Lion Dairy & Drinks

Response to request for feedback –

ACCC Inquiry into the Australian dairy industry Issues Paper

12 December 2016

About Lion Dairy & Drinks

Lion Dairy & Drinks (***Lion***) is a leading food and beverage company based in Australia and New Zealand. Lion is one of Australia's largest dairy processors, as well as producing a range of dairy brands that includes Dairy Farmers, Pura, Masters, King Island Dairy, Dare, Big M, Farmers Union and Yoplait.

Lion's dairy and drinks business employs approximately 2,300 people and our manufacturing footprint in Australia spans 13 sites including milk, specialty cheese and yoghurt processing facilities.

Each year, Lion purchases hundreds of millions of litres of raw milk in Australia from nearly 400 dairy farmers and other local processors.

As Australia's largest branded dairy business, Lion has a vested interest in building long-term sustainable value in the Australian dairy industry.

Introduction

Lion welcomes the opportunity to provide feedback on the Issues Paper published by the Australian Competition and Consumer Commission (***Commission***).

In Australia, fresh, nutritious and safe dairy products are readily available and consumed by most people on a daily basis – dairy is an inherent part of the Australian diet. The wide availability of fresh dairy products to Australian consumers requires the participation and financial commitment of a wide range of stakeholders across all parts of the country - dairy farmers, processors, distributors and retailers, many of whom are small business people living and working in regional Australia.

To ensure the long-term sustainability of the dairy supply chain, and to fund investments in innovation and product development for the health and benefit of consumers, adequate financial returns need to be achievable for all stakeholders.

Lion submits that in carrying out its Inquiry into the Australian dairy industry, its profitability and overall operation, the Commission should consider all available options that promote the long-term sustainability of the entire supply chain and allow all industry participants to earn reasonable, sustainable returns from the production and supply of dairy goods to the Australian public.

1. Competition for milk

Dairy commodity markets are global

In considering the level of competition between processors, it is important to note that Australia is a net exporter of dairy milk products and a large supplier to the global market. Although Australia's milk production accounts for a low proportion of total global volume, it accounts for a higher proportion of traded milk volumes. As such, competition (and therefore, price) in the domestic acquisition of raw dairy milk is fundamentally driven by global demand. Consequently, increases or decreases in international dairy commodity prices will quickly be reflected in local prices paid to farmers by processors

Processors' supply and demand-driven business models

Murray Goulburn Co-operative Company Limited (***Murray Goulburn***) and Fonterra Co-operative Group Limited (***Fonterra***) are the two largest processors in Australia. Together, they accounted for more than 50% of the total volume of raw milk processed nationally in 2015/16.

Murray Goulburn and Fonterra each operate a supply-driven business model, where the commercial focus is on the production of tradable, commodity-type products with longer shelf-lives that are largely sold on export markets, e.g., skim milk powder, whole milk powder, whey powder, bulk cheddar cheese and butter.

The long shelf-life of these products (most in excess of 12 months) enables these processors to invest in high throughput production facilities and to cover the seasonal nature of raw milk supply.

As a consequence, Murray Goulburn and Fonterra both require substantially greater volumes of raw milk than Lion to meet their respective production needs.

By contrast, Lion operates a demand-driven business model and, although we are Australia's largest branded dairy company, our raw milk procurement needs are much lower than the two largest processors. By way of comparison, Lion acquired only 7% of raw milk volumes produced in Australia in 2015/16.

Lion's demand-driven model focuses on the production and supply of shorter shelf-life products, e.g., white milk, milk-based beverages (such as flavoured milk), yoghurts and speciality cheese. Consequently, Lion's production facilities are geared towards localised manufacturing of fresh dairy products and don't necessarily rely upon the same volume requirements as commodity products. This means procurement decisions are complex and require careful management to ensure acquisition of raw milk volumes correlates very closely with likely demand for the products made at these facilities.

Consequently, Lion's raw milk procurement strategy is based on the following considerations, which may differ from those of other processors, particularly supply-driven operations:

- domestic demand for drinking milk is relatively consistent and flat;
- consequently, Lion's production operations require a reasonably consistent, flat supply of milk year round;
- the fresh dairy products produced by Lion have a relatively short shelf life, which is maximised by using high quality raw milk; and
- guaranteed volumes of raw milk are needed for the optimal operation of Lion's processing facilities.

In assessing the degree of competition, account needs to be taken of processors' different business models and how they influence raw milk acquisition and pricing decisions.

Australian dairy regions

As the Commission notes in its Issues Paper, milk production in Australia is regional and tends to be based in coastal and high rainfall areas or inland regions with access to irrigation. The majority of milk production is located in south-eastern Australia, with Victoria accounting for 65% of the total raw milk volume produced in 2015/16.

Acquisition of raw milk in Australia tends to be relatively localised due to the need for proximity between the purchaser's processing facility and the dairy farms from which milk is sourced. Transporting raw milk over longer distances to a processing facility can result in substantial cost increases for the processor.

