Dairy Farmers Milk Co-operative Submission to the ACCC's Inquiry into the Dairy Industry (Part 2)

Dairy Farmers Milk Co-operative Limited is pleased to have an opportunity to express its views on potential improvements in the functioning of the Dairy Industry in Australia.

We have broken the submission into two separate submissions. Part 1 relates to Collective Bargaining and its operation, while Part 2 (this document) addresses a number of other matters raised in the ACCC's Issues Paper. The reason for the separation is that we believe that effective Collective Bargaining Groups hold the solution to a number of important issues.

COMPETITION, PRICING AND CONTRACTING FOR MILK

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INTRODUCTION

Dairy Farmers Milk Co-operative Limited (DFMC)[1] is a co-operative registered under the Co-operatives National Law and currently has 345 dairy farmer members in five regions – Far

[1] DFMC has entered into a Milk Supply Agreement (MSA) with National Foods Limited (now Lion Dairy & Drinks)(LDD). Pursuant to the MSA, DFMC supplies its members' milk to LDD. DFMC currently supplies approximately 270 million litres of milk to LDD per year.

North Queensland, South East Queensland, Central NSW, Northern Victoria and Central South Australia. DFMC currently supplies approximately 270 million litres of milk per year.

DFMC believes that the Australian dairy market is not always working for dairy farmers. In the domestic space, our products are used by large retailers as 'loss leaders' to grow their own businesses and in the export markets prices are determined by factors far removed from anything we can influence.

There is a better way.

DFMC believes that Australia is better served by a dairy value chain that is:

1. Fair to everyone, including farmers; and
2. Transparent, competitive and profitable.

For well over 100 years DFMC farmers have been the suppliers behind the Dairy Farmers milk brand. The DFMC model of co-operative is unique as it operates as a Collective Bargaining Group. It supplies milk to Lion Dairy & Drinks (LDD), under a long-term Milk Supply Agreement (MSA). DFMC is proudly owned and run by 'grass roots' dairy farmers.

1. A VALUE CHAIN FAIRER TO EVERYONE (Issues 1, 2 and 4)

In addressing Issues 1, 2 and 4 in the ACCC Issues Paper (8 November, 2016) DFMC submits that the Australian dairy value chain can be made fairer to everyone (in particular to farmers) by:

a. assessing milk swaps for their capacity to be anti-competitive, resulting in an artificially-low milk price for the farmer;
b. discontinuing the practice of loyalty payments to farmers by processors;
c. discontinuing the practice of retrospective price reductions by processors;
d. utilising an effective collective bargaining mechanism, both on price and terms and conditions, to support negotiations between farmers and processors;
e. requiring farmers to give processors a 90-day notice period of intended change to supply; and
f. preventing retailers from 'loss leading' the price of fresh milk and selling milk at the same price in all regions (irrespective of the true cost of supply).

Issue #1 - Competition for milk

Impact of the export markets in farmer regions

Despite supplying a domestically focused player in LDD, price movements on export markets potentially have an impact on the prices paid to our members in all regions except Far North

Queensland (which is simply too far away for cheaper southern milk to be an economical option).

As the export processors also operate in the domestic market, the prices they pay their farmers have an impact on either their profitability or the sell price they are prepared to accept for products such as packaged milk, dairy foods and cheese. For example, if Devondale Murray Goulburn (DMG) pays its farmers 40 cents per litre (cpl) for milk that is used for both domestic and export products, it is expected to use that price as the 'input price' for raw milk in their contract for retailer branded ('house branded') milk contracts in Victoria. LDD and Parmalat need to be able to offer a similar price, taking into account other factors such as required supply patterns, quality requirements, etc or they will not gain any such contracts.

Export market pricing also has an impact to a lesser degree in both New South Wales and SE Queensland. When milk is 'cheap' in the south, domestic processors are reluctant to pay what would be regarded as a sustainable price in the northern regions because 'cheaper' milk can be trucked north (sometimes for reasons outlined later, they simply can't afford to). While freight costs have to be born and the age of the transported milk needs to be managed, in some years it is a viable alternative. This is an unfortunate short-term view for the maintenance of the overall industry.

In recent months, DMG recently dropped its price to its NSW farmers by 6 cpl. This was due to DMG having attracting more milk than was required for its local contracts and the fact that the excess milk was destined for a depressed export market after being transported to Victoria. From our limited knowledge of DMG's contractual arrangements, we understand that this handed savings to their retail partner. LDD took a longer term view and dropped its price by only 2 cpl despite having the ability under the MSA to drop it more.

Milk swaps and their role in distorting the market

Milk swaps originally evolved to reduce freight costs when processors needed to move milk over long distances from one of their plants to another. If a processor can find another processor that has receival facilities in a number of locations (i.e. a big 'footprint'), it is sometimes possible to transport milk 'on paper', rather than physically transfer the milk.

