Chapter Seven

Deregulation of the Australian Dairy Industry

The dairy industry is a significant rural industry, with a total industry gross value of production (including associated manufacturing) of over $7 billion, and with exports for 2000-01 projected to be $2.3 billion.

From July 1 this year the industry has been deregulated, the most significant change for dairy farmers being the removal of price regulations on milk sold for consumption. The focus of this chapter is the impact of this deregulation process.

Based on the preliminary evidence consumers have been strong beneficiaries of deregulation, with competitive pressures forcing down milk prices. For farmers, however, deregulation has had a negative impact on farm cash incomes, even after taking into account the potential benefit of the compensation package provided as part of the deregulation process.

The predicted rationalisation of the South Australian dairy industry (induced by the fall in cash incomes due to deregulation) may not occur in the short to medium term, as the price of manufactured milk (which accounts for 80 per cent of South Australian production) has increased due to improving world market conditions. This improvement in world prices (and the current weak Australian dollar), if sustained, will increase the cash income of an "average" South Australian dairy farm by more than the reduction due to deregulation of milk prices.

7.1 Profile of the Australian Dairy Industry

The dairy industry is a significant primary produce sector in the Australian economy. It is the third largest rural industry (behind beef and wheat) by value of production, with a projected Gross Value of Production of approximately $2.9 billion in 1999-00. When manufacturing of dairy products is included the estimated Gross Value of Production is approximately $7 billion.[1]

The export value of Dairy products is forecast to rise to about $2.3 billion by 2000-01, from $1.8 billion in 1996-97. For the past three years however, export value has been relatively static despite increases in volume, due to declining

1 Data quoted in the Senate Report into the Proposed Deregulation of the Dairy industry, Section 2.1.

world dairy prices. After 2000-01 ABARE projects that this situation will improve with export value increasing moderately due to increased volumes and slightly improved world prices, as the US and EU stockpiles of manufactured milk products gradually fall.[2]

According to the Senate report into deregulation of the dairy industry, over the past couple of decades the industry has experienced substantial consolidation and efficiency gains. The number of dairy farms is reported to have declined from over 30,000 in 1975 to 14,000 currently. This consolidation of farms, together with advances in farming techniques and associated technology, has increased productivity substantially, with milk production per cow rising from 2,750 to 4,744 litres. In total, national milk production has increased 30 per cent since 1970.

The dairy industry is unusual, in that milk sold by Australian dairy farmers is divided into two categories, "Market Milk" which is destined for direct consumption and "Manufacturing Milk" which is destined to be transformed into manufactured products such as butter and cheese. Prior to deregulation in July this year the farm-gate price (i.e., the price received by farmers) for Market Milk was fixed by the state governments at a level much higher than would otherwise have been paid. In contrast the price for Manufacturing Milk was determined by market conditions, and in particular the world prices of manufactured dairy products.

As can be seen in Table 7.1 below, the Australian dairy industry is dominated by Victoria, which is responsible for over 60 per cent of national production. The destination of production also differs significantly between States, with almost all of Tasmania's and Victoria's (and a substantial proportion of South Australia's) milk production going to manufacturing, whereas roughly half of the production in the other States is sold as Market Milk. This difference accounts for the substantial differences in average milk prices, which in 1998-99 ranged from 24.9 c/L in Tasmania up to 40 c/L in Queensland.

Table 7.1 can also provide an indication as to the level of effective subsidy which was provided by the Domestic Market Support Scheme and 'farm-gate' price support, which are described in more detail in Section 7.2. These subsidies led to average returns for South Australian dairy farmers of 29.3 c/L in 1998-99, which translates to an average price support in the order of 6c/L for South Australian milk (based on 1998-99 Manufacturing Milk prices of approximately 23 c/L). For an average South Australian dairy farm this would equate to total assistance per farm somewhere in the order of $45,000 p.a.[3]

7.2 Regulations Prior to July 2000

The dairy industry in Australia has traditionally operated within a regulated environment which afforded a degree of protection to incomes in the industry. These regulations were removed on the 1st of July this year. The predicted and actual experience of deregulation in the dairy industry is the primary focus of this chapter.

