Auspork Industry Commission Submission

September 1998

Table of Contents

Executive Summary

Auspork Limited is a Public Company that owns and operates the Daylesford Abattoir and Auspork Australia, a meat wholesaler specialising in pork.

Auspork Australia is wholly owned by pig farmers and has developed from a joint venture marketing operation to the point where it will have export slaughtering and boning operations in Victoria and South Australia in the next 18 months if the company proceeds as planned.

Auspork Australia decided to make a submission to the Productivity Commission Hearings because the company believes that the industry in Australia is in a precarious position. Auspork Australia also believes that there are significant opportunities for the industry if some stability and confidence can be put back into the marketplace.

Auspork Australia believes that the future for the industry lies in the development of significant export markets and the development of better value adding opportunities in the domestic market. The company is on the verge of making decisions that will significantly contribute to the development of the facilities that are required to carry out this vision. However such decisions require significant capital inputs at a company and supplier level which require cash flow and confidence.

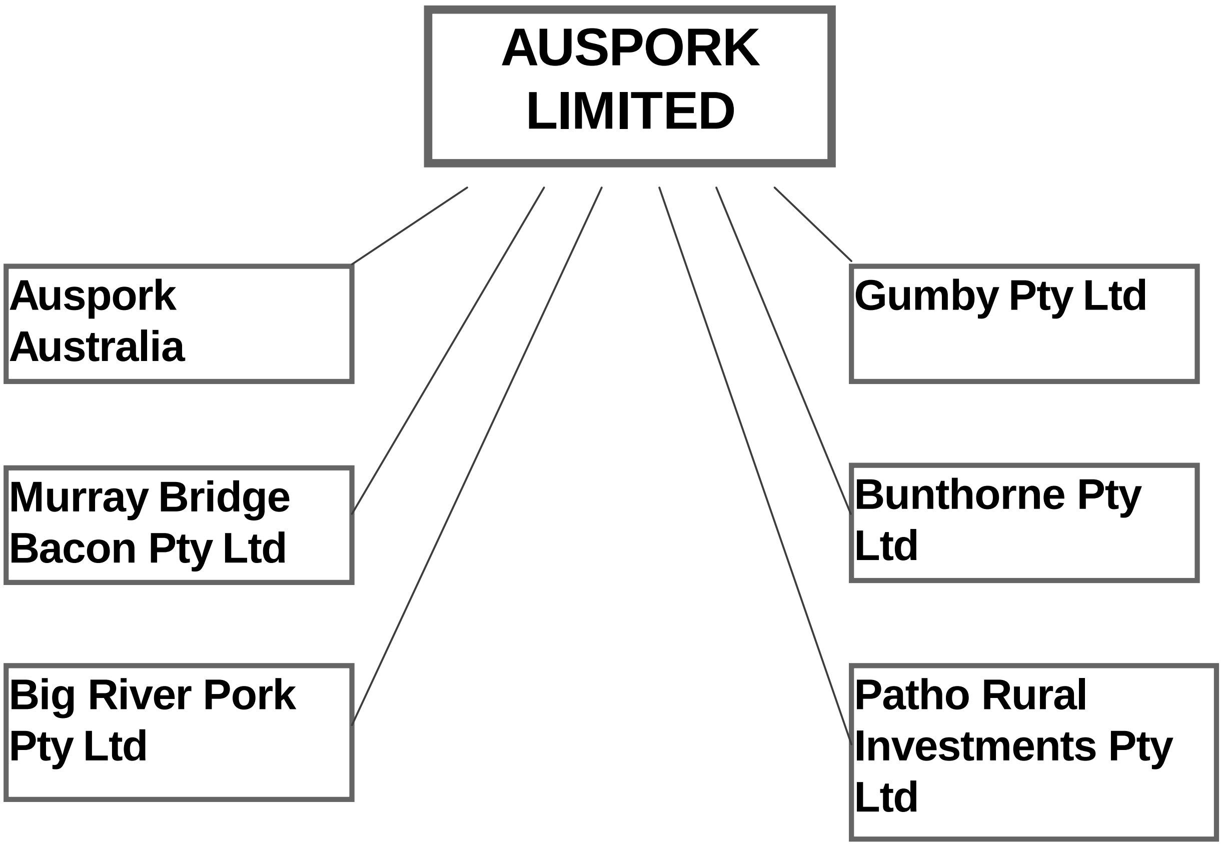
In this submission Auspork will demonstrate that imports have significantly damaged the industry over the last twelve months. Using industry and internal company data we will show the significant effect that price changes have had on the cash flow and profitability of the operations of farmer suppliers.