For example, LDD might have milk in northern Victoria that it wished to transfer to its Simpson plant in the Western Districts, Victoria (when it was operating). It could come to an arrangement with someone like Fonterra – put the milk into Fonterra's Stanhope plant (Nth. Vic) and be supplied with an equivalent amount from Fonterra's farmers around LDD's Simpson plant. There would be a balancing of milk solids over time and both processors would share in the logistics saving.

Over time, in some cases these swaps have been used to alter the competition landscape.

As an example, a real distortion occurs in South Australia. As DMG and Warrnambool Cheese & Butter (WCB) have farmers in the central South Australian region around Adelaide, the export price has largely become the *de facto* price for milk in that region, despite neither of them having processing capacity within 500 kilometres of the region. The farmers supplying those processors do not have a lot of options as the local major processors are not taking on more farmers. LDD recently took on farmers in the Mt Gambier area (450 kilometres from LDD's Salisbury plant in Adelaide) which it can then milk swap with WCB. The other option would have been to take on more farmers from WCB or DMG in the central region or to allow DFMC to do likewise.

Milk swaps have also been used to level out supply into the Sydney market whereas a different pricing regime would have to be used if these swaps between competitors were not carried out. Over time, LDD has used milk swaps with Fonterra taking milk from their farmers in the central west of NSW or with DMG due to their surplus of milk in NSW, with the effect of reducing the need for additional milk from local suppliers.

Milk swaps can be also used by processors to buy milk in the south for use in the north – which of course only works when there is a significant pricing differential between the regions.

In DFMC's opinion, milk swaps need to be assessed for their capacity to be anti-competitive, resulting in an artificially low milk price for the farmer.

The ability of farmers to switch processors

- Choice

  Economic rationalists would say that in all regions except Far North Queensland, farmers have a number of options as to where they can supply their milk. This is not the case in all regions – particularly those where the only processing is to supply the local fresh milk market.

  In practice, most opportunities to change processors in the Northern Regions only arise when retailer branded milk contracts switch from one processor to another. In NSW, as far as Coles is concerned, this won't happen for another eight years or so although the timescale for Woolworths in that state is somewhat shorter. When a retailer contract changes from one processor to another, many farmers supplying the unsuccessful processor have no choice but to move anyway as their current processor probably will not need some or all of their milk. If they stay, they will usually be offered a much lower milk price.

  In Victoria, the limited handling capacity of processors during the spring flush may limit their ability to take on additional supply at other times when milk is in shorter supply due to the seasonal impacts. Like most other buyers of raw milk, DFMC has a long list of current DMG and Fonterra farmers wishing to supply us, but we have no practical use for the milk. We understand that WCB would have taken on more farmers when the recent retrospective 'step downs' occurred but were limited by their capacity to handle the additional milk in Spring.

- Timing of contracts

When one processor in a region has a contract start month that is different to another (or others) in a region, it is difficult for farmers in that region to change processors – depending on their supply contract. Parmalat has contracts that start on the 1st January whereas the vast majority of processors use the 1 July. Depending on the contract incentive that is paid, this alone can be a significant 'hook' to maintain farmers and limit the ability of farmers to change processor.

- Loyalty payments

Loyalty payments in our view are anti-competitive. They are milk price 'step-ups' used as a 'hook' to prevent farmers from leaving their current processor. 'Step-ups' are payments made when a processor (normally operating to a significant degree in export markets) has taken a conservative approach to pricing. As the full-year price becomes more apparent and if the selling price is going to be reliably higher, the farmer is paid an increased price for their milk which is back-dated to the start of the year (or from when they commenced supply, whichever is the later). There is a usual final 'step-up' after the financial year finishes as well.

For many years, these payments were made to farmers for milk already supplied to the processor, whether or not that farmer was still supplying the processor. This was in recognition that the processor had taken a cautious approach at the start of the year and had corrected the price later. In the last decade, some processors have turned these 'step ups' into a form of loyalty payment. Someone who leaves on 1 July will not be paid any catch-up payment for their previous full year's supply of milk – for a 2 million litre farmer this could amount to $30,000 to $40,000. This therefore discourages that farmer from switching processors unless she or he will be substantially better off than $40,000 for the year with the new processor.

DMG has indicated it will be more conservative in its opening price in the future. This will most likely mean that the Loyalty Payments will become an even larger percentage of the total price. As LDD uses the DMG price as a base for its payment model in the south, this will also impact DFMC and LDD farmers as LDD will not pay any 'catch-up' payment to farmers who have left.

DFMC believes the practice of loyalty payments must be discontinued.

