

# OUTLOOK

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title

**Dairy outlook to 2007-08**

session

Dairy  
2.15–3.45 Wednesday 5 March

National Convention Centre, Canberra



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## DAIRY OUTLOOK TO 2007-08

firm milk prices to help in recovery from drought

Brad James, Dale Ashton and Ian Shaw

- **Australian milk production is projected to grow over the next few years, but at a slower rate than in the 1990s.**
- **Only limited growth in world demand for dairy products is expected over the medium term.**
- **Returns for Australian dairy farmers are projected to remain flat (in nominated terms) over the next few years.**

### Structure of the industry

The structure of the Australian dairy industry has changed significantly over the past decade. Advances in technology, improved farm management, and changing domestic and world markets had, until the current drought, resulted in increased milk production in Australia. With only slow growth in the domestic market for dairy products, most of the increase in production over the past decade has been exported as manufactured dairy products.

The drought has resulted in a significant fall in Australian milk production in the current financial year. When the drought does break, milk production is expected to recover over the next few years; however, the rate of growth in milk production is expected to be slower than during the 1990s (figure A).

Only limited growth in world demand for dairy products is assumed over the medium term. As a result, there is expected to be little upward pressure on world dairy prices and outcomes in world

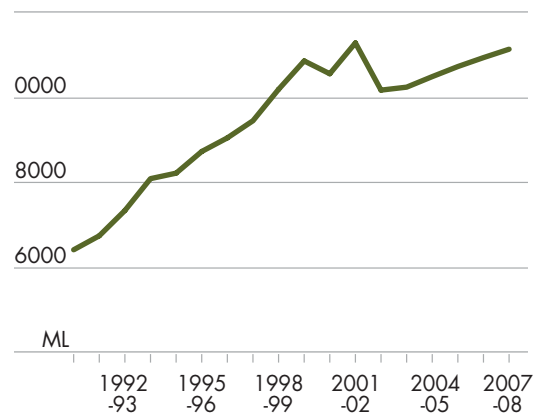
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markets are likely to be driven mainly by changes in supply.

World markets for dairy products remain distorted, however, with nearly all of the major milk producing and trading countries (with the exception of Australia, New Zealand and Argentina) having policies that provide support to milk producers. Although the nature of support varies widely from country to country, they all lead to distortions in international trade.

Substantial rewards await the Australian dairy industry if some policy induced distortions in world markets can be reduced. Previous research (ABARE 2001) highlighted the potential economic benefits (both globally and to non-subsidised producers such as Australia) of a reduction to trade barriers in some of the major world markets for dairy products.

### A Australian milk production



## World overview

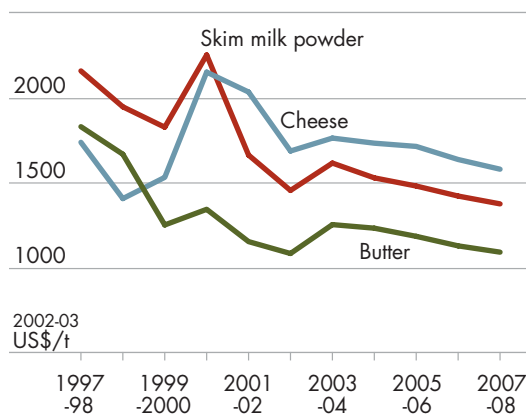
International spot prices for milk powders and cheese have risen substantially over the past six months, largely because of lower supplies in Australia and stronger demand for milk powder in EU vealer markets. Prices are expected to stabilise over the remainder of the 2002-03 financial year before easing slightly in 2003-04, as Australian milk production recovers from the drought, but to remain well above the lows of 2002. As a result, world prices for dairy products are forecast to average slightly higher in 2003-04 than in 2002-03.

Over the medium term, world prices for dairy products are projected to fall slightly in nominal terms because of expanding supply and slow growth in demand.

Among the developing country markets, those in south east Asia are expected to have the best growth, principally because of growing consumer interest in dairy products for health and taste reasons, improving infrastructure, improved packaging and longer shelf life.

Prices of all dairy products are projected to decline in real terms (figure B). Such price trends are indicative that at least a part of the world dairy industry's ability to keep increasing output will be through productivity enhancement — such as increasing milk yield per cow — especially in nonsubsidising countries such as New Zealand.

