

Notes and comments on the ACCC's interim report on the dairy industry 2018

This note contains comments on various parts of the interim report.

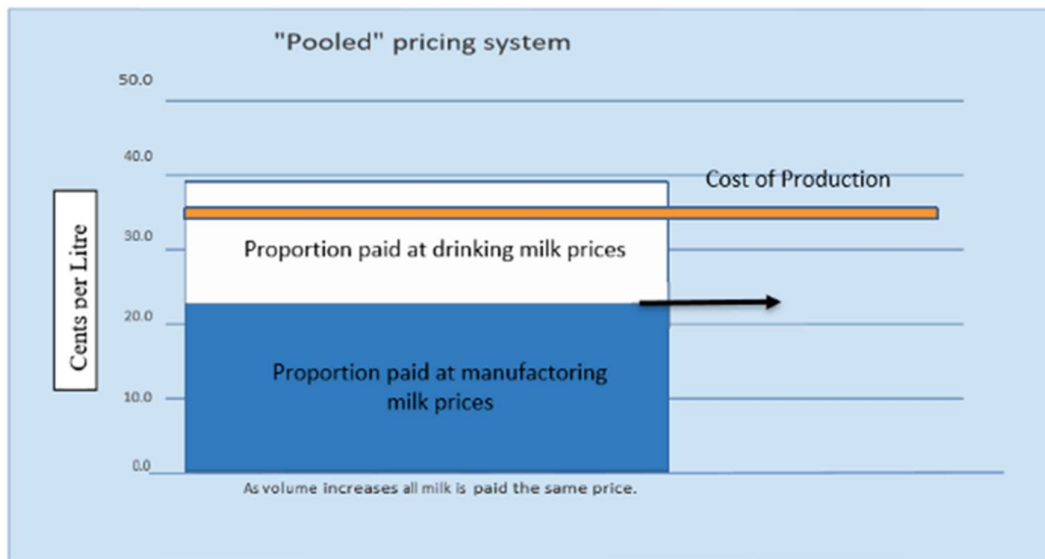
There are many observations that do not acknowledge past systems and policies that formed and shaped the dairy industries (each state is different) prior to deregulation.

In my opinion, the reasons that the industries in various states are described as "domestic focused" and "Export focussed" states is NOT EXPLORED at all. This makes the workbeing done – reactive rather than STRATEGIC.

The clue is that EXPORT focussed states had a POOL system for their milk supplies AND DOMESTIC focussed states had QUOTA systems!!

The significant difference between these systems were:

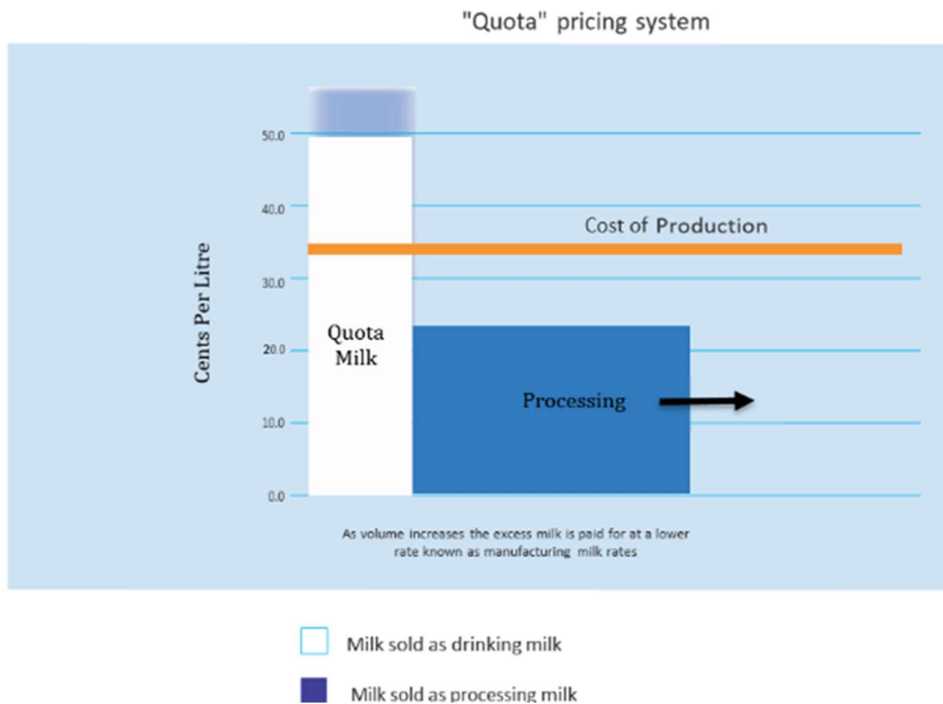
- The Pooling system – the FIRST and LAST litre were worth the same – commanded the same price. This system promoted volume growth and so continuous growth in processing factories so that they became WORLD SCALE PRODUCERS – ABLE TO MATCH INTERNATIONAL PROCESSORS ON THE COST OF CONVERSION TO SALABLE EXPORT PRODUCTS.



