parmalat

5 October 2016

Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Sir

Re: Economics References Committee Enquiry - Australian Dairy Industry

1. Parmalat Australia Background

Parmalat Australia Pty Ltd is a wholly owned subsidiary of the Italian Parmalat group that is in turn majority owned by the French family group Lactalis, the world's largest dairy group by revenue. Parmalat Australia can trace its roots via the "Pauls" brand back to Queensland in the 1920's and today has close to $2 billion in turnover. Parmalat Australia employs 2,700 staff and operates 15 milk, cheese and dairy product factories across Australia. Annually, Parmalat Australia purchases over 1 billion litres of milk direct from 550 dairy farmers in nearly all regions delivering some $500 million in farm gate income. In the last 3 years Parmalat Australia has invested over $300 million in acquisitions and capital in dairy processing in Australia and like most global food groups has confidence in Australian agriculture's long term success.

2. Terms of Reference

The terms of reference for the enquiry were listed as:

a. the legality of retrospective elements of milk contracts;
b. the behaviour of Murray Goulburn; and
c. any other related matters.

3. Parmalat Submission

3.1. Legality of Retrospective Milk Price Adjustments

The export focused southern Australian milk regions comprising Victoria (including the southern NSW Riverina region), Tasmania and South Australia have for several decades, operated a flexible milk pricing system whereby farmers are provided an opening price for the season and most often an "indication" of the full season price. During the financial year as both actual sales and forward sales are secured, processors gain increased confidence as to their sales income, cash flow and earnings and will announce step-ups or increases to the opening price with back payments of the step-ups to the beginning of that financial year. Therefore, retrospective increases in milk pricing have been a regular feature of southern Australian milk pricing for many years.

Historically the Opening price has ranged between 85%-90% of the full year estimate. For example an opening price might be set at $5.50 per kilogram milk solids (/kgMS) approximately 40.7 cents per litre (cpl) with a full season "indicative" price of $6.00 /kgMS or 44.4cpl. During the year the processor would then step-up 3 to 4 times with each step between $0.14 - $0.20 /kgMS (1-1.5cpl).

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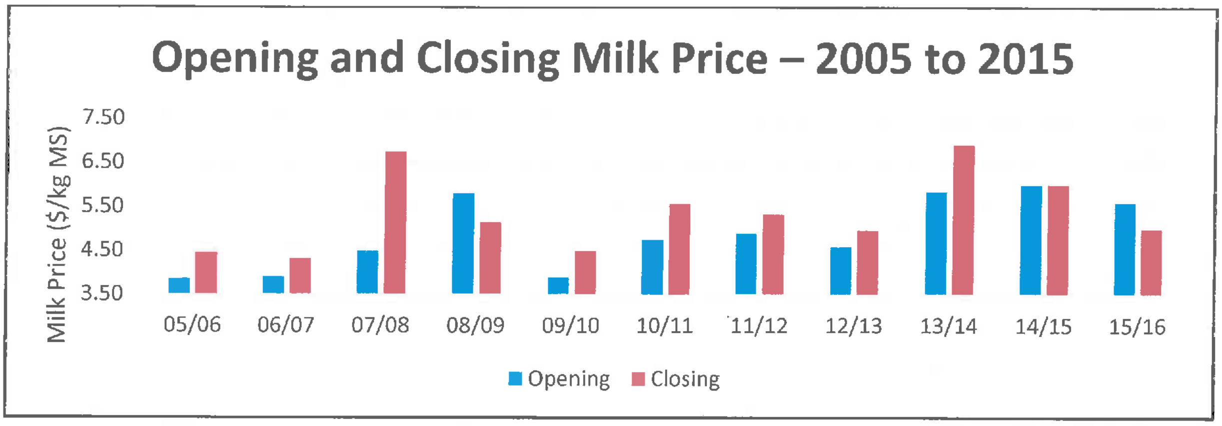
If the global prices were higher and/or the AUD/USD exchange more favourable then the full season price would exceed the indicative price and extra step-ups would be paid. Conversely if global prices reversed and/or the AUD/USD was unfavourable there would be less step-ups or even none.

Before April 2016, there had only been 1 instance in many years where the major processors advised mid-season that the opening price was wrong and that the full season prices would in fact be lower than the opening. That year was 2008/09. The table below shows the history of opening and closing for the last decade.



In the 2008/09 season, Murray Goulburn advised in early December 2008 that the opening price was unsustainable and that the price paid for milk in the 6 months January to June 2009 would be much lower than the opening advice. This was in fact the first step-down or retrospective price reduction for more than 2 decades and was devastating for many farms.

Regrettably the change in leadership that occurred at Murray Goulburn over the next few years resulted in a significant loss of corporate memory, and as in 2008/2009, a step-down was repeated just 7 years later. To make matters worse, the step-down was not announced until the 10th month of the season with only 2 months remaining.

