



Australian Dairy Industry Council Inc.

25 July, 2000

Please find enclosed a submission to the enquiry, commenting as requested on the First Report of the Inquiry, on behalf of the Australian Dairy Industry Council (ADIC).

The ADIC is the national peak representative body of the Australian Dairy Industry comprising representatives of the Australian Dairy Producers Federation, the Australian Dairy Farmers Federation and the ACTU on behalf of dairy process workers. The ADIC is the body that, under relevant legislation, advises the Minister on the Federal levies that fund Dairy industry activities – including research through the Dairy Research and Development Corporation and administration and industry assistance through the Australian Dairy Corporation.

We are keen to register with the Inquiry the commitment and success of the dairy industry in contributing to national economic growth and value adding. The dairy industry has become Australia's largest processed food export industry by adjusting to the rapidly changing economic and technical environment of the global food industry. At all levels of the industry there has been a continued willingness to embrace and profit from change and to accept the challenge of the market place.

In order to continue to grow as a value-adding industry, we rely on government to ensure that the market place is fair, open and not encumbered by costly regulations or regulations that create burdens for export industries in their attempts to establish export markets. In our experience, there have been great improvements in the openness and competitiveness of the Australian economy under both Labor and Coalition governments over the past decades, which has contributed to the dairy industry's prosperity.

The Committee's work encourages us to believe that this improvement will continue.

Yours Sincerely,

Helen Dornom
Chief Executive Officer

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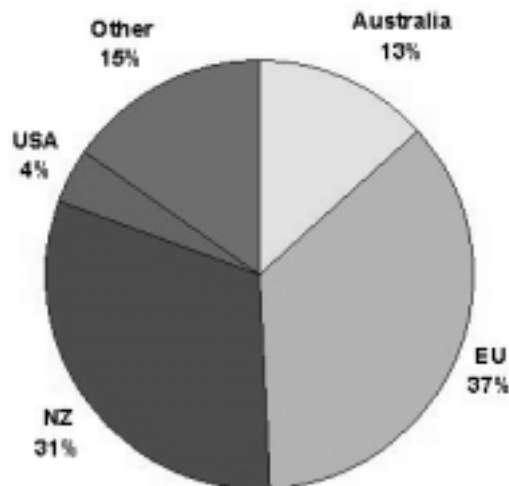
High levels of Value Adding in the Dairy Industry

The level of value adding in the dairy industry is indicated by a study undertaken by the Centre for International Economics for the Australian Dairy Industry Council in May 1998. Although the regulatory structures at State and Federal level then in place distorted the distribution of value adding between regions, the national results place show a very different picture of the dairy industry to that suggested by the First Report.

Value at farm gate	\$2.5 billion
Value ex-factory	\$7.0 billion
Exports	\$1.7 billion (FOB)
Domestic sales	\$7.6 billion

The CIE report shows that Australian Dairy processors – predominantly the farmer-owned cooperatives – transformed milk valued at \$2763 million at the factory input into packaged milk and manufactured products. Exports accounted for \$1.7 billion while products destined for domestic outlets were valued at \$5418 million ex-factory and \$7551 million at the point of final (domestic) sale.

1999 World market shares



Dairy Value Adding underestimated in the First Report

The First Report contains a statistical error that has apparently led to the Committee to greatly underestimate the level of value adding in the dairy industry.

The dairy industry – Australia’s third largest agricultural industry and the largest processed-food export industry in Australia – adds the greatest absolute and proportional value to farm output of all broad-acre agricultural industries, by a **large margin**.

Farm milk production valued at almost \$3.0 billion is converted into an ex-factory value of production of over \$7.5 billion. Exports of \$2.0 billion represent more than 50% of total milk production and more than 65% of manufactured dairy product output.

This level and proportion of value adding far exceeds the ex-factory value of the wool (approximately \$3.0bn), beef (less than \$6.0 billion), wheat (just over \$6.0 billion) or sugar (approximately \$2.5 billion) industries. The proportion of exports that are value added and highly-value added also far exceeds that of any other food crop.

