



BEGA CHEESE

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Senate Standing Committees on Economics

PO Box 6100

Parliament House

Canberra ACT 2600

Re: Senate inquiry into the dairy industry

Dear Sir,

Bega Cheese Limited (Bega Cheese) welcomes the opportunity to make a submission to the Senate Economics References Committee inquiry into the dairy industry.

1. Bega Cheese History

Dairying started in the Bega Valley in the 1850's. In those days each farmer produced and sold products such as cheese and butter from their dairy. After a period of time local farmers decided to improve their individual production and marketing activities and banded together to establish The Bega Co-operative Creamery Company in 1899.

Bega Cheese's original factory was opened in Bega in 1900. The original site at Lagoon Street still operates today producing cheddar and mozzarella cheese and whey powders. In 1997 Bega Cheese built a cheese processing and packaging facility in Ridge Street in Bega, value adding cheese for both the Australian and International market.

In April 2007 Bega Cheese acquired a 70% controlling interest in Tatura Milk Industries (Tatura Milk). Tatura Milk was established in 1907 and is located in the township of Tatura in Northern Victoria. Tatura Milk produces a wide range of dairy products and employs more than 300 people. Tatura Milk products are exported primarily to North and South East Asia. The acquisition was a good fit for Bega Cheese as it broadened the company's product range with the addition of cream cheese, milk powders, infant formula and nutraceuticals complimenting Bega's existing range of natural and processed cheddar cheese and whey powders.

In October 2008 Bega Cheese purchased the assets and operations of De Cicco Industries in the Melbourne suburb of Coburg. This site adds significantly to our bulk cheese manufacturing capability.

In March 2009, Bega Cheese acquired the cheese manufacturing facility of Kraft Foods at Strathmerton in Victoria. The asset was one of the largest processed cheese facilities in Australasia and Bega Cheese further invested in the infrastructure adding natural cheese cutting capacity to the plant.

An important milestone for Bega Cheese occurred in August 2011 when the business listed on the Australia Stock Exchange (ASX). Following the successful listing, Bega Cheese acquired the final 30% of Tatura Milk, which then became a wholly owned subsidiary of Bega Cheese.

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In March 2014 a life stage nutritional canning and blending plant was commissioned in Derrimut, Victoria. This new facility added to the Company's capabilities which now included the supply of retail ready infant formula and growing up milk powders to Australian and international customers. This initiative exemplified the underlying long term strategy of developing value-added products which can be sold throughout the world.

There are now approximately 500 farmers supplying the Bega Cheese group with around 700 million litres of milk from the Bega region in NSW, as well as Gippsland and the Northern and Western Districts in Victoria. Today, with sites spread from Bega to Melbourne to Northern Victoria, Bega Cheese employs over 1,700 people and the company has evolved from its modest and localised co-operative heritage in Bega into a significant and innovative player in the Australian and international dairy industry. The Company's production of approximately 230,000 tonnes of dairy products equates to a sales turnover in excess of \$1 billion per annum.

Bega's rich history stands in pride of place across the business and the factors which have driven its success for over a century remain enmeshed in its culture, ensuring that it remains an Australian icon.

2. Milk Price Setting Approach

a) Introduction

A cornerstone of the development of the Bega Cheese business has been the organisation's understanding of, and focus on retaining and growing milk supply.

The careful management and recognition of the changing environment dairy farmers operate in has seen Bega Cheese develop a close association with its suppliers. The organisation's capacity to respond to supplier concerns, deliver appropriate market signals and provide support on key issues remains a core competency.

