# SUBMISSION BY FARMER POWER TO THE PRODUCTIVITY COMMISSION COMMENTS ON THE INTERIM REPORT INTO DAIRY PRODUCT MANUFACTURING

## Overview

The following comments are submitted by Farmer Power, with the aim of representing the interests of Australian dairy farmers. As an initial comment we note that there has to date been no consultation with dairy farmers in the preparation of the Interim Report, and we would be willing to assist the Commission by facilitating such consultations before the final report is produced. The various industry bodies which have been consulted by the Productivity Commission are not correctly representing the views of many farmers in our view, and as a result farmers are withdrawing from membership of these bodies – this is why Farmer Power has been formed. We have a particularly strong membership amongst dairy farmers. We have separately called on the Minister for Agriculture to overhaul the structure and funding of the various dairy industry bodies because of the persistent concerns by farmers that they are not representing grass root views.

A further preliminary comment is that the Productivity Commission has correctly observed the critical role of dairy farmers in contributing to an efficient and profitable dairy manufacturing industry in Australia. However because of the limited input by farmers, some of the Commission's observations are not well informed in terms of the current obstacles to farm productivity, which has led to the alarming decrease in milk production and the exit of farmers from the industry (23,000) dairy farmers in the 1990's to 6,000 today, milk production has also dropped form 11billion lts to 8billion lts). As farmers we do not attribute this to deregulation per say, nor to periodic drought and flood events, as our industry has been through drought and floods before without seeing such a dramatic drop in farmers and production, but the focus being taken of profitability at the farm gate. This is explained in some detail below, together with potential strategies for addressing this decline.

The consequence of falling milk supply for manufacturing industry is that huge capital investments are currently being made by manufacturers on the assumption that milk supply will increase in the future.
The potential strategies that could be applied by industry or government to build future supply are not correctly identified or applied. The result is an increasing squeeze on falling milk supply that is already evident, which may lead to a failure by manufacturers to obtain the required returns on their capital investments. Falling profitability will continue the cycle of falling capacity to pay a viable farmgate milk price.

Farmgate milk price is of course the primary concern for dairy farmers, who fully recognize the relationship with world prices for dairy products. Here we would point to the significant restrictive practices within the Australian dairy industry which have not been recognized in the Productivity Commission's interim report. The priorities of dairy processors have been to peg farmgate milk price as low as possible, in order to protect their profit margins. Such action may prove to be a misguided strategy in the long term as it is a major contributing factor to falling milk supply. There are also signs that the artificially depressed farmgate milk price (which is NOT following world milk prices) will be seen as a commercial opportunity by new industry investors, potentially leading to a destabilizing price correction. While this would offer some immediate relief to farmers, preventing some foreclosures, price instability does not provide farmers with the long term confidence for them to build their herds and to invest in their farm capital.

We have structured the following comments in terms of a summary response to the relevant information requests, and a more detailed response to the observations made in the different sections of the interim report. We would be pleased to provide further information or clarification as necessary to assist the Commission in finalizing its report.

## Summary Response to Information Requests

*Information Request 3.3: Is the volume and seasonal variability of Australia's raw milk supply constraining dairy manufacturers from achieving economies of scale and/or optimal asset utilisation? What are the major impediments to increasing raw milk supply, or achieving more consistent raw milk output year-round? To what extent can supply agreements (including contracts) between farmers and manufacturers overcome these issues?*

We have made some detailed comments relating to seasonality of production in the sections below. However we see the major constraint to dairy manufacturing efficiency and asset utilisation as falling raw milk supply. The major impediments to building supply are (i) a farm gate milk pricing which does not provide a viable foundation for farm operations, and (ii) a lack of confidence by farmers in future farm profitability.

We have made detailed observations on the nature of supply agreements in our submission to the Government's White Paper on Agricultural Competitiveness. We believe that the Productivity Commission has not been provided with accurate information about the nature of these agreements. What justification can there be for a manufacturer to pay a farmer only 80-90% of the payments due for his or her milk, when a farm is operating on earnings of only around 10% of sales (sometimes less), and then withholding the balance of the payments if the farmer does not continue to sell milk to the same manufacturer?

In any one locality there is very limited choice for farmers in how to direct their supplies, and it is likely that the few dairy manufacturers benchmark their prices to one another even if there is no active collusion. Increasing demands for confidentiality agreements on the part of the manufacturers prevent farmers from comparing prices, but when they do they find that different farms are being paid different prices for their milk by the same manufacturer in the same locality with no clear rationale. There is clear evidence that farmgate milk price has fallen at the same time as world dairy prices have risen, and that exchange rate movements have favored a price increase. It would be interesting to graph dairy farmer incomes (reported by Dairy Australia, with a large proportion of farmers reporting negative income) against the gross earnings of dairy manufacturers. A change in the nature of supply agreements could have a very positive influence on the long term viability of the dairy manufacturing industry. This change is also well justified in terms of removing any opportunity for restrictive practice and enabling a deregulated market to operate as it should.

*Information Request 4.2: Is access to capital — financial and physical — a problem for dairy manufacturers or dairy farmers? If so, what are the reasons for this?*

Access to low interest finance that can reduce debt financing is essential to keep farmers in business. This can then provide a platform for rebuilding the industry, including attracting new farmers to replace those who are retiring. One major processor is charging it suppliers who have borrowed against their shareholding interest rates as high as 11%, and shareholders wishing to cash their shares have to wait up to 5 years before being paid out.

*Information Request 4.6: What are the costs and benefits of, and potential reforms to: dairy food safety regulations? Other regulatory standards affecting the dairy industry?*

Dairy farmers fully appreciate the need for stringent food safety standards, and have demonstrated excellent performance in this regard. One of the factors that contributes to the disempowerment of farmers in negotiating a fair price for their milk is regulation that effectively prevents dairy farmers from selling their milk directly to consumers. It is noted that in the EU, New Zealand and increasingly parts of the USA, raw milk sales by farmers are permitted subject to a farm food safety plan, using approved storage and dispensing equipment. It is ironical that the Australia-New Zealand Food Standard that prevents raw milk sales in Australia does not apply to New Zealand. Requests from Farmer Power that

the recent review of restrictions on raw milk sale be extended from its limited focus on cheese manufacture have been ignored. In effect Food Standards agencies are enforcing a prescriptive practice without regard for alternative ways of achieving food safety performance. Like Dairy Australia the funding of food safety is funded by Government and Farmers, NO CONTRIBUTION from processors.

There would be other ways for farmers to be empowered to sell directly to the public, to establish a competitive basis for farmgate pricing. While the currently approved processes for pasteurization are not within the reach of most dairy farmers, there are alternative methods of sterilizing milk which could be developed and approved if there was a will in the industry to do so. Some of these would offer health advantages, as factory pasteurization is often carried out for long haul, ie applying sterilization practices that are unnecessary for localized supply chains. Alternative technologies include high pressure treatment, pulsed electric field pasteurization and ultraviolet pasteurization as examples. Some of these treatments could be combined with evaporation and on farm water capture, to reduce transport costs, processing costs and farm water demands, for example where milk is destined for powder production. The lack of research into these technologies and the lack of regulatory reform to enable their application reflects the way that industry and research is dominated by the vested interests of dairy manufacturers, even where this does not support the efficiency of the dairy industry as a whole.

*Information Request 4.7: To what extent do policies such as drought assistance, or taxation and superannuation arrangements, discourage farm exit or amalgamation? Can participants identify examples of such policies? If so, how could these impacts be alleviated?*

Anything that can alleviate the current financial stress faced by dairy farmers may help retain farmers in business for the short term. However in the long term much more can be done through restructuring the industry and this is essential if the trend to declining milk supply is to be reversed. It should be noted that some of the current financial stress amongst dairy farmers results from their past investment in drought proofing, including pasture adaptation. They were encouraged to do this before the current anti-competitive pricing regimes emerged. If farmgate milk prices had subsequently followed the broader dairy market, there would be less difficulty in managing this inherited farm debt. It should also be noted that bigger is not always better. As farmer become bigger it is the dairy cows that carry this burden by being forced to walk longer distances in order to reach pasture, this has led to a break down in cow heath which has been shown to be the case in New Zealand. Farms in New Zealand that have gone to once a day milking have seen a marked improvement in animal heath as a result of cows not having to walk long distances twice a day.

*Information Request 4.8: How does research and development (R&D) in the dairy industry affect costs for dairy farmers and dairy product manufacturers? Is there scope for improving arrangements for R&D in the industry?*

Dairy farmers are concerned that they have insufficient influence over the priorities of the industry bodies which set the research agenda. As a result there is a huge amount of research carried out, much of it paid for by a compulsory levy on farmers ( DA Levy), which has negligible or marginal benefit for farmers. It is clear that there are areas of research that would have significant benefit to farmers (such as those referred to under 4.6 above, and others referred to below) which are not being addressed.

