Submission
to the
Senate Standing Committee on Economics

on

Competition and Pricing
in the
Australian Dairy Industry

26 October 2009

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Committee Secretary
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Department of the Senate
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Dear Committee Secretary,

Re: Competition and Pricing in the Australian Dairy Industry

Australia Dairy Farmers (ADF) is pleased to submit the following comments to the Senate Standing Committee on Economics to assist with its inquiry into competition and pricing in the Australian dairy industry.

The dairy industry is Australia's third largest rural industry. In 2008/09 it was valued at around $4.0 billion at farmgate. The Australian dairy industry is open, with high levels of trade in manufactured dairy products, and the setting of prices and terms of supply is unregulated. This is reflected in the fact that around half of Australia's total milk production is exported (as a range of dairy products) to more than 100 countries.

Australia exports around 50 per cent of its milk production, and the domestic market is open to imports of dairy products from all parts of the world. As a result, the Australian farm gate price for milk is directly set off world market prices, recognised as amongst the most distorted of all world traded commodities. This is due to the use of export subsidies (particularly by the European Union), and through barriers to imports in most of the major dairy consuming nations.

Current Situation and Outlook for Farmers

At present Australian dairy farmers are operating in extremely difficult conditions. The cumulative effects of long-term drought conditions, higher costs of production due to the need to buy in water and/or feed and the high cost of servicing loans have combined with the lowest opening farmgate milk prices in five years to see many farmers operating at break even levels or below.

As farmers are paid per litre of milk, and as milk production levels are forecast to drop in response to dry conditions and excessive rains in some areas and reduced cow numbers, the full impact of low milk price on farmer incomes is likely to be exacerbated in the coming months. Dairy Australia estimates that 9 billion litres of milk will be produced in 2009/10[1] a 4% decline on 2008/09 levels. Dairy Australia have attributed this reduction to farmer exits from northern Victoria and the southern Riverina, wet conditions in Tasmania and reductions in cow numbers and supplementary feeding rates across the industry.

In southern dairy regions, where farmers are most exposed to export returns, the rapid flow-on of the effects of the global financial crisis adversely affected the sales of dairy products, leading to a major downturn of dairy commodity prices internationally. This led to a significant step-down in farmgate milk price, mid-season as dairy companies sought to protect their financial positions from the risk of sizable losses. Step downs are almost unprecedented in the dairy industry – the last one occurring in the mid-70s. Farmers committed to feed and other inputs based on opening price plus 10 to 15% over the full season. The announcement of the step down in price allowed little opportunity for farmers to adjust their plans and reduce costs, with many fixed in high cost systems

[1] Dairy Australia, Situation and Outlook Update, October 2009

by unfavourable seasonal conditions. Effective from February to June 2009, the step-down saw previously announced opening prices reduced by 30% to 40 % for the last five months of the season.

As you would be aware, dairy farmers have been coping with very tough seasonal conditions for many years. They have demonstrated a remarkable resilience and implemented many changes on-farm to adapt to climate variability – investing in new systems and infrastructure to maintain milk production with significantly less water and pasture. Throughout this period, confidence among dairy farmers has remained quite strong, with an average of around 78% feeling positive about the industry in 2008. The onset of the milk price drop has pierced this confidence, with 95% of the industry stating they felt a major impact, with those farmers feeling positive about the future falling to 60% in September. Dairy Australia, has advised that the number of dairy farmers considering exiting the industry within three years increased from 3 to 16% between March and September 2009. ADF hopes that improved seasonal conditions combined with increasing milk prices and government support to farmers will combine to bring these numbers down. [2]

The financial impact has been severe as many farmers in southern regions – through necessity (eg drought) and encouraged by previous farm gate price signals – have found themselves locked in to high input production systems with limited cost flexibility. These pressures are most acute in northern Victoria and Tasmania but also exist in other regions of Victoria, South Australia and New South Wales.

