure. It is proposed that the conversion of the existing statutorily based raw sugar marketing operation to one with largely the same goals but delivering enhanced outcomes will be based solely on contractual imperatives. This would provide initially for the retention of the existing Board structure, retention of staff and operating systems and servicing of existing commitments.

Marketing Vehicle

The Working Group’s preference is to replace compulsory vesting arrangements with a contractually based marketing company that is the preferred marketer by suppliers of Queensland produced bulk raw sugar and a supplier of preference to customers.

In seeking to pursue this preference, the Working Group decided to use QSL as the base model. QSL has considerable commercial experience in marketing Queensland raw sugar. In undertaking an assessment of the functions and operations of QSL, it was noted that very few of the activities undertaken required legislative support and it would provide a relatively simple transition for QSL to move from management of a vesting mandate to operating entirely within a commercially focused environment. QSL has developed considerable goodwill and is highly regarded and well known in the international marketplace. Adopting QSL as the base model would provide seamless change and stability, particularly in the context of customer perceptions.

The Working Group investigated other corporate structures including Australian Molasses Trading Pty Ltd.

The approach taken by the Working Group has been to identify those minimum changes required to QSL’s structure and operations to operate on a voluntary basis, and then to identify the level of changes to structure and operations that would be necessary to address the preference outlined above.

The Working Group acknowledges that the Board of QSL has a fiduciary obligation to act in the best interests of the company as a whole. Many of the recommendations set out below require the goodwill and cooperation of the Board of QSL to implement in order for QSL to be transformed into the industry marketing company.

A contractual arrangement between bulk raw sugar suppliers and the marketer:
- ensures certainty of supply and seamless forward contracting with customers for export;
- allows funding of operations and advances to suppliers; and
- allows hedging of product, exchange requirements and margin call financing.

Recommendation 1
That QSL be the vehicle used as the basis for a contractually based sugar marketing company.
Drivers to Responsive Marketing Within Standard Business Framework

It is envisaged that the initial marketing arrangement will adapt to provide responsive marketing within the standard business framework. In order to ensure maximum participation and ensure that the transformation takes place in a timely manner, the Working Group proposes that initial contractual arrangements between the marketer and suppliers include obligations on the marketer to meet defined milestones by due times. A failure to meet a milestone could enable the supplier to opt out of the supply contract. This may alleviate potential tension between seeking to “lock in” certainty of maximum supply participation over the initial contracted period and the ability to opt out if insufficient progress is being made against specified milestones. The milestones and due dates are to be determined by the marketer in consultation with the suppliers and be incorporated in contractual arrangements.

Recommendation 2
In order to ensure maximum participation and ensure that transformation takes place in a timely manner, the Working Group proposes that the initial contractual arrangements between the marketer and suppliers include obligations on the marketer to meet defined milestones by due times. A failure to meet a milestone could enable the supplier to opt out of the supply contract.

Timing of Legislative Changes

While the State Government legislative agenda is not known at this stage, it is unlikely that the review in 2006 under National Competition Policy guidelines would uphold the current legislated vesting arrangements. The failure to achieve approval for legislative vesting would be the precursor for the State’s withdrawal from sugar marketing intervention. Given the likely timetable for change, it was considered prudent to prepare for these changes and work towards the introduction of a new system for marketing of raw sugar prior to the requirement for review in 2006. The Working Group proposes that sections of the Sugar Industry Act 1999 covering vesting and marketing of sugar in QSL operate only for the 2005/06 season.

It is expected that contractual arrangements between QSL as the marketer and suppliers of sugar for the 2006/07 season would need to be concluded in the second half of 2005. This may necessitate the introduction of some transitional legislative arrangements to ensure that these arrangements can be entered into. Transitional arrangements may also be necessary covering the repeal of sections of the Sugar Industry Act 1999 covering vesting and marketing of sugar from the end of the 2005/06 season.

Following these legislative changes, suppliers of sugar would not be restricted in their choice of marketer from the 2006/07 season.

Recommendation 3
Sections of the Sugar Industry Act 1999 covering vesting and marketing of sugar in QSL operate only for the 2005/06 season. To facilitate the introduction of commercial, contractually based marketing arrangements from the 2006/07 season, transitional arrangements would need to be introduced during 2005 to enable QSL to enter into contractual arrangements with suppliers.
Marketing Company

1. Corporate Structural Issues

(i) Corporate Structure
Currently, QSL is a company limited by guarantee and this structure works reasonably well in an environment where QSL operates as a cost centre and passes the net revenue to the industry. QSL is currently exempt from income tax under the Income Tax Assessment Act 1997.

