Farming Together – Complex Services Report – Case 02304

Farming Together Program

Jersey Milk Group Project

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Jersey Australia Advocacy Paper

FARMING TOGETHER PROGRAM – CASE 02034 2018

ACKNOWLEDGEMENT

This report has been prepared by myself with the help of Jane Sykes and Mike Weise from Jersey Australia consulting a wide range of people involved in the dairy industry. A number of interviews and discussions have taken place in person and by telephone. I would like to acknowledge specifically Mike Weise and Jane Sykes for their help in preparing this report. In addition to Mike and Jane I would like acknowledge the work done by Patten Bridge in preparing the original report.

This report should be read in conjunction with the original report prepared in October 2017.

A wide range of people have been spoken to in preparation of this report from farmers, processors and industry bodies.

KEY DEFINITION

Milk pricing mechanisms in this report refers predominately to processors in Southern Australia where the major product mix is manufactured product, not liquid milk. The same principles apply to other regions but there are a mix of pricing mechanisms.

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1 PROJECT BRIEF

Jersey Australia's objective of this report is to develop an advocacy position with industry leaders to push for support to simply payment systems:

- to provide clearer and more accurate market signals
- to enable farmers to more easily compare prices between processors
- to recognise the value of higher milk solids, regardless of the breed of cow producing the milk

Initially meetings with a number of industry participants were had the initial Farming Together report findings are presented here.

2 EXECUTIVE SUMMARY

Milk pricing mechanisms in Southern Australia are unnecessarily complicated and do not always send the appropriate market signals. It is difficult for farmers work out exactly what their price is. There is no evidence at all to suggest that the current values of fat and protein used by processors represent actual market returns. Processors use pricing mechanisms for competitive reasons as opposed to sending market signals to value of individual components.

Milk pricing mechanisms should be simplified and based on milk solids as opposed to fat and protein. There should be a volume charge to reflects the benefits of producing higher solids milk.

The issues in regard to milk pricing are not about breed of cow but recognising the value of premium quality and higher solids milk.

3 THE CURRENT ENVIRONMENT FOR DAIRY

The dairy industry in Australia is at a crossroad, will it start to grow again and continue to be a major exporter or will it continue to contract and just be a domestic industry?

The Australian dairy industry today first time in its history now has no major cooperative. It is likely Murray Goulburn will no longer exist shortly and it has been unable to set a competitive milk for the last few years. There are a still number smaller cooperatives left but they do not represent a significant volume of milk. Farmers need to understand that non-cooperative companies will pay what they have to for milk supply whereas a well run cooperatives will pay what it can for milk supply. Cooperatives are needed to set the benchmark for milk price.

As a result of the recent prices shocks sent through the industry in Southern Australia in 2016 by the two major processors Murray Goulburn and Fonterra there is much uncertainty about the industry's ability to recover and grow again. Milk production in 2016/17 of 9.03 billion litres has fallen to its lowest level in twenty years. The differential in milk prices paid to individual farmers supplying the major processors in Southern Australia has moved from around 20 cents KG/MS in 2009/10 to around $1 per KG/MS in 2017/18. This has come about from major changes to seasonal and productivity incentives over the last 10 years. There has never been less transparency in milk prices than there is today.

Addressing pricing mechanisms is one of the most important issues for the dairy industry going forward if it is to be successful. The changes to pricing mechanisms over the last ten years has created a seriously fragmented industry at farm level. Historically in Southern Australia, prior to 2007/08 when major changes were made to pricing mechanisms, all farmers were treated reasonably the same. Changes to milk price mechanisms accelerated in 2010/11. This has resulted in farmers being divided, seasonal versus flat supply, Jersey versus Holstein.

Unless the issue of pricing mechanism is resolved it will be difficult for all farmers to go forward together. Processors must understand that for the dairy industry to be successful we must have a profitable farm sector. This can only be achieved if pricing mechanism encourage farm profitability as opposed to pushing costs back on to farmers. Farmers understand that markets go up and down so it critical that there is much more fairness in pricing mechanisms.

4 SYNOPSIS OF THE INITIAL REPORT OCTOBER 2017

The initial report concluded that current milk pricing systems in Australia, particularly from the major processors in Southern Australia, are complex and make it difficult to demonstrate a direct line of transparency between market value for milk products and the price paid to farmers for the components of the milk they produce.

From the initial analysis it is difficult to draw any conclusion that Jersey milk is disadvantaged relative to Holstein milk on the basis of the price paid for milk solids although one processor, Murray Goulburn, have a slight advantage for Holstein profile milk. This is probably not by design but due to the fact that there has been a lot of tinkering with the milk price over the last ten years making it much more complex and complicated than it was historically.