### **B** World dairy product prices



## Manufactured dairy products

### Skim milk powder

International spot prices for skim milk powder rose sharply from a low of US\$1163 a tonne in July 2002 to a peak of US\$1800 a tonne in December. An increase in demand from the EU vealer market and expectations of lower supply from Australia because of drought appear to have been the key factors behind the sharp increase in prices.

Although world spot prices are forecast to ease somewhat over the course of 2003-04, prices are nevertheless expected to average higher than the 2002-03 lows. The world spot price for skim milk powder is forecast to rise by 14 per cent to average around US\$1650 a tonne in 2003-04.

World prices for skim milk powder are projected to ease beyond 2003-04. Skim milk powder will continue to face competition from whey powder and other products in animal feeds and foodstuff manufacture. However, in the case of animal feeds, the effects of these substitutes will be partly offset by the EU ban on meat and bone meal in the feed chain that will strengthen demand for a range of alternative feeds, including skim milk powder.

The likely continuation of US and EU subsidisation of skim milk powder exports is also expected to contribute to weaker world prices. In particular, the United States has retained its Dairy Export Incentive Program under the 2002 farm bill as a way of dispersing its large accumulated public stocks of skim milk powder.

### Whole milk powder

World prices for whole milk powder have also risen over the past six months. After a low of US\$1210 a tonne in June 2002, monthly spot prices rose to US\$1800 a tonne in December. Prices are forecast to average around US\$1700 a tonne in 2003-04.

Over the medium term, world demand for whole milk powder for reconstituting into drinking milk and as a food ingredient is expected to continue rising. However, increasing world production is projected to result in whole milk powder prices falling in real terms over the next few years.

## Cheese

Stronger demand for cheese and lower supplies, as some milk has been diverted to milk powder production, has contributed to recent rises in international spot prices for cheese. From a low of US\$1550 a tonne in July 2002, world cheese prices rose over the remainder of the calendar year to US\$1850 a tonne in December.

With milk powder prices rising more quickly than cheese prices in the second half of 2002 (albeit from a lower base), and the need for

exporters to meet forward contracts in the face of contracting milk powder supply in the near term, world production of cheese is expected to fall in the short term in favor of increased milk powder production. As a result, international spot prices for cheese are forecast to rise further in 2003-04, to average around US\$1800 a tonne.

Over the medium term, world cheese production is expected to increase more quickly than growth in demand. As a result world cheese prices are projected to fall in real terms over the outlook period.

## Dairy outlook

	Unit	2000 -01	2001 -02	2002 -03 f	2003 -04 z	2004 -05 z	2005 -06 z	2006 -07 z	2007 -08 z
<b>World</b>									
<b>Indicative price</b>									
<b>Butter</b>									
- nominal	US\$/t	1 293	1 127	1 082	1 280	1 290	1 270	1 240	1 230
- real a	US\$/t	1 342	1 152	1 082	1 252	1 231	1 183	1 127	1 090
<b>Skim milk powder</b>									
- nominal	US\$/t	2 167	1 625	1 453	1 650	1 600	1 588	1 563	1 550
- real a	US\$/t	2 250	1 661	1 453	1 614	1 527	1 479	1 420	1 374
<b>Cheese</b>									
- nominal	US\$/t	2 070	1 988	1 685	1 800	1 813	1 838	1 800	1 780
- real a	US\$/t	2 149	2 032	1 685	1 761	1 731	1 712	1 635	1 578
<b>Australia</b>									
Cow numbers b	'000	2 176	2 123	2 055	2 086	2 125	2 157	2 189	2 220
Yield per cow	L	4 846	5 309	4 944	4 953	5 000	5 045	5 101	5 151
<b>Production</b>									
Total milk	ML	10 545	11 271	10 160	10 333	10 624	10 883	11 167	11 436
Milk sales	ML	1 920	1 908	1 916	1 922	1 923	1 932	1 931	1 931
Manufacturing usage	ML	8 625	9 363	8 244	8 411	8 701	8 951	9 236	9 505
Butter c	kt	151	164	149	146	157	155	159	163
Cheese	kt	376	431	369	361	354	374	382	391
Skim milk powder	kt	244	261	238	236	254	250	256	263
Wholemilk powder	kt	205	239	240	238	239	244	246	247
<b>Milk price de</b>									
- nominal d	Ac/L	29.0	30.3	27.0	28.5	28.0	28.5	29.5	30.0
- real g	Ac/L	30.6	31.1	27.0	27.8	26.6	26.4	26.7	26.5
<b>Export volume</b>									
Butter c	kt	108	108	108	96	97	105	109	112
Cheese	kt	219	218	218	181	218	227	239	246
Skim milk powder	kt	203	210	210	197	201	217	227	232
Wholemilk powder	kt	167	165	165	165	168	169	175	181
<b>Export value</b>									
- nominal	A\$m	3 047	3 196	2 727	2 658	2 840	3 027	3 169	3 334
- real g	A\$m	3 223	3 286	2 727	2 591	2 701	2 808	2 868	2 944