It is noted that marketing bodies in other rural industries following deregulation are typically transformed into companies limited by shares:

- **Graincorp Operations Limited**, originally the Grain Elevators Board / Grain Handling Authority of NSW, was corporatised in 1989 as NSW Grain Corporation Limited. The company was subsequently acquired by Prime Wheat Association (now The Grain Growers Association Limited) and restructured. In 1993, it was named GrainCorp Operations Limited. In 1997, an exempt market commenced for the trading of “A” Class Shares and in 1998 it listed on the ASX.
- **Queensland Cotton (Holdings) Limited**, originally Cotton Marketing Board of Queensland, was incorporated in May 1989 following deregulation and listed on the ASX in 1992.
- **AWB Limited**, originally Australian Wheat Board, was incorporated in 1999 and listed on the ASX in 2001.
- **Grainco Australia Limited**, originally formed out of the merger in 1991 of the Barley Marketing Board, the Central Queensland Sorghum Marketing Board, State Wheat Board of Queensland and Queensland Grain Handling Authority. It was acquired by Graincorp in September 2003.

The reasons for this transformation in other industries vary, but include a number of common themes:
- a desire for self determination by moving from a statutory controlled and governed environment to a more commercially orientated status which they own and control;
- a need for an adequate capital base to enable greater commercial flexibility and to fund growth, including participation in value adding opportunities.

It is noted that a change in company type is permitted by the Corporations Act 2001 and involves the termination of membership of the guarantor members, extinguishments of guarantees, and the issue of shares to the persons specified in the application to change the type of company. Shares may be issued to existing members or new members or a combination of both. Generally the procedure is relatively simple.

The Working Group notes that if a decision is taken to issue shares, then it would be possible to issue one class of shares to industry participants. There are a number of models that could be used to determine relative equity arrangements, including those based on production history. It was noted that one method for allocation of shares between eligible growers and millers could be determined in accordance with the principles of the 2004 Federal sustainability grant.
The Working Group noted that the calculations for the first tranche payment to the industry have been calculated and could be applied to determine a pro-rata allocation of shares to eligible growers and millers. Whilst consideration of the ownership structure of the marketer has merit, it is not seen as critical to moving to a new marketing arrangement.

The Working Group proposes that the Board of the marketer address the ownership structure in consultation with its members. This would involve developing a clearly articulated vision for the marketing company. If the vision is to continue to operate purely as a marketer, then continuation with a company limited by guarantee may be the appropriate ownership structure. If the vision is to expand the marketer’s operations to take advantage of value added or enhanced access opportunities through strategic investments, then a company limited by shares may be the appropriate. Other factors, including particularly the consent of the existing owners, would be essential to ensure any departure from the current ownership structure is robust.

The Working Group notes the related issue of taxation. It is envisaged that the marketer would operate initially on a cost recovery basis with some limited opportunities to enhance its capital base from the provision of tailored services. It is expected that the tax status would need to be assessed if there is either a change in the ownership structure or its cost recovery role.

**Recommendation 4**
*That the Board of the marketing company take appropriate steps to address the ownership structure of the company once commercial operations have been commenced. Structural change will necessitate referral to and support of current members.*

(ii) Board of Directors
The current Board comprises 11 non-executive directors together with the Chief Executive, with four directors elected by grower members and four elected by miller members. The three independent directors are appointed by the eight directors.

The composition and skill base of the Board is likely to need to be varied to better match the needs of the marketer as it alters its operations to conform and respond to a more standard business framework.

**Recommendation 5**
*There should be sufficient grower and miller representation on the Board of the marketer to ensure transparency and a number of independent directors to bring a depth of experience and diversity of skills and perspectives. The present composition and skill base would need to be flexible as to ensure that the company is able to respond to a more standard business framework.*

(iii) Constitution of QSL
The Working Group has identified a number of possible changes to the Constitution of QSL for the consideration of the Board of the marketer.

The Constitution of QSL contains an objects clause. The principal object of the company is to promote the development of the sugar industry and a number of lesser objects are detailed to assist in the attainment of that principal object, including references to obligations.
outlined in the *Sugar Industry Act*. In carrying out its objects, a number of powers are
detailed, for example, it can purchase, sell and participate in any form of trade and
commerce about the products of the Queensland sugar industry. A copy of the objects clause
is attached.