In addition, the highly perishable nature of raw milk and consequential need for an end-to-end cold supply chain between the farmgate and the processing facility is another reason why it is undesirable to transport raw milk over long distances.

Notwithstanding this, Lion submits that, with the exceptions of Western Australia and Far North Queensland, the geographic scope of raw milk acquisition markets is wider than a single State. This is due to the different pricing structure used in Victoria, Tasmania and South Australia compared to other States and the ability of processors to tanker milk from one State to another if required, described in further detail below.

Lion considers that geographic markets for milk acquisition are regional in scope and there are three separate dairy regions in Australia, each with distinct characteristics:

- Victoria, Tasmania and South Australia (***Southern Region***);
- Queensland and New South Wales (***Northern Region***); and
- Western Australia.

<u>Southern region</u>

The Southern Region is Australia's largest dairy production area, with volumes significantly exceeding consumer demand in these States. The Southern Region is comprised of 'commodity States' where the majority of raw milk produced is used as 'manufacturing milk', i.e., transformed into longer life products like milk powder, bulk cheddar cheese, butter, etc, much of which is exported.

As a commodity-driven market, the Southern Region is characterised by greater price volatility than other Australian dairy regions, as it faces greater exposure to variations in commodity pricing in global export markets. Farmgate prices also tend to be lower as a result.

Within the States comprising the Southern Region, Victoria and South Australia have both experienced a decline in production volumes in the period since 2000/01, when the Australian dairy sector was deregulated. Victoria, although still the largest State by raw milk production, has experienced the greatest overall decline in raw milk volumes (approximately 600 million litres). By contrast, in the same period Tasmanian production volumes have increased by nearly 300 million litres.

However, given the size and importance of the Southern Region to Australia's milk production, there are a significant number of large processors active in each State, as well as many smaller and boutique processors.

Table 1: large dairy processors - Southern Region

Victoria	**South Australia**	**Tasmania**
Murray Goulburn Fonterra WCB Bega Parmalat Lion[1] Australian Consolidated Milk Australian Dairy Farmers Corporation	Lion[2] Murray Goulburn Fonterra WCB Bega Parmalat	Lion[3] Murray Goulburn Fonterra Cadbury Betta Milk Co-operative Ashgrove Cheese

Of these processors, Murray Goulburn is the largest, accounting for nearly half of raw milk procurement in Victoria in 2015/16.

As a result of its size and the large number of farms contracted to Murray Goulburn, it is the 'price setter' in the Southern Region, i.e., other processors must take account of Murray Goulburn's price in calculating their own price offer. For example, Lion's Farmgate Agreements in the Southern Region include terms guaranteeing Lion's milk price will not fall below Murray Goulburn's announced price for that season, or which commit Lion to paying a price which is a certain cents per litre higher than Murray Goulburn.

Northern Region

By contrast, overall the Northern Region does not produce significant surplus raw milk volumes. New South Wales is the second largest State behind Victoria in terms of raw milk production and while some of the overall volume is used in commodity products, the remainder is used to make drinking milk for consumption in New South Wales and Queensland.

Consequently, Lion considers the Northern Region to be comprised of 'market milk' States, i.e., supply is sufficient to meet production demand with the majority of raw milk procured in the Northern Region processed and consumed domestically, leaving a relatively limited tradeable surplus.

[1] In Victoria, Lion has two processing facilities located at Chelsea and Morwell, respectively, which produce drinking milk and yoghurt.
[2] Lion's South Australian facility is located in Salisbury north of Adelaide and produces drinking milk.
[3] In Tasmania, Lion has three processing facilities located at Lenah Valley near Hobart, Burnie and King Island, producing drinking milk and specialty cheese. Lion also owns two dairy farms located on King Island.

By virtue of the greater balance between demand and supply, prices in the Northern Region tend to be less volatile and also higher than the Southern Region, with prices in Far North Queensland generally higher than in South-East Queensland as a result of factors including its relative isolation, the climate and the quality and availability of raw milk.

Like the Southern Region, there are a number of processors, again, both large and smaller boutique operations, active in milk acquisition in the Northern Region, where Murray Goulburn and Parmalat are the largest purchasers by volume in New South Wales and Queensland, respectively.

Table 2: large dairy processors - Northern Region

New South Wales	**Queensland**
Murray Goulburn Lion[4] Fonterra Bega Parmalat Norco Richmond Dairies Riverina Fresh	Parmalat Lion[5] Norco Maleny

It is notable that milk production volumes in Queensland have fallen by almost half in the period since 2000/01 and the volume of production is now less than the volume of drinking milk consumption in the State. As a result, Queensland has become a net importer of milk produced in New South Wales and (if necessary) Victoria.

Western Australia

Western Australia is a stand-alone State and its geographical isolation from the milk regions in eastern Australia also means Western Australia is susceptible to greater 'lumpiness' in raw milk supply and demand from year to year.

