



Dairy inquiry

Final report

April 2018



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Australian Competition and Consumer Commission
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Glossary

Anhydrous milk fat (AMF)	fatty product made by removing all of the water and nonfat solids from pasteurised cream or butter.
Announced price	the base farmgate price announced by a processor around the commencement of a dairy season. Typically a volume weighted average price that is expected to be paid over the season. In some cases a processor will announce one price, in other cases a processor will announce an opening price and a forecast closing price. In the case of the latter, the ACCC has adopted the forecast closing price as the announced price.
Australian Dairy Farmers (ADF)	the national policy and advocacy body representing dairy farmers in Australia.
Branded products	refers to products that are manufactured by a processor for sale under its own proprietary brand name.
Bulk milk cell count (BMCC)	the BMCC test measures the number of white blood cells ('Somatic Cells') in milk. A high cell count increases the risk of raw milk contamination and may cause problems with manufacturing processes, product taste and shelf life.
CCA	<i>Competition and Consumer Act 2010.</i>
Dairy Australia	national service body and investment arm for the Australian dairy industry, funded by a combination of levy, government and leveraged funds.
Dairy Farmers' Milk Co-operative (DFMC)	a dairy co-operative with members in Queensland, NSW, Victoria and SA. Supplies Lion Dairy and Drinks.
Dairy season	a 12-month period set by processors and typically follows a financial year, i.e. starting 1 July and ending 30 June, but sometimes a calendar year.
Dairy products	processed and semi-processed products produced or derived from raw milk.
Drinking milk	fresh drinking milk or long life milk.
Export focused processors	generally located in the Southern region, these processors mainly produce exportable products such as milk powder, butter and certain types of cheese. They may also produce some non-exportable products such as drinking milk.
Exportable products	sometimes referred to as manufactured products, these refer to dairy products that are made primarily for export markets and can include WMP, SMP, AMF, butter and hard cheeses.
Farmgate milk price (farmgate price)	the price farmers receive for the raw milk they produce.
Flat Milk Incentive (FMI)	a pricing formula used by Murray Goulburn to incentivise raw milk production during the off-peak period (the months of July, August, February, March, April, May and June).
Flavoured drinking milk	fresh drinking milk or long life milk to which colours and/or flavours have been added.
Forum	throughout February and March 2017, the ACCC held eight public dairy forums around Australia, focused on hearing from farmers and stakeholders regarding issues in the industry.

Forecast closing price	the expected final farmgate milk price for a dairy season as announced by a processor. This may incorporate step-ups accrued throughout the dairy season.
Domestic focused processors	these processors mainly produce fresh dairy products such as drinking milk, predominantly for domestic consumption. They are located in all dairy regions, including the higher cost Northern and WA regions.
Fresh drinking milk	milk which has been pasteurised to make it safe for human consumption. Requires refrigeration. May be full fat or modified milk.
Fresh products	dairy products with a short shelf life such as fresh drinking milk, cream and yoghurt, produced primarily for the domestic market.
Full fat milk	full-cream, whole or regular drinking milk. Cow's milk containing no less than 3.2 per cent milk fat.
Global Dairy Trade (GDT)	global, multi-seller online dairy auction headquartered in New Zealand. Operationally and physically separated from owner Fonterra Cooperative Group.
Homogenised	milk which has been processed to allow a smooth consistency in which no visible cream separation occurs.
Inquiry	The inquiry into the competitiveness of prices, trading practices and the supply chain in the Australian dairy industry directed by the Treasurer, the Hon Scott Morrison MP, pursuant to s. 95H(1) of the CCA on 27 October 2016
Major processor	acquires over 500 million litres of raw milk per season.
Long life milk	milk which has been ultra-pasteurised to extend shelf life up to nine months. Only requires refrigeration after retail packaging is opened. Also known as UHT (Ultra-Heat Treated) milk. May be full fat or modified milk.
Loyalty bonus	a payment which is either conditional upon a farmer completing a full season of supply with their processor, or upon a farmer continuing to supply their processor in the next dairy season.
Milk equivalent	the quantity of raw milk required to furnish the milk solids in manufactured dairy products.
Milkfat	the fatty portion of milk, which provides part of the basis for differential pricing. Also known as butterfat.
Milk powders	either WMP or SMP.
Milk supply agreement	a formal written contract between a farmer and processor, generally for a fixed duration. Often contains limited information such as supplementary terms not commonly found in a Supplier Handbook.
Modified milk	low-fat, reduced-fat or skim drinking milk. Cow's milk containing no more than 1.5 per cent milkfat.
Murray region	encompassing northern Victoria and the NSW Murray region.
Northern and WA regions	includes WA, Far North Queensland (FNQ), northern NSW/ southern Queensland, and central NSW.

Notice period	<p>for a fixed-term supply agreement—the period before the conclusion that requires one party to notify another party of their intent to exit the agreement.</p> <p>for an on-going agreement—the period one party needs to notify another party before the agreement can be terminated.</p>
Opening price	the starting farmgate milk price for a dairy season as announced by a processor.
Opening price letter	a letter sent by processors to farmers providing the processor's opening farmgate price, forecast closing price and monthly price schedule for that dairy season.
Private label	also known as home brands, own brands, store brands or generic products. These are products that are manufactured or provided by a company (which may also produce its own proprietary branded products in competition with the private label) for sale under a retailer's brand.
Processing plant	a facility used to commercially process raw milk into dairy products.
Raw milk	unpasteurised cow's milk.
Representative groups	encompasses all bodies that represent members or sectors of the dairy industry such as farmers.
Rollover clause	provides that a new contract term (generally of a specified length) will automatically commence if termination notice is not given within a certain timeframe prior to a contract expiring.
Senate Inquiry Report	the Senate Economics References Committee report titled <i>Australia's dairy industry: rebuilding trust and a fair market for farmers</i> released on 17 August 2017.
Skim milk powder (SMP)	the product resulting from the partial removal of fat and water from pasteurised milk.
Small processor	acquires less than 500 million litres of raw milk per season.
South Australia region	South Australia excluding the southeast region of SA.
Southern region	includes eastern Victoria, Murray region, western Victoria region, SA region, Tasmania.
Spring peak	refers to the increase in milk production that occurs during the spring months (September-November).
Step-down	a downward revision to the price being paid by a processor to a dairy farmer for raw milk during a dairy season.
Step-up	an upward revision to the price being paid by a processor to a dairy farmer for raw milk during a dairy season.
Supplier Handbook	typically sets out the majority of terms and conditions that govern an overall supply agreement, including price components and quality requirements.
Supply agreement	refers to a broad range of agreements in place between farmers and processors, including Supplier Handbook contracts and milk supply agreements.
Unfair contract terms (UCT) laws	introduced to assist small businesses and farmers that may have limited bargaining power, by prohibiting businesses from using UCTs in standard form contracts (which make up the majority of farmer-to-processor contracts).

Voluntary Code	The Code of Practice: For Contractual Arrangements between Dairy Farmers and Processors in Australia. Developed following negotiations between the Australian Dairy Industry Council (ADIC) and ADF. Commenced 30 June 2017.
Warrnambool Cheese and Butter (WCB)	dairy processor wholly owned by Saputo.
Western Victoria region	western Victoria and southeast SA.
White drinking milk	fresh drinking milk or long life milk to which colours and/or flavours have not been added.
Whole milk powder (WMP)	product resulting from the partial removal of water from pasteurised milk.

Executive summary

Through this inquiry, the ACCC has analysed the performance of the industry and the structural and behavioural features which contribute to this performance.

The dominant picture that has emerged is one of significant imbalances in bargaining power at each level of the dairy supply chain. This begins with the relationships between retailers and dairy processors, and progresses down to the relationship between processors and farmers.

The ACCC has identified a range of market failures resulting from the strong bargaining power imbalance and information asymmetry in farmer-processor relationships. These features of the industry result in practices which ultimately cause inefficiencies in dairy production.

Neither the existing provisions of the *Competition and Consumer Act 2010* (CCA), nor a voluntary code of conduct, sufficiently address these market failures. Therefore, the ACCC makes eight recommendations for improved transparency and allocation of risk in the commercial relationship between Australian dairy processors and farmers. Most significantly, the ACCC recommends that a mandatory code of conduct be introduced to address the market failures we have identified.

Context of the inquiry

Late-season retrospective changes to the farmgate prices paid by Australia's two largest dairy processors in April 2016 caused substantial detriment to dairy farm businesses in the southern regions of the Australian dairy industry and were the catalyst for this inquiry. These 'step-downs' caused severe and unforeseen reductions in the incomes of more than 2000 dairy farmers and significantly impacted the productivity of the industry. Farmers exited the industry and the volume of milk produced fell substantially in the following season.

The events of 2016 resulted in a crisis for the industry. They prompted public discussion about the structure and practices of the industry, and the implications for its performance, especially the impact on farmers.

Concerns within the general public about the welfare and wellbeing of farmers are not new. For many years questions have persisted about the fairness of prices and other trading terms that Australian dairy farmers receive for the milk they produce. These intensified after Australia's major supermarkets reduced the retail price of private label milk to one dollar per litre in 2011 and arose again in 2016.

Overview

Australia's dairy farmers and processors supply products to global and domestic markets. These markets are competitive and demand continuous supply of high quality products at low prices.

In the domestic market, the major Australian supermarkets have exercised their bargaining power to elicit lower wholesale prices from processors. The most notable illustration of this is the pricing of private label milk.

The ability of the supermarkets to leverage their bargaining power has reduced the profit margins of processors. Ultimately this has enabled the supermarkets to maintain low retail prices. While supermarkets have retained some of these savings for themselves, they have mostly transferred them to consumers.

Processors that are able to supply both export and domestic markets can mitigate their exposure to supermarkets' bargaining power to some extent by adjusting the focus of their businesses on different markets as needed. Some negotiating power can also be derived from supplying differentiated and premium products.

Unlike others in the supply chain, most dairy farmers have little bargaining power and limited scope to reposition their businesses or switch to a different farm enterprise to mitigate this. Larger-scale farms can sometimes receive more favourable prices and trading terms, and there are clear productivity benefits from scale as would be expected, but this is not the typical farmer experience. The generic and

perishable nature of raw milk, and large number of farmers relative to processors, means that effective contract negotiations between most individual farmers and processors are unlikely to occur.

The typical Australian dairy farm is a family owned and operated enterprise which involves high fixed costs and requires year-round intensive work amid uncertain and sometimes damaging climate conditions. For most dairy farmers, profitability is uncertain and subject to many variables beyond their control.

Many farmers believe that the major supermarkets pricing their milk at \$1 per litre devalues the work they, their families and staff do to consistently produce high quality milk. The ACCC acknowledges and respects these concerns. \$1 per litre is an arbitrary price that has no direct relationship to the cost of production for the supply of milk by farmers and processors to the supermarkets.

Recognising these concerns, the ACCC conducted an in-depth examination of the effects of retail pricing along the dairy supply chain. This included the use of compulsory information gathering powers to obtain data and documents from supermarkets and processors from FY2010 to FY2016, and summoning all relevant processing and retailing businesses to give evidence under oath in private hearings.

The ACCC did not obtain any evidence that supermarket pricing, including \$1 per litre milk, has a direct impact on farmgate prices. Importantly, we found that contracts for the supply of private label milk allow processors to pass the farmgate price paid to farmers through to the wholesale prices they charge to retailers. This means that processors do not have an incentive to reduce farmgate prices as a result of the lower wholesale prices they receive for private label milk, as the farmgate prices are passed through to the supermarkets.

Further, farmers' lack of bargaining power means that they are unlikely to benefit from an increase in the retail (or wholesale) prices of private label milk or other dairy products. Even if processors were to receive higher wholesale prices from sales to supermarkets, this does not mean the processors will pay farmers any more than they have to secure milk.

Farmers' ability to capture their appropriate share of profits will, as in all industries, depend on their bargaining power. As noted above, most dairy farmers have little bargaining power and limited scope to reposition their businesses or switch to a different farm enterprise.

Farmers are also disadvantaged by a significant imbalance in the amount of pricing, market and product information available to them compared with processors. Processors are also far better informed about the minimum price that farmers are likely to accept than farmers are about the maximum price that processors are willing to pay. These information asymmetries mean that farmers are more likely to settle for a good offer rather than a better offer that could be available if they were better informed.

We have found that the bargaining power imbalance and this information asymmetry result in practices that transfer disproportionate levels of risk to farmers and soften competition between processors. These include complex and poorly timed pricing information, and contract terms which deter switching. These features add to uncertainty of farm income and make it difficult for farmers to identify and act when it is in their interests to switch to a competitive offer from another processor.

An example of this risk transfer was the retrospective price step-downs in 2016, which demonstrated that contractual arrangements between processors and farmers are structured in a way that allows processors to lessen the impact of their poor commercial decisions by retrospectively reducing the price they pay for farmers' milk, long after the milk has left the farm. While the 2016 actions were limited to just two processors, the nature of milk supply contracts between processors and farmers means, without change, others could take similar action in the future.

Two main concerns arise from the ACCC's key findings. First, bargaining power imbalances deter productivity-enhancing investments by farmers if they are unable to capture a sufficient share of the returns to make their investment worthwhile. Second, restrictions on switching soften competition between processors and reinforce farmers' poor bargaining position.

Following consultation with the industry on our interim findings and recommendations, the ACCC concludes that a mandatory code of conduct would improve the quality of information and price signals, enable fairer allocation of risk, and remove restrictions on farmers' ability to switch processors. While the introduction of a mandatory code will not overcome farmers' relative bargaining

disadvantage, it will mitigate some of the significant negative consequences. The removal of barriers to switching will also enhance existing competition between processors for raw milk.

Most major dairy processors are now corporations and not farmer-based cooperatives. However, industry practices have not substantially changed to reflect that processor and farmer interests are no longer closely aligned. A mandatory code will assist this transition, by clearly setting out the rights and obligations of farmers and processors.

A change to industry practices to the benefit of farmers will mean some loss of bargaining power for processors relative to farmers. As expected, therefore, most processors opposed this recommendation. However, having carefully considered the submissions opposed to this recommendation, we consider that a mandatory code of conduct can be designed in a manner that improves the efficiency of the industry without substantial regulatory burden on processors.

This report presents the ACCC's analysis of these and other associated issues in detail. Our findings and recommendations are focused on encouraging practices that will ultimately facilitate more efficient dairy production and supply in Australia, including improvement of the bargaining position and welfare of dairy farmers.

Findings

Geographic influences on milk production and competition

Competition between processors for the acquisition of raw milk in Australia primarily takes place in nine distinct regions:

- eastern Victoria (Gippsland)
- Murray region (northern Victoria and southern NSW)
- Western Victoria and south east SA
- Tasmania
- SA
- central NSW
- northern NSW/southern Queensland
- far north Queensland (Tablelands region), and
- WA.

Region-specific characteristics, including climate and production profiles, dictate the end markets targeted by processors in each region, and the nature and extent of competition between those processors.

For the purpose of this report, these production regions are broadly grouped as either the 'Southern region' or the 'Northern and WA regions'.

The Southern region mostly produce products for export such as cheese and milk powders. While these regions also produce dairy products for domestic markets, most of these processors are export-orientated.

The Northern and WA regions mostly produce fresh drinking milk. These processors export only a small proportion of their regional dairy production, if at all.

Bargaining power and risk allocation in the supply chain

Supermarkets have significant bargaining power in their dealings with processors in most circumstances. This is reflected in the low wholesale prices supermarkets are able to negotiate and the terms of supply agreements between supermarkets and processors. Due to their bargaining power, supermarkets also have significant control over the level of risk they choose to be exposed to and the risks they pass onto processors.

The type and extent of the risks that processors are exposed to depends on the products they manufacture and the nature of their wholesale supply agreements with customers. These include, for instance, exports, long term private label contracts with supermarkets or short term domestic supply agreements. Processors that are able to diversify by producing a variety of products and supplying a mixture of international and domestic customers reduce their exposure to specific risks.

Processors that mainly supply fresh dairy products for domestic consumption generally have more certainty about wholesale prices. As a result they are more likely to offer farmers fixed price contracts, which results in more price certainty for farmers. However, these processors face some uncertainty over continuity of supply to supermarkets which can limit their appetite for offering multi-year supply contracts to farmers.

In recognition of the significant imbalance in bargaining power between supermarkets and their suppliers, including processors, supermarkets' dealings with processors are presently governed by the *Food and Grocery Code of Conduct*.¹ This is a prescribed voluntary code under the the act.

1 Australian Competition and Consumer Commission, *Food and Grocery Code of Conduct*, <https://www.accc.gov.au/business/industry-codes/food-and-grocery-code-of-conduct>.

Processor discretion to vary prices allocates disproportionate risk to farmers

Processors have significant bargaining power over farmers. Dairy farm businesses are typically small operations supplying much larger and financially stronger processors. Further, as raw milk is an essentially generic product, processors' options for acquiring milk far outweigh farmers' options for selling it. This makes it easier for a processor to threaten to not purchase from farmers in negotiations. This is aggravated by the perishable nature of milk, which prevents farmers from withholding supply to negotiate better terms with processors. Consequently, farmers are rarely able to negotiate contracts or prices with processors.

The bargaining power imbalance is reflected in farmgate prices, milk supply contract terms that favour processors and the extent to which processors can pass on risk to farmers.

Supply contracts between processors and farmers vary significantly, ranging from multi-year fixed-price contracts to arrangements that are effectively day-by-day, relying on terms in the processor's Supplier Handbook which can be varied by the processor at any time.

Farmers can face significant uncertainty in both the price they receive for their milk and the costs they incur to produce milk. This uncertainty can make it difficult for farmers to plan and make investment decisions to increase their productivity.

Farmers in export-focused regions in particular face uncertainty about the milk price they receive from year to year and within a season. This uncertainty, and the associated risks, largely reflects the market uncertainty faced by processors.

Farmers in domestic-focused regions experience greater price certainty, but have greater cost uncertainty due to their stronger reliance on fodder inputs to produce year-round milk.

In general terms, processors that pass on uncertainty and risks to farmers do so by adopting any or all of the following practices:

- offering only indicative pricing for a contract period (in some cases changing farm gate prices mid-season)
- incentivising flat milk supply (or, penalising seasonal milk supply)
- offering only short term supply contracts to farmers.

The events of 2016 demonstrate that within-season price step-downs can cause significant detriment to farmers and the industry more broadly. The 2016 step-downs also demonstrate that processors generally have significant discretion when deciding whether to vary farmgate milk prices.

The ACCC's view is that processors should be able to manage their risk exposure during a dairy season without needing to shift this risk to farmers through mid-season milk price adjustments. This might be achieved by processors offering fixed prices for most of the milk they acquire within a season, so that farmers can choose the level of milk price risk their business is exposed to. Partially fixed price contracts have the capacity to reduce price uncertainty for farmers, allowing them to make better planning and investment decisions.

Farmgate milk prices

Price setting and price announcements

Farmers have limited insight into how farmgate milk prices are set by individual processors.

Pricing offers from processors are complicated and often difficult to interpret. Final pricing is determined by many variables. These can be difficult for processors to forecast accurately at the time they make their opening offers to farmers for consideration, meaning that prices received by farmers can vary significantly from both the announced headline farmgate price, and the income estimates provided by the processors. This uncertainty arises even in the absence of mid-season price adjustments such as step-downs.

Dairy farmers rely heavily on income estimates prepared by processors when budgeting for a dairy season. However, they may not be aware of the assumptions made to produce these estimates, and the consequences of these assumptions not being met. As such, some farmers receive payments that are significantly less than they projected.

Initial price offers from processors are often made very close to the commencement of, or sometimes after a new contract period has commenced. When combined with the complexity of offers, this timing reduces farmers' ability to make well-informed decisions about production and budgeting, and whether to switch to a better offer from another processor.

Timing of opening price announcements

Practices associated with the timing of Opening Price announcements have the potential to soften competition between processors and lower farmgate prices, especially if processors simply follow the price leads of other processors to avoid price competition.

However, the ACCC analysed the historical price leadership behaviour of Victorian processors over time, and did not find any clear pattern of price leadership. In particular, we did not find evidence to suggest that Murray Goulburn or any other processor has in the past consistently signalled an Opening Price which other processors have then followed.

Announced prices often do not reflect actual prices paid to farmers

Processors typically make uniform pricing offers by announcing a single farmgate price at the start of the season. However, the actual prices that individual farmers receive vary significantly from the announced price. Further, farmers each receive different prices from processors despite the opening offers generally being uniform.

The extent to which farmers generally receive prices above or below a processor's announced price varies from processor to processor and from year to year.

A range of factors influence the farmgate milk price paid to farmers. These include:

- Competition between processors for the acquisition of raw milk—the degree of competition for farmgate milk varies significantly between regions and at different times of the milk production cycle.
- Farm size—the largest farms typically receive better farmgate milk prices than smaller farms. This occurs for a number of reasons, including pricing incentives in contracts being tailored to favour larger farms and in some cases, the largest farms negotiating their own supply contracts.
- Incentives for year-round milk production—processors may set price offers to encourage farmers to adopt a less-seasonal milk supply profile (flat production). The extent to which processors encourage flat production varies between regions and processors. In some regions the ability of a farmer to respond to seasonal pricing has a significant impact on the overall farmgate milk price they receive.
- The quality of milk produced—quality factors significantly affect the farmgate milk price.

Competition assessment of relevant dairy markets

Competition for raw milk

Most regional markets for the acquisition of raw milk in Australia are concentrated or highly concentrated.²

While market concentration is a useful indicator of market structure and the potential for firms to have market power, it is also possible for concentrated markets to display signs of healthy competition. In this regard, the ACCC has found evidence that processors closely monitor each other's price and non-price offers to farmers. Internal documents demonstrate that processors monitor and counter the offers of their competitors, to recruit and retain milk supply from farmers.

² Based on processors' purchase data, Dairy Australia, and ACCC analysis.

The ACCC does not presently have significant concerns about the concentration of markets for raw milk acquisition in most regions. However, there are many regions where further consolidation is likely to alter the competitive dynamics and exacerbate farmers' poor bargaining position.

Available processor capacity, especially during the peak spring milk supply period, plays an important role in the number of farmers a processor can contract with and therefore the extent to which processors contest available milk supply within a region. The extent to which processors seek to utilise or expand capacity varies across regions and through time.

Even in the more competitive regions, all but the largest dairy farmers lack bargaining power relative to processors. Processors who actively compete for raw milk have the option to negotiate with at least hundreds and sometimes more farmers who are mostly substitutable for each other. In contrast, the average farmer has only a few alternatives, and in some cases just one option, for selling their milk.

These imbalances place processors in a significantly stronger negotiating position than farmers and result in contractual terms that are heavily in favour of processors. Overly complex milk supply contracts and price offers, delayed loyalty payments, and price announcements which allow farmers insufficient time to compare alternative offers, also restrict farmers' ability to compare and switch between processors soften competition at the farmgate.

Exclusive supply clauses in milk supply agreements do not restrict farmer switching and can be efficient for both farmers and processors. However, these kinds of clauses can be anti-competitive if they have the purpose or effect of substantially lessening competition in a market. The ACCC also acknowledges that dual supply arrangements can benefit farmers and small processors in some instances. These matters are assessed on a case-by-case basis.

Other risks to competition between processors include milk swaps and trades.

The ACCC's view is that milk swaps and trades between processors have not had a significant adverse impact on competition for farmers' milk in recent years.

However, both swaps and trades between processors have the potential to reduce competition and farmgate prices. There is evidence that some processors have traded milk to other processors with the purpose of protecting their own milk supply within a region.

In some limited circumstances swaps appear to have increased competition by allowing processors to buy milk in regions where they otherwise would not, due to a lack of processing facilities. Swaps can also allow processors to operate more efficiently by managing seasonal supply and demand fluctuations and optimising milk collection logistics.

Overall, despite evidence of close processor competition, there are aspects of the industry that limit competition for raw milk. Contracting practices employed by processors can inhibit farmer switching and hence competition. The extent of farmer switching varies by year and region, but processors generally experience between two and nine per cent churn of suppliers year-on-year (including farmers retiring or ceasing dairy farming). Farmers in export-focused regions tend to switch processors more frequently than farmers in domestic-focused regions such as Queensland and NSW.

Removing barriers to effective farmgate competition, and reforming contracting practices, will increase rivalry between processors and deliver better outcomes for farmers.

Competition in wholesale and retail markets

Australian exporters of dairy products compete in global markets and are considered price takers given the relatively small share of world dairy exports originating from Australia.

The ACCC considered the different characteristics of dairy products (for example fresh versus longer life exportable products) while assessing the general state of competition for the wholesale supply of dairy products in Australia.

In the domestic market, wholesale prices are constrained by competition between processors to supply major domestic customers including supermarkets. Competition for the wholesale supply of fresh drinking milk is predominantly regional or state-based.

For products with a longer shelf life, processors face national and import competition. There are significant imports of long life dairy products, in particular cheese and butter. These imports constrain the wholesale prices able to be charged by local processors.

Supermarkets carefully manage the shelf space allocated to dairy products, and regularly conduct range reviews to determine whether their dairy product range is maximising returns. Supermarkets remove products if they do not meet sales or margin expectations. While this process encourages dairy processors to ensure that their products meet the needs of consumers, the bargaining power of supermarkets can also act as a disincentive for investment by processors if they consider that supermarkets are likely to appropriate the benefits of investment or if there is too much uncertainty about whether a product is likely to continue to be ranged by supermarkets.

Recent milk processor capacity expansions and upgrades are indicators of competitive rivalry between processors. The ACCC's analysis identified that total national processing capacity for drinking milk, milk powder and cheese has increased over time as facilities have expanded and new plants have been built. In contrast, butter production capacity has not expanded. It appears that aggregate national dairy production levels are consistently below total capacity, particularly for milk powders, primarily because of the seasonal nature of milk production.

The major supermarkets and ALDI compete strongly on dairy products of key importance to their customers, in particular fresh milk and block cheddar cheese. This has resulted in lower real prices for consumers.

Supply chain profit analysis

The relative bargaining strength of supermarkets, processors and farmers is an important determinant of the share of profits that each earns in the dairy supply chain.

Supermarkets use their strong bargaining position to negotiate low wholesale prices and reduce the profit margins of processors. This bargaining power has enabled the supermarkets to profitably supply private label milk at one dollar per litre since 2011.

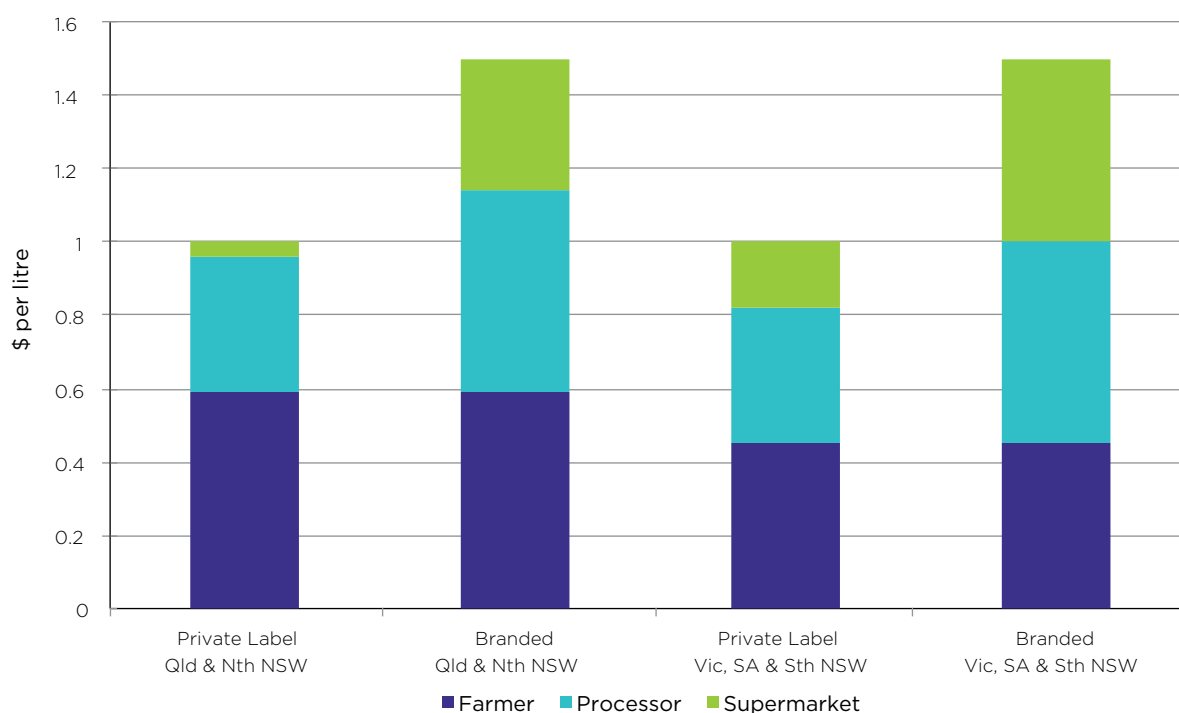
This pricing strategy was introduced by Coles, and quickly followed by Woolworths and ALDI, and subsequently by some other retailers. Many farmers consider that this pricing devalues the work they, their families and staff do to produce high quality milk. Farmers are frustrated that the retail price of milk has stayed the same, and declined in real terms, since 2011, when this would not be the case for most grocery items.

The ACCC acknowledges and respects these concerns, which are held by many farmers. \$1 per litre is an arbitrary price that has no direct relationship to the cost of production for the supply of milk by farmers and processors to the supermarkets.

However, domestic retail pricing strategies, in particular \$1 per litre private label pricing, are unlikely to have a direct impact on farmgate prices. Consumption of drinking milk is largely insensitive to price changes. Total supply chain profits would, therefore, be likely to rise if there was an increase in retail prices, such as for private label milk. However, this by itself would be unlikely to benefit farmers. Any increases in margins flowing from an increase in the retail price would likely be captured by the major supermarkets, or at best shared between the supermarkets and processors.

Farmers' weak bargaining power means that an increase in processors' profits would not necessarily result in higher farmgate milk prices. This is illustrated by our finding that farmers do not receive additional benefit from the sale of milk at higher retail prices, such as branded milk (see figure 1). Processors set farmgate prices in response to market conditions and at the minimum level required to secure necessary volumes. Farmers are not paid according to the type or value of the end product that their milk is used in.

Figure 1: Distribution of revenue from sale of private label vs branded fresh drinking milk



Source: ACCC analysis from supermarket and processor data

Domestic dairy retail prices over time

Wholesale and retail milk prices have been declining in real terms since the industry was deregulated in 2000. Since 2011, the retail price of private label milk has declined in real terms by a further 12 per cent on earlier reductions.

Consumers have benefitted from the lower real retail prices of a range of other dairy products including cream, UHT milk and a number of cheese products over the past eight years.

Distribution of profits throughout the supply chain

The introduction of \$1 per litre private label milk in 2011 initially reduced supermarket margins and transferred the benefit of these savings to consumers. We have found no evidence that it had any initial effect on processor margins or on farmgate milk prices, nor was any clear evidence presented to us during the inquiry that this was the case. However, we have found that both supermarkets and some processors incurred significant reductions in profit as a result of substitution by consumers from branded to private label milk.

From 2014 onwards, supermarkets have used their bargaining power to encourage increased competition between processors for the supply of private label milk. This has enabled supermarkets to negotiate lower wholesale milk supply costs and improve their profit margins.

While margins earned by supermarkets on private label milk are lower than for many other products, including branded milk, supermarkets still generally sell private label milk at a gross profit, except at times in Tasmania and Queensland (once distribution costs are taken into account). Supermarkets choose to absorb lower and sometimes negative margins in higher cost regions while making higher margins in lower cost states and from more profitable products. This is not particular to their dairy products, and enables them to maintain a competitive and consistent national pricing policy designed to build trust among consumers. In some instances supermarkets stock locally-sourced produce to support farmers in the region.

Processors' gross margins on private label milk have generally fallen, with wholesale prices approaching average production costs. Despite this, processors have continued to compete strongly for private label

milk contracts because the volumes of milk involved provide economies of scale in production, adding to overall profitability.

Processors generally earn significantly higher profits on most other dairy products. These margins vary significantly between products, states and processors, but range between 30 and 60 per cent. Evidence obtained by the ACCC indicates that processors appear to offset lower margins on private label contracts with the higher margins earned on branded products.

