Professor Ian J Lean

www.sbscibus.com.au

SBS cibus

30th September, 2009

A brief Response to the Senate Committee Regarding the Pricing of Milk from Dairy Farms: Especial reference to Tasmanian whole milk suppliers to National Foods

Personal Background

1. I have a long standing interest and publications on the profitability of dairy production. I consult to farmers and corporations nationally and internationally and am a graduate veterinarian. I am a past president of the Australian Association of Cattle Veterinarians and the Cattle Chapter of the Australian College of Veterinary Scientists. I have been on faculty at Universities of California and the University of Sydney and completed my PhD in 1990 at University of California in with majors in Nutrition and Epidemiology. I am a registered specialist in Medicine and Management of Cattle, have over 200 scientific articles in international scientific journals and am an Adjunct Professor in Veterinary Clinical Studies with the University of Sydney. I have acted on the scientific boards of three international companies and was awarded in 2009 the Gilruth Prize, the Australian veterinary professions highest honour.

2. I apologize for the brief nature of this response. It reflects the very limited time available to prepare this document. Similarly, I have not had sufficient opportunity to thoroughly reference this document.

Industry Background

3. The price paid for dairy products reflects two distinct market entities – the internal market for dairy products (milk, yoghurts, flavoured milk products etc) and the external or export market dominated by sale of milk powders, butter and cheese.

4. Milk for the internal market is ideally of highest quality; changes in the organoleptic qualities influence product quality and consumer acceptance. Dairy farmers that provide a more even, ie less seasonal, calving pattern are more capable of producing milk that fits these needs. Inevitably, these producers feed grains, byproducts and conserved grass (either hay or silage) because grass growth is seasonal, even with the use of irrigation. The costs of producing milk all year round are higher in cents per litre than a strictly seasonal pattern.

The latter does not ensure, though, that such producers are less profitable, as these often produce more milk than seasonal suppliers. It does ensure that they need a higher underlying price for milk than seasonal suppliers to remain profitable.

5. The price received for milk by processors for the external market is, in general, much less predictable than for the internal market as the major products sold are sold largely as commodities on the corrupted, that is subsidized, international market. Therefore, market signals do not, necessarily, reflect the costs of production of product.

6. Australia has a highly concentrated internal market for agricultural products. Coles and Woolworths have an approximately 80% market share. This concentration of purchasing power has been used to reduce returns to farmers (In an Interview of Roger Corbett, Woolworths reported in the Australian newspaper (March 3, 2003), Corbett noted that he had transferred $500 million per annum of income from dairy farmers in Australia to Woolworths; This interview was subsequent to deregulation of the milk market and following the establishment of the Woolworths home brand milk).

7. In my view, this unique oligoscopy of Supermarket ownership results in a disproportionate position in regard to negotiation for supply of milk. In the US and UK there is a far more diverse internal market for whole milk.

8. There has also been a reduction in the number of milk companies. This limits the number of companies to which farmers can supply. The relatively low number of potential buyers places dairy farmers at a very substantial disadvantage in negotiation.

9. Milk prices have regularly dropped well below the average costs of production in most markets in Australia during the last 10 years and have been subject to a number of State Government enquiries.

Key Points

10. The combination of limited numbers of processors competing for milk and concentration of buying power in Coles and Woolworths places Australian dairy producers in an extremely disadvantaged position.

11. There is no equity of scale of enterprise in the negotiations on milk pricing between dairy farmers and milk processors.

12. The economic cycles that determine supply and demand reflect international production pressures and a corrupted market. While the long term trends for milk production, and probably price, are positive, these will remain volatile and determine export pricing. The export prices, in turn, are used, to a large degree, to determine internal pricing by dairy companies and supermarkets.

13. Prices for milk, therefore, do not reflect costs of production which are determined by natural cycles (weather), the biological constraints of cattle and costs of key inputs (fertilisers, other feeds and labour).

14. The biological cycle of cattle is i) annual – reflecting the average lactation length of a cows (approximately 305 days) and a need for the cow to rest before calving again (dry period, approximately 60 days). ii) Approximately, tri-annual, a period reflecting the time between getting a cow pregnant and that calf entering the herd as a calving cow.

