

19 December 2016

Australian Competition and Consumer
Commission
GPO Box 3131
Canberra ACT 2601

dairyinquiry@accg.gov.au

Attention: Amy Bellhouse & Mark Laybutt

Dear Ms Bellhouse and Mr Laybutt

Inquiry into the Australian Dairy Industry – Feedback in response to the Issues Paper

Fonterra welcomes the opportunity to provide feedback in response to the Issues Paper released on 8 November 2016 as part of the ACCC's inquiry into the competitiveness of prices, trading practices and the supply chain in the Australian dairy industry.

Fonterra sees the Inquiry as an important measure to help instil confidence in the industry and position it to achieve a bright future.

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

Locally, Fonterra Australia works with some 1,100 dairy farmers and employs around 1,500 people, the majority 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.

As one of the most significant companies in the Australian milk processing market, Fonterra is well placed to comment on the matters raised in the Issues Paper.

We have summarised our response in the section below, headed Key Points, and provided further detail under each of the six issues highlighted in the Issues Paper.

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Key points

Competition

- The Australian milk market is highly competitive.
- Competition is intensifying as processors compete for a declining milk pool.
- In the past few seasons, competition and our commitment to invest in its Australian operations has meant that Fonterra has not been making high profits or margins.

Milk pricing

- The Victorian and Tasmanian dairy manufacturing industry generally operates on a milk pricing system whereby an opening forecasted price, based on an estimate of expected market returns for the season, is provided with effect from the beginning of that season.
- Where a processor, such as Fonterra, exports a significant portion of its production, it is very difficult to reliably predict farmgate returns 12 months in advance.
- To assist with this, farmgate milk prices can be increased or decreased during the season. Increases (step ups) are common, while decreases (step downs) are rare, occurring in just two of the last ten seasons for Fonterra suppliers.
- Fonterra does not agree with calls to ban step downs, either entirely or late in a season, as this would inevitably lead to lower opening prices and more conservative step ups.
- Fonterra gives farmers options to manage the risk of step downs by “locking in” a fixed milk price or range.

Domestic retail markets

- In Fonterra's view, there is a place for private label milk so long as it is a portion of the fresh milk market.
- Branded milk provides a point of difference for the consumer and puts more money into the value chain.

Global markets and the future of dairy

- Global markets greatly influence dairy prices in Australia.
- 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.
- The confluence of global oversupply and weak demand saw dairy commodity prices hit decade lows last season.

- Despite global volatility, the long term fundamentals for dairy remain positive.
- A growing population, expanding middle class and increased urbanisation in Asia, mean demand for dairy is forecast to grow.
- Australian dairy is well positioned to capitalise on this opportunity.
- Fonterra sees enormous opportunities for Australian dairy in the global market going forward, which is why maintaining the industry's international competitiveness is so important.

Issue 1 - Competition for milk

Overview

The Australian milk market is highly competitive.

The level of competition is intensifying even further as processors operating in Australia with existing processing plants, fixed costs and available processing capacity compete for a declining milk pool.

The annual Australian milk pool has declined from nearly 11 billion litres in 2000, to just over 9 billion litres in 2015. Over the same period, the annual New Zealand milk pool has surged from approximately 12 billion litres to more than 21 billion litres (see figure 1, below).

To maintain supply, processors must pay prices at around the same level as their competitors — even if that has a substantial negative impact on the processor's profitability.

The Southern Australian milk pool, comprising Victoria, Tasmania and parts of South Australia, is particularly competitive.

The impact of fierce competition is evident in two recent decisions by processors to increase their milk price in order to secure milk supply:

- Murray Goulburn's decision in October 2016 to use \$50 million in debt to fund a step-up in its milk price of approximately \$0.25 per kg of milk solids;¹ and
- Bega's decision in 2014 to allocate up to \$25 million over three years to sustain and grow its milk supply.²

A further demonstration of the impact of price competition is Fonterra's milk supply agreement with the Bonlac Supply Company (**BSC**). Under that agreement, Fonterra is required 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.

¹ Murray Goulburn Co-operative Co Limited, *Murray Goulburn announces completion of Milk Supply Support Package review*, ASX Announcement, 27 October 2016.