a In 2002-03 US dollars. b At 31 March on establishments with an estimated value of agricultural operations of \$5 000 or more in 1998-99, and at 30 June thereafter. c Includes the butter equivalent of butteroil, butter concentrate, ghee and dry butterfat. d Includes freight from farm gate to processor in some states. e Weighted average price of fluid milk and manufacturing milk. g In 2002-03 Australian dollars. f ABARE forecast. z ABARE projection.

Sources: Australian Bureau of Statistics; Australian Dairy Corporation; ABARE.

## Butter

In June 2002, international spot prices for butter fell to a low of US\$950 a tonne. Despite remaining weak, international spot prices for butter have improved over the past six months. In the second half of calendar 2002, international butter prices averaged around 10 per cent higher than in the previous six months, rising to around US\$1300 a tonne in December. Improved demand from the Russian Federation, a major importer of butter, was the main reason for the improvement in prices.

For 2003-04, international spot prices for butter are forecast to average around US\$1280 a tonne, 18 per cent higher than in the previous year.

Over the medium term, international butter prices are projected to continue to decline in real terms. Even if the Russian Federation maintains import demand at current levels, world butter demand overall is not likely to improve. With high stocks of butter in the European Union and world production expanding, traded butter prices are likely to come under some pressure.

## Major dairy producers

### European Union

Stronger domestic demand, particularly for skim milk powder, and higher internal prices contributed to lower EU exports of dairy products in the second half of calendar 2002.

Over the medium term, the EU dairy market will be affected by the recent changes to the Common Agricultural Policy announced late last year. Principal among the reforms are a 3.2 per cent increase in the milk quota and a reduction in support prices for butter and skim milk powder over the period 2004-08.

In recent times, growth in EU milk production averaged only around 0.3 per cent a year but the expanded quota alone will result in almost an additional 4 million tonnes of milk production by 2008.

The tradeoff for the increase in quota is lower internal support prices over the same period — 35 per cent and 17.5 per cent lower for butter and skim milk powder respectively. By 2008 support

prices for skim milk powder and butter are expected to be more closely aligned with world prices. However, butter support prices in 2008 would still be nearly double current world prices.

Lower support prices will lead to a fall in internal prices for dairy products and improve the European Union's competitiveness in world markets over the next few years.

A further substantial change for the European Union is the accession of eastern European countries, most importantly the large dairy producers of Poland and Hungary. Some thirteen countries have applied to become members of the European Union, ten of these are located in central and eastern Europe. Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia are scheduled to join the European Union by 2004.

The accession process means that the dairy industries in the new member countries will become subject to the same rules as those currently in the European Union. This includes the establishment of a new common market organisation for dairy products that remains based on intervention and public storage of butter and skim milk powder as well as certain aid schemes and marketing measures. Also, milk quotas are to be introduced for all new member countries.

### United States

The United States is one of the world's largest producers of milk and dairy products. However, a large domestic market and the nature of its dairy policies tend to isolate it somewhat from world markets. Nevertheless, the United States is still a major exporter of dairy products, particularly skim milk powder under the Dairy Export Incentive Program (DEIP).

The 2002 US farm bill contained no significant changes from previous legislation for the dairy industry. The domestic milk price support scheme was extended and the DEIP was given authority to continue.

With a WTO commitment to limit subsidised exports of skim milk powder under the DEIP to 68 000 tonnes and large public stocks of skim milk powder, the United States has increasingly resorted to food aid programs to dispose of surplus production. In 2002, the United States

allocated 200 000 tonnes of the current public skim milk powder stockpile to overseas food aid donation programs for 2002-03. This volume is nearly four times that shipped as food aid in the previous financial year.

