



AUSTRALIAN
**FOOD &
GROCERY**
COUNCIL

AFGC SUBMISSION

SENATE INQUIRY: AUSTRALIAN DAIRY
INDUSTRY

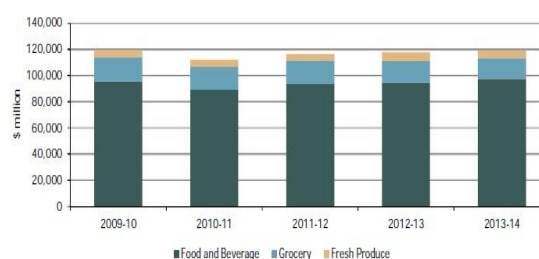
Sustaining Australia

PREFACE

The Australian Food and Grocery Council (AFGC) is the leading national organisation representing Australia's food, drink and grocery manufacturing industry.

The membership of AFGC comprises more than 190 companies, subsidiaries and associates which constitutes in the order of 80 per cent of the gross dollar value of the processed food, beverage and grocery products sectors.

Figure 3.1: Composition of the defined industry's turnover (\$2013-14)¹¹



Source: Based on ABS, catalogue number 8221.0, 8159.0 and 8155.0

Australia's food and grocery manufacturing industry takes raw materials and farm products and turns them into foods and other products that every Australian uses every day. With an annual turnover in the 2013-14 financial year of \$118 billion, Australia's food and grocery manufacturing industry makes a substantial contribution to the Australian economy and is vital to the nation's future prosperity. It adds over \$32 billion to the value of the products it transforms.

Manufacturing of food, beverages and groceries in the fast moving consumer goods sector is Australia's largest manufacturing industry. The diverse and sustainable industry is made up of over 26,651 businesses and represents 30% (almost one third) of the total manufacturing industry in Australia.

The food and grocery sector accounts for over \$61.7 billion of the nation's international trade in 2014-15, with a trade surplus worth over \$10 billion to the Australian economy in 2014-15. These businesses range from some of the largest globally significant multinational companies to family-based small and medium enterprises.

The food and grocery manufacturing sector employs more than 322,900 Australians, paying around \$16.1 billion a year in salaries and wages.

Many food manufacturing plants are located outside the metropolitan regions. The industry makes a large contribution to rural and regional Australia economies, with over 40% of the total persons employed being in rural and regional Australia. It is essential for the economic and social development of Australia, and particularly rural and regional Australia, that the magnitude, significance and contribution of this industry is recognised and factored into the Government's economic, industrial and trade policies.

The contribution of the food and grocery sector to the economic and social well-being of Australia cannot be overstated. Australians and our political leaders overwhelmingly want a local, value-adding food and grocery manufacturing sector.

Data source: AFGC and EY State of the Industry 2015: Essential Information: Facts and Figures

AFGC SUBMISSION

The AFGC provides this submission in response to the Senate Inquiry into the Australian dairy industry.

Recent events in Australia's dairy sector have sparked a high level of public interest. The causes of the current turmoil are complex, however, and warrant consideration of global factors that have directly contributed to shifts in prices, exports and returns for all players in the Australian dairy sector. In addition The AFGC acknowledges that Australia's regulatory agencies, the Australian Securities and Investment Commission (ASIC) and the Australian Competition and Consumer Commission (ACCC), are undertaking detailed investigations of recent events in the Australian dairy sector and so does not propose to comment on matters covered by these investigations.

THE GLOBAL GLUT IN DAIRY EXPORTS

Globally the dairy sector has been significantly impacted by a massive increase in dairy production and export volumes from the European Union over the past two years. Total EU exports in the year to February 2016 increased by 22 per cent¹, with butter and blends increasing by 46 per cent and liquid milk by 39 per cent. At the same time the EU has increased its stockpile of Skim Milk Powder (SMP) 1,362² per cent (to 415,422 MT) in the year to August 2016. SMP is a key dairy export commodity and the increasing EU stockpile hangs over the global market, depressing prices.

The surge in EU production and exports had two key drivers:

- Removal of production quotas by the EU in April 2015 resulted in significant increases in dairy production in key EU members states, notably (in the year to August 2016) the largest producer Germany (3.07 per cent³) and the Netherlands (11.47 per cent). Overall EU production is up 4 per cent.
- The international embargo on exports to Russia imposed in August 2014. Prior to the embargo Russia was one of the largest markets for EU dairy products, a market that has now been severely curtailed. For example, imports of dairy products by Russia from the EU in the year to February, decreased by 77 per cent.

The EU represents approximately 30 per cent of world trade in dairy products, meaning the increased production and export volumes has had a direct impact on global dairy trade and consequently on Australian dairy exports. In particular, the Russian embargo has resulted in the EU actively pushing product into the Middle East and Asian markets in direct competition to Australian exporters.