² Bega Cheese Limited, *Bega Cheese invests in Milk Supplier Sustainability and Growth*, ASX Announcement, 25 March 2014.

This guarantee operates for the benefit of farmers, and they insisted on it to ensure Fonterra paid them a fair price. It also reflects the trust farmers have traditionally placed in Murray Goulburn, as the leading processor and a farmer-owned cooperative.

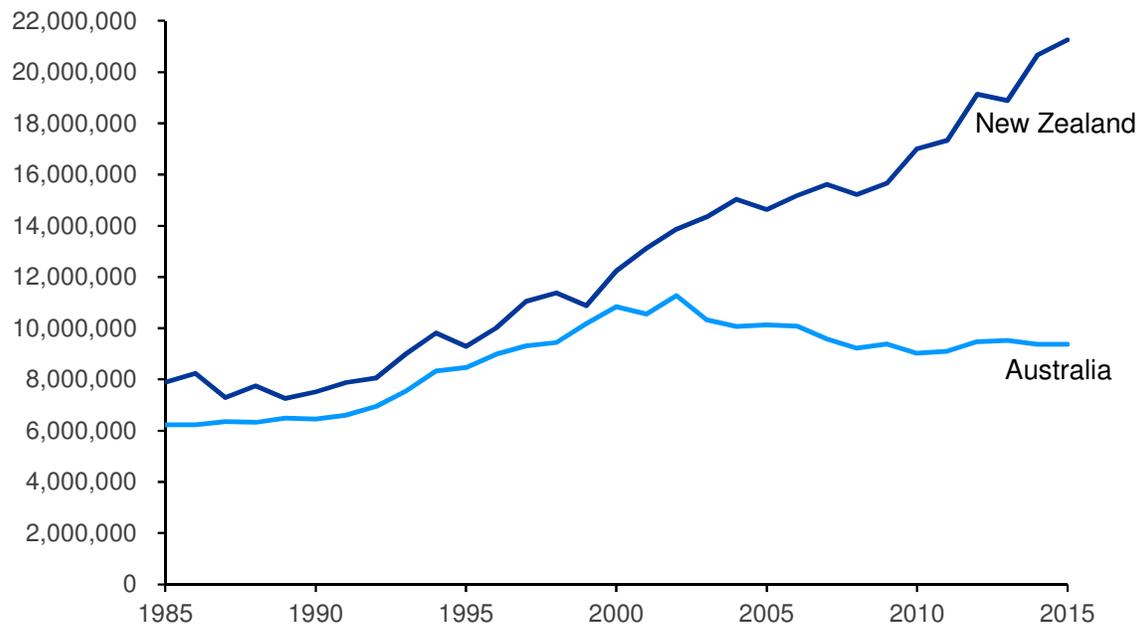
Although the guarantee only requires Fonterra not to pay any *less* than Murray Goulburn, for five of the last seven seasons, including last season, Fonterra has paid a higher farmgate milk price than Murray Goulburn.

Appendix I sets out a comparison of farmgate milk prices in Australia (Fonterra and Murray Goulburn) and New Zealand (Fonterra) since 2000. It shows that Australian farmers received more last season than their counterparts in New Zealand, where approximately 90 per cent of milk produced is destined for the export market.

Last season, New Zealand dairy farmers received the equivalent of ~\$3.65 per kgMS (NZ\$3.90 per kgMS), only slightly higher than their season 2014-15 farmgate milk price of ~\$3.61 per kgMS (NZ\$3.85 per kgMS).

The willingness of processors in Australia to match each other's prices, and to offer incentives to keep their existing suppliers, helps reduce the rate of suppliers switching between processors. The fact that suppliers do not change processors more regularly should not be viewed as indicating any lack of competition.

Figure 1: Annual milk pool, comparison of Australia and New Zealand



Competitive forces impacting processors

The Australian dairy market includes a number of large established processors and significant new entrants.

These new entrants have had a significant impact on the level of competition for two main reasons.

First, larger processors are generally obliged to accept delivery of all of the milk produced by the farmers who supply to them. This requires substantial investment in assets capable of handling peak milk flow (such as powder dryers). New entrants, who do not have such an asset footprint, have greater flexibility in selecting a product mix that generates a higher return, which results in them having the ability to pay a higher milk price. New entrants can also generally avoid adding peak milk handling assets by either incentivising farmers' milk curves or selling the milk back on the spot market. This has a secondary benefit of enabling new entrants to avoid commodity exposures and removes volatility from their ability to pay.

