



UNITED DAIRYFARMERS OF VICTORIA

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Submission for the Inquiry into

***“Impact of Competition Policy Reforms on Rural
and Regional Australia”***

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Introduction

The United Dairyfarmers of Victoria (UDV) has developed this submission to provide background to the Productivity Commission on the role and value of the Victorian dairy industry. The Victorian dairy industry to date has been impacted by National Competition Policy reform through deregulation of industries that supply goods and services. The review of the Victorian *Dairy Industry Act 1992* is not expected to be completed for the Victorian State government until May 1999.

This submission provides the reader with background on the Victorian dairy industry, the UDV's opinion on issues raised in the "Inquiry Issues Paper" and comment on other factors the UDV believe should be considered when developing the report to address the Inquiry "Terms of Reference".

Background to the Victorian dairy industry

The Victorian dairy industry consists of 8,095 dairyfarmers and 36 milk manufacturing and processing plants. 16 plants are situated in regional Victoria, generating employment for 6,500 rural Victorians. Including dairy farm businesses, total employment for rural Victoria equates to approximately 31,000 jobs.

Whilst manufacturing occurs in all states, Victoria accounts for between 80-95% of output for most major product lines. Both farmer owned co-operatives and private companies (including local affiliates of overseas dairy companies) operate within this sector, however co-operatives dominate production processing with around 70% of all manufacturing milk supplies.

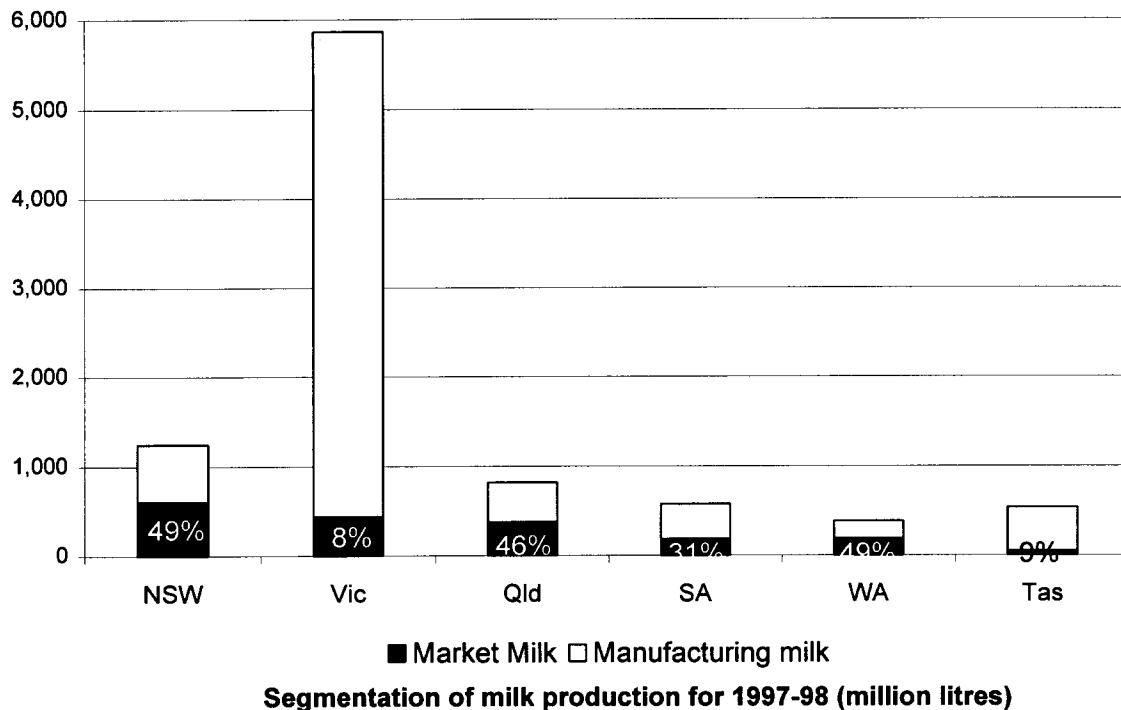
The United Dairyfarmers of Victoria members contribute in excess of \$2billion worth of exports for the Victorian economy. Victoria's dairyfarmers are innovative and progressive. They have embraced changes in their industry ranging from technology through to industry restructuring.