In cases of occasional over or under-supply of milk, processors' options are limited and costly. For example, it is possible to tanker milk to or from South Australia (as the closest milk-producing State) for the manufacture of some dairy products, but this is an option of last resort and as a result day-to-day milk balancing for Lion in Western Australia can be extremely complex and expensive. This is exacerbated by the fact that Lion does not have local 'sink' facilities to deal with excess milk in cases of over-supply.[6] Over the past three years, Lion has had to transport milk both into and out of Western Australia to help balance milk supplies.

[4] In New South Wales, Lion's production facilities are located in Penrith and Wetherill Park, in western Sydney. These facilities manufacture drinking milk. In the ACT, Lion also has a joint venture in place with Bega Co-operative Society Limited called Capital Chilled Foods (Australia) Pty Ltd.
[5] In Queensland, Lion operates two production facilities located in Malanda in Far North Queensland and Crestmead in Brisbane, both producing drinking milk.
[6] In Western Australia, Lion has one processing plant located at Bentley producing drinking milk. Other large processors also present in Western Australia include Brownes and Harvey Fresh (Parmalat).

In extreme cases, this can result in very difficult situations, such as the one which arose this year, when a number of out-of-contract dairy farmers in Western Australia were unable to find a buyer for their milk because supply exceeded demand. When local processors (including Lion) operating on a supply and demand model have secured sufficient raw milk from existing contracts, acquiring additional volumes becomes economically unfeasible.

Milk supply management

Balancing the supply of raw milk with demand is a highly complex and unique challenge for the dairy industry. The financial cost for processors of 'getting it wrong' can be high.

Unlike other primary industries, e.g., wheat or wool, where goods can be stockpiled for relatively long periods, milk must be collected from farms regularly and frequently, even where processor demand does not require this. This is an inherently complex process. Moreover, milk requires careful environmental management: it must be chilled immediately upon collection from the cow and picked up by the processor within 48 hours of the first milking, in order to minimise the risk of microbial contamination. These issues exacerbate the complexity of supply.

Milk balancing requires careful forecasting to align Lion's contracting and purchasing cycle with seasonal milk production periods throughout the year, as well as variations in commodity-driven milk prices. By virtue of its demand-driven business model, milk balancing is particularly relevant to Lion as we do not operate dairy 'sink' facilities, which can utilise excess raw milk volumes by transforming it into longer life dairy goods. Lion's dairy procurement team undertakes milk balancing on an almost daily basis.

However, there are occasions when Lion either has excess milk or requires more milk than we can procure from our contracted farmers. To manage over or under-supply, Lion employs a number of different techniques. These include transporting raw milk to other States (for example, from Victoria to New South Wales, New South Wales to Queensland, or South Australia to Victoria), or by having other processors contract manufacture products on our behalf locally where the over-supply occurs.

Commonly, Lion will acquire raw milk from or sell milk to other processors. This is principally done to help balance contracted raw milk supply and wholesale demand over the year and to avoid unnecessary transport costs being incurred.[7] This is a critical and, by its nature very complex, situation in which Lion has to balance the seasonal nature of farm gate milk with the flat demand of the majority of our short shelf-life products.

Processors also swap milk to reduce the financial and environmental impacts of moving milk. In simple terms, a milk swap may occur when two parties have the opportunity to avoid costs associated with transporting milk from a distant supply area back to a processing facility. Instead, the milk swap occurs when Processor A delivers their milk to Processor B's factory because this is closer than Processor A's own facility, or *vice versa*. Typically, the milk balance is reconciled every month and a sales invoice is generated, based on a protein and fat price that has been negotiated between Processors A and B. Milk swaps occur year-round on a needs basis.

Supply terms

[7] Milk balancing may also include the sale or purchase of milk components, such as cream, skim milk powder and other dairy powders.

Exclusivity

Under Lion's Farmgate Agreements (***FGA***s), contracted farmers agree to supply all their milk to Lion and not to supply anyone else, while Lion agrees to acquire all the milk produced by the farmer during the term of the agreement.

This ensures certainty of supply for Lion, but also certainty for the farmer in terms of the purchase and collection of milk produced pursuant to the agreement. Even in circumstances where milk volumes may be surplus to Lion's requirements, we remain contractually bound to take these volumes from our farmers.

The ability to guarantee that Lion's milk supply will meet our production demand requirements is critical. For this reason, exclusive supply clauses are included in nearly all Lion's FGAs.

Quality assurance is another key reason for exclusivity. By ensuring exclusive supply, Lion is able to better manage the quality of the milk supplied to it, as quality assurance occurs within a controlled environment. Without exclusivity, it is likely that an additional layer of complexity would be introduced as processors would no longer be able to manage and control issues such as milk ageing (by collecting 100% of milk, a processor can ensure age requirements on the milk are satisfied).