The company has also supplied confidential information on the company's future plans to demonstrate that we are firmly committed to removing the structural blocks that restrict the industry from developing significant exports. Auspork will use a period of market stability that can only be delivered be controlled volumes of imports to make significant capital investment so that the industry is in a much stronger position to withstand the pressures of international competition.

Background to Ausporak Limited

Company Structure and Outline

Ausporak Limited is an Unlisted Public Company with approximately 80 shareholders with the following structure:



⇒ **AUSPORK Australia operates as a wholesaler of pork carcases and part carcases.**

⇒ **Gumby Pty Ltd operates the Daylesford Abattoir which slaughters pigs for AUSPORK Australia and performs contract slaughter operations for other businesses.**

⇒ **Bunthorne Pty Ltd owns the land and buildings at the Daylesford Abattoir site.**

⇒ **Murray Bridge Bacon Pty Ltd is building the new plant at Murray Bridge in South Australia**

⇒ **Big River Pork Pty Ltd is operating the boning room operations at Daylesford and will operate the slaughtering and boning operations at Murray Bridge**

⇒ **Patho Rural Investments holds land and permits for supplier development**

The shareholders of Auspork Limited are all pig farmers. Some have been with the group for the whole period, others have come on board with existing farms when the agreed with the philosophy of what we are trying to achieve. New investors have been brought into the supplier part of the company (and have taken up shareholdings in Auspork) in the last two years.

The majority of the farms themselves are basically located North of Adelaide, in South Australia and at Leitchville/Gunbower in Northern Victoria. There are other farms involved as well and there is significant cross ownership between the two major groups.

Directors and Staff

Auspork Ltd has six directors:

Ian Parish (Chairman)

Previous committee member of Australian Association of Pig Veterinarians for 2 years. Previously a member of the executive of the V.F.F. Pig Commodities Group, and the V.F.F representative on the Animals Preparation Board. Commenced pig farming in 1976 and operates a 900 sow piggery at Leitchville in Victoria, and has interests in the Sheaoak Log and Wasleys Piggeries in South Australia and Gunbower Piggery in Victoria, and the Plains Weaner Joint Venture in Gunbower

Ron Lienert O.A.M.

President, Australian Pork Producers Federation 1982-87. Vice- President 1980-82 and member since 1977.
Council member of the Australian Pig Industry Research Committee 1979-85.
Represented the Australian Pork Industry on the National Carcase Classification Supervisory Committee 1980-82.
President of S.A. Pig Livestock Marketing Committee 1978-82.
President S.A. United Farmers' & Stockowners Pig Council 1978-80, 1982-84.
Director, Australian Pork Corporation 1987-90.
Currently Executive Member S.A.F.F. Pig Council, S.A. Swine Compensation Fund, Pig Industry Liaison Committees and delegate to the Australian Pork Council.
Commenced pig farming in 1960 and currently operates a 450 sow piggery in South Australia, and has interests in the Sheaoak Log and Wasleys Piggeries in South Australia.

Roger Nolan

C.P.A, Bachelor of Business Studies. Accountant in private practice in Kerang in a country based practice and also a pig producer for the past 14 years. Operates a 350 sow piggery in partnership with family.

Paul Higgins

Bachelor of Veterinary Science, Bachelor of Animal Science. Previous President V.F.F. Pig Group. Previous President Pork Council of Australia. Previous President of Australian Association of Pig Veterinarians. Commenced pig farming in 1989 and operates a 400 sow piggery in Leitchville, has an interest in Terricks Weaner

Joint Venture at Gunbower and previously had an interest in Wasleys piggery in South Australia.

Robert Fielke

President of the M.M.P.P. for the past 10 years. Previous past President of U.F & S Loxton Branch, Chairman of Loxton Hotel-Motel for the past 8 years.
Commenced pig farming in 1968 and currently operates 150 sow piggery in partnership with L.J. Fielke, and has interests in the Sheaoak Log and Wasleys piggeries in South Australia.

Aeger Kingma

Operates and manages Gunpork Joint Venture, Patho Piggeries Pty Ltd and Kincaid Piggery in the Leitchville and Gunbower area. Has an interest in Gunpork farms and Patho Piggeries Pty Ltd

Key Staff are:

Colin Walton (General Manager)

Colin Walton has been with the company for 8 years following extensive experience in sales and marketing in the agricultural sector. Colin is responsible for the overall operations of the company with a particular emphasis on market development.