From the analysis prepared for the initial report it is reasonable to conclude that the benefits for the processors of milk with higher solids, whatever the breed of cow, are not fully reflected in the pricing mechanism.

The report further highlights current industry concerns around payment mechanisms in that have become much more complex, hard to understand which in turn makes it much more difficult to compare pricing between processor and do not necessarily translate market signals to farmers. There is no doubt that the current pricing systems, particularly in regard to the values placed on fat and protein, are confusing and are based more on past practice rather than real values. The most important value for farmers is the total price paid for milk solids, fat and protein.

5 MEETINGS AND DISCUSSIONS

Key Issues and Questions Discussed.

What is the method for determining the value of fat & protein in milk pricing?

How do prices really relate to current market values for fat and protein?

Why is there not transparency in milk pricing?

It has been shown that higher component milk is more efficient for many processors. For example, lower cartage costs per kg milk solids and lower power costs for water removal. How can the milk price paid to farmers better reflect the benefit of this for processors?

Do processors see any value in higher solids milk?

Should it be easy for farmers to be able to independently be able to compare prices between processors?

Are breeds like Jerseys where the solids are high are treated fairly under current milk pricing mechanisms?

Dairy farmer comments:

Current payment mechanisms are not working. The volume charge never really acted as a deterrent to low solids and it has changed over the years. Quality of milk is the most important fact. The current payment mechanisms have led to farmers chasing protein and volume at the expense of milk solids. Processors should consider paying the same price for both protein and butterfat, i.e. one price for milk solids. There needs to be a focus on issues that make farmers more profitable, for example the science of growing pasture.

Payment mechanisms need to be more transparent.

Processor comments:

There is no real method for determining the value of fat and protein. The values are really based on historical decisions made many years and do not really reflect current market values. Milk pricing mechanisms have been driven by competition for supply and do no always relate to markets values. Over the past few years in Southern Australia milk prices have not reflected market returns.

Milk prices should:

- reflect market signals
- should be simple
- recognise it is a competitive market for supply

It should be noted in Tasmania Mondelez (Cadburys Burnie) from 1 July 2017 have introduced a milk payment mechanism that pays on milk solids only. The same price for fat and protein. This has been very well received by their farmers.

Processors do value higher solids milk.

Processors do not promote one breed of cow versus another.

Private companies have different objectives when setting milk price compared to cooperatives.

Farm Consultants Comments:

Farm payment mechanisms far too complicated. The issues around pricing are not about breed of cow but about sending the right market signal to farmers. In Southern Australia the current gap between the lowest and highest paid farmer is approximately $1.00 per kg/MS. In 2010 this was 20 cents per kg/MS. The difference is not about breed but complicated by productivity incentives, seasonal incentives, loyalty incentives and different interpretations around what a volume charge is.

A simple price mechanism is needed as there is to much focus on this and this can impact on how farms are being run. This has lead not necessarily a focus on farm profit but more focus on revenue by some farmers.

<u>Norco and Richmond Dairies - Jersey Milk</u>

Norco has no incentive to produce Jersey milk and although butterfat is the main product they use in manufacturing they pay less for butterfat than protein.

Richmond Dairies who around twenty supplier who are nearly all Jersey they do not pay a specific incentive for Jersey milk their pricing mechanism does encourage higher solids milk. They have base for milk of 4.2% butterfat and 3.3% for protein and they pay a bonus for every 0.1% above the base.

Richmond Dairies have done some work trying to develop a premium Jersey product success has been limited. They just want higher solids milk.

Findings from Meetings

The current basis for values of Fat and Protein has no real relevance to market prices. Market prices are volatile and change over time. The basis for fat and protein pricing has not changed greatly over the last 30 years but the markets have.

The real issue for farmers is a simpler milk pricing mechanism with a focus on a fair transparent price for their milk solids. Current milk pricing mechanisms do not necessarily reflect the value processor get for higher solids milk. Milk prices are not necessarily set in the best interest of all farmers. Milk price mechanism are not encouraging efficiency and profitability at farm level. They are often sending the signals and encouraging higher cost and lower profitability for farmers.

Pricing mechanisms become complicated and have changed over recent years for the wrong reasons. Processors are using them as a perceived competitive advantage to attract the type of supply they think they want to the detriment of a significant number of farmers. This is being done through the use of productivity and seasonal incentives that send the wrong signals to farmers.

Pricing mechanisms should be simplified by processors so farmers can focus on what is important for them, running their farms efficiently and profitably.

Processors should be more transparent with pricing so farmers can easily calculate what they are being paid for their product.

Pricing mechanisms should reward farmers for quality and higher solids if this delivers efficiencies to processors. This is not necessarily an issue about breed but for cheese and powder manufacturers in particular the higher the milk solids the better. Jerseys have natural advantage from this perspective.