Historically, another form of 'hook' has been used. Anecdotally, DFMC has been informed by farmers that they were concerned that if they leave a processor and came to DFMC, that their current processor may not ever take them back. This was a risk that many were not prepared to take, particularly due to the impact of the movement of supermarket contracts. We believe that this practice is no longer in force but it could be used again in the future.

Issue *2 - **Contracting practices**

Risk

Historically, it has been largely true that, reluctantly, farmers are price-takers. Because of the nature of the market into which they supply, this is more likely to be an unpleasant reality in Victoria and Tasmania as the milk price is partly (around 50%) set by international market forces. However, even there and certainly in the northern states, this should not necessarily be true. Due to limited market power, farmers usually have to bear all or most of the risk of market movements or structural changes.

There are several forms of risk. The obvious risk is that of pricing variability from year to year (or even within year as we have recently witnessed). In some cases, where the amount of milk processed is destined for an external market and there is no capacity within the market locally to absorb the milk, the farmer will need to wear most of the risk. Where the processor is operating within the domestic market, there should be no 'in year' risk as the product has been sold locally before any risk impacts have effect.

Another risk is to the farmer's enterprise over time. This can occur when the processor is unable to pay the price it needs to pay to maintain the supply it actually requires to supply milk or other products in that region. This can only happen when the market is dysfunctional. We are witnessing this in the northern regions of Australia where the power of the retailers is upsetting the normal effects of market economics. This is a short term view on their part. In this situation, the power still lies with the processor to a degree and they will protect their business by either reducing prices or not allowing them to rise.

As outlined in a later section, LDD and DFMC offer some opportunities for farmers to reduce their risk in the two southern regions by contracting milk for longer periods.

Step-ups, step-downs and retrospectivity

In export-based markets, future pricing is rarely certain. While export contracts are entered into for a reasonable proportion of the milk, processors are unable to contract all of their milk due to timing issues and the uncertain level of their total supply (for various reasons including the weather). Not all contracts are entered into just before the start of the financial year, either. Most processors dealing in this market usually take a conservative approach. As market circumstances become clearer they then increase the price paid across the whole year. This 'step-up' approach is quite reasonable.

Very rarely, when market disasters occur such as through the Global Financial Crisis, there becomes a need to decrease or 'step-down' the price. This may be due to major export contracts not being honoured – in the case of the GFC, the transfer of money became almost impossible for a time.

What is not acceptable are retrospective adjustments downwards. In the most recent example of Devondale Murray Goulburn, it was clearly obvious to most that the 'opening price' being paid was not achievable. Facing reality when it occurs will avoid the necessity for such retrospective actions. It would appear that the sudden reduction in price was not due to a disaster but due to a failed attempt to maintain share pricing in denial of very poor international prices, given that the milk price and dividend (and therefore share price) were linked.

Neither LDD nor DFMC have engaged in retrospective price reductions**. In the opinion of DFMC the practice of retrospective price reductions must be discontinued in the dairy industry.**

Balance of power

The balance of power in the relationship between processor and farmer, clearly lies with the processor. Even though a market may be dysfunctional in economic terms (e.g. in SE Queensland where there is rising demand but falling supply), the processor still has the opportunity to take a short term view and protect itself at the expense of the farmers. Clearly, some processors view the farmers as a ‘safety valve’ which will allow them to maintain profitability. They do not wish to be in a position where they MUST pay the market price as they would have to with other business inputs such as HDPE plastic pellets or sugar.

Farmers are not necessarily aware of the prices, terms and conditions that they can achieve for their production and do not have the same market information as the processor. The processor knows what they are paying others in the area and often applies confidentiality clauses to keep it that way. Even if the farmer’s market knowledge was the same or similar to the processor’s, the farmer generally only has one processor to choose from whereas the processor can choose from many farmers. In addition, individual farmers are unlikely to be able to have the resources (both financial and otherwise) to seriously challenge the processor’s price, terms and conditions.

Unlike other organisations, DFMC publishes its prices and pricing policies (that have been negotiated and agreed with LDD) in each region so there is complete transparency in relation to an individual farmer’s arrangements. In DFMC’s opinion, the overall lack of transparency within the dairy Industry around pricing is a substantial impediment to determining whether farmers are being paid the market value or price for their milk.

In DFMC’s opinion, an effective collective bargaining mechanism, on both as to price and terms and conditions, is fundamental to the dairy market being fair to everyone (in particular to farmers).

Contract renewal

DFMC requires its members to give a 90-day notice period of intended change to supply which can end on or after the contract end date. Members continue to be paid the contract incentive until the end of their notice period. While the contracts are Fixed Term, they technically do not end until after the 90-day notice period has passed. If DFMC and LDD agree, the farmer can leave before the 90-day notice period has passed.

We believe a 90-day notice period gives a fair balance between the needs of the farmers and the need for the processor to find an alternate source of milk to replace that of the departing farmers.