Richard Grimes (Financial Controller)

Richard Grimes is Company Secretary and Group Financial Controller. Richard has been with the company for 7 years after 15 years experience in finance and accounting in the chemical and manufacturing industries.

Company History and Direction

History

Auspork Ltd was formed as the Independent Pig Producers Group Pty Ltd (IPPG) in 1986 as a direct response to the reduction of the number of outlets for pork from non-corporate farms.

Immediately after forming IPPG Ltd formed a wholesale company which trades as Auspork. This company now markets approximately 5500 pigs per week that results in an annual turnover of approximately $50 million. Marketing is targeted 7000 pigs per week by December 1999.

IPPG Ltd purchased the Daylesford Abattoir in 1994 after leasing the operation for a number of months. At the time of purchase the abattoir slaughtered beef cattle, sheep and pigs. Since that time the operation has been re-organised with the sheep line being replaced by a completely new pig slaughter line. The beef floor has been replaced with an export grade offal handling facility and the previous pig floor has been closed down. The abattoir now has the capacity to slaughter up to 8000 pigs per week on a single shift five-day basis.

Company Direction

Auspork Limited has moved in two significant directions over the last 12 months:

1 Firstly a heavy emphasis on quality and food safety has resulted in:

a) Early qualification for the Victorian Meat Authority (VMA) accreditation process for abattoirs for the Daylesford Plant

b) ISO 9002 accreditation for the Daylesford Plant. This has been achieved as an underpinning to the Company's domestic operations and to be used as an integral part of the company's export plans

2 Secondly, the company has recognised that to grow further and provide the best possible returns to pig farmer shareholders the company has to be involved in the export market and move further down the processing chain. To achieve this change the company is:

a) Upgrading the Daylesford Abattoir to export status. $900,000 has been spent on the site in the last six months and export accreditation was gained in August 1996.

b) Developing a joint venture boning operation at the Daylesford site for three reasons:

(i) To move further into marketing pork products as well as carcases.

(ii) To reduce costs by removing a transport step between carcase and boned meat products.

(iii) To improve food safety. The highest standards of food hygiene are required to export chilled products into the premium markets of Japan and Korea.

c) Construction of a new Export Processing and Boning Plant at Murray Bridge in South Australia. This plant will be built as a stand alone slaughter plant with attached boning rooms. The slaughter plant and connections to the boning room plant will allow other businesses to operate boning operations. Auspork has the capacity to be a joint venture partner in these operations. The application has been approved by the local council and is now going through the issues of objections to the development. The plant in South Australia is being constructed for several reasons:

(i) Extra capacity for the company as it moves to develop a larger supply base.

(ii) Efficiency of operations. Transport of live pigs from South Australian suppliers is extremely inefficient. Reducing the distance between the farms and the abattoir will significantly reduce costs as well as improving carcase quality by reducing travel time for the pigs.