The question by the Committee as to whether such retrospective price changes are in fact legal is not one we are qualified to comment on except to say that such retrospective reductions were rare and that custom and practice over a very long time have demonstrated this. As noted above, retrospective increases in prices have occurred over many years and have excited little or no comment. However, while the legality is an important aspect, the reality is that no processor who has a significant portion of sales in export markets can reliably predict selling prices and therefore farm gate returns 12 months in advance. In Europe today the majority of farm gate milk prices are set for only 3 months at a time.

The system of opening price and step-up may not be ideal but in all but 2 of the last 30 or more years, has given southern dairy farmers a clear 12 month price signal that enabled reliable business planning. The NZ system of advising a full year price (and updating that prediction regularly), but actually only paying a portion of that price during the season until the final price is 100% determined reflects an attempt to manage price uncertainty that is very similar to the southern Australian position.

The key to the success of the opening price and step-up system or the NZ version is in fact the prudence and good governance of systemically important processors such as Murray Goulburn. The alternative is to adopt a price system with a much shorter horizon which farmers find unworkable for their agricultural businesses.

Although completely assuming this market uncertainty is beyond the remit of processors, we believe that appropriate and consistent dialogue between all industry participants concerned can assist in managing inherent market uncertainty in a transparent and practical manner. To this end, having industry participants develop an appropriate consultation framework that could be incorporated into an industry code of conduct (discussed below at 3.3(c)), may be one way to minimise uncertainty, increase transparency, and adopt a more collaborative approach to managing risk in respect of consultation on farm-gate prices with farmers.

3.2. Behaviour of Murray Goulburn

The decision of Murray Goulburn to pursue rapid expansion to produce "value added" products was largely driven by the obvious success of Fonterra NZ and the view promulgated by the Murray Goulburn leadership that Australia was missing out on global export success in dairy. At the exact same time the EU removed production quotas and global dairy prices were in a major slump, Murray Goulburn rushed to raise capital from external shareholders and in turn confronted the inherent conflict between farmers who want returns in the form of higher milk price and shareholders want the best returns on investment.

Nowhere in the world has a dairy model worked where it's half listed and half cooperative without some form of pre-agreed formula that defines the farm gate price (as the Fonterra NZ system uses) and delivers transparency in price signals. Murray Goulburn wanted what Fonterra NZ had, but never recognised the leadership, education, price setting practices and the continuous and early communication of price risk that underpinned the NZ story.

Transparency of global market information constantly communicated to farmers in terms of forecast and outlook is essential. Murray Goulburn did the opposite. The eventual decision in April 2016 by Murray Goulburn (followed Fonterra but no other processor), to retrospectively cut its 2015/16 milk price to claw back $183m in overpaid milk price is a demonstrable case of leadership failure by a systemically important industry organisation.

The extraordinarily poor leadership, management and governance at Murray Goulburn resulted in the setting of a 2015/16 opening price that appeared unrealistically high to other industry participants. This has caused not only short term distress for both its suppliers and the wider industry, but longer term it undermines our ability as an industry to grow and succeed in an increasingly global market. We believe that it is important for milk processors to engage in socially responsible behaviour and to approach engagement with farmers in a way that ensures the ongoing prosperity and viability of the industry.

3.3. Other related matters.

a. Industry Leadership

Since deregulation of the state dairy structures in July 2000, the national industry has experienced many changes with each state having differing experiences. Tasmanian milk production has grown 150% since 2000 with most of that going to export, while Queensland production has fallen 50% and now largely services its regional fresh milk demands. The key export region comprising Victoria, South East SA and the Riverina in NSW have seen milk production fall by 7%-10% with difficult and recurring drought conditions in the 2000's a major contributor to that performance.

It's important to recognise that during the same period our southern dairy region contracted, the NZ industry almost doubled (a 180% increase). Many explanations have been put forward for this massive difference including the virtual monopoly enjoyed by Fonterra. While Australian climate and pasture conditions certainly contribute to the gap, there is no question that the fundamental difference is the quality of the industry leadership and co-operation in NZ that in turn provided the farmers, financiers and service providers confidence and capability to invest and grow a world class dairy export industry. The NZ success did not happen overnight and the fundamental seeds to that success were planted well before the creation of Fonterra.

Australia pursued a national industry policy of deregulation in an effort to improve consumer prices and services via the removal of state monopolies and the introduction of genuine competition. But that same process of deregulation, while it endeavoured to compensate dairy farmers with a $1.7b package paid for by consumers over 10 years, did nothing to improve the farmer/industry leadership that was essential if the southern dairy industry was to grow in a similar fashion to NZ. Left to market dynamics Australia's largest export orientated co-operative chose instead to focus on domination of the low margin domestic dairy market rather than build systems of leadership, communication, understanding and transparency needed for individual farmers to unite and participate in long term high value export growth.