Non-exclusive supply is also likely to have cost implications for processors. Typically, processors collect milk by taking it first from the point furthest away and then 'working back' towards the nearest processing facility. This enables efficiencies to be achieved by ensuring the tanker is full at the end of the run. With dual supply this becomes materially more difficult to manage as it may be uneconomic for a processor to make multiple pick-ups of lower milk volumes.

Consequently, the majority of Lion's supply contracts for raw milk are for exclusive supply with farmer suppliers. Exceptionally, Lion has a very limited number of non-exclusive supply agreements in place. These contracts are with very large 'commercial' suppliers that allow for dual supply of raw milk to other processors in addition to Lion. This is primarily because, even with dual supply these farms are of sufficient size and scale that they able to supply a significant percentage of Lion's volume requirements.

Loyalty or other bonuses

Lion's payment structure provides a range of incentives that support optimal commercial outcomes for Lion, i.e., high quality milk provided by efficient farms, operating at scale and located in close proximity to our processing facilities.

Schedule 4 of Lion's FGA contains the following payment criteria:

- **Base rate**: the amount paid on a component or volumetric basis each month;

- **Volume incentive:** an amount paid in addition to the base monthly rate that offers any increased rate for higher annual supply volumes;

- **Contract premium:** an increased payment where farmers elect to commit to Lion for a longer contract term;

- **Logistics:** in some regions, Lion offers additional payment to farms in close proximity to a processing facility, or charge a fee to reflect increased transport costs to tanker milk from distant farms;

- **Milk quality matrix:** sets out the parameter and rates of bonuses and/or deductions applied to the base rate, depending on the quality of the milk delivered to Lion by the farmer.

2. Contracting practices

Lion currently purchases milk supplied by approximately 400 dairy farmers across Australia. Lion contracts directly with 180 farmers, with the balance sourced through Lion's arrangement with the Dairy Farmers Milk Cooperative Limited (***DFMC***) and its farmer members, located primarily in New South Wales and Queensland, but also Victoria and South Australia.

Farmgate Agreements

The key factor influencing Lion's dairy milk intake from year-to-year is the volume of milk produced by our contracted farmers and whether or not extra volumes are needed in a particular region.

Where possible, Lion enters into FGAs with farmers that:

- have a 'flatter' milk production curve over the year (as opposed to more seasonal production);

- produce high quality raw milk; and

- operate long-term, sustainable farms.

Lion offers contracts for fixed periods of either one, three or five years. Under the FGA, the annual contractual period runs from July 1 to June 30, with the exception of the final year of the contract, which may extend for an additional three month period. This extension occurs when a farmer elects not to renew their supply contract, to avoid the potential for a shortfall in volume for Lion.

Towards the end of each annual period, Lion sends letters to contracted farmers setting out any amendments to price, calculation methodology, volume or other relevant factors affecting their overall compensation under the FGA.

Lion's FGA comprises four documents:

- **General Terms:** in recent years, Lion has substantially amended and simplified the General Terms, including the removal of a number of terms, e.g., Lion's entitlement to recover consequential losses from farmers. A cover note setting out a plain English explanation of key terms of the FGA is also included;

- **Milk Supply Policy:** sets out the criteria under which raw milk is to be supplied by farmers in compliance with, e.g., food safety processes, animal welfare, OH&S and environmental sustainability requirements;

- **Schedules:** setting out the monthly planned volumes and the price Lion will pay for milk, including discounts, charges (levies, collection charges, logistics charges) and adjustments such as volume and quality incentives; and

- **Letter of offer:** sets out the offer prices and the available terms including any contract premiums that may be offered in the particular region.

Farmer payments

Lion pays its suppliers based on the volume of production per calendar month.

Payments for raw milk supplied are processed and paid by Lion no later than 14 calendar days after the end of the preceding month. During the month, farmers have full transparency of volume and payment information within 48 hours of farm gate collection. Information on milk quality (fat, protein, somatic cell count) is also provided to each farmer by Lion. This information is accessible via text message sent directly to the farmer or via a dedicated website[8] which records the full supply history and key payment data for each farmer.

In addition, from time to time, on an exceptional basis and depending on individual circumstances, Lion may enter into financial support initiatives with its farmers, e.g., pre-paying for future milk deliveries with recoupment over a period of time, where these arrangements help farmers to reinvest in herds, or get through periods of financial hardship.

All farmers are offered a base milk price which is adjusted, as set out in the FGA, to take account of factors including:

- **Quality:** Lion increases or decreases the base milk price option chosen by the farmer, based on the quality of raw milk supplied, in accordance with the quality adjustment percentage set out in the FGA (Schedule 4);

- **Other bonuses and incentives:** base milk price payments may also be reduced to take into account any applicable logistics charges or bonuses, collection charges, regional factors, or any amount owing to Lion in relation to the farmer's supply of milk (such as for advance payments for milk), or increased to include any logistics bonuses, production incentives and contract premiums, as set out in the FGA (Schedule 4);

- **Transport surcharge:** Lion may apply a transport surcharge if a farmer does not comply with minimum collection requirements set out in the Milk Supply Policy;

- **Industry levies:** Lion may include in the collection charge any levies that Lion pays on behalf of the farmer to the relevant industry body or authority. If the levy is voluntary, the farmer

[8] See: http://dairysuppliers.lionco.com/.

can request Lion to stop collecting and paying that levy;

- **Set-off:** Lion can set off any amount which the farmer owes to it under or in connection with the FGA against any amount owed to the farmer by Lion.

