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9 November 2016

Senator Chris Ketter  
Chair  
Senate Economic References Committee  
PO Box 6100  
Parliament House  
CANBERRA ACT 2600

Dear Senator Ketter,

### **RE: Senate Economic References Committee Inquiry into the Dairy Industry**

Fonterra Australia welcomes the opportunity to provide a submission to the Senate Economic References Committee Inquiry into the Dairy Industry. The inquiry is taking place at an important time for the dairy industry, and it is vital that the reasons for the price revisions last season are well understood.

Fonterra acknowledges its price revision had a significant impact on the farmers who supply it. We have seen that impact clearly as we have been in frequent communication with those farmers over the past six months. We rely on the trust of our farmers and are extremely disappointed that, despite our efforts to warn, we were not able to prevent this situation from happening.

Our submission explains the global and domestic factors that led to Fonterra revising its milk price on 5 May 2016.

We also outline a number of measures Fonterra is undertaking, of its own initiative and together with other participants in the Australian dairy industry, to strengthen our relationship with suppliers and restore confidence in the industry.

### **Introduction to Fonterra Australia**

Fonterra Co-operative is a global dairy business and the world's largest dairy exporter, and owned by around 10,500 farmer-shareholders, who have over AU\$1 billion of equity invested in Australia.

Locally, Fonterra Australia works with around 1,100 dairy farmers and employs around 1,500 people, the majority of whom are based in regional areas. Last season we collected and processed roughly 18 per cent of Australia's milk at our seven factories located throughout regional Victoria and Tasmania.

### **Global challenges**

Over the past few seasons, global political and economic factors led to an oversupply of milk and weaker demand, culminating in a reduction in global dairy prices. Russia's self-imposed trade sanctions closed its borders to dairy imports from Europe, the US and Australia, meaning that product that would ordinarily go to Russia was now on the global market, searching for a buyer. Coupled with the removal of dairy production quotas in Europe and resulting in a 3.5 per cent increase in EU dairy production,<sup>1</sup> global dairy markets experienced a surge in supply.

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<sup>1</sup> Dairy Australia "Situation and Outlook, October 2016", p. 23

On the demand side, lower oil prices affected Middle Eastern economies, lessening their purchasing power and subsequently their demand for dairy. Similarly, a weaker Chinese economy saw a fall in demand for bulk commodity powders, including Whole Milk Powder (WMP) and Skim Milk Powder (SMP).

The confluence of global oversupply and weak demand saw dairy commodity prices hit decade lows last season. This is evident in the decline in SMP prices from 2013-2016 (see table 1 below).

**Table 1: Decline in Skim Milk Powder Prices – 2013-2016**

Month and Year	Price of SMP
April 2013	US\$5,142 a tonne
August 2015	US\$1,419 a tonne
May 2016	US\$1,658 a tonne

Source: *GlobalDairyTrade* SMP results, <https://www.globaldairytrade.info/en/product-results/skim-milk-powder/>, accessed 7 October 2016

This volatility came as the Australian dollar surged relative to the US dollar, which had an adverse effect on the returns received for our dairy exports from Australia.

Across the global dairy industry, for the past two seasons farmers have been adapting to the low milk price environment. For example, in New Zealand, where approximately 90 per cent of milk produced is destined for the export market, last season dairy farmers received the equivalent of ~\$3.65 per kgMS (NZ\$3.90 per kgMS), only slightly higher than the season 2014-15 farmgate milk price in New Zealand of ~\$3.61 per kgMS (NZ\$3.85 per kgMS). For much of last season, the average Southern Australian farmgate milk price of \$5.60 per kgMS did not reflect the global market price for milk.

### Domestic challenges

In addition to these global challenges, the Australian dairy industry has also been challenged domestically.

The demographics of the Australian dairy industry are highly varied. Queensland, New South Wales, and Western Australian production largely services the domestic market. Victorian, Tasmanian and some South Australian production is predominantly directed to the export market. This means the Southern Australian milk pool is subject to the volatility of the global market.

Climatic conditions throughout season 2015/16 were highly unfavourable in the Southern Australian milk pool, with an El Niño and resulting high temperatures and low rainfall affecting pasture growth, and high grain prices increasing input costs for farmers.