Murray Goulburn and Bonlac Foods, the two largest co-operatives (both farmer owned), account for close to 50% of the national milk intake. On going industry rationalisation has seen significant increases in average factory throughput over recent years and investment to facilitate this growth in volume has been significant as follows (NB. The majority of this investment has come from dairyfarmer shareholders):

- Bonlac Foods Darnum plant \$150 million
- Bonlac Foods global distribution centre \$15 million
- Murray Goulburn Cobram, Maffra, Leongatha plants \$70 million
- Murray Goulburn global distribution centre \$18 million
- Tatura Milk Industries plant upgrade \$50 million
- Kraft Foods plant upgrade \$130 million
- Nestle Echuca mill upgrade \$180 million

Victoria is the largest dairy state in Australia and in 1997-98, produced 62% of the nations milk.

The dairy industry consists of 2 major segments viz. liquid or drinking milk and milk destined for manufacturing. Victoria is predominantly a "manufacturing milk" state as shown in the graph below:



66% of Victoria's total production ends up on the export market. Tasmania realises up to 59% of their production on the export market, however, all other states are under 20% in terms of "exposure" to international prices. Victorian dairyfarmers have adjusted their businesses to farm at predominantly international prices.

Regulation

The Victorian dairy industry is facing the sunset of Federal legislation for Domestic Market Support (DMS) which supports the price of manufactured product sold on the domestic market against heavily subsidised export markets. Termination of the scheme is scheduled for 1 July 2000.

The Victorian Government has also announced its' National Competition Policy review on the Victorian *Dairy Industry Act 1992*, which sets farmgate prices for drinking milk.

Both of the above arrangements have provided a stable economic environment that has allowed an annualised industry growth of 4% over the past 15 years.

The UDV has commissioned a study (Inquit, 1998) into the impact of deregulation on the Victorian dairy industry. As a result of this study the UDV has adopted the view that deregulation will occur and that the industry should put its efforts into ensuring that Victorian dairyfarmers are best positioned to manage in a deregulated environment.

Where is competition lacking?

The Victorian dairy industry has been deregulated post farmgate for several years. Victorian consumers now pay the highest price per litre of anywhere in Australia ie. \$1.35/litre. It is of concern to the UDV that with regulation of the farmgate price being removed that the 2 major processors control 84% of all drinking milk and it is likely they will compete the price of milk down. All price reductions are ultimately passed on to dairyfarmers.

There is also concern that with only 3 major supermarket chains that they will increase pressure to lift margins. Again the dairyfarmer will pay the price for supermarket power. In the past 2 years with post processor deregulation in Victoria, we have seen prices to consumers increase by 20% and no corresponding increase in farmgate price.

Transitional and short-term impacts of the NCP reforms

Whilst manufacturers have been implementing strategies for some years to enable them to capture the opportunities available in a deregulated environment, it is of concern to the UDV, how long it will take to deliver on these strategies.

The UDV is of the strong opinion that it will take 2-3 years for manufacturers to start to realise the benefits of deregulation of the dairy industry. In a deregulated environment, members of the UDV will be reliant on the performance of their manufacturers to secure sustainable returns from the industry.

Whilst, the UDV believes that deregulation of the industry is ultimately the most desirable outcome, it also believes that without an orderly transition from a regulated to deregulated environment unnecessary social and economic adjustment will occur.

It is important to recognise that whilst the Victorian dairy industry has made significant improvements in productivity, this has been based off increased investment, debt and declining terms of trade. International prices are continuing to be depressed by heavily subsidised product in the international market and the downturn in the Asian economy. These drivers, combined with the ongoing impact of El Nino has severely impacted on the viability of many farms. The UDV believes that those most exposed with deregulation are the future of the industry – young, dairyfarming families who have taken on debt to develop their businesses.

Discussions with financial institutions indicate that up to 25% of the dairy industry are financially exposed. Nationally this could impact as many as 3,200 dairyfarmers.

Flow of benefits and costs in the longer term

Over the next 5 years the UDV believes that deregulation of the industry will eliminate distortion of market signals and ensure investment is targeted towards the most efficient use of resources. It also means that in the longer term Victorian dairyfarmers' returns will start to improve.

In a deregulated environment investors will be encouraged to invest in the industry.

Victorian dairyfarmers expect that they will gain access to new market opportunities.

