



Legislative Council Select Committee Inquiry - Dairy Industry in Tasmania

Submission by
Lion Dairy & Drinks Pty Ltd

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Executive Summary

Lion Dairy & Drinks (Lion) appreciates the opportunity to make a submission to the Legislative Council's Select Committee Inquiry on the Tasmanian dairy industry.

Throughout the recent challenges in the Southern milk markets, Lion has continued to support its farmers through a commitment to what we term, '**The Three Ps**' – **Competitive Pricing, Long Term Partnerships and a Clear Purpose**

We are committed to both competitive **pricing** and contract terms, to **partnerships** for the long term, and to a clear **purpose** and strategy built around growing profitable consumer demand for dairy. This is the only way to ensure sustainable returns throughout the supply chain.

Retrospective changes in milk price including retrospective price cuts, are anathema to Lion, as they undermine trust, drive volatility and damage farmers' ability to plan for and invest in their businesses. That is why, unlike some processors, Lion has not imposed retrospective price cuts in response to recent market conditions and does not support them as a matter of principle.

There is significant competition for Tasmanian milk. Recent retrospective price reductions by some processors were driven by the prices milk and associated products have been realising in the international commodity markets and management decisions taken over time by those processors. There is no reason to believe additional processors in the State would have altered recent events given domestic milk price in the Southern States is driven by the price achieved for these products in international commodity markets.

Lion believes there are significant opportunities for processors operating in Tasmania to leverage off and contribute to the growth of 'Brand Tasmania'. The region has a reputation for quality, artisan products. Lion is proud of the role it has played in helping build this reputation through brands like King Island Dairy, South Cape and Tasmanian Heritage.

Any investment in building Brand Tasmania's quality dairy credentials would of course be welcomed, however, we believe the Tasmanian Government will yield the greatest return from any investment it makes in the dairy industry from initiatives to assist farmers to invest in technology and efficiency initiatives to cut their costs and improve their resilience and in doing so improve the overall competitiveness of the Tasmanian industry.

Equally important are steps ensuring the costs structures faced by processors are competitive, including the relative cost of milk supply, freight and transport, water access, business taxation and other costs of doing business in Tasmania. It is these factors that will ultimately determine the size and success of the dairy industry in Tasmania.

About Lion

Lion Dairy & Drinks (Lion) forms part of the Lion Group, a leading beverage and food company based in Australia and New Zealand.

The core activities of Lion Dairy & Drinks (Lion) in Australia are the manufacture and wholesale of white milk, flavoured milks, fresh dairy foods, speciality cheeses and fruit juices.

Lion, formerly known as National Foods, has dairy origins stretching back to the formation of the Dairy Farmers' Milk Cooperative in 1900. In Tasmania, its forebears include Baker's Dairy, Lactos and the still iconic, King Island Dairy.

We make and market many of the region's favourite brands including, Pura, Dairy Farmers, King Island Dairy, Dare iced coffee, Tasmanian Heritage, Farmers Union, Yoplait and Berri.

The Lion group employs around 6,700 people, including 2,300 who work in our Lion Dairy & Drinks business.

Lion spends around \$505m each year to procure milk from Australian dairy farms. Our Australian dairy and juice manufacturing footprint spans 15 sites including milk, specialty cheese, yoghurt and juice facilities. We own and operate two dairy farms on King Island, and have a yoghurt manufacturing site in New Zealand.

Analysis from Deloitte Access Economics suggests our business generates around \$1.75bn in total economic contribution to the Australian economy, and supports 11,300 jobs across our full value chain. As Australia's largest branded dairy business, Lion is focused on building long-term sustainable value in the Australian dairy industry.



Lion's footprint in Tasmania

The Lion group enjoys a strong presence in Tasmania through our dairy and brewing operations.

We directly employ approximately 462 people in Tasmania and our company is an integral component of the state's agricultural, retail, hospitality and tourism industries – making an estimated \$164 million contribution to the state economy every year.¹

Lion works with 71 Tasmanian dairy farms (including 11 dairy farms on King Island – two of these King Island dairy farms are owned by Lion), purchasing around 131 litres of milk annually. We also partner with independent family-owned and operated chilled distribution businesses responsible for the daily delivery of dairy products into the Tasmanian marketplace.

The Heritage, Burnie Speciality Cheese Manufacturing site

Our Heritage site in Tasmania manufactures almost 100 cheese products and is the largest specialty cheese manufacturer in the southern hemisphere.

The site currently produces approximately 16,800 tonnes of product every year – operating 24 hours per day, six days per week.

The Heritage site was established in 1955 as *Lactos*, producing 50 tonnes per year of Edam, Gouda and Swiss cheeses. Since then, Lion has invested over \$150 million to transform the site into one of the world's most technically advanced specialty cheese facilities, with a capacity of 25,000 tonnes of product per year.