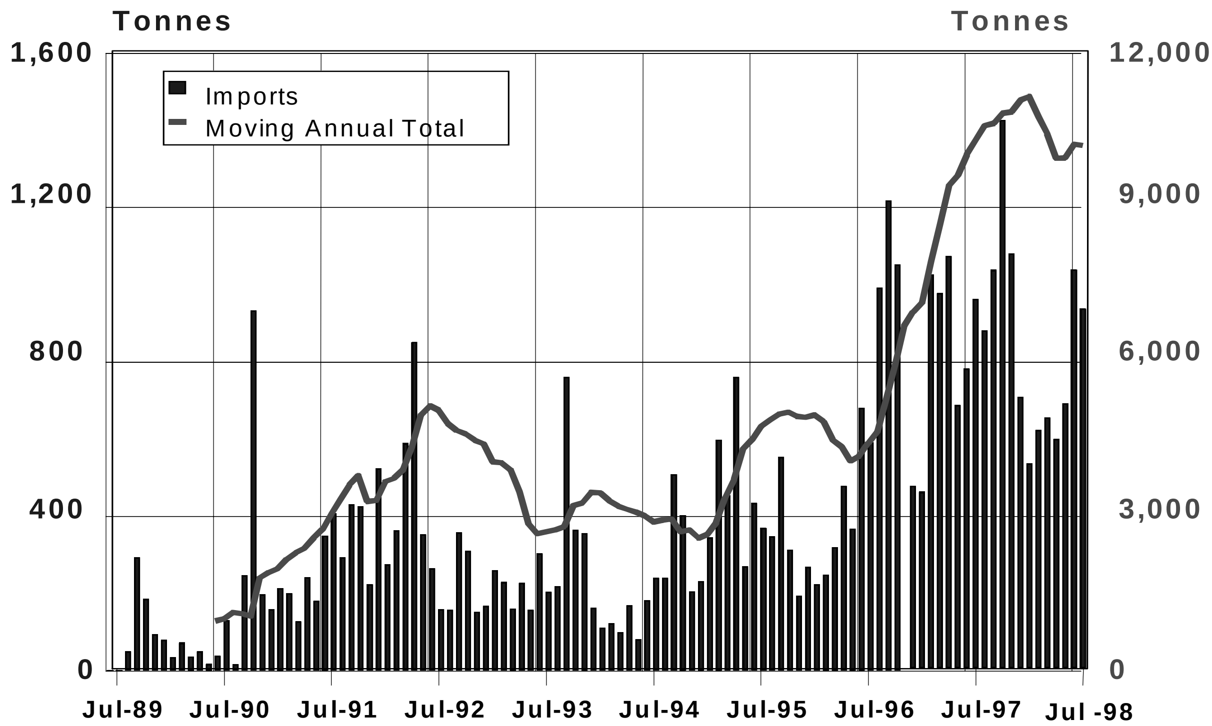
(iii) To develop a green field site that is built specifically as an export pig processing plant from the ground up.

SUBMISSION INFORMATION BASED ON STEPS IN THE PRODUCTIVITY COMMISSION ISSUES PAPER

Step 1. Have Imports Increased?

It is very clear from the information that is available through the Australian Bureau of Statistics (ABS) and the Australian Pork Corporation (APC) that imports have increased. The following graph clearly demonstrates that the levels of imports rose dramatically in 1997 and in particular in the second half of 1997.