Issue #4 - **Domestic retail markets**

In certain markets (Queensland, New South Wales, South Australia), $1 supermarket milk has had a significant effect on the ability of processors to pay the level of price for milk needed to maintain local production.

While the retailers claim to require their packaged milk processors to pay the competitive price for milk in each market to their farmers (and probably do), ultimately this has a downward pressure on farmgate milk prices in the longer term.

How can this be?

In the absence of a regulated price to be paid to a farmer, if a processor's profitability comes under pressure, in their view the only real alternative is to reduce the price to the farmer if they cannot increase the sell-price of their product and other costs rise. As stated in a previous section, farmers are regarded as price-takers by the majority of processors so the ultimate impact is on the farmers, more often than not.

Delivering packaged milk to smaller retail outlets is costlier than distributing to the supermarket channel – partly because of volume but more so due to their disparate location. In addition, the smaller retailers are not able to increase their prices as they might need to as the difference between what they can charge compared to the larger players is already greater than it can sustainably be. This is demonstrated by the continued decline in volumes through the smaller retail channels.

The other issue related to location is that retailer branded milk is basically sold everywhere in Australia for the same price. While the larger retailers can absorb any additional cost as a 'loss leader' product, the processor supplying customers other than the retailer network has to pay significant costs to reach these outlying markets.

As a result of escalating costs borne by processors in servicing such markets in Queensland, LDD is restricted in what it can pay dairy farmers for milk and Parmalat is considering reducing its price, despite the fact that milk supply is in long term decline in the South East Queensland market. LDD brings milk up from NSW to solve any supply issues but supermarket contracts usually have a clause that requires local region milk to be used. This method of dealing with shortages is also only effective while southern milk prices are low.

In Far North Queensland, the situation is even worse in that LDD has to pay an even higher price to ensure supply and fulfil contracts yet balancing the milk supply is extremely difficult at times and requires them to ship milk in at a freight cost well over 20 cents per litre, with no way of recovering this in the market.

In summary, there are two problems. Firstly, the ability of large retailers to 'loss lead' a few products such as milk to increase sales of their 20,000 or so full-priced products and secondly, the reality that they can distort local markets in outlying districts by offering the 'same price' in all regions irrespective of the true costs of supply.

In the opinion of DFMC the practice by retailers to 'loss lead' (discount) the price of fresh milk and sell milk at the same price in all regions (irrespective of the true cost of supply) needs to be prevented or controlled in some manner.

2. TRANSPARENCY, COMPETITIVENESS, PROFITABILITY (Issues 3, 5 and 6)

In addressing Issues 3, 5 and 6 in the ACCC Issues Paper (8 November, 2016) DFMC submits that the Australian dairy value chain can be made more transparent, responsible and profitable by:

a. using milk swaps only when the practice does not artificially lower farmgate prices – when the processor is only saving freight in moving milk from one of its processing plants to another;

b. publishing independently-audited, comparable prices offered by processors (this will empower farmers to determine if the price they receive is truly competitive);

c. allowing farmers to disclose price and contract terms (and discontinuing the practice of confidentiality clauses);

d. developing a rolling index of ALL export prices received for all milk products by an independent body such as the Australian Bureau of Statistics or ABARE;

e. allowing farmers to fix the price for up to 50% of their milk for three years or all of their milk for 1 year (this enables them to reduce their risk to volatile global markets); and

f. providing farmers with reliable data for production costs and farm profitability on a region-by-region basis.

Issue #3 - Transparency and price signals

Setting and announcing prices

DFMC announces its prices close to the end of June each year. In the three northern regions, a single price per region is announced.

In Far North Queensland, pricing is set on the basis of anticipated production movements with the aim being to maintain production within LDD's requirements (with some margin due to seasonal fluctuations). The issue is that LDD is at a point where, due to $1 milk, it is difficult to justify commercially what it needs to pay for long term supply in the region.

In South East Queensland and Central New South Wales, prices are based on the competitive price set for each region and what is happening in terms of overall supply. There is also an impact from the level of southern region milk pricing. For example, if the average price in Victoria is 35 cents per litre (cpl), the landed price in Brisbane may be 50 cpl. When the Victorian price is 50 cpl, the landed cost is likely to exceed 65 cpl. Processors use milk concentrate in some circumstances but its use is limited to modified milks and dairyfoods. The other issue is that the price of milk in Victoria is usually higher in winter when the shortage in SEQ is likely to occur making the potential landed cost in some years even higher.

As Central NSW is closer to Victoria and the opportunities for milk swaps greater, the southern milk prices have a bigger influence due to lower freight costs and more milk being available in the region, generally.