Direct suppliers - regional terms

As described above, Lion acquires raw milk on a regional basis and this is reflected in the terms we offer to farmers. The principle difference between regional FGAs is in the pricing options available to farmers. This is a consequence of the differences in market dynamics (specifically, commodity pricing in the Southern Region versus 'market' milk pricing in the other Regions).

Southern Region pricing

Following feedback from Lion-contracted dairy farmers, and to provide greater certainty for both Lion and farmer suppliers, in the trade-exposed and more volatile Southern Region, since 2013 we have offered farmers a range of fixed and variable pricing options for contracts of varying lengths (one, three or five years).

Farmers contracted to Lion in the Southern Region may choose from the following options to best suit their business and balance their need for price certainty against the opportunity for risk-taking:

- variable pricing underpinned by a minimum pricing guarantee;
- fixed pricing for the duration of the contract;[9] or
- a combination of fixed and variable pricing.

In addition, the variable milk price offered by Lion is underpinned by a price guarantee mechanism that ensures a premium is paid when compared to that of a key alternative processor (often the benchmark used is the price offered by the largest processor).

Where variable pricing is offered, Lion makes back payments, as required, to meet its price guarantee to farmers who have chosen a variable pricing option.

Any downward pricing changes are communicated to farmers prior to implementation (in practice, Lion gives at least a month's notice of the variation). Reductions apply only to future milk prices paid. <u>Lion does not apply retrospective reductions ('clawbacks')</u>.

Lion's fixed pricing options have enjoyed strong take-up, with approximately 92% of eligible farmers in the Southern Region electing to have this option apply to at least part of their volumes in the 2015/16 season. This is due to the fact that fixed pricing gives a greater measure of certainty to farmers who are wholly exposed to market pricing, as is the case in the Southern Region.

Northern Region and Western Australian pricing

[9] 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 approach in the 'market' milk areas of the Northern Region and Western Australia reflects, in part, lower inherent price volatility as well as generally higher production costs.

In select Northern Region farms and Western Australia, Lion offers farmers a cents-per-litre base price, which is adjusted for quality and a range other factors directly relevant to the farmer's locality. FGAs in these Regions are entered into for periods of either three or five years.

Collective bargaining

Lion has a small number of collective bargaining arrangements in place with farmer groups, the most significant of which is the arrangement in place with the DFMC, which has milk supply contracts with its farmer members located primarily in New South Wales, South Australia, Victoria and Queensland.

DFMC's principal activity is the acquisition of milk from its members (pursuant to supply contracts between the cooperative and its members)[10] and the sale of these volumes to Lion.

The milk price payable to DFMC-contracted farmers is subject to a lengthy negotiation process between the DFMC and Lion. Milk prices paid to the DMFC and in turn its farmers are set by Lion on a regional basis, in the same manner as prices offered to Lion's individual farmer suppliers.

However, in the case of the DFMC negotiation, the process of agreeing the price also covers other related issues including discussions of DFMC's views on:

- Anticipated Full Demand (AFD) – the volume to be supplied by DFMC's farmers in each region where the DFMC operates;
- proposed amendments to the DFMC Milk Policy;
- Lion's requested DFMC farmer contract amendments; and
- milk pricing.

If the parties cannot agree on a negotiated price, either DFMC or Lion may raise a dispute for mediation in accordance with the terms of the DFMC Milk Supply Agreement. If mediation does not resolve the dispute, Lion and DFMC may then submit the dispute for expert determination. Lion is not aware of whether this is also the case with respect to negotiations between other processors and collective buying groups.

Lion purchases milk from DFMC on the same terms (including price) as DFMC purchases from its farmers, known as a back-to-back arrangement. Under the back-to-back arrangement:

- DFMC must adopt the same milk purchasing policy (including price structure) in relation to its acquisition of milk from its members as Lion applies to its purchase of milk from DFMC;
- DFMC must sell milk it acquires from members to Lion on the same terms and conditions relating to payment, pricing, collection and quality as contained in its farmer contracts; and

[10] Copies of the DFMC Milk Policy and Pricing letters are available from the DFMC website: http://www.dfmc.org.au/operation/ .

- DFMC must adopt the same milk price in relation to the purchase by DFMC from its farmer suppliers as DFMC received from Lion for the milk it sells to Lion.

