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Dairy for life

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The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Secretary

Inquiry into the impacts of supermarket price decisions on the dairy industry

Thank you for the opportunity to provide information to the Economics References Committee for its inquiry into the impacts of supermarket price decisions on the dairy industry.

The recent reductions in the price of house brand fresh milk by supermarket retailers has fundamentally changed the dynamics of the fresh milk market and this is something all players in the market will have to grapple with – including retailers, milk vendors, processors, farmers and their communities.

The shift from branded milk to lower priced house brands means lower returns to processors and farmers. It is well recognised in the industry that house brand milk contracts are a cost recovery exercise for processors rather than a profit making venture and for these contracts to be viable processors must balance them with branded milk contracts so that a reasonable return can be achieved once the price is averaged across the entire milk volume.

As a result of the shift to the cheaper house brand milk, value has been taken out of the dairy supply chain. Farmers and processors who were already under severe margin pressure, are operating in a new environment with even lower margins and it is not clear if this will be sustainable for the long-term.

Initially, the retailers involved were saying that they will not pass on the price reduction to the processors. If they were to pass the price reductions on it would exacerbate an already stressed operating environment with already diminishing margins from the shift to house brand.

It has been suggested that the processors who sit between the farmers and retailers are the ones who are making unreasonably high margins and taking value out of the system. Nothing could be further from the truth. Dairy processing is a capital intensive exercise and those in the industry struggle with seasonal conditions, price volatility, higher input and energy costs, higher safety and quality costs, and erosion of margin. Further, developing market leading dairy brands with consumer propositions around health, wellbeing, superior nutrition, taste and convenience, requires significant investment in research and development. Dairy processors in Australia make only a modest return on their invested capital and this may be a reason why Australian interests have sold dairy assets to foreign entities in recent years.

In terms of how price is set with the retailers, we negotiate a wholesale price with retailers at yearly and half yearly reviews and the price we receive at the wholesale level is dependent on a range of factors including ranging, supply chain arrangements, promotions and so on. Then, like any business, we have to manage our costs and processing as efficiently as possible to ensure we return a milk price to farmers that will encourage the right level of production and allow them to invest in and grow their business. It does not serve our interest to pay a low price to farmers – if we do, we will lose supply. A steady, reliable supply of milk is critical to business success. We know we have to pay farmers a competitive milk price to attract and maintain the ongoing quality supply of raw milk that we need. We regularly review the milk price we pay to farmers and are motivated to pay them the level of return that will help us achieve the right level of supply to manage the demands of our customers.

At the core of Fonterra is its farmer co-operative heritage. We are motivated to work in partnership with our dairy farmer suppliers and return to them a milk price that ensures a good ongoing relationship. We have a history in Australia of paying market leading prices to ensure secure and stable supply of high quality milk and to ensure supplier loyalty.

Fonterra Australia is not a player of any significance in Australia's white milk market, holding a national market share of just 3 per cent. On March 20, 2011 we expect to complete the sale of our Western Australian Brownes milk business to Archer Capital, thereby virtually exiting the fresh milk market in Australia ourselves. Fonterra in Australia is primarily a brands business in cheese, spreads, yoghurts and dairy desserts, with interests also in foodservices and ingredients. Therefore the direct impact to Fonterra of this price reduction in fresh milk is minimal; however, our concern is the effect on the overall dairy industry.

The value that is being taken out of the value supply chain will inevitably impact farmers. The level of impact will depend on whether the supermarkets continue to absorb the price reductions, but one has to expect that a new low benchmark price is being set for fresh milk which will change the dynamic of that market for the long term.

This comes at a delicate time for dairy farmers. We know from our work with the 1,500-plus dairy farmers we collect milk from in Australia that, many farmers, are facing tremendous hardship and anxiety as a result of high levels of indebtedness, climate volatility, tough market conditions and rising input costs. Over recent years evidence of this is the fact that total milk volume in Australia has dropped from 11 billion litres to 9 billion litres since 2002. There are higher expectations than ever before to invest in food safety and quality initiatives. Any productivity gains on farm are being offset by higher costs. In this environment, the dairy sector needs a boost in confidence and investment rather than a margin squeeze.

The future of the dairy sector is strategically important to ensure Australia has food security going forward. We have a concern about what might happen to the entire dairy sector if these price reductions move into other dairy categories, such as cheese and butter. For these products there is an international commodity market and if domestic prices become too low, processors will be forced to sell product on the global market, rather than selling at a loss domestically. A lower level of supply will push prices back up, which is not a good result for consumers.

Fonterra remains committed to working with all its dairy supply chain partners to ensure that there is a sustainable dairy industry for the long term. A sustainable dairy industry requires consumers to achieve a good value price at point of purchase; it requires retailers to achieve a return from their activities; manufacturers to operate as efficiently and effectively as possible to maintain their margin and return on investment; and farmers have to be paid a price for their milk that is viable for their ongoing business. All these factors need to be present.

We would recommend that as part of its deliberations the Senate Inquiry Committee seek a full and comprehensive understanding of the price dynamics and margin pressures throughout the dairy supply chain and an understanding of where value is being added and where investment is being made to support a sustainable dairy sector for the long term.

We would be happy to provide any further information to the Inquiry or answer any questions the Committee may have.

Yours sincerely

John Doumani
Managing Director
Fonterra Australia New Zealand