Second, larger processors also generally have a uniform base milk price (before seasonal incentives) and operate across multiple geographies. Accordingly, if a new entrant is paying a higher milk price to attract supply in a particular region, the larger commodity-exposed processor would have to pay that competitive milk price across its entire base and has limited ability to offer individual prices. It is generally not economic for larger processors to take such action.

The competing buyers for raw milk now include:

- **Murray Goulburn Co-operative Co Limited** has the greatest market share in the milk and cream processing market with 10 processing plants across Victoria, New South Wales, and Tasmania.³ Murray Goulburn purchases the largest quantities of raw milk in Australia, produces a range of dairy products and is a significant exporter.
- **Lion Pty Ltd** is a wholly owned subsidiary of Kirin Holdings Company Limited, which is a global beverage company. Its Dairy & Drinks division originated from Lion's acquisition of the Australian Co-Operative Foods Ltd in 2008.⁴ IBISWorld identifies Lion as the second largest company in the milk and cream processing industry in Australia.
- **Parmalat Australia Pty Ltd** is a wholly-owned subsidiary of Parmalat Belgium SA, which operates on a global scale. Parmalat Australia entered the fresh milk market by acquiring Pauls Limited in 1998. It operates in the market through a range of milk brands, including flavoured milk, and also through UHT milk products.⁵
- **Fonterra Australia** is owned by the New Zealand-based Fonterra Co-operative Group Limited. Fonterra Australia processes milk throughout seven factories located across Victoria and Tasmania, manufacturing drinking milk and a variety of dairy products. Products are sold in both domestic and international markets.
- **Warrnambool Cheese & Butter** Factory Company Holdings Limited (**WCB**) produces a range of dairy products and ingredients for both the domestic market and export.⁶ It is one of the oldest dairy processors in Australia, operating since 1888.⁷ After a competitive bidding process, Saputo Inc., a Canadian dairy company, acquired an 87.92% stake in WCB in 2014.

³ IBISWorld Industry Report C1131 - Milk and Cream Processing in Australia (May 2016) 24; IBISWorld Industry Report C1133c - Butter and Dairy Product Manufacturing in Australia (November 2016) 23; <http://www.mgc.com.au/our-story/locations/>, accessed 5 December 2016.

⁴ IBISWorld Industry Report C1131 - Milk and Cream Processing in Australia (May 2016) 25.

⁵ IBISWorld Industry Report C1131 - Milk and Cream Processing in Australia (May 2016) 26; <http://www.parmalat.com.au/brand/>, accessed 5 December 2016.

⁶ <http://www.wcbf.com.au/Home>, accessed 5 December 2016.

⁷ <http://www.wcbf.com.au/About-Us/History>, accessed 5 December 2016; IBISWorld Industry Report C1133c - Butter and Dairy Product Manufacturing in Australia (November 2016) 26.

- **Bega Cheese Limited** is another of Australia's oldest dairy companies. It operates in New South Wales and Victoria, and is the largest cheese manufacturer in Australia.⁸ It operates in the industry through Tatura Milk, which it acquired in 2011.
- **Australian Consolidated Milk Pty Ltd** is an Australian-owned dairy company based in northern Victoria that focuses on identifying high value niche market opportunities.⁹ ACM is expanding its collection of organic milk, and is looking to produce fresh and UHT organic milk for domestic and export markets.¹⁰
- **Bulla** is a Victoria-based dairy manufacturer which has been operating since 1910.¹¹ Bulla manufactures a range of dairy products including cream, sour cream, cottage cheese, spreadable cheese, ice cream, and yoghurt.
- **National Dairy Products** was, until its recent appointment of voluntary administrators, a milk broking firm focused on liquid ingredient supply of dairy products.¹² It had established its dairy supply base in Victoria.¹³
- **The Midfield Group** is a Victoria-based meat processing company which operates in the domestic and international export markets.¹⁴ The company is developing a milk processing facility in Warrnambool, Victoria, and also entered into a joint venture with Louis Dreyfus Company Dairy Asia Pte Ltd in August 2016 for the construction and management of a dairy processing plant in Penola, South Australia.¹⁵
- **Tasmanian Dairy Products** was fully acquired by Murray Goulburn in October 2015. Murray Goulburn indicated that, at the time of acquisition, TDP processed approximately 25 per cent of Tasmania's milk.¹⁶

⁸ *IBISWorld Industry Report C1133c - Butter and Dairy Product Manufacturing in Australia* (November 2016) 26.