The flow through effect of this global glut has been to force dairy farm gate prices lower in all major markets including Australia. In New Zealand, the farm gate price reduced from a

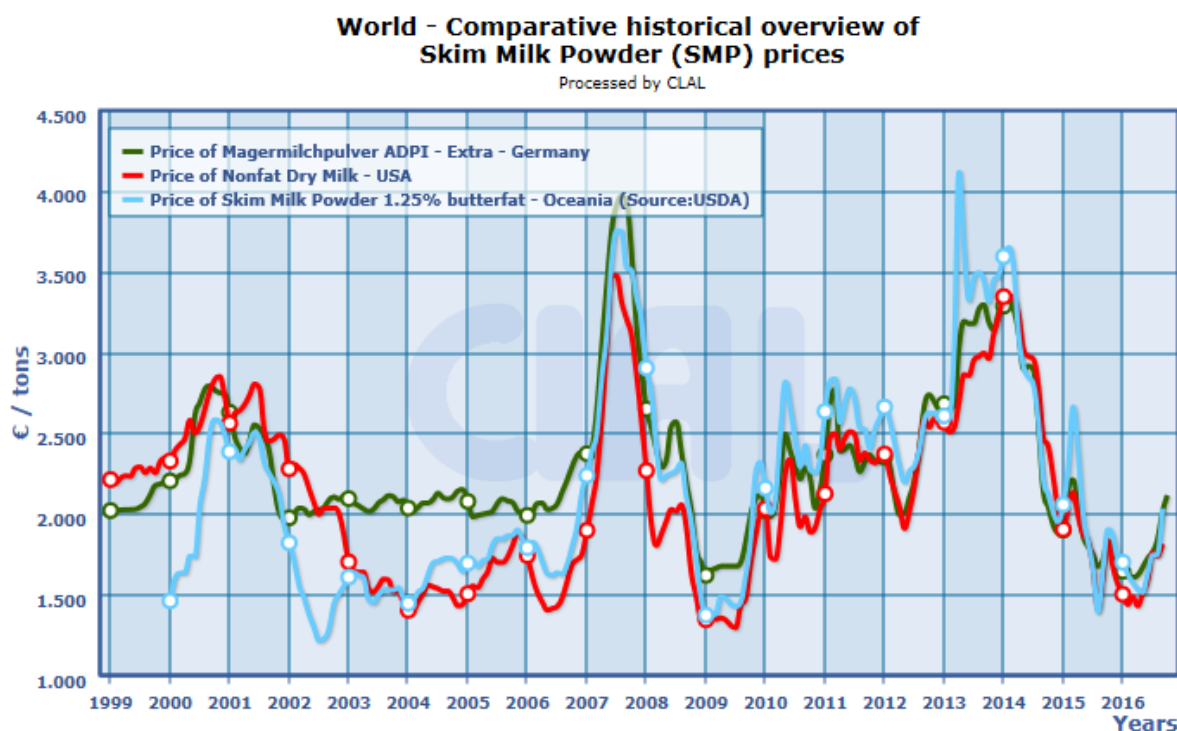
¹ Dairy Australia (2016)

² Source: CLAL.it (2016)

³ Source: CLAL.it (2016)

peak in February 2014 of NZD 8.65/kgMS (Milk Solids) to NZD 4.25/kgMS⁴ in August 2016. In Australia, the farm gate prices can differ greatly between states as some are more manufacturing and export focussed than others. However the Victorian farm gate price went from a peak of 6.81/kgMS in 2013/14 to 4.45/kgMS⁵ in August 2016.

To give an overview of worldwide dairy prices, SMP, as one of the most traded dairy products, is a useful indicator. The below graph shows the correlation of products in the EU, US and Oceania markets and the associated large falls in prices from the peaks in 2013/14 to the trough in late 2015/16. Prices fell by over 55 per cent over this period.



Source: CLAL.it (2016)

Recent announcements relating to EU milk supply are expected to have a future impact on global markets. . On 26 September 2016 the EU announced a EUR 500 Million aid package to the dairy industry including:

- EUR 150 million Milk Production Reduction Scheme. This will pay participating farmers to reduce their production by approximately 20 per cent, with an overall reduction of 1.06 Million tonnes of milk. This will reduce total milk deliveries in the last quarter of 2016 by 2.9 per cent.
- EUR 350 million will be spent on 'support packages' to dairy farmers.

⁴ Fonterra (2016)

⁵ Dairy Australia (2016)

However, the EU support to store greater volumes of SMP is continuing at least until February 2017. Support for the program has already been extended once and may continue to be, meaning this increasing stockpile will continue to overhang the market.