The United States also committed 136 000 tonnes of public skim milk powder stocks for conversion into casein (equivalent to around 45 000 tonnes of casein). The additional supplies of casein and resulting import substitution will contribute to downward pressure on world casein prices. The US casein market is around 100 000 tonnes a year, with the majority of it being imported. These imports account for around 40 per cent of world casein trade. In 2001-02, Australia exported 6500 tonnes of casein to the United States, valued at \$56 million.

In a further attempt to improve the balance in its domestic milk powder market, the US announced changes in November 2002 to government support prices for skim milk powder and butter. The new skim milk powder support price is US\$1764 a tonne, down 11 per cent from US\$1984 a tonne. This compares with a current world spot price of around US\$1800 a tonne. The new butter support price has risen by 23 per cent to US\$2315 a tonne, US\$1015 above the current world spot price.

### New Zealand

While not experiencing the drought that has occurred in Australia, poorer conditions early in the 2002-03 season affected milk yields and have slowed the rate of growth in New Zealand milk production. New Zealand produces less than 3 per cent of world milk production and, with a small domestic market, around 96 per cent of New Zealand milk production is manufactured into dairy products. The majority of these dairy products are exported, with New Zealand being the second largest exporter of dairy products behind the European Union.

The presence of tariff rate quotas in New Zealand's major markets of the European Union and the United States mean that growth in exports to these markets is limited and that New Zealand will increasingly look to other markets for its dairy products. In particular, New Zealand exporters will seek an increased presence in some

of Australia's major markets such as in south east Asia and Japan.

Continued land use conversions from sheep and wool production to more profitable farming enterprises such as dairying, are expected to result in higher New Zealand milk production over the medium term.

## Outlook for Australia

A major challenge facing the Australian dairy industry is to maintain its competitiveness in export markets. The longer term decline in the number of Australian dairy farms is expected to continue as higher cost operators leave the industry as part of ongoing adjustment following the removal of the domestic market support scheme and state based market milk support regulations. Despite the sometimes regionally concentrated costs of the adjustment process, Australia's overall competitiveness in international dairy markets will be improved.

### Farm gate milk prices

Reflecting weaker world prices for manufactured dairy products, average farm gate prices for milk fell in 2002-03. Farm gate prices are forecast to rise slightly in 2003-04, but to fall in real terms over the next few years. An assumed overall decline in the Australian dollar relative to the US dollar is expected to be a positive for Australian dairy product prices over the medium term. This decline is likely to offset some of the effects on returns of lower world prices, with the result that farm gate prices (in nominal terms) are projected to average higher over the medium term than in the previous decade.

### Australian milk production

Drought in most dairying regions of Australia has resulted in the largest fall in milk production since 1976-77. The most substantial reduction (in volume terms) has occurred in the irrigation districts of northern Victoria. Although in the minority, production has risen in some areas — such as Victoria's Gippsland — where seasonal conditions have not been as severe as in other parts of Australia.

For the six months from July to December 2002, total Australian milk production was around 3 per cent lower than in the previous year. A lack of irrigation water in northern Victoria — a region that normally accounts for around 20 per cent of national milk production — contributed to a significant fall (over 8 per cent) in milk production in that region.

With the worsening of the drought in the second half of 2002, dairy farmers reduced cow numbers by selling surplus or cull cows, and drying cows earlier than usual. As a result, the dairy cow herd in 2002-03 is estimated to have fallen by around 3 per cent nationally. This follows a 2 per cent decline the previous year when dry seasonal conditions also contributed to a fall in cow numbers.

Higher feed grain prices and reduced supplies, mainly as a result of the drought, have resulted in reduced supplementary feeding of dairy cattle

in 2002-03, subsequently resulting in an estimated 7 per cent fall in average milk yields.

The combined effect of fewer cows being milked and lower milk yields is an estimated 10 per cent fall in national milk production to around 10.2 billion litres in 2002-03. Assuming the drought breaks in autumn 2003, higher milk yields and a slight rise in cow numbers are forecast to result in a slow recovery in milk production. Looking further out, the cow herd is projected to remain relatively steady over the medium term, with increased milk production resulting from higher milk yields. Total milk production is projected to rise to 11.4 billion litres by 2007-08.

## Reference

ABARE 2001, *Trade Liberalisation in World Dairy Markets*, Current Issues 01.1 Canberra.