In the two southern regions, prices are set based on what the export processors are likely to pay. As outlined previously, this is because that is the price that will drive prices for domestic products in the market. Also, when export prices are low, we tend to see more 'specials' being offered on Ultra Heat Treated (UHT) milk which some consumers will substitute for their fresh white milk purchases.

The South Australian distortion has previously been covered.

The DFMC submits that milk swaps should only be used when the practice does not artificially lower farmgate prices (when the processor is only saving freight in moving milk from one plant to another).

Pricing transparency

DFMC is one of the few milk buyers which contracts their supply to offer complete pricing transparency. Most do not, including LDD and Parmalat. It is difficult for farmers to determine the price they receive is truly competitive in their situation. They have to rely of the processor's claims as to the 'average' price.

The reason for confidentiality in practical terms is unclear. Farmers should be free to disclose price and contract terms if they wish to. Confidentiality solely benefits the processor.

The methodology by which processors quote the price they are supposedly paying is also quite variable. Some quote on the basis of maximum quality, some on a basket of their various offerings if they have different price schedules – such that an individual farmer may receive a price that is quite different to the one quoted in the region. This all makes comparison difficult.

This situation could be rectified by using a 'comparison rate' type approach such as is used in the home loan market. DFMC would support the introduction of a 'comparison rate'.

It is the opinion of DFMC that the publication of independently-audited prices from processors will enable farmers to determine if the price they receive is truly competitive.

Other sources of price data

The problem with much of the short term data available to processors or farmers is that it is 'spot market' focused. 'Spot market' prices are sometimes misleading as they can represent the prices sought in times of shortage (when the vast majority has actually been contracted at a lower price) or conversely, prices in times of excess when the majority has been contracted at a higher price. They are nonetheless a general guide.

The Global Dairy Trade (GDT) operation is more useful in that it covers up to ix months into the future, but the volume through it is quite small so the data can be unrepresentative.

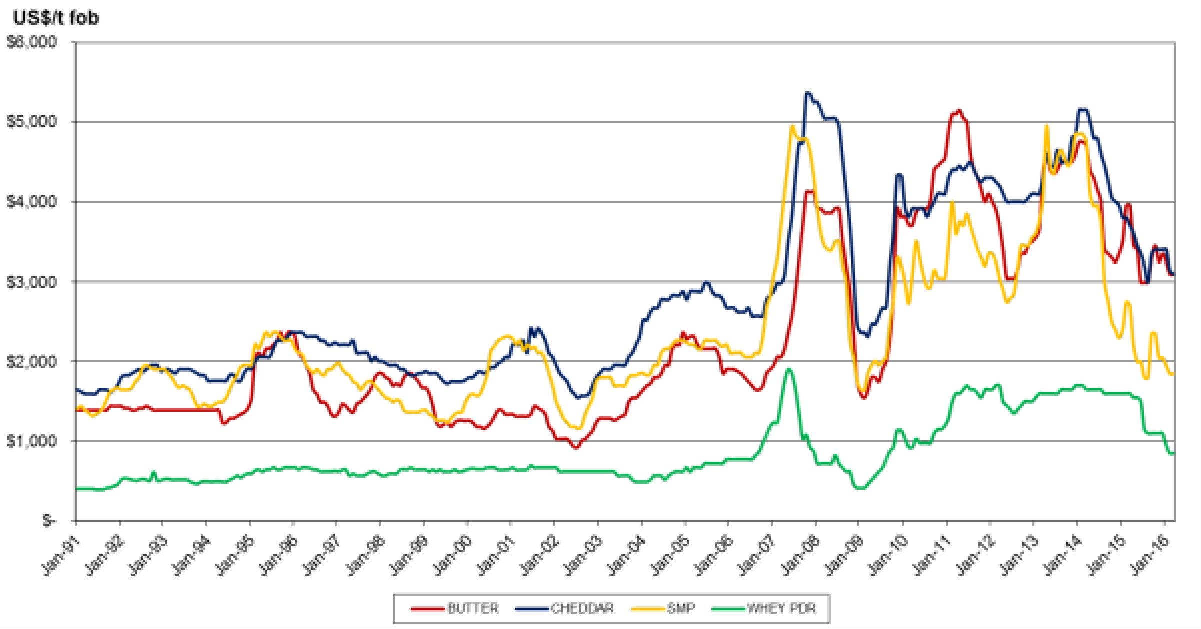
One option is to use the Australian Bureau of Statistics dairy export data to maintain a rolling index of the export prices received for all milk products – not just products sold at 'spot prices'. This would give a more accurate guide to the likely price paid to farmers by export processors. The main disadvantage is that the data lags by a number of months – however, technology should be closing this gap. DFMC maintained a crude index such as this for a period. A central body with more resources could handle this much better.

Issue #5 - Global markets

Volatility

The fact is that volatility in world markets is increasing – and not just in the dairy industry.

