

Large Herds Conference

Ensuring Maximum Dairy Profitability - Who Decides and How?

**Dennis Hussey
DIRECTOR
ACIL AUSTRALIA PTY LTD**

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ENSURING MAXIMUM DAIRY PROFITABILITY - WHO DECIDES AND HOW?

1. INTRODUCTION

To be invited to a conference attended by New Zealand's leading dairy farmers is an honour, and an encouraging indication of your interest in the debate being stimulated by ACIL's research into agricultural marketing regulation.

To me, there is an interesting contrast between the inquiring attitudes of the many dairy farmers I have met and the often defensive and emotional reactions of the industry's leadership, at least as portrayed through the media. However, even though all the old myths have been recycled and some new conspiracy theories added, I see evidence that the need for change is slowly being recognised, even at the top.

There has been in-principle acceptance that the bundling of milk and investment returns is distortionary, even though there is dispute over the size of the distortions. Arguments supporting much less regulation over exporting have not been convincingly rebutted. The only argument I've seen against corporatising the Dairy Board is that farmers cannot be trusted to retain a good investment, given the choice. Having initially rubbished ACIL's conclusion that you were producing butterfat at a loss, the Board is now asking you to consider ways of overcoming the "gloomy future for butterfat sales," and Federated Farmers dairy section chairman, John Boddy, has suggested that some of expected increase in milkflows is "not covering the cost of production".

The debate is addressing issues which are important to your future. I expect this conference will accelerate the process.

Your conference theme is 'Farming for Profit'. I applaud the focus on profitability rather than farm gate returns. The major theme in ACIL's work is that a focus on profitability is imperative if you are to maximise investment returns. The current focus on the farm gate payout and the associated competition-restricting regulations are creating distortions and preventing industry profit maximisation. This is a compelling reason for change.

My letter of invitation asked, among other things, "what structures the New Zealand dairy industry should consolidate on to provide the dairy farmer with the highest level of profitability, coupled with stability in the short to long term ?" While I intend to follow the brief and discuss a number of the issues it raises, I first want to suggest that you are not asking the right questions. If you don't ask the right questions you will get misleading answers in your quest for maximum profitability. In particular, I want to draw your attention to the words "consolidate on".

Are your interests in fact best served by trying to predetermine the industry's structure? Might you not be better off with an operating environment which is open and flexible and where structures develop and survive because they are the most profitable for investors?

The dangers of preordaining an industry's structure are that you may get it wrong or block out alternatives which would yield higher profits. Who can claim to know what's going to be right or best in the future? Are there any logical reasons why there will only be one right answer for all?

2. THE IMPORTANCE OF ASKING THE RIGHT QUESTIONS

One thing certain about the future is continuing uncertainty. "The unexpected happening never happens when it is expected," it is said. Commercial success in these circumstances requires flexibility and adaptability. It would be foolhardy to cut off any options, including those that are currently not even being contemplated.

I'm sure you will agree that unanimity of views across individuals and businesses on issues of business strategy is rare. Attitudes to risk vary enormously. People hold different opinions about how the future will unfold. Judgments on what will be commercially successful differ, even where there is agreement on generally expected developments. Everyone has different ideas, and opinions on the ideas of others.

Most want to test their ideas because they're usually convinced they are right.

Therefore, if you ask what structures the industry should "consolidate on" you immediately raise another unavoidable question: Who decides? Who decides what will work best for the industry and for you individually, and what if they're wrong?

Would it not be better, and more consistent with your individual aspirations, to ensure all ideas, opinions and judgments can be tested, with the best selected by performance instead of being predetermined?

This goes to the heart of the debate over whether competitive processes serve long-term industry and national interests better than command and control systems where planning and decisions are centralised. I believe logic, empirical evidence and history all demonstrate that the competitive approach is superior. It has established its superiority not through being perfect but because it works better than the alternatives. It is the approach countries and industries return to when experiments with the alternatives fail - as they always do eventually.

Given this reality, why do industries keep being attracted to centralised planning and moulds which force all to cooperate? It is a phenomenon very similar to moths flying into the fire. It reflects a fundamental human trait - we prefer certainty and stability and grab anything we think can provide security. We ignore the inevitable costs in our search for elusive and unrealistic benefits.