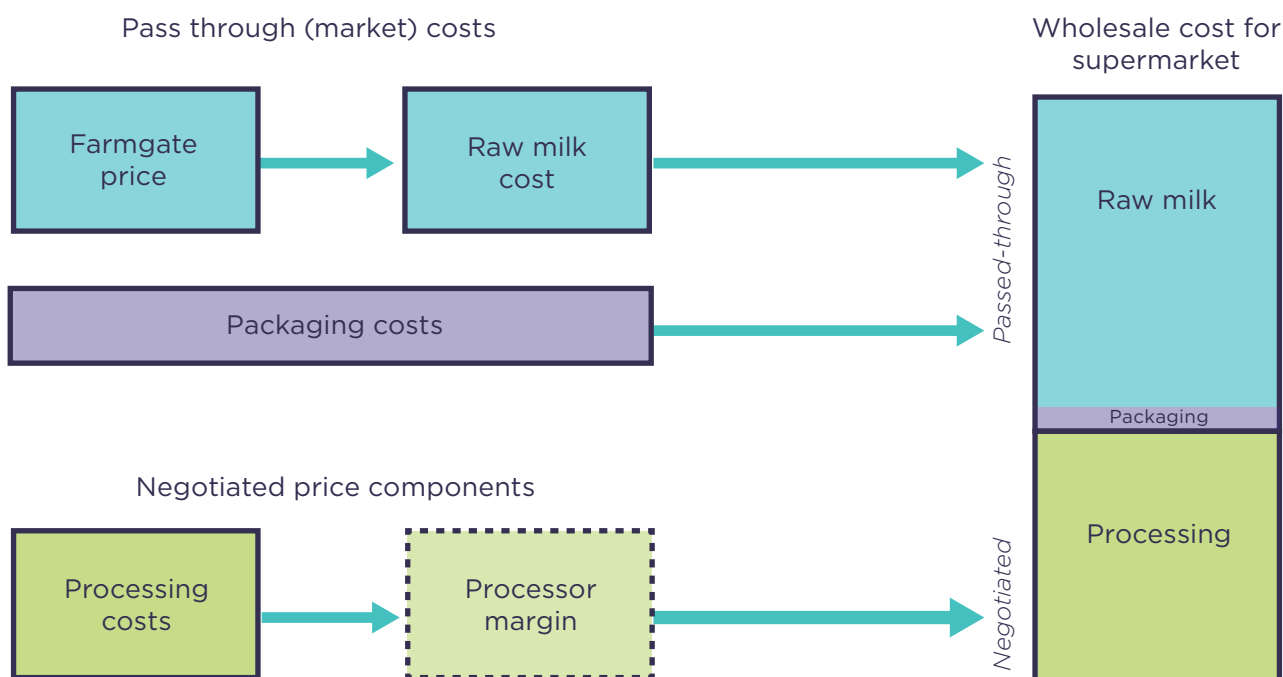
Margins for most other dairy products have been stable or decreasing since 2011. The ACCC did not obtain evidence of wholesale prices falling below levels that would force efficient processors to exit the industry. Although processors' gross margins are very small for private label milk, they are positive, and processors are generally profitable overall.

Key influences on farmgate prices

The geographic location of dairy producing regions and their relative exposure to global and domestic dairy markets are the strongest and most direct influences on farmgate prices.

Evidence obtained by the ACCC under our information gathering powers demonstrated that almost all contracts for the supply of private label milk have clauses that allow processors to pass-through movements in farmgate prices to supermarkets. As a result, there is no direct relationship between retail private label milk prices and farmgate prices. For this reason, changes to the retail price of private label milk are unlikely to result in any changes in the farmgate milk price received by farmers, because processor profits on private label milk are not influenced by whether farmgate prices are high or low. Figure 2 illustrates the negotiation process between a supermarket and a processor for a typical private label milk supply contract.

Figure 2: Typical supermarket private label milk contract



This suggests that measures to improve the bargaining power of farmers in their interactions with processors are a more appropriate mechanism to ensure the pricing policies of retailers do not cause undue long-term harm to the industry.

Deregulation, and the gradual removal of pricing support for farmers, has had a pronounced impact on milk production and farmer profitability in Australia. Farmgate prices in Queensland and WA fell significantly immediately following deregulation, as processors sought to reduce production volumes to the level required to meet domestic demand. Many higher cost farms exited at this time. The ACCC has found that:

- production volumes have trended down in these higher cost regions since price support was removed; the price of private label milk does not appear to have altered this trend
- farm exit trends in the higher cost regions have not changed in response to the introduction of one dollar per litre milk
- total farm numbers, output and profitability trends have not changed since the introduction of one dollar per litre milk.

Implications of retail pricing for future milk production and processing

Competition between processors facilitates the lowest possible wholesale prices. Therefore it is not in the interests of supermarkets to force wholesale prices down to a point which causes processors to be unprofitable and exit.

Processors' margins on private label milk are already small and it may be hard for processors to achieve further cost efficiencies. Private label milk prices also constrain the wholesale prices that processors can achieve with non-grocery customers. This is straining processor profitability in high cost regions where supermarkets sell private label milk at low or negative margins. Therefore, wholesale prices will likely have to rise at some point in the future to maintain processor profitability. In turn, this would require action by the supermarkets which could include:

- increasing the retail price of private label milk
- absorbing any losses at the retail level into their own margins
- restructuring their supply chain in such a way that reduces costs, but maintains incentives for farmers to produce required volumes of raw milk.

Contracting practices

Contract arrangements in the dairy industry between processors and farmers are favourable to processors and exacerbate most farmers' weak bargaining power.

There appear to be few differences between the contracting options and terms offered by corporate processors and farmer-owned co-operatives.

Certain contract terms and the complexity of contracts have limited the ability of farmers to switch between processors, and resulted in a lack of milk price transparency, and the uneven allocation of risk between processors and farmers.

Contracts for the supply of raw milk may also contain some terms that are potentially unfair. The Unfair Contract Terms (UCT) legislation introduced by the Australian Government in 2016 provides protections for small businesses contracting with large businesses, and is likely to apply to some of these contracts. The ACCC is presently considering potential issues under the UCT arising from milk supply contracts for the 2017-18 season.

Contract termination notice periods and automatic contract rollover clauses are problematic in most circumstances. Notice periods that require farmers to make supply decisions with limited or no access to price and/or other contract information may impact their choices and could also raise concerns under the UCT laws. Automatic rollover clauses may also raise concerns under UCT laws where they can be extended by significant periods of time.

Although many milk supply agreements currently contain dispute resolution clauses, these often do not specify the process that is to be utilised to resolve disputes and therefore are rarely satisfactory. Given the significant imbalance in bargaining power between processors and farmers, the ACCC considers that the industry should develop a dispute resolution process that allows for mediation, arbitration or expert determination, where disputes cannot be resolved through negotiation.

This inquiry has revealed that many farmers are not aware of the terms and conditions of their milk supply contracts or agreements with processors. While the ACCC has concerns with the transparency and fairness of terms, farmers should more actively analyse their supply agreements and obtain relevant legal or financial advice where appropriate, including from representative groups, given the large monetary value involved. That said, their limited bargaining power will ultimately reflect the terms they are offered.

Collective bargaining and boycotts

Collective bargaining authorisation is a legal tool available to farmers seeking to act collectively to redress bargaining power imbalances.

The ACCC considers that although collective bargaining has worked in some circumstances in the dairy industry, it is not a broad remedy to the issues arising from the bargaining power imbalances that exist in the dairy industry.

Processors mostly lack incentives to negotiate with, or enter into agreements with collective bargaining groups. They rarely achieve gains from engaging in collective negotiations and therefore commonly choose not to engage with CBGs.

Processors are often in a position to circumvent engagement with bargaining groups by offering standard form contracts for milk supply to farmers on a 'take it or leave it' basis. These contracts are generally favourable to processors.

This is not to say that current collective bargaining groups are ineffective or that collective bargaining should be disregarded as an option in the future. The ACCC has examined the history of collective bargaining groups in the dairy sector and found examples that work well. However, some of these groups were formed in unique circumstances, and have features that typically do not apply to most groups.

Collective boycott arrangements, if authorised by the ACCC, might improve the negotiating strength of collective bargaining groups and help overcome the shortcomings observed. However, due to the perishable nature of milk, the threat of a boycott may be less effective in bringing dairy processors to the negotiating table and reaching a negotiated outcome than is likely to be the case in other industries.

The need for a mandatory code of conduct

Market failure in the dairy industry results from the strong bargaining power imbalance between processors and dairy farmers, combined with the information asymmetry between them.

These features result in contracting and industry practices that are weighted heavily in favour of processors and which make it difficult for farmers to make efficient investment decisions. Efficient investments are likely to be deterred if farmers do not have the certainty that they will be able to capture a sufficient share of the returns to make their investment profitable.

In addition, the barriers to switching between processors that we have outlined above reduce the effectiveness of competition for raw milk, and suppress farmgate prices.

Australia's competition and consumer laws are able to retrospectively address isolated instances of behaviour and conduct which harm competition and efficiency in the industry. These laws include the unfair contract terms laws and prohibitions on misleading and deceptive, and unconscionable, conduct. However, the problems we have identified in the dairy industry emanate from the broader and inherent bargaining power imbalance across the industry, particularly between processors and farmers. The resulting effects and risks to the industry are widespread, and cannot be effectively addressed through the particular provisions of the CCA.

The recently developed Voluntary Dairy Code has led to some processors offering improved terms in milk supply contracts for the 2017-18 dairy season. However, the Voluntary Code is not enforceable and processors can choose not to participate or comply with the code at any time. The ACCC does not consider that the Voluntary Code will adequately address the structural bargaining power imbalance, and the associated contracting practices in the longer term. Further, a process for monitoring

compliance with the Voluntary Code currently does not exist, and it is unlikely this code could be effectively enforced in the future.

The ACCC considers the issues identified and examined in this inquiry are of such magnitude as to warrant being addressed by a mandatory code of conduct for processors. It may be appropriate to exempt certain processors from the application of a mandatory code based on market share, revenue or other threshold to ensure that regulatory compliance costs are distributed appropriately relative to businesses' capacity to manage these.

Recommendations

This final report sets out the ACCC's recommendations for improving interactions through the supply chain and supporting market conditions that facilitate efficient production and supply of dairy products in Australia.

Contracting practices

1. Processors and farmers should acknowledge in writing the terms and conditions for milk supply.

This recommendation seeks to increase the clarity and transparency of the arrangements between processors and dairy farmers by ensuring that farmers are aware of, and acknowledge, the terms and conditions of their supply.

This recommendation does not require the creation of any new or additional documents.

Acknowledgement may simply take the form of signing or initialling a page in a Supplier Handbook, or sending a processor an email confirming that the contract has been accepted.

Most importantly, contract variations that occur during a season or the duration of a contract should not be implemented until a farmer has acknowledged the contract variation in writing.

For the avoidance of doubt, this recommendation does not suggest that parties be required to enter into contracts of fixed duration.

2. Processors should simplify their contracts where possible, including by minimising the number of documents and clearly indicating which documents contain terms and conditions of milk supply.

For example, in some cases the terms of a Supplier Handbook and a Milk Supply Agreement could be incorporated into a single document.

This will provide benefits to processors and farmers, as contracts will be more transparent and easily understood. Clearer price signals can increase certainty and transparency in contracting practices and can improve efficiency in the market.

The Australian Dairy Industry Council (ADIC) is in a position to work with processors to identify how contracts can be simplified and ensure this recommendation is implemented.

3. Processors should provide all contractual documents simultaneously before the commencement of the dairy season or contract term.

Farmers should be provided with all the proposed terms and conditions of their contract—whether that be the Supplier Handbook, any Milk Supply Agreement and/or any other documents that contain terms and conditions—simultaneously and with a sufficient time to properly consider them before the season (or contract term) commences.

This will increase transparency and ensure farmers have the necessary information to make supply decisions before they have committed to supply a particular processor.

For clarity, this recommendation does not require Opening Price Letters to be provided at the same time as contract documents, but does require Opening Price Letters to be provided before the new contract is entered into and commences.

4. Milk supply contracts should not include terms which unreasonably restrict farmers from switching between processors.

Many milk supply agreements contain clauses which act as switching barriers. These include loyalty bonuses or other payments that are paid in respect of one dairy season but require ongoing supply into a new dairy season.

This recommendation is currently reflected in the requirements of the Voluntary Code, but this code is not enforceable.

5. The industry should establish a process whereby an independent body can mediate and arbitrate in relation to contractual disputes between farmers and processors.

The ACCC recommends ADIC should be responsible for establishing the body, and as part of this process should consult closely with farmer representative groups to determine the scope and procedure of the dispute resolution process.

The ACCC also recommends that processors include detailed dispute resolution clauses in farmer contracts that allow for binding determination or arbitration.

For the avoidance of doubt, this dispute resolution process should govern disputes between farmers and processors, and between collective bargaining groups and processors.

6. Farmers should ensure they have properly considered the legal and financial implications of their contracts with processors.

The average value of a supply contract varies across farms and regions, but in 2015–16 was just under \$700 000.³ The ACCC's view is that contracts of such significant value should be carefully and actively considered by farmers before they are entered into. However, we understand that in general, many farmers do not seek professional legal or financial advice before entering into a contract, and many are not aware of the terms and conditions of their milk supply agreements that apply to them.

Farmer representative groups are well placed to provide general guidance about how common contract terms operate and how these can impact farm income.

Because of the significant impact contracts can have on farmers' operations, farmer representative groups should prioritise facilitating farmers' general understanding of the procedures and key aspects of supply contracts. This may involve procuring legal advice to assist with providing guidance to farmers at a generalised level. This may include assistance in interpreting contracts, identifying emerging contracting trends and directing farmers to specialist legal and financial advisers.

Farmgate milk prices

7. Processors should publish information identifying how their pricing offers apply to individual farm production characteristics to enable better farm income forecasts.

Processors need to improve the transparency of their contract pricing terms.

This could be achieved through an interactive online model which allows farmers to enter their own production characteristics and obtain a reliable estimate of the final income to be received.

Processors should publish information identifying how their pricing offers apply to a standardised set of model farms, accounting for common differences in farm size, seasonality of production, whether production is growing or retracting and how penalties, such as those relating to quality requirements, impact on pricing offers.

This will improve transparency of pricing, allow farmers to make better comparisons of processors' milk supply terms and enhance competition.

A mandatory industry code of conduct

8. A mandatory code of conduct within the the act should be established for the dairy industry.

The ACCC recommends that a mandatory code of conduct to apply to processors be prescribed for the dairy industry.

Our view is that the inherent bargaining power imbalance between processors and dairy farmers, combined with unequal availability of information between them (information asymmetry) results in market failure in the Australian dairy industry.

³ This estimates is based on the following 2015–16 Dairy Australia figures: Average herd size of 273 cows, average per cow production of 5669 litres per annum and an average price of 44.9 cents per litre. See <https://dairyaustralia.com.au/publications/australian-dairy-industry-in-focus-2016?id=4801EB12663D4FDF93150963BE85B614>.

Contracting and industry practices are weighted heavily in favour of processors. This has led to inappropriate allocation of risk, increased potential for inefficient investment decisions by farmers and less effective competition between processors.

A mandatory code should therefore be designed to improve transparency and certainty in contracts, set minimum standards of conduct and provide for dispute resolution processes. In particular, a mandatory code should contain obligations on processors to improve the timing and manner of processors' communication of price and other key information, and increase farmers' ability to switch in response to significant changes to their trading terms.

We have reached this view having considered alternative remedies, including relying on the existing provisions and mechanisms of the CCA (including collective bargaining), and other types of industry codes of conduct, namely a voluntary code or prescribed voluntary code of conduct.

The ACCC notes it may be appropriate to exempt certain processors from the application of a mandatory code based on market share, revenues or another threshold to ensure that regulatory compliance costs are distributed appropriately relative to businesses' capacity to manage these.

The ACCC's inquiry

The Government's direction under Part VIIA of the CCA allows the ACCC to use compulsory information gathering powers to request information, documents, and sworn oral evidence.

The ACCC has received information from a variety of sources, including through submissions, public forums, compulsory information requests, voluntary information requests and stakeholder feedback. This information has helped the ACCC's inquiry to:

- assess the impact of \$1 per litre milk on the supply chain ('\$1 per litre milk')
- identify the key unfair contracting practices between processors and farmers
- measure the impact of milk swaps on competition for farmgate milk
- determine the formulation and timing of opening price announcements and their impact
- assess regional differences across the dairy industry.

The ACCC has made a number of findings, and recommendations for improvements to the operation of the industry.

The ACCC published the Dairy inquiry interim report on 30 November 2017 and provided the final report to the Treasurer on 30 April 2018.

Inquiry framework

The ACCC is required to hold an inquiry in public pursuant to s. 95R (1) of the CCA. As the inquiry is a public process, written feedback has been published on the ACCC's website. Parties are permitted to request that information provided not be disclosed to the public on the basis that disclosure of the information would damage the competitive position of the party.⁴

A range of parties have made confidentiality claims over the information they provided to the ACCC. Where the ACCC considered that disclosure of information was necessary in the public interest, the ACCC consulted with the relevant parties before disclosing that information.

Issues paper submissions

The ACCC published an issues paper on 8 November 2016. The issues paper outlined the key issues of relevance to the inquiry, and requested feedback by 12 December 2016. The ACCC continued to receive submissions in relation to the issues paper throughout 2017 and in total received 82. A wide range of interested parties made submissions, including farmers, processors, collective bargaining groups and industry representative groups. A full list of parties who made public submissions is at appendix 3. All public submissions are available on the ACCC's website.⁵

⁴ *Competition and Consumer Act 2010* (Cth), s. 95ZN (1).

⁵ See: <https://www.accc.gov.au/about-us/information-for/agriculture/dairy-inquiry-0/submissions>.

Public forums

Throughout February and March 2017 the ACCC held eight public dairy forums around Australia. The forums were focused on hearing from farmers and took place in:

State	City	Date
Queensland	Toowoomba	6 February 2017
New South Wales	Taree	7 February 2017
Victoria	Traralgon	14 February 2017
Victoria	Warrnambool	27 February 2017
Victoria	Shepparton	28 February 2017
Western Australia	Bunbury	16 March 2017
South Australia	Hahndorf	20 March 2017
Tasmania	Burnie	22 March 2017

The forums were attended by ACCC Commissioners and staff. The ACCC heard a range of views from approximately 600 farmers and stakeholders regarding issues in the industry. The ACCC thanks all attendees for their time and contributions.

Compulsory information gathering powers

The ACCC has used its compulsory information gathering powers to obtain evidence. From December 2016 until February 2017 the inquiry issued notices under s. 95ZK of the CCA to processors and retailers.

These notices required a variety of information be provided, including documents, information and data about:

- organisational structures
- suppliers
- processing operations
- transport and distribution operations
- production and volumes
- sales and volumes
- logistics
- milk supply contracts
- retail dairy product contracts
- private label and branded dairy product strategies
- competition strategies.

The ACCC issued notices to eleven processors and three retailers.

The inquiry issued further notices to some businesses during June and July 2017. An important focus of the inquiry has been to analyse supply chain data. This is described in detail in chapter 6.

Over the course of the inquiry, the ACCC received over 25 000 documents from notice recipients. The ACCC reviewed the information, documents and data received, which included an extensive data and contract analysis. Notice recipients claimed confidentiality over the majority of material submitted.

The ACCC has also issued a number of voluntary information requests to participants in the dairy industry.

Public sources of information

In addition, the ACCC has made significant use of data from Dairy Australia and ABARES. The public reporting of various aggregated price and sales information through the supply chain is valuable for market transparency. Information relied upon by the ACCC has included aggregated production data for raw milk and milk components, processed products, wholesale trade, exports and imports. It has also included historical information such as farm and cow numbers, productivity statistics, indicative farmgate milk prices, dairy consumption, and farm performance. The ACCC recognises that the depth of market reporting provided by Dairy Australia depends on the provision of quality information from a range of market participants.

Hearings

The ACCC held private hearings under s. 95R of the CCA, as part of its compulsory information gathering process. The inquiry Chair summoned witnesses to attend the hearings pursuant to s. 95S (3). Witnesses were permitted to provide written statements at the hearing, and to object to the hearing being held in public on the basis that the evidence likely to be given was of a confidential nature.⁶

Witnesses were required to swear an oath or affirmation before providing information.⁷ All witnesses objected to the hearings being held in public as the information to be given was confidential.

The ACCC held hearings with eight processors and three retailers in June and July 2017.

The hearings were attended by inquiry members, including Chairman Rod Sims, Commissioner Sarah Court and Commissioner Mick Keogh and were assisted by Counsel for the ACCC.

The hearings provided the inquiry with the opportunity to gather additional information from stakeholders that it had not already asked for, to clarify questions that had arisen from the information and documents provided and test concerns raised at the forums.

Meetings with stakeholders and other steps taken during the drafting of the interim report

The ACCC held several meetings with stakeholders during the inquiry and prior to the release of the interim report. These included:

- Australian Dairy Farmers (ADF)
- Queensland Dairyfarmers' Organisation (QDO)
- Port Curtis Milk Suppliers Co-operative Association Limited (Port Curtis)
- Dairy Farmers Milk Co-operative (DFMC)
- Tasmanian Suppliers Collective Bargaining Group
- Manning Valley Collective Bargaining Group
- WA Collective Bargaining Group
- Farmer Power
- Victorian Farmers Federation (VFF)
- WA Farmers
- NSW Farmers' Association.

While travelling for the forums, ACCC staff also visited farms and processing plants in various locations.

On 1 September 2017 the ACCC attended a Dairy inquiry consultation meeting with ADF's Markets, Trade and Value Chain Policy Advisory Group and representatives of each state dairy farming organisation. The meeting allowed the ACCC to update the parties on the status of the inquiry.

These meetings assisted the ACCC to discuss specific issues in depth with stakeholders, and developments in the industry.

⁶ *Competition and Consumer Act 2010* (Cth), s. 95R (2)–(3).

⁷ *Competition and Consumer Act 2010* (Cth), s. 95S (1).

Interim report

The Dairy inquiry interim report was published on 30 November 2017, which sought industry feedback to the interim report and the interim findings and recommendations. Submissions to the interim report were due by 31 January 2018.

The inquiry received over 30 submissions in response to the interim report. All public submissions to the inquiry are listed at appendix 3.

The ACCC also invited industry stakeholders to meet with inquiry staff in order to gather feedback and discuss stakeholder submissions. Meetings were held with:

- Fonterra Australia Pty Ltd
- Norco Co-operative Limited
- Farmer Power
- Dairy Connect Ltd
- United Dairyfarmers of Victoria
- ADF
- QDO
- NSW Farmers' Association
- SA Dairyfarmers' Association Inc.
- Port Curtis
- DFMC.

The ACCC considered the wide range of views provided by industry participants and took these into account when drafting its final report.

Summary of stakeholder feedback on the interim report

This section contains a summary of the feedback received from a range of stakeholders on the interim report. Specific issues are addressed in more detail in the relevant section of this final report.

As a general comment, some processors were concerned that the report did not sufficiently highlight that different regions create significant differences in how processors operate across Australia.⁸

Supply chain profit analysis

Many farmer groups disagreed with our analysis of the impact of \$1/L milk on the industry supply chain, particularly our findings in relation to the impact on farmgate prices.⁹

It was submitted that our assessment that \$1/L milk had not impacted farmgate prices did not reflect industry experience and that the long term sustainability of the industry was jeopardised by \$1/L milk.¹⁰ Farmer groups argued that retailer pricing decisions are forcing farmers out of the industry.¹¹ We were urged to reconsider our analysis, particularly the indirect impact \$1/L milk has on the supply chain.¹²

Despite this, some farmer groups agreed with our finding that the imbalance in bargaining power between processors and farmers meant any increases in the retail price of \$1/L milk were unlikely to be passed onto farmers, and that this imbalance should be remedied.¹³

One farmer group stated that in some states where one fresh milk processor is the 'price setter', there is evidence that other processors farmgate prices had decreased to match the price set by that processor.¹⁴

Farmer groups stated that supermarkets ability to recoup all efficiency savings made by processors is of major concern, as it impacts the ability of processors to invest for the future.¹⁵ It was also submitted that \$1 per litre milk threatens the long-term sustainability of the dairy industry, particularly in high cost regions like northern NSW, Queensland and WA.¹⁶

8 Lion Dairy & Drinks, *Australian Competition and Consumer Commission (Commission) inquiry into the Australian dairy industry—Lion—Dairy & Drinks Pty Limited (Lion) submission on Interim Report*, 31 January 2018, p. 2; Norco Co-operative Limited, *Submission to the Australian Competition and Consumer Commission*, 31 January 2018, p. 2.

9 Australian Dairy Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2; WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 3.

10 NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 7; WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 3; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 7.

11 WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, 3; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 7.

12 Farmer Power, *Comments on the ACCC Interim Report on the Australian Dairy Industry*, 23 February 2018, p. 4.

13 Farmer Power, *Comments on the ACCC interim report on the Australian dairy industry*, 18 January 2018, 4; Port Curtis Milk Suppliers' Cooperative, *ACCC Dairy inquiry interim report feedback*, 31 January 2018, 3; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 3; Tasmanian Farmers and Graziers Association, *Submission to the ACCC Dairy inquiry interim report*, 7 February 2018, p. 1; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 7.

14 Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 4.

15 Australian Dairy Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2; WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 3; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 7.

16 Dairy Farmers Milk Cooperative, *Response to the interim report into the Australian dairy industry*, 29 January 2018, p. 2; Farmer Power, *Comments on the ACCC interim report on the Australian dairy industry*, 18 January 2018, p. 5; Niche Agribusiness, *Notes and comments on the ACCC's interim report on the dairy industry*, 25 January 2018, p. 9; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 7; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 8; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 7; WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 3.

Farmer groups stated that supermarkets can make up any losses incurred on \$1/L milk on margins earned on other grocery products.¹⁷ The ACCC was informed that despite our analysis, the pricing of private label milk at \$1/L has devalued the product in consumers' minds.¹⁸

Some farmer groups also criticised the ACCC for not analysing the imbalance in bargaining power between processors and retailers further, and making no recommendations to address this.¹⁹

The proposed mandatory code of conduct

The majority of farmer groups and farmers were supportive of the ACCC's interim recommendation of a mandatory code.²⁰ Further information about how the proposed mandatory code is likely to be drafted and enforced was requested by stakeholders.²¹

Some farmer groups were concerned about the unintended effects a mandatory code may have on the industry and innovation, requesting a full cost benefit analysis for the supply chain be undertaken.²² One group noted that developing the Voluntary Code has rebuilt positive relationships and trust between processors and farmers, and that Government should recognise this.²³ Further, they submitted the Voluntary Code will be reviewed this year, and the ACCC's feedback will be taken into account.²⁴

Some processors were of the view that a mandatory code was not yet warranted, as the Voluntary Code has not had an opportunity to operate in practice for a substantial period of time.²⁵ Some processors were also concerned about the application of a mandatory code to the different styles of businesses that operate in the industry.²⁶

Finally, one representative group and some farmers submitted that a mandatory code will not resolve the current market failure, and that new legislation, a retailer-processor code or reregulation should be considered to set prices and deal with alleged retailer and processor anti-competitive behaviour.²⁷

17 NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 16; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 7.

18 Port Curtis Milk Suppliers' Cooperative, *ACCC Dairy inquiry interim report feedback*, 31 January 2018, p. 5; Duncan McInnes, *Submission*, 30 January 2018, p. 2.

19 NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 8; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 6; United Dairyfarmers of Victoria Wannon, *UDV Wannon Branch Submission to the ACCC Interim Report of the inquiry into the Australian Dairy Industry*, 24 January 2018, p. 4; Australian Dairy Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2.

20 Dairy Farmers Milk Co-operative Limited, *Dairy Farmer Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, 23 February 2018, p. 1; Farmer Power, *Comments on the ACCC Interim Report on the Australian Dairy Industry*, 23 February 2018, p. 7; Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, p. 5; WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 7; Tasmanian Farmers and Graziers Association, *Submission to the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2.

21 Tasmanian Farmers and Graziers Association, *Submission to the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 1.

22 United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, 3-4; Australian Dairy Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, pp. 2-3.

23 Australian Dairy Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, pp. 2-3.

24 Australian Dairy Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2.

25 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 5; Australian Dairy Products Federation Inc., *Dairy inquiry Interim Report, November 2017*, 7 February 2018, pp. 2-3.

26 Lion Dairy & Drinks, *Australian Competition and Consumer Commission (Commission) inquiry into the Australian dairy industry—Lion—Dairy & Drinks Pty Limited (Lion) submission on Interim Report*, 31 January 2018, p. 3; Norco Co-operative Limited, *Submission to the Australian Competition and Consumer Commission*, 31 January 2018, p. 2.

27 Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, pp. 8-9; Graeme Muldoon, *Submission*, 9 March 2018, pp. 1-2.

Competition for raw milk

One processor disagreed with our analysis that raw milk markets are limited to local geographic regions, as raw milk can easily be transported across regions if there is an economic incentive to do so.²⁸ One farmer group was also critical of our market analysis, and argued that clearer definitions of geographic and product based markets were needed to establish the impact of supermarket market power on the industry.²⁹

Some farmer groups criticised and questioned our finding that milk swaps have not had a significant adverse impact on competition for farmers' milk.³⁰

Many stakeholders submitted that exclusive supply should be removed from the industry and that farmers should have the discretion to engage in dual supply.³¹ On the other hand, some processors emphasised the need for processors to retain the ability to enter into exclusive supply contracts with farmers, to ensure milk quality and consistency in supply.

Farmgate milk prices

Farmer groups were largely in support of the interim recommendation that processors should publish pricing information which can be applied to individual farms, in order to improve price transparency.³² Farmer groups also reiterated their concerns about the late timing of farmgate price announcements, which leave farmers short timeframes to make processor switching decisions.³³

Some processors did not support our finding that processors should be able to manage their risk exposure throughout a season and offer fixed prices for most of the milk they acquire.³⁴ They said this was due to the unpredictable influence of international markets on their businesses.³⁵ One processor warned that farmers' desire for early price announcements must be balanced with the desire for accuracy.³⁶

28 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 8.

29 NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 14.

30 Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 5; Farmer Power, *Comments on the ACCC Interim Report on the Australian Dairy Industry*, 23 February 2018, p. 3; Dairy Farmers Milk Co-operative Limited, *Dairy Farmer Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, 23 February 2018, p. 3; Philip and Elisabeth Beattie, *Submission to the Interim Report of the ACCC Dairy inquiry*, 31 January 2018, p. 2.

31 Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, p. 2; United Dairyfarmers of Victoria Wannon, *UDV Wannon Branch Submission to the ACCC Interim Report of the inquiry into the Australian Dairy Industry*, 24 January 2018, p. 2; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 2; Scott Briggs, *Comments in relation to the ACCC's Dairy inquiry interim report*, 18 January 2018, p. 2; Philip and Elisabeth Beattie, *Submission to the Interim Report of the ACCC Dairy inquiry*, 31 January 2018, p. 1; Robin M. Preibe, *Submission*, 12 December 2017, p. 1.

32 Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, pp. 4–5; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 3; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 13; Dairy Farmers Milk Co-operative Limited, *Dairy Farmer Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, 23 February 2018, p. 1.

33 Tasmanian Farmers and Graziers Association, *Submission to the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 13.

34 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 7; Bega Cheese Limited, *ACCC Dairy inquiry interim report—next steps*, 2 February 2018, p. 1.

35 Ibid.

36 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 5.

Risk allocation

Farmer groups agreed with our findings that there is a bargaining power imbalance between processors and farmers, which results in disproportionate risk being shifted to farmers.³⁷

One processor argued that all supply chain participants are affected by risk.³⁸ Processors collect all of a farms milk volume, which represents a large risk to the processor that they will have excess milk.³⁹ It was submitted that processors do shield farmers from risk by avoiding price step-downs when possible, but that they should not be required to protect farmers from risks outside of their control.⁴⁰

Contracting practices and collective bargaining

The ACCC made a number of interim recommendations in relation to the industry's contracting practices. Farmer groups largely supported these, finding that farmers signing written contracts and having simplified, transparent contracts would be beneficial for the industry.⁴¹

Some processors opposed the interim recommendations. One processor advised that requiring farmers to sign written contracts would create an undue administrative burden on both parties.⁴² One processor also submitted they had already taken steps to simplify their contracts, and noted that although contract simplification was the ideal, it is in the benefit of farmers to have necessary information included in their contracts in order to assist business decision-making.⁴³

Industry feedback to the ACCC's interim recommendation that an independent dispute resolution body be established for the industry was largely positive.⁴⁴ However, the ACCC was informed it is important that the body is independent and removed from processor influence.⁴⁵ One processor noted the body should only mediate disputes that arise under the code, and not separately between a processor and farmer under a contract.⁴⁶

Feedback to the Collective Bargaining chapter acknowledged the challenges of collective bargaining in the dairy industry.⁴⁷ Some industry groups noted that they considered collective bargaining does serve a purpose and should be retained going into the future.⁴⁸

The ACCC thanks all stakeholders for their responses to the Interim report. This feedback has been considered by the ACCC and is addressed in this Final Report.

37 Tasmanian Farmers and Graziers Association, *Submission to the ACCC Dairy inquiry interim report*, 7 February 2018, p. 1; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, pp. 8–9; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 2.

38 Fonterra Australia Pty Ltd, *inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 6.

39 Fonterra Australia Pty Ltd, *inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 6; Norco Co-operative Limited, *Submission to the Australian Competition and Consumer Commission*, 31 January 2018, p. 2.

40 Fonterra Australia Pty Ltd, *inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 6.

41 Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, p. 2; Dairy Farmers Milk Co-operative Limited, *Dairy Farmer Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, 23 February 2018, p. 1; WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 4.

42 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 2.

43 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 3.

44 Dairy Farmers Milk Co-operative Limited, *Dairy Farmer Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, 23 February 2018, p. 1; Farmer Power, *Comments on the ACCC Interim Report on the Australian Dairy Industry*, 23 February 2018, p. 7; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 12.

45 Farmer Power, *Comments on the ACCC Interim Report on the Australian Dairy Industry*, 23 February 2018, p. 7.

46 Fonterra Australia Pty Ltd, *inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 4.

47 Graeme Muldoon, *Submission*, 9 March 2018, 1–2, Philip and Elisabeth Beattie, *Submission to the Interim Report of the ACCC Dairy inquiry*, 31 January 2018, p. 1.

48 Farmer Power, *Comments on the ACCC Interim Report on the Australian Dairy Industry*, 23 February 2018, p. 6; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 7; Dairy Farmers Milk Co-operative Limited, *Dairy Farmer Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, 23 February 2018, p. 3.

1. Industry background

Key Points

- The dairy industry has consolidated since deregulation in 1999–2000; dairy farm numbers have fallen more than milk production volumes in each state and nationally.
- Since deregulation, national milk production has decreased by 15 per cent but [over the last 10 years] has become increasingly stable both nationally and in each state.
- Dairy production regions can be broadly grouped as either northern or southern, with the Northern and WA regions focusing primarily on shorter shelf life products for domestic consumption, and Southern regions also producing longer shelf life products suitable for export.
- Total national processing capacity for some major dairy products has increased.