- Milk sold as drinking milk
- Milk sold as processing milk

- The Quota system – there was a significant difference in the value of the last litre, so much so, that it was not economical to produce, and so, processing plants did not grow into world competitive operations. In fact, they were filled with old, fully depreciated equipment which would transform excess milk at the lowest cost possible into a product that could be sold easily – most commonly an undifferentiated commodity. MILK VOLUMES MATCHED LOCAL DEMAND AND AFTER DEREGULATION OCCURRED NO CAPITAL WAS SPENT ON THE MARKET MILK OR THE SECONDARY PROCESSING PLANTS. THEY THEN WITHERED AND DIED, MOST DON'T EXIST ANY MORE.

This does not mean that these areas are not fit for producing milk. Areas such as Western Australia, Far North Queensland, southern Queensland and parts of NSW all can support large herds of dairy cows. They also have long histories of producing export products in the past. However, INDUSTRY STRUCTURE AND THE ASSOCIATED ECONOMICS CAUSED THE ISSUES. There is plenty of room on the Atherton Tableland, Darling Downs, South West Australia, South East NSW, Central and Northern NSW to produce more milk.



IF A MANDATORY CODE OF PRACTICE IS IMPLEMENTED – Care must be taken to promote the industry in any part of Australia that milk production is possible. This will be good for the country. History says that the Australian Dairy Corporation favoured states such as Victoria and Tasmania with product sales. I had personal experience in both Far North Queensland and Western Australia where the Australian Dairy Corporation WOULD NOT allow perfectly acceptable cheese made under ISO 9001 quality systems TO BE SOLD TO WILLING JAPANESE CUSTOMERS. They would only sell cheese made in Victoria, Tasmania and South Australia. These actions held back the regional industries which were not as close to the ADC as the residents of the southern states were.

It is great that the ACCC has recognised that there is a significant imbalance of market power between a farmer turning over between 1 and 2 million dollars, processors who turn over hundreds of millions of dollars and large-scale food distributors who turn over thousands of millions of dollars (Billions)

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The current report includes this statement

“Geographic influences on milk production and competition between processors for the acquisition of raw milk in Australia primarily takes place in nine distinct regions: • eastern Victoria (Gippsland), • Murray region (northern Victoria and southern NSW), • Western Victoria and south east SA • Tasmania, • SA, • central NSW, • northern NSW/southern Queensland, • far north Queensland (Tablelands region), and • WA. Region-specific characteristics, including climate and production profiles, dictate the end markets targeted by processors in each region, and the nature and extent of competition between those processors. Dairy production regions can be **broadly grouped as either export or domestic-focused**. Export-focused regions in Victoria and Tasmania largely produce exportable products such as cheese and milk powders. While these regions also produce dairy products for domestic markets, many processors are export orientated. **Domestic-focused regions in Queensland, NSW, WA, and SA mostly produce fresh drinking milk and processors only export a small proportion of regional dairy production, if at all.** The industry has consolidated since deregulation, with the number of dairy farms falling and the average size of dairy farms increasing, along with increases in milk production per cow. This has occurred nationally, and in each state. Raw milk production has fallen to varying degrees in all states other than Tasmania since deregulation in 2000. National production has decreased by 15 per cent since that time. However, production has also become increasingly stable from year to year both nationally and in each state.”

Following this logic, our close neighbour, New Zealand should have dropped in production too. However, in the same period, it has doubled production on a smaller land area and a population equivalent to Victoria. – WHY IS THIS SO?

Why this has occurred, is a great question to ponder!!! Policy is the only feasible answer. If the ACCC can develop a policy that develops an innovative and profitable dairy industry for the future, its time and funding will be well spent.

Another point to add is that in **1999/ 2000** Australia's population was about **19 million** people
NOW

At the beginning of **2018**, Australia's population is approximately **24.7 million people**.