Graph 1 – Import tonnages July 1989 – July 1998

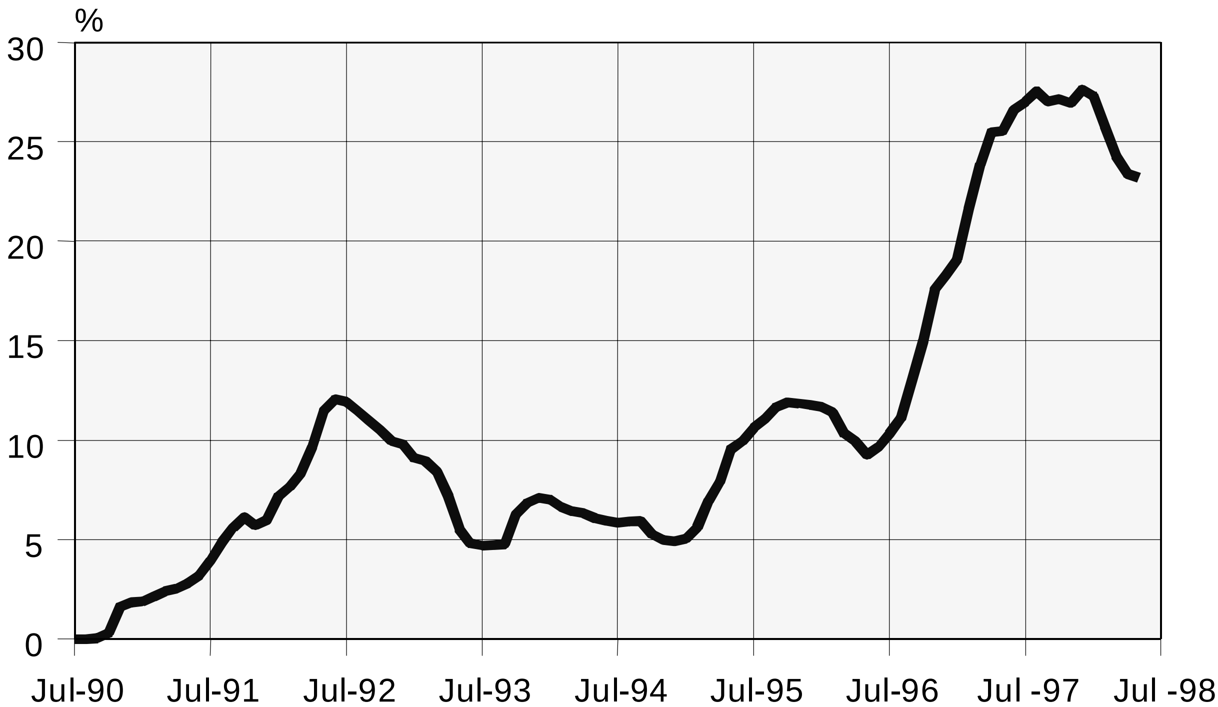


Source: ABS International Trade

In particular the increase has occurred primarily in the import of boned out leg product for the processing sector and is tightly focussed on the Christmas demand for processed leg meat. As the vast majority of imported product has been boned out legs and only approximately 60% of legs produced go into processing and that

the legs are approximately 1/3 of the carcase the imports have been a very large percentage of the processed leg market as demonstrated in Graph 2.

Graph 2 – Canadian Imports as a Percentage of Australian Processed Leg production



Source: ABS & ABARE

In order to understand the impact of this it is vital to understand the importance of the leg market in Australia where it is the key driver for price in the marketplace. The industry has traditionally made a large of its money in the last quarter of the year when demand for Christmas hams drive the market. This was not he case in the last quarter of last year when the price of pigs fell in the last quarter of the year. The dramatic effect of this problem on the cashflow of our farms is discussed in the confidential section.

Step 2 – What is the Industry

(Issue of Like or Directly Competitive Product)

Using the information that is supplied in the issues paper from the Commission it is obvious that the pig production part of the industry is clearly producing like product and that the product that farms produce is in direct competition with the imported product.

Auspork in itself is part of the industry where part of the processing chain is owned by the pig farmers themselves. As Auspork as a company is breaking and boning pigs to supply processors with legs for processing into leg hams and boneless leg product we are clearly producing like product.

However if that narrow definition was used it leaves out a large part of the industry that has clearly been affected.

We believe that the vast majority of producers are producing like product due to the simple fact that the vast majority of the producers are only paid for carcases not for live pigs. The point at which the ownership of the product takes place is at the scales before the carcase enters the chiller. At this stage the pig has been slaughtered, de-haired, eviscerated, cleaned and trimmed. Therefore the product is carcase at the point of change in ownership. In our system many of our customers pay for the carcase at this point even though they may request further trimming past the scales. That is, they pay for the carcase as a standard hot weight carcase at this point even though they may require further trim for their final specifications. Therefore the pig farmer is clearly selling a carcase and not a live pig at this point.

As 93-95% of carcases are sold in this way and only 5-7% of pigs go through live markets this means that the vast majority of the industry transfers ownership of carcases. This means that the vast majority of industry is producing like product that is in direct competition with imported product.

Step 3. Has the Industry Suffered or is Likely to Suffer Serious Injury

In order to support the view that the industry has suffered serious injury we would like to present two sets of information.