Australian Commodity Spot Prices, Jan 1991 - Mar 2016
in US$/Tonne fob (Source: Dairy Australia)



Experience in the sugar industry shows that product hedging is not necessarily the answer. Hedge funds bought up huge numbers of forward contracts in the late 2000s causing a huge spike in the sugar price (from an average of around 12 cents per pound to 35 cents) which came crashing down eventually when users turned to other sources of sweetening and the oil price dropped.

And, as outlined in the ACCC Issues Paper, our market is quite different to products like sugar in that a lot of countries produce dairy products (mostly for domestic consumption) with only 7% traded internationally. However, a couple of the larger producing countries only have to have a rise in production of 5 or 10% to have a significant impact on the product available in the world market.

Hedging at farmer level

We are unfamiliar as to how processors use hedging in the dairy space. They certainly do for products such as sugar and companion products such as orange juice concentrate.

At the farmer level, to a degree, LDD and DFMC offer a form of hedging to farmers in the two southern regions with the ability to fix prices for up to 50% of their milk for three years or up to 100% of their milk for one year. The number of farmers who take up the three-year option is limited. This option however does offer farmers the opportunity to manage the vagaries of the world market.

Product differentiation

Even when new products are developed that create a point of difference, pressure is placed on the innovative processor to 'share' that technology or concept with their 'retail partner'. This results in value dilution for the innovative processor which will ultimately lead to such processors questioning the value of innovation.

The DFMC submits that enabling farmers to fix the price for up to 50% of their milk for three years or all of their milk for one year does offer farmers the option of hedging against volatile global markets.

Issue #6 - **Production costs and profitability**

As indicated previously, DFMC has farmer members operating across four states in five distinctly different dairying locations supplying predominantly to a fresh product market.

These markets generally require a consistent milk supply across the year, meaning a farm is encouraged by our processing partner to have a flat consistent raw milk supply. In QLD and NSW there is little use for surplus milk outside of the fresh milk market and it becomes difficult for processors to handle larger volumes of milk in spring peak periods.

Our Far North Queensland farms operate in a hot tropical farming area in the high rainfall zone of the Atherton Tablelands. This zone is known for its fertile volcanic soils suited to growing tropical pastures for grazing dairy cattle. In normal seasons a typical average Far North Queensland dairy farm will derive 55% to 65% of its total feed requirements from its own farm. The balance of the industry's feed requirements, mostly grain and protein meal is generally imported by road transport from Central or SE Queensland with considerable additional transport cost. Local grain producers are aware of the competitive benefits of their location and charge prices accordingly.

In general, the higher cost of production in FNQ is associated with the extra freight cost in delivery of the supply of goods and services into that region. Grain, fertiliser and repairs and maintenance costs all tend to be higher in FNQ dairy businesses compared to SEQ[2]. Ultimately this has affected profitability to dairy businesses in the region with the average EBIT per farm lower than SEQ Dairies since 2011[3].

Production costs in SE Queensland are driven greatly by the seasons and the need for farmers to keep a 'flat line' of supply to meet the fresh white milk market. Farms tend to be smaller in size compared to southern regions due to the competition for land from other agricultural enterprises and the urban sprawl in the greater south eastern area.

[2] Queensland Dairy Accounting Scheme (QDAS) Reports 2009-10 to 2015-16

[3] Queensland Dairy Accounting Scheme (QDAS) Reports 2009-2010 to 2015-16 Combined Profit Reports

Combining highly variable production costs and ongoing drier seasons has driven production systems into more intensive operations which also have a greater reliance on purchased or ‘bought in’ feed. These operations tend to be more capital intensive with added management complexities requiring a diverse skilled labour base. Average total operating cash costs for SEQ dairy farms has risen from 30.4cpl in 1999-2000 to 59.5 in the 2014-15 FY whilst total farm incomes (milk and livestock sales) have moved from 42.4cpl 1999-2000 to 61.6cpl respectively[4].

The traditional dairy regions of NSW (Sydney Basin, Illawarra and Shoalhaven, Hunter and Manning Valleys) have all faced land use conflicts in recent years. Competing interests in land from urban development and mining has led to farm closures, farm intensification or farm relocation to Central Western NSW and the Riverina districts. Traditional grazing operations in higher rainfall zones find it hard to continually increase productivity to stay in front of rising production costs without the opportunity to expand their land use resource base.

Production costs in NSW are of a similar nature to Queensland but due to a smaller data set from the industry benchmarking program it is harder to comment on industry wide trends. Dairy farms in NSW tend to be slightly larger in size and can dilute some of their associated fixed production costs compared to those in Queensland. For sixty-four sets of data from 2011-12 FY to 2014-15FY, report Average Total Operating Costs for NSW dairy farms at 52.4cpl. For the same data set net farm income after finance costs is reported to be a loss of 1.1cpl[5].