3 COMMERCIAL COMFORT VERSUS REALITY

Instability, uncertainty and risk are fundamental characteristics of markets and commerce. They cannot be written out of the script but their consequences can be mitigated.

Participants in competitive markets come up with an amazing variety of approaches for dealing with instability, uncertainty and risk. Diversification, vertical integration, contracting, hedging, insurance, cash reserves, borrowing facilities and even business and industry selection are all used for this purpose. The range of solutions reflects the diversity of views among market participants. In opting for regulatory solutions we suppress market-based alternatives. The history of institutionalised or centrally planned stability is one of persistent failure.

My brief speaks of profit maximisation "coupled with stability in the short to long term". There are two points you need to think about when trying to achieve stability by means other than letting individuals handle it as they think best in the market place.

First, instability is a market reality. When something changes in the market you are being sent a message. Ignoring or distorting these messages is never a good idea. Current institutional arrangements do both to varying degrees.

Secondly, institutionalised stabilisation arrangements usually collapse with a market crisis. The desire to achieve stability and avoid market reality distorts the messages and leads an industry away from what the market dictates. Eventually the gap becomes unsustainable. The market then imposes adjustments which are invariably swift and severe.

At that point the industry typically loses any ability to manage change and minimise adjustment costs. This happened in the wool industry recently and is currently happening in the kiwifruit industry. It will happen in your industry if you don't make some fundamental changes.

4. WHAT NEEDS TO BE CHANGED?

I will summarise the main things ACIL believes are wrong with your current arrangements. I will then suggest how you should restructure your industry if you want to maximise your profitability.

There are three major faults with the way you currently do things.

- You restrict competitive exporting in the mistaken belief that New Zealand has monopoly power in a market which is intensely competitive and has other suppliers and substitutes which you cannot control. The result is to limit entry of people, ideas and capital needed to expand markets for your milk.
- You have a single type of business structure - the cooperative - in marketing and processing - and remember the Dairy Board is essentially a cooperative. This structure provides no useful information on investment profitability and no effective shareholder control because you cannot easily choose whether or not to invest.
- Because of their structure, your processing and marketing businesses deliver a milkfat payout which is a commercial cocktail of milk returns from markets paying different prices, returns from non-dairy trade and business profits - the bundled return. This distorts your investment and production decisions and lowers your profitability.

Let me turn first to the bundled return and the problems it is creating.

5. WHY DO YOU HAVE A 'BUTTERFAT PROBLEM'?

In my recent travels I have heard a lot about a phenomenon called 'Southland conversions'. It's not confined to Southland and it involves people entering dairy farming, or significantly expanding production, on the basis of expected payouts which most agree are very optimistic and far higher than the market will return for this extra milk. I have heard stories of farm transactions based on budgeted payouts as high as \$8 per kg.

Why are people doing this? There are two main reasons.

First, your bundled payout - which is currently about \$6 - is significantly higher than returns in lower priced markets. You only need simple mathematics to prove this. The \$6 is an average of returns from all markets, including the premium from the United Kingdom market and the profits from your off-farm businesses. ACIL estimates these two items alone amount to at least 85 cents per kg.

If \$6 is the average of this commercial cocktail, then clearly the lower end of the range - that is, returns from the lower paying markets - must be less. ACIL's calculations suggest considerably less. I am not aware of any publicly available information to tell you exactly how much less.

The second reason for the 'Southland conversion' phenomenon is the success of your industry's public relations and the misconceptions it fosters. It is widely believed that the dairy industry model is successful. Our research suggests exactly the reverse - the problems of your industry, in terms of resource misallocation, may be larger than those of any of the other major rural industries. You do not maximise profits when you distort the allocation of resources. Just to observe that you sell all the milk that's produced and that dairy farmers are still in business does not prove that you are maximising returns on your investments.

You do not have to be a university professor, or even an economic consultant, to work out that if people budget on a \$6-8 payout in the erroneous belief it's profitable and then the milk is sold for much less, your industry is pressing ahead with loss-making investments.

Existing structures mean all farmers take a share of this loss. Because loss-making production drags the payout down across the industry it reduces your profitability, even if you are not one of those responsible for increasing production. You can do nothing about it, short of getting out of dairying. If, as your conference organisers suggest, you want structures which will maximise profitability, you must do something about bundling. You must ensure the milk price you receive is accurately telling you what the market is prepared to pay. You must take your off-farm investment returns in another form.