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## **Max Ould**

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title

## **Drivers of change in the Australian industry**

session

Dairy

2.15–3.45 Wednesday 5 March

National Convention Centre, Canberra



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## **ABARE CONFERENCE**

**MARCH 2003 – MAX OULD**

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In preparing for this speech, I referred back to an address I delivered to this conference in 1998. It was interesting to take note of the challenges the industry was facing at that time. We were confronting the Asian economic crisis and were concerned about our dairy export markets and growth prospects generally for the industry. Industry deregulation was actively being discussed and increased competitive pressures were expected within the domestic marketplace as new players entered.

I suggested then that the industry would continue to prosper, despite increasing uncertainties, because our primary cost base for producing milk is some of the lowest in the world, giving us a sustainable, competitive advantage. The forecast was that further industry consolidation would be required and that capital investments would take into account lower price expectations from our customers and appreciate that we are a global business and, as such, investments would be in products or geographic areas where competitive positions could be maintained.

Today, the Dairy Industry remains a significant and vibrant agri-business sector with funds employed of around \$16b delivering a return of close to 9%. This is pretty much the same level of investment as before deregulation and debt level is also similar at around \$5b. Of course, there have been winners and losers. The farm sector has slightly improved its returns while the processors' returns have declined over this same period.

The most significant event occurring in our industry recently was deregulation. This only served to sharpen the focuses within the industry and, I believe, delivered a more sustainable and robust future. Deregulation, however, coincided with three fundamental changes – the first being ownership change where we saw the emergence of Fonterra and its role in Australia. No doubt this will continue to be a catalyst for further change as we are all reading about daily. The second issue to be dealt with was that of deflation in domestic retail pricing. This was most noticeable in the large market milk segment, which accounts for about 20% of Australia's milk production, and was the result of increased retail power in purchasing and distribution. Finally, the strengthening of the international market place where we saw improved commodity prices and devaluation in the Australian dollar deliver significantly higher milk prices. These factors and the Dairy Restructuring Act (DRA) which provided almost \$2b in assistance moderated the full and immediate effects of deregulation. The inevitable changes of marginal, high-cost players exiting the industry – both farmers and processors - must, and will occur.

Farmer numbers have been reducing steadily over the last two decades, although since deregulation we have seen this decline accelerate – almost 2000 or 16% to 11,000. According to ABARE research, farm cash profits improved on average due to the strong

commodity cycles and the continual innovative nature of farmers in improving productivity, operational practices and containing debt levels. Unfortunately, this masks the concern of those farmers dependent on the higher prices of the previously regulated market milk sector. Production costs to produce year round milk exceed returns and continuing adjustments will be necessary in these regions. The milk levy has allowed these farmers the time to assess their future but any hope of a return to the "good old days" must be tempered with the economic reality of the market place.

Using averages does not always reveal the extent of the extremes in any industry but average returns of 7% on funds employed by farmers is not particularly attractive, given the cost of money, and will force many to seek alternative opportunities. Overall, the farmers have maintained their lot during these uncertain times and can now make decisions on their future with the outlook a little clearer.

Processors by and large have not fared so well. Although total revenues are up about 15% over the past 3 years, cash earnings are down 3%. This can be fundamentally attributed to higher milk costs being paid by the processor sector to farmers (16% more) and the inability to raise wholesale prices in a deflationary domestic environment. Debt increased by almost 50% in this same period as

reinvestments continue by the processors seeking greater efficiency and operational capabilities. Co-operatives clearly have made this choice of increasing returns to their members and this is appropriate, but the industry as a whole cannot go on doing this if growth opportunities are to be pursued.

Australian consumers of fresh liquid milk have noticeably been the winners following deregulation where they are now paying an average 6 cents per litre less than they were three years ago and this is after contributing to the DRA levy of 11 cents per litre. Had pricing just kept pace with inflation we would have been receiving more than 20 cents per litre additional – what a difference that would have made to the industry.

With the demise of regulation, **no longer do we have an industry that is captive to history.** Rather than relying on the past to enable us to forecast the future, we are now faced with a new, volatile, dynamic environment. The globalisation of the dairy sector, the uncertainties that are ever-present in the agri-sector (and we are seeing some of these today with drought conditions), the attractiveness of the Australian industry to international players given our very low cost base, and the increasing power of the customer, will combine to ensure that we continually rewrite the industry dynamics. We cannot expect to go back to how it was. Price increases and particularly profit improvements are going to be very hard won.