Alliances and mergers (potentially across State borders and internationally) will occur and these will drive efficiencies into the businesses to enable them to compete more efficiently on the domestic and international market.

Whilst 66% of Victoria's milk ends up on the export market, the markets for manufactured product on the domestic market and market milk markets have traditionally supported a sound economic base for the Victorian dairy industry to continue to grow and develop its export markets.

It is of concern to the UDV that without the restructure and rationalisation post farmgate there will be minimal opportunity for manufacturers to pass on the economic benefits of operating in a deregulated environment.

Traditionally margins have been competed away, which has impacted on the final farmgate price.

Trade Practices Act

How will competition affect consumers, producers and industries in country and metropolitan Australia

1. Consumer

Since the partial deregulation of market milk 2 years ago consumers have seen significant price rises. This has occurred through higher rents being collected by retailers and processors ie. increased margins. This has been a direct cost to consumers.

It is likely in the longer term with consolidation in the processing and manufacturing sector that competition will be minimised in the domestic market and lead to higher prices to the consumer.

2. Producers

The work conducted by the UDV through their Inquit study (1998) identified that through lower farmgate prices there would be an 8% reduction in production at the farmgate level. This represents an approximate loss of \$400million to the Victorian dairy industry. This equates to \$16,000 per average Victorian dairyfarmer.

Victorian dairyfarmers' will be forced to cut input costs to their businesses, which will directly impact on small and regional towns. For every dollar generated at the dairy farmgate level there is a multiplier effect of \$2.66 through the local community.

For example, a typical regional centre services up to 400 dairyfarming families. The total value loss to a regional community will be in the order of \$15million annually. Many dairyfarmers will bypass small businesses who provide goods and services to those dairyfarms today. Dairyfarmers will secure their inputs from larger business operations who have the ability to pass on higher discounts. This will directly impact on small town businesses.

Victorian dairyfarm businesses employ approximately 1 labour unit per business across Victoria. With a likely decline in farmgate prices dairyfarmers will shed labour to maintain viability in their business.

3. Industries

The Murray Goulburn plant at Leongatha currently employs 450 people, drawn from a radius of up to 120 kilometres. The net economic benefit on an annual basis is currently \$35million/annum to the local communities. Over the past 10 years the growth in this business has been 10% annually. It currently collects milk from over 1,000 dairyfarmers within the region. With a peak daily volume of 3.5million litres valued at \$750,000 and a low of 800,000 litres this provides stable employment to the 450 employees all year round.

With an expected decline in production of 8% this represents a value loss of \$2.8million to the local community and a reduction in employee numbers of 36 people.

Prices of inputs used by country producers and product prices for country and metropolitan users

1. Fertiliser

With the likely lower farmgate returns dairyfarmers will be reviewing their use of fertiliser. It is likely that they will reduce their total fertiliser requirements while increasing their use of nitrogenous fertilisers. In the longer term if the right balance of trace elements and fertilisers are not used in these business there will be a marked decline in productivity. Also there may be some detrimental impact on the environment with higher applications of nitrogen. Not only does nitrogen stimulate pasture growth there is also increased possibility of leaching of nitrates off the farms in high rainfall and irrigation areas. With the reduced profitability in the business, dairyfarmers may not be able to maintain sustainable environmental practices.

2. Electricity

Victorian dairyfarmers consume 25% of all rural power usage (approximately \$25m annually). The transmission infrastructure, which not only services dairyfarmer businesses and but local communities, has realised a 4% growth in consumption over the past 10 years. This has created job opportunities for further upgrading of infrastructure and expanded transmission lines.

On 1 January, 2001, the electricity industry will be totally deregulated in Victoria. It is anticipated that distribution and network charges will rise significantly. Subsidisation between rural and urban users will be eliminated. Therefore, for the first time, dairyfarming businesses will be charged the real cost of power generation and delivery. There are likely to be significant increases in electricity costs. Some estimations have been as high as 20-30% increase.

The average dairyfarmer uses \$3,000 worth of electricity annually. This represents an annual increased cost of \$4.8million to the industry.

Structure and competitiveness of industries and markets important to country Australia

The European Union (EU), United States of America (USA), Canada, Japan, Korea, and most non EU countries of Europe, provide sufficient support to their dairyfarmers to maintain an income which allows the excess production dumped on the export market.