Victorian and South Australian production systems tend to be more seasonally focused towards a spring grazing peak as discussed earlier in our brief. Combining peak cow numbers to spring pasture growth maximising ‘home grown feed’ generally results in a lower cost base dairy system than relying on large amounts of purchased forages. For 75 sets of data from 2006-07 FY to 2015-16FY, a Dairy Base report Average Total Operating Costs for VIC dairy farms rose from 36.6cpl in 2006-07 to 44.3cpl in 2015-16FY. For the same data set net farm income after finance costs are reported to be negative 3.1cpl to negative 2.2cpl[6].

Alternate income sources and diversification

Diversification has generally not occurred on a large scale throughout the industry due to the intensive nature of a dairy business. Dairy farms are usually farms that have been in the business of dairy for a number of generations. Simply put, farmers have stuck with what they know. As previously stated, most dairies require large capital investments and result in very tight margins with little ‘free cash’ to invest into diversification projects. For a family farm to exit a dairy business and move into a beef enterprise using the same land resource base usually requires some family members finding employment off farm. Simply put, the gross income in the beef market per hectare is much lower compared to dairy in our typical dairy areas.

In recent years we have seen a small increase in livestock sales as a percentage of total farm income due to the increased sales into the live export market and more recently an increase in

[4] Queensland Dairy Accounting Scheme (QDAS) Reports 2009-2010 to 2015-16 Combined Profit Reports

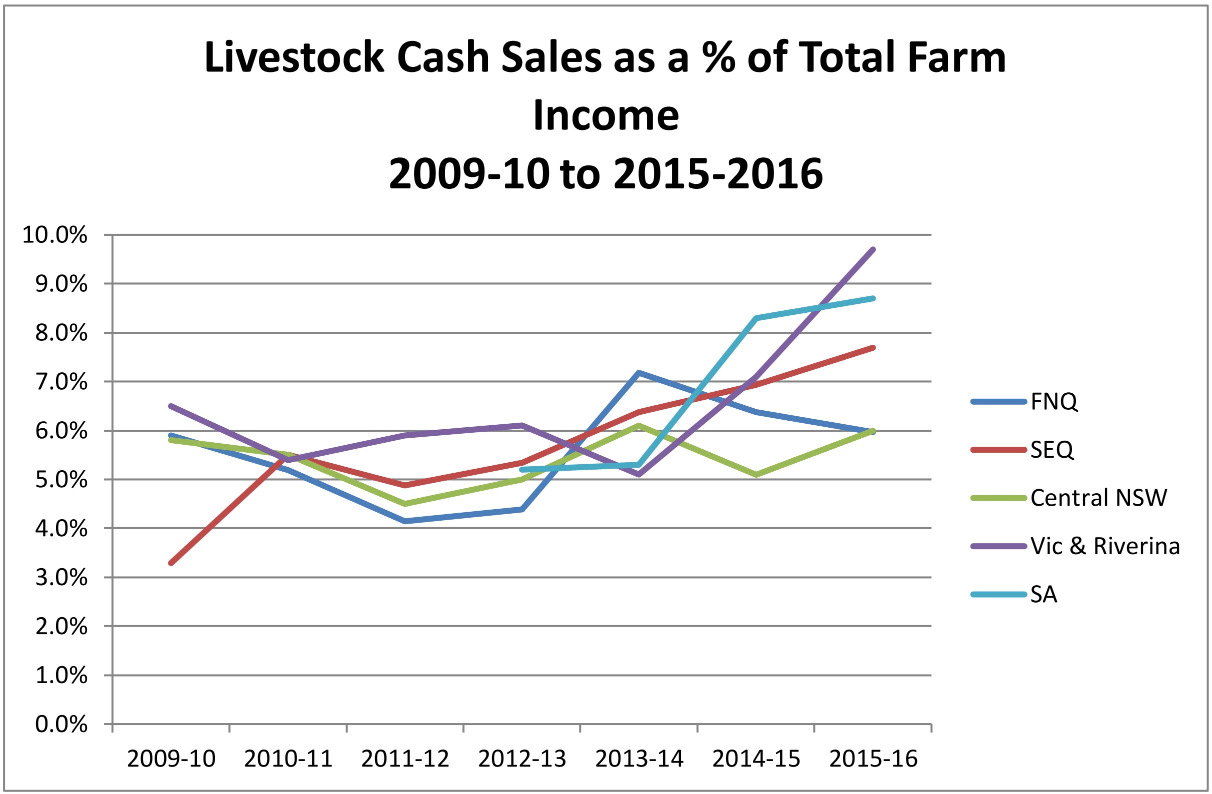
[5] Queensland Dairy Accounting Scheme (QDAS) Reports 2009-2010 to 2015-16 Combined Profit Reports

[6] https://app.dairybase.com.au/#/reports/comparison

the chopper market for cull dairy cows. These markets account for less than 10% of total farm income in all regions (see table 1).

