



Inquiry into the Australian dairy industry to the Senate Economics References Committee

Submission by
Lion Dairy & Drinks Pty Ltd

October 2016

Executive Summary

Lion appreciates the opportunity to make a submission for consideration to the Senate Inquiry into the Australian Dairy Industry, and help the Committee understand Lion's approach to milk procurement in Australia.

The core activities of Lion Dairy & Drinks (Lion) in Australia are the manufacture and wholesale of white milk, flavoured milks, fresh dairy foods, speciality cheeses and fruit juices. Lion formerly known as National Foods, has dairy origins stretching back to the formation of the Dairy Farmers' Milk Cooperative in 1900.

Our approach to milk procurement is based on offering farmers 'three P's': competitive **pricing** and contract terms, **partnerships** for the long term, and a clear **purpose** and strategy built around growing profitable demand for dairy and ensuring sustainable returns through the supply chain.

Retrospective changes in milk price including price cuts, are anathema to Lion, as they undermine trust, drive volatility and damage farmers' ability to plan for and invest in their businesses. That is why, unlike some processors, Lion has not imposed retrospective cuts in response to recent market conditions and does not support them as a matter of principle.

Lion's farm gate milk pricing offer for the 2016/2017 milk season compares favourably to competitors and we are confident that this pricing is a compelling mix of reward and security for dairy farmers.

We are committed to creating sustainable partnerships with our dairy suppliers and this premium on milk price comes as Lion continues to lose money on our white milk business in Australia. Throughout the past year we have again experienced a decline in modified white milks - this is offset by our performance in other dairy categories namely milk based beverages and yoghurt.

Since 2013, Lion has offered its dairy farmers in the southern region (Victoria, Tasmania and South Australia) a broad range of fixed and variable farm gate pricing options for contracts of varying lengths (one, three or five years) that help farmers to better manage market volatility.

Lion's fixed term contract options continue to enjoy strong take-up, with the majority of southern region farmers opting to secure all or part of their pricing for up to three years. Due to the carryover of fixed contracts from past seasons, Lion expects to pay the majority of its direct farmers in 2016/2017 in the southern region the net weighted average price of \$5.67 per kilo of milk solids.

This price represents a premium of 27% over the forecast opening price announced by the price setter in the southern region.

In the southern region for 2016/2017 our three year fixed price is \$5.50 per kilo of milk solids, while the one year fixed price is \$5.10 per kilo of milk solids and the one year variable price is \$5.00 per kilo of milk solids. These prices are based on standard 7.2% milk solids.

During the past months we have had a number of suppliers approach us asking to move their supply to Lion, unfortunately as we procure our milk based on our demand, we have been unable to accommodate these requests.

About Lion

Lion is a leading beverage and food company based in Australia and New Zealand. We make and market many of the region's favourite brands including Dairy Farmers, Pura, King Island Dairy, Dare iced coffee, Farmers Union, Yoplait and Berri.

The Lion group employs around 6,700 people, with 2,300 of them working in our Lion Dairy & Drinks business.

Our Australian dairy and juice manufacturing footprint spans 15 sites including milk, specialty cheese, yoghurt and juice facilities. We also own and operate two dairy farms on King Island, and have a yoghurt manufacturing site in New Zealand.

Lion spends around \$540m each year to procure milk from Australian dairy farms.

Analysis from Deloitte Access Economics suggests our business generates around \$1.75bn in total economic contribution to the Australian economy, and supports 11,300 jobs across our full value chain.

As Australia's largest branded dairy business, Lion is focused on building long-term sustainable value in the Australian dairy industry.

We are investing in the health of the dairy category and, in particular, promoting and leveraging the nutritional credentials of our dairy products through our brand marketing initiatives and Lion's *Goodness Project*. The Goodness Project celebrates the existing goodness of our products and illustrates our commitment to a range of public targets.

These targets look to further improve the nutritional value of Lion Dairy & Drinks products, address portion size and improve the nutritional literacy of consumers. Achieving our Goodness Project targets by 2019 are expected to remove around 4 tonnes of sodium, 1400 tonnes of sugar and 500 tonnes of fat from the national food supply annually¹. We will also remove all artificial colours, flavours and added fructose from our children's products.