A large proportion (37 per cent in 2016–17) of Australian milk production is exported in various product forms, exposing processors and hence dairy farmers to movements in international markets.

This chapter provides background, facts and figures on the dairy industry, relating to Australian dairy production; the industry before, during and after deregulation; unique demand and supply factors in each dairy region; the processing sector (products, players and consolidation); domestic and export markets, and farm profitability.

1.1 Australian dairy production

The dairy industry is the fourth largest contributor to Australian agriculture, with a gross value of raw milk production of \$4.1 billion in 2015–16.¹ More than two-thirds of Australian dairy production occurs in Victoria (see figure 1.1).

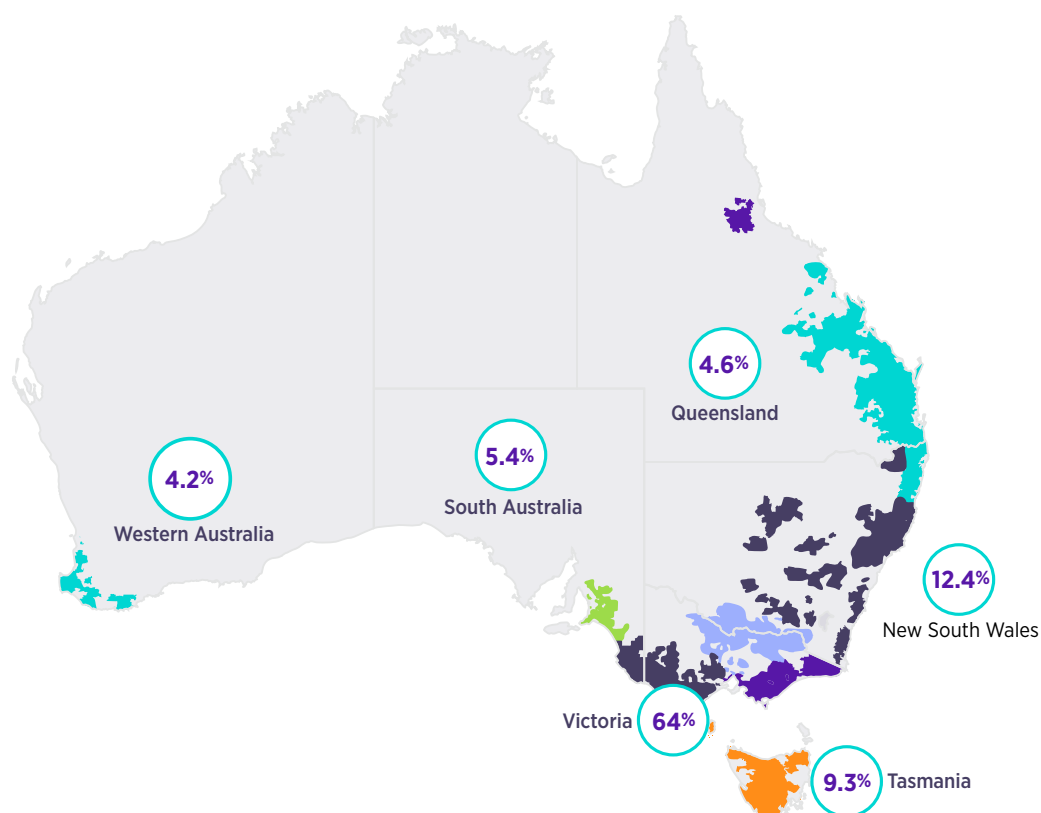
The national dairy cow herd was estimated at one and a half million head in 2016–17 (table 1.1).² The predominant breed is Holstein (or Holstein-Friesian), making up 75 per cent of Australian dairy cows, followed by Jersey cows.³ Jerseys are known for producing high fat content milk. The majority of dairy farms maintain a herd of cows for milking and a small number of other cattle, including heifers and bulls, for herd replacement and breeding.

1 Australian Bureau of Agricultural and Resource Economics and Sciences, *Agriculture commodity statistics 2016*, Department of Agriculture and Water Resources, December 2016.

2 Dairy Australia, *Australian Dairy Industry in Focus 2017*.

3 Dairy Australia, *Cows and Farms*, accessed 4 October 2017, <https://www.dairyaustralia.com.au/industry/farm-facts/cows-and-farms>.

Figure 1.1: Australian dairy production



Source: Dairy Australia data, processor's purchase data and ACCC analysis

Table 1.1: Australian dairy herd by state, 2016–17⁴

	Dairy cows ('000 head)	Share of national milk production ⁴	Average dairy cows per farm (head)
Victoria	995	64 per cent	256
New South Wales	165	12.4 per cent	250
Tasmania	145	9.3 per cent	330
Queensland	87	4.6 per cent	212
South Australia	65	5.4 per cent	270
Western Australia	55	4.2 per cent	372
Total	1512		261

Source: Dairy Australia, *Australian Dairy Industry in Focus 2017*, and ACCC analysis

Cows are generally milked twice daily, with milk then refrigerated on farm in bulk tanks until collected by the processor, generally within 24 to 48 hours. Drivers take milk samples from each vat at the time of collection using in-line sampling equipment located on the milk tanker. This is later tested for human health and quality parameters such as Bulk Milk Cell Count (BMCC), inhibitory substances or residues, and fat and protein content. Before accepting and loading the milk into the tanker, drivers check the temperature of the milk and also conduct a 'senses' test which involves checking if the vat contains any visible extraneous matter, discoloration or unacceptable odour.

While tests for human health parameters must be performed rapidly on-site before unloading, testing for qualities that impact payment, such as milkfat and protein content, may be performed by the processor in their own on-site laboratory, or by an accredited third party provider. See chapter 3 for further information on how milkfat and protein content impacts milk prices paid to farmers.

⁴ Dairy Australia, *Milk*, accessed 4 October 2017, <https://www.dairyaustralia.com.au/industry/production-and-sales/milk>.

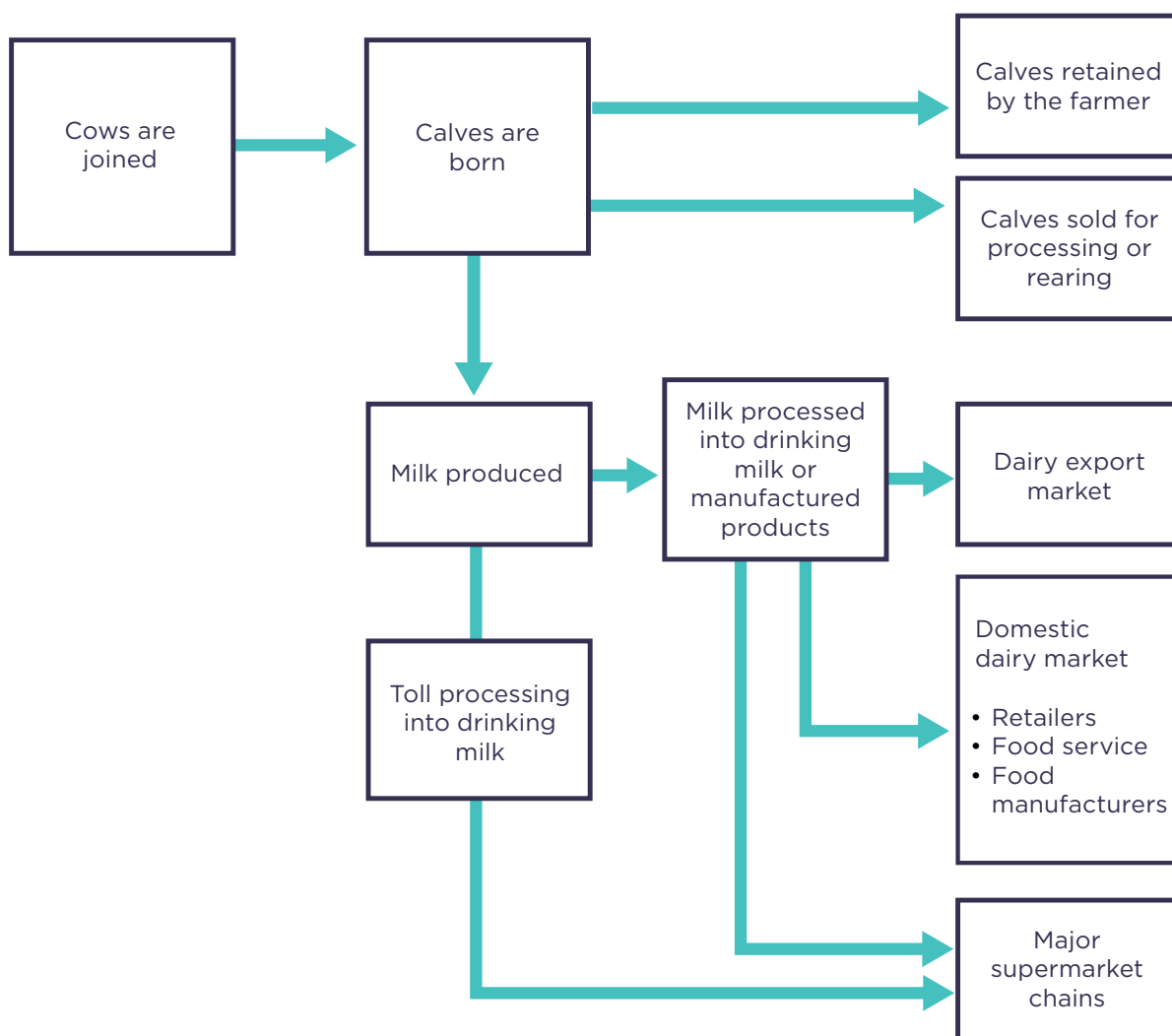
Processors submitted that the maximum distance it is financially viable to transport raw milk ex-farm typically ranges from 300 to 600 km. Financial viability depends on a number of factors, including the implications of seasonal conditions on meeting food safety standards (as an appropriate temperature must be maintained) market prices and time taken to transport the milk.

Depending on the processor and the intended end use, raw milk is generally pasteurised within 24 to 48 hours of collection from the farm. During spring when milk production is at its peak and storage capacity is under pressure, holding times may be reduced. Processors submitted the maximum time that raw milk can be stored is 72 to 120 hours.

Following pasteurisation, milk is further processed into drinking milk or exportable products such as cheese, butter, yogurt and milk powder. These products are then sold domestically (primarily through retail outlets, but also to food service and food manufacturing customers), or exported.

Over 90 per cent of the drinking milk, including long life milk, produced in Australia is consumed domestically, whilst the majority of milk powders and about half the cheese produced in Australia are exported. Major supermarket chains account for most fresh drinking milk sales. Figure 1.2 outlines in broad terms the Australian dairy supply chain.

Figure 1.2: Stylised supply chain diagram



1.2 Deregulation of the Australian dairy industry

The Australian dairy industry was fully deregulated on 1 January 2000 with the end of the Domestic Market Support Scheme (DMSS) and repeal of state legislation governing the sourcing and pricing of fresh drinking milk. The Australian Government created an eight year \$1.7 billion structural adjustment package to support the deregulation of the industry, funded by a consumer levy on dairy beverages which was applied at the rate of 11 cents per litre from July 2000 until February 2009.⁵

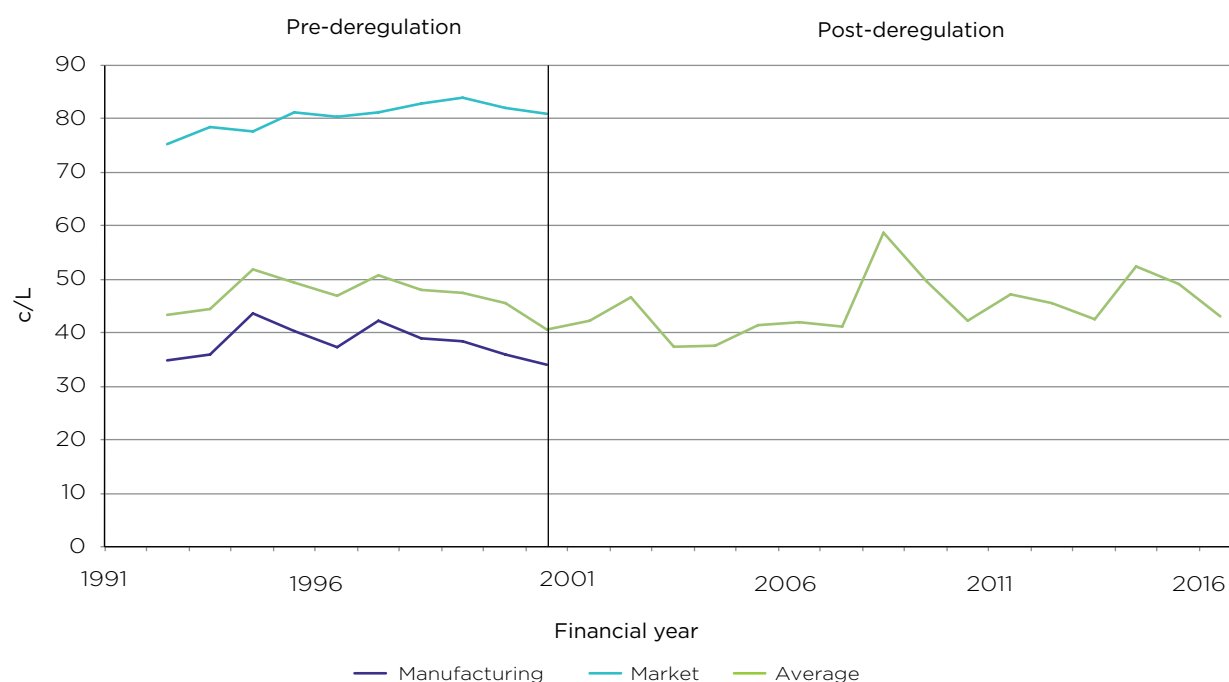
1.2.1 Milk production, price and support measures during regulation

During regulation, both state and federal governments implemented legislation that regulated the production, price and use of milk, as well as equalising dairy farmer returns. Milk production was designated by its use:

- market milk used to supply the drinking milk market, and
- manufacturing milk used to supply manufacturers of dairy products, such as cheese, butter and milk powder.⁶

Raw milk prices were set by state governments, with the price of market milk set significantly above that for manufacturing (figure 1.3). This reflected consumer demand for continuous fresh drinking milk supply throughout the year and the higher production costs associated with meeting these demands, particularly in regard to feed.⁷

Figure 1.3: Australian average farmgate milk prices, by use, real terms (2016 dollars)



Source: ABARES, Australian commodity statistics, accessed 15 September 2017

State governments also regulated the volume of raw milk production used to supply the drinking milk market. In some states farmers were allocated a specific quota, while other states operated milk pools where a specified proportion of each farm's production was allocated to the drinking milk market.⁸

⁵ Senate Rural and Regional Affairs and Transport References Committee, *Deregulation of the Australian Dairy Industry*, Department of the Senate, Canberra, 1999.

⁶ *ibid.*

⁷ David Harris, *Industry adjustment to policy reform: A case study of the Australian dairy industry*, Rural Industries Research and Development Corporation, August 2005.

⁸ Senate Rural and Regional Affairs and Transport References Committee, *Deregulation of the Australian Dairy Industry*, Department of the Senate, Canberra, 1999.

Although manufacturing milk was not subject to production controls, the federal government operated an income support scheme for producers. This reflected the difference between market and manufacturing milk prices, resulting from the exposure of manufactured dairy products to international markets.

The DMSS imposed two levies on domestic milk production. The first was a levy paid by dairy farmers on milk used to supply the drinking milk market and the second was a levy paid by manufacturers on dairy products sold in the domestic market. The monies generated from these levies were then paid to dairy farmers based on the volume of milk used for the manufacture of dairy products.⁹

1.2.2 The industry consolidated following deregulation

Pressure to achieve improved productivity and efficiency resulted in consolidation of Australian dairy farm numbers for several decades prior to deregulation. However, the end of regulated prices for fresh drinking milk meant that dairy regions underwent further structural adjustment. In addition, many farms accepted deregulation exit payments (under the Dairy Program Exit Scheme 2000) and left the industry.¹⁰

Consequently, while the number of farms has fallen in all states, the largest declines have occurred where raw milk was produced mostly for the fresh drinking market. Between 1999–2000 and 2016–17, farm numbers fell 62 per cent in NSW, 73 per cent in Queensland, 64 per cent in SA and 65 per cent in WA. Lower production costs contributed to fewer exits in Victoria and Tasmania, where farm numbers fell by 50 and 40 per cent, respectively.¹¹ Nationally, the number of dairy farms has fallen 55 per cent over the same timeframe.¹²

Small-scale farms, with total capital of less than \$3 million, accounted for the entire decline in dairy farm numbers.¹³ Consolidation has resulted in increased average milk production per farm in all states (figure 1.4). While large numbers of small-scale producers exited, others expanded, increasing the number of farms with total capital of between \$3 and \$8 million, which now account for the majority of milk production, although farms with total capital of over \$8 million account for an increasing proportion.¹⁴

9 Senate Rural and Regional Affairs and Transport References Committee, *Deregulation of the Australian Dairy Industry*, Department of the Senate, Canberra, 1999.

10 Dairy Australia, *History of Australian dairy industry deregulation*, accessed 15 October 2017, <https://www.dairyaustralia.com.au/about-dairy-australia/about-the-industry/history-of-australian-dairy-industry-deregulation>.

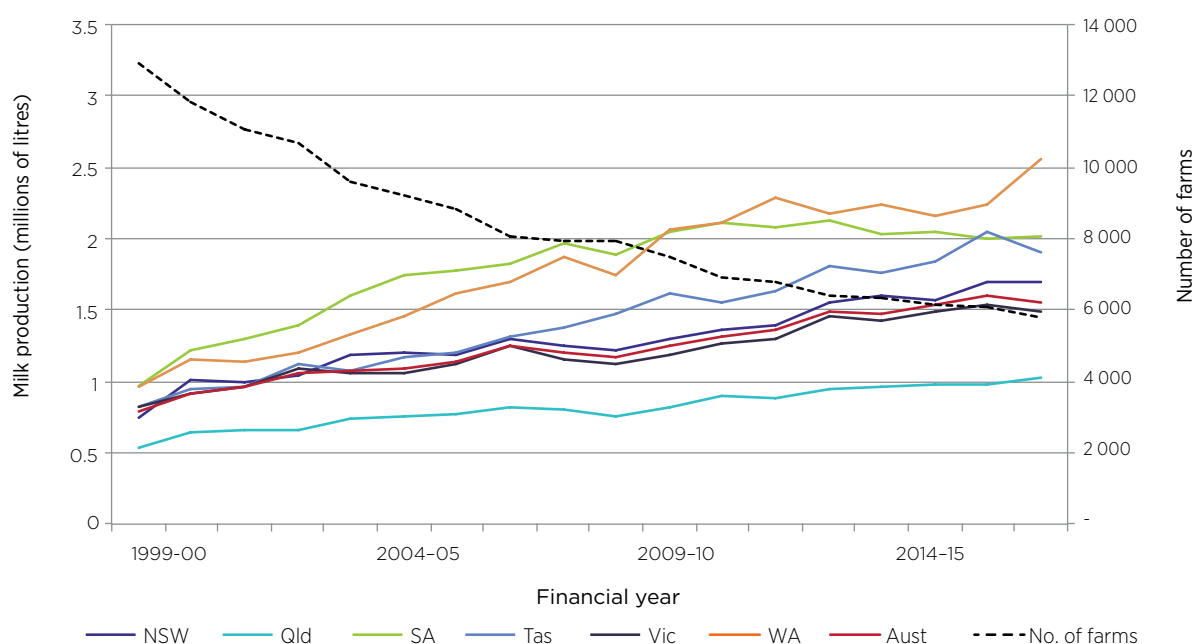
11 Dairy Australia, *Australian Dairy Industry in Focus 2017*.

12 *ibid.*

13 Peter Martin, Walter Shafron and Paul Phillips, *Australian dairy: Financial performance of dairy farms 2013–14 to 2015–16*, Australian Bureau of Agriculture and Resource Economics and Sciences, 2016.

14 *ibid.*

Figure 1.4: Average raw milk production (per farm)



Source: Dairy Australia, state milk authorities, dairy manufacturers, and ACCC analysis

1.2.3 Australia's milk production is increasingly stable

Total national milk production averaged just over 9.3 billion litres per year for the 10 years to 2016-17 (figure 1.5) and was relatively steady year-to-year, fluctuating by no more than 4 per cent around the 10-year average. Season-to-season, production has risen or fallen between 1 and 4 per cent, except in 2016-17, when it was 6 per cent below the 2015-16 level.

Raw milk production has, however, fallen significantly in some states. In Queensland, 2016-17 production was 45 per cent of the 2000-01 total, while in SA production was 30 per cent. Current production in Victoria, NSW and WA is also lower than in 2000-01.

In contrast, Tasmania has exhibited strong growth, with total 2016-17 production being 142 per cent of 2000-01 levels. Hence, processors in some states have faced greater challenges than others in maintaining volume throughput.

Figure 1.5: Raw milk production over time



Source: Dairy Australia data, state milk authorities

1.3 Climate and customer focus strongly influences competition and prices

1.3.1 Different demand factors in each dairy region

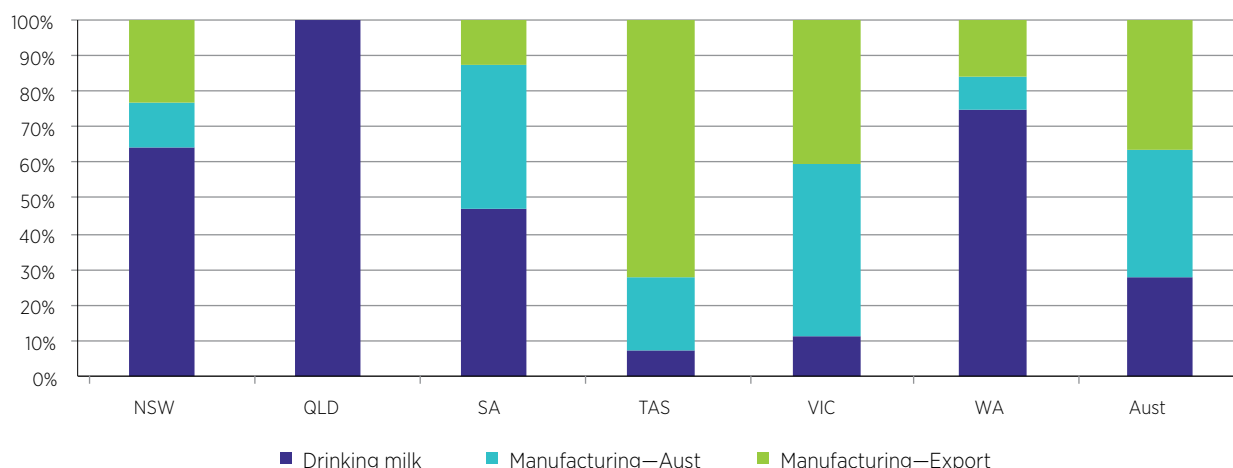
The ACCC's analysis indicates that competition between processors primarily takes place across nine distinct regions: eastern Victoria (Gippsland), the Murray region (encompassing northern Victoria and southern NSW), Western Victoria (extending into south east SA), SA, Tasmania, central NSW, northern NSW/southern Queensland¹⁵, Far North Queensland (FNQ) (Tablelands region), and WA. This analysis is discussed further in chapter 4.

The production focus of each region affects competition for raw milk. For example, figure 1.6 demonstrates that in 2016-17, all raw milk produced in Queensland was used to manufacture fresh drinking milk. Similarly, in NSW and WA the majority of raw milk was used to manufacture fresh drinking milk, while in SA about 40 per cent was used to manufacture dairy products for the domestic market. In Victoria, about 40 per cent of milk was used to manufacture dairy products for export, and in Tasmania this figure was about 72 per cent. Victoria and Tasmania produce much less fresh drinking milk relative to exportable products than other states, at about 11 per cent and seven per cent respectively.¹⁶

¹⁵ Low milk production volumes and farm numbers in central Queensland mean it has not been defined as a distinct region.

¹⁶ Dairy Australia, *Australian Dairy Industry in Focus 2017*.

Figure 1.6: Use of Australian milk by state 2016–17



Source: Dairy Australia, Australian Dairy Industry in Focus 2017.

Export-focused regions

The total supply of raw milk in export-focused regions exceeds domestic fresh drinking milk demand. The surplus is therefore used to manufacture dairy products for export, exposing processors to fluctuations in global dairy commodity prices. Processors therefore compete more strongly for shares of raw milk supply in periods where global market conditions are favourable, and less so when they are not.

At times when raw milk supply is high and/or global demand is weak, competition for raw milk acquisition may be subdued because supply exceeds processors' demand.

Domestic-focused regions

In the Northern and WA region, where processors are primarily exposed to domestic wholesale prices and volume demand, the industry is typically more stable than in global markets. In these regions, private label contracts are a key factor influencing demand for raw milk, and processor market shares for raw milk purchases vary less year-to-year, although there may be significant periodic shifts.

Traditionally, relatively stable domestic market conditions have meant that processors in these regions enter into longer term supply agreements with farmers. Fixed-term contracts with common expiry dates are much more common than in export-focused regions (see chapter 3). These arrangements mean that competition for raw milk acquisition is most intense around the times of contract renewal, and there is less scope for farmer switching during the contract period. As a result, market shares for raw milk acquisition are relatively stable.

Effective competition for raw milk appears to be weakest in central Queensland and FNQ. Farmers at these locations have only one major processor that farmers can sell to. In other regions such as WA, central NSW and northern NSW/southern Queensland, processors must compete with at least two other processors for milk supply. The major processors in each region are detailed in chapter 4.

Competition between processors is generally strongest when local raw milk supply is insufficient to meet local demand. Production is lower than consumption in Queensland, and this has been the case at times in WA and SA. In these circumstances, if processors wish to maintain factory throughput they must win supply from rivals in the region, encourage increased raw milk production, or transport raw milk from other regions (see box 1.1).

Farmgate milk prices in Queensland, SA and WA are therefore often constrained by the farmgate price in other regions, plus the cost of transport. Price competition of this nature was envisaged at the time of deregulation, when it was expected that "all markets [would] eventually move into parity with Victoria, with some premiums remaining to reflect transport costs and other local supply advantages."¹⁷

¹⁷ Dairy Industry Adjustment Bill 2000, Explanatory Memorandum.

For example, declining farmgate milk prices in Victoria over the last three years, combined with steady farmgate prices in northern NSW and Queensland, have raised the incentive for processors to transport raw milk north. The ACCC understands that the current cost to freight raw milk from Victoria to Queensland is approximately 17 cents per litre. For the last five dairy seasons, the average Queensland price has been 10 to 16 cents per litre more than the Victorian price, except for 2013-14 where there was approximately three cents per litre difference.¹⁸ This suggests that maximum northern raw milk prices are constrained by southern prices, and thus to some extent indirectly influenced by global price fluctuations.

Box 1.1: Raw milk transport costs influence competition

Perishability and transport costs are the two main constraints on the distance that raw milk can be moved, and therefore the extent to which processors can compete for farmers who are not located close to their processing plants.

Haulage rates are calculated on a cents per litre basis. These calculations incorporate a range of factors including distance, labour costs, administrative costs and depreciation on vehicles.

Haulage companies primarily transport raw milk from farms to processors. To increase efficiency they commonly use the same tanker when collecting from farmers located close to one another but supplying different processors.

Intra-plant transport also occurs, but it is generally between two facilities owned by the same processor. On occasions, the companies transport component loads consisting of cream or skim milk concentrate. No companies the ACCC spoke to transport bulk pasteurised milk.

The average distance raw milk is transported varies from company to company and by state. Data analysis showed that the average distance is about 150 to 200 km, with the maximum distance being 600 km. The ACCC understands that it is technically possible to transport raw milk significantly further, but it is not financially viable to do so, and it is generally for the purposes of meeting a short term need or gap in local production. Where milk is being transported very long distances, it is more likely to be pasteurised and bottled, such as milk transported from SA to NT.

1.3.2 Unique supply factors of each dairy region

Climate impacts production methods and costs

Dairy production mainly occurs in high rainfall areas in coastal regions, with inland production supported by irrigation. Year round pasture growth is supported in Victorian production systems by relatively high rainfall in Gippsland and Western Victoria, and irrigation in northern Victoria and southern NSW. In contrast, pasture growth in Queensland and WA is generally less consistent and of comparatively lower quality, hence farms in these states rely more heavily on supplementary feed.

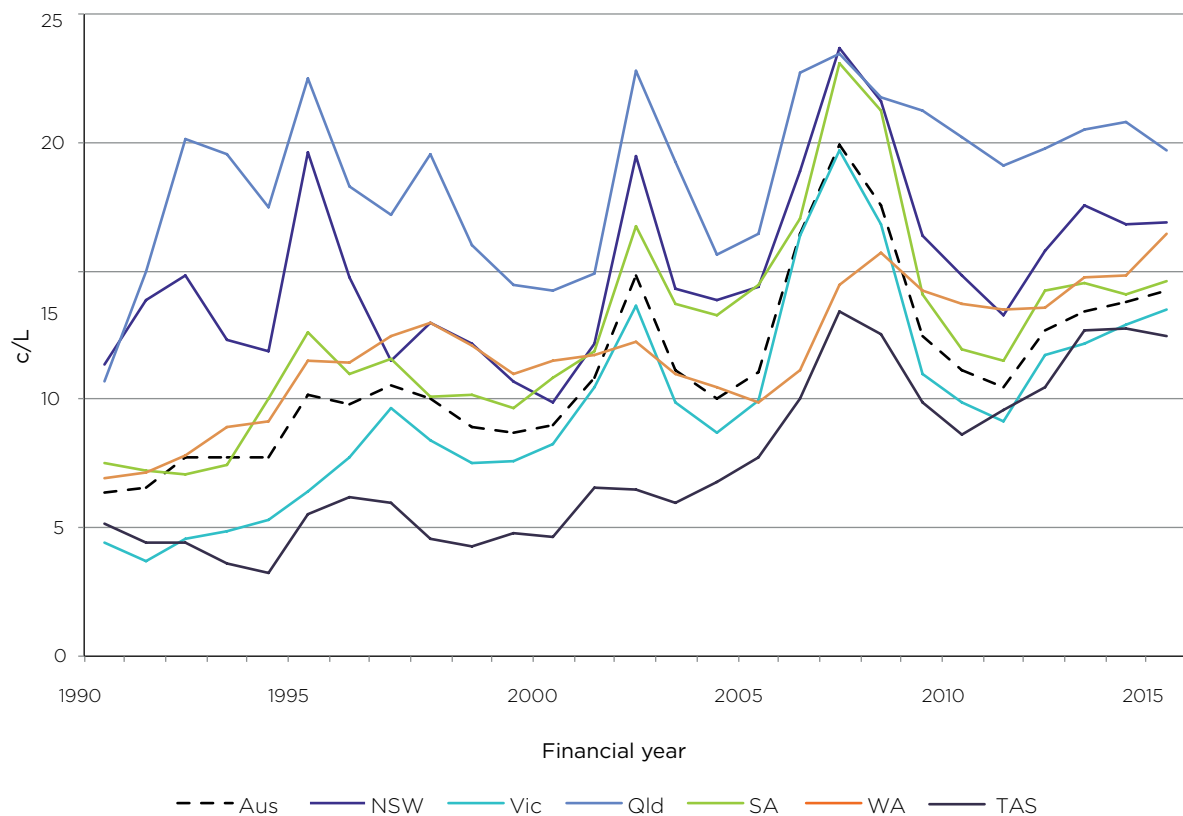
Climatic conditions and business management preferences influence the feeding system employed on-farm, ranging from pasture based with little use of supplementary feed to a high reliance on purchased including grain and fodder. Pasture production is generally the lowest cost manner in which to feed cows, giving farmers in south-eastern Australia comparative cost advantages. Figure 1.7 demonstrates the variability in purchased fodder costs between states and the change over time (for more detail on farm profitability over time, see section 1.6).

This comparative advantage is reflected in the concentration of manufacturing facilities and farms in Victoria, where raw milk in excess of local drinking demand is used to produce a greater range of products, such as cheese, butter and milk powders. Many of these are long shelf life products. Lower production costs in the state also mean that manufacturers can compete effectively in export markets.

The higher costs of production in Queensland and WA mean that production from these farms generally cannot compete to supply raw milk for manufacturing. Instead, these farms focus on producing drinking milk for domestic consumption. This higher cost base is reflected in the recent reduction of milk intake by processors in WA as processors in the state withdrew from export markets and reduced their demand for raw milk.

¹⁸ Dairy Australia, *Australian Dairy Industry in Focus 2016*, p. 10.