QUICK FACTS ABOUT THE HERITAGE

- Established in 1955
- Manufactures nearly 100 cheese products
- Annually produces 16,800 tonnes of product
- Uses approximately 80 million litres of locally-sourced milk
- Employs 250+ people

The site utilises four different processing technologies for its different cheese types – soft ripened cheese, ultra filtration feta, pressed cheese and club/ extruded cheese. Products are manufactured using between 80 and 90 million litres of milk annually. Whilst we endeavour to purchase all of our dairy milk directly from Lion dairy farmers from time to time we may need to acquire from a third party to accommodate demand spikes in our business.

This includes a range of popular products for some of Australia's most loved brands:

- Soft cheese – *South Cape and Tasmanian Heritage*
- Pressed cheese – *South Cape, Heidi Farm and Tasmanian Heritage*
- Club Cheese – *Mersey Valley and South Cape*

The Heritage site employs over 250 people, with seasonal fluctuations increasing to over 300 people.

The site is actively engaged with the community through sponsorship of events and causes, including the *Burnie Gift* and the *Burnie 10*. The site also works directly with various local education facilities to support education development programs.

¹ Deloitte Access Economics Report, FY15

Lenah Valley Milk Manufacturing Site

Our Lenah Valley site in Hobart manufactures a range of over 50 milk and milk-based products, with all products made with fresh milk and cream sourced direct from Tasmanian farms.

The site currently produces approximately 40 million litres of product every year.

Originally called Baker's Milk, the site at Lenah Valley dates back to 1932 when Dick Baker started selling fresh milk from the site. The factory was established in 1943 and officially commenced operations the same year.

QUICK FACTS ABOUT LENA VALLEY

- Established in 1932
- Manufactures over 50 fresh milk and cream products
- Annually produces 40 million litres of product
- Receives 1,600 tanker loads each year of locally-sourced milk
- Employs 50 people

Operating as a dairy processing site ever since, the Lenah Valley factory has been run under a variety of names; however, it is still often referred to by locals as 'Baker's Corner'.

Today, under the ownership of Lion, the site receives over 1,600 tanker loads of fresh milk every year and produces items across the whole milk, modified milk (e.g. low fat), flavoured milk and fresh cream categories.

This includes a range of popular products for some of Australia's most loved brands:

- Flavoured milk – *Dairy Farmers Classic* and *Pura Classic*
- Iced coffee – *Dare* and *Farmers Union*
- White milk – *Pura*
- Cream – *Pura*

All products manufactured on site are distributed Tasmania-wide along with a range of additional Lion products from other sites, including Yoplait, Fruche, Big M and Vitasoy.

The site sources all its milk and cream locally, as well as its two and three litre bottles. All other ingredients and packaging are sourced from Victoria.

The site employs 50 people and is actively engaged with the local community through its support of the local Progress Association.

The King Island Dairy

Our King Island Dairy site in Bass Strait manufactures our range of world-class King Island branded speciality cheese products, all made from locally-sourced dairy milk.

The site currently produces approximately 1,500 tonnes of product every year, also operating its own cheese shop which is open to the public seven days per week.

The King Island Dairy site has been manufacturing dairy products since 1902, and specialty cheeses since 1972.

Today, the site produces a range of white, blue, washed rind, hard and black label cheeses from over 14 million litres of milk sourced from 11 King Island dairy farms, two of which are now Lion-owned. Almost every drop of milk produced on the island is used for King Island cheeses, except for a small portion which is consumed by the local community.

King Island Dairy cheeses are regularly awarded at various national royal shows and primarily distributed to Coles and Woolworths across Australia.

The site employs approximately 80-100 people and is actively engaged with the community, including being a major sponsor of local events including the *Festival of King Island* and *Imperial 20*. The site provides donations to a range of community events and initiatives.

Committed to sustainability, the site has received significant capital investment over the past 10 years to reduce its overall footprint on the environment, particularly through upgrades to the trade waste processing facility. A further \$3-\$5 million will be spent updating this facility over the next three years.

QUICK FACTS ABOUT KING ISLAND DAIRY

- Operating since 1902
- Manufactures world-class specialty cheese products
- Annually produces 1500 tonnes of product
- Using 14 million litres of locally-sourced milk
- Operates its own cheese shop
- Employs 80+ people

Our dairy farmer relationships

Lion seeks long-term relationships with the almost 400 dairy farmers who supply our business around Australia. Across Australia we have 398 dairy farms who supply milk to Lion – this comprises of 180 direct Lion suppliers and 218 suppliers through the Dairy Farmers Milk Cooperative (DFMC).