6. TWO-TIER PRICING – A MOVE DEEPER INTO THE MIRE

The Dairy Board accepts that, in principle, bundling is distortionary but not yet of sufficient consequence to be a concern. At least that was the Board's position five months ago when ACIL released its report.

The Board also said at the time that:

"The report appears to be implicating [sic] less milk production - and arguing that dairy farmers in New Zealand are being paid too much for their milk. It would be difficult to find anybody who would agree that farmers, or New Zealand, could make more money by producing less milk, even if some of the unbundling ideas advocated by the report were adopted".

However, a recent media report quotes Board chairman Dryden Spring as saying that "action must be taken on the gloomy future for butterfat sales" and that "burgeoning milk production in New Zealand meant the industry needed to address the fat production issue again". I note with interest that it needs to be addressed "again".

The evidence that you need to do something about bundling is staring you in the face - Mr Spring is implicitly acknowledging the problem.

What, then, needs to be done? It is with horror that I find the industry is being asked to consider two-tier pricing so that farmers who produce surplus milk receive a lower return for it. Mr Spring said he did not think farmers would resist measures such as two-tier pricing. This is no solution and will take you deeper into the mire.

Mr Spring is also reported to have said that the Board would not attempt to control milk production and that it had the responsibility to reflect as accurately as possible the value of what dairy farmers produced. I have no argument with either proposition. However, two-tier pricing is production control through the back door, and it does very little to improve the accuracy of those price signals.

First, a two-tier pricing system will do little to effectively unbundle your bundled return. The vast majority of existing production will receive the first-tier price which will remain a commercial cocktail. You will still have a misleading signal about true dairy farming profitability, and no useful information on the performance and profitability of your off-farm investments in processing and marketing. The worst distortions will remain.

Secondly, you will have to add to your already complex structural arrangements measures for deciding which milk is 'surplus', and who is producing it.

Think about the consequences of doing this. Those with expansion plans - and the best performers always have expansion plans - will face a very low price for their additional production. An individual farmer might be able to produce it profitably, but for the industry as a whole it's loss-making and must be prevented.

You will quickly find that if you want to expand your farming business you will have to buy an entitlement. This is the fundamental reason why two-tier pricing schemes invariably involve tradeable production entitlements or quotas. They are the common form of production control.

If you, the leading dairy farmers in New Zealand, want to grow your businesses and maximise your profits without having to pay for the right to do so, then the first structural change you should "consolidate on" is to get that payout completely unbundled. Do not treat the symptoms of bundling with measures which will only make the problem worse. Stay away from two-tier pricing schemes.

7. HOW WILL THE INDUSTRY FUND GROWTH?

An issue I find increasingly discussed in the dairy industry is how it will fund growth in the off-farm sector as milk production expands. My brief raised this issue. There is talk of production reaching 500 million kg within five years. This is an increase of over 20 percent on current production levels. The fact that you, as dairy farmers, have to be concerned about how off-farm growth is funded is further evidence that your existing structures are flawed.

Let me explain how I reach this conclusion by discussing three issues related to your off-farm dairy investments. These are:

- the implications of current arrangements for your income and liabilities;
- your lack of knowledge about investment returns and your inability to invest as you think best; and
- the conflict between the industry's need for capital and market growth, and existing restrictions on who can participate.

(i) Lower incomes but increased liabilities

Currently funds for off-farm investment can only be obtained by borrowing on your behalf or raising equity from you. Servicing borrowings or raising equity means deductions from your payout. Dairy industry leaders and company executives wanting to be popular by raising the payout are understandably concerned with the prospect of increased deductions to meet capital needs.

As dairy farmers you should also be concerned. Farmers I speak to are no longer accepting the party line - "capital raising hasn't been a problem in the past and so it will not be a problem in the future".

That is transparently wrong.

Farmers need to think about the extent to which their off-farm businesses incur liabilities on their behalf. This has probably not been much of an issue in the past because statutory bodies have either not become insolvent or, as in the case of the meat industry in the 1980s, taxpayers' money was used to meet the liabilities.