Following the enactment by the Commonwealth of the *Company Law Review Act 1998*, the
Corporations Law provided companies with basic powers and rules and thereby dispensed
with the need to include an object clause in constitutions. Constitutions of a number of
agribusinesses were reviewed, including ABB Grain Ltd, Australian Molasses Trading Pty
Ltd, Australian Pork Limited, AWB, Australian Wool Exchange Limited, GrainCorp
Limited, Namoni Cotton Co-operative Limited, Peanut Company of Australia Limited and
Sugar Terminals Limited.

Many of the companies reviewed did not have an objects clause. Subject to taxation advice,
clause 6 detailing the objects of QSL could be amended to read:

(a) The principal object of the company is to purchase, sell and participate in any form of
trade and commerce about the products of the Queensland sugar industry or a sugar
industry elsewhere.
(b) In carrying out its object, and without limiting its powers under the law, the company
will promote the development of the sugar industry.

A number of other changes to the Constitution are required as a consequence of
implementing the proposed legislative amendments to the *Sugar Industry Act (1999)*.

1. Clause 1 “Definitions” – delete the definition of “Minister” and delete from clause
19 “Passing Resolutions” the following subclause (c) –
“A Resolution to change any Article of this Constitution dealing with the
company’s purpose or function must be approved by the Minister before being
considered by the Members.”

2. Clause 29 “Maximum Number” – delete in the second sentence the following
phrase “As required by the Sugar Industry Act 1999 (Qld),” and the word “vesting”.

3. Clause 38 “Powers of Directors” – delete in subclause (c)(i) the phrase “to Mill
Owners under the Sugar Industry Act 1999 (Qld)” and delete subclause (d) in its
entirety.

4. Clause 44 “Chair of Directors” – delete subclause (a) and renumber the balance of
the clause.
Recommendation 6
The Working Group proposes that, subject to taxation and legal advice, the Constitution of QSL is amended as follows:

1. Clause 1 “Definitions” – delete the definition of “Minister”.

2. Clause 6 “Objects” – omit and replace with –
   (a) The principal object of the company is to purchase, sell and participate in any form of trade and commerce about the products of the Queensland sugar industry or a sugar industry.
   (b) In carrying out its object, and without limiting its powers under the law, the company will promote the development of the sugar industry elsewhere.

3. Clause 19 “Passing Resolutions” – delete subclause(c).

4. Clause 29 “Maximum Number” – delete in the second sentence the following phrase “As required by the Sugar Industry Act 1999 (Qld),” and the word “vesting”.

5. Clause 38 “Powers of Directors” – delete in subclause (c)(i) the phrase “to Mill Owners under the Sugar Industry Act 1999 (Qld)” and delete subclause (d) in its entirety.

6. Clause 44 “Chair of Directors” – delete subclause (a) and renumber the balance of the clause.

2. Relationship between Marketer and Suppliers

The relationship between the marketing company and suppliers would be governed by contractual arrangements. Although the terms of those contractual arrangements would be matters to be determined between the suppliers and the marketing company, it is envisaged that there could potentially be at least two main types of contracts with suppliers:

- a Sale of Goods contract where ownership of the bulk raw sugar passes to the marketer in accordance with the terms of the contract; or
- a Principal/Agent contract where the marketer is vested with full contractual capacity and authority to market and sell bulk raw sugar on behalf of the supplier.

In the transformation to responsive marketing, it is expected that these contractual arrangements would provide greater flexibility and a wider portfolio of options and services for participants.

Although the types of and terms of contractual arrangements are matters to be negotiated by the marketing company with each supplier, it is recommended that rules relating to participation, entry and exit would be determined by the Board of the marketer in consultation with suppliers and incorporated into supply contracts. The Working Group considered that the goal of the marketer is to secure a commitment from each participating supplier to supply 100% of bulk raw sugar for export. While reduction of this percentage of available export commitment is a matter for the Board, less commitment could reduce QSL to an export marketer of last resort.
The marketer would need to finalise the terms of supply contracts as soon as possible to enable suppliers sufficient opportunity to consider the terms. Suppliers seeking to participate should commit to the initial contract arrangement as soon as possible and no later than 31 December 2005. The term of the initial contract should be three years, with a provision entitling a supplier to opt out in the event that agreed milestones are not satisfactorily achieved. Beyond that initial three year period, a rolling two year period could be appropriate.