⁹ <http://www.australianconsolidatedmilk.com.au/about-us.html>, accessed 2 December 2016.

¹⁰ <http://www.weeklytimesnow.com.au/agribusiness/dairy/demand-drives-australian-consolidated-milk-organic-call/news-story/642c73c9e6b25f80a3114d1b4f42939d> (10 March 2016), accessed 2 December 2016; <http://www.abc.net.au/news/2016-11-21/acm-organic-dairy/8042702> (23 November 2016), accessed 5 December 2016.

¹¹ Regal Cream Products Pty Ltd trading as Bulla Dairy Foods; <http://bullafoodservice.com.au/legal>, accessed 5 December 2016; <http://www.bulla.com.au/#/the-bulla-story>, accessed 2 December 2016.

¹² <http://www.nationaldairyproducts.com.au/products-and-services/>, accessed 5 December 2016.

¹³ *Ibid.*

¹⁴ <http://www.midfield.com.au/about-us/>, accessed 5 December 2016.

¹⁵ <https://www.midfield.com.au/divisions/midfield-coonawarra/>, accessed 5 December 2016; <http://www.midfield.com.au/the-midfield-group-and-louis-dreyfus-company-dairy-asia-announce-joint-venture/>, accessed 5 December 2016; <http://www.abc.net.au/news/2015-05-05/dairy-warrnambool-jobs-milk-cows-midfield-factory/6447006> (6 May 2015), accessed 5 December 2016.

¹⁶ <http://www.mgc.com.au/media/30287/MG-acquires-Tasmanian-Dairy-Products.pdf>, accessed 5 December 2016.

Table 1: Level of competition in dairy processing

Industry	Level of competition	Trend of competition
Milk and cream processing	High	Increasing
Cheese manufacturing	High	Increasing
Butter and dairy product manufacturing	High	Increasing
Milk powder manufacturing	Medium	Increasing

Sources: *IBISWorld Industry Report C1131 - Milk and Cream Processing in Australia (May 2016)*; *IBISWorld Industry Report C1133a - Cheese Manufacturing in Australia (April 2016)*; *IBISWorld Industry Report C1133c - Butter and Dairy Product Manufacturing in Australia (November 2016)*; *IBISWorld Industry Report C1133b - Milk Powder Manufacturing in Australia (October 2016)*.

In its recent industry reports on the dairy industry in Australia, IBISWorld found:

- In the milk and cream processing industry, market players have invested considerable resources into branding, expanded product innovation and differentiation, and established national milk distribution networks.¹⁷ There is also pressure on milk processors to lower prices from large supermarkets at the retail level, as well as external competition from dairy product alternatives.
- The milk powder manufacturing industry has become more exposed to international and domestic market forces, with exporters competing fiercely with each other to access international markets.¹⁸
- In the cheese, butter and dairy product manufacturing space, Australian manufacturers compete against each other and foreign dairy producers in both domestic and global markets.¹⁹

The impact on Fonterra

In the past few seasons, the intense competition for milk and our commitment to invest in its Australian operations, has meant that Fonterra has not been making high profits or margins in Australia.

Fonterra has been particularly vulnerable to global and domestic challenges because of its product mix, which has seen milk directed into products delivering lower stream returns. This has impacted Fonterra'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.

Nonetheless, Fonterra's investment in its assets and operations over this period includes:

- \$140 million to rebuild and expand our factory at Stanhope, which was destroyed by fire in late 2014.

¹⁷ *IBISWorld Industry Report C1131 - Milk and Cream Processing in Australia (May 2016)* 21.

¹⁸ *IBISWorld Industry Report C1133b - Milk Powder Manufacturing in Australia (October 2016)* 20.