These arrangements have been authorised by the Commission (with conditions) for ten years until 25 July 2023, to allow DFMC members to collectively negotiate the terms and conditions of supply with Lion.[11]

In addition to Lion's arrangements with DFMC, Lion also engages in collective bargaining with a small group of farmers on King Island, as well as the Tasmanian Suppliers Collective Bargaining Group.

In terms of the effectiveness of collective bargaining arrangements in the dairy sector, Lion's current view is largely reflected in previous submissions made to the Commission:

- the collective bargaining process may provide time savings through the ability to reach a consistent contract with members of a collective bargaining group;

- some collective bargaining groups, particularly those which have strong farmer leadership and knowledge of the marketplace, tend to operate more effectively than others;

- the voluntary nature of the process, the limitations on the structure of the bargaining groups and the restrictions on information sharing are key conditions of authorisation;

- there is a risk that the use of third party negotiators by bargaining groups may complicate the process and compromise the spirit of negotiations.[12]

3. Transparency and price signals

Price setting

As stated above, competition for raw milk at the farmgate ultimately determines the price Lion offers to dairy farmers.

Historically, Lion has not been the first to market with new season pricing. One reason for this is that, as a demand-driven processor, we need to ensure we are able to acquire sufficient volumes to support our forecast demand. To do so, we need to ensure our pricing is at least as good as, if not better than, the largest competing processor in the region.

Lion also strives to pay its farmers a price which is intended to assist them in managing volatility in their business and allow them to be sustainable over the longer term.

Southern Region price setting

[11] Please refer to Commission decision A91364 at: http://registers.accc.gov.au/content/index.phtml/itemId/1105941/fromItemId/401858.
[12] Please refer to decision Commission A90966: http://registers.accc.gov.au/content/index.phtml/itemId/744862/fromItemId/401858/display/acccDecision.
[13] See: https://www.globaldairytrade.info/.

The traditional cooperative dairy company model plays a central role in determining farmgate prices for raw milk in the Australia. For example, the size and scale of Murray Goulburn's intake makes it the driver of farmgate milk value from year to year in the Southern Region.

Consequently, Lion pays a milk price in the Southern Region that is benchmarked against Murray Goulburn's variable price (or Fonterra in Tasmania). The price we offer also needs to be sufficiently competitive to achieve long-term sustainable milk intake volumes for our own manufacturing and processing operations. For this reason, Lion's variable price FGAs include a minimum price guarantee to ensure the average annual price paid to contracted farmers is higher than the price paid by the major dairy cooperatives.

In addition, Lion requires year-round raw milk supply for its drinking milk business and not only at times of peak supply. This means that Lion pays more than other competing acquirers in the Southern Region.

In setting the base milk price offered to farmers in the Southern Region, Lion considers the following factors to calculate its pricing projections for the year ahead:

- prices announced publicly by the volume leader, and market price setter, Murray Goulburn;
- global dairy prices, as well as commodity price forecasts and forward-looking industry analysis from bodies such as Dairy Australia and the Fonterra-owned Global Dairy Trade service,[13] which are used to analyse Lion's projected milk price over the near term;
- Lion also takes into account the US dollar value of an exported basket of dairy goods. This is constructed using:
    - Dairy Australia data;
    - international market reports, e.g., the Rabobank Food & Agribusiness Research and Advisory; [14]
    - AUD/USD exchange rates (dairy products are traded internationally in US dollars);
    - theoretical returns potentially available to processors with export exposure and how these returns, in turn, may influence the local milk pricing market; and
    - a price which allows farmers to assist them in managing volatility in their business and to be sustainable over the longer term.

The tenure of farmer contracts also affects the price Lion pays for raw milk, as does the mix of fixed and variable pricing that farmers have selected. These contracts begin and end at different times leading to differences in contract pricing being paid to farmers in certain dairy regions.

Northern Region price setting

[13] See: https://www.globaldairytrade.info/.
[14] See: https://research.rabobank.com/far/en/sectors/dairy/index.html#sort=%40farcreated%20descending.

In areas outside the Southern Region, local factors also influence farmgate prices. For example, production in the Northern Region is more costly than in the Southern Region due to climatic conditions not conducive to milk production, which often results in higher input costs. In general, this production cost differential leads to higher prices from processors in the Northern Region to ensure ongoing supply. The alternative would be for processors to transport milk potentially long distances and bear the associated additional costs.

In the Northern Region, Lion must also take account of the price announced by major competitors, to effectively secure sufficient milk supply for our operations in the region.

In practice, the prices offered in the Northern Region are comparable to the raw milk price paid in the Southern Region plus freight (i.e., the price it would cost Lion to send milk north in order to service its processing facilities in those States).

Pricing raw milk in Western Australia and Far North Queensland also requires Lion to take account of the geographic isolation from other milk production regions and the escalated costs of purchasing or freighting milk.

In Far North Queensland, Lion is the only major processor present. Consequently, the price offered to local dairy farmers reflects the price paid in South East Queensland, plus modifications based on production needs at Lion's Malanda processing facility.