The improved financial state of the industry will only come about with greater efficiencies and value-adding. Farmers who choose to stay need to accept the reality. Prices cannot be pushed up to address short term issues – the market won't bear it. Processors must find ways to get better returns on the \$4b funds they have invested - whether this is with ownership consolidation or working together in the supply chain to eliminate costs and lost revenues. Improved quality and logistics efficiencies are just two examples that could deliver sustainable benefits to the industry. Wastage (of product and resources) remains a key challenge for us all.

The formation of Dairy Australia is a positive development in ensuring a coordinated approach is adopted for the industry, however, it must be appreciated the game is changing and all the benefits for industry sustainability cannot be focussed on the farm sector alone. Additional research needs to be allocated to improving consumer opportunities. The New Zealand industry considerably outspends Australia on its R&D activities and now this is all being focussed through a totally integrated industry player in Fonterra.

By many standards, the Australian Dairy Industry has been privileged. It has received strong Government support and consumer subsidy through the various regulatory environments that have existed. We have world cost advantages – but now we need to be much more focussed on delivering greater collective wealth.



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title

## Pathways to growth in dairying: Dairy Farmers Group perspective

session

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## **PATHWAYS TO GROWTH IN DAIRYING**

### **DAIRY FARMERS GROUP PERSPECTIVE**

The Dairy Farmers Group has maintained a vision of growth throughout the 1990's and has recently, publicly, re-affirmed this commitment for the next decade. The commitment is not merely at the corporate level but also applies to its farmer members. It is, in my opinion, a vision compatible with the needs of the Australian dairy industry as a whole.

A commitment to the pursuit of growth leads to a set of outcomes that need to be understood and this Paper will focus on;

- Identifying the outcomes
- Understanding why such outcomes are desirable
- Recognizing the decisions necessary to bring them about.

Prior to discussing such issues it is worth reflecting on the “corporate fascination with a growth objective”.

To some farmers the corporate focus on growth is about executive ego and such farmers challenge the extent to which past growth strategies have delivered returns to them as farmer suppliers and owners of the co-operatives throughout Australia.

Growth for growth sake has never been an objective of responsible leadership amongst the processor sector, co-operative or proprietary. Growth has been a pre-requisite to maintaining commercial relevance in a competitive environment increasingly dominated by economies of scale, market positioning, brand development and customer supply relevance.

The international dairy industry has seen the continued growth of international giants such as Nestle, Parmalat, Danone etc. and within the co-operative sector, spectacular growth examples such as Dairy Farmers of America, Fonterra, Arla etc.

Within Australia there has been continued consolidation within the dairy sector and there are clear signs that such consolidation is not completed. Nestle, Parmalat and Danone have all built relevant positions within Australia and several have clearly signaled that they intend to expand upon such a base.

The recent consolidation of the various New Zealand interests into what will be a 100% Fonterra owned Australasian Foods Holdings consisting of Peters & Browns, Mainland Cheese and Bonland Foods indicates that international organizations have positioned themselves to achieve aspects of their growth strategies within this country. This should not be surprising.

In one respect corporate growth is a defensive mechanism as major customers such as supermarkets, convenience stores etc. develop their own national buying positions and associated power. Countervailing power has always been a relevant economic concept and dealing with very large customers is much easier for a processor with scale, brand power and national processing, distribution and logistics capability. The dairy processors of the past would not have possessed such attributes.

Importantly growth objectives extend beyond defensive justification.

Long term successful organizations are invariably dynamic organizations and growth underpins dynamism. The potential benefits of growth are well recognized in the private sector and reflected in higher price multiples for shares of such companies. Investors know that growth in corporate size, if successfully managed, leads to growth in enterprise value and equity worth. This is why proprietary companies in the dairy sector have such a strong focus on growth.

Most Australian dairy co-operatives do not have the same focus on building enterprise value and equity worth as the equity of their farmer members is usually under recognized and undervalued with very limited owner expectations. Thus growth within the co-operative sector is focussed on defensive positioning on issues of competitiveness. This does not make it less valid as an objective.

***Identifying and Understanding the Outcomes Resulting From A Vision of Growth (Dairy Farmers Group Perspective)***

- Total milk production will rise throughout the next decade in the current three key production regions of the co-operative, namely Queensland, New South Wales and South Australia.