Figure 1.7: Fodder costs per litre of milk produced



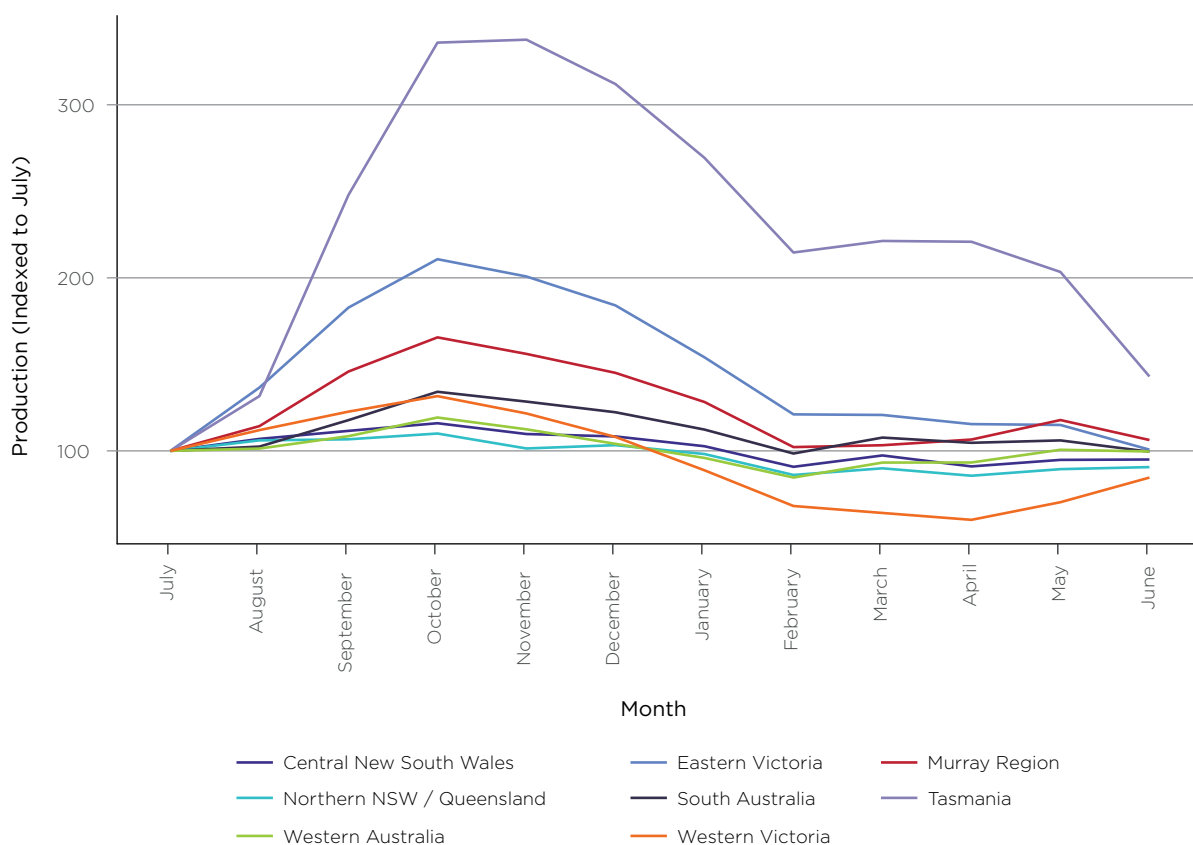
Source: ABARES Agsurf database

Seasonality of milk production varies between regions

The end use of milk requires dairy farmers to adopt different production practices. Processors who manufacture fresh drinking milk require consistent volumes throughout the year as consumer demand is flat.

In contrast, processors who produce longer shelf life products are generally able to accommodate variations in the volume of raw milk supply. These processors are typically located in export-focused regions. As can be seen in figure 1.8, raw milk production in these states is more seasonal than in domestic-focused regions, exhibiting a strong peak during spring and lower production in the autumn–winter months.

Figure 1.8: Relative variation in raw milk production throughout the season



Note: Five-year average 2012–13 to 2016–17

Source: Dairy Australia data

The time at which dairy herds calve has a strong influence on the variability of milk production throughout a season.¹⁹ Calving systems can be broadly described as seasonal (all cows calve in a single time period, generally spring or autumn), split (cows calve in two or three distinct time periods, generally spring and autumn), or year-round (cows calve throughout the year).

Of the seasonal calving systems, spring calving results in a strong peak in production in the spring months, autumn calving an autumn peak, split calving both spring and autumn peaks, and year-round calving produces more consistent production throughout the year.

Consequently, favoured calving practices vary depending on the focus of the region, and the processors that can be supplied by a farm. While year-round calving occurs to some extent in all states, it is the predominant system in NSW, Queensland and WA. Southern regions see a greater proportion of split and seasonal calving. In these regions, the highest peaks in spring milk production have the greatest reliance on spring calving.

As cows have an increased energy requirement during their peak production period, it is generally considered to be cheaper for farmers to follow a spring calving pattern, when pasture growth is greatest. Autumn, split or year-round calving requires greater use of supplementary feed, increasing both production costs and risk exposure.

¹⁹ Milk yield increases during the first months of a lactation period, which lasts around 305 days. This is followed by a dry period of around 50–70 days before a cow gives birth to a calf, beginning a new lactation period.

1.4 A number of competing processors produce a broad range of dairy products

1.4.1 Australia produces a range of dairy products for domestic and export markets

Australian raw milk production was just over 9 billion litres in 2016–17, falling from over 9.5 billion litres in 2015–16. While there is significant regional variation in end products manufactured from raw milk, a primary use is cheese. Cheese production accounted for about 33 per cent of milk utilisation in 2016–17 and resulted in production of around 336 742 tonnes (figure 1.9). Almost 30 per cent of milk production was used for drinking milk, including fresh and long life, and just over a quarter of milk production was used in the manufacture of co-products²⁰ butter (85 869 tonnes) and SMP (222 109 tonnes) in the 2016–17 financial year.²¹

In 2016–17, around 2.5 billion litres of drinking milk were produced for sale on the domestic and international market. Much smaller shares of milk production were used in the manufacture of WMP (just under 60 000 tonnes) and a range of other products, including whey products, yoghurts, dairy desserts and ice cream.²²

Major supermarket chains account for a large proportion of domestic sales of dairy products, representing about 56 per cent of domestic fresh drinking milk sales in 2016–17. About 51 per cent of dairy manufacturers' total domestic sales of cheese was sold to major supermarket chains. Supermarket chains represented the majority of dairy manufacturers' domestic sales of most dairy products in 2016–17, with the exception of milk powders and cream.²³

Australia exported about 797 000 tonnes of dairy products in 2016–17, generating \$3 billion in export revenue. Exports accounted for approximately 37 per cent of total milk production. Milk powders and cheese accounted for the majority of exported dairy products in 2016–17.²⁴ See section 1.5.2 for further discussion of sales channels.

20 Butter and SMP are manufacturing co-products. Butter uses the majority of the fat component of the milk, with the resulting skim milk component commonly dried into powder.

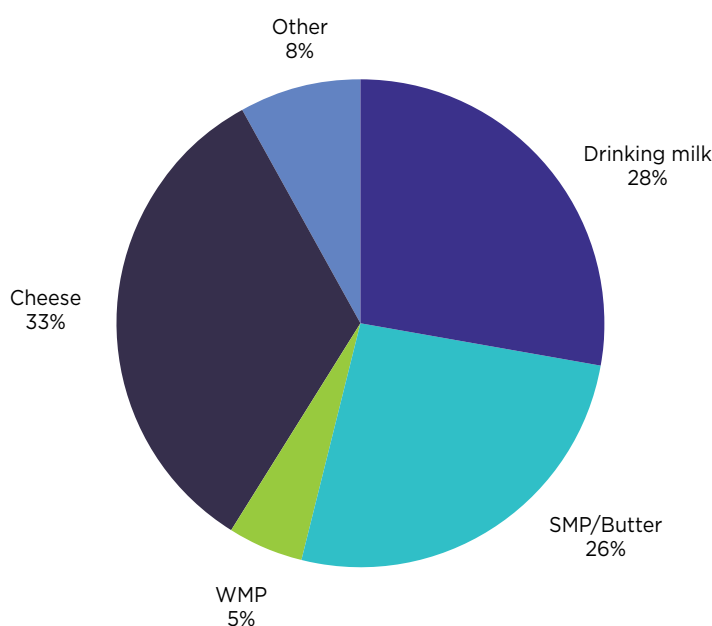
21 Dairy Australia, *Australian Dairy Industry in Focus 2017*.

22 Dairy Australia, *Australian Dairy Industry in Focus 2017*.

23 *ibid.*

24 *ibid.*

Figure 1.9: Milk utilisation 2016–17



Notes: Drinking milk includes fresh and long life milk; other includes yoghurt, dairy desserts, whey protein etc. SMP and butter are co-products

Chart measures utilisation in Milk Equivalents, or the quantity of raw milk required to furnish the milk solids in a manufactured dairy product

Source: Dairy Australia, Australian Dairy Industry in Focus 2017

1.4.2 The processing sector

The Australian processing sector is characterised by several major processors and a relatively large number of smaller operators (figure 1.10).²⁵

The major processors include:

- **Murray Goulburn Co-operative Co. Limited (Murray Goulburn):** a co-operative operating 11 processing facilities in Victoria, Tasmania and NSW, drawing raw milk from those states and SA. In 2014–15, Murray Goulburn processed around 3.6 billion litres of milk, equivalent to around 37 per cent of Australian milk production.²⁶ Given its scale of operations, Murray Goulburn produces a full range of dairy products (cheese, butter, fresh drinking milk, butter, cream and milk powders) and services both domestic and export customers. In 2014–15, around 55 per cent of company revenue was derived from domestic market sales.²⁷ In May 2017, Murray Goulburn announced the closure of three processing plants in northern Victoria and Tasmania following large drops in its milk supply and revenue.²⁸
- **Fonterra Australia Pty Ltd (Fonterra):** a subsidiary of Fonterra Co-operative Group Limited, based in New Zealand. Fonterra operates eight facilities in NSW, Victoria and Tasmania, processing around 1.6 billion litres of milk a year. The company produces a full range of dairy products servicing domestic and export customers.²⁹

²⁵ Major processors acquire a significant volume of milk (i.e. above 500 million litres per season).

²⁶ Murray Goulburn Co-operative Co. Limited, *Supplier handbook, Southern milk region 2016/17*, accessed 01 February 2017, mgc.com.au/media/36238/2016_17southernmilkregion_supplierhandbook.pdf.

²⁷ Murray Goulburn Co-operative Co. Limited, *Facts at a glance*, accessed 01 February 2017, mgc.com.au/media/30385/mg_facts_at_a_glance_web_9112015.pdf.

²⁸ John Durie and Sue Neales, *Murray Goulburn to close three facilities, 'forgive debt'*, The Australian, May 2 2017, accessed 23 October 2017, <http://www.theaustralian.com.au/business/companies/murray-goulburn-to-close-three-facilities-forgive-debt/news-story/ad45fe547f3c42df336c420768ab25a8?nk=bbe5591c40777abac695ad22f54cf363-1510806674>.

²⁹ Fonterra, *Fonterra in Australia*, accessed 01 February 2017, fonterra.com/au/en/About/Our+Locations/Australia.

- **Lion Dairy and Drinks Pty Ltd (Lion):** a business division of Lion Pty Ltd, formerly trading as Lion Nathan National Foods, owned by Kirin Holdings Company Limited. Lion operates 11 processing plants across all the eastern states, and one in WA, processing around one billion litres of milk a year. The company produces a full range of dairy products servicing domestic and export customers.³⁰
- **Parmalat Australia Limited (Parmalat):** a subsidiary of Italian parent company Parmalat, which is owned by Lactalis Group, a family-owned multinational based in France. Parmalat operates 12 facilities across all states and territories, with the exceptions of Tasmania and the ACT, buying about one billion litres of milk a year from farmers.³¹
- **Warrnambool Cheese and Butter Limited (WCB):** owned by Canadian dairy company Saputo. WCB operates a processing plant at Allansford, Victoria and packaging plants at Allansford and Mil Lel, SA, processing around 900 million litres of milk a year.³² The company produces a full range of dairy products, servicing export markets, domestic retailers, food manufacturers and other bulk ingredient users.
- **Bega Cheese Limited (Bega):** operates seven facilities across NSW and Victoria, processing around 650 million litres of milk a year. The company primarily supplies cheese and bionutrients (used for infant formula), with smaller amounts of milk powder. Major customers include export markets, domestic retail, food manufacturing and the food service industries.³³

Smaller processors include:

- **Burra Foods Australia (Burra):** operates a single facility at Korumburra, Victoria, processing around 300 million litres of milk a year. The company supplies a range of products for food preparation and in bulk (fresh cheese, cream and liquid milk) and milk powders, including those suitable for use in infant formula.³⁴
- **Norco Co-operative Limited (Norco):** a farmer-owned co-operative established in NSW. Norco operates three facilities in NSW and Queensland, processing around 200 million litres of milk a year. The company produces a wide range of dairy products, including fresh white and flavoured milk, butter, cheese, cream and dairy desserts. The majority of Norco production is sold on the domestic market, with smaller volumes of fresh drinking milk and ice cream exported primarily to China and Japan.³⁵
- **Bulla Dairy Foods (Bulla):** operates four facilities in Victoria, processing around 120 million litres of milk a year. The company supplies a range of products for retail sale and for use in the food service, quick service restaurant and food and beverage manufacturing industries, including yoghurt, ice cream, cream and fresh cheese.
- **Brownes Foods Operations Pty Ltd (Brownes):** operates two facilities in WA, processing around 144 million litres of milk a year. The company supplies a range of drinking milk, yoghurt and cream products for domestic retail sale and also produces limited volumes of cheese.³⁶ In November 2017, Brownes' parent company Archer Capital announced the sale of the company to Shanghai Ground Food Tech.³⁷

30 Lion Pty Ltd, *Milk beverages & alternatives*, accessed 01 February 2017, lionco.com/our-brands/milk-beverages/white-milk.

31 Parmalat Australia Ltd., Submission to Senate Inquiry into corporate avoidance of the *Fair Work Act 2009*, 2016.

32 Grant Thornton, *Warrnambool Cheese and Butter Factory Company Holdings Limited*, Independent expert's report and financial services guide, 2015, accessed 01 February 2017, wcbf.com.au/Content/INVESTORS/Annual-General-Meeting/Warrnambool-Cheese-and-Butter_IER_FINAL_2015-03-26.aspx.

33 Bega Cheese Limited, *Contact Us*, accessed 01 February 2017, begacheese.com.au/contact-us/; Bega Cheese Limited, *Annual report 2016*, accessed 01 February 2017, begacheese.com.au/wp-content/uploads/2012/10/00-Bega-Cheese-2016-Annual-Report-interactive.pdf.

34 Burra Foods Australia, *Operational capability*, accessed 01 February 2017, <http://www.burrafoods.com.au/our-business/operational-capability>.

35 Norco, *Annual report 2016*, accessed 01 February 2017, norco.com.au/wolfAdmin/uploads/norco-annual-report-2016-web_001.pdf.

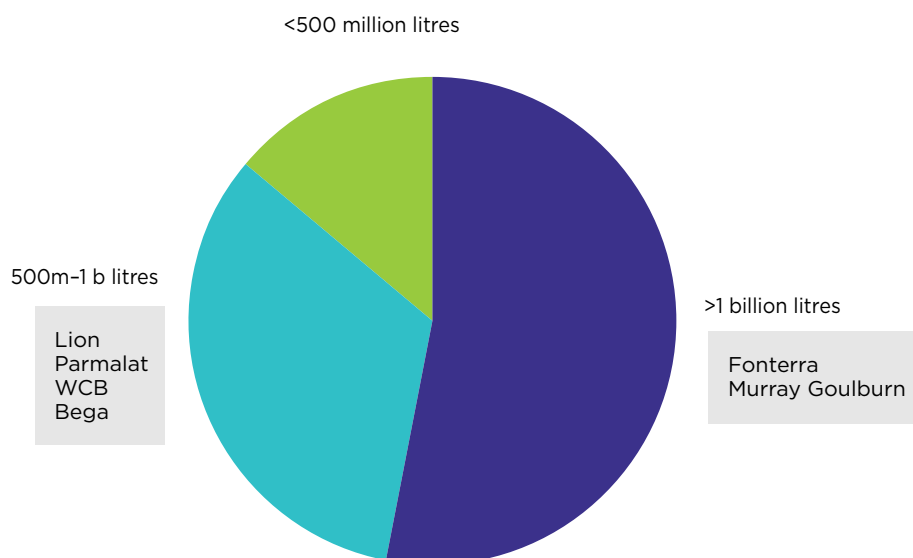
36 Brownes Dairy, *Our story*, accessed 01 February 2017, brownesdairy.com.au/our-family/.

37 Rebecca Trigger, Bridget Fitzgerald and Briana Shepherd, *Brownes Dairy sold to Chinese firm Shanghai Ground Food Tech*, 14 November 2017, accessed 15 November 2017, <http://www.abc.net.au/news/2017-11-14/brownes-dairy-sold-to-shanghai-ground-food-tech/9149776>.

- **Union Dairy Company (UDC)** is a new entrant that commenced operating in August 2017. UDC is a joint venture between The Midfield Group (a meat processing company) and the Louis Dreyfus Company. It has a processing plant based in Penola, south east South Australia, with an inward capacity of 250 million litres of milk a year.³⁸ UDC manufactures milk powders, anhydrous milk fat and cream, servicing both domestic and export markets.

In addition to those listed above, there are a number of other small processors who can be identified as niche or micro-processors. These businesses process relatively low volumes of milk, generally for the production of niche products or for regional markets. Examples of niche dairy processors include Maleny Dairies in Queensland, Fleurieu Milk Company in SA, and several specialty cheese manufacturers.

Figure 1.10: Share of national milk intake 2015–16



Note: <500 million litres includes Brownes, Bulla, Burra Foods, Maleny Dairies, Norco, Woolworths and others. The ACCC notes that processors' share of milk intake varies across dairy regions.

1.4.3 Consolidation and capacity of the processing industry

There has been consolidation of dairy processing assets since deregulation (see appendix 2). Fonterra undertook a number of acquisitions throughout the early to mid-2000s, most notably Bonlac Foods in 2006, to become Australia's second largest processor by milk intake.³⁹ Another notable acquisition was of Dairy Farmers by National Foods (now Lion) in 2008, which added significant capacity to National Foods' dairy operations.⁴⁰ Over this period there were also a number of smaller acquisitions, including the divestment of assets⁴¹ and processors seeking growth opportunities in a specific region or product category.

38 Simone Smith, *Union Dairy Company insists it has surplus milk capacity*, *The Weekly Times*, 14 June 2017, accessed 22 March 2018, <https://www.weeklytimesnow.com.au/agribusiness/dairy/union-dairy-company-insists-it-has-surplus-milk-capacity/news-story/37108137373c64ff8f5f25efe82e3a9d?nk=9b17a54ecf77f2896eb48b15ab32f3b8-1521696021>.

39 Phillip Hopkins, *Fonterra set to milk Australia*, *The Age*, 8 June 2005, accessed 01 February 2017, theage.com.au/news/Business/Fonterra-set-to-milk-Australia/2005/06/07/1118123840030.html.

40 New York Times, *National Foods makes offer for Dairy Farmers*, 25 August 2008, accessed 01 February 2017, nytimes.com/2008/08/25/business/worldbusiness/25iht-dairy.1.15599774.html.

41 For example Parmalat's acquisition of former Dairy Farmers assets from National Foods. Lion Pty Ltd, *Parmalat to acquire certain fresh milk operations from national foods*, 20 May 2009, accessed 01 February 2017, lionco.com/media-centre/parmalat-to-acquire-certain-fresh-milk-operations.

In more recent times, acquisition activity has been undertaken by a number of foreign investors (for example, Saputo's acquisition of WCB in 2014⁴² and Fuyuan Farming Co's acquisition of a controlling interest in Burra Foods in 2016⁴³), and businesses seeking to vertically integrate (for example, Beston Global Foods acquisition of United Dairy Power assets⁴⁴). In November 2017 it was announced that Shanghai Ground Food Tech acquired Brownes Dairy.⁴⁵

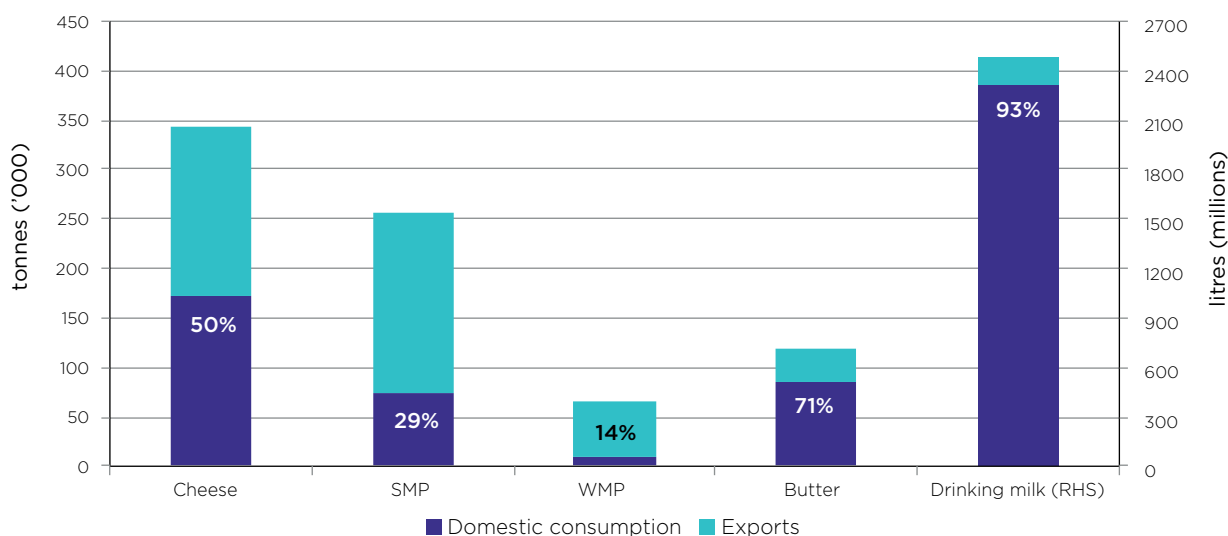
Since 2009–10, total national processing capacity for fresh drinking milk, milk powder and cheese has increased as facilities have been expanded and new plants have been commissioned. Capacity to produce butter has been relatively steady.

1.5 Domestic and export markets influence farmgate milk prices around Australia

1.5.1 The majority of production is consumed domestically

The majority of Australian dairy production is consumed domestically, primarily as drinking milk, cheese, yoghurt and butter. Milk powders and cheese accounted for the majority of exported dairy products (figure 1.11).

Figure 1.11: Share of production consumed domestically by major product, 2015–16



Note: drinking milk includes fresh and long life milk and is referred to on the right hand axis.

Source: ACCC estimate using ABS data.

In 2016–17, domestic consumption of drinking milk was estimated at 103 litres per person. For the same period, consumption of cheese, yoghurt and butter was estimated at around 13 kg per person, 7 kg and 5 kg, respectively. Per person consumption of dairy products has been relatively stable over the past decade, with total consumption primarily increasing through population growth.

⁴² Warrnambool Cheese and Butter, *About Us*, accessed 17 October 2017, <http://www.wcbf.com.au/About-Us/About-Us>.

⁴³ Australian Food News, *Burra Foods sells out 79 per cent to Chinese company*, 11 May 2016, ausfoodnews.com.au/2016/05/11/burra-foods-sells-out-79-per-cent-to-chinese-company.html.

⁴⁴ Simone Smith, *Beston investment into South Australian dairy industry welcome*, *The Weekly Times*, 05 August 2015, accessed 01 February 2017, weeklytimesnow.com.au/agribusiness/dairy/beston-investment-into-south-australian-dairy-industry-welcomed/news-story/9caf41ad2f98b9ee118cc1af1243ff2f.

⁴⁵ Rebecca Trigger, Bridget Fitzgerald and Briana Shepherd, *Brownes Dairy sold to Chinese firm Shanghai Ground Food Tech*, 14 November 2017, accessed 15 November 2017, <http://www.abc.net.au/news/2017-11-14/brownes-dairy-sold-to-shanghai-ground-food-tech/9149776>.

1.5.2 Domestic sales channels

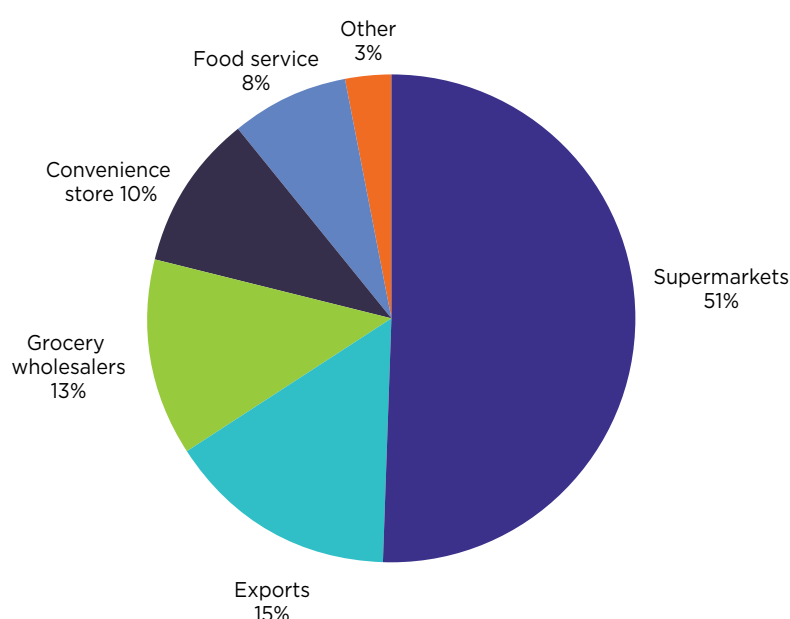
Supermarkets represent the largest channel for domestic dairy sales (38 per cent) followed by route/convenience stores (33 per cent) and food services/hospitality (27 per cent). Major supermarket chains account for over half of domestic fresh drinking milk sales. Figure 1.12 presents the share of domestic sales by channel for milk and cream, cheese, and butter and other dairy products.

Within supermarkets, private label brands accounted for 61 per cent of regular full fat and 50 per cent of modified fresh white milk sales in 2016–17.⁴⁶ Although these shares have remained relatively stable over the past five years, there have been changes in sales by pack size. Over the last decade, 2 litre bottles have remained relatively stable with a share of 47 per cent, while one litre cartons and bottles have fallen from 33 per cent to 16 per cent, offset by increased sales of three litre bottles.⁴⁷

Private label cheese accounted for around 35 per cent of supermarket cheese sales in 2014.⁴⁸

Figure 1.12: Sales channels for domestically manufactured dairy products⁴⁹

Milk and cream



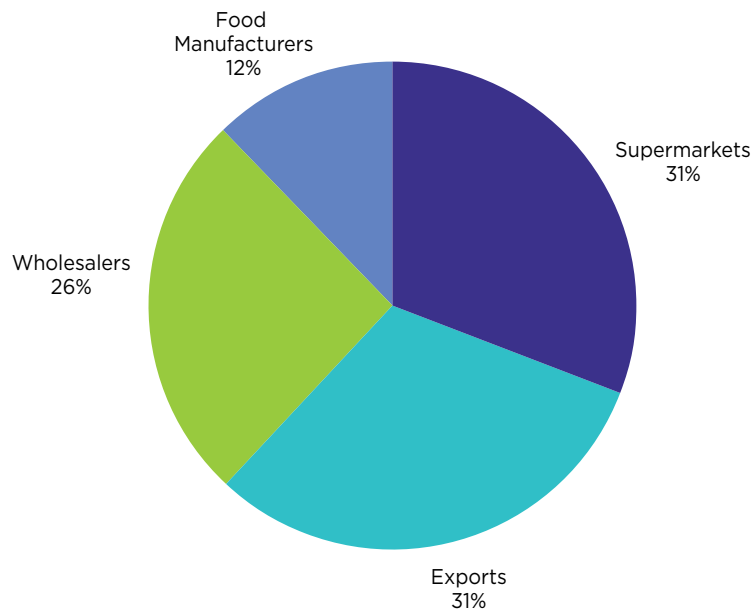
⁴⁶ Dairy Australia, *Australian Dairy Industry in Focus 2017*.

⁴⁷ Dairy Australia, *Domestic sales summary*, accessed 01 February 2017, dairyaustralia.com.au/Markets-and-statistics/Production-and-sales/Domestic-Sales-Summary.aspx.

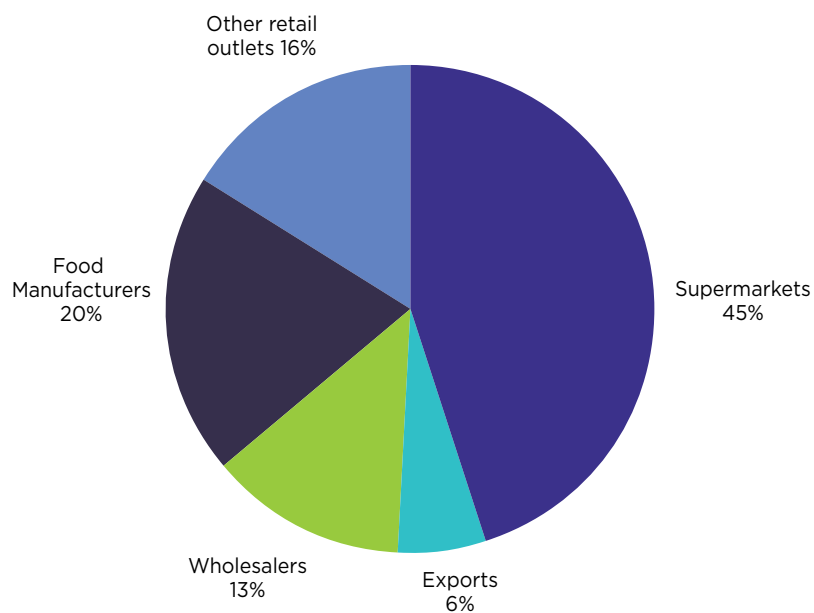
⁴⁸ Dairy Australia, *Dairy situation and outlook, February 2014 update*, Melbourne, dairyaustralia.com.au/-/media/Documents/Stats%20and%20markets/S%20and%20O/S%20and%20O%20Feb%202014/LANDSCAPE%20SO%20FebWEBFINAL3.pdf, accessed 01 February 2017.

⁴⁹ IBISWorld industry reports, *Cheese Manufacturing in Australia*, accessed 31 January 2017, clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=1856; IBISWorld industry reports, *Butter and Dairy Product Manufacturing in Australia*, accessed 31 January 2017, clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=96; IBISWorld industry reports, *Milk and Cream Processing in Australia*, accessed 31 January 2017, clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=94.

Cheese



Butter and other dairy products



Notes: Milk and cream includes fresh and long life drinking milk and cream; butter and other dairy include butter (32 per cent), proteins (23 per cent), yoghurt (10 per cent), condensed milk (7 per cent) and other (28 per cent), e.g. flavoured milk, ice cream mix and milk based stock feeds

Imports

Australian imports of dairy products were valued at \$1.77 billion in 2016–17. New Zealand is the single largest source followed by the European Union and the United States.

Imports of milk powder (including infant formula) and butter are mostly used as food ingredients in the manufacturing sector.⁵⁰ Cheese imports from New Zealand and the United States are mainly lower value processed and block cheeses, while those from Europe tend to be higher value specialty cheeses, such as Gouda, parmesan and brie.⁵¹

⁵⁰ Dairy Australia, *Australian Dairy Industry in Focus 2016*.

⁵¹ *ibid.*

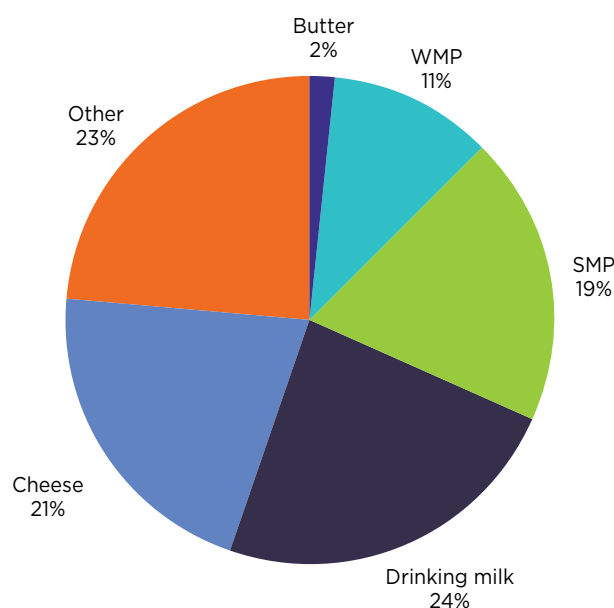
1.5.3 Exports

A large proportion (37 per cent in 2016–17⁵²) of Australian milk production is exported in various forms. Consequently, some processors and many dairy farmers are exposed to movements in international markets. This is particularly the case in regions that supply large volumes of milk for exportable products, such as cheese, butter and milk powders. The impacts of fluctuations in this market also flow into domestic-focused areas. Processors supplying milk for dairy product exports are considered to be price takers because they do not control sufficient share of global markets or offer sufficiently differentiated products to influence prices.

Dairy is a thinly traded commodity, meaning that small changes in supply or demand can have large impacts on prices; making markets volatile (see section 1.5.4 for recent movements in global dairy markets). According to the Food and Agriculture Organisation, approximately only 13 per cent of world production is traded.⁵³ Australia accounts for around 6 per cent of world dairy product exports.⁵⁴ In addition, strong competition from major dairy producing countries, including the EU member states, New Zealand and the United States, and fluctuations in exchange rates significantly affect prices received by exporters (see section 1.5.5 for more information on Australia's major competitors in world markets).

Australian exports of dairy products were valued at just over \$3 billion in 2016–17, a slight rise on the previous year. Figure 1.13 shows the share of Australian exports by volume for some major dairy products.

Figure 1.13: Share of Australian dairy product exports by volume, 2016–17



Notes: SMP: Skim milk powder; WMP: Whole milk powder (includes infant powder)

Sources: Dairy Australia, *Australian Dairy Industry in Focus 2017*

⁵² Dairy Australia, *Australian Dairy Industry in Focus 2017*.