Lion also strives to pay its farmers a price which is intended to allow its farmers to be sustainable over the long term.

Price transparency and negotiations

The market for raw milk in Australia is competitive and price data is transparent, with information on the global dairy commodity market readily available to farmers and processors alike. For example, Dairy Australia publishes regular forward-looking updates on the supply and demand market for raw milk, which gives a detailed and comprehensive analysis of the global and local market outlook.[15]

In relation to price terms offered to farmers by competing processors, farmers have significant visibility over pricing for the upcoming milk year. For example, most large processors, including Lion, typically issue media statements publicly announcing their new market prices.[16]

As described above, Lion is typically not the first processor to publicly announce its new pricing. In the period leading up to the new milk year, we endeavour to communicate with our contracted farmers regarding the likely trends, based on available market data. However, Lion generally only announces its final price offer once the largest competing acquirer in a dairy region (the market 'price setter') is known publicly, in order to meet any price guarantee terms in our contracts.

[15] See: http://www.dairyaustralia.com.au/~/media/Documents/Stats%20and%20markets/S%20and%20O/2016-10%20S%20and%20O/2016%20October%20Situation%20and%20Outlook%20Oct.pdf

[16] For example, this has been the practice of Murray Goulburn (http://www.mgc.com.au/media/4791/Opening-Price-Media-Release_UPDATE.pdf), Fonterra (https://www.fonterra.com/au/en/hub+sites/news+and+media/media+releases/fonterra+australia+sets+fixed+base+milk+price+for+season+201516/fonterra+australia+sets+fixed+base+milk+price+for+season+201516), Parmalat (http://www.parmalat.com.au/current-price-list-effective-19-may-2014/) and also Lion (https://www.lionco.com/media-centre/lion-announces-milk-pricing).

4. Domestic retail markets

Grocery and non-grocery distribution channels

The majority of Lion's overall retail sales of dairy products continues to be made via the large national supermarkets such as Coles, Woolworths and Aldi, wholesalers such as Metcash and also independent grocery banners.

However, a majority of Lion's fresh white milk sales are made through the convenience and foods service channel, which includes outlets like local milk bars, takeaway food outlets, corner stores, cafes, bakeries, newsagents, schools, hospitals, prisons, day care or aged care centres nationally, the majority of which are small, local businesses.

Distribution of fresh milk to the convenience and food service channel relies on an extensive and complex delivery system. Lion's non-grocery network comprises approximately 292 distributors and franchisees as well as a fleet of contracted delivery vehicles across Australia. Lion estimates it delivers fresh dairy products through a chilled distribution network to over 75,000 outlets nationally in the non-grocery trade.

Since the advent of $1 per litre milk, Lion has observed a profound channel shift in fresh milk sales volumes away from the non-grocery/convenience channel and into supermarkets, as consumers switched in response to the $1 price point. However, recently Lion has observed a sharp drop in private label milk sales as consumers switched back to purchases of branded white milk, most likely as a direct consequence of the milk crisis earlier in 2016. It remains to be seen whether this is a long-term trend or whether consumers will revert to purchasing private label milk sold at lower price points.

It is worth noting, however, that $1 per litre milk has not resulted in increased demand for fresh milk (although it has resulted in a shift from branded milk to private label milk consumption by consumers). Rather, due to its central role in the Australian diet, the volume of milk required to satisfy domestic demand does not vary greatly regardless of its price, such is the inelastic nature of demand for fresh milk.[17]

The major Australian supermarket chains continue to account for the majority of sales volumes for Lion's dairy products overall (i.e., milk-based beverages, yogurt, cream and specialty cheeses, as well as white milk). As such, supermarkets are and will remain an important route to market for Lion.

Production and supply of private label milk

In addition to the channel shift observed by Lion, $1 per litre milk has also accelerated the shift towards commodification of fresh white milk, with consumers switching from branded to private label products within the supermarket channel.

[17] Traditionally, growth in the milk category has been in line with growth in the overall size of the Australian population.

Lion has a number of contracts in place across Australia to produce and supply major supermarket chains with private label milk. Competition amongst processors to win these contracts is high as they account for large volumes of processed milk over relatively long periods (contracts are often five years' duration and may be longer). This stability of demand enables processors to better manage raw milk demand forecasts and also improve plant utilisation and efficiency.

Concomitantly, the loss of a private label milk supply contract can also have serious commercial consequences for a processor (and its farmer suppliers) as the loss of a contract means the processor has to find an alternative use for any raw milk volumes they have committed to acquire from dairy farmers, but for which they no longer have a contracted buyer. If they cannot, this may result in the non-renewal of farmers coming out of contract as processors seek to shed volumes that have become surplus to requirements.

The move of volumes away from branded to private label milk has also resulted in a corresponding decline in the financial return for brand owners, such as Lion. Given the capital intensive nature of the dairy industry at every point in the supply chain, it remains a challenge to achieve profitability in processing of white milk in Australia.