¹⁹ *IBISWorld Industry Report C1133c - Butter and Dairy Product Manufacturing in Australia (November 2016)* 20; *IBISWorld Industry Report C1133a - Cheese Manufacturing in Australia (April 2016)* 20.

- Expanding our capacity at our Wynyard and Cobden sites.
- Signing long term partnership agreements with key customers for nutritional products to fill our Darnum factory.
- Consolidating our distribution network and six warehouses under one facility in Melbourne with a 10 year Warehouse Services Agreement with NewCold Advanced Logistics.

Issue 2 - Contracting practices

Milk pricing system

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. This price is 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 12 months in advance.

To assist with this, as the season progresses, and certainty is gained on market returns, 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.

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.

In Australia, processors generally pay, throughout the season, a relatively high proportion of their forecast closing price compared to other jurisdictions. For example, processors in Australia normally start the season at around 90% of their predicted closing price, compared with around 60-70% in New Zealand.

The higher proportion paid in Australia increases the risk of a step down later in the season. However, step downs still remain rare, and the system generally assists farmers with cash flow throughout the season. This is important to farmers who incur greater costs trying to create a flatter production curve (more consistent throughout the year), which differs from the more natural, seasonal farming pattern, more typical in New Zealand.

Fonterra gives farmers options to manage the risk of step downs by “locking in” a fixed milk price or range.

Our *Fixed Base Milk Price* allows suppliers to lock in a volume of milk at a set price, similar to locking in part of a home loan at a fixed interest rate.

This programme gives suppliers the opportunity to de-risk by committing between 10 to 70 per cent of their expected milk solids volume to a set monthly price. 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 sets a price range so suppliers can be confident of knowing the minimum and maximum price for a set volume of milk, providing greater certainty around income and profit margins.

The *Milk Price Range* programme allows suppliers to lock in the minimum and maximum monthly price for between 10 to 70 per cent of their expected milk solids for the season. This provides farmers with greater security because a fixed volume of their monthly milk solids will receive a minimum price, while still being exposed to some market upside.

Fonterra does not agree with calls to ban step downs, either entirely or late in a season. In our view, banning step downs would inevitably lead to lower opening prices and more conservative step ups. This would have an adverse effect on farmers' cash flow throughout the season.

Types of contracts with suppliers

For most suppliers, the terms and conditions of milk supply to Fonterra are set out in Fonterra Australia's *Milk Supply Handbook*. The Handbook is provided annually to every Fonterra supplier and explains our milk pricing system, including step ups, step downs and our fixed base milk price and milk price range programs.

Suppliers who supply Fonterra pursuant to the Handbook, and not any other agreement with us, are free to cease supplying to Fonterra at any time.

As a recent initiative, Fonterra has reviewed and amended its Handbook in preparation for the commencement of the new unfair contract laws.

Fonterra also has fixed-term Exclusive Milk Supply Agreements (**EMSAs**) with some suppliers. The terms of EMSAs vary between one and five years, and during that term the supplier must supply their milk to Fonterra exclusively. EMSAs typically offer higher prices for milk and/or other incentives to suppliers.

As noted above, Fonterra also has a milk supply agreement with BSC. BSC plays a role in providing feedback from Fonterra's supplier base and ensuring visibility into farmer sentiment. We consult with BSC in connection with our contracts with farmers.

Industry code of conduct

Fonterra is one of the members of the Australian Dairy Industry Council's committee, which is developing a Dairy Industry Code of Conduct on contractual arrangements between processors and farmers. The Code is intended to be mutually beneficial and to assist in sharing risk along the supply chain.²⁰

²⁰ Victorian Farmers Federation, Media Release - 'Dairy farmers champion transparency in proposed industry Code', 7 October 2016, 2.

It is anticipated that the Code will address, amongst other matters, transparency in contracts and supply agreements, pricing formulae or mechanisms, notice of step downs, mechanisms for modifying contract conditions and the negotiation of variations to contracts.²¹

Issue 3 - Transparency and price signals

Price forecasting

Fonterra recognises the importance of price forecasts to its suppliers, and regularly communicates with its suppliers regarding this issue through a number of means, including:

- Cluster meetings with suppliers within and across regions at different stages through the season.
- Weekly communications through DairyWeb, a web-based communications system that provides suppliers with important business information including pricing updates, and also a weekly email titled *Watt Matters*.
- Monthly Australian Global Dairy Updates, which include information on market conditions, commodity prices, currency and input costs — the factors that influence cost of production and farmgate milk price.