The First Report, however, asserts (p. xviii) that

Only a small proportion of the dairy industry’s output, for example, is processed beyond the basic milk stage

This view is apparently based on the data in Table 13 of the First Report, which shows (for 1997) that only 8.4% of total cows milk production in Australia was processed into the major primary dairy commodities (butter, cheese, whole milk and skim milk powders).

This estimate is **out by a factor of 10!**

In 1999, 81% of total cows milk production of 10,178 million liters was used for manufacture of the primary dairy commodities (*Dairy Industry in Focus*, ADC pp 12 – 14) and only 19 % was consumed as ‘drinking milk’. Cheese manufacture absorbed 30% of total milk production (not 3% as asserted in the report), SMP/Butter accounted for 27%, WMP 11% and other products (casein/butter, other manufactured products) approximately 13%.

Impediments to value-adding in the dairy industry

In the past decade, since the effective removal of border protection for dairy products, the greatest impediments to value-adding in the dairy industry have been the regulation of prices and production by State governments. As of 1 July, 2000, this regulation has been eliminated. International trade barriers and subsidies, domestic tax regimes which negatively impact on investment and employment and intellectual property regimes which limit the access of Australian industry to innovation opportunities now represent the greatest impediments to investments in value-adding.

Value-adding a limited measure of industry performance

“Value adding” provides a limited and ambiguous benchmark for manufacturing industry performance or the fitness of policies affecting investments and production.

This is because the concept measures simply the difference between output and input prices. It provides a measure of the *unit return* to labour and fixed factors such as capital and land.

It does not, however, provide data that is commensurate across different markets where input and output prices can vary widely for a variety of ineluctable reasons including geographic distance or environment. Worse, the major factors affecting the differences in price levels between roughly comparable and contiguous markets are very likely be differences in regulations that are the subject of the Committee’s investigations. This makes it difficult to use “value adding” unambiguously to assess the appropriateness of a policy.

For example, policies that artificially raise the price of a unit of output or depress the price of a unit of inputs have the effect of increasing unit value added. The effect of the same policies on economic growth or on the investment environment as a whole may be, however, decidedly negative.

This has, in fact, been the case in the dairy industry where price regulations raised value adding in some regions above the levels that could have been sustained by the market and to the ultimate detriment of the industry as a whole.

In accounting terms, too, the concept has little analytical value: it does not measure a firm's profit performance. Although the difference between total revenue and the cost of intermediate inputs is roughly the net revenue per unit of output, many other factors affect profitability notably the cost of capital needed to achieve a level of unit value-added, the level of sales and the commercial risk associated with the value-added market.

State milk price/production regulations

The State-based regulation of drinking milk prices at the farm gate and – up to 1999 at the transport and retail level in some states – produced significant distortions in apparent value-added levels in the Australian dairy industry.

By artificially raising the price of more than half of the milk at the farm gate and the price of all packaged milk, the regulations had the effect of making the value-adding contribution of farm and processor investments – in NSW and Qld in particular - seem much larger than would have been the case under market prices for drinking milk products.

Also, the combination of an artificially high farm-gate price and a quota entitlement system in NSW led to 'surplus' production of milk which was offered as manufacturing milk at prices that appeared to be unsustainable without the 'cross-subsidy' of the high price for 'market milk'. The low offer price for this milk, however, boosted the apparent value-adding performance of the manufacturing industry in that state.

Manufacturing investments in other states were also affected by the price regulations. The performance of investments in much larger-scale production of high-value processed products in Australia's largest dairying regions, Victoria and Tasmania, appeared less attractive and the value-adding performance of manufacturing in those states appeared somewhat lower.

Data compiled by CIE in 1998 (report cited above) showed that the farm sector value-added in NSW, Queensland was significantly higher than in other states due to the price and quota regulations then applying.

In the processing sector, too, NSW enjoyed a significant lead in value-adding on a unit basis due in part to the effect of regulations and in part to the product-mix strategies of the major processors (Dairy-Farmers', NORCO and National Milk) which at that time focussed on the highly processed end of the domestic consumer market.