Shelf share and product position

In negotiating contracts with supermarkets to manufacture and supply private label milk, processors are often able to include contractual provisions whereby the supermarket agrees to range the supplier's branded goods in-store.

Notwithstanding this, allocation of shelf space or product positioning in supermarkets tends to be driven by the supermarket's need to balance sales volumes from private label SKUs against the better margins delivered by branded SKUs. As such, in-store positioning and shelf share are based on a number of factors, including consumer demand, availability and cost-to-serve.

5. Global markets

Currency risk

As described above, most raw milk procured by Lion is used to manufacture branded dairy goods which are predominantly sold and consumed domestically. However, as a business which trades in some international markets, Lion utilises foreign exchange management practices to manage the risks inherent in doing business in a currency other than the Australian dollar (e.g., the US dollar). Over recent times, the strength of the Australian dollar has made Lion's exports less competitive in its export markets and impacted profitability domestically.

Across its broader group business, Lion does deploy hedging strategies for its purchase of certain commodities. For raw milk, however, Lion does not hedge the milk price or the US dollar exposure to it.

International markets

Lion's international dairy business was established to focus on the growth of Lion's Australian branded dairy products in Asia. Lion aims to leverage its established dairy brands and Australian provenance to build sustainable positions in select Asian markets. As a branded dairy business, Lion does not intend to focus at the commodity end of the international market.

Lion's focus markets for its yoghurt, milk and speciality cheese brands are South-East Asia and Greater China, including Singapore, Thailand, Malaysia, Taiwan, China and Hong Kong. Lion also distributes its dairy products to smaller volume markets such as the Philippines, Indonesia, Vietnam and the Pacific Islands.

In addition, from time to time, Lion sells bulk processed dairy products on the spot market to commodity traders, which are exported to international markets.

However, sales volumes into these markets remain relatively limited due to a combination of factors, including the perishable nature of the products, transport distances, the need for an end-to-end cold supply chain and fierce competition from international companies seeking to gain a foothold in Asian markets, especially China.

Non-Tariff barriers to trade

The biggest executional challenges for Lion in its export markets relate to speed to market and maintenance of the highest quality and most efficient supply chain.

In Lion's view, there are a number of ways in which access to overseas markets could be improved for Australian branded dairy products, including:

- breaking down non-tariff trade barriers;
- building relationships between Australian agencies and regulators in export markets;
- bilateral initiatives to cut through red tape;
- improved transparency of processes; and
- improving companies' access to regulators.

Lion's experience has been that there is a lack of harmonisation of food safety regulations across the South East Asian markets to which it exports. The accelerating pace of regulatory change further exacerbates these issues. Currently, Lion's ability to enter new markets faces the following challenges:

- multiplicity of regulations both within each market and across different markets and a lack of standardised packaging/labelling requirements;
- the large number and variety of different food regulators operating across the different markets mean it is often difficult to build direct working relationships. For example, when dealing with the Food and Environmental Hygiene Department of Hong Kong (***FEHD***), all communication between Lion and the FEHD must go through the Australian Government's

Department of Agriculture and then the Australian Consular General in Hong Kong, which results in significant delays;

- long product registration processes and customs clearance times are a particular problem for perishable products.

Consequently, although Asia remains as a big opportunity, the challenges to gaining and then maintaining access for Australian dairy products should not be underestimated.

6. Production costs and profitability

Alternative income streams

Lion does not take account of alternative income streams when determining the acquisition price for raw milk. Farm gate competition is what ultimately determines the price Lion offers to farmers, although Lion understands that farmers may derive income from the sale of livestock or from other sources.

With respect to the disposal of livestock, there are provisions within Lion's FGAs that oblige farmers to obtain Lion's prior written consent in the event they wish to reduce their milking herd by more than 10% through sale, transfer, natural attrition or otherwise. This provision exists to ensure that the farmer will have sufficient milking cows to achieve the contracted volumes.

Supply of inputs

Sustainable dairy farms underpin a sustainable Australian dairy industry.

Towards this, Lion offers a range of benefits to farmer suppliers to help reduce input costs. These include grants support improvements in farm efficiency and sustainability, professional advice and support. For example, the recent Lion Dairy Pride program helps dairy farmers boost profitability and reduce the environmental impact of farming, as well reducing costs and improving the overall sustainability of their operations.

Insights from successful projects are shared with other farmers. To date, 52 farmers have received granted of $10,000 each under the Landcare Grants Program. In addition, Lion operates capital loans programs and safety schemes to help farmers improve the efficiency of their production methods.

In 2016, Lion introduced a program whereby our dairy farmers could purchase brewers grain at a discounted rate (brewers grain is a 'waste' by-product from beer-making at Lion's breweries. However, it has another use as a highly nutritious stockfeed).

Lion considers that a sustainable dairy sector is critical Australia's agricultural and regional economy. As such, any fluctuations in farmer input costs and the effect these may have on farm milk supply are always relevant.