In addition to low milk price, Tasmanian farmers are also dealing with excessive rain which has affected milk production and necessitated additional supplements as pastures become unstable. Farmers in the region are reliant on Spring pasture growth for milk production and to minimise input costs. The current conditions mean additional supplementary feeding has been a required at a time when feeding costs should be at their lowest. This has placed additional and unforseen pressures on cash flows. These pressures will continue as many pastures now require renovation. In line with this, the number of Tasmanian farmers considering exiting the industry has risen from zero in March 2009 to 18% in October 2009.[3] Farmers supplying domestically-focused processors had been insulated from the immediate impact of the price drop as supply contracts remain in force.[4] However, as these contracts come up for renewal over the next twelve months, we expect that the impacts of low milk prices will spread right across the industry. This will be particularly the case if the Australian dollar continues to rise.

Farmers supplying fresh milk processors in regions such as northern New South Wales and southern Queensland are somewhat buffered from the impact of international markets by the need for year round supply close to large population centres and the high freight costs of alternatives supplies for other dairy regions. This is not the case in Tasmania, where drinking milk represents less than 10% of the state's production.

Despite the global financial crisis, the Australian market for dairy continues to deliver volume and value growth, with per capita consumption at around 300 litres in milk equivalent terms.[5] After the major downturn of late 2008, the global dairy market is also recovering, demonstrating the long term demand for milk as a tasty, nutritious product. Bearing in mind forecast population growth (in Australia and globally) combined with food security concerns as less of the world's land is dedicated to agriculture, maintaining a robust dairy sector in Australia is vitally important.

Milk Pricing

The ownership of the Australian dairy industry at the processor level has changed significantly in the last decade, with a greater proportion now owned by public and international interests. Notwithstanding this, it is apparent that the Australian milk price is set by the process outlined in the Department of Agriculture, Fisheries and Forestry (DAFF) report on *Price Determination in the Australian Food Industry*. The report states,

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[2] Dairy Australia, Situation and Outlook, October 2009.
[3] Dairy Australia, Situation and Outlook, October 2009.
[4] Dairy Australia, Situation and Outlook, June 2009
[5] Dairy Australia, Situation and Outlook, October 2009.

> "Milk prices at farmgate are driven by the level of returns to the Victorian production regions which produce more than two-thirds of total output and more than 75 per cent of exports. Milk is sourced by dairy companies on a regional basis – each production region is regarded as a discrete economic milk field by companies relevant to their alternative sources of input that are available to their plants.
>
> Major exporting cooperatives set farmgate milk prices based on net returns that can be achieved from their operations, making allowance for capital costs and working capital. Milk price is generally determined as a residual amount after the costs of business.
>
> 'Step-ups' are paid by several large dairy companies and cooperatives over the year as the cash flows from proceeds of the annual sale of product permit. Step-ups are generally in the order of 5-100 per cent of the eventual full year price and are typically only paid by companies that have a highly seasonal milk supply exposure.
>
> A variety of approaches have been taken to the structure of farmgate supply contracts, with the major packaged milk processors now relying on contracts which contain a range of signals and incentives to suit the needs of the packaged milk business for high reliability. These signals address the shelf life of the milk product, volume efficiencies, the costs of collection and haulage to the factory and the avoidance of impurities in their milk. As a result they can cause significant variation in the ultimate per litre price for the product."[6]

In practice this means that the Murray Goulburn Cooperative (MG) has a major role in setting milk price in Australia. As a farmer cooperative, MG sets its opening price based on its cost of production plus returns to farmers. As MG purchases the largest volume of milk, is a significant exporter (eg trade exposed) and also supplies to supermarkets domestically, this price tends to set a signal for the industry. In 2008/09 MG bought around 3.4 billion litres of milk, compared with Fonterra which bought around 1.8 billion litres.[7]

This inquiry also examines the question of whether breaches on the Trade Practices Act 1974 are currently occurring through supermarket exploitation of buying power. ADF notes that the ACCC examined this issue in 2008 with much of the dairy industry contributing to the review. The final report covered dairy products although other fresh food and meat was not included.