¹ Base-line annual sales volumes, excluding everyday cheese

Our dairy farmer relationships

Lion seeks long-term relationships with the almost 400 dairy farmers who supply our business around Australia. We contract 180 dairy farmers directly and, following the National Foods acquisition of the former Dairy Farmers businesses, we also source milk via the Dairy Farmers Milk Cooperative (DFMC), who in turn have milk supply contracts with 218 farmers primarily in New South Wales and Queensland.

Lion believes sustainable dairy farmers underpin a sustainable dairy business, high quality products, happy farmers and healthy cows. Our approach to milk procurement is therefore based on offering farmers ‘three P’s’: competitive **pricing** and contract terms, **partnerships** for the long term, and a clear **purpose** and strategy built around growing profitable demand for dairy and ensuring sustainable returns through the supply chain.

Our pricing model: Lion offers dairy farmers competitive contracts that recognise local dynamics, offer secure pricing and as much choice as possible. We do not believe in retrospective price cuts and, in the trade-exposed and more volatile Southern states, we offer farmers a broad range of fixed and variable pricing options for contracts of varying lengths (1, 3 or 5 years). More than two thirds of eligible farmers have chosen to lock in at least part of their pricing under Lion’s innovative pricing model.

Partnerships: Lion offers a broad range of partnership benefits to the farmers who supply us, including grants to improve farm efficiency and sustainability, best practice advice and support. For example, the annual **Lion Dairy Pride Landcare Grants Program** helps dairy farmers boost profitability and reduce the environmental impacts of their farms, often also reducing their costs and improving the sustainability of their operations. Insights from successful projects are shared with other farmers. To date, 52 farmers have received grants of up to \$10,000 under the Program. In addition, Lion operates capital loans programs and safety schemes to help farmers improve the efficiency and sustainability of their businesses.

We have a dedicated Farm Services team that promotes best practice dairying techniques and works individually with our dairy farmers around Australia to help them plan and improve their businesses. Farmers also have 24 hour access to Lion’s people support program which provides a free independent counselling service, and all the resources on our Dairy Supplier website.

A further initiative is a new farmer sustainability program we have developed called Lion Dairy Pride, which will launch in October/November 2016. The program has been designed to provide our dairy farmers with simple tools to measure, evaluate and improve key areas of sustainability on their farm, and will be available to all Lion direct dairy farmers and suppliers through the Dairy Farmers Milk Co-Operative (DFMC).

This unique program includes a website that consists of valuable information and an easy on-line self-assessment tool that provides our dairy farmers with a trusted star rating across the following areas:

- Milk Quality;
- Animal Welfare;
- Environment;
- Business Management; and
- People, Community & Wellbeing.

In addition, The Lion Dairy Pride Program provides key information and valuable resources in each section. For example, within the Business Management section, farmers will have access to business plan templates and succession planning tips.

Purpose: Lion has a clear and credible strategy that is focused on the long term and committed to driving value and profitability back into dairy. Farmers who supply Lion share our pride in making some of the most iconic dairy brands in the country. We are also united in our passion for promoting the nutritional benefits of dairy and making sure more Australians enjoy great tasting dairy goodness every day.

Milk Procurement in the Southern Region

In the southern region (Victoria, Tasmania and South Australia) Lion has been receiving clear feedback from farmers for some time that the volatility inherent in commodity-based pricing had a highly negative impact on their businesses. Milk price volatility can make it difficult for farmers to plan for, invest in and sustain their businesses. From a processor perspective, milk price volatility is also a significant financial swing factor. Managing this volatility has become more difficult, and critical, as processor margins have compressed with the advent of \$1/l milk and grocery price deflation.

To provide greater certainty for both our business and farmers, since 2013 Lion has offered southern region farmers a range of fixed and variable farm gate pricing options and a choice of secure contract terms of one, three or five years. We believe our innovative and flexible contract options set Lion apart from other processors in the Australian market.