Australia's largest dairy manufacturers (Bonlac, Murray-Goulburn), located in Victoria, had a product strategy that focussed on primary dairy commodities (milk powders, cheese, butter etc) with lower unit value-added.

It should be noted that both the highly-processed and the primary-commodity strategy were chosen by firms that considered each was a profit-maximising strategy in the market environment in which the firm operated. The level of unit value-added did not – and does not now – determine the profitability of a dairy manufacturing firm or the performance of its capital investments.

International trade barriers and subsidies

To the extent that firms wish to adopt any product mix strategy in the Australian dairy industry, international trade barriers and subsidies are potential impediments.

The primary dairy commodities other than fresh milk – which cannot economically be transported long distances - dominate international dairy trade.

Within the primary dairy product groups, however, there is a range of value-adding due to e.g. the maturation of the product (e.g. cheddars) or the intellectual property attached to the product (e.g. branded cheese products) or to the degree of refinement (e.g. specific characteristics, mixes of milk powders).

Australian exporters now service all of these higher value added markets with high quality mature cheeses, technically demanding high-specification powders and mixes and – by manufacturing under license – global or regionally-branded products. Global food companies, including Nestle, Mars, Kraft, Snow Brand, Meiji, Parmalat have sourced significant volumes of manufactured dairy product from Australia for well over a decade, much of which is in this ‘higher value added’ range where the added value is due to demanding specifications or to intellectual property (including brand).

The competitive price of high-quality milk and the technical efficiency of Australian production offer still greater opportunities for expansion of manufactured dairy exports.

The ADIC believes that the pace of growth of the export dairy industry to 1998 noted in the first report (doubling within a decade) will be exceeded in the decade 1995 to 2005.

The most important barriers to this expansion, however, and to the expansion in the higher value-added end of the primary dairy commodity spectrum are trade barriers in the major export markets of the EU, USA, Japan and, to a lesser extent, in other East and North Asian countries.

The ADIC considers it appalling that after a half-century of GATT trade reform, the world’s largest markets for dairy products – and the WTO’s richest and most powerful members – the USA and the EU allow imports to account for no more than 4 to 5 % of domestic consumption.

Barriers to dairy products in these markets are equal to tariffs of 60 – 200% of the world price. Furthermore, the barriers rise as the level of value adding in the product increases, sometimes more than proportionately to the value added.

Dairy access barriers excessive

Tariff rates in selected markets (%)*

Product	EU	USA	Japan
SMP	99	67	89.9
WMP	102	77.5	153.8
AMF	207	16.6	198.6
Cheddar Cheese	108	74.3	31.5

*Rates for out of quota trade. Specific rates are shown as a % of estimated world price in November 1999

EU and USA export subsidies also inhibit strategies designed to access markets for value added dairy exports by depressing the returns from international markets. Without domestic price regulations or import barriers, international prices are quickly transmitted to Australian prices for final products and for milk at the farm-gate. The use of subsidies by the EU and USA pushes down export market prices for final products and quickly results in lower prices for all milk in Australia – whether the milk is ultimately destined for domestic or export markets, manufacture or drinking milk.

Dairy export subsidies

- EU
 - 1995 – 1.562 bn ecu
 - 1996 - 3.186 bn ecu
- USA
 - 1995 – \$69m
 - 1996 - \$27m
 - 1997 - \$110m
- **Budget for food aid projects supported by
FAO in 1998 ~ \$3bn**

(<http://www.fao.org/UNFAQ/WHATITIS.HTM>)

When the price of the final product is depressed by these subsidies, Australian value adding in constant dollar terms is depressed; first at the ex-factory stage and subsequently as the farm-gate stage.

This is not a theoretical consequence of EU and USA export subsidies: the most severe down-turn in milk prices experienced by Australian dairy farmers in the past decade – 1995/6 – was caused mostly by the subsidy policies employed by the EU and USA in response to supply imbalances arising from market and climatic events in 1994/5.