More than 70% of globally traded dairy product originates from countries with large export subsidies. Some of these assistance measures include:

- Domestic price support schemes
- Import volume restrictions
- High tariffs on imports
- Minimum price support
- Government purchasing and storage
- Of surplus products
- Government disposal of surpluses
- Export subsidies
- Direct farmer social welfare payments
- Preferred access quota

7% of the world's dairy production is traded on the world market, which is dominated by the EU despite quota control. The EU accounts for 45% of international dairy trade.

EU refunds as a percentage of world price at 20th October 1998

	ECU/E	US\$/E	% of world price
Butter	1700	2045	120
AMF	2160	2599	130
Cheddar Cheese	1029	1238	69
SMP	825	993	74
WMP	1026		75

NB: Spot bulk price for October

Professor Cox of the University of Wisconsin estimates that if subsidies and barriers to imports for world traded dairy product were removed, prices received would be equivalent to the USA domestic price. This price is 68% above the current farmgate price received by Victorian dairyfarmers.

At a meeting of the Cairns group in Sydney, the Minister for Primary Industries Mr John Anderson stated that farm subsidies are costing developed countries \$400 billion annually. According to OECD data, support transfers to farmers totalled \$280 billion (A\$420 billion) last year and has not changed significantly over time.

The Australia and New Zealand have the lowest level of support in the OECD countries. Support to Victorian dairyfarmers for export milk production is approximately 12%, which is just under 1/4 of the OECD average. Unlike major dairy nations of the world (excluding New Zealand) Australia has an open border import policy. There are no tariffs or quotas on dairy products imported in Australia excluding a small tariff of 5% on cheese imports (not paid by New Zealand). New Zealand enjoys an economic advantage over the Victorian dairy industry with a preferred access quota into the EU, which generates an approximate \$200 million benefit to their industry. This equates to a direct benefit of approximately \$7000 for New Zealand dairyfarmers.

What will be the social impacts of the legislation review program – positive or negative effect on business costs, investment and employment

The UDV expects a percentage of currently profitable businesses may experience negative cash flow immediately following deregulation. Farmers will seek to lower their input costs, with subsequent flow on to businesses servicing these farms. There will be increased demand for government assistance under the "Agriculture – Advancing Australia" initiatives. Farmers will shed employees, with minimal opportunity for alternative employment in the region.

Infrastructure Reform

Electricity

Quality of supply

The supply of quality power is mandatory for all dairyfarms. They consume 25% of all rural power usage. There is anecdotal evidence that suggests the quality of electricity supply and associated services has declined. Service units have been centralised in an effort to contain costs and capture efficiencies. This has contributed to increased response time to service problems and delays in reconnection.

How are changes affecting price

The majority of Victorian dairyfarmers are not yet contestable customers because their annual electricity usage does not exceed the 160MWh threshold. Most dairyfarmers must wait until 1 January, 2001 to receive the benefit of reduced electricity tariffs. It is unclear what savings will be available to this last tranche of contestable customers.

Of major concern to rural Victoria is the real potential for substantial increases in network tariffs when network charges are reviewed prior to full deregulation of the electricity industry on 1 January, 2001.

The UDV have two concerns in this regard. Firstly the loss of cross subsidisation that occurs between urban and rural network costs which would see a substantial increase in rural network charges. Secondly, the equity of the re-determination of network charges, particularly in regional areas. Much of the existing infrastructure was constructed under "group schemes" whereby much of the capital was supplied by consumers. In determining the return to distributors it is important that the contribution made by consumers to existing assets is recognised. Unless the consumer contribution is recognised when calculating new network tariffs consumers will end up paying twice for those assets.

Future Investment

For farming groups the major issue is not future investment in generation or major transmission systems. We have confidence that the new competition policy will assist in rationalising these decisions. The major issue for rural groups will continue to be investment in rural reticulation systems.

As with telecommunications the levels of service provided by the electricity system is much lower than that provided in urban Australia. Lack of quality infrastructure is an impediment to development of some rural industries. For example lack of capacity, particularly on Single Wire Earth Return (SWER) systems in Western Victoria is limiting the capacity for expansion of the dairy industry in the region.