*Information Request 4.9: Are there other factors affecting the performance and competitiveness of the Australian dairy industry, such as policy inconsistencies across jurisdictions? Are there lessons to be learned from the policy settings in other countries?*

We repeat our comments made to the Minister in our submission to the White Paper on Agricultural Competitiveness as follows. We call for an overhaul of the structure of the various industry bodies that should be representing the interests of farmers as well as dairy manufacturers. There is widespread dissatisfaction amongst farmers in their performance, and we believe that the Government should also be concerned about the poor value for money it is receiving from its investment in these bodies.

The farmers peak lobbying body is being funded in part by the processors who pay in excess of $1.2 million out of profits which is compulsory unionism, money that was being paid to the farmers, this change happened without any consultation with the farmers.

Following deregulation, dairy farmers were obliged to contribute to the operational costs of the peak industry body Dairy Australia. These payments are deducted by the milk processors from the payments made to farmers for their milk. Farmer contributions to Dairy Australia amount to over $30M per year, with the Australian Government making an annual contribution of around $19M. The levy made by a typical farm is around $5-7,000 per annum, which may exceed the personal incomes of some struggling farmers. Effectively it has become a tax rather than a levy.

Farmer Power believes, based on the views of its members that an independent review of Dairy Australia is long overdue in order to determine if Government and Farmers are getting value for their investment.

It is noted that:

- dairy processors do not contribute to the operational costs of Dairy Australia but they are over-represented on the board.

- Dairy Australia's constitution is such that the dairy processors (Australian and international) and major industry bodies control the selection of all board members.

- Dairy Australia activities do not serve the interests of farmers as none of its research activities have addressed the key concerns of farmers about farm gate price, direct sale to consumers or the elimination of restrictive industry practices.

- Dairy Australia does not accurately describe the state of the Australian dairy industry in its reports to Government, so that the Australian Government receives poor returns for its significant investment.

- farmers have the right to disapprove proposed increases in the levy to Dairy Australia (by way of its constitution), and did so in 2012, but this has been met by a proposed change to the levy setting mechanism by Dairy Australia with a view to securing the planned increase in its funding

- A review of Dairy Australia conducted in 2012 was claimed to be "independent" but was internally commissioned and controlled, and conducted by personnel who have close ties with Dairy Australia. Farmers had very limited input to this review.

Further levies are collected from farmers through the State based farmer organisations. Farmer Power members acknowledge the good work done by the South Australian Dairy Farmers' Association in establishing a new direct retail outlet for farmers. Levies for membership of the State bodies could cost a typical farmer around $2,000 pa and unlike the Dairy Australia levy, the State based levy is not compulsory. As payments are made by the manufacturers through a levy on the farm gate milk price, many farmers do not realise their membership could be withdrawn. Nevertheless the fact that farmers feel that their membership is not producing any value has resulted in a situation where some farmers have now left the organisation, and others are likely to follow.

An example of industry bodies acting outside farmers' interests is illustrated by the recent lobbying by both Dairy Australia and the United Dairy Farmers of Victoria in relation to the potential takeover of Warrnambool Cheese and Butter. This has unfortunately been reflected in the Productivity Commission interim report. Support was given by these industry bodies to the Murray Goulburn Co-operative, despite the very evident feeling of many dairy farmers that this would not be in their best interests. Many of

Farmer Power's members are concerned that an expanded Murray Goulburn would have been able to put further downward pressure on milk prices, and point to the company's past record in that regard. There were also concerns about Murray Goulburn's debt levels (now and following any takeover) and how this would impact on the company's ability to pay farmers a fair price. This could have led to a complete collapse of the company, following the path previously taken by Bonlac in over-reaching in its revenue raising. Farmer Power issued a press release urging the industry bodies to keep out of the takeover debate as it was in the interest of farmers to have greater competition for their milk.

## Comments on the Findings of the Interim Report

*Preliminary Observations*

*The Commission's preliminary assessment is that Australian dairy product manufacturers face some cost disadvantages relative to their competitors, but also some relative advantages (including lower raw milk costs). Some cost disadvantages arise from inefficient policies where corrective action by governments could be warranted, but others simply reflect market conditions where policy interventions are not warranted. A major constraint on dairy product manufacturing appears to be raw milk supply, but the commerciality of increasing milk production is primarily a matter for manufacturers and dairy farmers.*

The way that the industry has been structured provides a severe competitive disadvantage to farmers in their dealing with manufacturers. This situation is an indirect result of government policy following deregulation, and it requires government intervention to correct the situation. Without such action it is likely that the industry will collapse completely as a result of continuing decline in milk production.

*Australian farmgate milk prices have generally been lower than those in the United Kingdom and United States (and broadly on par with those in New Zealand) (figure 2), largely due to the absence of price support mechanisms for raw milk and relatively low on-farm production costs in key dairy regions (owing to natural climatic advantages and pasture-based feeding).*

In recent years Australian farmgate milk prices have been significantly lower than those in New Zealand, largely because of the greater farmer shareholder influence within Fonterra and the price formula linking to world dairy prices. The much more favorable farm gate price coupled with slightly lower production costs (less fodder costs because of climatic factors providing all year pasture) has led to New Zealand milk production doubling over the same time that Australian milk production has fallen significantly. We would suggest that the Commission should assess what are the key factors explaining this marked difference, which is of critical importance for Australian dairy manufacturing. Australia's declining milk supply should be seen as a demonstration of failed public policy, in comparison with the New Zealand situation.

Low on-farm production costs in Australia can now largely be attributed to subsidized labor, as Australian farmers have been forced to lay off hired labor and to work long hours of unpaid overtime. This is not sustainable in the short or long term. On current trends Australia will become a net milk importer within ten years, and its manufacturing sector will disappear completely as domestic supply is directed to the fresh milk market. Other contributing costs such as fodder, power and fuel are increasing sharply, putting further pressure on farmers to cut corners (see below for impact on herd numbers).

Figure 2 showing trends in farmgate milk price for different countries clearly illustrates how the position of Australian dairy farmers has sharply declined in recent years, and is continuing on a downward trajectory, just at a time when world prices for dairy products are increasing. We would suggest that interpretation of this graphic should be reflected in the report's commentary.

*Raw milk volumes and seasonal variability may be limiting manufacturers' ability to achieve scale efficiencies and better asset utilisation.*

Seasonal fluctuations in milk supply are worsening as a result of the pressure on farmers. For example in south-west Victoria there used to be a complementary fluctuation in production north of the highway and south of the highway as a result of different rainfall and groundwater conditions. This has now disappeared as much of the land north of the highway has fallen out of production (farmers quitting the business). In all areas farmers are likely to keep any supplementary feeding to a minimum if their earnings are negative (a situation which applies to around 25% of farmers in some areas, with some farmers unable to put bread on the table for their families).

*Raw milk output has declined since 2001, partly because of drought and despite strong productivity growth. Substantial restructuring (and relocation) in the farm sector in the period following deregulation may also have contributed. Dairy manufacturers are responding by offering farmgate price incentives for 'new' milk, entering into co-investment schemes with dairy farmers (underpinned by longer-term supply agreements) and seeking third-party capital investment.*

These comments reflect a lack of understanding of what is actually happening. Dairy manufacturers are not responding in a way which creates incentives for herd expansion. Some of the "co-investment" arrangements consist of loans to farmers at rates well above conventional bank lending rates with security taken out against farmer shareholdings, and are seen as a virtual feudal system for increasing farm indebtedness to manufacturers.

Any potential new entrants to the dairy industry, from within or outside Australia, are likely to offer much improved terms to farmers for long term milk supply in order to secure a share of the market. This could result in a major pricing shake up which will threaten the viability of even the larger dairy manufacturers, particularly in a situation where they have borrowed heavily to invest in new plant on the assumption that they will increase their own share of raw milk supply. Such a shakeup is an inevitable consequence of the artificial suppression of farmgate milk price over the past few years, but it may come too late to stop farmers from quitting the industry. This could have been avoided if there were long term strategies in place to encourage farmers to increase milk supply, including a stable price regime linked to world price and set at a point which provided a viable framework for farm operations. The Dairy Industry has no long term planning for the future direction of the industry.