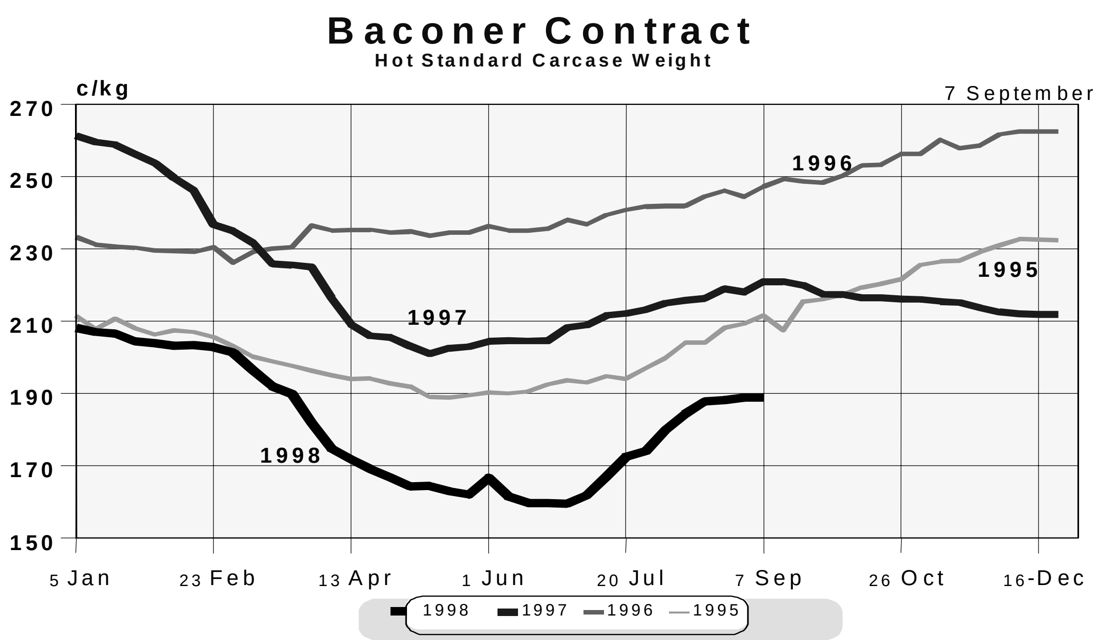
Industry Information

Graph 3 shows the contract bacon prices for the last four years up to 7/9/98 sourced from QPPO and ABS data. This graph clearly demonstrates that:

1 The price of pigs fell in the last quarter of 1997 which is unique in the industry in Australia due to the seasonal nature of the Christmas demand. This is supported by the data for 1996 and 1995.

2 The price of pigs was significantly below the levels of previous years constituting serious injury to the industry.

Graph 3 – Baconer contract price information



Source: QPPO & ABS

The unusual part of the market situation was that the price fell in the last quarter of the calendar year. This created a situation where the price was much lower than normal at the start of the year. Therefore a larger fall than usual in the first half of the year created a much larger problem than otherwise be the case.

It can be seen that the 1995 price started at a similar level to the 1998 year. However the 1995 year was a year in which there was a large exit of production as the following figures from PigStats show:

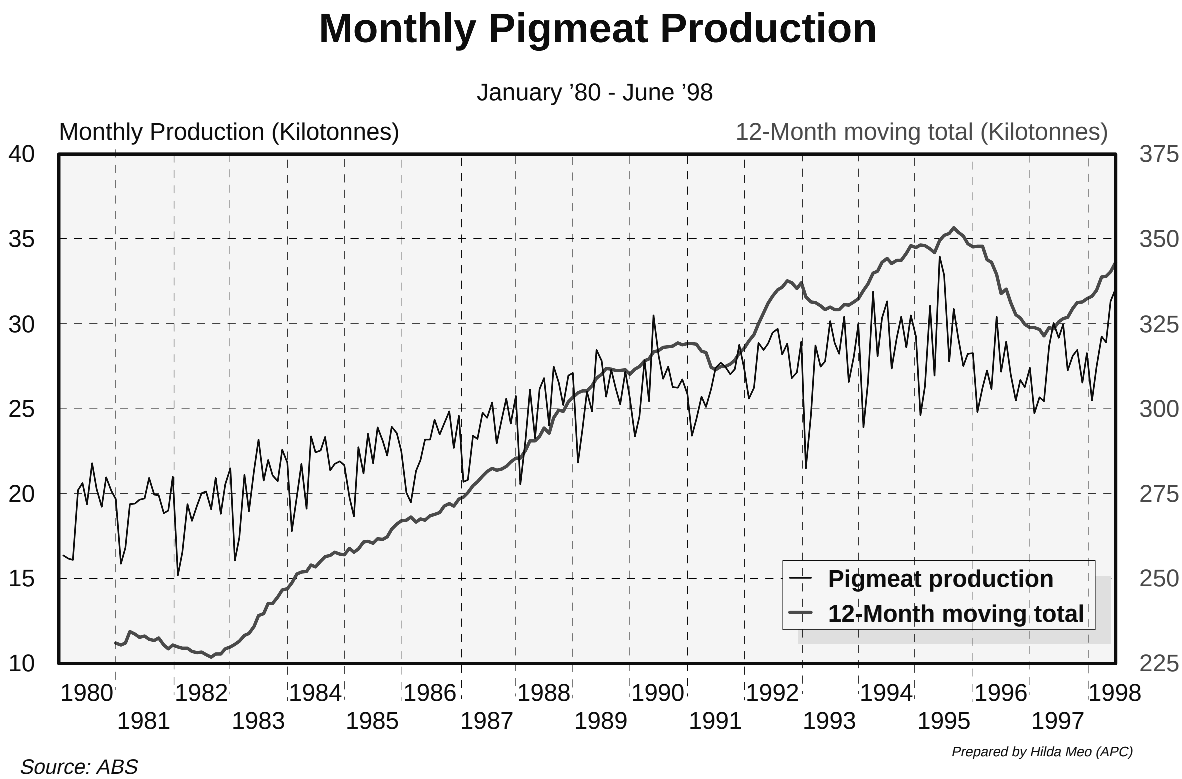
Table 1 – Farm and Sow Numbers from PigStats

	Farm Numbers	Sow Numbers
June 1993	4,754	308,250
June 1994	4,583	319,534
June 1995	3,615	290,026
June 1996	3,552	290,029
June 1997	3,337	298,815

These numbers also show up in the production and consumption figures in graph 4.

