

SENATE ECONOMIC REFERENCES COMMITTEE
ENQUIRY INTO THE AUSTRALIAN DAIRY INDUSTRY
SUBMISSION BY
PETER H. LAVERY AM

1. Basis of Submission.

This submission is made by me on a personal basis and I do not purport to represent any organisation. I take personal responsibility for the views I have expressed which are my own and may or may not conform with the views of others. Rather than cover a wide range of issues, I have confined my comments to three areas: the current international dairy market, dairy price indices and cooperatives and Murray Goulburn. In my view, much of the public discussion of these three matters has not properly addressed the underlying issues. I would be happy to respond to other matters should the Committee wish me to do so.

2. The Current International Dairy Market.

Prices for dairy commodities in the international dairy market have always been subject to fluctuations. Many well informed observers say it is roughly a seven year cycle in which prices approximately halve then recover to go on to new all-time highs. The current weakness in prices fits this pattern and is not the worst that I have seen. Indeed, since some discipline has come into the EU's Common Agricultural Policy, the volatility of the market is less than previously.

In each down-turn, there are inevitably farmers who are unable to cope and leave the industry. This is, largely, natural attrition with larger (and generally more economic) farmers taking over the role of those leaving the industry. Consider the following approximate figures for the Australian Dairy Industry.

	1970	2014/15
Number of Dairy Farms	28,000	6,128
Average herd	70	284
Litres/Cow	< 3,000	5,592
Litres/farm	< 210,000	1,588,000
Milk Production	7.0 b litres	9.73 b litres

The reality is that dairy farming is a production industry. Since the 1950s, and particularly with the development of computers and electronic technology, all production and extractive industries there have been declines in number of producers and increases in production per unit. The same phenomenon can be seen in industries such as motor cars, household appliances, other farm commodities, etc., etc., etc.

While this is no comfort to those leaving the industry, at every stage of the deregulation of the industry and at other times of stress, packages were put together by the industry and/or government to compensate those leaving. The most obvious example was the \$1.6 billion package which supported the deregulation of the liquid milk market.

The fact is that the current weakness in international dairy prices is part of the usual cycle and is not as bad as has been seen in some previous downturns. What has made this cycle seem so severe for dairy farmers is that they received a price for their milk for the bulk of the year's production and

then found the price retrospectively reduced. Apart from the direct loss of income many farmers would be financially embarrassed because they would have committed much of the money elsewhere – a new milking shed, herd improvements, fencing, etc. It is that price reversal which has made this downturn so severe. I refer further to this matter later in this submission.

3. Dairy Price Indices.

It has been suggested that an index for farm gate milk prices should be developed to assist dairy farmers with their planning. Whilst the desire for an index of this type is understandable it is more complex than it appears and, in some circumstances could be more misleading than helpful.

Issues which complicate developing a farm price index include:

- a. Milk can be manufactured into a wide range of products for sale. Indeed, only about 20% of Australian milk is sold as milk (and even that is standardised to remove excess fat). In manufactured products, each individual commodity requires certain proportions of fat and/or non-fat solids which do not conform with the natural ratio of fat to non-fat solids. For example, just for the major commodities, based on a vat of 10,000 kg of milk with 4.2% fat and 8.8% non-fat solids and the yields in KG are:

Commodities → Product Mix V	Butter	Skim Powder	Buttermilk Powder	Whole Powder	Casein	Cheddar Cheese	Whey Powder
Butter/Skim Powder	508 kg	855 kg	55 kg	-	-	-	-
Butter/Whole Powder	117 kg	-	12 kg	1,263 kg	-	-	-
Cheddar Cheese/Butter	114 kg	-	11 kg	-	-	975 kg	530 kg

- b. The prices of the individual commodities do not move in parallel so the return from one product mix can vary from another. Whilst in the long run they may even out, in the short term (i.e. for an individual season) differences of as much as 20% are not unknown.
- c. Any calculation of a farm-gate milk price needs a market price for all these commodities and, given that their prices can fluctuate up or down by 30% or more in a year. The average amount realised by a manufacturer therefore depends on what the manufacturer produces and when it is sold.
- d. Dairy farmers are paid on the basis of annual returns. An index would therefore need to be based on an estimate of the likely realisable price over a year. A “spot” price may provide an indication on an individual day but that is of little use to a dairy farmer who must, by virtue of cows’ lactation patterns, commit to production on an annual basis.
- e. The comments above are only for the basic product mixes. There is a vast range of other products including a multitude of cheese varieties, whey and protein concentrates, infant formulations, etc., etc. These are steadily using increasing proportions of Australia’s milk.
- f. An estimate of farm-gate milk price would also require estimates of direct manufacturing costs for each product, manufacturers’ overheads and milk collection costs. These can vary widely from manufacturer to manufacturer.

For the above reasons, it is difficult, if not impossible, to develop a farm-gate milk price index which provides reasonable guidance to dairy farmers. In any event, once the cows are joined and a season has started, a dairy farmer’s ability to vary milk production and inputs is limited. On a forward basis, the “Situation and Outlook” documents provided by Dairy Australia are as good as anything produced in this area – but even they come with cautions.