*Most costs incurred by dairy product manufacturers (including raw milk costs) and dairy farmers are largely driven by their commercial decisions and market factors. Dairy manufacturers and farmers have little choice but to adapt to market conditions.*

Market conditions can operate effectively when all participants have access to relevant information and where there is an ability to negotiate over price. Dairy farmers understand that they have to adapt to market conditions. their livelihoods. In an effective market it would be supposed that this situation would Instead dwindling milk supplies are encouraging processors to lower their prices further, so that they can return the same level of profits to their shareholders even with reduced outputs (as illustrated by recently reported company profits). There is a notable absence of long term strategic planning for increased milk supply, and instead we can see increasing dysfunction as manufacturers seek to tighten their grip on their own shares of the raw milk market.

*Removing inefficient policies that advantage particular firms or industries at the expense of the rest of the economy (including dairy product manufacturers and dairy farmers) would have community-wide benefits.*

This is agreed, and Farmer Power would endorse a return to a level playing field for all industry participants.

*Good policy outcomes depend on good policy processes. A key feature of 'best practice' regulatory process is to ensure that unnecessary regulations are not introduced in the first place. The expected benefits and costs of significant regulatory reforms must be assessed to avoid imposing unnecessary burdens on all businesses, including dairy product manufacturers and dairy farmers.*

Farmer Power is calling for regulatory reform based on good policy, including long term planning for halting the decline in milk supply (currently running at 9% annual decline in some key production areas, and 3.5% per annum nationally).

*Businesses are reducing excess capacity (and associated costs) through plant rationalization, and diverting resources toward producing higher value dairy products (in place of basic commodities).*

It is most unfortunate that current analysis of production types does not distinguish between production of WMP/SMP and infant formula. It is clear to those in the Australian dairy industry that there is a massive shift of resources into production of infant formula, involving significant capital investment, fuelled by increasing demand in China and other parts of Asia. The profit returns from infant formula can be 3-5 times those from WMP/SMP with only modest increases in input costs. However this trend is high risk. Importing countries have different specifications for infant formula, all highly demanding for quality control, and these can be subject to change without notice. Export supplies can be turned back at port, and there is already experience of warehouses being filled with rejected cans of infant formula, originally intended for sale at $12-20 per 900gm can but subsequently worth around $2 per can as animal fodder. We are surprised that there is no strategic monitoring of this highly risky scenario, which risks industry viability.

Even if such risks can be avoided, the increasing focus on this highly specialized market (in which New Zealand is a major player and able to exert market influence) is leading to reduced production of cheese – a product in which Australia has originally had some competitive advantage. Cheese plants are being put out of production, and the closed shop modus operandum is resulting in expensive plant and equipment being cut up and sold for scrap rather than being sold to alternative (and willing) producers. This represents a massive waste of production capacity.

We point to these industry dynamics but we are doubtful whether there is a role for government in directing what products should be the focus for Australian dairy manufacturers apart from accurate analysis of market trends and risks (a role for which Dairy Australia is paid but in which we consider it fails to perform). A greater concern for government should be the overall loss of production capacity being caused by falling milk production, just at a time when global market conditions should be encouraging increased production. Production increases are being achieved not only in New Zealand but also in the EU, Canada, the US and Brazil in response to world demand and price.

*Some farmers and manufacturers have shifted toward greater mechanization, reducing reliance on land and labor. Farmgate price incentives and co-investment schemes are increasingly being used to encourage on-farm investment and increased raw milk supply.*

We suspect that this reflects rhetoric rather than reality. The various industry bodies have consistently reported over the past few years that declines in milk supply are being halted, and have set optimistic targets for increased supply. However no realistic strategies have been put in place and targets are missed year after year. Unfortunately there does not seem to be any accountability for these failings.

To understand how strategies could be formulated, it is necessary to understand the realities of herd management.

Cows come into heat at around 13 months of age and are bred by artificial insemination or running with a bull (many farms practicing a combination of both). The gestation period is around nine months. However not all cows will become pregnant at first attempt, and the average age for first calving is two years. Farmers are advised to test all cows for pregnancy as early as possible so that the breeding process can be repeated, and so that diet and milking regimes are adjusted appropriately. This has the potential to

slightly reduce the average age of first calving however declining cow fertility is an issue for the industry as a whole. Cows having their second or subsequent calves continue to be milked during the first few months of pregnancy, but are dried off for around six weeks before giving birth.

Cows tend to produce less milk after they reach six years of age. If they are under short term financial pressure, some farms may cull as much as 30% of their herds each year, despite the fact that this reduces the lifelong returns on the investment of rearing cows in the initial years. Clearly a low farm gate milk price necessitates aggressive culling rates to enable farm survival, and at this maximum culling rate herd size will contract. However in better times farms manage to maintain a productive life of their cows up to ten years of age, and given a better rate of return for their milk there would be incentives to do this, to maximise the volume of production rather than the rate of return on immediate input costs.

If the culling rates can be contained to around 15% per year, involving extending the average life of cows from six years to eight years, then it would theoretically be possible to increase herds by 25% per annum after the first couple of years. However a more modest increase of 10% per annum may be more readily achievable, perhaps increasing milk production by around 1billion litres per year after the initial few years of restoring confidence and financial capacity. It should be noted that the plant expansions already committed by the major processors would readily soak up this increased production. Without such a turnaround the production plants will not be able to operate as planned.

*Scale is important but not the whole story. For manufacturers, the potential benefits from consolidating manufacturing plants need to be weighed against offsetting costs, including additional transport and storage costs. Where the Australian dairy product manufacturing industry continues to compete in global markets, greater consolidation of the industry reflecting commercial considerations should offer potential for scale-based economic gains and wider community benefits.*

The advantages of consolidation need to be weighed against the risks of further monopolization of milk supply in any given locality, and the unfortunate downward pressure this puts on the farmgate milk price. We agree that scale is not the whole story, and product diversification is an issue that needs consideration to manage industry risks. There is much scope for product innovation which is being lost as the major manufacturers focus more on those product lines that have greatest short term profitability, and prevent new industry entrants for fear of losing their dwindling share of milk supply.

*While the focus of this study is on dairy product manufacturing, the performance of this industry is inextricably linked to, and dependent on, activities and outcomes in upstream and downstream sectors. For this reason, where it is relevant, other elements of the dairy industry supply chain will also be examined by the Commission.*

We welcome the Commission's recognition of the critical importance of on farm production. Clearly without a halt to the decline in milk production on farm there will be no dairy manufacturing industry in Australia.

## About the Study

*The Commission has consulted as widely as possible given the compressed timetable for this study. The Commission released an issues paper on 11 April 2014 and met with a range of participants including dairy manufacturers, industry bodies, regulators and government departments.*

The appended list of consultations and submissions clarifies the lack of farmer input, and Farmer Power would like to work with the Commission in correcting this omission.

## Snapshot of the Australian Dairy Product Manufacturing Industry

*Year-round raw milk production generally entails higher feed costs (as pasture availability is affected by seasonal conditions, so reliance on purchased feed increases). This generally means that manufacturers must pay higher raw milk prices, all else equal, to meet domestic consumers' demand for fresh dairy products. Manufacturers may also encourage a 'flatter' raw milk supply where the benefits (such as better asset utilisation and scale economies) outweigh the associated costs.*

Farmers could invest in production regimes that flatten the supply curve if there were incentives to do so, but this is not possible under the current pricing regime.

*In the 1990s, the Australian Government began phasing out these market support arrangements. A review of Victoria's market milk regulations in the late 1990s found evidence of a negative net public benefit, and the Victorian Government subsequently decided to dismantle the regulations. The other states subsequently agreed to do the same. Since 1 July 2000, Australian milk prices have been set by market forces, not government regulations.*

We assert that Australian milk prices are not set by market forces.

*There has been a long-term trend toward fewer but larger (and more productive) dairy farms in Australia. Since deregulation in 2000 to 2012-13: Farm numbers have declined from about 13 000 to 6400 (figure 2.2). Structural change has been particularly pronounced in Queensland and Western Australia; farm numbers declined by 29 per cent and 28 per cent respectively between 2006-07 and 2012-13 (compared to an 8 per cent decline in the number of Tasmanian dairy farms over the same period) (calculations based on Dairy Australia 2013b). Average herd size has steadily increased, from about 170 cows per farm to 258 cows per farm (Dairy Australia 2013b). Annual milk yield per cow has increased from around 4800 litres to 5400 litres (ABARE 2013a).*

Observations such as those made by Dairy Australia and other industry bodies that Australian dairy farmers are becoming more productive because of higher yield per cow are highly misleading. If this is based on a snapshot measurement then the measured improvement in milk yield per cow in any given year could be because:

- older cows are being culled early to save on short term costs, exacerbating herd reductions and falling milk supply, or

- only the most productive farms, ie: those with optimal pasture and climatic conditions, are managing to survive and much slightly less productive dairy country is being lost to farming, also exacerbating the milk shortage.