*De-regulation of the market milk farm gate price from July 1<sup>st</sup> 2000 resulted in a 12% decline of milk production in Queensland for the two year period to June 30<sup>th</sup> 2002, a 4% decline in New South Wales with South Australian milk production remaining unchanged. The drought in the current 2002 – 2003 will result in a further reduction in the two northern States.*

*It is interesting to note that ADC statistics indicate an approximate 25 % reduction in the number of dairy farms in each of New South Wales and Queensland compared to a 7% reduction in combined milk production. In the same two year period there was a 20% reduction in dairy farms in South Australia, which maintained a constant volume of milk. These three States weathered de-regulation much better than many had anticipated. Cow numbers in NSW and Queensland have remained relatively constant during this period indicating a dramatic change in the size of the remaining farms.*

*The observation of the Dairy Farmers Group is that there has been a fundamental change in the mindset and skills level of the farmer members in the northern States and that farmer members in South Australia continue to further enhance the momentum that commenced in the mid 1990's. The deregulation process was incredibly painful for many farmers in the north and as a result there was a significant exit from the industry in those regions.*

*The response of a significant number of those remaining has been to invest in their farm infrastructure and to focus on growth. It is the conclusion of the Dairy Farmers Group that given a normal climatic year there would have been a very significant increase in production in both New South Wales and Queensland. This potential has not been lost to the drought and it will be realized in the near future.*

*An unfortunate aspect of the drought is that in the short term many of the farmers in the northern States who embraced the challenge of deregulation and invested in expansion have become most exposed to the immediate impact of the high input costs of grain and feed.*

- Milk payment systems in northern states and South Australia have substantially moved to a common milk price regardless of end use. Innovative milk payment incentives will continue to encourage farmers to expand production and increasing use of contracts will aim to provide both farmer and processor security. Payment systems focussed on reducing seasonality of milk flows will also be a feature in these regions.

*The Dairy Farmers Group were reluctant to move directly to a blended milk pricing at the time of de-regulation of the market milk sector due to concern of farmer reaction. Concurrently it was at a time of very low international prices for dairy commodities. Although the initial payment schemes had embedded features to encourage growth the risk was a continuing over focus by the farmers, the local media and definitely the politicians on market milk despite the reality that less than 50% of the co-operative's milk was destined for consumption as liquid milk.*

*Thus within 18 months the Dairy Farmers Group moved to a blended pricing system where the price of the last litre was the blended average price rather than a discounted residual price. Farmers immediately accepted the new system and saw the opportunity to expand. Those who were uncomfortable with the concept exited the industry.*

*One of the significant corporate challenges to the Dairy Farmers Group was to ensure adequate milk supply through an expensive manufacture products infrastructure in the northern States. Thus special incentives were introduced to pay premium prices for "growth" milk. Such premiums ranged from 3 to 6 cents power litre depending upon the time of the year.*

*Simultaneously further significant infrastructure expenditure occurred to not only upgrade the plants but to convey confidence to the members. In the process factory rationalization occurred to ensure that the processing infrastructure was competitive.*

- In the future capital investment by proprietary processors in the northern States will be limited to market milk processing and distribution facilities. The Dairy Farmers Group being the only processor investing substantial sums in the manufactured products sector within the region. The one exception being the Bega co-operative operating close to the Victorian border.

*In the lead up to de-regulation the uncertainty of future milk supply resulted in proprietary processors transferring some manufactured products to Victoria. Apart from the Bega co-operative which is close to the Victorian border, and the Dairy Farmers Group, very little capital investment has occurred in central and northern New South Wales and in Queensland during the last decade.*

*Taking Queensland as an example the only investment in manufactured products has been by the Dairy Farmers Group which has invested \$54.5m during the past five years, 60% of this investment has been in cheese processing the balance in liquid milk. For the current 2002 – 2003 year the co-operative will produce approximately 22,000 tonnes of cheese, mainly mozzarella in Queensland.*

*The importance of these statistics is that without a manufacturing product base there will be no opportunity of on farm production growth for Queensland or central and northern NSW farmers. Without such an option then there would be no opportunity for farmers to improve their efficiencies as required in the de-regulated environment. This has placed enormous responsibility on the Dairy Farmers Group to take the risk of maintaining a capital investment program during such an unsettling period.*

*It is the view of the Dairy Farmers Group that there will be no significant viable industry in the Northern States without a manufacturing product base. This is one of the reasons there has been so much hesitation in the past to take-over attempts by proprietary companies that have not demonstrated a similar commitment in these regions. As the farmers progressively adjust to de-regulation and improve their efficiencies this risk reduces.*

- All significant processors will share the vision for growth and this will lead to continuing rationalization and capital investment.