As part of our commitment to communicate clearly with our suppliers about pricing, Fonterra introduced a simplified milk pricing structure in 2014. This has increased price transparency and given farmers greater certainty in relation to their income by reducing the range of outcomes that they might potentially receive (see case study 1, below).

Case study 1: Fonterra leads the way in simplifying milk price

In 2014, Fonterra Australia announced an industry-leading overhaul of its milk pricing structure, reducing risk and complexity. The key changes included:

- (a) a simplified base price;
- (b) the removal of Seasonal Ratio Payment incentives (which a farmer could miss out on if they had a bad final month of the season) and reinvestment into off-peak pricing to reduce risk for farmers and maintain a price signal for the value of off-peak milk to our customers; and
- (c) reinvestment of a growth incentive back into base price, and supporting growth outside the pricing system to make it more attractive and material for farmers in an expansion phase.

The system is simpler, fairer, equitable, and more transparent, reducing the range of prices paid to farmers against the average.

The system was developed in partnership with BSC, in collaboration with industry experts such as John Mulvany (an independent farm consultant), UDV and international pricing system experts. It also captured feedback from farmers.

²¹ Ibid, 1.

At the time of the announcement, John Mulvany noted that complexity in milk pricing did not support good, profitable decision-making on farm, and that the new system would send clear pricing signals so that farmers could focus on running their farms rather than deciphering prices.

Issue 4 - Domestic retail markets

There has been much debate regarding the retail price of private label milk in the Australian dairy industry. Private label milk is a small component of Fonterra's business.

Under competition law, processors must not exert pressure on retailers to increase their prices to reach a particular price. The retail price is a decision for retailers. Fonterra's role as a processor is to create and provide products that consumers want to buy.

Fonterra's involvement in the private milk market commenced in August 2015 through a supply deal with Woolworths in Victoria. At the time of commencement, the product and price was already well established in the market, as Woolworths had been supplied by another processor.

In Fonterra's view, there is a place for private label milk to meet consumer demand for a high volume/everyday staple at good everyday value purchase. Private label milk is available across the world and is sustainable so long as it is a portion of the fresh milk market. A healthy milk market requires a balanced portfolio of both private label and branded products.

Branded milk provides a point of difference for the consumer looking for more, such as fortification or filtration. Branded milk also puts more money into the value chain, generating more return for processors to innovate, employ and invest, and bringing more money back to farmers.

For example, Fonterra's Anchor milk uses ceramic filtering to create the only milk in Australia that is finely filtered for a fresher taste (see case study 2).

Case study 2: Fonterra's Anchor milk

In February 2016, Fonterra launched its Anchor milk brand in Victoria, the first finely-filtered milk in Australia, which boasts a longer shelf life than normal pasteurised milk, while retaining a fresh taste.

While normal pasteurised milk has a shelf life of 15 days, the Anchor brand uses microfiltration technology to produce a longer shelf life of 21 days.

Anchor milk uses a unique ceramic filter to remove more of the unwelcome bacteria present in milk, helping it to stay fresh until the very last drop.

Sourced exclusively from a small number of farms in Western Victoria, the milk is collected daily and processed at Anchor's Cobden processing site, to create an innovative product for consumers and generate revenue to suppliers.

"Milk has become something of a commodity in Australia, but we saw the opportunity to raise the bar with Anchor and believe microfiltration will be a game-changer," said Kiril Simonovski, Director of Marketing at Fonterra.

Issue 5 - Global markets

Impact of global markets

Global markets greatly influence dairy prices in Australia.

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, which resulted in a 3.5 per cent increase in EU dairy production,²² global dairy markets experienced a surge in supply.

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 2 below).

Table 2: 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.

In its 2014 report on the Australian dairy industry, the Productivity Commission explained the impact of global markets this way:²³

The integration of the Australian dairy manufacturing industry into world markets means that domestic product prices — and, by consequence, raw milk prices — are strongly influenced by international prices. ...