In terms of pricing, Lion farmers in the southern region are free to choose from the following options:

- variable pricing underpinned by a minimum pricing guarantee;
- fixed pricing for those who prefer a set and determined price* and
- a combination of fixed and variable pricing.

*Farmers can choose to lock in 50% of their volume at a fixed price for up to three years. They can then lock in all or part of the remaining 50% of milk volume on a 12-month fixed rate or select variable pricing.

Lion's fixed pricing options have enjoyed strong take-up. Some 92% of Lion farmers in the southern region locked in pricing for at least part of their volumes for the 2015/2016 season. This means that almost all farmers who supply Lion in the southern region currently enjoy a greater measure of price certainty than those who are wholly exposed to market pricing.

Due to the carryover of fixed contracts from past seasons, Lion expects to pay the majority of its direct farmers in 2016/2017 in the southern region the net weighted average price of **\$5.67 per kilo of milk solids**.

This price represents a premium of 27% over the forecast opening price announced by the price setter in the southern region.

In the southern region for 2016/2017 our **three year fixed price is \$5.50 per kilo of milk solids**, while the **one year fixed price is \$5.10 per kilo** of milk solids and the **one year variable price is \$5.00 per kilo of milk solids**. These prices are based on standard 7.2% milk solids.

Milk Procurement in market milk regions

Lion does not believe in a 'one size fits all' approach to milk procurement, instead tailoring our offer on a region-by-region basis in response to local factors, farmer feedback and the need to remain both competitive and sustainable. Our approach in the market milk states reflects in part their lower inherent price volatility, as well as generally higher production costs.

In **New South Wales**, Lion announced a competitive weighted average milk price of 53.7cpl for direct suppliers for the 2016/2017 season. This is a clear sign of Lion's confidence in the NSW dairy industry and a concrete demonstration of our commitment to building secure and mutually rewarding partnerships with our farmers.

Elsewhere in Australia Lion announced in June 2016 that its current pricing remained unchanged. That current pricing is:

In **South East Queensland** Lion offers direct farmers a competitive weighted average milk price of 59.6cpl, while in **Far North Queensland** Lion offers the DFMC a strong weighted average milk price of 59.2cpl.

Lion will continue to pay direct farmers in **Western Australia** a competitive weighted average price of 54.7cpl for the 2016/2017 season, which is the highest published price in the state.

Differentiated milk pricing

We note that some commentators have called for a pricing approach that differentiates between milk that finds its way into private label milk and milk that is processed for branded milk. This has arisen from recent calls by farmer representatives and media personalities for Australian consumers to buy branded milk in order to support dairy farmers.

As Lion is predominately a branded dairy business, we pay farmers a premium on all milk supplied to us, regardless of what products we ultimately manufacture from that milk.

In the past, Lion experimented with a two-tier pricing structure of this kind which reflected the return Lion could secure for its products. This proved unpopular with farmers as returns on highly commoditised products were very low. In practice, if this approach was applied to sales of private label and branded milk, such an approach would only be beneficial to farmers if the long term decline in branded milk market share is reversed. There is obviously no guarantee that this will happen. On the basis of all available evidence – including the strong and sustained growth in volume share of retailer own brand milk– our expectation is that retailer own-brand milk is here to stay.

This said, claims that farmers do not benefit from increases in branded milk volumes are a gross over-simplification and are focussed on short-term market dynamics. It is precisely because Lion is a branded milk player focused on sustainable margins and profitability that it can offer the sort of price premiums, contract security and choice to farmers outlined above. Any further erosion in branded milk and dairy volumes will only compound margin compression in the processing sector, which is already struggling to generate sustainable commercial returns.

Retrospective pricing

Retrospective changes in milk price including price cuts are anathema to Lion, as they undermine trust, drive volatility and damage the ability of farmers to plan for and invest in their businesses. That is why, unlike some processors, Lion has not imposed retrospective cuts in response to recent market conditions and does not support them as a matter of principle.

Lion has never introduced retrospective payments as part of its milk supply contracts, either with farmers who supply us directly or through the Dairy Farmers Milk Co-operative.