We have approximately 6 million more mouths to feed, less domestically produced milk and more imported cheese and butter.

Is this good policy?

Supply chains, price, bargaining power and the biology of milk.

The first thing to realise is that milk is a biological product, its production is based on the cow, when she has a calf, her nutrition at the time of calving, the breed of cow, the climate that the cow lives in and the health of the cow.

The only easy way to turn a cow off is to kill her! Any other way requires forethought and management. It is hard if not impossible to get a cow to produce more milk once she has reached her initial production peak, regardless of feeding regimes. **This means that farmers must plan a long way ahead.** Dairying is the only agricultural enterprise that is harvested twice (2x) per day. This provides certainty of supply, but also puts farmers at risk if they cannot find places to sell their milk. This situation was seen in WA where contracts were not renewed, and processors did not need or want extra milk.

The market milk supply chain is very consistent, at one part of my career, I ran a market milk plant. The thing that amazed me was that the orders to a local city were incredibly consistent. Varying by no more than 1% week on week. So, company competition can be an issue, but maintaining supply from dairy herds which do not produce constant volumes from day to day and month to month requires diversity of products etc. So, a farmer supplying this sort of supply chain is locked into as flat a supply curve as possible. This costs money as it is difficult at times of the year to produce milk. Sometimes it is too hot, sometimes too wet, sometimes too cold. The point of this description is to demonstrate that changing production patterns is not easy for a dairy farmer.

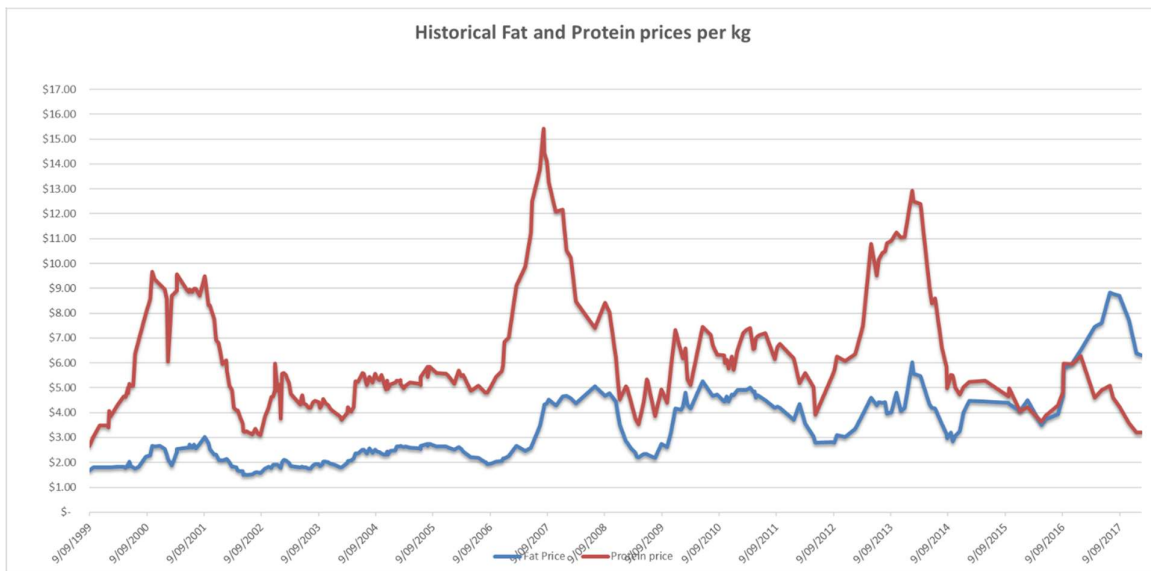
I see the price of milk being driven by several factors. There was talk companies waiting for Murray Goulburn (MG) to set their price before announcing their prices. This is generally correct, in my opinion. This is because MG was primarily an export company. They would assess the world market, develop a price they thought they could support through the following year and start with an "opening price" that was in the order of 80% of the final price. As profits came in "step ups" were paid. This usually allowed for market fluctuations to be managed without major issues and the farmers could plan to use a price that they could depend on. (That worked most of the time, except for the events that triggered this inquiry and I believe one other time)

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World prices and Australian domestic prices.

The world price of milk can be very volatile! The graph below is from my monitoring since mid-1999. The prices were calculated from the world price of Butter for fat and the world price for Skim Milk Powder.