A strategy that aims to maximise production volume per cow would ultimately lead to the number of farms progressively being reduced to one, ie: the most efficient. A strategy that aims to increase milk supply, and which measures productivity in terms of whole-of-lifespan for the cow, would be quite different.

There are many potential strategies that could be advocated and easily implemented for increasing milk supply. The fact that these are not put forward to government by the industry bodies is one more illustration of how remote they have become from the realities of dairy farming. As just one example, pregnancy testing is a critical measure for ensuring herd growth as quickly as possible, but the cost of this testing has grown to the point at which a cash strapped farmer may choose not to do this if there are other more pressing bills to pay (the one-off cost of pregnancy testing could represent 10% or more of net annual earnings). If dairy manufacturers paid for pregnancy testing amongst their suppliers this would be a very minor cost to them, and one which would help secure their milk supplies for the future. This would

be a genuine loyalty program, as opposed to the punitive withholding of payments that carry the guise of loyalty incentives at present.

*Only 3 per cent of farms followed a corporate farm model, in which shareholders (as opposed to the operator) own the business, and management is carried out through a board of directors.*

Dairy Australia and other industry bodies have produced some reports that purport to propose strategies for building a sustainable dairy industry into the future. Examination of Dairy Australia's Sustainability Strategy and the "Glass Half Full" report prepared by Westvic Dairy will indicate the lack of practical suggestions put forward to date. These reports glibly suggest that the decline trend is already being reversed through a process of farm amalgamation and corporatisation. It is clear to those on the ground that this is far from the case and it easy to understand why. There are two main factors:

- corporate farms fold as soon as their earnings are insufficient to pay wages for their workers, whereas family farmers will provide free labour for a while to see through the hard times – there is much potential dairy country that is now out of production as a result of a succession of failed corporate farming ventures

- Some larger family farms have resulted from farmers going out of business, selling their land and cows to adjacent farmers, but this does not necessarily present any wins for the industry.

- Larger farms require milk laden cows to walk further to be milked, placing more stress on the animals, with consequences including less milk production, poor health and shorter lifespan. If there was a real strategy to focus on larger farms then this would need to be accompanied by a completely different management regime (frequency of milking, breeds of cows etc.) but this has not been considered as part of the "bigger is better" strategy.

*Production remains below pre-drought levels Following a decline during the 1970s, raw milk production in Australia increased steadily from the 1980s until the early 2000s, and reached a (historic) peak of 11.27 billion litres in 2001-02 (figure 2.3). The nature of dairy farming means that farmers are heavily reliant on rainfall and/or irrigation for the production of forages and drinking water for cows. Consequently, major droughts in 2002-03 and 2006-07 had a significant effect on raw milk production, with year-on-year volumes falling by about 9 per cent and 5 per cent, respectively.*

Continuing falls in production can no longer be blamed on drought or its' after effects. As explained earlier, many farmers have proceeded to drought proof their farms, adapting their pastures and water usage accordingly. Year-on-year falls in milk production are continuing at rates of 9% in some areas and 3.5% nationally, and may continue to do so unless there is a major shake -up of the industry.

*The market for raw milk is competitive. Raw milk is purchased by dairy product manufacturers or milk brokers (who then on-sell milk to manufacturing companies). Since the removal of price support mechanisms, the market for raw milk has operated competitively. Dairy farmers can choose who they sell milk to, and buyers are free to negotiate the terms of that supply. In its 2008 report into the competitiveness of retail prices for standard groceries, the ACCC noted that it was: … satisfied that the acquisition of raw milk from the farmgate is competitive and price is set by market forces of supply and demand.*

Please read some of the supply agreements that farmers are signing, and the confidentiality agreements that prevent them from comparing notes. Look at the different prices negotiated with farmers in the same locality. Ask farmers how much the various "loyalty" cost penalties are worth in terms of lost revenue if they switch their suppliers. Look at the compulsory levies placed on farmers without their consent, including passing on more and more of production cost and risk to benefit the manufacturers. Look at the

complexity and lack of accountability of the whole pricing system compared with that in other countries. Farmer Power can fully appreciate that much of this information will not have been made available to the Commission through the people and agencies it has consulted to date.

*Manufacturers compete on price and non-price terms to acquire raw milk from farmers. Negotiations between farmers and manufacturers can be facilitated by co-operatives, collective bargaining groups or occur on an individual basis. The nature of supply agreements also varies. The large dairy product manufacturers tend to operate 'step-up' payment systems (Phillips 2013), where: the manufacturer agrees to acquire all milk produced by the farmer; prior to the commencement of the season, a monthly schedule of prices is announced; during the season, the manufacturer may announce additional payments (step-ups), which apply retrospectively to milk already delivered.*

Collective bargaining could be a very useful mechanism for farmers to obtain a fair price for their milk, but the opportunities for this have been steadily reduced. Exceptions are within Norco, which is the only significant remaining farmer co-operative in functional terms, and in the collective retailing recently undertaken by the South Australian Dairyfarmers Association (which has notably distanced itself from the activities of the Australian Dairyfarmers).

*Collective bargaining has emerged as a method of organization amongst farmers, used in the negotiation process for the sale of raw milk to dairy product manufacturers. In 2002, Australian Dairy Farmers (a non-profit organization representing dairy farmers) was granted authorization by the Australian Competition and Consumer Commission (ACCC) to allow dairy farmers to collectively bargain with dairy product manufacturers. The authorization was extended by the ACCC in 2011 for a further 10 years. The ACCC remarked: … collective bargaining arrangements will continue to result in public benefits through transaction cost savings and providing the opportunity for increased farmer input into contracts relative to a situation where farmers negotiate individually with the processor they supply. A number of conditions apply to the collective bargaining authorization held by Australian Dairy Farmers, including: Collective bargaining groups may only be formed by farmers with a 'shared community interest' — farms must have a reasonable expectation of supplying the same plant and be within the economic delivery zone of the plant, in addition to demonstrating that they have similar supply patterns or supply a specialty raw milk product. Dairy companies are able to choose whether or not to negotiate with collective bargaining groups (ACCC 2011). The Department of Agriculture submitted that there are currently 19 dairy farmer collective bargaining groups in operation and observed that: … while a number of collective bargaining groups have been formed, a majority of producer-processor supply contracts are established on an individual farmer basis. Similarly, Australian Dairy Farmers submitted to the Australian Competition Tribunal: Collective bargaining groups are not prevalent in Victoria and Tasmania or particularly active where access to multiple processors is available.*

We agree with the ACCC remarks that a collective bargaining system would have considerable benefits. However we have no confidence that the Australian Dairy Farmers has the capacity or will to support its implementation.

*According to Australian Dairy Farmers: Typically, in June of each year farmers are advised of an opening price for the following financial year. This price is usually 85 per cent to 90 per cent of an expected final price. During the financial year farmers receive step-up payments towards the final price which are also paid retrospectively for previous month's supply in that current financial year. Alternatively, farmers and manufacturers may enter into 'direct' contract arrangements on an annual or multi-year basis. The two largest drinking milk processors in Australia — Lion and Parmalat — use direct contract arrangements These contracts typically specify the volume of milk a farmer is expected to deliver, and the prices to be*

*paid. Multi-tier pricing structures are often used to encourage consistent raw milk production throughout the year. The Department of Agriculture remarked: Management can include sending market signals such as a two-tiered … contract pricing system which pays farmers a higher price per litre for tier one milk, which secures supplies for the drinking milk market, and a lower price for excess (tier two) milk. More recently, a number of 'direct source' contracts have been entered into between dairy cooperatives, including Murray Goulburn and Norco, and the major supermarket chains. Supermarkets are also contracting directly with individual dairy farmers in some cases. The Department of Agriculture has suggested that it is too early to assess the full impact of the new arrangements on farmers and manufacturers. The scope for dairy farmers to change (or 'switch') manufacturing companies to secure more favorable terms and conditions also drives competition in the raw milk market. Some evidence suggests that switching activity is relatively low. As Australian Dairy Farmers submitted to the Australian Competition Tribunal: A relatively small proportion of suppliers move processors each year. We estimate this would be less than three per cent per year. Possible reasons for low switching rates include the length of supply contracts between farmers and manufacturers, and the step-up benefits offered by manufacturers (where the step-ups are linked to 'farmer loyalty'). The Queensland Dairyfarmers' Organisation considered that the scope for farmers in that state to switch is particularly constrained: With only two main processors in Queensland, combined with the requirement to supply milk in a flat supply system … it makes for a difficult operational environment for dairy farmers with limited or no alternative supply and production systems options. Notwithstanding this, a number of study participants regarded the potential for switching as an important feature conditioning the farmer–manufacturer commercial relationship.*

The complexity of pricing arrangements and the way they are changed without notice over time is a critical issue. Effectively this means that farmers agree to sell their milk without knowing what they will get for it, and without the ability to compare prices with the next farmer, or between purchasing manufacturers. The step up arrangements combined with low or non-existent margins results in situation where switching can mean the difference between any profit at all or financial loss. A farmer changing factories loses any further step ups (increased payment for milk delivered has had a name change from step ups to loyalty payments) even though those payments are based on milk delivered.