Further investment in upgrading rural reticulation systems is almost undoubtedly justified on broad economic grounds. While the financial returns to distributors from upgrading rural reticulation systems do not appear particularly attractive, there are very substantial flow-on effects. Recent studies by UDV have shown that for every \$100 of turnover on dairy farms in Victoria, \$266 of additional economic activity is generated from milk processing and flow on activities in rural towns.

The flow-on effects from relaxing infrastructure constraints on the farm need to be more widely quantified, but almost undoubtedly will justify further investment in rural infrastructure.

We note that the Government has made a commitment to ensure that future investments are made in rural telecommunications by placing Public Service obligations on all telecommunications companies, to be funded by the telecommunications industry itself. There is perhaps a case for similar consideration being given to electricity.

The UDV is currently looking at updated group payment schemes for upgrading rural electricity reticulation systems. At this stage we are not sure that these will be viable under the National Competition Policy. We would like to reserve the right to make supplementary submissions to the Commission once our studies on such schemes or alternative arrangements for funding rural infrastructure upgrades have progressed further.

In summary however we believe that current studies will show that substantial new investment is needed and is economically justified in upgrading existing reticulation systems. These rural systems will continue to be managed by regional monopolies, and some ongoing regulation may be required to ensure that these investments are made.

Business and employment opportunities

The Victorian dairy industry provides employment for over 31,000 people many of which are in rural areas. Dairying is quite unique in that the product in most instances must be processed at a location relatively close to the point of supply providing excellent employment opportunities for local people.

Dairying has achieved an annualised growth rate of about 4% over the last 15 years. This growth is expected to continue well into the next millenium if current infrastructure constraints can be overcome. Dairying will be a major contributor to the Victorian Government's drive for \$12 billion dollars of exports from Victoria by 2010.

Gas

Price and quality of supply

It is timely to pose this question. Victorian dairyfarmers at this stage appear that they will end up wearing the final cost of the gas crisis in Victoria. Despite attempts by the UDV to have the Federal and State governments exempt dairy companies from paying road excise on diesel fuel used after burners were converted from gas to diesel, the governments have chosen to ignore the request. Dairy companies will not only be passing on the cost of lost sales to dairyfarmers but also the increased cost to keep plants running.

It is extremely disappointing that the both governments have allowed Victorian dairyfarmers to carry the cost burden for lack of forward planning and adequate backup facilities.

Water

The reform process

In 1994 COAG agreed to water reform. At this time the focus was on an economic approach and a mechanical framework to met the defined guidelines and reporting procedures. The process was too removed from the people most affected by the recommendations.

The Victorian government has a working group involving all the water user stakeholders, entitled the Murray Water Entitlement Committee (MWEC). MWEC is charged with modelling a system, allocation, water security and environmental requirements. Full public consultation is held before MWEC gives final recommendations to the Government.

It is vital that governments provide quality resources to work with communities to develop strategies so they can work through, and potentially helping implement the COAG reform

initiatives. It is imperative that governments communicate in dairyfarmers and rural communities language to facilitate ownership of the reform initiatives.

Adjustment costs of ongoing water reform

The figure of \$90billion is often quoted as the investment in water infrastructure. This money has been invested over a long period of time and was based on all sorts of drivers, including the political and economic environment.

What has not been taken into account is the on farm investment. This is many times greater than what the government has invested.

This investment has occurred because of the policy's and rules of government at a time when water users, in good faith, put in their own money. Dairyfarmers are nervous of how changes in government policy now impact on the investment dairyfarmers have made themselves.

There are existing discrepancies within the water delivery systems. Some have had renewable works completed prior to the COAG agreements being developed in 1994. With the most recent rounds of water reform some systems are disadvantaged.

It is important that our water reform policies do not make us uncompetitive compared to other countries.

In the past governments have made decisions on water policy without extensive consultation with all stakeholders. The best decisions are made when knowledge is shared between all stakeholders. Too often it is done in isolation from major stakeholders.

Australia has so little water , therefore, we have no option but to manage it well and wisely.

Reform is only part of that big picture.

Environmental impacts on country Australia

The environmental impact is important, however, it has become a political football with experts on every front. Rural people want a sustainable environment. This will be a mixture – better farming practices and most importantly, profitable farm enterprises.

It is easy to be environmentally friendly when your business is operating profitably. It places increasing pressure on people who are facing financial hardship.