For me, there are four notable points in the graph.

1. The period after "9/11" where the price of skim milk powder almost halved in 6 months.
2. The period in 2007 where prices sky rocketed and later plummeted, when the 2008 Global Financial Crisis stopped credit and therefore trade and
3. The highs of 2014 and the following crash when Europe deregulated their market and abolished production quotas – allowing for runaway production as farmers produced more than the markets could adsorb. At this time Russia also placed sanctions on Europe, causing product to come to Asia and take Australia's markets.
4. The world butter shortage which for the first time in many decades has put the price of butter fat higher than dairy protein. These are partly due to global consumption changes. It is not known how long this will last, but the price of butter is falling rapidly at the time of writing.



Skim milk powder and Whole Milk Powder prices are very low.

The three high points or 2000, 2007 and 2014 caused the export prices to exceed domestic milk prices. This raised prices all round and raised farm profitability. The following crashes made it necessary for exporters to drop their price and allowed domestic packers to put pressure on their suppliers to accept lower prices.

There was no smoothing due to legislation. Another factor not discussed here is the price of grain and fodder which is added to Australia's predominantly pasture fed dairy system.

The point of this section is – That international price fluctuations and policy changes affect domestic prices in Australia.

Levies and other funding sources during the regulated period prior to 2000 deregulation were developed via the Kerin plan <https://www.pc.gov.au/inquiries/completed/dairy/14dairy.pdf>

Prior to deregulation there were the following income streams:

- a farmer levy which directed funds to what is now Dairy Australia, then known as the Dairy Research and Development Corporation,
 - this provided research at the farm and processor level. This kept Australia at the forefront of technological innovations. **THIS STATUS IS NOW LOST in the name of lower industry costs!**
- A market support levy paid by processors for product sold to the domestic market. This levy supported marketing and sales support in international markets where the Australian Dairy Corporation (ADC) was the sole marketer / single desk supplier.
 - This assisted Australia to become the major exporter of cheese to Japan. This status is now slipping.
 - At one point the ADC owned recombining plants in Thailand, Malaysia and Indonesia. These are all gone now. Interestingly Fonterra now has a plant in Indonesia!
- Profits from the local market milk authorities who bought all milk to be processed into drinking milk and sold it to the processors. Market milk had regulated prices all along the chain, ensuring a profit to each section of the chain. Since deregulation, it can be argued that the margins have “slipped to the distribution end of the chain”
 - Profits from the authorities were distributed back to farmers as premiums. Some authorities developed innovative products such as Big M in Victoria which developed Australia’s liking for flavoured milks. Australia still has a per capita consumption of flavoured milks significantly higher than the USA and UK.
 - Currently market milk processors derive a lot of their profit from flavoured milks as there is much more ability to differentiate the products than when selling standard white milk.

I suggest the ACCC review the section of the report that discusses this

There are people in WA and Queensland who would dispute the following statement in the report

In contrast, pasture growth in Queensland and WA is generally less consistent and of comparatively lower quality, hence farms in these states rely more heavily on supplementary feed.


For example –

- Far North Queensland has different (cotton seed and Molasses) supplements and less supplementary feed than most areas, it is a unique system in Australia which has two peaks of grass production, a tropical peak and a winter temperate peak. There is no off season due to cold wet climates or hot dry climates.
- Western Australia has an incredibly consistent climate where local farmers grow annual grasses and conserve fodder for the dry summer – the same as in the cooler temperate climates where fodder is conserved for winter when there is no growth. There is no significant drought in WA although there is a consistent dry season every year.

I suggest that the ACCC confirm this statement with agronomists and bench markers familiar with the systems.

Also, it MUST be noted that if a farmer is supplying milk all year round their costs will be different to seasonal producers who dry their cows off in the most difficult / expensive times to produce milk.

The following is from a presentation by Neil Lane on behalf of Dairy Australia after he analysed results from the Dairy Base database.



Key Points

- Variable costs per litre decrease as the % of grazed pasture increases
- Overhead costs are not dependant on % grazed pasture
- WA farms are more than comparable with SE Australia farms on a like for like basis
- Zero grazing ie TMR systems inevitably have a cost of production (before any debt servicing) of at least 50 cents/litre which is consistent with US and EU farm performance data
- Well managed TMR systems appear to be the only option for producing milk to a guaranteed perfectly flat curve <1.15:1

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This indicates that when WA farms are producing milk all year round, their costs of production are equal to or better than a farm producing the same volume of milk in SE Australia.