⁵³ Food and Agriculture Organization, *Dairy production and products*, accessed 01 February 2017, fao.org/agriculture/dairy-gateway/the-dairy-chain/markets-and-trade/en/#.WJE7Y9Jf2Uk.

⁵⁴ Dairy Australia, *Australian Dairy Industry in Focus 2017*.

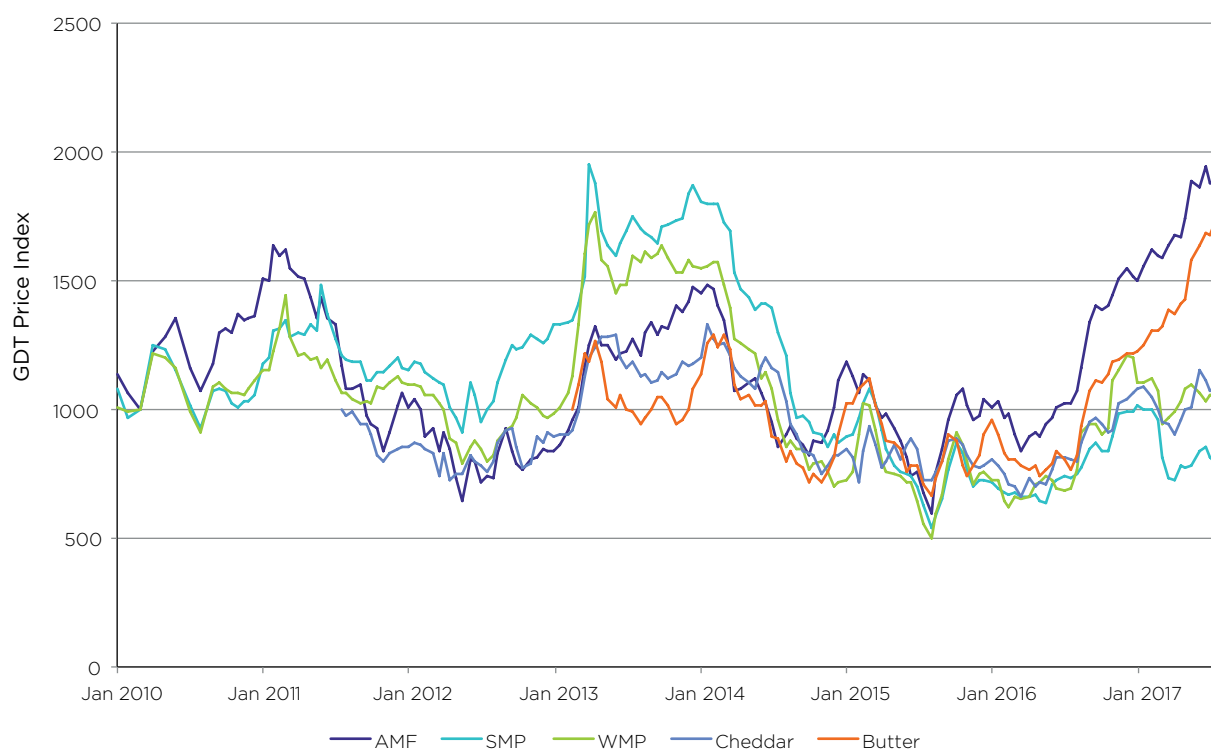
Australia exported almost 167 000 tonnes of cheese in 2016–17, with Japan accounting for just under half of all shipments.⁵⁵ The majority of exports to Japan are fresh and cheddar cheeses, primarily used in food manufacturing.⁵⁶ Other major destinations for Australian cheese exports are China and Hong Kong (15 per cent), South Korea (6 per cent) and Malaysia (5 per cent).⁵⁷

In 2016–17, Australia exported over 153 000 tonnes of SMP. Indonesia was the largest destination, accounting for 24 per cent of shipments, followed by China and Hong Kong (16 per cent), Malaysia (12 per cent) and Singapore (9 per cent). Additionally, 9 per cent of SMP exports went to the Middle East in 2016–17. About 38 per cent of Australian exports of WMP including infant powder went to China and Hong Kong, which was also the largest market for butter exports (with 22 per cent). China was the largest market for drinking milk exports (with over 36 per cent) in 2016–17.⁵⁸

1.5.4 International dairy product markets have been depressed

World dairy product prices have fallen substantially from the record highs achieved in early 2013, reflecting weakening consumer demand, trade bans and increasing world raw milk production (figure 1.14). Strong demand growth from developing markets, particularly Chinese milk powder imports, underpinned the rapid increase in world prices from mid-2012.

Figure 1.14: GDT Price Index Components⁵⁹



Source: Global Dairy Trade

⁵⁵ Dairy Australia, *Australian Dairy Industry in Focus 2017*.

⁵⁶ Dairy Australia, *Market brief: Japan*, accessed 01 February 2017, dairyaustralia.com.au/Home/Standard-Items/-/media/Documents/Stats%20and%20markets/Exports%20and%20trade/2016%20Market%20briefs/Market%20briefs_Japan.pdf.

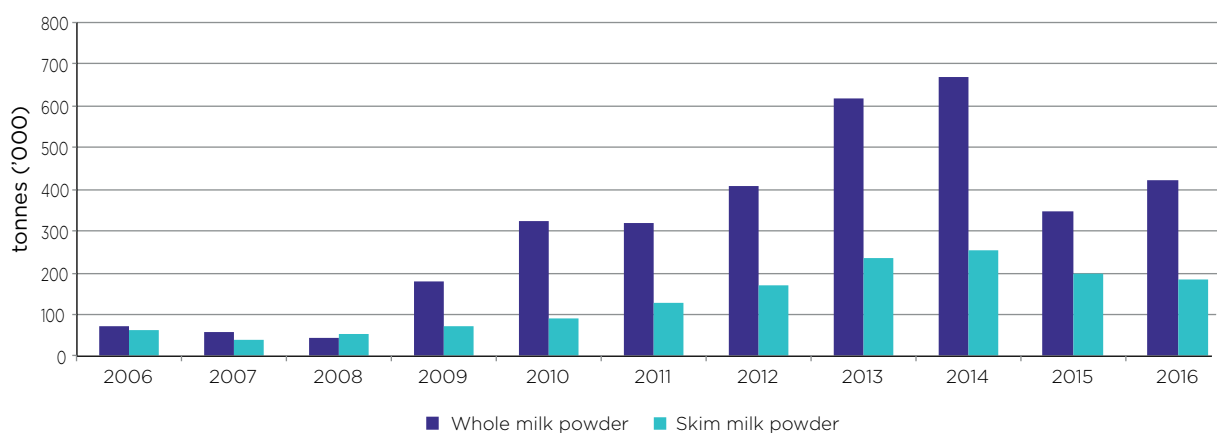
⁵⁷ Dairy Australia, *Australian Dairy Industry in Focus 2017*, 30.

⁵⁸ *ibid.*

⁵⁹ AMF: Anhydrous milk fat. SMP: Skim Milk Powder. WMP: Whole Milk Powder.

In early 2014, world dairy prices began a steep decline, reflecting the combined effects of weakening world demand, trade bans and increasing global raw milk production. On the demand side, Chinese imports of dairy products declined significantly, reflecting large milk powder stocks, weakening domestic retail sales and increased domestic milk production.⁶⁰ In 2015, imports by China, the world's largest buyer of WMP and third largest buyer of SMP, fell 54 per cent for WMP and by 23 per cent for SMP (figure 1.15).⁶¹

Figure 1.15: Milk powder imports, China



Source: United States Department of Agriculture, Foreign Agricultural Service

World demand for dairy products has also been negatively affected by a trade embargo imposed by the Russian Federation on agricultural imports since August 2014. Before the embargo the Russian Federation was the world's largest importer of butter and cheese. Subsequently, European Union exports of were directed to other markets, including destinations in Asia which are primary markets for Australian product. This put downward pressure on world prices and negatively impacted Australian exporters.

While global demand for dairy products weakened, milk production increased. This largely reflected improved seasonal conditions and low feed grain prices in the United States following several years of drought, and a lifting of milk production quotas on European Union member states which led to an expansion of production in member states with a comparative advantage in milk production.⁶² During 2016–17, global prices for key dairy commodities such as butter, cheese and WMP improved, reflecting more balanced supply-demand dynamics.

1.5.5 International competitors in world dairy markets

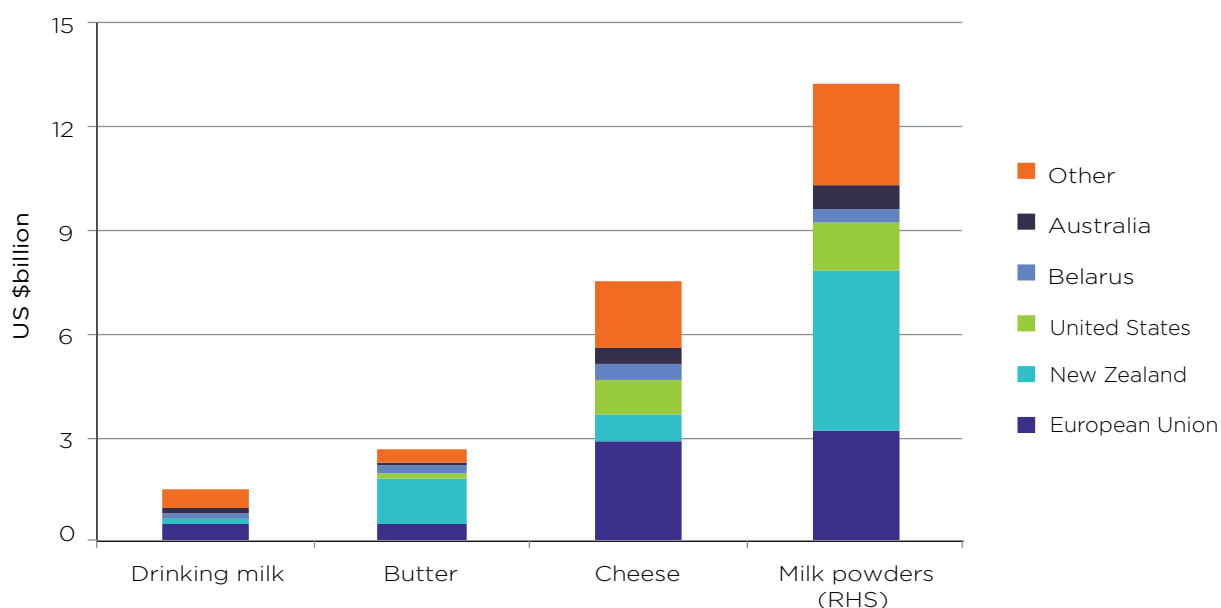
Australian dairy exporters face strong competition in international markets, particularly from the European Union, New Zealand and, to a lesser extent, the United States (figure 1.16).

⁶⁰ Owen McCarthy, *Australian Commodities*, ABARES, 2015, vol. 5 no. 4, pp. 118–125.

⁶¹ Tim Whitnall, *Agricultural Commodities*, ABARES, 2016, vol. 6 no. 2, pp. 107–114.

⁶² Owen McCarthy, *Agricultural Commodities*, ABARES, 2015, vol. 5 no. 4, pp. 118–125.

Figure 1.16: Major world dairy exporters by selected products, 2015



Notes: drinking milk includes fresh drinking and long life milk; butter includes oils and fats derived from milk, milk powders are referred to on the right hand axis

Source: UNComtrade database

Australia is a relatively low cost producer of raw milk. The International Farm Comparison Network estimated that the cost of producing 1 kg of a standardised unit of milk (ECM, energy corrected milk) was around US30 to US35 cents in 2010 for a representative farm in Australia. This was substantially lower than representative dairy farms in most European Union member states, with production costs ranging from US35 cents a kilogram in Ireland to more than US70 cents in Finland. For Australia's other major competitors in international markets, production costs were between US25 and US35 cents per kilogram in New Zealand and between US35 and US45 cents per kilogram in the United States.⁶³

Although Australia can produce raw milk relatively cheaply, processing costs erode this advantage, with labour, packaging and utilities being major cost components. Taking labour as an example, Australian dairy processors are at a considerable disadvantage to major competitors. Hourly compensation costs for manufacturing workers in 2012 were US\$48 for Australia, US\$36 in the United States and US\$25 for New Zealand.⁶⁴ For the European Union, only Belgium, Sweden and Denmark have higher compensation rates than Australia, although these countries only collectively account for 8 per cent of EU milk production.⁶⁵

63 Torsten Hemme, Mohammad Uddin and Oghaiski Ndambi, 'Benchmarking cost of milk production in 46 countries', (2014), *Journal of Reviews of Global Economics*, pp. 254-270.

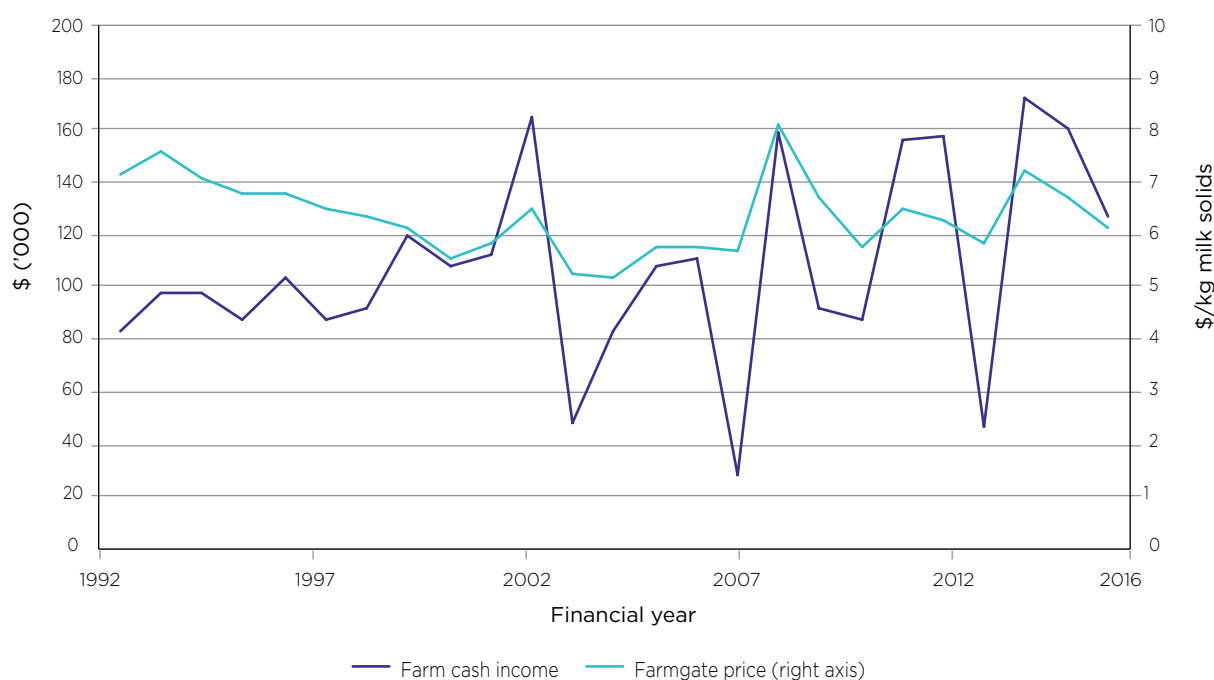
64 Bureau of Labor Statistics, *International comparisons of hourly compensation costs in manufacturing*, 19 December 2012, accessed 01 February 2017, <https://www.bls.gov/news.release/pdf/ichcc.pdf>.

65 European Union Commission, *Milk and milk product statistics*, October 2016, accessed 10 August 2017, http://ec.europa.eu/eurostat/statistics-explained/index.php/Milk_and_milk_product_statistics.

1.6 Profitability varies significantly between states

Farm cash income for Australian dairy farms has been highly volatile since deregulation. Favourable seasonal conditions reduced production costs and strong demand supported farmgate milk prices for most of the five years ending 2015–16⁶⁶, resulting in an average per farm cash income of around \$133 000 per year (in 2016–17 dollars) (figure 1.17).⁶⁷ Farm cash incomes averaged around \$127 000 per farm in 2015–16 (in 2016–17 dollars). This is due to lower farmgate milk prices and increased production costs (primarily fodder inputs).⁶⁸

Figure 1.17: Average dairy farm cash income and farmgate milk price, real terms (2017 dollars)



Note: Chart highly influenced by Victoria due to the majority of production occurring there. For more detailed analysis by state, see chapter 6

Source: ABARES, Agsurf database, and Dairy Australia data

In the 16 years since deregulation, the rate of return on capital (excluding capital appreciation) for dairy farms averaged 2.2 per cent per year, compared to 2.1 per cent per year in the decade prior to deregulation (1991–2000).⁶⁹

Rates of return on managed assets vary significantly between regions. The average annual rate of return in south west Victoria was 3.4 per cent over the 10 years to 2015–16, followed by northern Victoria (3.4 per cent) and Gippsland (3.3 per cent). This compares with 1.9 per cent in Queensland.⁷⁰ In Queensland, this lower rate of return largely reflects generally higher farm cash costs and lower milk yields per cow compared to the southern states, which more than offset the effect of typically higher farmgate milk prices (figure 1.18).

Shorter time series shows rates of return for SA (2.5 per cent, four-year average), NSW (2.6 per cent, five-year average), WA (5.6 per cent, three-year average) and Tasmania (6.8 per cent, three-year average).⁷¹

⁶⁶ With the exception of 2012/13, when cash incomes fell due to a decline in milk price and increased production costs.

⁶⁷ ABARES, *Agsurf database*, accessed 15 September 2017, apps.daff.gov.au/agSURF/.

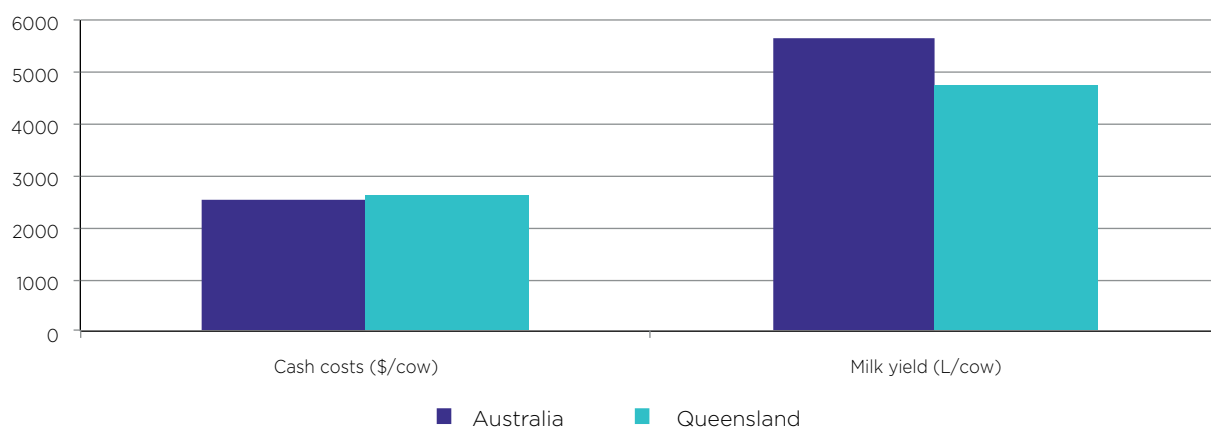
⁶⁸ *ibid.*

⁶⁹ *ibid.*

⁷⁰ Dairy Australia, *DairyBase Farm Data Output Report*, 17 May 2017.

⁷¹ Dairy Australia, *DairyBase Farm Data Output Report*, 17 May 2017.

Figure 1.18: Selected dairy production indicators, five-year average to 2015–16



Sources: ABARES Agsurf database (costs and yields)

1.6.1 Livestock sales can provide an important source of additional income

Cattle sales frequently provide an important source of additional income for dairy farms. Over the 10 years to 2015–16, livestock trading profit made up an average of 7.5 per cent of gross income per year in south west Victoria. This percentage was 7.1 per cent in northern Victoria, 6.9 per cent in Gippsland and 5.4 per cent in Queensland.⁷² Shorter time series⁷³ show the contribution of livestock trading to gross income in SA (7.9 per cent, four-year average), NSW (8.5 per cent, five-year average), WA (12.5 per cent, three-year average) and Tasmania (8.3 per cent, three-year average).⁷⁴

Cattle may be sold to other farms, into live export markets, or for slaughter. Breeding operators seek to improve characteristics in their stock, such as milk yield or fertility. They may sell bulls, cows, heifers or calves, offer stud services, or sell genetic material (including embryos and semen) for use in artificial insemination. Customers include dairy farmers seeking to improve their herd, other cattle breeders and export markets (including shipments of live cattle and genetic material). Beef from old or otherwise undesirable cows culled from the herd is used for manufacturing purposes and is often exported to the United States for use in the food service industry, particularly for hamburgers.

⁷² Dairy Australia, *DairyBase Farm Data Output Report*, 17 May 2017.

⁷³ These shorter run time series should not be compared to the 10-year averages, and are likely skewed by high beef cattle prices in recent years.

⁷⁴ Dairy Australia, *DairyBase Farm Data Output Report*, 17 May 2017.

2. Bargaining power and risk allocation in the dairy supply chain

Key Points

- There are clear differences in bargaining power through the dairy supply chain. Supermarkets have stronger bargaining power than processors, and processors have stronger bargaining power than farmers.
- Risk is also transferred throughout the supply chain proportionate with the strength of bargaining power:
 - some risks faced by supermarkets are passed on to processors and ultimately to farmers
 - dairy processors have an inappropriate degree of discretion to pass on risk to farmers
 - farmers are exposed to a high degree of uncertainty, for example, they do not have insight into the degree of risk that is associated with farmgate price offers.
- The substantial imbalance in bargaining power between processors and farmers is caused by:
 - the nature of the relationship, whereby a significant number of small farms supply a large processor with a generic product.
 - significant disparity in the volume and quality of information that is available to farmers when compared to processors. Farmers:
 - have very limited information about the way processors operate and the risks they are exposed to
 - do not have timely access to information about prices, contracts and the associated degree of risk that processors may pass onto them
 - are not able to identify future indicators of farmgate milk prices.
 - the perishability of raw milk.
- The inherent bargaining power imbalance between processors and dairy farmers combined with unequal availability of information between them (information asymmetry) results in market failure. The consequence of market failure is:
 - contractual and industry arrangements that are weighted heavily in favour of processors and make it harder for farmers to evaluate rival offers and switch between processors
 - farmers bear disproportionate risk.

2.1 Introduction

This chapter considers the power dynamic in the contracting relationship between supermarkets and processors, and between processors and farmers, and the implications this has for transparency and the allocation of risk through the supply chain.

Bargaining power imbalances arise when there are significant differences in the value of the next best alternative (the 'outside' or 'walk-away' option) available to the negotiating parties. The party with the stronger outside option has the greater ability to walk away from negotiations and thus is usually able to negotiate a deal that is more favourable.

The ACCC has found clear differences in bargaining power through the dairy supply chain. Supermarkets have significantly stronger bargaining power than processors, and processors have significantly stronger bargaining power than farmers. This bargaining imbalance is responsible for and reflected in:

- the setting and negotiation of wholesale milk prices by supermarkets
- the setting of farmgate milk prices by processors and the transparency of these prices
- the distribution of value and profits through the supply chain
- the allocation of risk through the supply chain
 - the transparency and fairness of non-price contract terms.

The impacts of the bargaining power imbalance on farmgate prices and contracting practices are discussed in chapters 3, 4 and 7. The implications of bargaining power for profit allocation in the industry is discussed in chapter 6.

2.2 Interim report feedback

The responses to the interim report were generally supportive of our analysis and findings on bargaining power. Stakeholders largely agreed with the ACCC's characterisation of relative bargaining power through the dairy supply chain and the risk allocation that results.

However, the ACCC also received feedback that:

- In regard to the relationship between supermarkets and processors:
 - there was agreement with the assessment that large supermarkets hold a substantial degree of bargaining power over processors¹, and processors over farmers²
 - several parties expressed disappointment that the imbalance of bargaining power between processors and supermarkets was not further scrutinised.
- In regard to the relationship between processors and farmers:
 - some export-focused processors submitted that they do not simply pass risk on to farmers, but instead shield them through the opening-price model³, and that the ability of processors to increase prices during a season allows farmers to benefit from improved returns⁴
 - processors submitted that if farmers are to be shielded from risk such as export price movements, they will necessarily receive a more conservative farmgate price⁵
 - processors also submitted that market volatility impacts all parties in the dairy supply chain, and processors also face losses if global prices fall⁶
 - processors argued that they take on the risk of accepting the entire volume of milk supplied by a farmer for the season, even if it exceeds their demand⁷.

2.3 Bargaining power in the dairy industry

The supply side of the Australian dairy industry contains thousands of farmers, six major processors⁸ and a number of smaller processors. The demand side consists of the global dairy export market, and three national supermarket chains that dominate the domestic retail market.

While supermarkets have significant bargaining power in their negotiations and supply agreements with processors, the dynamics vary between dairy regions and products. In particular, supermarkets have greater bargaining power in regions where there are a small number of major processors, and for products which cannot be exported (such as fresh drinking milk). Where a processor supplies a product under a popular or differentiated brand, they generally have stronger bargaining power in negotiations with supermarkets.

Processors face risk and uncertainty as price-takers in the global market, and due to their weaker bargaining position relative to supermarkets in the domestic market. The type and extent of risk depends on the variety of dairy products they manufacture and the nature of their wholesale supply agreements. These may include export contracts, long-term private label contracts, or short-term

1 United Dairy Farmers of Victoria, *UDV Submission—ACCC Interim Report into the Dairy Industry in Australia*, 7 February 2018, p. 1

2 Australian Dairy Farmers, *Submission to the ACCC Dairy inquiry interim report February 2018*, 2; NSW Farmers, email submission, 31 January 2018, 1; United Dairy Farmers of Victoria, *UDV Submission—ACCC Interim Report into the Dairy Industry in Australia*, 7 February 2018, p. 1; United Dairy Farmers of Victoria Wannon Branch, *submission to the ACCC interim report of the inquiry into the Australian dairy industry*, 24 January 2018, p. 2;

3 Fonterra Australia Pty Limited, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 6

4 Bega Cheese Limited, email submission, 2 February 2018, p. 1.

5 Fonterra Australia Pty Limited, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 6

6 Fonterra Australia Pty Limited, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 6

7 Fonterra Australia Pty Limited, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 6

8 Bega, Fonterra, Lion, Murray Goulburn, Parmalat, Warrnambool Cheese and Butter.

domestic supply agreements. Manufacturing a variety of products and supplying a mixture of international and domestic customers reduces exposure to specific risks.

The bargaining dynamic between processors and farmers also varies between dairy regions. It is primarily affected by the number of processors available for a farmer to supply, and farmers' ability to switch between them. The largest farms in a region appear to have some level of bargaining power with processors (see chapter 4).⁹

These factors are discussed further below.

2.4 Supermarkets' bargaining power over processors

As discussed in chapter 1, supermarkets are the major dairy product retailers in Australia, selling on average approximately 60 per cent of dairy products produced in Australia each year.

All of the major dairy processors in Australia supply products to supermarkets, with some more reliant on this sales channel than others. Supermarkets are a particularly important sales channel for highly perishable dairy products which cannot be exported, such as fresh drinking milk. Supermarket bargaining power is particularly strong in relation to contracting for private label products, where consumers' preference for low prices appear stronger than the value placed on the attributes of processors' brands.

The bargaining power of supermarkets relative to processors and the extent to which it varies between products is evidenced by the analysis of wholesale prices and terms which is considered in detail in chapter 6. Below we consider the extent to which supermarket bargaining power allows them to minimise risks by passing them on to processors, and subsequently farmers.

2.5 Farmers have little bargaining power

The ACCC heard throughout this inquiry farmers' concerns that:

- they have no bargaining power
- they are 'price takers' obliged to accept offers made on a 'take it or leave it' basis
- there is a general imbalance in contract negotiations and terms, which are weighted heavily in favour of processors
- there is a lack of information and communication from processors.¹⁰

The ACCC considers that these concerns are well founded, and we examine them further below.

2.5.1 The relative size of processors and farmers

Processors, even those who compete for raw milk with other buyers, are in a much stronger bargaining position than farmers, who are almost invariably price takers. At most times a single processor has the option to purchase milk from hundreds and sometimes more than one thousand farmers whose product is mostly generic and interchangeable. In contrast, the average farmer has only a few alternatives, and in some cases just one option, for selling their milk. This makes the bargaining power imbalance significant and means that in practice there is very little negotiation between the parties.

There is a clear resource and production imbalance between farmers and processors, which contributes to imbalances in bargaining power. For example, in Australia, the annual average raw milk production per farm is approximately 1.5 million litres¹¹, which is typically much less than 0.5 per cent of a major processor's requirements: Bega, Fonterra, Lion, Murray Goulburn, Parmalat, and WCB all collect more than 500 million litres per year. In 2017 Murray Goulburn purchased approximately 2.73 billion litres of milk.¹²

9 Traralgon and Hahndorf Dairy inquiry forums; Western Australia Collective Bargaining Group, *Submission to ACCC's inquiry into the Australian dairy industry*, 12 December 2016, p. 4; Alan and Leanne Pattison, *Submission to ACCC's inquiry into the Australian dairy industry*, 12 December 2016, p. 1.

10 NSW Farmers' Association, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 7.

11 Dairy Australia, *Dairy in Focus 2017*, p. 2.

12 Murray Goulburn, *Murray Goulburn Annual Report 2017*, 28 September 2017, p. 1.

This means that processors' total purchases of raw milk are large compared with individual farms' total production, and farmers are therefore far more financially dependent on their relationship with a processor, than the processor is with any individual farmer.

2.5.2 The generic and perishable nature of raw milk

Farmers supply a product (raw milk) that is essentially generic. This means that processors can acquire the same product from many farmers in a region.

Processors therefore have many more 'outside options'¹³ to purchase milk than farmers have options to sell their milk. This makes it easier for a processor to threaten to not purchase from a farmer. In some regions, farmers have only one processor bidding for their milk and therefore no other option than to accept the processor's offer.

For those farmers that have the option of selling milk to more than one processor (see chapter 4), their bargaining power is also limited by the perishable nature of raw milk. Farmers must have their milk collected almost daily. Consequently, farmers are more likely to accept poor terms and a lower price in order to avoid the risk of their milk not being collected. The ACCC heard at forums that the perishable nature of raw milk makes farmers vulnerable, and more likely to accept poor agreements.¹⁴

2.5.3 Access to information

The asymmetry of information available to farmers and processors reinforces this imbalance.

Processors have good access to the information they need to make informed production and pricing decisions, including:

- prevailing prices and trends for globally traded commodity dairy products, which directly affect revenues, obtained from sources such as GDT and Dairy Australia.
- wholesale prices for their own domestic supply contracts with major customers
- retail price trends for dairy products sold in supermarkets, obtained from sources such as IRI-Aztec
- farmgate prices for the major input of raw milk, including general information about the prices being paid by their competitors and the price and availability of inputs for farmers (such as supplementary feed and water), which can be sourced from Dairy Australia and other publicly available sources.

However, much of this information is not available to farmers, is not presented clearly, or is not available at the critical time at which they have to make a decision. For example:

- While prevailing prices and trends for globally traded dairy products are available to farmers (through sources such as GDT and rural newspapers), the way these prices affect processor revenues is not clear, giving limited insight into how farmgate milk prices are set or may change, and the export or exchange rate risk associated with a price offer.
- Processors typically make uniform pricing offers by announcing a single farmgate price at the start of the season. This information is available directly from some processors, through public statements, and from neighbouring farmers supplying different processors. However, the actual prices that individual farmers receive vary significantly from the announced price and may be subject to change without notice (as discussed in detail in chapter 3).
- Pricing offers from processors are complicated and difficult to interpret. As discussed in chapter 3, there are many variables affecting milk price, detailed in multiple documents. To assist in interpreting them, farmers rely heavily on income estimates prepared by processors' field officers. However, the assumptions made to produce these estimates, and the consequences of these not being met, are frequently unclear.
- Processors have discretion over the timing of price announcements, and farmers often have insufficient time to compare alternative offers and select the best one for them.
- Milk supply contracts are overly complex and often restrict farmers' ability to compare processors.

Consequently, in general farmers have significantly less information than processors which contributes to their bargaining disadvantage.

¹³ An outside option is the value of the next best alternative if a buyer or seller walks away from dealing with one another. This sets the minimum terms that a buyer or seller is willing to accept for the deal to take place.

¹⁴ For example, at the Dairy inquiry forum in Toowoomba.

2.6 The impact of bargaining power on contractual negotiations

A significant consequence of the imbalance in bargaining power is that farmers are rarely able to negotiate contract terms or prices with processors.

ACCC analysis indicates that approximately 99 per cent of milk supply contracts are not negotiated, meaning that farmers are generally provided with standard form contracts and non-negotiated prices. The 1 per cent of milk supply contracts that are negotiated are those involving large volume farms.¹⁵ Therefore, most farmers are offered standard form contracts weighted heavily in favour of processors. For example, the prices and terms offered in many contracts provide processors with considerable discretion and leave farmers with significant uncertainty.

The ACCC accepts that the transaction costs of negotiating individual agreements with farmers would be high, and this reduces the scope for effective negotiations between processors and individual farms.

Industry culture also discourages individual negotiations. The ACCC heard at a number of forums and in submissions that many farmers prefer uniform pricing and supply agreements, considering it to be unfair when some farmers negotiate individual agreements. Processors are aware of the importance of perceived equality among suppliers and gave evidence to the ACCC that this is one of the reasons why they rarely negotiate with individual farmers.