### An unfavourable product mix

Fonterra has been particularly vulnerable to these global and domestic challenges owing to an unfavourable product mix, which has seen milk directed into products delivering lower stream returns.

In late 2013, Fonterra lost a major nutritionals customer from its Darnum processing plant in Eastern Victoria. This resulted in milk that had previously been directed into high-value nutritional powders instead being directed into SMP, which at the time was selling for approximately ~US\$4,500 per tonne on the *GlobalDairyTrade* index.<sup>2</sup>

In December 2014, Fonterra's Stanhope plant in Northern Victoria suffered a fire that destroyed its primary cheese plant. This resulted in the further redirection of milk that had been producing high-value cheese into SMP, which in December 2014 was selling for approximately ~US\$2,500 per tonne on the *GlobalDairyTrade* index.<sup>3</sup>

<sup>2</sup> *GlobalDairyTrade*

<sup>3</sup> *GlobalDairyTrade*

The redirection of milk from nutritionals and cheese, products delivering higher returns, into comparatively low-value SMP, had a substantial impact on Fonterra Australia's profitability, with losses to the Australian arm of the business sustained in financial year 2014 circa \$208 million and financial year 2015 circa \$137 million.

### **Southern Australian milk pricing**

The Victorian and Tasmanian dairy manufacturing industry (including Fonterra), generally operates a milk pricing system whereby an opening forecasted price is provided with effect from the beginning of the season, based on an estimate of expected market returns for the season. Where a processor, such as Fonterra, exports a significant portion of its production, it can be difficult to reliably predict farmgate returns from 12 months in advance.

To assist with this, as the season progresses, and certainty is gained on market returns for the season, farmgate milk prices can be increased or decreased. Price increases are referred to in the industry as "step ups" and are usually paid retrospectively for milk supplied from the beginning of the season. Price decreases are referred to as "step downs" and generally do not require suppliers to repay payments for milk already supplied; rather, the milk price is reduced for milk supplied for the remaining months of the season to achieve a season average. The terms and conditions of milk supply to Fonterra, including our milk pricing system and the implementation of step ups and step downs, are set out in Fonterra Australia's Milk Supply Handbook, provided annually to every Fonterra supplier.

Price increases, or step ups, are common in the dairy industry, while step downs are rare, occurring in just two of the last ten seasons for Fonterra suppliers, twice in 2009-10, following the global financial crisis, and last season, 2015-16.

For this milk pricing system to function successfully across the industry and be sustainable, it is very important that processors provide transparent and timely price forecasting so farmers can do their income and business planning.

The Southern Australian milk pool is highly competitive, with processors competing for supply to fill their factories. In order to retain supply, companies are compelled to set their milk price at a level similar to that of their competitors.

Fonterra Australia has an agreement with the Bonlac Supply Company to pay farmers no less than the price paid for that season by the leading Victorian processor (by milk volume), which for the term of the agreement has been Murray Goulburn. This guarantee operates for the benefit of farmers and was insisted upon by them to ensure Fonterra did not pay them a price that was too low. It reflects the trust farmers have traditionally placed in Murray Goulburn, as the leading processor and a farmer-owned cooperative, to protect farmers' interests in setting the milk price that it pays, and to exercise good corporate governance and be realistic in making price forecasts.

Although the guarantee only requires Fonterra not to pay *less* than Murray Goulburn, for five of the last seven seasons, including last season, Fonterra Australia has paid a farmgate milk price *more* than that of Murray Goulburn (Appendix I).

In 2014 Fonterra Australia introduced a tool to assist farmers in managing risk in their business, Fixed Base Milk Price. This programme allows Fonterra suppliers to lock in a volume of their milk at a set price, similar to locking in part of a home loan at a fixed interest rate. It was introduced to aid suppliers in managing risk and provides greater certainty by helping them to plan ahead with confidence.

In 2015 we expanded the offering to introduce Milk Price Range, which set a price range so suppliers could be confident of knowing the minimum and maximum price for a set volume of milk.