A long term, sustainable supply of milk ensures Bega Cheese's manufacturing facilities operate efficiently and competitively meet the short and long term needs of its customers.

b) Milk Price Policy and Milk Prices in Various Regions

Bega Cheese considers the following issues in relation to the milk prices set for the various supply regions:

- **place of origin** - the significance of the place of origin of the milk used in manufacture of particular dairy products
- **financial returns from dairy products** - the financial return expected to be earned from dairy products manufactured using milk supplied by the relevant farmers;
- **sustainability of supply base** – Bega Cheese will endeavour to ensure the long term sustainability of dairy farming in the relevant region;
- **competitive circumstances** – the competitive farm gate milk prices in each region.

c) Company of Choice

Bega Cheese endeavours to be the preferred company choice of dairy farmers in South Eastern Australia for the sale of their milk. The combination of a competitive, and ideally

leading, manufacturing milk price, and innovative farm extension programs are the key to attracting and retaining milk supply.

3. Industry Circumstances FY2016

Dairy industry deregulation in the year 2000 and a decade of drought or near drought conditions between 2002-2012 combined with farm gate milk price volatility has seen the dairy industry at all points in the supply chain having to adjust and change.

The industry has been affected by different drivers in different regions. In the traditional “market milk States” of NSW, QLD and to some extent WA costs, weather and supply and demand drivers coupled with returns of liquid and manufactured milk products are recognised as impacting the development and sustainability of both dairy farmers and dairy manufacturing infrastructure. In the “manufacturing milk States” of VIC, SA and TAS the same costs, weather and supply and demand drivers exist but there is a far greater exposure to international dairy commodity markets and currency relativities.

In all of the above cases return for dairy products and therefore the farm gate milk price depends on the particular mix of manufacturing capability and markets the relevant companies are exposed to. The value attributable to a litre of milk in one market does ultimately also have potential to effect the value of a litre of milk in another market.

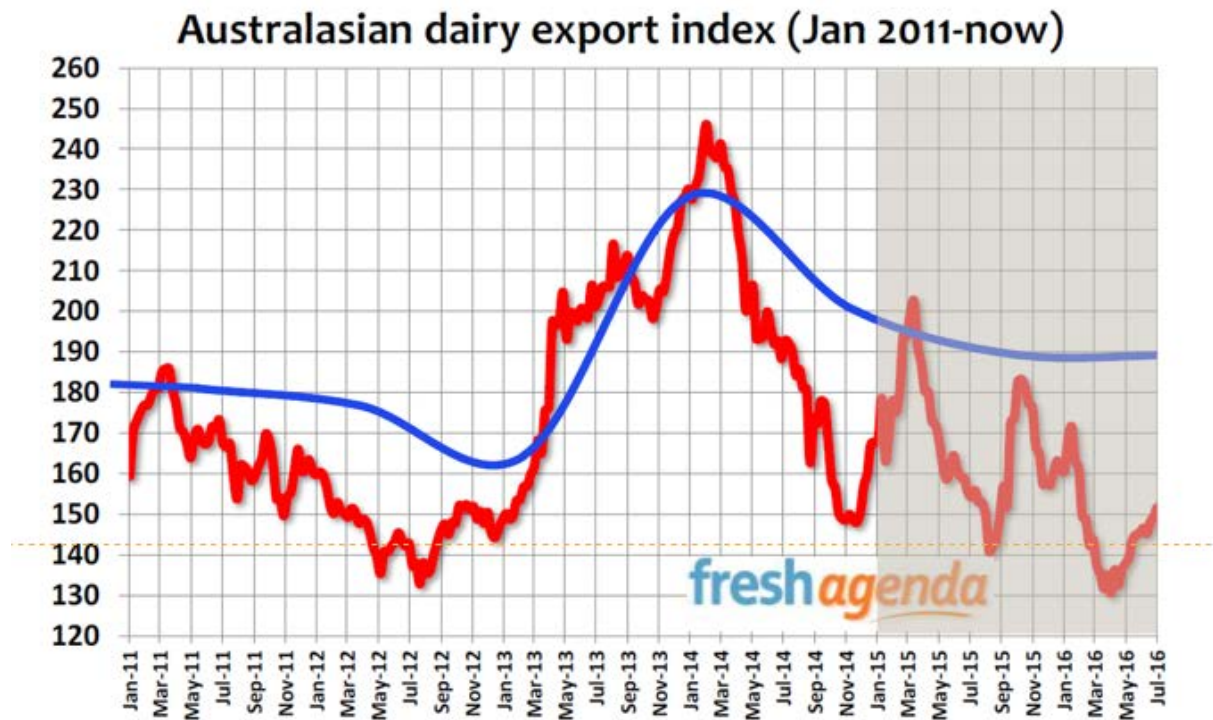
The farm gate milk price “in manufacturing milk States” is affected by international markets and does have the potential to ultimately impact milk prices in other regions in Australia, i.e. there is some correlation (although not entirely) between Victorian farm gate milk price plus freight in regard to the price affect beyond market returns in each supply region. Price variations between regions is therefore driven by three factors being, the market return derived from the milk, the alternative source of milk or dairy ingredient and the sustainability of dairy farming within a particular region.