The subsidies paid under the old regulated environment were substantially different between Market and Manufacturing Milk, with Manufacturing Milk receiving a cash subsidy, and Market Milk being

2 ABARE (2000a), *Australian Commodities.*

3 Information on average farm from ABARE (2000) *Farm Surveys Report*

Table 7.1
Characteristics of The Australian Dairy Industry
Data is 1998-99 Unless Otherwise Indicated

	NSW	Vic	Qld	WA	SA	Tas	Australia
No. of Farms	2,052	8,215	1,732	448	816	740	14,003
Ave. Farm Cash Income (1999-00)	65,000	56,400	84,400	92,100	61,400	69,100	63,200
Ave. Farm Business Profit (1999-00)	-200	-14,200	4,100	12,500	-9,700	-4,500	-8,300
Ave. Rate of Return (1999-00)	1.5	0.8	2.0	1.8	0.9	1.8	1.2
Ave Farm capital ($'000)	1,418	1,147	958	2,721	1,003	1,090	1,203
Ave. Farm Business Debt ($'000)	192	225	148	350	203	246	215
Ave. Farm Equity ratio	86.4	80.4	84.6	87.1	79.8	77.4	82.1
Proportion of National Production	12.6	62.9	8.4	3.9	6.2	5.9	
Market Milk Production (ML)	559.3	439.9	416.7	158.1	114.5	-	1,688.4
Proportion of Market Milk	44.9	7.1	50.1	41.2	18.7	-	
Total Milk Production (ML)	1,246.3	6,197.7	832.2	384.1	611.4	584.8	9,856.6
Ave. Milk receipt, c/L	34.5	25.9	40.0	33.6	29.3	24.9	28.6

Source: ABARE (200b), pp. 4, 75, 102-105, calculations by SACES.

protected by regulation of farmgate prices.

Under the former regulatory framework the Manufacturing Milk subsidy, called the Domestic Market Support Scheme (DMSS), was operated by a Commonwealth statutory body, the Australian Dairy Corporation (ADC). The ADC described the workings of the DMSS to the Senate inquiry into dairy industry deregulation as follows:

> "Two levies are imposed on domestic milk production. The first is a levy on milk produced for consumption as domestic liquid milk. This levy is payable by dairy farmers. A second levy applies to milk used in the manufacture of finished products for domestic sale (i.e., butter, cheese and milk powders etc.). This levy is payable by dairy manufacturers. Manufacturers are assumed to fully pass on this levy to local consumers of dairy products (in either the retail, industrial or food service sector). Milk used in production of exported products is exempt from levy.
>
> The monies generated by these levies flow into the Domestic Market Support Fund. The ADC subsequently re-distributes these funds to dairy farmers in the form of a Domestic Market Support payment. DMS payments to farmers are based on the volume of manufacturing milk produced by a farmer in any month."[4]

As the second levy was payable by dairy product manufacturers it was believed to place Australian manufactured dairy products at a competitive disadvantage in the domestic market. In a submission to the Commonwealth Minister of Agriculture, quoted in the Senate report, the Australian Dairy Industry Council (ADIC) says *"[t]he DMS scheme effectively provides a 3.6c/litre commercial advantage to imports"*.[5] Payments to dairy farmers by State from the DMSS are shown in Table 7.2.

4 ADC quoted in Senate Inquiry into Dairy Deregulation, p. 22.
5 Senate Report, p. 24

Table 7.2
Domestic Market Support Scheme Payments by State ($M) 1997-98[*]

	Vic	NSW	Qld	WA	SA	Tas	Aust
Market Milk levy paid by farmers	10.13	10.74	6.98	3.38	3.24	1.30	35.77
DMSS payments to farmers	90.84	10.69	7.10	3.20	6.61	8.31	126.74
Net Gain from DMSS	80.71	-0.06	0.12	-0.18	3.37	6.95	90.97

Note: (*) ADC quoted in Senate Inquiry into Dairy Deregulation, p. 23.

The other significant price support regulation was controlled by State legislation, and involved regulating the 'farm-gate' price of Market Milk. In the 1995-96 financial year the regulated 'farm-gate' price for market milk in South Australia was 49.24 c/L for average protein level milk, compared with the market price of Manufacturing Milk which was in the range of 21.5 to 22.6 c/L. This equated to a premium above manufacturing milk prices in the order of 27 c/L (more than 100 per cent) most of which was effectively a subsidy. Milk for UHT and flavoured milk processing was set at 67 per cent of the market milk price. A price equalisation system existed so that all farmers received a proportionate share of market milk revenues.

7.3 Predicted Consequences of Deregulation

Predictions as to the likely consequences of deregulation of the Australian dairy industry can be divided into two types, predictions as to the likely future prices received by farmers and consequent impacts on the number of farmers remaining in the industry, and predictions as to the impact of deregulation on the retail price of milk, and hence the benefits for consumers.