In the first year of the Fixed Base Milk Price programme, approximately 100 million litres of milk was locked in across our supplier base at an average fixed price of \$6.22 per kgMS from the total volume of milk collected of 1.6 billion litres, or approximately 6.25 per cent. Last season just 12 million litres — an 88% reduction on the previous year — was committed by farmers under the programme, or approximately 0.75 per cent of our total milk volume, at an average fixed price of \$5.80 per kgMS. This season, that amount has risen to around 45 million litres, or approximately 2.81 per cent of our total milk volume, at an average fixed price of \$5.10 per kgMS.

## Season 2015-16

In August 2015, less than ten weeks after the season opened, dairy commodity prices hit ten-year lows due to the aforementioned global supply-demand imbalance. Our contractual obligations under the BSC agreement meant that we were bound to pay a price not less than the leading Victorian processor, Murray Goulburn, which was \$5.60 per kgMS for much of season 2015-16, despite the global market not supporting that price.

Fonterra shifted from bi-monthly to monthly price reviews in August 2015 to provide more regular price advice to suppliers, and warned suppliers that a step down was possible if the global market did not materially improve. In late August 2015 Fonterra Co-operative CEO Theo Spierings made public comments that the Australian domestic milk price was too high (see Appendix II),<sup>4</sup> prompting widespread criticism that Fonterra was talking the Australian industry down.

Despite Fonterra's warnings, farmers knew that Fonterra was obliged to pay not less than the price paid by Murray Goulburn. It was not until late April 2016 that Murray Goulburn revised their price to \$4.75–\$5 per kgMS.

Following the price revision by Murray Goulburn, Fonterra reviewed its own farmgate milk price in the context of the global market and our own ability to deliver \$5.60 per kgMS. Unfortunately due to exposure to the global markets and our unfavourable product mix, and the fiscal position of the Australian business, the difficult decision was made to revise our milk price to a season average of \$5.00 per kgMS, effective 5 May 2016. To achieve the season average, this corresponded to an average milk price of ~\$1.91 per kgMS for milk supplied from 5 May to 30 June 2016. No supplier was required to repay any money already received for milk supplied.

Due to the price revision, Fonterra lost some volume of its forecast milk supply (as farmers on standard term contracts had the ability to cease supplying Fonterra immediately and others chose to dry off early). This meant our average milk price for the 2016 financial year was ultimately A\$5.13 per kgMS, higher than the revised price that was announced and a premium of 33 cents per kgMS from the final Murray Goulburn price of \$4.80 per kgMS (excluding its Milk Supply Support Payment).

## Season 2016-17

This season we've provided our suppliers with stability, offering a competitive opening price of \$4.75 per kgMS with a forecast closing price of \$5.00 per kgMS, and in November stepping up to \$5.10 per kgMS with an increased forecast closing price of \$5.20 per kgMS, currently the highest farmgate milk price amongst Australian processors.

As demonstrated in table 2 below, Fonterra is again on track to deliver our suppliers a higher farmgate milk price than Murray Goulburn. This is even though Fonterra's pricing is based on the current global market for dairy commodities, whereas Murray Goulburn's pricing is partially funded by debt.

**Table 2: Murray Goulburn and Fonterra Australia financial year 2017 price movements**

MG FY17 Pricing	Opening	13 <sup>th</sup> Sept	20 <sup>th</sup> Oct	27 <sup>th</sup> Oct	June 2017	Full Year
Full Year Forecast	\$4.80	\$4.88	\$4.70	\$4.95	\$4.95	\$4.95
Opening/Current	\$4.45	\$4.60	\$4.60	\$4.73	\$4.86	\$4.95
MSSP	\$0.14	\$0.14	\$ -	\$ -	\$ -	\$ -
Cash Price	\$4.31	\$4.46	\$4.60	\$4.73	\$4.86	\$4.95

<sup>4</sup> "Aussie farmers being overpaid amid global dairy rout, says Fonterra boss", Jared Lynch, *Sydney Morning Herald*, <http://www.smh.com.au/business/aussie-farmers-being-overpaid-amid-global-dairy-rout-says-fonterra-boss-20150824-qj645k.html>, 28 August 2015, accessed 11 October 2016

Fonterra FY17 Pricing	Opening	13 <sup>th</sup> Sept	20 <sup>th</sup> Oct	27 <sup>th</sup> Oct	June 2017	Full Year
Full Year Forecast	\$5.00	No change		\$5.20		\$5.20
Opening/Current	\$4.75			\$5.10		\$5.20