6 FONTERRA NZ PRICING MECHANISM

Fonterra milk pricing mechanism is subject to audit and verification by the NZ Commerce Commission. This was a condition set by the NZ government when Fonterra was created. The Fonterra milk price is governed by a milk price manual and reported in an annual Milk Price Statement. This provides transparency for farmers and milk transfers to other processors. The milk price is calculated off a commodity base using Wholemilk Powder, Skimmilk Powder, Butter, AMF(Butterfat) and Buttermilk Powder. It does not account for products such as cheese and UHT milk.

The focus in NZ is on milk solids but Fonterra does set a price for fat and protein based on the commodity prices. They do have a volume charge and farmers are either charged or paid more depending on whether milk solids come with more or less water than the company average.

The value of fat and protein is adjusted annually based on market returns for the commodities mentioned above. This has seen the value of fat start to increase versus protein considerably over the last couple of years. The value of fat is still below the value of protein even though the markets reflects something different. (GDT 6 February 2018, AMF US$6,581 per tonne, SMP US$1,932 per tonne).

The Fonterra pricing mechanism does pay a lower price for spring milk, about $0.50 per KG/MS. In Australia the difference in price of milk in October versus June can be up to $3.00 per KG/MS.

All Fonterra farmers are paid off the same base. There are no loyalty or productivity incentives.

The Fonterra pricing mechanism has served NZ farmers well since its inception because it does deliver transparency. The product mix in Australia is different but the principles of transparency are still the same. The pricing mechanism is necessary in NZ due to the NZ Commerce Commission decision to allow the Fonterra merger.

A similar level of transparency in Australia would benefit dairy farmers.

7 CONCLUSION

Pricing mechanisms are only a means for paying milk and the breakup of components and other incentives does not necessarily relate to market conditions. They are often used for coemptive reasons as opposed to providing farmers a transparent price that sends transparent market signals.

Current pricing mechanisms do not necessarily disadvantage Jersey farmers but they are unfair to many farmers. They need to change if the if all farmers are to be treated fairly and are to be rewarded for producing premium milk with higher solids.

The complicated pricing mechanisms only confuse farmers. The only thing that is really important is the net return per kg/MS which than can be compared to the cost of producing milk.

Current pricing mechanisms will continue to distort market signals and frustrate farmers. The current pricing difference of up to $1 per milk solid to farmers who supply the one company is not sustainable and will not support a healthy dairy industry. This compromises one farmer versus another.

Today there is little pricing transparency and although it is proposed that a milk price index is to be developed and should be implemented by 30 June 2018. I feel that is over complicating what is a relatively simple process and if not implemented with the proper education will unfortunately further “muddy the water” in regard to pricing.

The simpler the pricing mechanism the better so farmers can focus on what they should, there farms. Pricing mechanisms should not necessarily be directed at particular breeds of dairy cows. It is not the role of a processor to dictate to a farmer through pricing mechanisms how they run their farm.

8 RECOMMENDATIONS:

It is recommended that a much simpler pricing mechanism would benefit the dairy industry in Southern Australia. This report does not recommend that pricing mechanism should be designed to benefit one breed or another but it should be designed encourage premium quality milk and higher solids milk.

The Fonterra NZ model offers some guidance in setting a new pricing mechanism because of its transparency. The product mix in Australia is more focussed toward cheese and the domestic market so it is not totally appropriate for Australia but the principle of transparency apply. Product mix has changed in NZ has changed considerably since Fonterra was formed with a much greater focus on Wholemilk Powder which makes it harder to place a separate value on fat and protein.

Due to product mix in Southern Australia in my view it is pointless trying to put a separate value on fat and protein and the focus should just be on milk solids for transparency and simplicity. For example you cannot value the fat or protein in cheese separately. The customer is buying Cheese, not fat or protein. The same applies to Whole Milk Powder and many other products.

Jersey Australia should join with other representative farmer groups and advocate for a simpler pricing mechanism that rewards higher milk solids regardless of breed. It is clear that the individual values placed on fat and protein by processors are artificial numbers and bear no resemblance to market returns for individual components and send the wrong signal to farmers.

Proposed pricing mechanism:

- one price for milk solids, butterfat and protein
- an appropriate volume charge that penalises lower solids milk

Although not part of the initial scope of the report it is also recommended that the following should be looked in conjunction with simplifying milk price mechanisms

- seasonal incentives be reduced significantly to reward farmers for producing low cost profitable milk. (There is a difference in price of up to $3.00 per KG/MS for milk in October versus June from some processors)
- productivity incentives should be reduced so as not to significantly penalise smaller farmers and younger farmers starting in the industry.

My personal view is that large seasonal and productivity incentives are unnecessary but that is probably “a bridge to far” for the processors today.

9 APPENDIX

Jersey Milk Component Report – Bridge Logic – October 2017