In general the industry predicted that deregulation would have significant negative impacts on average prices received by farmers, on farm viability and ultimately on the number of farmers remaining in the industry. Despite this concern the industry, in its submissions to the Senate inquiry into deregulation of the dairy industry was not as pessimistic about prices as ABARE was in its 1999 Outlook document. ABARE had predicted that the removal of 'farmgate' price regulation would eventually lead to the loss of any premium for market milk, with milk prices settling at the level determined by the international demand for manufactured dairy products, i.e. manufacturing milk prices. Industry estimates of the effect of deregulation assumed that some premium would continue to be paid in contracts for market milk, largely to ensure security of year round supplies (demand for milk is relatively constant, but production is highly seasonal). In general industry was predicting a loss of market milk premium of approximately 10-15 c/L.

In order to ease the financial burden of deregulation, the Commonwealth government is providing an assistance package to dairy farmers. A statutory body, the Dairy Adjustment Authority, has been established to administer the applications process for the adjustment programmes. There are three type of assistance being offered[6]:

- the Dairy Structural Adjustment Program which provides assistance

[6] Information on the various assistance packages have been drawn from the Dairy Adjustment Authority's website at www.daa.gov.au.

to all farmers who were in the industry on September 28, 1999;

- the Dairy Exit Program which provides up to $45,000 tax free (subject to an asset test) to farmers exiting the industry as an alternative to the Dairy Structural Adjustment Program (intended for farmers who believe that this will provide better compensation for their decision to exit the industry); and
- the Dairy Regional Assistance Program which provides funds for diversification to communities previously reliant upon the dairy industry.

The most significant of these programmes is the Dairy Structural Adjustment Program which provides the industry with approximately $1.6 billion over 8 years. The level of assistance provided to each farmer is determined on the basis of 1998-99 milk sales, with provisions to use longer term data if 1998-99 was an unusually poor year. Farmers will receive total assistance (paid in quarterly instalments over 8 years) equal to 46.23 cents for each litre of Market Milk sold in 1998-99 and 8.96 c/L of Manufacturing Milk. These payments are available whether or not farmers remain in the industry and in this sense the package is neutral in its impact on decisions about exit and rationalisation. The assistance package is being funded by an 11 c/L levy on retail sales of milk (including UHT and Flavoured milk) collected at the wholesale level.

The distribution of funds available under the restructure package among states is shown in Table 7.3 below. States other than Victoria and Tasmania will receive relatively high payments, due to their higher dependence on Market Milk sales. As a proportion of 1998-99 average annual milk receipts, total assistance ranges from 35.9 per cent for Tasmanian farmers to 74.4 per cent for farmers in New South Wales. As can be seen in Table 7.3, based on 1998-99 production data displayed in Table 7.1, an average South Australian dairy farmer would receive total assistance of approximately $120,000, or $15,000 per year. This annual assistance is equivalent to 6.8 per cent of 1998-99 milk receipts for an average South Australian dairy farmer.

Dairy industry sources have in the past questioned whether decreases in farmgate milk prices would flow through to consumers. It was suggested that any decreases in 'farmgate' milk prices would be swallowed up by increases in processor and retailer margins. Indeed, some dairy organisations were predicting that a reduction in 'farmgate' milk prices would actually lead to an *increase* in retail prices for milk as producer and retail margins together would increase by more than the difference between the fall in farmgate prices and the new retail milk levy designed to fund the adjustment package.

An example of this was a submission Norco (a NSW dairy cooperative) made to the Senate inquiry, which presented "best guess" estimates of the various factors which fed into retail milk prices before and after deregulation. Norco claimed that deregulation would lead to retail margins increasing slightly from 25 to 27c/L; processor margins increasing sharply from 28 to 47c/L, and farmgate prices falling from 50 to 34 c/L. This would mean that, once the removal of the old 4c/L DMSS levy for the new 11c/L retail levy had been taken into account, the price paid by consumers would increase by 11c/L.

Table 7.3
Distribution of The Proposed Restructure Package

State	Market Milk ($ million)	Manufacturing Milk ($ million)	Total ($ million)[1]	% of Total Assistance	% of Total Milk Production	Average Per Farm ($)
VIC	203.4	515.9	719.3	47.6	62.9	87,556
NSW	258.6	61.6	320.1	21.2	12.6	156,002
QLD	192.6	37.2	229.9	15.2	8.4	132,720
SA	52.9	44.5	97.4	6.4	6.2	119,413
WA	73.1	20.2	93.3	6.2	3.9	208,365
TAS	0.0	52.4	52.4	3.5	5.9	70,814
Total	**780.6**	**731.9**	**1,512.4**			**108,007**

Note: These calculations slightly understate the total assistance to be provided, as they do not include additional payments for those farms which experience unusually bad production in 1998-99.
Source: Dairy Adjustment Authority and ABARE (200b), author's calculations SACES.