For all of QLD and some of NSW the ‘Blue Tongue[7] line’ remains a barrier to entry into some live export markets and as a result the uplift in livestock sales as a percentage of total farm income has not been as large in recent years compared to the VIC and SA regions.

Table 1 -



Livestock sales as a % of total farm income					
	FNQ	SEQ	Central NSW	Vic & Riverina	SA
2009-10	5.9%	3.3%	5.8%	6.5%	
2010-11	5.2%	5.5%	5.5%	5.4%	
2011-12	4.1%	4.9%	4.5%	5.9%	
2012-13	4.4%	5.3%	5.0%	6.1%	5.2%
2013-14	7.2%	6.4%	6.1%	5.1%	5.3%
2014-15	6.4%	6.9%	5.1%	7.1%	8.3%
2015-16	6.0%	7.7%	6.0%	9.7%	8.7%

In the opinion of the DFMC providing farmers with reliable data for production costs and farm profitability on a region-by-region basis will enable farmers to make better-informed decisions.

[7] Blue Tongue is a disease of ruminants transmitted by insects. Cattle from known Blue Tongue areas are not able to be exported to some countries. Tropical and sub-tropical areas in Australia are affected.

CONCLUSION

In this submission, DFMC has sought to explain why and how fairness across the dairy value chain together with transparent and competitive milk pricing need considerable improvement.

A fairer dairy value chain

DFMC does not believe that a premium product such as milk should be sold at prices inferior to other chilled products such as water or even juice sold in retail chains, purely so that the retail chains can take more and more business away from smaller operators, or so that they grow their share relative to the competitor (and even then, that competitor often responds in a similar manner defeating the purpose of the action anyway). In many cases, even ambient water and soft drink prices are more expensive despite their uncomplicated production requirements and non-chilled transport needs.

While the consumer no doubt welcomes a lower household shopping bill, in the long term it will jeopardise the availability of fresh milk in various regions around Australia or at the very least it will result in an increase in the 'food-miles' to make such milk available. Perhaps a minimum selling price for fresh milk might correct this if the larger retailers are not prepared to stop this dangerous game?

Dairy farmers have a low level of power when negotiating with processors. We have all seen the recent example where a number of Western Australian dairy farmers have been abandoned by their current processor, due to the loss of some export contracts.

In other circumstances, we see processors using various means of reducing farmers' ability to take advantage of better offers available to them with other processors through mechanisms such as 'step ups' dressed up as 'loyalty payments'.

In many parts of Australia, there is no reason that the farmers should be the price takers. Milk supply is not in excess to demand in those markets and in many cases supply is in decline at the local level. It is only due to external artificial factors that this is the case. While economic rationalists might say that we should not maintain an industry in a region purely because of history, all of the costs and factors must be taken into account before any such judgement is made.

The balance of power needs to be addressed so that all can be successful in the supply chain.

Transparent, competitive milk pricing

The most recent example of the dramatic reduction of price for DMG and Fonterra suppliers demonstrates the need for an independent source of pricing data so that such events need not happen again. It need not have happened in the manner it did.

Suppliers in all regions should be aware of prices paid by competitors so they can assess whether their own processor is performing well or whether the farmer is being used to make up for market failures further up the chain.

Policy-makers need also to have accurate information about the production costs facing farmers so that they may act to curb unfair behaviour before too many farming families' lives are destroyed.

In summary, it is DFMC's opinion that:

- the practice of loyalty payments must be discontinued;
- the practice of retrospective price reductions must be discontinued in the dairy industry;
- an effective collective bargaining mechanism, both on price and terms and conditions, is fundamental to the dairy market being fair to everyone (in particular to farmers);
- a 90-day notice period gives a fair balance between the needs of the farmers and the need for the processor to find an alternate source of milk to replace that of the departing farmers;
- that milk swaps should only be used when the practice does not artificially lower farmgate prices (when the processor is only saving freight in moving milk from one plant to another);
- the practice by retailers to 'loss lead' (discount) the price of fresh milk and sell milk at the same price in all regions (irrespective of the true cost of supply) needs to be prevented or controlled in some manner;
- the publication of independently-audited prices from processors will enable farmers to determine if the price they receive is truly competitive;
- consideration be given to using the Australian Bureau of Statistics dairy export data to maintain a rolling index of the export prices received for all milk products – not just products sold at 'spot prices' and
- processors be urged to enable farmers to fix the price for up to 50% of their milk for three years or all of their milk for 1 year to give farmers the option of hedging against volatile global markets.

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