Basically a combination of poor prices and high grain prices due to the drought in Australia led to a very tough period in the industry. The resultant loss of production shows up very clearly in the production figures. The moving annual total falls more slowly due to the way that it is calculated and that low numbers are the first to drop off the calculation. This loss of production meant that prices did not fall sharply during 1995 and then rose in 1996 as the full effect of the loss of sow numbers was felt.

Graph 4 – Monthly Meat Production Figures



Source: ABS

Specific Farm Information

This information is contained in the confidential section of our submission. It consists of information that has been supplied to the Company by its shareholders. Those shareholders have requested that the information that they have submitted remains confidential as it includes full financial results for the operations involved. This information shows the effects of the price falls on the operating profits and cashflows of the farms that supply Auspork.

We believe that there is also a serious threat of further serious injury and will argue that point in our conclusion.

Step 4. Are Imports Causing Serious Injury

There is no doubt from the preceding information that the industry has suffered serious injury. There has been considerable debate about the causes of this injury the main one being that over production has been the cause of the industry problem.

The theory can be shown to be false by an examination of the facts. As discussed previously there was a significant loss of producers and production in the 1995 calendar year. The data that is presented in graph 4 clearly shows the effects of that loss. The graph also clearly shows that the industry had started to recover from the slump in production that resulted. However production was still well below the peak levels that were experienced in 1995 and at about the same levels as the two years either side of those peaks. Yet prices have been much lower.

A second argument that has been leveled is that consumption levels are down and that marketing is our problem. As consumption is measured by dividing net production plus imports by the population this is at odds with the previous argument. As consumption is calculated in this way the fall in production that followed the exodus of farmers in 1995 naturally leads to lower consumption levels (as measured) as production falls and population increases. Consumption measured in this way is not a measure of demand.

The market has been fundamentally altered by the importation of large amounts of boneless leg ham products for the Christmas market. As can be seen in the graphs that we have presented the rise in imports has been mirrored by a fall in prices that has no other discernable cause. The impact of this is clearly shown in our private graphs of farm profitability.

Step 5. What Safeguard Measures Would Remedy Serious Injury

Our view on safeguard measures is based on four factors:

1. The rules that govern the process as defined in the Commission's Issues Paper.

2. Our view that the impact of the imports is related to a combination of a volume effect and the threat of higher volumes.

3. The Company's plans for development and in particular export development and the time frame in which they are occurring. These are contained in the confidential section.

4. Our view about the requirements of the industry to deal with the competitive effect of imports in the long term. These are tied in with our private plans which seek to address some of these issues.

Due to the fact that is going to take some time to construct increased export facilities and pursue some of the competitive issues that have been discussed in the submission a reasonable time frame of stability is required. A reasonable time frame is also required for investor confidence to obtain the sort of capital that we require and for those investors to have a reasonable view about receiving a return on their investment commensurate with risk.

We also believe that before the major increase in levels of imports last financial year the industry was able to cope with the levels of imports that occurred in the three years previously.

Therefore we would like to propose two possible models for the Commission to consider:

Tariff Quota Model

This is a combination of a quota below which all imports are tariff free and then a tariff imposed above that level to manage import levels.

The proposed quota level would be 4000 tonnes which represents an average of the three years before the recent surge in imports. This is based on the fact that the industry coped with these levels of imports and that to include the year that has caused serious injury would be incorrect.

The tariff level above that quota would be $2.00 per kilogram. This is based on the fact that prior to large volumes of imports coming in to the country boneless legs were selling from $5.50 per kilogram. The current import price is approximately $3.49 (average of last two months, based on ABS import data. Therefore the imposition of this level of tariff would restrict imports to 4000 tonnes unless the market returned to normal trading terms where legs could then still be imported at a competitive price.
This model would allow access to the market but allow some stability to occur. We believe that the industry needs a minimum of 3 years to get infrastructure changes

in place. Therefore we propose a three year tariff quota at this level, rising to 6000 tonnes in the fourth year to allow some graduated exposure to full market access.