AUSTRALIAN AND NZ DAIRY EXPORTS

Notwithstanding the global glut Australian dairy export volumes have managed to increase by 7 per cent in the year to February 2016. Exports to China have grown by 21 per cent and Japan by 7 per cent in that period. However, it should be noted that EU exports into China increased by 60 per cent in that period and to Japan by 12 per cent reflecting the dramatic increase in competition from the EU for Australian dairy exports. Australia exporters are reporting anecdotally that exports to China have slowed in recent months particularly milk powders.

New Zealand has experienced a significant fall in the value of their dairy exports. In June 2016 their export of dairy products reduced by 5 per cent (year on year), with a 22 per cent fall in August 2016 (month on month). The largest impact has been on dairy exports to China and the UAE, again showing the effect of increased EU competition in Asia and the Middle East.

AUSTRALIAN PRICES AND SUPPLY

Earlier this year the Rural Industries Research and Development Corporation's (RIRDC) detailed report *"From Farm to Retail – how food prices are determined in Australia"* found that "Wholesale prices for manufactured dairy products (cheese, spreads and ingredients) and most farmgate prices are highly influenced by world market prices for traded dairy commodities."⁶

The local impact of the global dairy glut and falling export prices has varied across the different dairy production regions within Australia reflecting the level of exposure to export markets. Western Australia, Queensland and northern NSW rely more on domestic fresh milk consumption, whereas the southern states, where production is highest, direct a higher proportion of production into processed products and export markets.

RIRDC noted this in its report:

- "Prices are more stable in northern regions (Qld and NSW) and WA where the majority of milk is used to supply local fresh milk demand, compared to southern regions where prices are more directly influenced by manufactured returns, in turn affected by export returns."
- "In fresh milk regions there is greater use of contracts and price signals aimed at encouraging flat supply to avoid surpluses, as there is no capacity with major milk processors to process surpluses into storable dairy products in these regions."

⁶ RIRDC, 2016, *From farm to retail – how food prices are determined in Australia*, section 4.5

- “As international market volatility has increased, the variability of southern prices has also increased... Southern mainland dairy regions produce about 70% of Australia’s milk. Milk prices paid to farmers in that region closely track trends in global dairy commodity prices...”
- “Farmer shares of retail milk prices in Australia are comparable to major northern hemisphere producing and consuming countries, where comparable products are used. “

Lower world prices and the knock on effect of lower farm gate pricing in the Australian domestic market is expected to reduce the overall milk supply by between 5 and 10 per cent. The impact is likely to be greatest in the southern states, impacting the largest processors and exporters. Lower throughput will reduce plants’ productivity and profitability, which may hamper the processors’ ability to bounce back when export markets improve.

A lower supply from Australia is not expected to have any great effect on the world market. With the largest exporter and low cost producer next door to Australia, it is considered that New Zealand would easily fill any shortfall in Australian exports.

FUTURE PROSPECTS

As can be seen from the SMP prices shown above, the market seems to have found a floor which has been reflected in the recent announcements regarding modest increases in farm gate prices in Australia.

Global demand is expected to remain relatively stable, however the US and Europe are expected to slightly increase consumption. Whilst the EU is curtailing production via subsidies, Rabobank reports volumes are also expected to fall in New Zealand, Australia, Argentina and Brazil.

Australian exports are showing gradual improvement. The July to August period in 2016 shows a 9.6⁷ per cent increase in volume from the same period last year, with an 11.6 per cent increase in value reflecting slightly better prices.

Forecasts regarding price increases are cautious due to the stockpiles that will have to be cleared, however the fall in production is expected to have a significant effect on prices in 2017. In the long term, global demand for dairy products is expected to remain strong with some analysts predicting a 25 per cent increase in consumption by 2025⁸. With continued consumption growth in the Asia region, including China, the medium to long term prospects for Australian dairy exports are solid.

As the RIRDC report found, the farmgate share of retail milk prices in Australia is comparable to other major northern hemisphere countries. With a stabilisation in world

⁷ Dairy Australia (2016)

⁸ Farm Journal (2016)

markets, the balance between dairy farmers and processors will be maintained due to the strong interdependent relationship between the groups.

The AFGC also notes that in addition to an exposure to export price volatility, the Australian dairy industry is affected as much as any other major export industry by non-tariff barriers (NTB's) to trade. For example it was recently reported that a dairy processor has shelved plans for an AUD 500m upgrade to their processing capabilities citing uncertainty in the China market regarding import regulations as a major reason, along with the global oversupply. A greater focus on addressing NTBs will be required if the Australian dairy sector is to fully realise its export growth potential.