For the purpose of this submission Bega Cheese will focus its commentary on our view of the factors that have in recent times affected the farm gate milk price for the majority of Australian milk which is produced in the manufacturing states of Victoria, TAS and SA.

As a nation, Australia both imports and exports a variety of dairy products. The industry is inevitably exposed to world commodity pricing and the competitive impact of imports and competition in both the Australian and international market place. When considering the market environment the Australian dairy industry operates in, it is notable that it is one of the most competitive in the world with a wide range of dairy manufacturers competing for both market share and milk supply.

While international pricing has consistently been demonstrated as one of the key drivers of farm gate milk price it is also the case that the long term opportunities identified particularly in Asian markets, combined with a smaller overall milk pool (Australia’s production over the past decade has reduced from approximately 11 billion litres to approximately 9 billion litres), and some very aggressive competitor behaviour, has seen competition for milk be very robust with companies both identifying potential opportunities in the market place and having spare manufacturing capacity to fill (in some cases additional capacity was being created while the milk pool was decreasing).

While robust competition for milk is a good outcome for dairy farmers it should always be recognised that ultimately the price paid for milk needs to align with the value that can be extracted from the market place. It is the case that for a great many years particularly in the manufacturing milk states, the farm gate milk price reflected international dairy commodity returns. In times of low commodity returns, manufacturers endeavor to deliver a return above dairy commodity value in order to ensure they have a stable and sustainable milk supply. There are occasions where this is not the case, but that is generally in times of very high international commodity prices delivering very strong milk prices to farmers. The fact that, in general, farm gate milk prices in Australia reflected international commodity prices is well demonstrated in the trend line in the graph below.



- Export trend index - global commodity prices/Australian currency impact source [freshagenda](#)
- Farm gate milk price trend

FY2015 Opening and closing milk price \$6.00 per Kg MS

FY2016 Opening and closing milk price \$5.60 per Kg MS

FY2017 Opening milk price \$5.00 per Kg MS

This graph also demonstrates that a departure from the strong reflection of international dairy commodity returns in farm gate milk price began to appear in 2013/14.

As a consequence of record international prices and increasingly aggressive competition in Australia, a disconnection began to appear between farm gate milk price and market returns. This disconnection to a large extent ended with a disastrous outcome for many dairy farmers as the close of the FY2016 approached and Murray Goulburn announced major price reductions and claw backs to its suppliers.

The market had become increasingly volatile as a result of a number of factors including; a global dairy supply response to high international commodity prices, the lifting of milk supply caps in the EU, Russian import sanctions and a slowing of imports to China all contributing to a period of volatility and an extended downward trend in global dairy prices.

A number of these factors were predictable, particularly the global supply response to strong dairy commodity prices and the fact that it had been announced a number of years previously that milk supply caps would be lifted in Europe.