The disastrous situation now facing the kiwifruit industry is forcing people to examine more carefully the way in which statutory arrangements make individual producers responsible for liabilities incurred on their behalf. These liabilities are incurred by organisations and people over which producers have no effective control.

Governments today are neither willing nor able to come to the rescue as they have in the past. In the case of kiwifruit, Mr Falloon recently made it abundantly clear that even if growers want to change

their marketing arrangements, they will not be allowed to do so until all their liabilities have been cleared.

There is no reason to believe that the dairy industry is different and that what is happening to kiwifruit growers will never happen to you. With existing arrangements and adverse market circumstances you could well find your involuntary debts and equity deductions rising while your incomes are falling. Do you normally increase your investment at the same time that your income is falling when these decisions are under your direct control? Surely it makes even less sense to do so when the decisions are not under your direct control?

(ii) All investment 'eggs' in the one 'basket'

The second problem is that you have structured your off-farm dairy businesses in a way that means you have no useful information on how they are performing and little scope for doing anything if dissatisfied. If you choose to be a dairy farmer you are locked into having all your investment eggs in one basket.

You cannot judge the performance of a business unless you have an indicator of its profitability. Having businesses which process and market your milk, deduct all their costs, and send you what's left tells you nothing about their performance. If asked how profitable your marketing and processing businesses are, you would have to say you don't know. Do you have any other investments where you happily accept this situation? Would you deposit money in a bank if it was not prepared to tell you the interest rate that would be paid?

If for any reason you would like to change your investments you have no choice but to sell the farm. It's all or nothing. Furthermore, if you sell the farm you will only realise part of your off-farm investment. Because the performance of the investment is hidden, and the capitalisation of its value into the farm is a crude and inflexible means of holding the investment, it will be heavily discounted compared with a situation where it could be traded as an asset separate from the farm.

The point I would make is that if, as a dairy farmer, you think it is important to invest in off-farm processing and marketing businesses, then by all means do so. But why insist it be done using structures that are so inflexible, that discount the asset's value when it's traded, and that do not provide useful investment performance information?

(iii) Restricted entry means restricted capital

Thirdly, your industry severely restricts who can invest past the farm gate. This is done very effectively by restricting who can export dairy products from New Zealand. One obvious consequence of these restrictions is to leave dairy farmers as the only source of equity and debt financing in the processing and marketing sectors. In the past dairy farmers have taken the attitude that this was an inconsequential price for retaining so-called ownership and control past the farm gate. Those days are over. Your industry needs capital and farmers do not and will not have the capacity to provide what is needed.

The dilemma for those advocating the continuation of restrictions on competition and blocking so-called outsiders is exquisite. They, and you, are between a rock and a hard place. You can accept the need for outside equity and allow more competition and scope for new entrants - because that's the only way you'll get that equity - or you can agree to lower incomes in the future. The third possibility is that you might be talked into halting the industry's growth through production controls. Do you really want to be part of a static industry?

Meat producers incurred a high cost in attempting to own and control their industry's processing and marketing businesses. They are now starting to appreciate the benefits to them as producers of

allowing diversity and competition past the farm gate. They are also seriously looking at ownership alternatives to the traditional cooperative structure. I believe the dairy industry must go the same way.

8. TWO COMMON MYTHS ABOUT COMPETITION

Before drawing some conclusions from what I've been discussing I want quickly to cover two areas where I think you are mistaken in believing more competition is not in your interests. Two arguments - or rather, myths - are regularly trotted out as reasons why dairy farmers would be disadvantaged by more competition in processing and marketing. One is that competitive exporting would disadvantage you because the world is so distorted and unfair. The other is that you must own the processing and marketing system to ensure outlets for your milk. Let me consider each in turn.

(i) "A distorted and unfair world"

You cannot, it is said, have a so-called level playing field at home – that is, competitive exporting – while the world is so distorted, unfair and cruel.