Although price variations for the final product are inevitable in a market such as dairy where climate and other stochastic factors affect supply balances, they are grossly exaggerated and prolonged by the use of market access barriers and export subsidies in the world's largest dairy producing and consuming regions: EU and USA.

Intellectual property restrictions

There is increasing concern in the dairy industry about the effect of commercial strategies by intellectual property owners on the development of value adding, particularly in the farm sector, but also in the manufacturing sector of the industry.

The Committee has already received some evidence on this issue from the CSIRO (p.75 of the First Report).

Where intellectual property owners – chiefly global corporations – choose not to make their enabling technologies available for licensing in Australia or price the licenses for applications of these technologies in a way that prohibits their use, they may represent a significant barrier to

- the efficient production of higher value added product **and**
- the development of alternative applications of enabling technologies that may be appropriate to Australian dairying conditions

These barriers are already apparent in some areas such as the development of specific applications of genetic technologies for better pasture and soil management under Australian conditions. ADIC believes that some corporations that own relevant patents – including patents on the actual biological processes that occur in natural pasture plants – have used their monopoly rights to inhibit the economic development of collateral knowledge and technologies in Australia e.g. by CSIRO.

Patent rights are created by law to offer a **balance** between the property interests of inventors and the interests of the public in the expansion of scientific knowledge and progress in the use of technology. It would be unacceptable, in ADIC's view, that the rights of patent owners should be allowed to supervene the public interest in the better management of pastures and soil or improved farm productivity and animal welfare.

Taxation issues

Important issues affecting the dairy industry are

1. **Depreciation schedules** for dairy farm and dairy processing equipment. It is essential that depreciation schedules allow dairy farmers and manufacturers to replace capital equipment on a basis that will allow them to remain competitive with international competitors
2. **Capital gains tax** on dairy investments must be competitive with international investment opportunities

Research and development incentives

The Dairy industry and firms in the industry devote significant resources to R&D. Dairy farmers are levied to support a contribution of approximately \$14 million to the Dairy Research and Development Corporation, amounting to approximately 0.5% of the gross value of production.

In order to remain globally competitive in a marketplace dominated by firms whose dairy foods divisions alone are twice to ten-times the size of Australia's largest dairy cooperatives, it is essential that the industry collectively and firms individually continue the research and development effort.

The 'public good' R&D effort supported by the Industry offers a key underpinning for all dairy research in Australia by leveraging other State, University and private research efforts to support basic and applied research into improvements in sustainable production and world-class manufacturing.

The reduction of the R&D tax concession undermined the attractiveness of these investments for the firms in the industry, however, making the choice for R&D expenditure more difficult for the farmer cooperatives, in particular, whose shareholders are already taxed for industry R&D efforts.

It would be disastrous, however, if the Federal matching funds for the industry R&D effort were limited in any way in the future. As Australia's largest processed food export industry, Dairy returns billions of export dollars every year to the economy: any diminution of its R&D underpinnings would harm that unique value.

Microeconomic reform

The Dairy industry has benefited from many phases of the microeconomic reform efforts of past decades: the reductions in tariffs, the gradual improvements in the enforcement of national competition principles and the promise of continued creation, liberalisation and reform of national markets for transport, energy and water resources.

There is still much progress to be made, however, in national energy markets and the economically efficient and fair use and pricing of water.

Furthermore, the slow pace of reform of quarantine regulations and policies that have effectively created protected 'niche' markets for a number of food products (chicken meat, pork, salmon, fresh fruits) continues to cause concern to the export industry. The trading partners most affected by these regulations are those on whose markets the Dairy industry most relies.

It is essential that Australian policies and regulations conform scrupulously to the rules of the WTO and, in addition, that wherever possible Australian policies accommodate the needs and interests of these countries in supplying Australian markets beyond the bare obligations that we have under WTO treaties. Because the alternative is inevitable difficulty and eventually retaliation in our Asian export markets against products such as dairy.