As mentioned above, the reflection of international prices through farm gate milk price has been well established for many years in Australia. The Australian dairy industry has always been a competitive one, particularly in the milk procurement, processing, manufacturing, marketing and sales sector. Every dairy processor and manufacturing business has evolved in different ways as dairy companies sought to create competitive advantage both in the market and in regard to milk supply procurement. While each company sought to develop advantageous capacity and capability in a variety of ways they were also inevitably exposed to the same factors affecting return such as; global commodity prices, business costs, investment requirements and international and domestic market dynamics.

The Australian dairy industry has evolved differently to the industry in New Zealand which it is often compared to. While the New Zealand dairy industry has a very small domestic market and is almost totally exposed to international markets, the Australian industry is more balanced with a little less than half of its production destined for international markets and the remainder being sold in the Australian domestic market. This difference has seen Australian based companies develop a strong focus on value added retail and food service products and high value dairy ingredients. The benefit of these strategies, and a more stable return in the Australian domestic market, can be seen in generally a stronger price to farmers in Australia when compared to New Zealand in periods where the global dairy commodity price in relative terms is low. In times where global dairy commodity prices are high generally the New Zealand farm gate milk price out performs the Australian price.

While the value added strategy of many companies and the presence of an Australian domestic market provides some level of stability to farm gate milk pricing when compared to businesses that are exposed in a greater way to global commodities, it does not, and never will, entirely insulate Australian farm gate price from the international market and the effects of competition from both Australian produced and internationally produced dairy products. An extended period of low global dairy prices inevitably affects not only commodity value but the return from value added dairy products.

Given the above, the long and well established behaviour of manufacturing milk companies announcing a conservative opening milk price to farmers which can be improved as the market becomes more clear, is one that has been very effective and was clearly understood by many farmers. It must be said that the expectation of many dairy farmers is that when using pricing tools such as opening prices, loyalty payments or step ups, companies would be appropriately conservative in their opening price offers reflecting their knowledge of the market and its risks.

In short, the dairy farmer would expect that the processor with their knowledge of the market would deliver an opening price that was appropriately conservative and has the potential to be improved upon or at least remain flat. They would not expect that the price may be reduced. There is one example in this generation of a price reduction. That occurred in the global financial crisis in 2007/8 which affected and to a certain extent has continued to affect global

business and politics. The global financial crisis is not an appropriate reference point for some of the behaviours that preceded the milk price claw backs and reductions by some Australian dairy companies.

Given the shock of the global financial crisis in 2007/8 and its impact on dairy prices in 2008/9 many dairy companies did ensure that they had the capacity in certain circumstances to change the milk price in a negative direction as well as a positive one in the event that something as significant as the global financial crisis should occur again. It is Bega Cheese's belief that in general dairy farmers viewed the capacity to decrease prices to be a "force majeure" style safeguard rather than a right that could be used to force the consequences of overly aggressive competition and poor risk management by an individual company onto dairy farmer suppliers.

Until the announcements of price claw backs and reductions neither the industry or dairy farmers were using terminology such as "crisis" and farmers were not marching in the streets. The world's dairy industry was recognising the challenges of global oversupply, Russian sanctions and the slowdown in imports to China. These would impact farm gate milk prices materially in many parts of the world.

In a number of dairy farming regions around the world farmers were already reporting that prices were below the cost of production for the 2015/16 year and it was expected that the 2016/17 year would also deliver prices below the cost of production. Sadly this was not the first time that the global industry reported such outcomes and it is one of the challenges of food and agriculture that producers do respond very quickly to positive price signals, often resulting in an oversupply to the market, or that the market evolves and changes quickly which ultimately affects the supply and demand dynamics and the price paid for the product.

The Australian dairy industry and many dairy farmers were expecting that farm gate pricing for 2016/17 financial year would be very sobering given the factors that were mentioned earlier. While there was of course much concern throughout the industry for the outlook for 2016/17 and questions as to whether the continued disconnect between market returns and Australia's farm gate milk price could be maintained, there was not an expectation that milk price cuts would occur before opening announcements for the 2016/17 year.