There are some ways for individual farmers to increase their bargaining power which can lead to better outcomes for them. For example, farmers may increase their production and farm size, which may enhance their competitive position.

However, for the reasons set out in section 2.5, effective contract negotiations between most individual farmers and processors are unlikely to occur.

2.7 The benefits of transparency

Production and investment decisions made by dairy farmers strongly influence the efficiency of the dairy industry. Consequently, the better informed farmers are when making investment decisions, the more productive the dairy industry will be.

Improved information flows to farmers, and greater transparency along the supply chain would provide better signals to help farmers make well-informed choices regarding which processor to supply, as well as budgeting and production decisions. Improved transparency would likely lead to:

- increased competition between processors for the acquisition of raw milk, which should lead to higher farmgate prices
- better information will lead to greater levels of certainty and improved incentives for investment by farmers, including improved access to finance
- more efficient milk production decisions in the Australian dairy industry, leading to lower cost and potentially higher profits.

The Australian Government has recognised this issue, and is supporting the development of a milk price index to help Australian dairy farmers better understand and interpret price signals from the global and domestic dairy market so that they can anticipate and prepare for fluctuations in the price they receive for milk.

The Commodity Milk Price Index will add to the information available that assists dairy farmers to better understand and interpret price signals, which they can use to inform their business decisions.

Feedback received by the ACCC from most dairy farmer organisations and a number of processors indicated that the dairy industry is highly supportive of a milk price index as proposed by the Australian Government.

¹⁵ This figure does not include contracts that have been negotiated by a collective bargaining group on behalf of its members.

2.8 Risks are allocated based on bargaining power

Even if there is greater market information transparency, farmers, processors and retailers of dairy products will continue to face commercial risks, broadly taking the form of uncertainty in:

- supply volumes of raw milk and dairy products (whether goods can be on-sold once produced, manufactured or purchased)
- costs to produce, manufacture or supply milk or dairy products, and
- prices that will be received for the supply of milk and dairy products.

The ACCC has considered these risks and how they are allocated and managed throughout the dairy industry. This is a specific term of reference of the inquiry¹⁶ and is relevant to the efficient allocation of resources in the supply chain.

At the forums, farmers in all regions raised concerns about the allocation of risk along the supply chain, and in particular the degree of risk that is passed on by processors. Farmers submitted that:

- farmers carry most of the risk in the dairy supply chain and sustain the biggest losses
- milk supply agreements are designed so processors pass on risks to farmers rather than having to manage that risk internally
- the push by most processors towards a flatter milk supply (that is, away from spring calving) adds increased risks to farmers for which they are not adequately compensated
- longer term private label contracts should result in processors offering more price certainty to farmers.

It is normal for businesses to face risks. In well-functioning markets, companies internalise risk as a cost of doing business and act accordingly. However, in some markets, risks faced by one party can be reallocated through transactions, and the terms of supply and purchase agreements. This usually arises due to imbalances in bargaining power.

As outlined below, the ACCC considers that in the dairy industry, the allocation of risk is proportionate with the degree of bargaining power throughout the supply chain:

- some risks faced by supermarkets are passed on to dairy processors, and then ultimately to farmers
- dairy processors have an inappropriate level of discretion to pass on risk to farmers
- farmers appear to be exposed to a high degree of uncertainty.

A consequence of this transfer of risk is to create inefficiencies in the dairy supply chain, due to underinvestment in productivity enhancement by farmers.

2.8.1 Supermarkets face limited dairy price risks

Supermarkets appear to face relatively limited risk in the dairy supply chain. For most branded dairy products, major retailers can change their ranging and purchasing decisions at short notice, providing limited or no long-term commitments to processors. Processors however, must generally be able to guarantee supply volumes in order for supermarkets to stock their products.

Processors generally agree to collect all milk produced by farmers for the duration of their contract—an example of risk being shared between farmers and processors, although moderated by processors capacity to change farmgate prices. Having products ‘de-listed’ on short notice or losing a private label contract can therefore cause a processor to be committed to purchase more milk than required.

Recent contracts for private label milk have more frequently involved longer term agreements¹⁷, providing processors with greater certainty. However, as supermarkets demand lower wholesale prices from processors in exchange for longer term contracts¹⁸, it is common for processors to incur substantial capital expenditure in order to obtain and/or retain these arrangements. For example,

16 Appendix 1, Term of reference viii, The allocation of commercial risk across the dairy supply chain.

17 Australian Food News, *Woolworths announces 10-year milk deals, but Lion is the loser in Victoria and WA*, 7 April 2014, accessed 14 September 2017, <http://www.ausfoodnews.com.au/2014/04/07/woolworths-announces-10-year-milk-deals-but-lion-is-the-loser-in-victoria-and-wa.html>.

18 Retail World Editor, *Private labels the dairy industry's new cash cow*, 11 March 2016, accessed 1 November 2017, <https://www.retailworldmagazine.com.au/private-labels-the-dairy-industrys-new-cash-cow/>.

in 2013 Murray Goulburn invested over \$150 million to secure a major long-term private label milk contract with Coles.¹⁹

These investments can be profitable and enhance efficiency. However, processors may be exposed and have a weakened bargaining position at the time of contract renewal if the profitability of their investments is dependent on the processor being awarded a further contract.

Wholesale prices for most dairy products are relatively stable over the course of the year and hence supermarkets face limited risk of price increases. However, supermarkets have some exposure to volatility in farmgate milk prices and international dairy prices due to the nature of their contracts with processors.

For example, global prices for butter increase when there is scarce international supply. At these times, supermarkets agree to pay higher prices to secure supply rather than risk the processor exporting the butter for a higher return. For such products (typically butter and some cheeses) supply agreements commonly have 'rise and fall' pricing provisions. The ACCC understands that supermarkets will sometimes absorb the impact of these changes and maintain a stable retail price, and in other circumstances may pass on cost increase to consumers.

Of more significance are the pricing components of private label milk contracts. Supply contracts between supermarkets and processors commonly apportion the cost price into separate price components for:

- raw milk: a price per litre for the raw milk used to produce private label drinking milk
- processing: which compensates processors for the cost of converting raw milk into drinking milk and delivering it to the supermarket distribution centre (sometimes the cost of packaging and delivery are specified as separate components).

The raw milk component is typically a floating price based on the weighted average farmgate milk price paid by the processor over the year, or some other publicly available benchmark. Either way, for private label milk, changes in farmgate prices, and their impact on margins, are generally a risk faced by supermarkets rather than processors.²⁰

The 'processing' component of longer term private label contracts commonly contains clauses which allow supermarkets to periodically test or benchmark processing costs. In some cases, supermarkets insist on 'open book' discussions, meaning that processors must provide access to their financial information to verify production costs.

The above provisions effectively remove the risk of a supermarket being locked into a contract which becomes uncompetitive on cost. In effect, processors pass on efficiency gains or input price reductions to the supermarket.

The ACCC considers that the breadth of these processing cost provisions and 'open book' practices is indicative of the bargaining power held by supermarkets relative to processors. This is used not just to reduce costs and increase profitability but also to reduce and reallocate risks the supermarkets may otherwise face.

2.8.2 Existing regulatory arrangements for supermarket-processor relationships

Notwithstanding the above, the ACCC does not consider it necessary to make recommendations relating to the relationship between supermarkets and processors.

There are significant differences between the retailer-processor relationship and the processor-farmer relationship. For example, there is greater price and contract transparency and certainty between processors and retailers than between farmers and processors. Processors are also generally better resourced to navigate their commercial relationship with supermarkets than farmers are with processors, and some have the ability to negotiate terms and prices, whereas farmers almost never have this option.

¹⁹ Joe Anderson, *The skinny on Murray Goulburn, Coles milk deal*, *The Financial Review*, 23 May 2016, accessed 10 October 2017, <http://www.afr.com/brand/rear-window/the-skinny-on-murray-goulburn-coles-milk-deal-20160523-gp1d98>.

²⁰ This is discussed in detail in chapter 6

As further evidence of this difference, the ACCC found evidence of processors electing not to participate in private label tenders they did not consider to be commercially appealing. The ACCC also saw examples of processors diverting raw milk to alternative products and sales channels in response to a product de-listing by a supermarket.

While supermarkets have leveraged their buying power to drive wholesale prices down and reduce the profit margins of processors, it is in their interest to maintain healthy competition between processors, as this is in part responsible for the supermarkets' ability to extract low wholesale prices.

Evidence of this is seen in the steps taken by retailers in recent years to encourage greater competition between processors by extending contract durations to encourage investment, or by offering contracts for single regions or product categories to attract smaller processors to the tender process.

Further, this retailer-processor power imbalance is not unique to the dairy industry but also occurs for a wide range of other suppliers of supermarkets, and consequently the Food and Grocery Code of Conduct²¹ has been adopted to better manage these commercial relationships.

The Food and Grocery Code of Conduct is a prescribed voluntary code regulated by the ACCC under the the act, meaning that it is binding on, and enforceable against, industry participants who become (and remain) signatories. Current signatories to the code are Coles, Woolworths, ALDI and About Life Pty Ltd. Metcash, a major distributor and marketer of groceries, has not become a signatory.

Conduct governed by the code includes grocery supply agreements, payments, termination, dispute resolution and a range of other matters. The code contains rules regarding the de-listing of products,²² a matter which was raised with the ACCC during this inquiry.

The Australian Government announced a review of the Food and Grocery Code of Conduct on 2 March 2018. The review, committed to by the Government when the code was introduced in 2014, is intended to ensure that it is working effectively. Among other matters the review will consider the extent to which the code assists in addressing any imbalances in the allocation of risks between retailers, wholesalers and suppliers²³.

In summary, the ACCC has not seen evidence during the inquiry to suggest that the imbalance of bargaining power between supermarkets and processors has manifested in a way which warrants intervention beyond the measures in the Food and Grocery Code of Conduct.

2.8.3 Risk transfers from processors to farmers

There is a general interdependence between processors and farmers, in that processors benefit from stable and efficient milk production. However, contract terms often give processors discretion to pass on price and volume risk to farmers.

In practice, processors have typically been cautious about exercising this discretion, particularly when this involves downward price changes. However, the price step-downs of 2016 (discussed in chapter 3) highlighted the exercise of this discretion by Murray Goulburn and Fonterra and illustrated that farmers are ultimately exposed to most of the risk in the supply chain.

The primary ways in which processors pass on risk are explored in chapter 3. In summary:

- contract terms often give processors the ability to unilaterally vary
- farmgate milk prices during a season
- milk quality requirements, and
- seasonal price differentials.

Some processors submitted to the ACCC that they face considerable risk associated with volatile commodity prices and the uncertainty of domestic wholesale contracts. They submitted that they have no choice but to share risks these with farmers.²⁴

21 Australian Competition and Consumer Commission, *Food and Grocery Code of Conduct*, <https://www.accc.gov.au/business/industry-codes/food-and-grocery-code-of-conduct>.

22 Competition and Consumer (Industry Codes—Food and Grocery) Regulation 2015 (see clause 19).

23 For more information, see The Treasury, *Terms of Reference, Food and Grocery Code of Conduct Review*, accessed 23 March 2018 from <https://treasury.gov.au/review/food-and-grocery-code-of-conduct-review/terms-of-reference/>.

24 Fonterra Australia Pty Limited, *inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 6; Bega Cheese Limited, *email submission*, 2 February 2018, p. 1.

Farmers who supply processors that are a cooperative may reasonably be expected to participate in the commercial risk faced by the processor (whether through fluctuations in cooperative earnings or in the milk price).

However, the industry has mostly transitioned away from cooperatives, with most major processors now multinational or listed companies. Despite this, they appear to have retained the same risk management and pricing practices. Farmers supplying these businesses still participate in the downside commercial risks without any equitable interest or benefit from unanticipated improvements in commodity prices.

Irrespective of their business structure, processors are much better placed to face and manage market risks than farmers.

2.8.4 Risk transfers from processors to farmers through contract mechanisms

Extended notice periods for the termination of milk supply agreements are discussed in chapter 7.

Clauses that allow processors to impose under-supply penalties in contracts, while not widespread, also have the potential to transfer disproportionate risk to farmers. These clauses more often arise in contracts offered by domestic-focused processors. These processors can face significant consequences if they do not have sufficient milk volume to fulfil commitments to major customers. Depending on the formulation, these clauses can transfer all risk of under-supply onto farmers, even though farmers have no involvement in the risk the processor commits to in its supply contracts, nor ability to control many of the factors affecting production (particularly climate).

2.9 Farm business risk

Dairy farmers may face significant commercial risk from exposure to unexpected changes in milk prices and input costs, which challenges their ability to make informed production decisions and to operate profitably.

Chapter 3 explores how:

- global dairy commodity prices influence the farmgate price in exporting dairy regions (southern NSW, South Australia, Victoria and Tasmania), and
- processors in these regions have the discretion to change farmgate milk prices during the course of a season.

This means that farmers in exporting dairy regions are often subject to a significant degree of revenue uncertainty from year to year as well as within a year. Price uncertainty can weaken farmers' confidence and affects their ability to make future business plans.

Dairy farmers have faced considerable volatility and uncertainty in prices since deregulation. The impact of deregulation on farm revenues and profitability is discussed in chapter 6.

2.9.1 Dairy farm input costs

Farmers can face considerable uncertainty in relation to their business input costs. While input costs risks are largely an inevitable source of uncertainty for farmers, there have been concerns raised that processors pressure farmers into facing higher and more volatile costs by pushing them to adopt "flatter" seasonal milk production profiles.

The biggest input cost for dairy farms is fodder. Recent ABARES data indicates that fodder accounts for 28 per cent of total farming costs for Tasmanian dairy farms (the state least reliant on fodder for milk production) and 39 per cent of total farming costs for Queensland dairy farms (the state with the greatest reliance on fodder for milk production) (table 2.1).

Table 2.1: Dairy farm input costs—proportion of total 2016

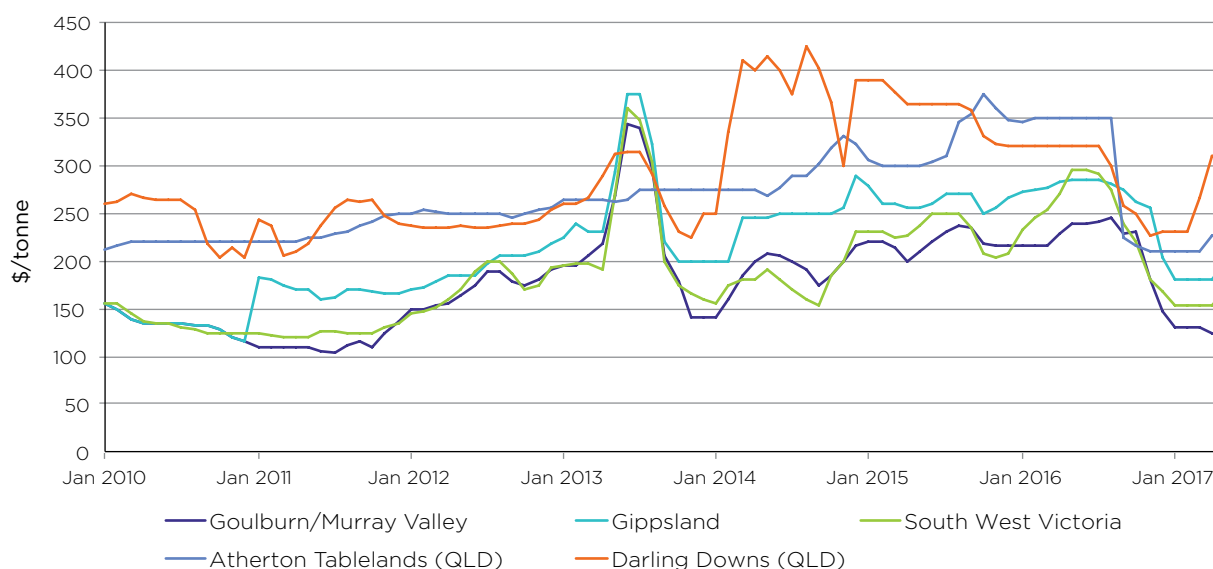
Cost Item	Australia	NSW	Vic	Qld	SA	WA	Tas
Fodder	32%	33%	31%	39%	33%	33%	28%
Repairs and maint.	8%	7%	8%	7%	7%	9%	7%
Interest paid	8%	7%	8%	7%	8%	7%	10%
Wages for hired labour	7%	9%	5%	7%	11%	11%	9%
Fertiliser	6%	7%	5%	5%	5%	9%	9%
Sharefarmer payments	4%	0%	6%	0%	1%	0%	2%
Electricity	3%	3%	3%	4%	5%	3%	5%
Handling and marketing	3%	2%	4%	2%	3%	2%	3%
Fuel oil and grease	3%	3%	3%	4%	4%	3%	3%
Contracts—cropping	3%	3%	3%	2%	3%	2%	3%
Land rent	2%	1%	3%	2%	2%	4%	2%
Livestock materials	2%	2%	2%	3%	2%	1%	3%
Water charges	2%	2%	3%	0%	1%	1%	1%
Other costs	18%	20%	18%	18%	17%	17%	16%
Key	>10%	10% > 5%	5% > 2%	<2%			

Source: ABARES data, ACCC analysis

As discussed in chapter 1, the extent to which farmers in the southern states depend on supplementary feed largely depends on the milk production profile they adopt, which influences the seasonality of calving. In contrast, most farmers in northern NSW and Queensland are more reliant on supplementary feed to maintain flatter seasonal production, which is favoured in drinking milk markets.

Price volatility in hay and grain markets can therefore be a major source of risk. Annual national production of hay and silage can be highly variable and only around 30 per cent of total fodder production is traded.²⁵

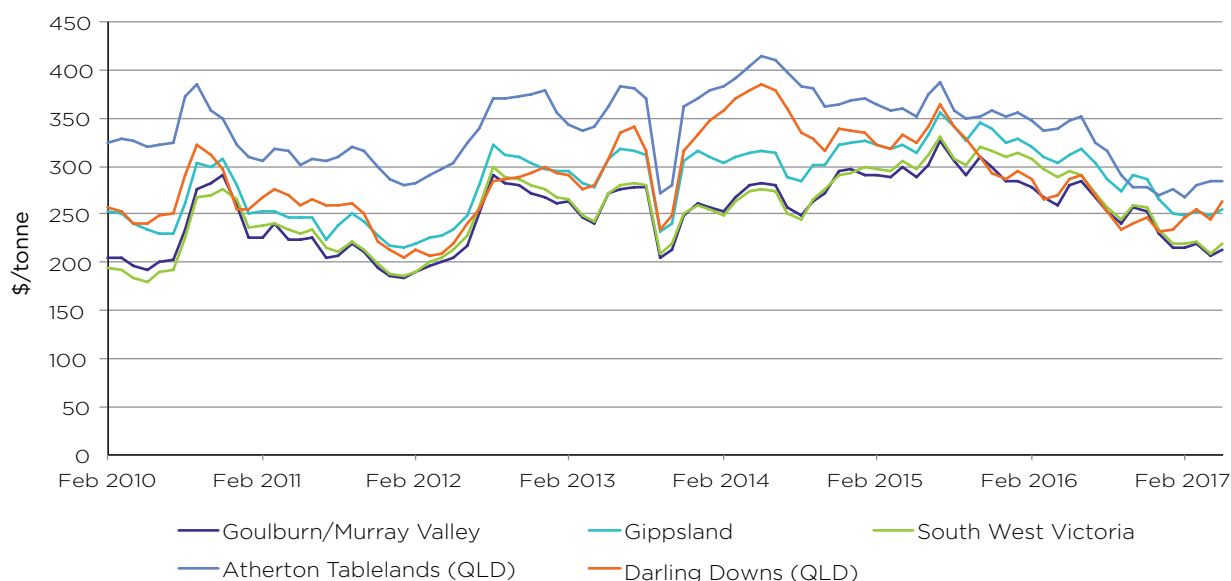
Figures 2.1 and 2.2 show the price volatility of some primary hay and grain inputs in Queensland and Victoria.

Figure 2.2: Monthly average cereal hay prices

Source: Dairy Australia data, AFIA

25 Dairy Australia, *Buying Feed—Fact Sheet*, accessed 6 September 2017, <https://www.dairyaustralia.com.au/farm/feedbase-and-animal-nutrition/feed-management/feed-markets>.

Figure 2.3: Monthly average wheat prices



Source: Dairy Australia data

Demand for fodder is often higher in years where pasture production is low, such as in periods of drought. For similar reasons, domestic demand for grain can also be high in years where production shortfalls occur. Furthermore, grain purchases can be contested between dairy farmers, livestock producers, global markets for human consumption and biofuels. As such, dairy farmers can face high volatility in their production costs, particularly those that are reliant on acquiring feed to supplement pastures.

2.9.2 Other sources of risk

Other input costs, such as fertiliser, fuel and water can also be volatile and, collectively, another source of uncertainty and risk for farmers. The availability of water is also uncertain at times, depending on the region. This has implications for pasture yield and quality and therefore requirements for fodder, the price of which is also affected by water availability more generally.

2.10 Limited risk management tools

2.10.1 Processors can limit commodity risks to some extent

Processors attempt to manage some of the risks they face rather than passing on all risks to dairy farmers. Notably:

- To the extent possible, processors engage in forward sales and lock in the terms of a proportion of major export contracts before they announce farmgate prices. This is a common way for processors to reduce the commodity price uncertainty they face throughout the year.
- There has been a trend toward further diversification of production and sales channels so that processors are less exposed to either one of export prices or major supermarkets.
- One processor submitted that the farmgate prices it offers to suppliers are considerably more stable than global dairy markets and that it shields farmers from some of the volatility by absorbing and managing price risk.
- Some processors have started trialling the effectiveness of dairy derivatives contracts, such as futures contracts for WMP, as a risk management tool, but have indicated that the liquidity of dairy derivatives is still very limited. If processors were able to effectively hedge against unexpected movements in global dairy prices during the course of a season, this would greatly reduce the need for processors to pass on risks to farmers through variable price contracts.

The ACCC considers that processors are better placed to hedge risks associated with exchange rate fluctuations given the wide range of easily available foreign exchange derivatives. The ACCC understands that some processors are active in foreign exchange markets to manage currency risks.

2.10.2 Management of farm input cost risks

The ACCC spoke with a number of profitable farmers who stated they placed a lot of focus on managing their input costs. Fluctuations in hay and grain prices are often considered to be the main risk exposure for farmers other than milk prices.

Managing this risk can involve:

- producing a proportion of fodder requirements on-farm
- keeping reserves of fodder available, and
- locking-in hay and grain costs once the milk price is known.

Dairy farmers may benefit from greater education and advice on the use of medium term forward contracting to lock-in grain, fodder and water prices if possible. Hedging of this kind could potentially be done on a localised collective basis rather than by farmers individually.

The use of advisors such as nutritionists, agronomists and financial consultants may be of assistance to farmers in managing their costs. Independent farm management advice of this kind is seen as a particularly important risk management tool and many dairy farms may benefit from the increased use of such services.

Further, the equity position of farms is seen as particularly important in minimising the impact of volatility and managing risk. Farms with high levels of equity have more capital reserves to draw on, and can use this as collateral for additional borrowings when necessary. Additional risk management tools available to farmers include:

- the Australian Government's Farm Management Deposits scheme, which is designed to manage income volatility by allowing producers to set aside pre-tax income in years of good cash flow to draw on in years of lesser cash flow
- diversification of income reduces exposure to volatility in returns on milk sales. Examples include livestock sales and off-farm investments.

3. Farmgate milk prices

Key Points

- There are shortcomings in the availability, timeliness and reliability of pricing signals given to farmers before the commencement of a dairy season:
 - farmers have limited visibility over how farmgate prices are set
 - actual prices received by farmers often vary significantly from the announced farmgate price
 - the potential for farmgate price step-downs transfers the risk of global commodity fluctuations from the processor to the farmer, whereas the processor is best placed to manage this risk.
- These issues give rise to poorly informed production and supply decisions by farmers. The ACCC considers that addressing these issues will improve the efficiency of the dairy industry.
- Processors set a farmgate price only as high as they need to in order to acquire the volume of raw milk production that meets their demand in that region. The minimum price that processors need to pay will generally be higher where there is stronger competition for acquiring milk.
- Farmgate price movements in the Southern region, where export focussed processors are generally located, are primarily driven by global dairy market conditions. Higher commodity prices lead to heightened demand and competition for raw milk by processors to supply into a global market.
- Farmgate prices in the Northern and WA regions, where only domestic-focused processors operate, are relatively more stable than prices in the Southern Region. This reflects the relatively static demand for raw milk in these regions and the relatively stable demand for dairy products domestically.
- The largest farms typically receive higher farmgate milk prices than smaller farms.
- There appear to be few differences between the contracting options and terms offered by corporate processors and those offered by farmer owned co-operatives.

This chapter examines how processors set farmgate milk prices and the impact of processors' pricing practices on farmers' ability to operate their farms efficiently.

3.1 Interim Report feedback

The ACCC received significant industry feedback in relation to its analysis of farmgate prices:

- Many stakeholders considered that farmgate milk prices should be made more transparent.¹
- There was strong support from some stakeholders for an online farmgate price portal and/or a standardised format for farmgate prices so that farmers can readily compare offers from different processors, as recommended by the ACCC.²
- Fonterra said that it has launched a suite of tools and resources under the brand 'Farm Source'. Farm Source includes a digital income estimator which enables farmers to see the impact of changes to production volume and solids composition, milk price revisions and the opening price for the next season.³ Farm Source is only available to current Fonterra suppliers.
- Concerns were raised about the lack of transparency associated with milk quality testing and the ability to independently verify results. Some farmers said there can be significant differences between the test results (in terms of solids and cell count) from different processors, which impacts on farmgate prices.

1 NSW Farmers' Association, *Submission in response to the ACCC Dairy inquiry interim report*, February 2018, p. 13; SA Dairyfarmers' Association Inc, *Submission in response to the ACCC Dairy inquiry interim report*, 6 February 2018, p. 2; United Dairyfarmers of Victoria, *Submission in response to the ACCC Dairy inquiry interim report*, 7 February 2018, p. 4.

2 NSW Farmers' Association, *Submission in response to the ACCC Dairy inquiry interim report*, February 2018, p. 8; United Dairyfarmers of Victoria—Wannon Branch, *Submission in response to the ACCC Dairy inquiry interim report*, 24 January 2018, p. 2; Australian Small Business and Family Enterprise Ombudsman, *Submission in response to the ACCC Dairy inquiry interim report*, 9 February 2018, p. 1.

3 Fonterra Australia Pty Ltd, *Submission in response to the ACCC Dairy inquiry interim report*, 31 January 2018, p. 4.

3.2 Introduction

Farmgate pricing practices in the dairy industry came under scrutiny following the price step-downs implemented by Murray Goulburn and Fonterra in 2016. The step-downs had severe ramifications, particularly in Victoria, where there was an increase in the rate of farm exits and a substantial decrease in milk production. The incident also highlighted the processors' discretion to alter prices, and the detriment that can be caused to farmers when prices do not align with processors' forecasts.

3.2.1 The history of the industry affects pricing practices

The dairy industry has a unique approach to pricing which is linked to its history. The use of variable pricing (including step-ups and step-downs) has in part evolved from co-operative models that historically characterised the industry. Traditionally, a co-operative processor set a conservative farmgate milk price at the commencement of each season and increased this price throughout the season as the likely profits that could be distributed became more certain.

While some fixed-price contracts exist, variable price arrangements are still the most common, despite most processors now trading as corporations.

Co-operatives have been a feature of the Australian dairy industry since the 1880s. They are typically run by elected directors and profits are returned to members. Where a farming co-operative is vertically integrated with processing facilities, farmers do not need to deal with corporate processors.

The two most prominent co-operatives currently in operation in the Australian dairy industry are Murray Goulburn and Norco. Murray Goulburn commenced operating in 1950 and is currently one of the largest co-operatives in the agriculture sector, with sales revenue of \$2.8 billion in 2016.⁴ On 8 May 2015 Murray Goulburn established the 'MG Unit Trust' which was listed on the ASX. The MG Unit Trust provides Murray Goulburn with an additional source of capital, but the co-operative is still member run. On 4 April 2018 the ACCC announced it will not oppose the acquisition of Murray Goulburn's operating assets by Saputo Dairy Australia Pty Ltd ('Saputo'), after accepting a court-enforceable undertaking from Saputo to divest Murray Goulburn's Koroit plant.

Norco commenced operations in 1895 and achieved total sales of \$541 million in 2016.⁵ Norco is owned by members and governed by a Board of elected farmer directors.⁶ It acquires milk from 218 farms across northern NSW and southern Queensland.⁷

In contrast to corporate processors, members of co-operatives receive dividends on their shares in addition to the farmgate milk price and any step-ups during the year. Norco members also receive rebates and interest free terms on purchases made at Norco's Rural Retail stores. These stores stock agriculture products including stockfeed and pet foods.⁸

In addition to these benefits, co-operatives are member run, with most directors being selected by their peers from the farmer base.

The Australian dairy industry also includes some corporate processors that were originally co-operatives. For example, Bega was founded as a co-operative in 1899 and was registered as a company in 2008. The use of co-operatives is decreasing across the agriculture sector generally. The ACCC notes that some stakeholders consider that co-operatives in the agribusiness sector can, at times, be inefficiently run and lack the benefit of corporate executives to properly manage the business.⁹

4 Fonterra Australia Pty Ltd, *Submission in response to the ACCC Dairy inquiry interim report*, 31 January 2018, p. 4.

5 Norco, *Annual Report 2016*, Norco Co-operative Limited, p. 2.

6 *ibid.*, p. 2.

7 *ibid.*

8 *ibid.*

9 Van Caenegem, *Collective Bargaining in the Agricultural Sector*, RIRDC, June 2015, p. 36.

3.2.2 Co-operatives and corporate processors offer farmers similar commercial terms

In the course of this inquiry, the ACCC analysed contracts offered by co-operative and corporate processors to farmers. We found that the contracting options offered to farmers by co-operatives and corporate processors are not significantly different, and generally contain similar pricing components, bonuses and deductions. In addition, both co-operatives and corporate processors can use exclusive supply clauses, step-ups and step-downs.

Processors rarely negotiate contract terms with farmers. In particular, co-operatives generally prefer not to negotiate individual terms so as not to undermine the co-operative ethos of providing equal benefits to all members. Therefore, being a member of a co-operative will not necessarily improve an individual farmer's bargaining position.

Many farmers view co-operatives as playing an important role in the industry. By returning all profits not reinvested (via the farmgate price or dividends), co-operatives provide a price that reflects market returns, which corporate processors must at least match in order to compete for supply.

3.3 Setting farmgate milk prices

Processors use a range of measures to estimate the volume of milk they need to fulfil product orders and to maximise earnings. They then estimate the farmgate milk price they need to pay to attract this volume of milk, generally taking into account the following factors:

- competition for the acquisition of raw milk
- forecast milk supply for the period (this is often based on previous season volumes)
- forecast revenues for the period which are influenced by:
 - (a) expected domestic sales volumes, product mix and wholesale prices, including assumptions regarding continuity of supply to major domestic retailers
 - (b) export supply contracts, including forecasts about global dairy price movements and exchange rates
- processing capacity and costs
- for co-operatives, how returns to members will be allocated, via the farmgate price or dividends.

The impact of global and domestic demand varies between processors, as they all have different levels of exposure to each market.

Processors announce an opening price at the start of each season or new contract period. The internal formulations and forecasts used to determine opening prices are not visible to farmers or other external parties.

3.3.1 Competition is an important influence on farmgate prices

Chapter 2 discussed farmers' weak bargaining position relative to processors and the fact that farmers are price takers for their milk.

Competition between processors is an important influence on price outcomes. In the dairy industry, as in any market, purchasers with bargaining power (in this case processors) aim to minimise their acquisition costs while ensuring that they can secure sufficient supply volumes. Processors therefore aim to set milk prices at the level required only to obtain the milk volumes they need.

In the absence of any competition, a monopoly processor would set farmgate prices at a level where the revenue it makes from selling an additional litre of milk is equal to the cost of acquiring and processing that litre of raw milk. The introduction of competition encourages all processors to sacrifice some of their profits by increasing farmgate prices to secure supply of raw milk from farmers. Therefore, greater competition between processors in a market results in higher farmgate prices as processors try to capture their required volumes of milk.

The degree of competition between processors in Australia varies from region to region and therefore so does the impact of competition on farmgate prices. Barriers to farmer switching, such as those imposed by making loyalty payments for a season conditional on continued supply into a new season,

also influence the degree of competition between processors for raw milk and therefore the farmgate price. Competition between processors for acquiring milk is discussed in detail in chapter 4.

Internal processor documents obtained by the ACCC demonstrated that processors pay attention to competitors' prices, with a view to maintaining or increasing their share of the regional milk supply. As discussed in chapter 4, reducing barriers to farmers switching processors would likely intensify competition between processors.

The evidence reveals that processors' demand for milk volumes and competitive strategies for acquiring milk vary from year to year, depending on whether they are seeking to grow, maintain or decrease their share of the total raw milk supply available.

Processors looking to increase milk volumes need to offer significantly higher prices to attract farmers away from competing processors. Following a period of expanding their acquisition of milk, processors may only need to match competitor prices to maintain their share of the milk pool.

Processors seeking to maintain their supply volumes may have to increase prices in order to defend against other processors looking to grow their shares.

Some processors also aim to smooth out farmgate prices over seasons, rather than fully pass on fluctuations in commodity prices. This can involve absorbing losses in the short term in order to maintain or grow their share of the milk pool.