We all know that the world is awash with ridiculous policies that make profitable exporting more difficult for New Zealand. But, and this is the crucial point, this doesn't mean New Zealand or its dairy farmers will be better off by constraining competitive exporting. The logic for this conclusion is straightforward:

- It is generally accepted, including by the Dairy Board, that if the world were not distorted by tariffs, subsidies and quotas there would be no justification for controlling New Zealand exporting.
- Tariffs and subsidies only affect prices in export markets and they do this in exactly the same way as normal market influences. They make profitable exporting more difficult but so, for example, does a market-induced devaluation of an importer's currency, or a seasonal surge in US milk production.
- Tariffs and subsidies, therefore, carry no particular implications for export regulation because they are just another price influence, however distasteful.
- Around 70 percent of New Zealand's dairy exports go to markets where there are only tariffs. There is no logical justification for regulating exports to these markets.
- In the remaining markets where quotas apply, New Zealand is not usually able to gain any quota premium or the potential gains are unlikely to outweigh the losses associated with restrictions on competitive exporting. Only in the special case of the United Kingdom butter market, while present arrangements last, does ACIL consider regulations are warranted, and they should be tailored to the requirements of that market.

The argument that "the rest of the world is distorted and not a level playing field" therefore collapses as a justification for wall-to-wall controls over exporting. To conclude otherwise is to believe erroneously that distortions which make profitable exporting more difficult can be countered by controlling exporting. It might be recalled that this logic was eventually accepted, including by farmers, in the policy debate over New Zealand's import controls.

This conclusion is reinforced in the case of branded and differentiated products. The Board says that over 60 percent by volume, and more by value, of your dairy exports now fall into this category and that the proportion is growing.

Branding and product differentiation are the means used by competitive marketers to secure a market position. They do not incur the efficiency costs of controls and monopolies. Would it not be sensible to provide maximum room for the development of brands and differentiated products? Regulation of entry and blocking the ideas, innovations and capital of new and existing players are inconsistent with achieving this goal.

(ii) "We must have an outlet for milk"

The second myth is that unless dairy farmers own and control the off-farm businesses they will be vulnerable to commercial exploitation and, at worst, not have an outlet at all. This argument is advanced as a key reason why your industry should not be opened up to outsiders who would run processing and marketing businesses for maximum profit - the same objective, incidentally, that you should have as investors in these businesses.

The argument ignores the way competitive markets actually work. When you look at the dairy industry from farmer to consumer, the most intense competitive battles are not up and down the chain but within each segment. Suppliers are not competing with processor/marketers. Rather suppliers are competing with other suppliers and processor/marketers are competing with each other for sales, and for the all-important suppliers.

It is because markets work this way that dairy farmers would be the beneficiaries, not the victims, of processor and marketer competition. Farmers are only in danger of a raw deal where this competitive process is blocked - as it is presently in industries like kiwifruit and dairy.

Let me quickly work through the practical realities of what I am saying.

Assume you sell milk to a processor/marketer business in which you have no investment or control. You will be paid no more for the milk than is necessary to encourage you to supply and prevent you from producing something else. This price will probably be lower than your current payout because it does not include an off-farm investment return component. However, it will be a reliable indicator of market demand for milk - which your current payout is not, because of bundling.

Now examine the fears about non-producer ownership. First is the fear that you will be exploited by the processor because you are locked into dairy farming and you must have someone to take your milk. In the short term this could be correct but in the long term it is not. Farmers change enterprises and industries - for example, 'Southland conversions'. Therefore, just consider the short term.

To cope with the short-term risk, what is wrong with supply contracts and why wouldn't they emerge in these circumstances? While your farm is dedicated to dairying in the short term, isn't the same true of the processing facility? How can anyone make money from a dedicated and capital intensive processing plant if there is no raw material? Maybe processors would be keener on negotiating supply contracts than you would.

This is an environment where anyone can have a go. Is it not certain there would be competition for your milk? This competition would be similar but more intense than currently exists where dairy company catchment areas join or overlap - that is, until further mergers remove that competition completely.

The next fear is that processing businesses you don't own and control will only stay around if it's profitable for them to do so. The moment things get tough - for example, when the industry has one of its periodic downturns - it is said they will pack up and you will have no one to process your milk. In contrast, companies with the interests of dairy farmers at heart are said to be in it for the long haul.

They take the good with the bad.

I suggest it is naive to think dairy farmer investors and their managers are the only ones able to work out what's a good long-term investment and that any other investors will shut plants down the moment losses are incurred. This isn't what we observe in other capital intensive processing industries like forestry or mining. They know they have to cope with cyclical ups and downs.