4. Dairy Company Response and Impact

It is the nature of food and agriculture that market places change and supply and demand dynamics can deliver volatility in pricing. In Australian manufacturing milk states there is a well established mechanism which has been continually refined to provide appropriate market signals and risk management. That mechanism is the approach of an opening price combined with the option to improve pricing in the form of steps ups or loyalty payments as the market improves. As mentioned previously the only time in more than 40 years that the price has been changed in the negative was a result of the global financial crisis which is not comparable to the current industry circumstances.

To reflect on the 2015/16 financial year we would provide the following commentary;

- The Australian dairy industry continued to be highly competitive
- Leadership at Murray Goulburn documented an expected milk price of \$6.00 Kg milk solids
- Murray Goulburn consistently communicated to their suppliers that their company's aggressive strategy could deliver on a milk price of approximately \$6.00 Kg milk solids

- Murray Goulburn revises to \$5.60 Kg milk solids and continues with strong rhetoric on price
- Dairy farmers accepted the commentary of Murray Goulburn leadership including public comments only days before announcements relating to profit and milk price reductions that China sales were strong and milk price in the medium term was sustainable at \$5.60 to \$6.00 Kg milk solids
- Reservations regarding farm gate milk price were being expressed by a number of industry players
- The Murray Goulburn unit trust further complicated milk price expectation given statements made in the prospectus
- Dry conditions and difficult farming circumstances in many regions were causing farmers to enquire regarding any potential increases in farm gate milk price for the 2015/16 year as financial pressure began to materialise on farm. There were rumours that Murray Goulburn were considering a price increase late in the 2015/16 year
- While the industry and farmers were contemplating a difficult year in 2016/17 no one was contemplating or expecting price cuts or enforced loan obligations. There was no precedent for such actions.
- While some capacity did exist for other dairy companies to accept supplier requests to transfer that capacity was limited leaving many suppliers with limited or no choice but to accept price cuts and claw backs

The decision by Murray Goulburn and then Fonterra to cut prices so late in the year created turmoil for the entire industry. It is notable that many other industry players including Bega Cheese, Parmalat, Lion Dairy and Drinks and Warrnambool Cheese and Butter did not follow that path.

At the time of the announcement by Murray Goulburn, Bega Cheese was vocal in its view that such an action was something that could not be managed by dairy farmers. Bega Cheese believed that given the time of the year, the risk and the outcome of aggressive competition was the companies to manage and should not be shared with its suppliers, the new financial year was two months away and opening prices are traditionally the time downward trends are reflected in price and equally it is the time that dairy farmers make their management plan for the coming year which is based on the newly announced prices.

It is notable that the two listed dairy companies in Australia, the multinational companies and many of the privately owned dairy companies did not follow the co-operative's in taking this highly damaging action of reducing and clawing back price.

5. Bega Cheese View

Bega Cheese remains of the view that the late announcement of price decreases and the failure by Murray Goulburn to clearly communicate that price reductions late in the year or indeed anytime in the year were likely and the decision by Fonterra to follow Murray Goulburn's lead caused great financial and emotional harm to their suppliers and affected confidence in the whole industry.

While it may seem a simplistic response Bega Cheese believes the actions were wrong and did not reflect the traditional way price has been managed or the trust relationship that is so important between suppliers and processors.

It is important to recognise that many companies did not take the decision to put such significant financial and emotional pressure on their suppliers.

From a broader perspective the relationship and contractual arrangements between dairy farmer suppliers, processors and the impact of customer actions (either in Australia or internationally) need to be viewed in the context of long term practice rather than the actions of a few. It is important to recognise that the fundamentals of how these relationships work have been developed and refined over many years. They will of course continue to be refined and Bega Cheese continues to work hard to build and enhance its relationships at all levels of the supply chain.

There are always new ways to approach farm gate milk pricing and we consider them in collaboration with our farmers and customers. Refinement is important but it is also important to not change some well established practices that do appropriately reflect the market and endeavour to share the opportunity and risk because of the wrong actions of some in the industry.