3.3.2 Limited transparency of pricing information

Where there are information asymmetries between farmers (who rely on publicly available information) and processors (who have wider market knowledge, and systems and staff to interpret industry developments), this imbalance of information exacerbates problems related to bargaining power, and can reduce the number and efficiency of transactions that occur.

There are clear information asymmetries between processors and farmers in relation to the setting of the farmgate price. For example, as discussed in chapter 2 (section 2.6):

- farmers rely on market information provided by processors to understand how prevailing prices and trends for domestic and globally traded dairy products affect processor revenues and farmgate price outlooks
- processors hold better information than farmers, including wider market knowledge at the farm, wholesale and retail level, and have discretion over when and how this information is disclosed
- processors often communicate price and contract information in complicated formats.

This means farmers have limited visibility as to how farmgate prices are set and how reasonable they are. Processors make public statements about factors that influence the upcoming pricing announcements, such as changes in dairy commodity prices, or new or lost domestic supply agreements. Processors may also provide commentary on market conditions in communications to farmers, such as opening price letters. Other sources of information such as Dairy Australia or rural news publications also provide commentary as to how changes in market conditions are likely to affect farmgate prices more broadly.

However, farmers do not have direct knowledge of the specific exposure that one processor or another has to specific market factors.

Greater transparency as to how commodity prices and other factors affect farmer income forecasts would increase farmers' ability to predict pricing adjustments. Farmers could also make better informed judgements on whether an indicative offer was conditional on risky propositions (such as Murray Goulburn's pricing in the 2015–16 season).

The ACCC does not consider it desirable for processors to publicly disclose how their prices are determined. However, the ACCC recognises that many farmers are in a relatively vulnerable trading position, and rely on transparent pricing information to budget effectively and make informed business decisions. Farmers therefore would benefit from increased transparency to better understand whether a price being offered by a processor is a realistic minimum and full year forecast price, or whether it is based on optimistic conjecture and subject to material risk of downward revision later in the season.

The negative consequences of information asymmetries on farmers may be mitigated through:

- reducing exposure to risk by increasing the availability of contracts with fixed-price components
- reducing barriers to farmers switching between processors during a dairy season.

These two issues are discussed in detail in chapters 2, 4 and 7.

3.4 The impact of global commodity prices

Export focused processors enter into agreements (often for large volumes) with international buyers and in doing so compete against international sellers. This exposes the Australian industry to global market conditions.

The level of exposure to global markets varies between processors and regions. Each processor has a different product mix, and is affected differently by changes in global prices for particular commodities.

Acquiring raw milk from farmers is the main cost of production for processors and also a cost over which they have significant influence. Broadly speaking, when global prices for dairy products decline in response to subdued international demand, export focused processors seek to adjust their milk acquisition. This is because, to the extent possible, processors need to balance their supply of raw milk to adjust to changes in global commodity prices. Further, when global prices are low, production cannot easily be redirected into domestic sales, as domestic demand is relatively stable.

When global prices rise, export focused processors have an incentive to increase production, and therefore to secure more raw milk, which prompts higher farmgate prices.

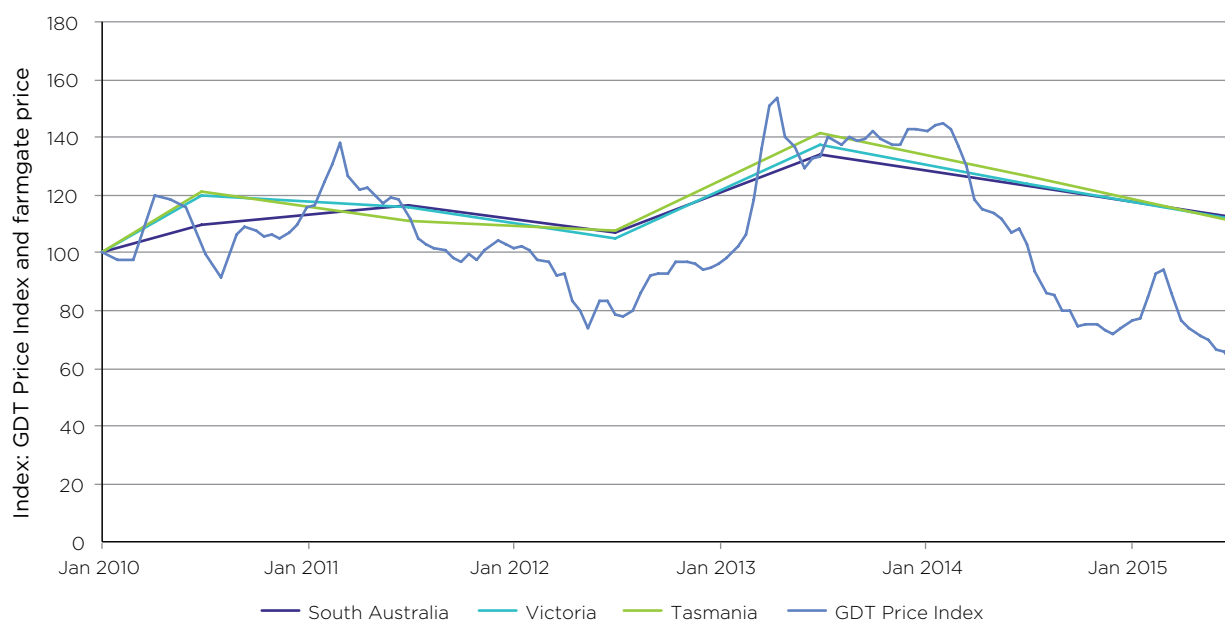
In contrast, domestic demand for products such as fresh drinking milk is relatively stable, with infrequent changes to the brands and products stocked by retailers. Therefore, farmgate prices in the Northern and WA regions are relatively stable.

Changes in domestic retail or wholesale prices are unlikely to occur and are therefore unlikely to affect farmgate prices, as both the end-user and processor demand for milk is relatively fixed. In contrast, demand for raw milk can be much more volatile year-to-year in the Southern region as demand and supply in the global market for dairy products is much more dynamic. This is why changes in farmgate prices in the Southern region are correlated with international prices.

Figures 3.1 and 3.2, using the GDT Price Index,¹⁰ show this effect and demonstrate that farmgate prices in the Southern region are linked to global commodity prices, whereas farmgate prices in the Northern and WA regions are not. While farmgate prices in the Southern region are correlated with changes in global commodity prices, processors in this region have generally not passed on the full extent of volatility in export markets despite having the discretion to do so.

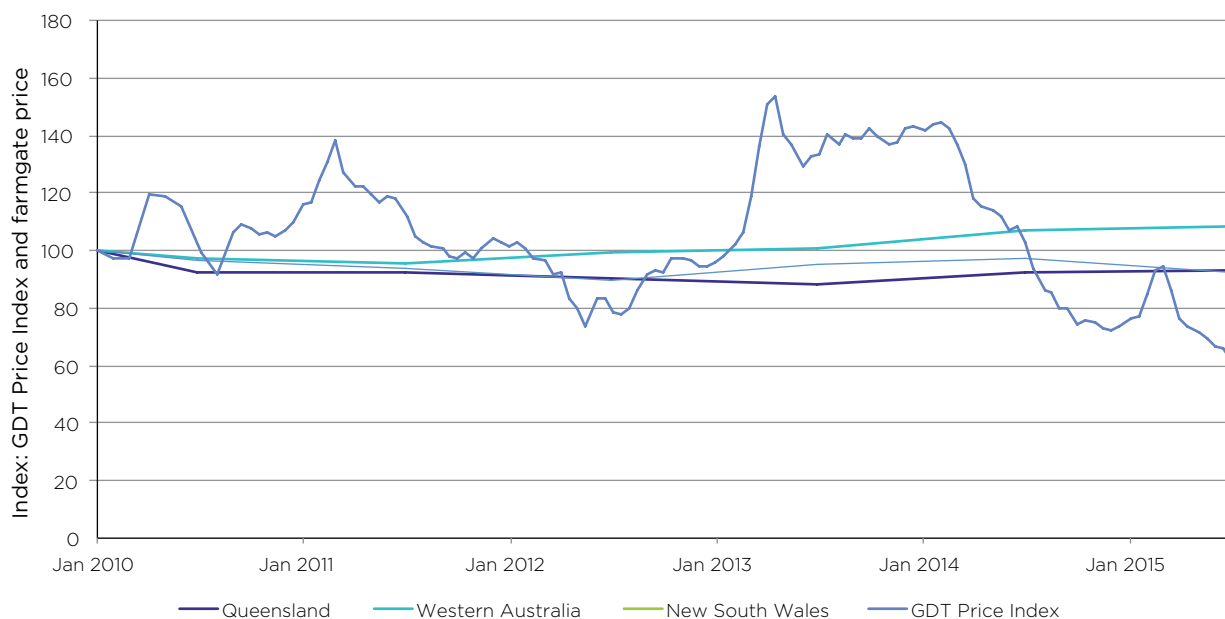
¹⁰ GlobalDairyTrade's price index is a widely-cited trade-weighted index of globally traded dairy prices.

Figure 3.1: GDT Price Index and farmgate milk prices, indexed to base 5 January 2010—Southern Region (Victoria, SA and Tasmania)



Source: GDT, Dairy Australia, ACCC analysis

Figure 3.2: GDT Price Index and farmgate milk prices, indexed to base 5 January 2010—Northern and WA Regions and WA (Queensland, WA and NSW)



Source: GDT, Dairy Australia, ACCC analysis.

Only a small proportion of total global dairy production is traded, with a few major exporting regions responsible for the majority of supply.¹¹ This can make world prices volatile as relatively small changes in dairy supply in these regions can have a strong impact on globally traded volumes.

Export contracts are also often foreign currency denominated so foreign exchange rate movements also often affect processor revenues.

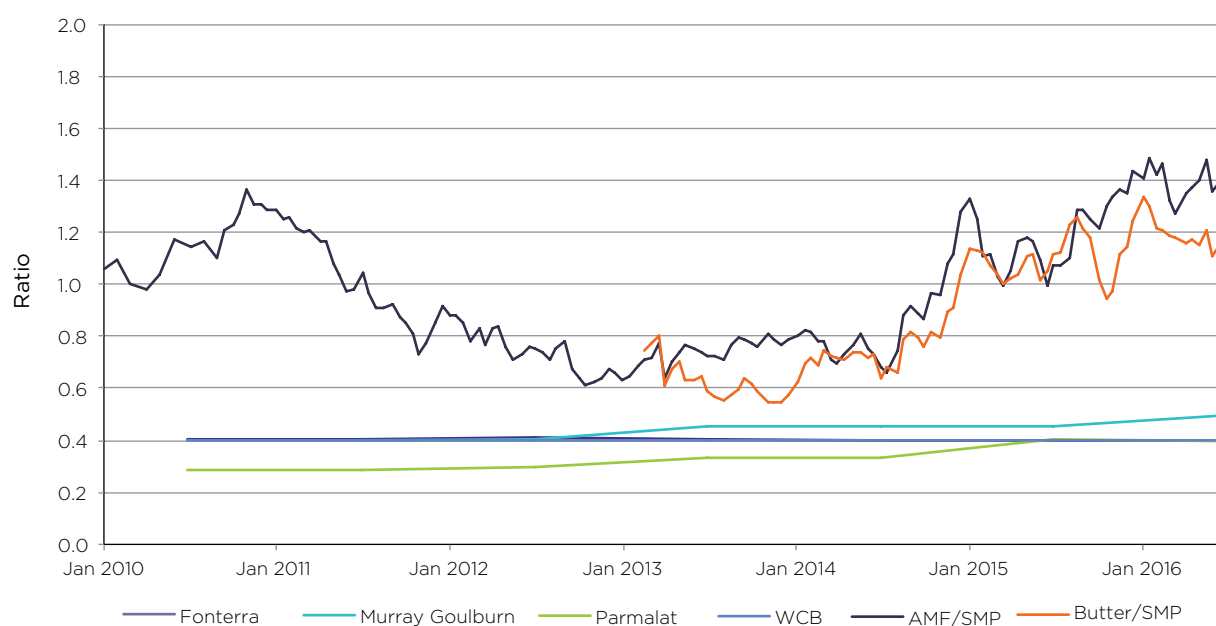
¹¹ Dairy Australia, *Dairy in Focus 2017*, p. 20.

As raw milk can be transported from one region to another, farmgate milk prices in parts of the Northern and WA regions (such as Queensland) can be, to a degree, influenced by prices in parts of the Southern region (such as Victoria). However, this influence is only likely when global commodity prices (and therefore farmgate prices in the Southern region) are particularly low. This is because when Victorian farmgate prices are high, the additional cost of transporting milk from Victoria to Queensland generally makes it cheaper to source milk from Queensland farmers, despite the higher Queensland farmgate price.

Farmers and farmer representative groups submitted there is weak correlation between processor payments for milkfat solids and global prices for butter. Farmers claim that, in this respect, fluctuations in the relative global prices for protein and milkfat are not reflected in farmgate prices for protein and milkfat (see figure 3.3). The ACCC considered this issue in further detail following the release of the Interim Report.

Processors use the ratio of their milkfat and protein solids prices to signal to farmers the ratio of milk solids that processors would like farmers to produce. The ACCC heard from farmers who would make adjustments to their pasture production and supplementary feed purchases, in consultation with nutrition experts, to optimise the milkfat and protein solids in their herds' milk, according to the prevailing prices of solids in their supply agreements. In the longer term, farmers may also transition some of their herd towards different breeds of dairy cow (such as from Holstein Friesians to Jersey cows) if the ratio of milkfat to protein solids prices incentivises them to do so.

Figure 3.3: Milkfat to protein solids price ratio—Southern region (Victoria, SA and Tasmania)



Source: GDT, selected processors, ACCC analysis.

Processors ultimately set their milkfat and protein solids prices with regard to the mix of products they produce and the milk solids required to produce these products. Processors who mostly produce fresh drinking milk typically have a lower milkfat to protein solids price ratio than those who mainly produce butter, whole milk powder or certain types of cheese.

A processor producing a mix of exportable products may change their ratio of milkfat to protein solids prices over time according to trends in international prices in the medium to long-term. Processors are less likely to immediately respond to incremental changes in global prices for milkfat based commodities such as butter and AMF, than they are to incremental changes in global prices for protein based commodities such as milk powder.

The ACCC notes Fonterra's submission in response to the Interim Report:

...the production of 1 metric tonne of butter produces over 2 tonnes of Skim Milk Powder (SMP) as a co-product. This means that if a processor is considering increasing butter production, the processor must also consider the return that it will receive on the sale of SMP. SMP prices have been systemically low ... with high global inventories and this means butter prices must be even higher to encourage butter production away from other alternatives such as Whole Milk Powder (WMP) and Cheese.¹²

Further, processors are also often restricted in their ability to change their product mix based on their factories. A number of major Australian processors do not produce butter.

Given the inflexible production mix that processors face, their demand for milkfat solids compared to protein solids is much more stable than the value of milkfat based commodities relative to protein based commodities.

These factors explain why farmgate prices for milkfat solids, and the value of milkfat solids relative to protein solids in Australia do not always reflect incremental changes to global butter or AMF prices.

3.5 Pricing to encourage flat production

Raw milk production has historically been seasonal, especially in the Southern region which has peak production in spring. While this is still the case, some processors now place a higher value on flatter production to meet customer demand and maximise plant efficiency. As discussed in chapter 1, in many regions the lowest cost method of producing raw milk is to maximise output in spring months when pasture yields are high, and reduce output in autumn when pastures are scarce and supplementary fodder needs to be purchased.

Domestic focused processors who mainly manufacture fresh dairy products with a short shelf life (such as fresh drinking milk, yoghurts, and fresh cheese) require a flatter milk supply to consistently meet retailer requirements. This is because these products are typically supplied into domestic markets, and the consumption of most dairy products in Australia is consistent throughout the year. These processors therefore place a higher value on flatter production.

Export focused processors face a trade-off in terms of whether to encourage seasonal or flatter milk production. On one hand, seasonal milk production is a lower cost farming method and processors can acquire the majority of their milk requirements in spring at a cheaper price. However, this requires high capacity production facilities to process the high volume of milk in spring, which are under-utilised at other times of the year. On the other hand, flatter milk supply allows processors to operate smaller capacity processing facilities at a consistently higher utilisation rate. This leads to lower production costs, but at the expense of higher milk prices.

Dairy farmers in the Southern region raised concerns with the ACCC about a perceived push by most processors towards a flatter milk supply, arguing it is an inappropriate shift of risk from processors to farmers for the purpose of improving processor efficiency.

Flatter milk production across a dairy season¹³ is typically encouraged by processors in two ways:

1. In some regions, processors increase the price premium for autumn milk and reduce the price paid for spring milk.
2. An alternative is to offer a higher overall price conditional upon certain milk supply volumes at certain times of the year, with penalties if the condition is not met.

For farmers, flatter milk production often results in higher costs of production (due to increased purchases of supplementary feed) and greater volatility in costs of production (due to volatility in feed prices).

However, in most cases, farmers still have discretion to choose their calving patterns and whether or not they wish to flatten their production profile. In the course of this inquiry the ACCC spoke with a number of efficient and profitable dairy farmers who have adjusted their calving patterns to take partial advantage of higher milk prices in winter while limiting their exposure to feed cost volatility.

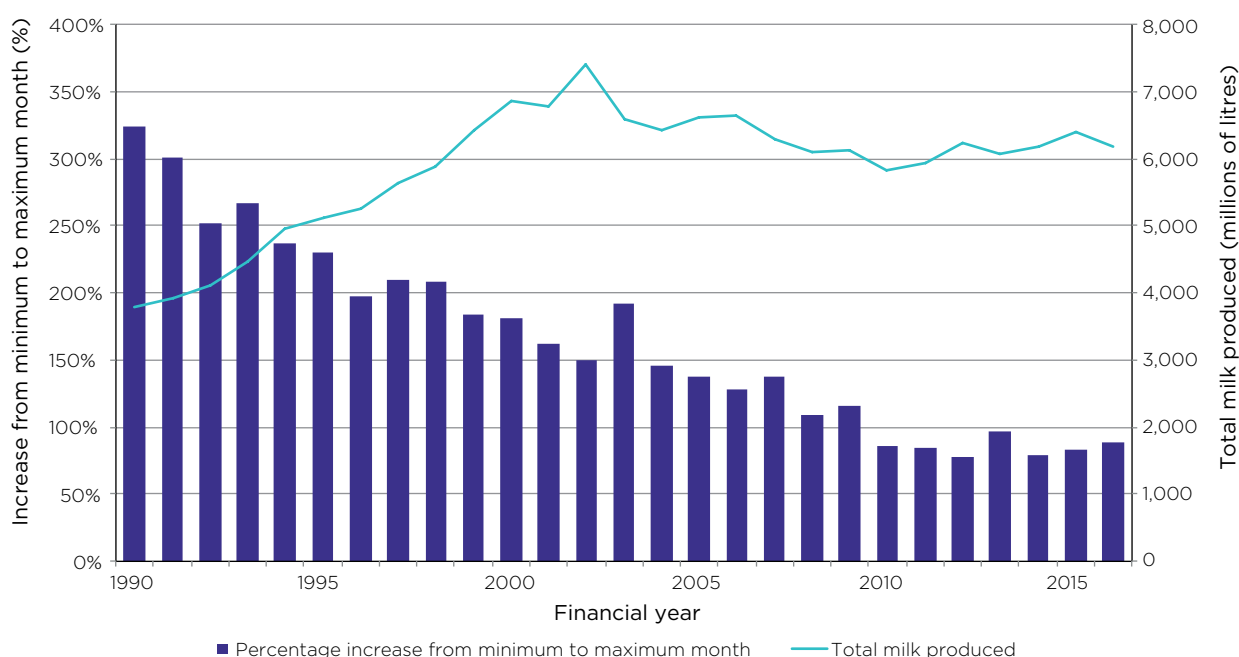
¹² Fonterra Australia Pty Ltd, *Submission in response to the ACCC Dairy inquiry interim report*, 31 January 2018, p. 9.

¹³ Discussion about how seasonality operates is included in chapter 1.

The ability of farmers to manage this issue varies from region to region. Many farmers in Victoria are able to choose the processor whose demand best fits their preferred production profile. This is because most Victorian processors have capacity to manufacture longer shelf-life dairy products and consequently can handle volatile production throughout the year (see chapter 5). Conversely, farmers in areas such as Queensland and WA seldom have this option and contracts and pricing in these locations favour those with flatter production.

Victorian milk production data indicates that variability between seasons declined significantly between 1990 and 2010, meaning the industry overall is generally moving towards flatter milk production. Figure 3.4 illustrates the extent of seasonality of milk production in Victoria over time by showing the percentage difference in the volume of milk produced in the minimum (autumn) and maximum (spring) months of production as a proportion of total milk produced. As can be seen from this figure, the difference between the minimum and maximum volume of milk produced per month in Victoria has fallen from around 180 per cent in 1999–00 to around 75 per cent since 2009–10.

Figure 3.4: Seasonality of milk production in Victoria

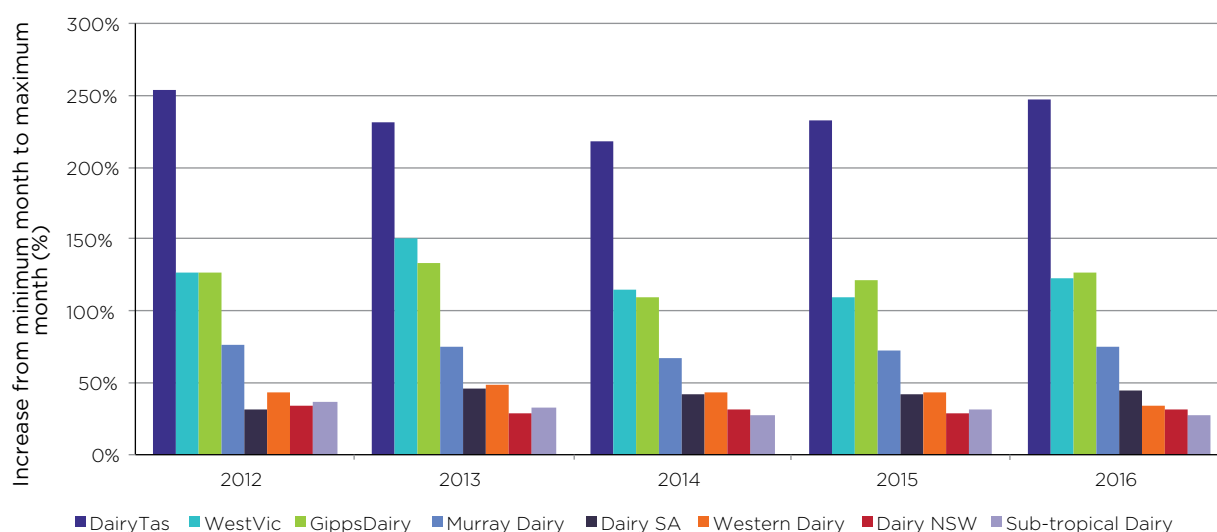


Source: Dairy Australia data, and ACCC analysis.

Figure 3.5 illustrates the highly seasonal milk production of Tasmania, and to a lesser extent Victoria, relative to the predominantly fresh drinking milk market in Queensland. Figure 3.5 shows:

- in Tasmania, peak monthly milk production in spring is approximately 250 per cent greater than the volume in the lowest month of production
- in Queensland, peak monthly milk production is only around 25–30 per cent greater than the volume produced in the lowest month of production for most years. This reflects that in regions such as Queensland and WA processors have a greater need to obtain a flat milk supply to meet fresh drinking milk demand
- in NSW and SA, peak monthly milk production is from 30 per cent to nearly 50 per cent greater than the volume produced in the lowest month.

Figure 3.5: Seasonality of milk production across Australia



Source: Dairy Australia data, and ACCC analysis.

3.6 The complexity of the components that make up the farmgate milk price

Farmers raised concerns that milk supply agreements are difficult to understand due to their complexity and the number of variables that affect payments.

This difficulty in interpreting supply agreements means it is difficult for farmers to:

- estimate their projected incomes for the year
- compare the offers of different processors
- identify the most suitable production system and milk supply pattern (taking into consideration farm size, location, and growth plans etc.).

These issues can lead to inefficient supply and production choices, and reduce competition.

Since deregulation, the diversity of price signals contained in supply agreements has progressively increased.¹⁴ The industry has seen a significant change in the formality and structure of supply arrangements offered by processors.¹⁵

The National Competition Council's 2004 report *The Australian Dairy Industry Since Deregulation* suggested that more complex and varied supply agreements have generally increased transparency over the value placed on milk components (e.g. butter fat, protein and other components used in co-products) and milk supply attributes (timing and consistency of milk supply) by processors. The NCC also considered this had 'provided producers with more choice concerning their production systems in response to the incentives available'.¹⁶

The ACCC has reviewed a wide range of past and present milk supply agreements and analysed their price components.

A common factor in milk supply agreements is that most milk is valued by processors according to its milkfat and protein content, with base prices expressed in dollars per kilogram for each of these components. The combined farmgate price is expressed in dollars per kilogram of milk solids (\$ kg/MS), which is the weighted average price of these components (determined by milk composition) plus any bonuses (incentives) less any charges and deductions (stop charges, volume charges or quality penalties). Given these variables, the headline farmgate price may not accurately represent the

¹⁴ National Competition Council, *Dairy—Now and Then: The Australian Dairy Industry Since Deregulation*, AusInfo, 2004, p. 35.

¹⁵ *ibid.*

¹⁶ *ibid.*

milkfat and protein content that will be delivered by any particular farm, or the particular bonuses and deductions that the farm will receive.

However, beyond this basic pricing mechanism, contracts are highly diverse. Table 3.1 shows the types of pricing mechanisms in supply agreements and the prevalence of these terms in offers from major processors.¹⁷ The relative importance of the various incentives, bonuses and penalties on the price paid for milk can vary a great deal between processors.

Table 3.1: Type of terms in 2016 processor supply agreements

Supply agreement term	Number of major processors using term (out of eight)
Flat supply incentive	5
Volume incentive	5
Quality incentive/penalty	6
Growth/Productivity incentive	5
Loyalty bonus	4
Productivity incentive	1
Collection charge	5
Long-term supply incentive	2
Undersupply penalties	1
Share purchase options	1
Supplier loans	1
Sign-on bonus	1

Major processors also often have a number of different supply agreements available, further adding to farmers' difficulties in identifying the best offer for them.

It is also difficult for farmers to forecast whether incentives, bonuses or penalties are likely.

¹⁷ ACCC analysis of contracts.

Box 3.1: Case study: Pricing components

The ACCC analysed the various components that comprise the overall milk price offered by processors. It was found that processors typically announced an average opening milk price expressed in either cents per litre (with reference to a standard composition of milkfat and protein) or as a price per kilogram of milk solids.

Underlying this average price were monthly base prices for milkfat and protein. In addition to these monthly base prices, most processors offered a premium rate for volume supplied during off-peak months. The base milk price was often variable and subject to change throughout the season depending on market conditions.

The overall milk price received by supplying farms was often subject to a number of additional payments and deductions, including:

- **The yield of fat and protein:** the base milk price is dependent on the quantity or ratio of milk solids. The overall milk price a farmer receives is therefore reliant on the fat and protein content of the milk supplied, which can vary day to day, within and between seasons.
- **A production payment:** an additional payment provided as an incentive to increase production. This payment is often calculated on a sliding scale based on the total amount of milk solids supplied during the season.
- **Milk quality incentives and penalties:** processors usually prescribe certain incentives and penalties related to the quality of milk supplied. The incentive or penalty will normally be calculated on a sliding scale based on test results, such as the BMCC and Thermoduric Plate Count. However, as the standards are determined by the processor, milk quality testing regimes are seldom consistent across processors.
- **A volume charge:** a flat rate charge for every litre of milk supplied.
- **A stop charge:** a collection fee that is typically only charged if a second milk collection is required.
- **The farm access rebate:** a rebate offered as an incentive to improve farmgate access. The rebate is determined by a set of criteria, such as farmgate or dairy access, track condition, turnaround area and safety.

The ACCC has found that most processors offer an overall milk price that combines variable seasonal rates, incentive payments, penalties and service charges. These offers are rarely consistent across processors. The number of components forming the overall milk price creates complexity for farmers, impeding their ability to accurately determine the overall milk price or compare the offers of competing processors.

Given this complexity, farmers are highly reliant on the field officers employed by the processors to translate payment terms into an income estimate based on the farm's historical production profile. While income estimates are a critical source of information for farmers, they are not a perfect solution to complicated supply agreements. This is discussed in more detail in box 3.2.

Box 3.2: Dairy farm income estimates

Field officers employed by processors visit supplying farms after the farmgate milk price is announced for the year, and provide each farmer with an income estimate based on the historical production profile of the individual farm. This is the primary way in which processors' offers are interpreted.

If a dairy farmer is contemplating the offer of an alternative processor, they are typically able to request a field officer to visit and provide an income estimate based on that offer.

Some farmers generate their own income estimates to compare the price offers of different processors, sometimes with assistance from a consultant or accountant. To do this effectively, the business needs to collect and retain good quality production data. However, most farmers are highly reliant on the field officers from their processor being able to translate farmgate price announcements into income estimates.

The ACCC received mixed feedback from farmers about the accuracy of the income estimates. Representatives of state farming bodies mostly indicated that the income estimates are accurate. However, some farmers raised concerns that income estimates significantly overstated the actual incomes they receive for the year.

The ACCC understands that field officers must make critical assumptions about the production profile, volumes and quality standards of the milk that each farm will produce and that these assumptions may not be met during the course of a season. In this circumstance the overall price received can be significantly impacted. In particular, actual prices can be greatly impacted by:

- changes to the seasonality of a farm's production
- changes to the total volume of milk produced
- variations in the fat and protein content of the milk produced
- failures to consistently meet milk quality requirements (which vary between processors).

The ACCC considers that given the strong reliance of farmers on income estimates it is important that the assumptions and risks are communicated clearly to each individual farmer and that the implications of not meeting all assumptions are also made clear.

3.7 Variable and fixed pricing

Processors generally have significant discretion over the variation of farmgate prices. While processors can typically pass on price movements to farmers, they may choose to absorb some losses instead of passing them on.¹⁸

In contrast, the vast majority of farmers are price takers with no pricing discretion. A farmer's only discretion is its choice of processor, which in some regions can be limited (see chapter 4). As has been discussed, there is generally very limited negotiation between farmers and processors over terms of supply.

¹⁸ In 2016, a number of processors other than Murray Goulburn and Fonterra chose not to step-down.

Box 3.3: 2016 Farmgate price step-downs

In April and May 2016 Murray Goulburn and Fonterra Australia announced substantial reductions to their farmgate milk price for the 2015–16 dairy season.

On 27 April 2016 Murray Goulburn announced it would reduce its full year farmgate milk price from \$6.05 kg/MS to between \$4.75–\$5.00 kg/MS. Murray Goulburn also outlined a plan to reclaim ‘overpayments’ from farmers over the next three years. The ‘overpayments’ were monies previously paid to farmers that were surplus to the reduced farmgate milk price following the step-down (these were later cancelled). At the time of the step-down, it was estimated that in total farmers would have to effectively repay Murray Goulburn between \$140 million and \$190 million. This was reported to cost the average dairy farmer \$127 500 over a three-year period.

On 5 May 2016 Fonterra Australia revised its full season farmgate milk price from \$5.60 kg/MS down to \$5.00 kg/MS. This price revision was not applied retrospectively. However, to achieve the revised full year average price, Fonterra Australia reduced the price for milk supplied for the remainder of the season, to \$1.91 kg/MS.

Parmalat, Warrnambool Cheese & Butter and Bega Cheese did not step-down their farmgate milk prices for the 2015–16 season. Lion Dairy & Drinks announced a step-down for its variable price milk supply agreements in certain regions for supply for June 2016.

The step-downs occurred in the context of challenging global market conditions. International prices had been in decline since 2014 due to a global oversupply of dairy products which resulted from a range of factors. These included the removal of production quotas in Europe, the introduction of a two year ban on dairy imports into Russia, and an economic slowdown in China. The oversupply led to a reduction in commodity values, ultimately affecting Australian farmgate prices.

There is ongoing debate within the industry about the extent to which the global conditions necessitated Murray Goulburn’s step-downs, and whether the global conditions and communication with farmers could have been better managed.

ACCC proceedings against Murray Goulburn

On 28 April 2017 the ACCC instituted proceedings in the Federal Court against Murray Goulburn alleging it engaged in unconscionable conduct and made false or misleading representations in contravention of the Australian Consumer Law.

The ACCC also alleged that the former managing director Gary Helou and former chief financial officer Bradley Hingle were knowingly concerned in Murray Goulburn’s conduct.

The ACCC alleged that from June 2015 until February 2016, and separately, from February 2016 until April 2016, Murray Goulburn misled farmers by representing that it had a reasonable basis for setting and maintaining an opening farmgate milk price of \$5.60 kg/MS and a forecast final farmgate milk price of \$6.05 kg/MS, and that it considered the forecast final farmgate milk price of \$6.05 kg/MS was the most likely outcome for the 2015–16 season, when in fact that was not the case.

Further, the ACCC alleges that from February 2016 until April 2016, Murray Goulburn misled farmers by representing it had a reasonable basis for expecting to be able to maintain its opening farmgate milk price of \$5.60 kg/MS for the remainder of the season, and that it considered a final farmgate milk price of \$5.60 kg/MS was the most likely outcome for FY16, when in fact that was not the case. The ACCC also alleges that, in all the circumstances, Murray Goulburn’s conduct towards farmers was unconscionable.

The proceedings were before the Court at the time this Final Report was completed.

The actual and potential use of price-steps down, especially retrospective step-downs, has been a contentious issue in the industry since the 2016 step-down events.