Perhaps where outsiders might differ from dairy farmers is in their reluctance to stay with businesses that are fundamentally unprofitable. Many dairy farmers do not appear to think like a normal investor, or even the same as you think when making other off-farm investments or investment decisions on the farm. You don't - but you should - think in terms of maximum returns from individual investments. You also need to consider the advantages of some businesses past the farm gate changing hands from time to time as a result of better owners and managers pushing out the relatively poor performers.

Heinz has recently expressed a vote of confidence in New Zealand as a base from which to push into Asian markets. The move has been positively received because the company has a good performance record. It is an illustration of the dynamic, competitive processes I have been discussing. Why wouldn't greater involvement by companies like Nestlé and Kraft be similarly beneficial to you?

There is a parallel between what I have been arguing and the labour market deregulation debate of a few years ago. You will recall that monopoly unions argued that competition would allow employers (the buyers of labour) to exploit workers and drive down wages. Having introduced competition it has been confirmed that, in fact, wages are determined by labour supply and demand, and that workers' best protection is bargaining freedom and competition for their services. Those suggesting competition would be bad in your industry stand in the same relationship in this debate to the former monopoly unions, and use similar arguments and rhetoric.

9. CHANGE OR BE CHANGED – THAT'S THE CHOICE

The essence of my message to you today is simple. As you consider what will serve your future interests best, you have to decide which of two distinctly different types of questions are the more important.

Are you going to ask, and try to collectively determine, what structures will work best in the future and then try to compel all to follow a single plan? Past the farm gate this has been your approach in the past. It is the cause of some of the problems you are now starting to realise need to be addressed. Alternatively, and this is the course of action I strongly commend to you, you can ask a different set of questions. These concern your operating environment and the advantages of a competitive process which taps into all available talent, tests all the ideas, and shapes industry structures in a dynamic way. This approach avoids the risks of centralised systems being wrong or missing some of the profitable options. It maximises the chances of all ideas and judgments being discovered and tested. It offers the prospect of expanded marketing efforts and market outlets to handle increased production. No one person or group will come up with all the ideas. A single organisation will not have either the time or the incentives to test them all.

Obtaining the benefits of competition and removing the bundling distortions does not require wholesale dismantling of what you have. That would not make sense. All that is needed is to reconstruct ownership so that investments are held and returns received in a manner similar to the conventional corporate model. Unnecessary restrictions on competition should also be removed.

This will ensure you have useful information on performance and profitability, non-distorted signals, and the flexibility to invest where you think the profits are highest. Never forget that it is only by maximising returns over time on each of your individual investments that overall profitability is maximised.

ACIL believes the Dairy Board should be corporatised and tradeable shares given to dairy farmers. You would receive its profits as dividends instead of in the milk payout. Competition from processors

for supplies would ensure you received the best milk price. The corporatised Board could be contracted to supply the UK quota market and the premium would be part of its profits and included in your dividend.

Whether the structure of existing dairy companies needs to be changed should be up to their current shareholders. Farmers will have to decide whether, in a more competitive market and with a corporatised Board, the cooperative structure is in their best interests. There should certainly be no restrictions on alternatives.

There are alternatives which involve removal of distortions but retention of majority farmer ownership and control. They are discussed, including their advantages and disadvantages, in ACIL's report. The meat industry is looking closely at some of these options as alternatives to their cooperative structures. You must examine critically the reasons being advanced for not making these changes. The fears you hold, or perhaps more correctly the fears you are said to hold, evaporate under scrutiny. You are experiencing the consequences of the distortions and the restrictions on competition and receiving nothing beneficial in return.

In my opinion the risks to you of not changing the way your industry operates past the farm gate are much higher than those you might think are associated with unbundling and more competition. Not only are they higher, they are more certain. Make the changes while you are still in control. Avoid what has happened to other industries where the correction of distortionary structures has eventually been enforced by the market. The scale of the problems in the kiwifruit industry, and the speed with which they developed, are a cautionary tale.

Above all else, do not be enticed by changes which will temporarily treat the symptoms but do nothing about the causes. Trying to solve the problems by further institutional measures - such as two-tier pricing and production controls - will only make you worse off. It would be a tragedy if the vigour and growth of one of New Zealand's great rural industries were stunted because its constituents were determined to cling to outmoded structures designed for a world that has now changed beyond recognition.