15. Decisions to increase production by increasing stocking numbers require, therefore, either considerable investment and biological risk (disease introduction) from purchase of cattle, or extended periods of investment in growing cattle before these enter the herds.

16. Therefore, farmers deciding to respond to positive signals sent by dairy companies who encourage them to produce, face significant risks – i) invest in extra cattle, incurring debt or expending capital, and risk of disease entry, or ii) increase inventory ie grow more heifer calves, thereby incurring increased costs on the basis of future potential returns from an expanded enterprise.

17. A lack of knowledge of future markets makes these decisions, inherently much more risky. Given, that the value of milk has dropped, regularly in recent years, well below costs of production.

Matters Pertaining to the Tasmanian Situation

18. Farmers negotiating contracts in Tasmania had, to the best of my knowledge, no certainty of the price that they were receiving while producing in July this year (2009), let alone an estimate of milk values consistent with the longer biological cycles 12 months hence or 3 years hence.

19. I received very clear confirmation from two milk suppliers that they had been encouraged to increase milk production in 2008 and 2009 by National Foods personnel.

20. Both these producers were confident that while price was anticipated to fall, there would be no major fall in pricing and prices would be maintained well above costs of production.

21. Both these producers made decisions that were consistent with the positive signals given. One (Charles and Richard Bignell) increased the herd size and invested ~~approximately~~ substantially ~~$500,000~~ in new facilities. The other (Styx River Farm) increased herd size and adjusted their calving pattern to better suit the requirements of National Foods for winter dominant milk production, after detailed discussion with National Foods. The latter decisions were extremely expensive and only undertaken, according to the farmers, after discussion with National Foods personnel.

22. A key concern was the extremely late negotiation of contracts with National Dairies. Dairy farmers were in no position to negotiate with other dairy manufacturers or plan for what was a profound drop in price.

23. It is simply not possible to turn cows off – they still need feeding. Sale of cattle into markets in which large numbers of farmers are selling cows can result in substantial economic losses and, due to the biological cycles limit the potential to produce if prices improve in the future. Therefore, the options for the farmers are very limited to respond to extremely precipitous falls in milk pricing, such as that in Tasmania this year.

24. The combination of encouragement to expand and the profound drop in milk price would place almost any producers in a precarious financial position.

Suggestions to address the high level of financial risk to dairy producers

25. I present three options for consideration in order to reduce the risk to dairy producers from financially damaging impacts of milk pricing.

26. Allow producers who are supplying milk for internal supply, that is inherently more expensive to supply, to negotiate milk pricing based on being priced above or, minimally, equal to the cost of production of milk produced by export milk producers on an annual basis. Therefore, if external markets drop below costs of production for a prolonged period, the more expensively produced internal market is buffered, allowing Australia to maintain a basal level of milk production to meet internal needs.

27. The suggestion presented in (25), maintains an effect of exposing producers to international market pressures, but recognizes the challenges of producing milk of higher quality and the value of maintaining a dairy industry. It also recognises the disparity in negotiating power between the dairy farmers and milk companies. Further, it recognizes that milk prices in the supermarket are not closely linked to fluctuations in farm gate pricing.

28. Protection for the milk companies in negotiation with the Supermarkets will need to be considered, as a flow on effect of (25). Otherwise, companies largely collecting milk for export could use the lower price of milk for export to gain supermarket share.

29. This suggestion has some similarity to the 'Tesco model' developed in the UK, where analysis of the costs of production by independent auditors has resulted in a higher price to milk producers.

30. Suggestion II: Establish a rolling average system to reduce spiking in the market, either up or down. While this will reduce potential for 'windfall profit', this is difficult to achieve in dairy systems due to the underlying biology (see above). More importantly, it may act to reduce the effect of profound drops in milk value observed in the last 12 months. Again, this

suggestion will need to be related to protection for the milk processors involved in their positioning as largely 'internal suppliers of milk products', rather than whole milk suppliers.

31. Suggestion III. Allow for parity in negotiation – large farmer groups that will have sufficient milk under control are essential to provide some degree of parity. Terms of negotiation need to ensure that there is sufficient lag time for fair negotiation.