Recommendation 7
It is recommended that rules relating to participation, entry and exit would be determined by the Board of the marketer in consultation with suppliers and incorporated into supply contracts. It is recommended that the goal of the marketer is that suppliers should commit to 100% of bulk raw sugar for export.

Recommendation 8
It is recommended that the initial contract arrangement be finalised no later than 31 December 2005 and that the term of that contract should be three years. Beyond that initial three year period, a rolling two year period could be appropriate.

3. Operational Structure

The company's business would broadly consist of the following key components:
(i) Marketing
(ii) Treasury, Risk Management and Pooling
(iii) Logistics, Shipping, Chartering
(iv) Bulk Sugar Terminals and Storage

(i) Marketing
In a non-statutory environment, the marketer could participate in a range of commercial marketing and pricing opportunities. In the initial phase of operation, the marketer would continue to focus on bulk raw sugar for export under contract with suppliers. The company is not precluded from offering other services under contract, including operating in the domestic market if commercial opportunities arise or providing tailored marketing services to suppliers provided that they do not materially impact on the integrity and effectiveness of the central goals of the marketing arrangement. The marketer would strategically manage the brand mix to maximise opportunities for participating suppliers.

Recommendation 9
It is recommended that the marketer focus on marketing bulk raw sugar for export under contractual arrangements with suppliers.

(ii) Treasury, Risk Management and Pooling
The treasury, risk and pooling functions undertaken by the marketer would depend upon the detailed contractual relationship with suppliers:

- Where the supply contract provides for the transfer of ownership of the bulk raw sugar to the marketing company, then it is expected that these functions would initially be similar to those currently operating, for example, a single contracted marketing pool for bulk raw sugar exports could be established which pools revenues and costs in the same way as is currently undertaken.
Where the company acts as a marketing agent, then treasury and risk management functions would be determined by the marketer in consultation with the suppliers. It is expected that QSL would not provide a separate arrangement to that offered by the contracted pool where any supplier would be competing with that supply pool.

Within the initial two years the marketer is expected to develop more innovative treasury, risk management and pooling arrangements.

**Recommendation 10**
Initially treasury, risk management and pooling functions would be similar to current arrangements but the marketer is expected to develop in the transition to standard business practice more innovative arrangements.

(iii) **Logistics, Shipping, Chartering**
Integration and co-ordination of production, receivals, storage, shipping and marketing provides the industry with a competitive edge and it is expected that these operations would continue. The Working Group notes that a level of flexibility would need to be introduced in order to accommodate external users of the storage and terminal facilities.

(iv) **Bulk Sugar Terminals and Storage**
The marketer will be required as part of the sublease arrangements with STL to review these arrangements. Initially, it is expected that the marketer would continue to manage all aspects of the operations of the bulk sugar terminal and storage facilities, including operations, repairs and maintenance and capital expenditures. It would, however, be necessary to develop, in conjunction with STL, third party access protocols to handle domestic sugar and any export sugar not placed with the marketer.

**Recommendation 11**
Bulk sugar terminals and storage operations would continue to be similar to current arrangements. The marketer, in conjunction with STL, will have to develop a third party access protocol prior to the commencement of the 2006/07 season.

(v) **Other Activities**
The marketer should continue to be actively involved in liberating world trade, e.g. Global Alliance, EU Challenge and be actively involved in and co-ordinate advice to governments on a range of policy issues where that involvement enhances marketing imperatives and potentially improves returns.

**4. Transparency Issues**
Initially, it is expected that all suppliers would seek to share in the benefits and disadvantages of supplying the full range of raw sugar qualities required to meet the requirements of all export customers. In its response to commercial business standards, the marketer is expected to develop a range of innovative products and services. It is expected that it will be necessary to provide greater transparency of costs and that there will be a level of cost disaggregation. There may also be a move away from the pooling of all costs and revenues.
Desirable Attributes

a. The credentials of the organisation
   i. Operate to Australian standard commercial practice with producer rights to ownership/control, initially as a company limited by guarantee with grower and miller members. The composition and expertise of the board would be similar to current QSL arrangements.
   ii. Experience and expertise in marketing, financing, pricing, foreign exchange, risk management strategies and operations.
   iii. Track record of performance in optimising net returns above benchmark (eg NY No.11 prices).
   iv. Commercial controls over product standards
      It is expected that the financial incentive arrangements would evolve commercially from those currently undertaken by QSL and would be developed by the board in consultation with industry organisations.