*Dairy cooperatives are generally financed by their members, who share in the profits generated by the cooperative, usually based on the quantity of milk they supply to the co-operative. Murray Goulburn is the largest co-operative in the Australian dairy industry. Other co-operatives in the Australian dairy industry include Norco, which in 2012-13 had 159 member farms and a milk intake of approximately 150 million litres. As Keogh observed of the differences between cooperatives and private companies:*
*A co-operative exists for the benefit of its members, while a company exists for the benefit of its shareholders. So while a dairy cooperative might pay a quite high price for milk and forgo some cooperative profits in order to bring benefits to dairy farmer members, a company is, by law, required to maximize its returns for shareholders. Commercial co-operatives have some drawbacks. For instance, because claims (unlike shares) cannot be traded, where a member's claim on the income generated from a particular asset is shorter than the life of an asset, there may be a tendency for co-operatives to under-invest in the asset. There may also be issues arising from principal–agent relationships, including the potential divergence of interests of owners (co-operative members) and agents (management).*

Many farmers including shareholders have raised with Farmer Power their concerns that Murray Goulburn no longer qualifies it to be regarded as a farmers' co-operative, given its performance in leading the downward pressure on the farmgate milk price, paying different prices for the same quality product to different suppliers on the same day and not allowing farmers to sell their shares that have been compulsory acquired from milk payments to farmers for periods up to five years. Its proposal to establish a unit trust, with shareholders who will demand a commercial return on investments, will increase this

separation from the interests of farmers, and who will be able to sell their share at will, unlike the suppliers.

*Murray Goulburn's capital structure proposal: Murray Goulburn is considering making changes to its capital structure to raise the equity capital required to fulfil its investment plans. Murray Goulburn hopes to raise $500 million in capital over the next three to five years. In a discussion paper sent to suppliers and shareholders in May 2014, Murray Goulburn considered that 'undertaking a $500 million capital investment solely from available sources of bank debt funding would result in Murray Goulburn being very close to reaching its prudent and permitted peak borrowing levels'. The structure proposed by Murray Goulburn would result in the creation of an ASX-listed unit trust, distinct from the shares held by Murray Goulburn's supplier shareholders. The holders of the securities (units) issued by the unit trust would not have voting rights in Murray Goulburn under the proposed structure; they would however, have the same economic rights as supplier shareholders, which principally relate to the right to receive the same dividend. Murray Goulburn has stated that the proposed restructure would not alter active dairy farmer control of the co-operative, and that its existing 100 per cent farmer control would not change. Furthermore, Murray Goulburn intends for existing supplier shareholders to be given the opportunity to purchase additional shares in the company at the market price, prior to the listing of any units on the ASX, to reduce the quantity of external equity required by the cooperative.*

We are aware that many farmer-members are extremely concerned about this proposal. There is particular concern that the new structure is being pursued with a view to raising capital that will increase pressure on Murray Goulburn to maximize returns to investors at the expense of its farmers, and that its investment strategies will worsen the high level of debt the company carries at present. There are even some doubts expressed from analysts (which are in the public arena) about the current liquidity of the company.

*In absolute terms, the production volumes of most dairy products have declined in recent years (Figure 2.6). Skim milk powder is a notable exception — output has increased from 205 kilotonnes in 2005-06 to over 220 kilotonnes in 2012-13.*

The lack of disaggregation to identify the trend to infant formula production is unfortunate, and distorts these observations. Dairy Australia should be called on to provide these disaggregated figures, which are essential if policy is to respond to real industry trends.

*Farmgate milk prices follow world product prices Australian dairy manufacturers compete to purchase raw milk from farmers. For manufacturers of heavily traded (less perishable) dairy products, the maximum price they will be willing to pay for raw milk is the residual of the price they receive for output (the world price) minus their processing value adding, other intermediate inputs and transport costs. Hence, for any given 'other' manufacturing costs, the world price of heavily traded dairy products and the price of raw milk will move together. Furthermore, a dairy farmer will not accept a lower price selling into one market than could be obtained in an alternative market. This means that manufacturers in a particular region will pay the same price for raw milk, regardless of whether it is destined for heavily traded or less-traded product markets. As such, world prices of heavily traded dairy products largely determine the raw milk prices paid by all manufacturers.*

This is true in some other countries but not in Australia. With restricted competition and the elimination of farmers' bargaining power the farmgate price is not "*the maximum price that manufacturers are willing to pay for raw milk*": it is in fact "*the lowest price they can get away with to maintain their short term profits*". We would urge the commission to plot farmgate price (if accurate data can be obtained) against earnings of dairy manufacturers and/or the world price to demonstrate this distinction. Also it would be instructional

to examine the sudden reductions in farmgate price that have been introduced over the past few years (eg: the sudden drop from around 55 cents per litre to 32 cents per litre imposed on many Victorian farmers in 2010) and how they can be justified by the trends in earnings from dairy products.

*Raw milk is the largest input cost for dairy product manufacturers. Other costs include manufactured food and beverage inputs (often milk-based), labor, packaging, transport, energy and capital. Raw milk prices paid by dairy product manufacturers in Australia appear to be generally lower than those paid in the United Kingdom and United States (although the cost gap has narrowed), and broadly on a par with those in New Zealand. Reasons include the absence of price support mechanisms for raw milk and relatively low on-farm costs of production in key dairy regions. – However, some participants indicated that the stagnation and subsequent decline in Australian raw milk output since 2001 due to factors such as drought has limited the ability of manufacturers to obtain scale efficiencies. – Seasonal variability in raw milk production in south eastern Australia can impact on asset utilisation and manufacturing efficiencies and costs.*

As explained, Australia's "relatively low on-farm costs" are substantially assisted by unpaid labor of family farmers within the current pricing regime. Blaming falling milk production on drought is highly misleading. A farmgate price of around 50cents per litre (similar to the New Zealand price, and around 25% higher than the price actually received by most Australian dairy farmers – despite claims to the contrary and promises made by some manufacturers) would be a viable basis for building a sustainable industry, and without this milk supply will continue to decline. What could occur in future is a massive price correction as supply gets even tighter, particularly if new market entrants seize the opportunity to offer a competitive price, and this could destabilize Australia's entire dairy manufacturing base.

## Cost of Dairy Product Manufacturing

*Cost structure analysis can help establish a broad understanding of the costs of Australian dairy product manufacturers relative to international competitors, and the drivers of those costs. In turn, they could provide insights into possible ways to reduce dairy product manufacturing costs in Australia. That said, care needs to be exercised in using cost structure analyses for formulating public policy. First, businesses in the dairy product manufacturing industry incur a range of costs. While some of the costs are amenable to public policy (for example, government regulation), other costs and cost drivers are not (such as raw milk price increases reflecting developments in world markets). Moreover, the decisions made by dairy manufacturers about, for example, their product mix, market focus, production technology, factor use and risk management will have a significant bearing on their unit costs of production. Furthermore, firms act to maximize profits (revenue minus costs). Profit maximization may mean that firms seek to improve their competitiveness through product differentiation (in terms of quality or branding), or by establishing relationships with key customers. Such strategies could entail higher costs (for example, paying higher prices for premium quality milk) in the expectation of bringing even greater revenues. Of course, profit maximization requires that any given output is produced at least cost, but this does not equate to cutting costs without regard to the impacts on outputs and revenues. Second, government intervention is not costless — even if policy interventions could reduce dairy product manufacturing costs, they inevitably impose costs on other areas of the economy. Where these costs exceed the benefits to dairy product manufacturers, the community will be made worse off overall. As a general principle, well-functioning markets promote community wellbeing by allocating resources (such as capital, labor and skills) to their highest value uses.*

This type of analysis is only valid if there is a functional market structure, and this does not currently apply to the setting of the farmgate price for milk as already explained.