### Supporting our farmers following the price revision

To assist suppliers following our price revision, Fonterra put in place a number of support measures:

- We made available to all affected suppliers a low-interest loan programme, known as the Fonterra Australia Support Loans. The programme offered suppliers a loan of up to 60c per kgMS, repayable from financial year 2018 onwards, to assist with cash flow in the short term. Approximately 40 per cent of suppliers have chosen to take up the loan offer.
- We also extended access to our Employee Assistance Programme to all suppliers, their staff, and families, so that they could access free, independent and confidential counselling services.
- In addition, we introduced an additional offset for milk supplied in May and June, payable to suppliers in the new season in July and August. This recognised the disproportionate effect our price revision had on autumn and split calving herds. The offset provided an additional \$2.50 per kgMS on volumes supplied from 5 May to 30 June 2015, payable in July and August. The autumn offset was aimed at reducing the disparity between suppliers with a peak or spring calving herd (most milk supplied in spring) and those with split or autumn calving herds.

### The way forward for the dairy industry

The past six months have been challenging for farmers, and many ideas have been raised to support farmers, from government, industry, and the public, some practical, and some not. We note in particular the proposed introduction of measures such as a floor price for milk or a 50 cent levy on the sale of fresh milk, with proceeds directed to an emergency fund to assist dairy farmers.

We do not support these proposals. We are concerned they would be steps towards re-regulation of the dairy market that would jeopardise our international trade agreements and undermine Australia's competitiveness. Accordingly, we urge the Committee to exercise caution, and not make recommendations that could unintentionally harm Australia's dairy industry by reducing our ability to compete globally. The ability to compete globally is vital for the industry particularly given domestic growth is not likely given pricing pressures.

Fonterra is supportive of a number of measures already being taken within the dairy industry, including measures initiated by Fonterra and measures supported by the ACCC, to rebuild relationships with suppliers and restore confidence in Australian dairy. Those measures include:

- Fonterra is an active participant in industry activities to address the underlying causes of the current issues facing the dairy industry, including through better signalling of global market conditions domestically by dairy industry participants and more timely and transparent pricing signals for farmers.
- We participated in the Dairy Symposium convened by the Australian Government, and we're a member of the Australian Dairy Industry Council's committee to develop a Dairy Industry Code of Conduct. We look forward to working with industry to develop a Code that provides greater certainty and sustainable profitability for everyone in the value chain, including farmers and consumers.
- Within our own business, our suppliers told us they wanted clearer price signals so that they could plan ahead with greater certainty, so we introduced a monthly Australian Global Dairy Update, which includes information on market conditions, commodity prices, currency and input costs – the factors that influence cost of production and farmgate milk price. We're also working



towards providing greater transparency on price so that suppliers better understand how their milk price is determined.

- The Australian Government has announced that the ACCC will conduct an inquiry into the dairy industry. We understand it will be conducted from November 2016 to November 2017. We intend to participate fully and constructively in that inquiry.
- The ACCC has also been communicating with the dairy industry regarding the new laws prohibiting unfair terms in contracts with small businesses. We are addressing this issue in preparation for the commencement of the new laws in November 2016.

In addition, in our own business:

- Over the last three years we've undertaken a significant business transformation to strengthen our business and make us more resilient and better able to adapt to volatile markets. This has included reducing headcount, reducing working capital, making operational improvements, streamlining our brands, and divesting non-core assets, including our yoghurt and dairy desserts business, our Wagga Wagga route business, our stake in Dairy Technical Services and our stake in Bega Cheese.
- We are committed to Australia for the long-term and investing in the future. This includes \$140 million to rebuild and expand our factory at Stanhope, expanding capacity at our Wynyard and Cobden sites, and signing nutritional customers to fill our Darnum factory. All these are happening now.
- We're focussed on delivering on our strategy to become Fonterra Co-operative's global ingredients hub for cheese, whey, and nutritionals, complementing our domestic consumer and foodservice businesses. This strategy ensures that we're extracting maximum value out of every drop of milk to ensure we are a strong business that can deliver sustainable returns right along the value chain, particularly to our farmers.