There were several assertions in this analysis that bear closer consideration. First, Norco were essentially assuming that there is no price competition in the retail market (i.e. between the major supermarket chains). If there is price based competition in milk retailing then a reduction in wholesale price should lead to at least some reduction in retail prices, as the various retailers (Coles, Woolworths etc.) would attempt to increase their market shares at the expense of their rivals. Secondly, Norco appears to have assumed that in price negotiations the milk processors have enormous protected market power as it is claimed that they, rather than the supermarket chains, would experience a very large rise in margins.

7.4 What has Been the Actual Experience of Deregulation?

It is now coming up to five months since deregulation. Market adjustments to the new environment are unlikely to be complete, and in fact anecdotal evidence suggests that major impacts on consumer prices really only began to flow through in September as renegotiated supply contracts came into force. However, some preliminary data has emerged as to the impact of deregulation on milk prices. Recent media reports (and media releases by National Foods and Woolworths) suggest that the retail price of a one litre carton of Woolworths branded milk has fallen by up to 27c/L (with the greatest falls in Victoria, for an approximate per carton price post deregulation of $1.19), and it could be expected that similar proportionate falls were experienced by other brands of milk. This indicates that consumers have unambiguously gained from deregulation.

Turning to farmgate prices, it is unclear exactly how much premium remains for market milk, as deregulation has meant that much of the price negotiation has now become commercially sensitive. A report in the *Australian Financial Review* (Wednesday, 25 October, p. 22) suggested prices paid to farmers in Queensland for Market Milk had fallen from 56 to 35 c/L.

These price estimates suggest that the downward impact on Market Milk prices is greater than the lower bound estimates by dairy organisations but smaller than that predicted by ABARE. This suggests that the impact on many farmers who are reliant on Market Milk, particularly those in the traditionally highly protected markets of NSW and

Queensland, could well be severe, although there will be a significant offsetting effect from the assistance package. It is worth noting that the compensation provided is significantly more generous than that which is generally provided to businesses operating in industries undergoing structural change. The current low Australian dollar will also provide some relief for dairy farmers, as ABARE based their estimates of Manufacturing Milk prices on exchange rates remaining just above US 60c to the Australian dollar. There was evidence of this offsetting effect in the AFR article where the President of the United Dairy Farmers of Victoria was quoted as saying that Manufacturing Milk prices were up to 4c/L higher than last year.

Using these price estimates it is possible to estimate the impact of deregulation on an "average" South Australian farm using ABARE Farm Surveys (2000) data.[7] On average a South Australian dairy farm produces 140,000L of Market Milk and 609,000L of Manufacturing Milk per year. Assuming that Market Milk prices fall 15c/L (from 50c to 35c) then the effect on an "average" South Australian dairy farm is a fall in its cash income of approximately $21,000.

In fact the adjustment package offers significant compensation for these negative impacts. SACES calculations suggest that an average South Australian dairy farm will receive $15,000 per annum over 8 years. However, the package is paid whether or not the farmer remains in the industry. This is a deliberate design feature intended to facilitate exit and rationalisation of the industry.

Fortuitously, one factor which may come to the assistance of South Australian dairy farmers, and significantly ease the adjustment process, is the current good prices for Manufacturing Milk due to improved world prices and the low Australian dollar. Assuming that the estimate from the United Dairy Farmers of Victoria is accurate, then prices being received for Manufacturing Milk are 4 c/L above last years level. If this is maintained then given an average South Australian dairy farmer produces 609,000 L of Manufacturing Milk p.a. this would improve cashflow by approximately $24,000. This is a significant improvement, and has the potential to mitigate significantly the impact of deregulation for most South Australian dairy farmers. The fortunate timing of this improvement in world prices, if it is maintained, will ease the transition to deregulation for most farmers as average cash incomes would actually rise from last year. Of course if Manufacturing Milk prices were to fall back to their 1999-00 levels, then this source of support would vanish.

7 It should be noted that as this data is a statewide industry average it is not necessarily reflective of the situation of any individual farmer.