*The broader policy, regulatory and institutional environment in which the Australian dairy product manufacturing industry operates will influence the productivity and competitiveness of manufacturers. This environment can also affect the incentives for, and the capacity of, dairy product manufacturers to respond to cost pressures and changing competitive conditions. In this context, the Commission's approach has been to draw on the cost analyses contained in this chapter to better understand the drivers of dairy manufacturing costs in Australia, and the possible reasons for differences in cost structures between countries. In doing so, the Commission draws a distinction between costs (and cost drivers) that are potentially amenable to policy action, and those which are not.*
*Further, while raw differences in cost structures between countries are expected — and are not necessarily symptomatic of any problem with Australia's policies or institutional frameworks — these comparisons can provide important insights and lessons, particularly where policy differences arise.*

We would urge that this analysis should take a long term (10-20 year) view. Clearly the most important incentive that the industry needs at present is an increase in milk supply, and a pricing (or cost/benefit distribution) structure is required that will achieve this.

*The cost share of agricultural products (predominantly raw milk) recorded in the input mix of Australian manufacturers is lower than all countries considered (however, as noted above, anecdotal information provided by study participants suggests that raw milk inputs may represent a higher proportion of costs in Australia than the input–output data suggest).*

It may not be surprising that the study participants have sought to downplay the low input costs of raw milk in Australia. We would suggest that the Commission should not be unduly influenced by such suggestions. From a farmer perspective, it would not be at all surprising if the raw milk costs of Australia are extraordinarily low, given the downward pressure exerted by the main manufacturers, but this will not benefit the industry in the long term.

*International comparisons indicate that farmgate milk prices in Australia have been at the lower end of the range when compared to other milk producing countries, including New Zealand, the United States and the United Kingdom (although the price gap has narrowed). This suggests that Australian dairy manufacturers enjoy a raw milk cost advantage relative to several of their key competitors. A number of factors underpin this advantage, including the competitive and largely unregulated nature of Australia's raw milk market and relatively low on-farm production costs. Raw milk production costs in major Australian dairy regions appear relatively low  The cost of producing raw milk can vary considerably from one farm to another, depending on the system of farming used, the scale of farming operations, operator expertise, herd genetics and various other factors. Nonetheless, average production costs for dairy farmers in Australia and New Zealand have historically been lower relative to farmers in most other major milk producing countries … This cost advantage partly reflects the various natural (including climatic) advantages enjoyed by Australian and New Zealand dairy farmers. For example, the lower cost pasture-based production system used in Australia and New Zealand is a key driver of cross-country differences in on-farm costs.*

Suggestions that the lower farmgate milk costs reflect largely natural cost advantages for farmers would not explain the progressive decline in milk production as farmers cull their herds and go out of business. The real reason for progressive and entrenched milk decline and its ramifications for dairy manufacturing industry deserve some further consideration in the Commission's report.

*In addition, Australia has experienced continued productivity growth at the farm level. A study by ABARE found that from 2000-01 to 2010-11, multifactor productivity growth in the dairy farm sector averaged 2 per cent per year (Dharma and Dahl 2013). This growth is higher than for all other broad acre agricultural industries in Australia (ABARE 2014a). Dharma and Dahl (2013) identified a number of reasons for this improvement, including: improved scale through the consolidation of dairy farms, with many smaller producers exiting the industry, and the production share of small operations gradually declining. Average farm size increased by 45 per cent between 1988-89 and 2010-11; a shift toward greater production mechanization and corresponding declines in the average farm's use of land and labor; advances in herd genetics, soil testing and pasture management have helped increase milk yields. Milk yield increased from 3811 litres per cow in the early 1990s to about 5630 litres per cow in 2010-11. That said, the gap in farmgate milk prices between low-cost producers, such as Australia, and regions with traditionally higher on-farm costs, such as Europe and the United States, has narrowed in recent years. This has been attributed to the weaker US dollar and the rising debt costs in the southern hemisphere associated with increasing land costs. The increased reliance of Australian farmers on fodder over pasture as a form of feed, particularly in drought years, is also likely to have contributed to the narrowing cost gap.*

Again, we would suggest that snapshot measurement of productivity gains is not appropriate and may be misleading. The critical question is whether milk productivity has increased over the life of the cow, not in a particular production year. Snapshot increases in productivity may reflect culling of herds. Real increases in productivity will be achieved when there is evidence of increasing milk supply, in contrast with the current rapid decline. It is a highly misleading statement that productivity has slightly increased when in fact production has markedly declined, and such an assertion invites an inappropriate policy response. Farmer Power believes that the farm debt level has increased substantially throughout this period adding to the exodus from the industry.

*Deregulation of the dairy industry has driven lower farmgate prices and on-farm efficiency improvements. In part, low on-farm costs and farmgate prices in the Australian dairy industry can be attributed to Australia's significant and long standing (by world standards) commitment to deregulation of the industry.*

If deregulation has produced a massive decline in milk production which is threatening the viability of the Australian dairy industry, how can this be claimed as a success? We suggest that the current situation is a policy disaster, but one which could have been avoided (and may still be corrected) by a more appropriate deregulated regime.

*Raw milk volume and seasonal variability also affect manufacturing costs. There are large fixed costs involved in manufacturing certain dairy products, particularly where significant infrastructure or mechanized technology is required. While dairy manufacturers in Australia are able to take advantage of comparatively low raw milk prices, the stagnation and subsequent decline in Australia's raw milk output since 2001-02 is claimed by some manufacturers to have limited the achievement of scale efficiencies at the manufacturing level. As noted by the Department of Agriculture: A decline in raw milk production over the past decade has constrained Australian dairy manufacturers' capacity to invest [in] operations in a period when many international competitors are aggressively pursuing such outcomes. Further, Australia's relatively small scale operations have affected its cost competitiveness in the global dairy commodity market.*

This is precisely why it is in the interests of manufacturers to encourage growth in milk supply. However it appears to us that each manufacturer is more concerned with exerting a short term stranglehold over its farmer suppliers, and preventing other industry participants from growing their share of total milk supply. As supplies decline further, it can be expected that manufacturers will lose critical mass and their capacity

to pay farmers will be more restricted. A longer term strategic plan for the industry is urgently required to break this cycle.

*The Commission is seeking feedback on the impact of the predominantly seasonal nature of Australia's raw milk supply on manufacturing efficiencies and costs.*

Manufacturers in all countries have to adapt to seasonal fluctuations in milk supply, and Australia is not unusual in this regard. However as explained earlier the current declines in milk production are exacerbating seasonal fluctuation, as farmers are unable to support out-of-season production.

*Why the lack of growth in milk supply? Possible reasons put forward by participants for the lack of growth in Australia's raw milk volumes include: severe drought and floods and the consequent impact on water availability, pastures and fodder ; dairy farmers lacking the capacity (and confidence) to invest at the farm level, due to factors such as low and/or variable farmgate milk prices, volatile and uncertain farmer returns and input prices, and higher debt costs (driven by increasing land costs); various other factors, including the relative attractiveness of exporting live dairy heifers.*

We suggest replacing the words "*lack of growth*" with "*significant decline*" in production, to reflect what is actually happening. We would also suggest that merely floating possible explanations is not an adequate assessment of the present critical situation. Consultation directly with farmer groups would be appropriate to correctly identify the cause of rapid production decline, which we assert is primarily the way the industry has been structured, with consequences including farmgate milk price manipulation. Such consultation would also assist in developing strategies to turn this situation around.

*Farmer decisions about on-farm investment and raw milk production are ultimately determined by market realities and risk assessment and preferences. Where manufacturers seek larger raw milk volumes (to exploit scale efficiencies or meet rising customer demand, for example), the price of raw milk would be expected to rise (all else being equal). Higher farmgate prices would, in turn, provide an incentive for farmers to invest on-farm and expand production. There is strong evidence that such market forces 'are working'. Manufacturers are responding by offering farmgate price incentives for increases in raw milk, or increasing expected farm returns by taking on risks including through entering into co-investment schemes with farmers (underpinned by longer-term supply agreements) and seeking third-party capital investment. Indeed, Dairy Australia recently noted that '… the focus on "new milk" is as strong as ever, with various price and co-investment incentives in place'* .

We do not see any evidence for the assertion that "*market forces are working*" and we ask that the Commission look further into the real situation. It would be a very strange market that produced a situation in which:

- global dairy prices are increasing,
- the exchange rate is becoming more favourable to Australian producers,
- dairy manufacturers are reporting increased profits,
- there are no major climatic obstacles to production in the major producing regions, and
- farmers are cutting milk production.

Conversely, it will be possible to claim that "*market forces are working*" only if production shows a clear growth trend in response to increased global demand.