The Australian dairy industry is highly dependent on world markets, with a large proportion of Australian dairy output exported (in various forms).

Nonetheless, as Australian dairy exports accounted for 7 per cent of global dairy trade in 2012, they are unlikely to affect international prices. As such, domestic dairy manufacturers are essentially 'price takers' on world markets. This means that

²² Dairy Australia "Situation and Outlook, October 2016", p. 23

²³ Productivity Commission, *Relative Costs of Doing Business in Australia: Dairy Product Manufacturing* (September 2014) 179 (references omitted).

domestic prices for dairy products that are heavily traded (that is, less perishable products such as milk powder and cheese) essentially follow world prices. Indeed, Dairy Australia stated:

... local Australian prices are driven by world dairy commodity prices which determine local export returns ... around 75 per cent of milk production is exposed to world prices for butter, cheese and milk powders ... Hence average Australian milk prices are strongly correlated with export returns and over the last three decades more than 90 per cent of the annual variation in milk prices is explained by movements in average export returns.

Australian dairy manufacturers will generally not sell into the domestic market at a lower price than can be obtained in export markets, and competition amongst domestic manufacturers and from imports (noting import barriers such as tariffs are low) will ensure that domestic consumers do not pay more than the world price (notwithstanding there will be some divergence in prices due to quality differences).

While considering the impact of global markets, it is also important to understand geographic differences in the Australian dairy industry.

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, and therefore subject to the volatility of the global market.

The influence of global markets is greatest on the processors that have the greatest exposure to the international market — in particular, Fonterra and Murray Goulburn. As shown by the past seasons, that exposure to the global market creates challenges, as well as great opportunities for Australian dairy (see below).

Opportunities for future growth

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 with its clean, green and safe reputation is well positioned to capitalise on this opportunity.

Fonterra sees enormous opportunities for Australian dairy in the global market going forward, which is why maintaining the industry's international competitiveness is so important.

Issue 6 - Production costs and profitability

Assistance to farmers regarding production costs and profitability

Fonterra recognises the challenges to farmers in managing production costs and profitability.

In 2013, we launched our *SupportCrew* program, where industry specialists visit farms to give farmers tailored advice, support and information to help improve profitability and add value to their farm businesses.

The program provides expert advice on key business areas, including:

- Farm Finances - through income estimations, annual and monthly budgeting, investment planning and financial business analysis.
- Nutrition and Agronomy - through pasture management, grazing management programs and nutrient management plans.
- Human Resource Management - through assistance with awards, contracts, recruitment, performance management and succession planning.
- Sustainability and Quality - through animal welfare and sustainability policies, energy cost efficiency and water management.

Within 18 months, SupportCrew had returned \$2 million to the bottom lines of suppliers across Fonterra's supply base in New South Wales, Victoria and Tasmania.

The benefits of the program are illustrated below (see case study 3).

Case study 3: Savings and higher returns achieved by farmers through SupportCrew

With the help of SupportCrew specialists, Fonterra farmers have modified their business practices to produce the following results:

- **Savings of \$50,000 on power bills** - a farming couple in Branxholme, Victoria, were able to negotiate a more affordable electricity pricing contract, which reduced their power costs by 23 per cent, resulting in a saving of \$50,000 each year.
- **Savings in excess of \$100 per cow on feed in a season** - a farming family in Wagga Wagga, New South Wales, modified their feeding system to an updated best-practice feeding approach to reduce significant waste in their annual feed budget.
- **Improved milk quality and doubled production within 18 months, leading to higher returns on milk** - a Numurkah, Victoria, dairy farming couple turned their flood-affected business around following daily updates and advice on sources of industry and government assistance.
- **Savings of over \$45,000 on supplement feeds** - a farming family in Leongatha South, Victoria, uncovered a 'feed to production' option to evaluate their herd's nutritional requirements, in order to cut costs without affecting production.