There is no doubt water will be attracted to higher value use, but the government should not try to pick winners by favouring one sector over another in directing water usage patterns. Governments have a social responsibility in developing water policy that creates equity across the community.

With the urban growth taking up good quality farmland, guaranteeing security of water on existing farmland will create social and economic benefits equitably. Urban areas will always have an advantage in purchasing power of water as they have the dollars. Agriculture will always be a high user of water but with a limited ability to pay high prices.

Contraction or expansion of activities as a result of the reforms

With consumptive water caps, water trading will become part of using water and the way it is managed. However, water trading will not solve every problem despite many bureaucrats believing it will.

There will be constraints on trade because water delivery systems are unable physically deliver the volumes required. Loss of water from one area to another will increase costs of water delivery to those remaining. The government has not put its mind to addressing how this will be handled.

These issues cannot be ignored. Failure to address these social impacts, along with the COAG reforms will ultimately cost Australia more, by losing productive people who fall to the bottom of the net and don't recover. It is unacceptable to waste this human resource.

Impact of trade water entitlement

The major issue with water presently is how to define water right/licence and the level of security over water supply in a 100 year timeframe. This has come about through the need for a consumptive cap on the Murray Darling Basin (MDB). The use of water year on year has brought the MDB to a point in the near future where sustainability of our water resource will be seriously eroded.

Road Transport

Impact of reforms on businesses and consumers

The National Farmers Federation has identified a \$1billion cross subsidy from rural to urban investment in infrastructure for road users. Over the last 5 years the Victorian government has closed and privatised many country rail lines which traditionally carried freight from the regional manufacturing operation to the Melbourne Port. With the increased traffic and introduction of "B" Doubles, many major country arterials are not sufficiently designed and constructed to carry this heavy traffic with the rail closures.

The conditions and design of country roads are adding significant cost to dairyfarmers and dairy industry businesses in the transportation of milk, milk products and farm inputs. Investment in maintenance and road construction has been diminishing in real terms for many years.

Reform of government monopolies

Telstra

With deregulation and increased competition the imperatives for good farm business practices will require farmers to have access to high quality telecommunication services. The current services are antiquated and do not allow farmers to use those systems to the same degree as their urban business counterparts.

Farmers will need the latest information and technology to make business decisions on management and investment. This is imperative for them to be able to drive their businesses at an international level in a sustainable manner.

The change from the analogue network to the digital network has disenfranchised many farmers who had come to manage their businesses more effectively through the use of mobile phones. The digital network is not of adequate quality or robustness to service the needs of rural Australia.

Impact of introduction of competition

Rural businesses will be charged higher rates in a deregulated environment. These costs will ultimately be bourn by dairyfarming businesses.

Distributional issues

Are the general community safety-net programs adequate for people in country Australia?

There continues to be rationalisation taking place in the dairy industry. In Victoria, dairyfarmer numbers have reduced by approximately 100 per year for the past 10 years. The UDV does expect that deregulation of the industry will cause the rate of exit to increase.

It is important to recognise that the existing community safety-net programs are unlikely to be adequate to cope with the commercial drivers in a deregulated environment.

The UDV supports a transitional package which will facilitate the Victorian dairy industry to manage deregulation with minimal economic and social dislocation.

Federal and State governments will need to support the Victorian dairyfarmers with responsible economic and social programs to allow Victorian dairyfarm businesses to restructure and position themselves to trade at export parity pricing.

It is essential that dairyfarmers have access to advice to assist them to make the best business decisions in terms of their future. Where dairyfarmers make the decision to exit the industry they must be eligible for programs and initiatives that enable them to continue to make a valuable contribution to our society in whatever way they choose.

The UDV preferred position is to have a transitional package which recognises the immediate value loss without regulation and also recognises investment in terms of land, technology and livestock. It is through these investments that dairyfarming businesses have generated a 4% improvement in productivity over the past 15 years.

Other issues

Has the ACCC approach to mergers had an impact on the structure and location of industries?

The UDV has a particular interest in the ACCC's approach to mergers. The UDV believes that there will continue to be rationalisation of dairy companies in Australia and are keen to ensure that there are no impediments to prevent this happening.

It is vital that harmonisation of commercial law under the auspices of Closer Economic Relations with New Zealand is implemented. It is our belief that New Zealand has a competitive advantage with dairy trade under the current ACCC guidelines.