The following statement indicates that the **distribution sector wields significant power**. It has been noted in another forum that **supermarkets have invested heavily in world class purchasing executives who drive the hardest bargain possible**. In this forum, it was suggested that small scale suppliers needed to develop equivalent sales skills to match the aggressive buyers. This is unlikely due to the small scale of the suppliers. The result will be that they will not get the best prices possible. Dairy companies are in a similar situation

Section 2.6.1 says

“The raw milk component is typically a floating price based on the weighted average farmgate milk price paid by the processor over the year, or some other publicly available benchmark. Either way, for private label milk, changes in farmgate prices, and their impact on margins, are generally a risk faced by supermarkets rather than processors. The ‘processing’ component of longer term private label contracts commonly contains clauses which **allow supermarkets to periodically test or benchmark processing costs**. Costs of packaging resin may be benchmarked quarterly, while production costs may be benchmarked annually or on an ad-hoc basis. **In some cases, supermarkets insist on ‘open book’ discussions, meaning that processors must provide access to their financial information to verify production costs**. The above provisions effectively remove the risk of a supermarket being locked into a contract which becomes uncompetitive on cost. **In effect, processors pass on efficiency gains or input price reductions to the supermarket**. The ACCC considers that the breadth of these processing cost provisions and ‘open book’ **practices is indicative of the strength of bargaining power** that supermarkets have relative to processors. The bargaining power of supermarkets is used not just to reduce costs and increase profitability but also to reduce and reallocate risks they may otherwise face.”

I believe that any company that can develop its own private label, dictate how much shelf space is dedicated to its own product, especially when the product is the “cash cow”, has world class buyers, has world class audit teams and has world class quality systems – has significant market power.

While it is understandable that the distributor wants to draw customers into the store using low prices on basic and common food items, it is incumbent on the government to ensure that industries stay viable. This is not the focus of the distribution sector. They are understandably focussing on themselves as they have been directed to give the ***“Lowest prices possible to the consumer” they have done this, Australia has got what it wanted, but the question is – Is it sustainable and will it be good for decades or more to come?***

The cost of losing supermarket contracts is high for a processor. Overheads cover a lot of base costs for a firm. The only control the processors have is on their input purchase prices. That is milk price paid. This makes it very difficult – even if it is said that farm gate prices are paid for by the supermarket. There will be questions as to what losses during processing are paid for and by who. The accounting point is significant within a business!!

Supermarket contracts are for 10's to 100's of million litres per year. Regular losses of these contracts can be devastating not only the companies, but also their staff. It is now almost a case of “you cant live with them and you cant live without them”

Note: at deregulation, farmgate prices dropped significantly in the quota states. While the system was not perfect, it did mean that farmers were significantly affected, and the cross subsidisation of other INDUSTRY supports – ***R&D, Marketing etc were dropped as well, thus weakening the industry.***

This statement needs to be examined

6.3.1

Deregulation removed various levies supporting farmers as well as removing a regulated pricing system for raw milk and some drinking milk. For all states for which ABARES holds data on farm profitability, there was a **dip in profits immediately following deregulation.** In addition, farm exits spiked and the total volume of milk production in Australia begin to fall after 2000.

As can be seen in the charts in *Appendix 4*, **average farm profits recovered within a few years follow**

Regarding the underlined sections, the dip in profits and the farm profit recovery needs to be analysed against world dairy commodity prices.

As mentioned before, drops in profitability correspond with market crashes and the profit recovery corresponds to the time when prices and demand was high and price signals were given to encourage production.

At the time of writing – January 2018, world prices are low, Europe continues to flood markets due to Russian sanctions and deregulation of their market and the USA continues to increase its production volume and exporting product.

The margin insurance program for dairy in the USA has a significant effect on producers, ensuring that they don't have catastrophic losses!! Details can be found at

<https://www.fsa.usda.gov/programs-and-services/Dairy-MPP/index>

These are some of the issues that affect the industry and some points that I believe should be clarified in the report.

Thank you again for the work that has been put into the report. I am heartened by the recognition that a compulsory "code of practice" is needed. The devil will be in the detail, however there should be no reason for Australia to import dairy products for domestic consumption. Legislation and regulations will be the answer. New Zealand has done it – australia can do it too.

We need to ensure that Australia will remain self sufficient in its food supply and dairy is one of these areas there there is NO REASON for imports.