So while consumers have been the big winners from deregulation with cheap milk, Parmalat Australia believes that the misleading price expectation set by Murray Goulburn in the past 2 seasons is directly attributable to poor leadership in that organisation.

Privately owned or listed processors (Parmalat, Lion, Warrnambool, Bega) even if foreign owned, are well aware of the balance between supporting their farmer suppliers with sustainable and realistic prices and delivering profits that fund ongoing investment. They are also aware that many farmers have a poor understanding of market realities and look to the processor to provide sensible advice on future outlook with integrity and trust. It appears that while this fundamental principle is clearly understood and underpinned a united and competent NZ dairy leadership, the egos and aspirations of a systemically important Australian co-operative were exactly the opposite.

While organisational leadership in the processing sector is one aspect, the industry structures that should help drive and create sensible whole of industry policy are in our view poor when compared to the EU, NZ or the US. Dairy Australia needs an overhaul. It no longer represents the interests of the 6 states and its relevance in delivering unified industry policy is questionable. For instance the work of DA in export support and development is virtually irrelevant to Qld dairy farmers who have a wholly domestic focus.

Parmalat Australia believes that the levies system could be retained but used to fund focused organisations that are better aligned to serve their core farmer constituents. For instance an export focused industry body might provide competent, independent advice to farmers covering global price expectations, global demand and supply outlook etc. Similarly, a different body may support and work for domestic focused farmers in Qld, central NSW, central SA and WA with a strong focus on cost of feed forecasts, cost of production statistics by region etc. In trying to be all things to all farmers Dairy Australia is significantly conflicted by highly differing agendas.

b. <u>$1 / litre Private Label Milk</u>

With a long term farm gate milk price of circa 45cpl ($6/ kgMS), milk collection of 3cpl and processing costs (including packaging) of approximately 25-27cpl, it is more than obvious that a Victorian, Tasmanian or SA retailer can expect to source local fresh milk from processors and sell that product for $1/litre. That price will cover the retailers own internal distribution cost plus achieve a real in-store margin on sales albeit at lot lower level than other chilled dairy categories. Given the average retail trade margin on branded chilled dairy is in excess of 45%, while Private Label $/1 a litre milk in southern regions is clearly not a loss leader its certainly not contributing to supermarket earnings consistent with other categories or brands and in that regard is a market distortion.

But in central NSW and WA where farm gate milk price is closer to 52cpl and milk collection 5cpl or Qld with a farm gate of 57cpl and collection also at 5cpl the economics of $1/litre Private Label must be even more questionable and the market distortion against branded milk and independent retail channel even more pronounced.

The fundamental question not resolved since the introduction of national $1/litre pricing in January 2011 is the impact of those shelf prices on the entire supply value chain and in particular in regions such as Queensland, New South Wales and Western Australia.

c. Processor/Farmer Code of Conduct

Competition remains an important mechanism to drive innovation and reward success. However, farmers locked into long term agreements with a processor with little or no price commitment or certainty is not enabling competition. A code of conduct for farmer/processor contracts or at the very least an industry agreed standard contract template, is overdue and would go a long way to restoring farmers confidence that they are being treated fairly.

The bargaining group authorisation process managed by the ACCC appears to have only limited success and is in fact irrelevant with the co-operative processors like Murray Goulburn. Common and widely adopted and agreed industry standards for farmer supply agreements that reflect a genuinely fair and appropriate sharing of market risk would re-build confidence and trust between producers and processors.

d. Advertising practices

Greater scrutiny and regulation over comparative and advertising practices such as "premium" and "credence" claims, particularly in respect of pricing and health-benefits, are other considerations that require further industry consultation. There is an inherent risk that significant harm to market participants, retailers and consumers associated with misrepresentations, particularly when they are not independently verifiable, by consumers is going unsanctioned. These practices affect consumer perceptions and buying habits, and distort competition by providing an unfair commercial advantage based on deceitful conduct.

What should not be overlook in the enquiry is the reality that the wider southern industry knew in mid to late 2015 (the Fonterra CEO identified it in late August 2015) that the Murray Goulburn prices set for 2015/16 were unrealistic. Murray Goulburn as the largest dairy co-operative holds a systemically important role both in the southern dairy industry and our national dairy export ambitions. Murray Goulburn and its board and management therefore has an obligation to act with great responsibility, and transparency. The ambition to succeed is essential but must be balanced with sensible and mature corporate behaviour.

Yours faithfully
Parmalat Australia Pty Ltd

Craig Garvin
Chief Executive Officer