While there are some difficulties administering this system we believe that it can be managed by allocating a quota to the importing countries that have access (currently Canada and Denmark) and allowing them to manage that quota. This system works for the export of beef from Australia to North America. Both countries in question have structures and systems in place now to manage their exports and it would fit neatly into their systems.

This proposal also deflects any potential problems in our second proposal with regard to the tariff levels that are set in that there is free market access fro some product even tough we do not have that reciprocal access to the EU market.

Tariff Only Model

In this model we would have a tariff with all product that enters the market which means that all importers are treated equally and there are fewer issues of administration. The key issue is at what level that tariff is set. Our view is that such a tariff would be set at $1.50 per kilogram of boneless product which would give an imported price of $4.92 - $5.73 per kilogram of boneless product based on the ABS import data which is attached in the appendices (avoiding the absolute low and absolute high price in the period from July 95 onwards.

Competitive Issues

The main issues that we believe are restraining our competitiveness with the rest of the world are:

Costs of inspection.

Despite the fact that our abattoir is accredited under project 2 which allows for company inspectors we still have costs of approximately 1.75 cents per kilogram that the North Americans do not have. This is $375,000 per year for our operation.

Grain Costs

Feed costs are approximately 70% of our total costs with grain being about 60% of feed costs (varies with price of grain and other inputs). The fact that we are exposed to unlimited meat imports while not being able to import significant quantities of grain means that we have the worst of both worlds. With the additional power of AWB Limited and the domestic market structures this means that we pay above world prices for grain.

At a price differential of $20 per tonne for grain this equates to $3.87 per pig (based on 60 grain cost of feed cost and a 4:1 feed conversion for a 75Kg dressed carcase). This equates to $1,107,096 per year under our current numbers. We believe that we have faced price differences of this order because of grain marketing and grain access in this country.

Carcase Weights and Specifications

We are at a significant disadvantage to the USA in particular where carcase weights are much higher than in Australia. Our estimates are that each 10Kg in carcase weight is worth 15 cents per kilogram in cost of production. Therefore increasing our average carcase weight would take approximately $3,218,000 in costs out of our production systems at current numbers. The main blocks that we see to carcase weight increases are:

⇒ Pork flavour issues. A recent vaccine present on the market reduces this problem significantly.

⇒ A reliance on middle rasher bacon compared to streaky bacon. Higher value needs to be made from the loin of the pig rather than making it into bacon. Changes are occurring in the market.

⇒ Supermarket requirements for pig size relating to portion control and handling.

⇒ Genetic advances required for better feed conversion at heavier weights.

Changes are occurring in the market but there is a risk. We need to have significant export facilities before we increase weights or the domestic market could become rapidly over supplied. Therefore the issue of infrastructure for export is vital for some of the structural changes that need to take place.

Conclusion

We have described our view on the issues that effect the industry and what has caused the recent downturn. Very clearly in our mind imports have caused the industry serious injury and there is a very great threat of further injury if some steps are not taken.

We believe that the industry is currently on a knife edge and there are two possible ways forward.

The first is that no change will occur in the industry's exposure to the threat of unlimited imports of pig meat. In this scenario we believe that the future of the industry will be one of a spiral that the industry cannot recover from. Every time that the industry is battered by increased volumes of imports our capacity to sustain a viable industry that has significant export markets is damaged.

The second is that some adjustment period is allowed so that those that are committed to the industry and its future can use this "breathing space" to invest in the future, develop more competitive structures and develop significant export markets. We still believe that this will be very tough and that the future we face will be more and more competitive. However the key issue is infrastructure and if we cannot get the capital, pig supply and the confidence to construct that infrastructure we will not even be able to get into the game.

We have presented the information that we have about the problem and we believe that the data is very compelling.

We have presented confidential information to the inquiry that shows our vision for the future and our commitment to put our capital on the line to achieve that vision.

Despite all that information the most compelling argument that we can mount does not rely on facts and figures. That argument is based on the people who we talk to in our organisation and the industry. That argument is based on the depth of the loss of confidence that we see around us at all levels. Without that confidence being returned we can do very little.

We believe that the measures that we have described will allow a return of confidence and give the industry a competitive future. We believe that such measures are good policy and that Australia should utilise the rights that it has under the WTO to implement them.

The industry will be much different than it is today in five years time. The question is which road at this key junction we will travel.