The outcome was that the ACCC judged that while 'buying power' is present in the Australian grocery market; this did not translate into a breach of the Trade Practices Act 1974 "at this stage". ADF considers that a regular examination of these issues by an appropriately authorised body, such as the ACCC, is appropriate given its acknowledgement that "prices paid to primary producers and the terms of trade for such produce are significant issues".[8]

<u>Mechanisms to Improve Returns to Dairy Farmers / Mitigating Further Reductions in Milk Price</u>

ADF strongly urges the Government to undertake or continue with those reforms that will increase the competitiveness of Australian dairy farmers globally, increasing their ability to operate profitably at world prices.

As a number one priority, ADF urges the Government to consider the true impact of any Carbon Pollution Reduction Scheme (CPRS) on the dairy industry. As demonstrated through our milk price structure above, even if agriculture is not covered, the nature of the dairy industry means that any carbon cost impacts imposed on dairy processing will pass on to farmers. This cost impact has been estimated between $5,000 and $10,000 per dairy farming business per year depending on the future price of carbon.

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[6] Spencer, S, Price Determination in the Australian Food Industry, DAFF (p 33-34)
[7] Dairy Australia, Situation and Outlook, June 2009
[8] ACCC, Grocery Pricing Report, p 18

While the industry is willing to take a positive role in supporting Australian efforts to reduce aggregate carbon emissions, we are concerned that the potential costs imposed by the CPRS (as currently drafted) will be excessive from a dairy farm and food processor perspective. As a priority it is vital to ensure that the final CPRS provides appropriate Emissions Intensive Trade-Exposed (EITE) status (or comparable treatment with major competitors.)

Water is another area where good policy is vital to provide assurance to dairy farmers about their capacity to operate in the future. The ADF has submitted, through the Australian Dairy Industry Council (ADIC) several submissions to the Productivity Commission, ACCC and government on water policy. ADF refers the Senate Committee to these documents for more detail. In summary, the ADIC supports Government measures to restore the balance between consumptive water use and water required to maintain river, wetland and floodplain health, provided:

- Individual property rights for land and water are respected by any water recovery mechanisms considered or adopted;
- An open and efficient water trading market is achieved, with the reduction or removal of artificial barriers to trade, and timely and transparent market information;
- There is coordination between buyback programs and infrastructure reform programs;
- Scientific evidence underpins the quantification of environmental needs and the consequent acquisition of water; and
- The human dimensions of water reform are considered, with community and stakeholder engagement inherent in the process.

Other important measures sought are detailed in the Australian Dairy Industry Council (ADIC) submission to the Agriculture and Food Policy Reference Group on *Ensuring a Profitable and Sustainable Agriculture and Food Sector in Australia.* To summarise, the ADF urges Government to:

- Pursue both multilateral and bilateral trade agreements to open up new dairy markets;
- Promote investment in infrastructure, especially transport (roads, rail and ports), energy and water.
- Implement national regulatory frameworks as the agricultural and food industries are national industries that operate globally;
- Undertake comprehensive risk assessments on any proposed policies to ensure their impacts are fully understood;
- Develop and implement policy to support regional communities and their people;
- Align and increase funding to research, development and extension with the needs of industry throughout the supply chain; and
- Ensure a national approach to natural resource management is developed and adopted.

At the same time, ADF has achieved a mechanism for dairy farmers to utilise collective bargaining as a tool to improve their returns and increase their market power. The ACCC ruling achieved by ADF in 2006 facilitates this option on a regional level. The authorisation also permits:

(a) groups of dairy farmers to form collective bargaining groups through which they may collectively negotiate terms of supply, including price, with a dairy processing company that each member of the group wishes to supply and

(b) the ADF to hold general, non-specific discussions with supermarkets, on an individual and voluntary basis, regarding the impact of tender processes on dairy farmers subject to the following conditions:

Support and training tools that assist dairy farmers to more fully understand and participate in collective bargaining agreements would facilitate greater uptake of these provisions.

Thank you for the opportunity to contribute to this inquiry. We would welcome the opportunity to discuss any of the points raised here directly with the Committee. We look forward to your report and hope that recommendations will be possible which lead to tangible benefits for dairy farmers.

Yours sincerely,

Wesley J. Judd.

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