Lion believes sustainable dairy farmers underpin a sustainable dairy business, high quality products, happy farmers and healthy cows. Our approach to milk procurement is therefore based on offering farmers 'three P's': competitive **pricing** and contract terms, **partnerships** for the long term, and a clear **purpose** and strategy built around growing profitable demand for dairy and ensuring sustainable returns through the supply chain.

Our pricing model: Lion offers dairy farmers competitive contracts that recognise local dynamics, offer secure pricing and as much choice as possible. We do not believe in retrospective price cuts and, in the trade-exposed and more volatile Southern states, including Tasmania, we offer farmers a broad range of fixed and variable pricing options for contracts of varying lengths (1, 3 or 5 years).

Partnerships: Lion offers a broad range of partnership benefits to the farmers who supply us, including grants to improve farm efficiency and sustainability, best practice advice and support. For example, the annual Lion Dairy Pride Landcare Grants Program helps dairy farmers boost profitability and reduce the environmental impacts of their farms, often also reducing their costs and improving the sustainability of their operations. Insights from successful projects are shared with other farmers. To date, 52 farmers have received grants of up to \$10,000 under the Program, including three dairy farmers in Tasmania. In addition, Lion operates capital loans programs and safety schemes to help farmers improve the efficiency and sustainability of their businesses.

Our Farm Services team promotes best practice dairying techniques and works individually with our dairy farmers to help them plan and improve their businesses. Farmers also have 24-hour access to Lion's independent counselling service, and all the resources on our Dairy Supplier website.

A further initiative is a new farmer sustainability program we have developed called Lion Dairy Pride, which will launch in December 2016. The program has been designed to provide our dairy farmers with simple tools to measure, evaluate and improve key areas of sustainability on their farm, and will be available to all Lion direct dairy farmers and suppliers through the DFMC.

This unique program includes a website that consists of valuable information and an easy on-line self-assessment tool that provides our dairy farmers with a trusted star rating across the following areas:

- Milk Quality;
- Animal Welfare;
- Environment;
- Business Management; and
- People, Community & Wellbeing.

The Lion Dairy Pride Program also provides key information and valuable resources in each section. For example, within the Business Management section, farmers will have access to business plan templates and succession planning tips. All Dairy Farmers supplying Lion either as a direct supplier or through the DFMC also have access to free 24-hour a day confidential independent counselling through our Lion Dairy Pride Farmer Support Program.

Purpose: Lion has a clear and credible strategy that is focused on the long term and committed to driving value and profitability back into dairy. Farmers who supply Lion share our pride in making some of the most iconic dairy brands in the country. We are also united in our passion for promoting the nutritional benefits of dairy and making sure more Australians enjoy great tasting dairy goodness every day.

In one key initiative, Lion is investing in the health of the dairy category through its *Goodness Promise*. The Goodness Promise (formerly known as The Goodness Project) celebrates the existing goodness of our products and illustrates our commitment to a range of public targets.

These targets look to further improve the nutritional value of Lion products, address portion size and improve the nutritional literacy of consumers. Achieving our Goodness Promise targets by 2019 are expected to remove around 4 tonnes of sodium, 1400 tonnes of sugar and 500 tonnes of fat from the national food supply annually². We will also remove all artificial colours, flavours and added fructose from our children's products.

Milk Procurement in the Southern Region

In the southern region (Victoria, Tasmania and South Australia) Lion has been receiving clear feedback from farmers for some time that the volatility inherent in commodity-based pricing had a highly negative impact on their businesses. Milk price volatility can make it difficult for farmers to plan for, invest in and sustain their businesses. From a processor perspective, milk price volatility is also a significant financial swing factor. Managing this volatility has become more difficult, and critical, as processor margins have compressed with the advent of \$1/l milk and grocery price deflation.

To provide greater certainty for both our business and farmers, since 2013 Lion has offered southern region farmers a range of fixed and variable farm gate pricing options and a choice of secure contract terms of one, three or five years. We believe our innovative and flexible contract options set Lion apart from other processors in the Australian market.

In terms of pricing, Lion farmers in the southern region are free to choose from the following options:

- variable pricing underpinned by a minimum pricing guarantee;
- fixed pricing for those who prefer a set and determined price* and
- a combination of fixed and variable pricing.

*Farmers can choose to lock in 50% of their volume at a fixed price for up to three years. They can then lock in all or part of the remaining 50% of milk volume on a 12-month fixed rate or select variable pricing.

Lion's fixed pricing options have enjoyed strong take-up. Some 92% of Lion farmers in the southern region locked in pricing for at least part of their volumes for the 2015/2016 season. This means that almost all farmers who supply Lion in the southern region currently enjoy a greater measure of price certainty than those who are wholly exposed to market pricing.