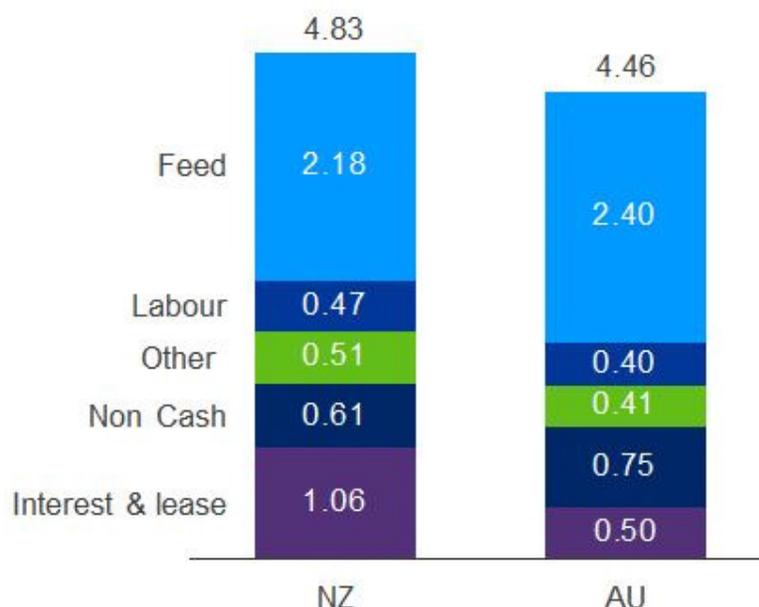
Cost comparison with New Zealand

Fonterra operates in both Australia and New Zealand, as well as other countries. Fonterra's analysis is that Australian farmers have lower fixed costs, such as land price, than their New Zealand counterparts but higher variable costs. In addition, the New Zealand industry is

focussed on growing the milk pool and becoming more efficient in order to supply export market opportunities. Australia has a shrinking milk pool, and this reduces efficiency and the price processors can afford to pay farmers.

Publicly available data indicates that the average cost of production in Australia in 2014/2015 was lower than in New Zealand — particularly in relation to property and financing costs (see figure 2, below). Note that these figures are averages and production costs can vary considerably for different farmers based on scale and other factors.

Figure 2: Average cost of production (US\$), comparison of Australia and New Zealand (2014/2015)



Sources: Victorian Government Department of Economic Development, Jobs, Transport and Resources & Dairy Australia, *Dairy Farm Monitor Project - Victoria, Annual Report 2014/15* (September 2015); DairyNZ, *DairyNZ Economic Survey 2014/15* (May 2016).

Other issues - potential government support for the industry

It is very important that any proposed government measures to support the dairy industry comply fully with Australia's international obligations, including in relation to the World Trade Organisation. Fonterra is active internationally, in cooperation with Australian industry, in efforts to remove government subsidies overseas for dairy industries and for agriculture more broadly.

Cognisant of New Zealand's international obligations, and based on strict criteria, New Zealand has established the Primary Growth Partnership (**PGP**) — a joint venture between government and industry that invests in long-term innovation to increase the market success of primary industries.²⁴

One PGP programme is *Transforming the Dairy Value Chain*. Led by DairyNZ and Fonterra, this programme is aimed at creating new products, increasing on-farm productivity, reducing

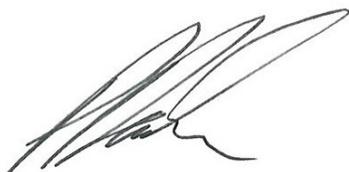
²⁴ <http://www.mpi.govt.nz/funding-and-programmes/primary-growth-partnership/>, accessed 14 December 2016.

environmental impacts, and improving agricultural education.²⁵ The programme's key themes include on-farm innovation and research, and transforming the dairy value chain through world-leadership in food structure design, processing and food quality management.

Other government programmes in New Zealand, not necessarily limited to the dairy industry, include a sustainable farming fund, an irrigation acceleration fund, an adverse events fund, trade promotion (which Australia is already very active in), agricultural education and training and rural support trusts.

We trust that the information in this response to the Issues Paper is of assistance to the ACCC in conducting the Inquiry.

Yours sincerely

A handwritten signature in black ink, appearing to read 'René Dedoncker', written in a cursive style.

René Dedoncker
Managing Director
Fonterra Australia

²⁵<http://www.mpi.govt.nz/funding-and-programmes/primary-growth-partnership/primary-growth-partnership-programmes/transforming-the-dairy-value-chain/>, accessed 14 December 2016.

Appendix I: Milk price in Australia since 2010

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

* As at November 2016