*Both co-operatives and proprietaries recognize the importance of the commercial momentum associated with growth.*

*Thus there will be continued pressure for mergers, amalgamations and acquisitions. There is a genuine concern regarding the potential for the building excess processing capacity thus industry rationalization increases in attractiveness.*

*In recent years there has been significant media speculation surrounding acquisitions in the fresh dairy business sector and media neglect of the potential of the potential benefits of rationalization in the manufacturing sector. The recent Murray Goulburn and Bonlac merger discussions have re focussed attention on the industry and national importance of this sector.*

*Without interfering in the deliberations of the Bonlac and Murray Goulburn directors, conceptually the merger of these two significant co-operatives makes sense. The potential for capturing synergistic benefits is obvious and the potential for limiting uneconomic capacity expansion is equally obvious. It would be a merger that would have more negatives than positives for the Dairy Farmers Group but on the surface the net positives for the membership of the MG and Bonlac and the industry as a whole would be substantial.*

- The milk pricing differential currently existing between farmers in northern States and Victoria will reduce but will not entirely disappear.

*Statistics for comparative milk pricing can be easily misinterpreted due to undisclosed variations in the measurement base. For example when quoted in cents per litre it must be remembered that the fat and protein levels in Victorian milk is on average above that of the northern States. Similarly the lower seasonality of the north is often ignored and part of this lower seasonality is a direct result of the quota history and current milk payment incentives offered.*

*However accepting such distortions the following observations can be made;*

- *In the year prior to deregulation the blended price in New South Wales and Queensland were approximately 50% to 60% higher than Victorian prices.*
- *In the first two years after deregulation the blended average prices paid in all three States and South Australia were approximately equal as Victorian prices rose quickly in line with international commodity prices and northern prices fell.*

- *In the current year milk prices for the northern States are approximately 23% higher than Victorian prices and South Australian prices approximately 17% higher.*

*In respect to the members of the Dairy Farmers Group milk price expectations in the future must be that they will progressively move more into alignment with Victorian prices but with less volatility and a small premium due to the lower seasonality. Current gaps of up to seven (7) cents per litre are not sustainable. However the different product mix and heavy domestic bias towards branded fresh dairy products should result in Northern and South Australian prices for the co-operative not falling to the lower trough points experienced by the Victorian farmers when international prices collapse as they have in recent times.*

- *Inevitably the New Zealand and Australian dairy industries will come closer together commercially as each recognizes that from a global perspective there are substantial benefits from closer ties in the face of increasing global competition.*

*Fonterra has obviously positioned itself to increase investment in Australia although recent public statements indicate that additional moves may not be imminent. Conceptually there are many advantages for the Australian co-operatives in particular to work more closely with Fonterra and no doubt there will be a great deal of interest in this arena in the future.*

- *The capacity of the capital base of co-operatives to maintain their growth aspirations will be inadequate. In the case of the Dairy Farmers Group this is an issue that must be addressed in the short term.*

*There is no single “right” answer to this question of capital adequacy. It will be for each co-operative to evaluate its own needs and then to implement plans to address such needs.*

*In the case of the Dairy Farmers Group there is a heightened state of awareness of equity value with the co-operative’s board for many years highlighting both the need for a stronger capital base and for the farmer owners to demand a return from their capital investment.*

*The growth-based vision for the Dairy Farmers Group clearly recognizes the need for a substantial permanent capital base and this is only possible with a flexible capital structure. The lack of a substantial capital base has already severely curtailed the options available for the co-operative. It must and will be addressed in the near future.*

## ***Conclusion***

The Australian dairy industry is a healthy, vigorous industry, which will continue to grow at all levels. It has a base of efficient farm supply and a strengthening processor sector that will further consolidate its strengths through ongoing rationalization. It is an industry that will see change in both the proprietary and co-operative sector where size and structure will play an increasingly important role.

A feature of the now totally de-regulated environment is that growth will occur throughout Australia. Although the dominance of Victorian production will continue there will be a “re-birth” or energizing of milk production in the Northern States provided that during these critical initial years after de-regulation processor confidence in building processing infrastructure for manufactured products continues.