Due to the carryover of fixed contracts from past seasons, Lion expects to pay the majority of its direct farmers in 2016/2017 in the southern region the net weighted average price of **\$5.67 per kilo of milk solids**.

This price represents a premium of 27% over the forecast opening price announced by the price setter in the southern region.

² Base-line annual sales volumes, excluding everyday cheese

In the southern region for 2016/2017 our **three-year fixed price is \$5.50 per kilo of milk solids**, while the **one year fixed price is \$5.10 per kilo** of milk solids and the **one year variable price is \$5.00 per kilo of milk solids**. These prices are based on standard 7.2% milk solids.

During the past months, several suppliers have approached us asking to move their supply to Lion. Unfortunately, as we procure our milk based on demand, we have been unable to accommodate these requests.

Differentiated milk pricing

We note that some commentators have called for a pricing approach that differentiates between milk that finds its way into private label milk and milk that is processed for branded milk. This has arisen from recent calls by farmer representatives and media personalities for Australian consumers to buy branded milk in order to support dairy farmers.

As Lion is predominately a branded dairy business, we pay farmers a premium on all milk supplied to us, regardless of what products we ultimately manufacture from that milk.

In the past, Lion experimented with a two-tier pricing structure of this kind which reflected the return Lion could secure for its products. This proved unpopular with farmers as returns on highly commoditised products were very low. In practice, if this approach was applied to sales of private label and branded milk, such an approach would only be beneficial to farmers if the long-term decline in branded milk market share is reversed. There is obviously no guarantee that this will happen. Based on all available evidence – including the strong and sustained growth in volume share of retailer own brand milk – our expectation is that retailer own-brand milk is here to stay.

This said, claims that farmers do not benefit from increases in branded milk volumes are a gross over-simplification and are focussed on short-term market dynamics. It is precisely because Lion is a branded milk player focused on sustainable margins and profitability that it can offer the sort of price premiums, contract security and choice to farmers outlined above. Any further erosion in branded milk and dairy volumes will only compound margin compression in the processing sector, which is already struggling to generate sustainable commercial returns.

Retrospective pricing

Retrospective changes in milk price including retrospective price cuts are anathema to Lion, as they undermine trust, drive volatility and damage the ability of farmers to plan for and invest in their businesses. That is why, unlike some processors, Lion has not imposed retrospective price cuts in response to recent market conditions and does not support them as a matter of principle.

Dairy Processing in Tasmania and the Role of Government

It is worth noting that the Australian and local Tasmanian branded dairy sector continues to struggle to make a commercial return on investment. Processor margins are well below acceptable benchmarks in most categories and, while there are some notable brand successes, the processing sector continues to face pricing and margin pressure in a highly competitive domestic retail environment along with continued cost pressures.

These pressures make it hard to fully exploit the capital and branding opportunities that could help the Australian industry reach its full potential. Lion is better placed than most given the support of its owner in Kirin which takes a long-term view of the industry. Margins however are very tight and investments must deliver a return.

Despite the challenges, there is significant competition for Tasmanian dairy milk. Recent price reductions by some processors were driven by the prices milk and associated products have been realising in the international commodity markets and management decisions taken over time by those processors. There is no reason to believe additional processors in the state would have altered recent events given domestic milk price in the southern states is driven by the price achieved for these products in international commodity markets.

Any investment in building Brand Tasmania's quality dairy credentials would of course be welcomed, however, we believe the Tasmanian Government will yield the greatest return from any investment it makes in the dairy industry from:

- assistance for farmers to invest in technology and efficiency initiatives to cut their costs and improve their resilience, in doing so improving the overall competitiveness of the Tasmanian industry.
- steps to ensure the cost structures faced by all processors are as competitive as possible, including the relative cost of milk supply, freight and transport access, water access, business taxation and other costs of doing business in Tasmania.

It is these factors that will ultimately determine the size and success of the dairy industry in Tasmania. They determine the amount of capital available to re-invest in the success of the industry. Given the right conditions to invest, processors have the skills, networks and know-how to further grow the Tasmanian industry.

Marketing Opportunities for the Tasmanian Brand

Lion believes there are significant opportunities for processors operating in Tasmania to leverage off and contribute to the growth of 'Brand Tasmania' as well as Australia's strong credentials as a quality dairy producer. The Tasmanian region has a strong reputation for quality and artisan products.

Lion is proud of the role it has played in helping build this reputation through brands like King Island Dairy, South Cape, Heidi Farm and Tasmanian Heritage and we would be very willing to offer our insights to any Brand Tasmania initiative.

The Australian mainland must be part of any such strategy as that will remain an important market for Tasmanian branded dairy goods.

China and South East Asia are opportunities but Tasmania does face higher freight costs than competitive regions and needs to focus where it can win.

Further information:

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