*Bega Cheese recently announced a $25 million initiative to encourage dairy farmers (by way of an additional payment per litre (in milk solid equivalents)) to make on-farm investments that either boost farm productive capacity or enhance the environmental sustainability of their farms. The Commission is seeking feedback on the impact of Australia's stagnant raw milk supply on manufacturing efficiencies,*

*and whether there are impediments that limit co-operation or co-investment between dairy farmers and manufacturers to increase raw milk supply.*

The term "*stagnant raw milk supply*" suggests it is static rather than rapidly falling. While initiatives such as that announced by Bega are welcomed, success will need to be demonstrated in the long term, bearing in mind the two year lead time for expanding herd numbers through natural increase. It may be useful to assess the impact of the South Australian Dairyfarmers Association initiative referred to earlier, as this has had time to show an increase in terms of building farmers confidence and economic capacity. Regrettably, the major dairy manufacturers have failed to adopt any such initiatives, despite the fact that this would clearly be in their long term interest.

*What are the major impediments to increasing raw milk supply, or achieving more consistent raw milk output year-round? To what extent can supply agreements (including contracts) between farmers and manufacturers overcome these issues?*

For reasons explained there is no simple quick fix to this situation. It requires a restructure of the industry within which there is a much clearer and more accountable system for setting the farm gate milk price. Farmers are clearly lacking confidence and many have exhausted all ability to source low interest funding at a time when there is NO long term vision for the industry. The age of farmers is increasing and without long term confidence there is little incentive to invest.

## Potential Policy Influences on Dairy Manufacturing Costs

*Where the Australian dairy product manufacturing industry continues to compete in global markets, greater consolidation of the industry reflecting commercial considerations should offer potential for scale-based economic gains and wider community benefits. …*
*The emergence of a dominant manufacturer need not be a prerequisite for achieving such a premium, however. In fact, even with the current level of diversity in the sector, the Australian Food and Grocery Council (AFGC) has proposed the development of a 'Trust Australia' brand: The AFGC recommends that the national food brand 'Trust Australia' be adopted … 'Trust Australia' tells consumers that they can trust the quality and safety of Australian food products … The development of a national food brand needs to be backed up by commitment from federal and state governments to adopt the national food branding and for States and regions to be promoted within the context of the national brand. All too often industry relays frustration from their customers about the fragmented Australian promotional activities and the confusion that causes. Unless a more collaborative and coordinated approach is adopted, Australia risks continuing to lose market share to countries that have a more strategic and coordinated promotional approach.*

Farmer Power wholeheartedly supports this recommendation, for the reasons stated by the Commission. However the benefits of the branding will only flow on to farmers if the present cost and benefit distribution system is overhauled.

*The United Dairyfarmers of Victoria (UDV) submitted: Australia's current competition laws do not allow any possibility of Australian owned manufacturing on an internationally competitive scale. This issue was highlighted in the widely publicized Warrnambool Cheese and Butter (WCB) bidding war … there were three bids on the table, however only two companies were given the opportunity for acquisition … The Australian Competition and Consumer Commission (ACCC) approved Bega's bid on October 31, 2013. The Foreign Investment Review Board (FIRB) and the Treasurer approved Saputo's bid on November 12, 2013. However … Saputo gained a … majority shareholding in the company on January 22, 2014 while Murray Goulburn was still waiting for approval … For Australia to be productive on a global scale, policy*

*priorities have to shift to allow Australian companies the chance to compete against our international competitors, such as New Zealand, which allow a company to have a majority of the market.*

Farmer Power received angry feedback from farmers over the stand taken by the United Dairyfarmers of Victoria on this issue. There is evidence that many farmers including Murray Goulburn shareholders would be concerned about further monopolization of the Australian market, which is likely to further reduce farmers' ability to demand a fair price for their milk.

*Debt for dairy industry farms increased from an average of $328 000 per farm in 2000-01 to $739 000 per farm in 2008-09, a larger increase than for broad acre farms. The average debt per dairy farm at 30 June 2012 in each state exceeded average debt per broad acre farm in all states except Queensland. More than 50 per cent of Tasmanian and Western Australian dairy farms carried in excess of $1 million in debt at 30 June 2012. The average equity ratio (that is, equity expressed as a percentage of farm capital) for dairy farms was 80 per cent. Twenty-eight per cent of dairy farms were estimated to have equity ratios below 70 per cent in 2011-12, while 38 per cent of dairy farms were estimated to have equity ratios exceeding 90 per cent at 30 June 2012. For dairy farms, debt to fund working capital increased by 300 per cent, in real terms, between 2000-01 and 2011-12 while debt to fund land purchase increased by 140 per cent. Over the same period, borrowing to finance farm buildings, structures and land development also increased by 300 per cent and borrowing to finance purchase of machinery, plant and vehicles increased by 50 per cent, in real terms. As discussed in the Commission's recent submission to the Agricultural Competitiveness White Paper, the availability of capital for the rural sector has increased significantly since financial deregulation. Between 1980 and 2013, rural debt grew from 22 to 91 per cent of annual agricultural production (peaking at 113 per cent in 2009, then falling in the years following the global financial crisis).*

Following deregulation, farmers were encouraged to borrow to make capital investments including drought proofing their farms. It was expected that farmers would maintain their share of dairy industry costs and earnings as a result of deregulation, and on this basis debts could have been repaid. What has happened since then is:

- the cost of debt servicing has increased
- earnings have been pegged (estimated now to be at the same level as in the 1960s)
- further debt has occurred as farmers have borrowed to maintain liquidity
- banks have downgraded the value of dairy farms because of their falling profitability, so that some farm values now offer insufficient security against current debts
- Foreclosures are taking place as a result.

*In addition to capital being accessible for farmers, it also appears unlikely that there are major problems accessing capital for the dairy product manufacturing sector. Any difficulties here may more lie with the ability of management to convince owners of the value of an investment, an issue not limited to unlisted companies. Nevertheless, the co-operative nature of some of the more significant manufacturers is likely to limit their ability to access equity. Government has no role to play unless an adverse regulatory factor can be identified. In fact, given the accessibility of capital for the dairy sector (and rural sector more generally), the Commission sees no role for government in credit provision. Government institutions such as the Commonwealth Development Bank and the Australian Industry Development Corporation have fulfilled a credit provision role in the past. However, while such bodies arguably served a 'second-best' purpose when the financial system heavily rationed credit (because there was room for specialized government-owned entities to make viable loans to borrowers unable to obtain private finance), financial market deregulation (the 'first-best' remedy) has eroded the raison d'être for such entities. One example of new thinking is the 'Partnerships' program developed by Murray Goulburn Cooperative [which] provides supplier-shareholders with an alternate pathway to farm expansion through leasing of*

*farmland owned by equity funds. This allows farmers to maintain capital for spending on cows and business infrastructure as it has not been sunk into the purchase of new farmland. While leasing of farmland is not a new concept, the structured and systematic approach in partnership with a large Australian company is promising.*

There are concerns that Murray Goulburn's Partnership Program merely serves to increase indebtedness to that company. The proposal to establish a National Rural Reconstruction Bank to buy back bad farm debts is supported by Farmer Power. We are surprised that there has been no comment on this in the Commission's interim report, and would hope that this does not suggest lack of support for this vital initiative, after all it was a State Premier by the name of Henry Bolte who had a vision for the industry and established low interest rates to encourage a massive growth opportunity for the industry and the broader community which saw Victoria grow into the biggest dairying state. The biggest export from the port of Victoria up until the current down turn was dairy and the export dollar for this state have well and truly proven his decision correct.

*While foreign investment in agriculture is often controversial, its importance as an additional source of capital should not be underestimated. Foreign investment augments the supply of capital to the Australian economy overall. Foreign direct investment in the dairy industry can also assist in improving and extending supply chains, help gain access to foreign markets, and promote increased competitiveness within Australia. …..*
*Moreover, the Commission understands there is a widespread perception in the global dairy industry that investing in Australia represents a strong potential springboard for exporting into growing markets in the Asia Pacific region. Improving the efficiency and competitiveness of the Australian dairy industry is likely to be a priority for these foreign investors.*

Farmers are not in our experience opposed to foreign investment in the dairy industry, particularly if this stimulates competition, product diversification and innovation. However we are concerned that the experience of foreign acquisition of Australian dairy farms has been notably disastrous. Dairy farms that have been secured by foreign interests have almost universally failed, and the land has been removed from dairy production. Australian farmers have a keen appreciation of how to produce milk efficiently and maintain herd health given local soil, water and climatic conditions. We would suggest that foreign investors should be encouraged to put their resources into dairy processing rather than farming.