b. Transparency of operation
   i. Funding
      The marketer would seek to not only recover operating and capital costs but also seek to make a small profit to enhance its capital base.
   ii. Flow of costs and market signals
      The marketer will operate on a cost based structure for services offered to suppliers.
   iii. Market intelligence, regular financial updates, etc. to assist producer’s production and financial planning.
   iv. Enhanced two-fold customer relationship focus – closer contact with producers and between producers and customers.
   v. Transparent provision of tailored services.

c. Flexibility in contractual arrangements and services
   The marketer would provide wider options and greater flexibility in contractual arrangements and services and address:
   i. Flexible pricing and hedging options, including producer pricing.
   ii. Seasonal finance and timing of payment options.
   iii. Flexible and responsive arrangements to individual volume and specification circumstance.
   iv. market access and product range options.

d. Operational focus
   i. Export focus
      The marketer would primarily be focused on bulk raw sugar for export; however, could operate as a supplier to the domestic market.
   ii. Brand focus
      The marketer would strategically manage the brand mix to maximise opportunities for participating suppliers.
iii. Trade and sugar policy focus
The marketer should continue to be actively involved in liberalising world trade, eg Global Alliance, EU Challenge and be actively involved in and co-ordinate advice to governments on a range of policy issues.

e. Degree of support/commitment by fellow suppliers
The level and duration of participation is critical to the overall attractiveness and performance of the voluntary marketer. If participation rules are set either too low or too high, then some suppliers may choose not to participate; conversely, market access and supply stability could be threatened.

i. Level of participation
The goal is for suppliers to commit the export component of each season’s production tonnage of bulk raw sugar for export. Where a supplier seeks to commit a tonnage for export less than 100% of their export intention, then that commitment would require the approval of the board of the marketer. Departure from 100% supply should only be considered where the Board has considered its impact on the integrity and effectiveness of the pooling arrangements.

ii. Timing/duration of commitment
The contractual period should be of a sufficient duration to facilitate marketing operations, including hedging and LTC arrangements. As a minimum requirement, the voluntary marketer should enter into rolling contracts with suppliers, for example, at least two years. The minimum notice period to withdraw from the contractual arrangement would depend on the nature and forward commitment of specific or tailored arrangements.

iii. Rules including other barriers to entry and exit
Any other rules relating to participation, entry and exit would be decided by the board of the marketer in consultation with suppliers and be incorporated in contractual arrangements.
APPENDIX ‘B’

Extract from
Constitution of Queensland Sugar Limited

Clause 6
(a) The principal object of the company is to promote the development of the sugar industry, assisted by the following objects:
   (i) to enhance the efficiency and competitiveness of the Queensland sugar industry;
   (ii) to provide access to markets for the Queensland sugar industry or the sugar industry elsewhere;
   (iii) to enhance the long term economy of the Queensland sugar industry and the benefits flowing from it to Growers and Mill Owners;
   (iv) to encourage initiative, innovation and value adding within the Queensland sugar industry or the sugar industry elsewhere and downstream processing of sugar;
   (v) to provide timely and relevant sugar market information to Growers and Mill Owners;
   (vi) to take title and possession of raw sugar pursuant to the Sugar Industry Act 1999 (Qld);
   (vii) to market that raw sugar within and outside Australia in the best interests of Growers and Mill Owners;
   (viii) to distribute the net proceeds of that raw sugar in accordance with the Sugar Industry Act 1999 (Qld);
   (ix) to act commercially in the discharge of its functions; and
   (x) to act competitively in the pricing of sugar or its raw sugar equivalent sold to Australian customers.

(b) In carrying out its objects, the company may, without limiting its powers under the Law:
   (i) purchase, sell and participate in any form of trade and commerce about, the products of the Queensland sugar industry or a sugar industry elsewhere;
   (ii) fund, manage and maintain bulk sugar terminals and other facilities for the processing, storage and handling of products of the Queensland sugar industry or the sugar industry elsewhere;
   (iii) undertake or fund research into marketing for the products of the Queensland sugar industry or the sugar industry elsewhere;
   (iv) perform the role of pricing administrator under payment schemes set up by the Sugar Industry Act 1999 (Qld) based on producer pricing; and
   (v) appoint another entity to, or establish another entity with, the role of pricing administrator mentioned in paragraph (iv).

April 2005