Although the dairy industry continues to be challenged by global volatility, the long term fundamentals for dairy remain positive. Global supply and demand is rebalancing, with lower milk prices now starting to affect European production, and demand is stabilising. With a growing population, expanding middle class in Asia, increasing urbanisation, and favourable demographics, demand for dairy is forecast to grow two to three per cent each year, and Australian dairy is well positioned to capitalise on this opportunity.

Yours sincerely,

Judith Swales  
Chief Operating Officer Velocity and Innovation  
Fonterra Co-operative Group Limited

Matt Watt  
General Manager Australian Milk Supply  
Fonterra Australia

## Appendix I: Milk price in Australia since 2010

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Fonterra Aust. Milk Price <b>AU\$kgMS</b>	\$ 4.50	\$ 5.70	\$ 5.45	\$ 4.97	\$ 6.95	\$ 6.00	\$ 5.13	\$5.10*
MG Milk Price <b>AU\$kgMS</b>	\$ 4.45	\$ 5.64	\$ 5.44	\$ 4.97	\$ 6.81	\$ 6.00	\$4.80-	\$4.73*
Fonterra NZ Milk Price <b>NZ\$kgMS</b>	\$ 6.10	\$ 7.60	\$ 6.08	\$ 5.84	\$ 8.40	\$ 4.40	\$ 3.90	\$ 4.25*

\* As at October 2016



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# Aussie dairy farmers being overpaid, says Fonterra's chief

**Dairy**  
**Jared Lynch**

Australian dairy farmers are being paid too much for their milk, says the boss of the world's biggest milk exporter, Fonterra.

Most dairy processors in Australia, including Fonterra, are paying farmers an average of \$5.60 a kilogram for milk solids.

But the New Zealand dairy giant's chief executive Theo Spierings, said this was too high and did not reflect a collapse of global prices for key dairy commodities.

"What you cannot do is pay money that you have not earned," Mr Spierings said.

"We need to have an honest debate about what is being earned in the market. There will be different views but at a certain point in time people will land at a certain number ... because [the farm-gate price] is not difficult to calculate".

Dairy companies have matched Australia's biggest milk processor, Murray Goulburn, which set the price for the season in June.

The farm-gate price forms a key part of Murray Goulburn's non-voting unit trust - which floated last month - because it is tied to its dividend. If the farm-gate price falls to 2012-13 levels, the yield would fall from 7.4 per cent to as low as 3.5 per cent, says its pro-

spectus.

Mr Spierings said he could calculate a more accurate farm-gate price based on Australia's dairy exports, which is 50-60 per cent of total production. "We know export prices so I can calculate based on the mix of exports that [farm-gate] price," Mr Spierings said. "And that is not on the level of \$5.60."

But he stopped short of saying what he believed the price should be, saying next week's global dairy trade auction could alter things.

In New Zealand - where Fonterra has a monopoly and up to 95

per cent of its total milk production is exported - the farm-gate price has plummeted from an average of \$NZ8.65 (\$7.81) to \$NZ3.85 in the past two seasons.

In that time whole milk powder prices have dived from \$US4999 (\$6957) to \$US1856 a tonne, while skim milk powder has plunged from \$US4780 to \$US1521 a tonne, show Global Dairy Trade figures.

Russian trade sanctions and weakening demand from China has led to an oversupply of dairy products on global markets.

Mr Spierings said the method on how Australian farmers were paid needed to change so it wasn't based just on the farm-gate price.

"It's loyalty and skin in the game that can lead to an upside. You can call it a dividend, or whatever, a

bonus per kilogram milk solids," he said. "But we need to have the conversation now about what the end-game looks like. What is the value being created - what's the size of the cake? Then we need to have a good debate with farmers ... about how are we going to share - how are we going to cut the cake?"

Part of Fonterra's strategy to deliver value to farmers has been slashing 500 jobs, or about 3.3 per cent of its global workforce. Most of these jobs have been support roles in procurement, finance, human resources, information services and legal departments.

Mr Spierings said the redundancies weren't part of a company restructure but a "mindset shift".

"So there are people, our sales people, who go into the market every day and sell the product at the best possible price in the right channels... at minimum rebates and discounts. Then we run our factories in the most efficient way."