*Several study participants, including UDV, raised concerns about the difficulties in recruiting and retaining labor for work on dairy farms and in manufacturing plants, and in attracting highly skilled graduates, managers and engineers.*
*…. Award rates for farm labor have largely risen in line with the general rate of inflation. However, the rates actually paid by dairy farmers have risen faster … wage rates paid to full time employees rose by 55 per cent between 1998-99 and 2012-13, in real terms. This is likely to reflect the higher than award rates farmers have needed to pay to attract and retain skilled farm labor.*

Farm labor and farmer succession are significant concerns for the industry. As farmers age, there is a need for hired farm labor. Older farmers are simply wearing themselves out in the current financial regime as they have to manage without hired help. As farmers retire or quit the industry, there are no incentives for new industry entrants, especially given the state of farm balance sheets. If an industry shake up does provide possibilities for herd recovery, then the next challenge will be to re-establish and grow the necessary skilled workforce. This needs to be acted on quickly while we still have the knowledge of these older farmers who would love to mentor the next generation.

*Since October 2008, all dairy businesses in Australia have been required to comply with the Primary Production and Processing Standard contained in the Food Standards Code. This requires dairy*

*businesses — including all dairy farms, milk transport operators, dairy manufacturers and most distributors — to be licensed and have an approved food safety program in place. Regular audits of food safety programs through the dairy food supply chain are conducted by the relevant regulator…Feedback provided to the Commission during this study, including from UDV, suggests that the dairy industry considers food safety to be of the utmost importance, and that industry participants are generally satisfied with current food safety regulatory arrangements. Regulators also expressed satisfaction with current arrangements. Submissions to other inquiries generally confirm this view..*

The statement that "*industry participants are generally satisfied with the current food safety regulatory arrangements*" is misleading. Farmer Power has previously made submissions and suggestions to food safety regulators on behalf of farmers' interests. As explained earlier, many farmers feel that the current arrangements discourage innovation and impede farm operations because of the prescriptive way they are imposed and administered. A more flexible regime may actually improve food safety by encouraging adoption of best global practices. In particular a regulatory regime that enables farmers to process milk cost effectively for direct sale to the public or others would do much to reintroduce competitiveness into the dairy industry.

*The presence of policy 'barriers' preventing or discouraging farmers from exiting dairy farming would potentially increase the cost base and diminish the competitiveness and efficiency of the Australian dairy industry. Many studies have shown that larger farms tend to perform better than smaller farms. Reasons for this include enhanced ability to exploit economies of scale, marketing advantages (including enhanced ability to enter into long-term supply chain arrangements with customers),greater bargaining power when purchasing inputs, scope for increased specialization, and potentially greater scope to adopt new technologies.*

We have already provided advice on why "bigger is better" may not apply to dairy farming. There are some economies of scale that apply upwards, but there are also factors which make larger farms less efficient. Optimal size is likely to vary across different regions. We would urge caution in making such sweeping statements, especially in the absence of real long term data that measures the relative productivity (per life-of-cow) of larger farms.

*Dairy Australia is the dairy research and development corporation. It acts as the 'investment arm' of the industry, using contributions from farmers (via the dairy services levy) and government to invest in projects that cannot be done efficiently by individual farmers or companies*
*…… Australia's Rural Research and Development Corporations - In 2011, the Commission undertook an inquiry into arrangements for Australia's Rural Research and Development Corporations (RDCs). It found the RDC model, based on co-investment between rural industries and the Australian Government, had a number of strengths. In particular, the design helped ensure public money was not spent on projects considered of no practical value by industry, reduced duplication of effort, and facilitated faster take-up of research outputs. However, the Commission found arrangements did not adequately cater for rural R&D research of benefit beyond specific industry groups, that there were no incentives for producers to increase their level of investment over time, and that much of the research funded would have been funded privately by industry without the need for public financial support. Recommendations by the Commission included: reducing the existing cap on dollar for dollar matching of industry contributions by government; creation of a new, uncapped 20 cent in the dollar subsidy for industry contributions above the level that attracts dollar for dollar matching; provision be made to allow for 'government directors' to be appointed to RDC boards where appropriate; improved project evaluation, performance reporting and monitoring; creation of a new RDC to sponsor broader rural research. The Commission considered*

*that the creation of a broader research body would provide the community with better value for money for its investment by widening the usefulness of the research undertaken…. In keeping with the views of participants — who did not express specific concerns about current arrangements for R&D in the dairy industry — the Commission considers that dairy industry R&D appears to be operating effectively.*

It is true that Dairy Australia is the main funding vehicle for dairy industry research, directly as well as indirectly through other agencies. However this relies predominantly on finance via the compulsory levy on farmers, and this is a significant cost impost which could represent 10% of net earnings for a typical farm in the current financial climate. As most of the research has negligible if any direct benefit to farmers, we question this funding model. Farmers would like a say on the research agenda, and it would be desirable for the industry as whole that this focuses on the essential issue of how to increase milk supply in the long term.

*The Commission considered that the creation of a broader research body would provide the community with better value for money for its investment by widening the usefulness of the research undertaken.*

We would welcome further exploration of this proposal, with direct input from farmers.

## Appendix A: Submissions

We note the lack of submissions directly from farmers, which may be explained by the publicizing of the Commission's work as having a focus on dairy manufacturing rather than milk production. Now that the linkage is clear, we would anticipate that farmers will want to have their say, and to correct some of the conclusions reached in the interim report based on some misleading information provided by others.

Farmer Power requests that in the event that its comments are not reflected in changes to the final report, its submission be published in full as an appendix to the report.

## Appendix B: Economics of Dairy Markets

*There are multiple manufacturers competing to purchase raw milk from farmers. This competition ensures that the price for raw milk will be equal to the maximum price that the marginal manufacturer is prepared to pay. For manufacturers of heavily traded products, this will be the residual of the price they receive for output (the world price) minus their manufacturing value adding, other intermediate inputs and transport costs. Hence, for any given 'other' manufacturing costs, the world price of heavily traded dairy products and the price of raw milk will move together. Dairy farmers will supply raw milk to manufacturers so that returns are equalized at the margin — a farmer will not accept a lower price selling into one market than could be obtained in an alternative market. Hence, all manufacturers in a particular region will pay the same price for raw milk, regardless of whether it is destined for heavily traded or less-traded dairy product markets.*

This is not the situation, indicating that the market is significantly distorted by including monopolization of local markets, severe penalties for supply switching, and lack of accountability.

*Farmgate prices are higher outside of export regions. In some dairy regions (such as in Queensland), it is not cost-effective for manufacturers to produce heavily traded products, as farmgate milk prices are higher than in the southern states. As a result, these regions only supply fresh products to local markets. Farmers in these regions enjoy limited natural protection from distance and transport costs (or perhaps a consumer preference and preparedness to pay extra for local product). However, the farmgate price*

*cannot be so high that farmers in other regions would find it worthwhile to supply the market. Higher farmgate prices might also make it worthwhile for these local farmers to incur the additional cost of buying feed to smooth seasonal fluctuations in raw milk.*

This observation does hold good, although the current crisis amongst Queensland farmers indicates some market failings in that State which have exacerbated by supermarket price reductions. We question how it is possible that supermarkets compete to attract custom by way of cheap petrol and carry the subsidy for this themselves (paid for from increased overall turnover) whereas in relation to milk the cost of the promotion is passed on to the farmers. We also point out that there is no advantage to farmers or the industry as a whole in stimulating domestic milk production through subsidized pricing in a situation of declining milk supply.

*In practice, supply agreements between manufacturers and farmers are complex and include a range of incentives, bonuses and penalties to encourage raw milk supply of a particular quantity, quality, reliability, or at particular times.*

In our submission to the Government's White Paper on Agricultural Competitiveness, we have called on the Minister for Agriculture to fully investigate and overhaul the current system. We are not surprised that the complexity the system has prevented the Commission from accurately describing it.

*Raw milk production costs affect farmer and manufacturer returns. An increase in the costs of producing raw milk, all else equal, tends to increase the farmgate milk price, but by less than the cost increase. The extent to which farmers and manufacturers bear the increased costs will depend on the elasticity's of raw milk demand and supply. However, because sales will generally decline, total farm returns could fall. Manufacturers of less-traded products will be able to pass on some of the increase in their costs to consumers, through higher product prices. However, in the heavily traded dairy goods market, where manufacturers take the world price as given, this is not possible. Here, the only effect will be lower output and commensurately lower total returns for manufacturers. A reduction in the costs of producing raw milk will have the opposite effect.*

These comments provide yet further illustration of how the current pricing structure is not market driven. Farm production costs are increasing but farmgate milk prices are falling. Supply is shrinking but there is no upward movement in farmgate price. Promises of increased price are not delivered, and prices are reduced without any bargaining or even explanation. Information is suppressed. Choice is penalized. There is no linkage to world price for dairy products. This situation must be addressed as a matter of urgency if the Australian dairy industry is to survive.