The desire for a farm-gate milk price index presumably relates, in part, to dairy farmers' desires to monitor the fairness of the price(s) they are receiving from the manufacturer to whom they supply and/or to minimise their risk. In my view, a farm-gate milk price index will achieve neither of these objectives. It is a little like the stock exchange - one knows what the index is today but that indicates nothing about what the index will be tomorrow or what dividends will be (overall or from individual companies) over the forthcoming period. In the end, predicting likely farm-gate prices is as much about experienced judgement as science.

There are, however, two aspects which might be considered in this area:

- a. There is scope for further and more regular communication to dairy farmers about prices. There are commodity exchanges which trade product on a future delivery/forward price basis. Examples are the New Zealand Stock Exchange contracts, the Chicago Mercantile Exchange, the gdT (Global Dairy Trade platform) and others. Where they provide for forward delivery, these can provide indications of price trends. Better communication in this area may assist farmers in their decision making.
- b. In the area of risk mitigation, I consider there is considerable scope to move some short-term risk away from farmers by allowing the formation of "milk supply cooperatives". These would act on behalf of farmers to negotiate prices with receiving manufacturers. On the assumption they have appropriately experienced personnel who are reasonably informed about the markets, these entities could better negotiate with manufacturers to reduce dairy farmers' exposure to short-term price volatility. They could also serve to weaken the current problems of farmers being "locked in" to manufacturers.

This would need to be discussed with the ACCC but given the improvement in the balance of bargaining power, it should be acceptable. (There are examples of ACCC approved farmer organisations of this type in New South Wales and Queensland.)

4. Cooperatives and Murray Goulburn.

In the late 19th and early 20th centuries there was virtually a dairy cooperative in every town in dairying areas. The reason for this was that milk was perishable and transporting it to another town for manufacturing was impractical. The cooperatives were formed to eliminate the disadvantaged bargaining position of dairy farmers. (Ironically, farmers now complain that the transport system is inefficient because a number of tankers pass their farm every day.)

From 1970 to 1990 there was substantial merger activity and the number of cooperatives was reduced to about ten with two dominant cooperatives emerging – Murray Goulburn and Bonlac (which subsequently failed and was bought by Fonterra). Other cooperatives were taken over so that Murray Goulburn is now effectively the only cooperative in the major milk producing states. Effectively Murray Goulburn now sets the base farm gate price for all dairy farmers in these areas.

It is arguable that there is no need for manufacturing cooperatives. It should be possible for farmers to form milk supply cooperatives which would negotiate milk supply prices and conditions with dairy manufacturers. This would balance the bargaining power between farmers and manufacturers without farmers having to invest in manufacturing plant and equipment. Such arrangements would need to be approved by the ACCC but, given these milk supply cooperatives would provide better balance in bargaining power, this should not be a problem.

However, if there is to be a manufacturing cooperative it has to be understood that the manufacturing and marketing of dairy products is a complex undertaking. It involves:

- a. Bulk products such as milk powders for which commodities skills are required.
- b. Ingredients which have special functionalities and involve advanced complex and capital intensive manufacturing processes.
- c. Sophisticated marketing of consumer packaged products.

In each case, account must be taken of both the domestic and export markets with related foreign exchange and financing issues.

Murray Goulburn handles over one third of Australia's milk, has a staff of 2,600 and a turnover of \$2.8 billion dollars. Traditionally, the board of directors has comprised a managing director and farmers elected from zones. This has been a major governance problem. A board selected in this manner has little chance of having the requisite skills or commercial experience to guide a large company in a complex environment. This has been reflected over the last two decades in which Murray Goulburn has failed to be successful in all significant corporate plays in the industry. These include, amongst others, Bonlac, Dairyfarmers Coop, Tatura and Warrnambool all of which have been taken over and successfully run by those who bought them. Put simply, there was not the commercial experience or judgement necessary to be successful in this area.

In relation to the retrospective farm milk price reduction, before the 2015/16 season started almost all dairy industry observers noted the market was weakening and held the view that farmers would be lucky if they received \$5.00 /kg solids, notwithstanding the (then) Murray Goulburn managing director's claims. Despite this, it was not until April, when the international market had deteriorated much further, that the Murray Goulburn board reacted. It is totally inexcusable for the board to have only come to a realisation of this situation at such a late stage. It is symptomatic of complete lack of collective commercial judgement.

Since 2012, there have been two directors with special qualifications on the board. They are highly appropriate members of the board but they are two out of nine. Murray Goulburn is a substantial manufacturing and marketing company – not a dairy farming enterprise. A properly balanced board covering the requisite skills to oversee Murray Goulburn should be the other way round – two farmers and nine with commercial backgrounds. It is hard to see Murray Goulburn becoming financially strong and progressive until this issue is resolved and, given its role in setting farm gate prices, that will be to the detriment of all Dairy farmers.

It would be useful to consider a structure such as that of Fonterra in New Zealand where there is a fully professional main board comprising two farmers and ten members with commercial backgrounds with a "Shareholders Council" elected by farmers to advise the Fonterra board on matters affecting farmers. The concept of "farmer supply cooperatives" mentioned earlier in this submission, is also relevant in this area.

5. Committee Hearings.

I am happy to make myself available at Committee hearings to answer any questions about this submission or any other matters Committee members may wish to discuss.