Both farmers and some processors were critical of the use of step-downs:

- Farmer Power stated the use of step-ups and step-downs is a clear demonstration that farmers carry most risk within the dairy supply chain.¹⁹
- NSW Farmers submitted that step-downs can be unfairly applied to mitigate business risk encountered by processors.²⁰
- Norco stated it 'does not use step-downs or claw back provisions as part of its pricing system'.²¹
- In a submission to a Senate Committee inquiry, Lion stated that 'retrospective changes in milk price, including price cuts, are anathema to Lion as they undermine trust, drive volatility and damage farmers' ability to plan for and invest in their business.'²²

In contrast, a range of stakeholders indicated that step-downs are a necessary feature of the industry. For example:

- DFMC stated: 'The step-up/step-down system is reasonable, as it allows processors to increase or decrease the price they pay to farmers as market circumstances become clearer. However, what isn't acceptable is retrospective step-downs...'²³
- Fonterra stated it '...does not agree with calls to ban step-downs, either entirely or late in a season. In our view, banning step-downs would inevitably lead to lower opening prices and more conservative step-ups. This would have an adverse effect on farmers' cash flow throughout the season.'²⁴

Some processors also indicated to the ACCC that their opening price is intended to be a minimum guaranteed average price for the season, and that any step-down would not reduce prices below this minimum (in which case, any step-down would need to have been preceded by a step-up within the season).

The ACCC received mixed feedback from processors about their ability and willingness to offer fixed price milk supply agreements.

Lion, which predominantly produces fresh dairy products for domestic consumption, offers its suppliers three year contracts in which they can lock in a price for up to 50 per cent of their production.²⁵ In its submission, Lion stated:

*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.'*²⁶

Some processors stated they are less willing or unwilling to offer fixed price milk supply agreements, especially on a multi-year basis. Reasons provided for this include:

- insufficient certainty at the beginning of the season about total revenue
- potential losses if there is a downturn in global commodity prices
- the fact that supermarkets do not offer long-term contracts for branded products, making it difficult for processors to provide price certainty to farmers.

The ACCC understands some export focused processors often lock-in prices for a substantial volume of their exports for the upcoming year. Furthermore, export focused processors often diversify into fresh dairy products for the Australian domestic market.

19 Farmer Power, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, p. 8.

20 NSW Farmers' Association, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, p. 8.

21 Norco, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, p. 3.

22 Lion Dairy and Drinks, *Submission to the Senate Economics References Committee*, October 2016, p. 2.

23 Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC Inquiry into the Australian Dairy Industry (Part 1)*, 12 December 2016, pp. 6-7.

24 Fonterra Australia Pty Ltd, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, pp. 8-9.

25 Lion Dairy and Drinks, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, p. 11.

26 *ibid.*

3.7.1 Should the potential for step-downs continue in the industry?

Given the volatility demonstrated by the GDT index, and that the majority of variable pricing provisions exist in southeast Australia (such as in Victoria), it could be argued that the ability to vary the farmgate milk price is necessary to enable processors to adapt to major changes in global market conditions.²⁷

However, the ACCC considers that the step-down process transfers the risk of global commodity fluctuations from the processor to the farmer, whereas the processor is best placed to manage this risk. This is because processors:

- have visibility over their own global market exposure
- have a better understanding of commodity price trends and movements than farmers do
- can lock in a significant proportion of their export contracts before they announce their opening price for the year.

3.7.2 Should processors set minimum guaranteed prices?

The 2016 step-downs shook farmers' confidence in their ability to rely on opening prices as the minimum price they will receive for the year. If farmers were able to rely on opening prices as a guaranteed minimum price, this would provide greater certainty and allow for more confident decision-making. However, it may also lead to processors setting opening prices cautiously low and forecasting larger step-ups, sending mixed signals to farmers and potentially leading to under- or over-investment in production.

The ACCC also considers that overly conservative prices may be detrimental to the industry, including farmers. This is because:

- lower returns in the early part of a season may create cash flow problems for farmers
- price step-ups are discretionary for processors, and there is no guarantee that improved prices will be passed on to farmers throughout the season
- sending inaccurate price signals to farmers may have negative productive efficiency consequences, such as encouraging farmers to produce less milk in circumstances where higher production volumes may benefit the industry.

Conservative pricing is also likely to be challenging in a competitive environment, where opening prices are a key means by which processors compete against one another for suppliers.

Taking into account this range of complex pricing issues, the ACCC considers that:

- most processors should be capable of offering fixed prices for the majority of the milk that they acquire and managing the residual risk themselves, rather than passing it on to farmers
- where both a fixed and variable price are offered, the fixed price can be lower than the variable price to reflect the additional price risk being worn by the processor (similar to an 'insurance cost')
- transparency in pricing and changes to forecasts are likely to be more critical issues when it comes to variable farmgate pricing than the potential for step-downs
- farmers' ability to exit agreements in response to a step-down is likely to mitigate risk of financial harm to them, and the risk of losing large volumes of milk supply may deter processors from imposing step-downs.

²⁷ See the charts in chapter 3.

Box 3.4: The Voluntary Code

The Voluntary Code contains provisions designed to limit the likelihood of detriment to farmers from step-downs. Section 4 of the Code states that:

- 30 days' notice must be provided before any step-down can be imposed
- if a step-down is imposed, the farmer can terminate their contract with the processor (for a fixed term contract) provided they give the processor 30 days' notice
- step-downs cannot be applied retrospectively.

Contracts for the 2017-18 dairy season offered by processors have complied with the provisions of the Code with respect to step-downs. For example, Murray Goulburn's 2017-18 Southern Region Supplier Handbook contains a Code compliant term that is extracted below.

Murray Goulburn's 2017-18 step-down provision

Term 8.2 (Other pricing changes) In addition to clause 8.1, MG may, at its discretion but acting reasonably, vary (including reduce) the Opening Price at any time provided that MG gives the Supplier at least 30 days prior notice of any reduction in the Opening Price. The Opening Price will be adjusted with effect from the expiry of the notice period.

If MG notifies a Supplier of a reduction in the Opening Price after 1 January in any year, and that Supplier has a Current Fixed Term Supply Commitment, that Supplier may terminate the Supply Arrangement by notice to MG within 30 days after MG notifies of the reduction. The Supplier may withdraw the termination notice by notifying MG at any time within 21 days of the date on which MG notified of the reduction.

3.7.3 Pricing in multi-year contracts

During the inquiry, farmers raised concerns that some processors are willing to provide contracts for multiple years (such as three- or five-year contracts) but are not willing to provide price certainty beyond the first year of the contract. Farmers therefore argued that processors have significant discretion in terms of pricing, and that farmers who enter into these arrangements could be subject to significant price reductions without the opportunity to exit the contract. These arrangements are more prominent in the Northern and WA regions.

In contrast, processors argued that:

- longer term contracts provide certainty and mutual benefit to processors and farmers
- as discussed above, global influences on farmgate milk prices make it difficult to predict farmgate milk prices into the future.

The ACCC recognises that farmers must inherently take on some risk in exchange for the benefit of a multi-year contract.

The ACCC also recognises that some processors have a legitimate interest in offering longer term contracts, which can assist farmers by providing secure offtake.

However, the ACCC considers the ability to reduce prices without restriction when a farmer is bound to a multi-year contract transfers too much risk to the farmer. As such, some counter-balancing rights should be provided to farmers where a downward price movement occurs.

The ACCC considers that processors should provide farmers with a specified price for the term of a contract. If the processor varies the price during the term of the contract, farmers should have the ability to exit the contract without penalty. This should form part of the mandatory industry code.

The ACCC has considered whether this recommendation may result in processors:

- being less likely to offer longer term contracts, and/or
- setting more conservative prices.

While these risks need to be considered, the ACCC does not consider that they outweigh the benefit from farmers having certainty over prices within a contract period.

3.8 The communication of farmgate prices to farmers

In the Southern region, processors announce opening farmgate prices around the start of the financial year. This price is typically subject to potential step-ups or step-downs throughout the season, although there are different types of offers provided to farmers. For example, processors may:

- announce a forecast full season or ‘closing’ price, being the average price it expects to pay over the course of the season
- offer a variable opening price, with no indicative closing price
- offer a fixed-price milk supply agreement for a defined period
- offer a combination of fixed and variable price offers.

In the Northern and WA regions, it is more common for processors to offer fixed-price milk supply agreements. As discussed above, opening prices (per kilogram of milk solids or per litre) are generally expressed as a weighted average price for the season, based on underlying monthly prices that reflect the value processors place on production at various times of year. The details of the monthly price are commonly provided to farmers in a separate letter, which supplements their supply agreement. Farmers are also typically informed of step-ups during the season by letters similar to opening price letters.

In some less common cases, farms receive specially negotiated price terms.

Processors also often make public announcements, such as by media release, to alert farmer suppliers and potential suppliers to their prices or pricing forecasts.

Box 3.5: Warrnambool Cheese & Butter 2017–18 opening price announcement

The media release issued by Warrnambool Cheese & Butter (WCB) to announce its 2017–18 opening farmgate milk price is typical of a public communication from a processor. These communications may be in a public form, or by letter to individual farmers (and in many cases will be both). Processor supplier letters are typically more detailed than their public announcements and may discuss additional matters, such as upcoming supplier meetings, contracting options and changes to contracts from the previous season.

The 9 June 2017 public announcement highlighted that the opening average milk price for the 2017–18 season was \$5.50 per kg milk solids. As is usual practice, it did not provide any information about how this figure was calculated.

In the public announcement WCB provided a high-level overview of forecast global dairy commodity prices stating, ‘Global dairy commodity prices have shown some recovery from the low levels we were experiencing this time last year.’ As is also common, the communication then gave a quick update on WCB’s business outlook, noting that WCB had welcomed many new suppliers and increased its capacity to produce cheese and other products. WCB also noted it has seeking new milk supply for the coming season.

3.9 The timing of price announcements

3.9.1 Competition for raw milk and the announcement of farmgate prices

The ACCC heard concerns that processors do not actively compete against one another, but simply ‘follow-the-leader’ in respect of opening farmgate prices (with the leader usually said to be Murray Goulburn), thereby restricting price competition.

UDV submitted that as product mixes and end markets vary between processors, their income profiles would be diverse and prices offered to farmers should reflect this diversity. However, UDV observes that processors typically set a similar opening price to the first processor to announce its price.²⁸

An instance in which farmgate prices may not reflect a competitive market is if there were coordination between processors.

²⁸ United Dairy farmers of Victoria, *Submission to ACCC’s Inquiry into the Australian dairy industry*, 12 December 2016, p. 7.

When one buyer is the price leader or setter over an extended period of time it can indicate limited price competition in the market. It can also reduce the incentive of the price leader to set high prices if it considers competitors will closely follow and not compete to grow market share. This may also facilitate coordination and result in lower farmgate prices.

The ACCC has analysed price leadership behaviour by comparing the opening price and announcement dates of various processors (table 3.2).

The ACCC did not find evidence that any particular processor has been the opening price leader for an extended period of time. With regard to opening price announcements in the Victorian region from 2010–18, the following was observed:

- over the eight year period each of Murray Goulburn, Fonterra, Bega and WCB has been the first processor to announce their opening price, with Fonterra the most frequent
- there is no clear pattern of processors matching or following the opening price
- Murray Goulburn, Fonterra and Bega have historically offered similar prices
- smaller processors, such as Lion and Parmalat, consistently offered a higher opening price than the first opening price announcement
- the 2017–18 dairy season saw a number of processors announce opening prices substantially higher than Murray Goulburn's opening price (although forecast closing price range estimates were similar)
- the pricing announcements made during the 2017–18 season are contrary to what would be expected if processors were behaving in a coordinated fashion
- some processors announced an opening price and forecast closing price (assuming step-ups), while others announced one price that was subject to variations
- the first processor to announce an opening price typically offered the lowest opening price.

Table 3.2: Processor opening price announcements (Victoria)

Announce- ment order	1	2	3	4	5	6	7
FY2011	Fonterra 24/05/10 \$4.36 kg/MS	Lion 17/06/10 \$5.56 kg/MS	Bega 22/06/10 \$4.99 kg/MS*	WCB 1/07/10 \$4.72 kg/MS	Murray Goulburn 1/07/10 \$4.75/kg MS		
FY2012	Fonterra 12/05/11 \$4.65 kg/MS	Bega 6/06/11 \$4.82 kg/MS	Lion 20/06/11 \$5.70 kg/MS	WCB 21/06/11 \$4.90 kg/MS	Murray Goulburn 29/06/11 \$4.90/kg MS		
FY2013	Bega 26/06/12 \$4.48 kg/MS	Murray Goulburn 28/06/12 \$4.50 kg/MS	WCB 29/06/12 \$4.50 kg/MS	Lion 29/06/12 \$5.12 kg/MS	Fonterra 4/07/12 \$5.99/kg MS*	Parmalat 10/07/12 \$5.20 kg/MS*	DFMC 1/09/12 \$5.12 kg/MS
FY2014	Murray Goulburn 5/06/13 \$5.60 kg/MS	Fonterra 14/06/13 \$5.60 kg/MS	Lion 20/06/13 \$6.03 kg/MS	Bega 25/06/13 \$5.62 kg/MS**	Parmalat 25/06/13 \$5.21/kg MS	WCB 29/06/13 \$5.65/kg MS	DFMC 2/08/13 \$6.03 kg/MS
FY2015	Fonterra 25/06/14 \$5.80 kg/MS	Murray Goulburn 25/06/14 \$6.00 kg/MS	WCB 26/06/14 \$5.86 kg/MS	Lion 27/06/14 \$6.35 kg/MS	Bega 27/06/14 \$6.00/kg MS	Parmalat 1/07/14 \$6.09 kg/MS	DFMC 2/07/14 \$6.35 kg/MS

Announce- ment order	1	2	3	4	5	6	7
FY2016	Bega 23/06/15 \$5.60 kg/MS	Murray Goulburn 24/06/15 \$5.60 kg/MS	WCB 26/06/15 \$5.60 kg/MS	Fonterra 29/06/15 \$5.60 kg/MS	DFMC 30/06/15 \$5.80/kg MS	Parmalat 1/07/15 \$5.91 kg/MS	Lion 2/07/15 \$5.80 kg/MS
FY2017	WCB 10/06/16 \$4.80 kg/MS	Bega 21/06/16 \$5.00 kg/MS	Murray Goulburn 28/06/16 \$4.31 kg/MS	Fonterra 29/06/16 \$4.75 kg/MS	Lion 30/06/16 \$5.00/kg MS	DFMC 30/06/16 \$5.00 kg/MS	Parmalat 1/07/16 \$5.46 kg/MS
FY2018	Murray Goulburn 6/6/2017 \$4.70 kg/MS	Bega 8/6/2017 \$5.50 kg/MS	WCB 9/6/2017 \$5.50 kg/MS	Fonterra 14/6/2017 \$5.30 kg/MS	Lion 23/6/2017 \$5.40 kg/MS	DFMC 26/6/2017 \$5.40 kg/MS	

* Price estimated based on processor price for butter fat and protein.

**net price

Source: Processors, media, ASX announcements and ACCC analysis.

As illustrated in chapter 4, market shares for the purchase of raw milk have been stable across the dairy regions for the 2013–14 to 2015–16 dairy seasons. On its face, this raises some concerns about how vigorous competition is between processors. However, as can be seen in table 3.2, meaningful variation in opening prices suggests there is price competition between processors.

3.9.2 The impact of announcement timing on processors and farmers

Farmers raised concerns that the timing of price announcements can leave too short a notice period for farmers to switch to a better offer from a competing processor, consider the terms of a supply agreement, or optimise the farm's operation over the year. Submissions from farmers included:

- that the timing of announcements in late June means that autumn calving farms have little to no pricing information when they are making important production decisions regarding how many cows to calve and optimal feeding
- farmers at the Taree forum indicated the new season price is provided only a short time before the commencement of the season which does not allow sufficient time for review or to seek to negotiate
- NSW Farmers stated that 'some processors only give two weeks for producers to consider the new contract [which] limits the opportunity for independent legal advice, querying any changes and negotiating terms.'²⁹

Concerns were also raised about the timing of step-ups and step-downs, which can be unpredictable.

In considering what constitutes a 'reasonable' notification period, two competing considerations must be weighed:

1. Farmers need access to accurate information as early as possible in order to be able to:
 - (a) make sound investment and other farm management decisions for the coming year
 - (b) analyse the price and supply agreement terms offered by the processor to determine the likely effect of those terms on the farm business
 - (c) consider potential competing offers from other processors.
2. Processors prefer to set prices close to the commencement of a dairy season. The ACCC has found that processors, particularly those in the Southern region, often delay announcing prices until they have greater certainty from locking-in a number of export contracts. However, processors have also

²⁹ NSW Farmers' Association, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 7.

often delayed making pricing announcements due to waiting for other processors to move first (as discussed in further detail in chapter 4).

In considering the timing of price announcements it is important to identify by when farmers must make a switching decision, as this is not typically 1 July.

The distinction between fixed-term milk supply agreements and Supplier Handbook supply agreements must also be considered. The majority of farmers are on Supplier Handbook agreements, which they can typically exit at any time. Evidence provided by processors indicates that processors are generally willing to take on new supply throughout a season, and farmers therefore do not need to switch at the start of the season. Farmers on Supplier Handbooks therefore may not be substantially impacted by the timing of price announcements, although they may be subject to contract terms that present barriers to efficient switching between processors. These are discussed in section 3.9.3.

In the case of fixed-term milk supply agreements, farmers may need to make switching decisions before a new season. However, the ACCC understands that in practice, farmers typically do not have to sign a new agreement before the new season commences.

The use of 'loyalty bonus' provisions and notice periods in processor contracts have historically presented barriers for farmers seeking to switch between processors. These two issues are examined in detail in chapter 4. The ACCC's view is that farmers on Supplier Handbooks and fixed term contracts should have a reasonable 'switching period' in order to allow sufficient time to make switching decisions, after their current processor has made their pricing announcement. This proposal is discussed in further detail in chapter 7.

3.9.3 Barriers to switching reinforce risk for farmers

Submissions suggest that both processors and farmers would prefer that pricing announcements be made as early as possible, to allow time to prepare for the upcoming season. However, later announcements may allow for a better-informed price with greater certainty. There was no evidence to suggest that processors deliberately delay the announcement of prices to harm farmers.

While the ACCC's general view is that there are benefits if prices are announced as early as possible, an early announcement that is inaccurate undermines the benefit of advanced notice.

The ACCC considers that minimising barriers to switching within a season, including through addressing certain loyalty bonus and notice period terms (see chapters 4 and 7), will mean that announcements made close to the commencement of the season are less problematic for farmers (depending on the nature and duration of their contract).

3.10 Distribution of prices received by farmers

As previously discussed in section 3.9.1, processors typically make uniform pricing offers to farmers and announce a single farmgate price at the start of the season. However, the prices received by farmers vary significantly from the announced price, as well as from that received by other farmers. The total volume, milk solids content and seasonal profile of production determine the milk price that any given farm receives.

3.10.1 Announced farmgate prices do not reflect actual prices received for many farmers

The ACCC analysed farm payment data of six processors to consider how the prices announced at the commencement of the dairy season compare to the actual prices received by farmers.

For the purpose of this discussion, the term 'announced price' is used to describe the base farmgate price announced by a processor before the commencement of a dairy season. This is typically a volume weighted average price that is expected to be paid over the season. In some cases a processor will announce one price; in other cases a processor will announce an opening price and a forecast closing price. In the case of the latter, the ACCC adopted the forecast closing price as the announced price for the analysis.

Analysis of data for farmers nationally across these six processors shows that the correlation of payments with announced prices varies significantly from year-to-year, and that the announced farmgate price does not reflect actual prices received for many farmers. For example:

- for the 2016–17 season, 73 per cent of farms received between 80 and 100 per cent of the announced price; only 4 per cent of farmers received between 110 and 120 per cent of the announced price
- conversely, in 2014–15 only four per cent of farmers received between 80 and 100 per cent of the announced price, and 36 per cent of farms received between 110 and 120 per cent of the announced price.

While these figures demonstrate the variance from the announced prices that can occur, it is also important to look at the data on a processor by processor basis. This is because within a region, and within a year, the variation of actual prices received compared to announced prices varies between processors, which may reflect that some processors set their opening prices more conservatively than others. Of the six processors that were analysed, the ACCC found that:

- four of the six processors paid prices that were typically equal to, or greater than, their announced price
- the prices of two of the processors were typically quite variable and could range from substantially above to substantially below their announced price.

This may demonstrate that some processors are:

- more accurately able to forecast their farmgate milk prices for a particular year, or
- willing to take more risk when announcing their price.

Figure 3.6 outlines the differences between three processors in a particular dairy region, across one year, in terms of the percentage of the announced price that is received by farmers. As noted above, the announced price can be the opening price or, where applicable, the forecast closing price, and not the final price that the processor states it has paid at the end of the season. The height of the curves indicates the proportion of farmers who receive the corresponding price. As can be seen from the figure, two of the processors paid the vast majority of their farmers a price that was less than their announced price.

Figure 3.6: Prices received by farmers compared to announced prices



Source: De-identified processors, ACCC analysis.

Overall, the variability in prices paid when compared to announced prices means that farmers would benefit from the existence of more accurate tools for calculating likely income.

3.10.2 Variations between farmers in the prices paid

When a processor communicates the price it ultimately paid farmers for a full season, it typically states the weighted average price per kilogram of milk solids (or per litre of milk). As noted earlier, there can be a number of different pricing mechanisms, incentives, bonuses and penalties, which determine the price actually paid by a processor to an individual farmer.

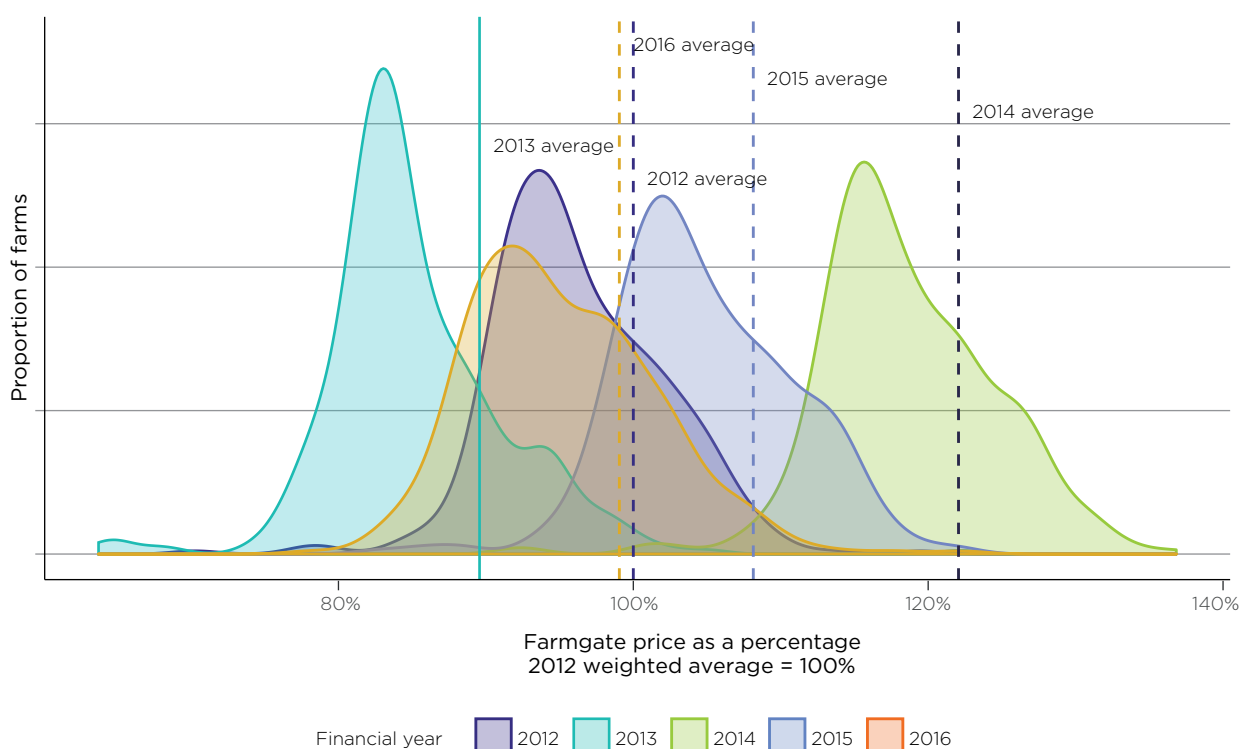
In the ACCC's hearings, processors indicated that the vast majority of farmers would achieve a price within five per cent of the weighted average farmgate price.

The ACCC's analysis of payments to farmers found that across the different regions of Australia for the 2016–17 season, approximately 60 per cent of farms received a price that was within five per cent of the processor's final weighted average price in a particular region. Further, approximately 85–90 per cent of farms received a price that was within 10 per cent of the processor's weighted average. However, the majority of farms, approximately two thirds, received less than the processor's weighted average price.

While the figures vary across processors, the vast majority of farms receive between 90 and 110 per cent of the weighted average price, and the majority of farmers receive a price between 95 and 105 per cent of the weighted average.

Figure 3.7 shows the distribution of prices paid by one processor in a dairy region over time. The chart shows that there is a significant distribution of prices paid around the average weighted price and that the maximum and minimum prices received can vary significantly from the average. The height of the curves indicates the proportion of farmers who received the corresponding price shown on the x-axis.

Figure 3.7: Distribution of prices paid to farmers for unidentified processor



Source: De-identified processor, ACCC analysis.

The price a farmer receives from a processor will depend on a range of specific factors including (but not limited to):

- the milk supply profile adopted by the farm (spring, autumn, split or year-round calving)
- the protein and milkfat content of the milk supplied
- the quality of the milk supplied (BMCC)
- the volume of milk supplied.

3.10.3 The impact of seasonal pricing on farmgate prices

In some regions, and particularly in the Southern region, seasonal pricing affects the farmgate price received as milk supply profiles vary significantly between farms. In other regions, such as Queensland, there is much less difference in the milk production profile between farms, and seasonal variation in prices does not strongly affect the relative prices that farmers receive.

A number of processors submitted that most farmers receive a price for their milk which is close to the final weighted average farmgate price, with the biggest determinant being whether the farm has:

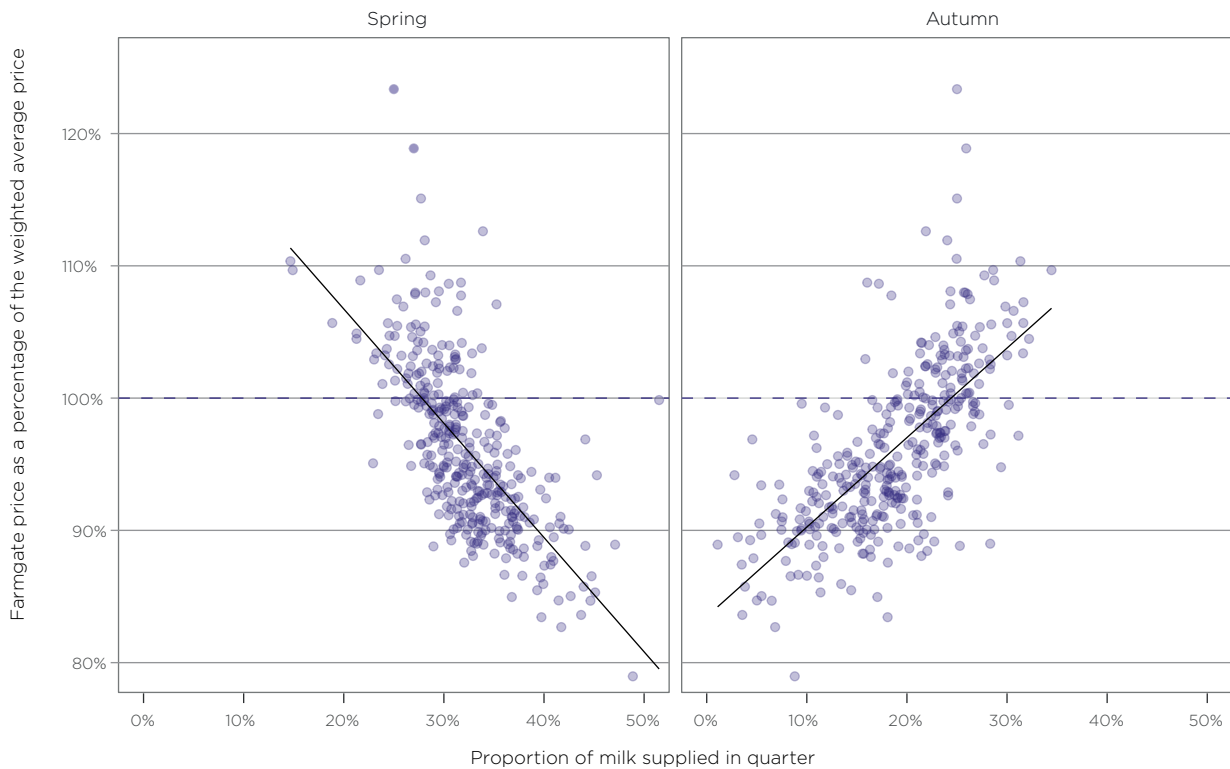
- a flatter supply profile (influenced by calving system), in which case they would generally earn a slightly higher average price for the season than the average farmgate price, or
- a supply profile which peaks in spring (primarily spring calving), in which case they would generally earn a slightly lower average price for the season than the average farmgate price.

The ACCC's analysis of milk payments in the Southern region confirmed that in most cases there is a significant negative correlation between the farmgate price received and the proportion of a farm's milk produced in spring.

Figure 3.8 presents the average weighted prices paid to individual farms by an export focused processor during the 2015–16 season. The weighted average farmgate milk price is equal to 100 per cent. This chart is indicative of a number of processors in the Southern region.

The chart shows that there was a positive relationship between the average price received by a farm over the season and the proportion of milk that farm produced in autumn (the low season). Equivalently, there is a negative relationship between the annual price a farm received and the proportion of milk produced in spring.

Figure 3.8: The impact of seasonal production on milk prices for farms in the Southern region

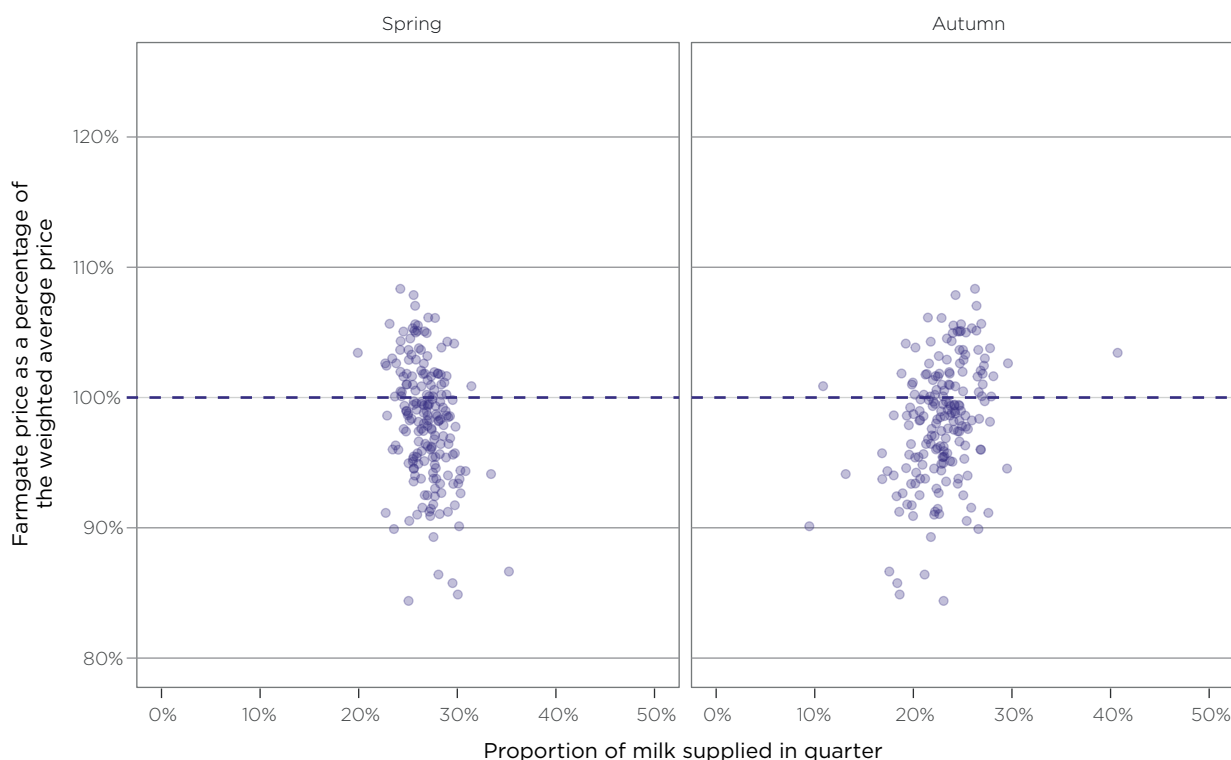


Source: de-identified processor.

This indicates that in the Southern region whether a farmer chooses spring, autumn, split or year-round calving will play an important role in the overall price received.

Alternatively, in the Northern and WA regions, there is not typically a strong link between the prices farmers receive and variations in calving systems. This is demonstrated in figure 3.9. This chart presents the average farmgate milk price paid to farmers by a processor in the Northern and WA regions in 2016–17. It reveals a greater consistency between farms in the timing of production throughout the year, and that variations in prices are not significantly explained by the timing of production.

Figure 3.9: The impact of seasonal production on milk prices in the Northern and WA regions



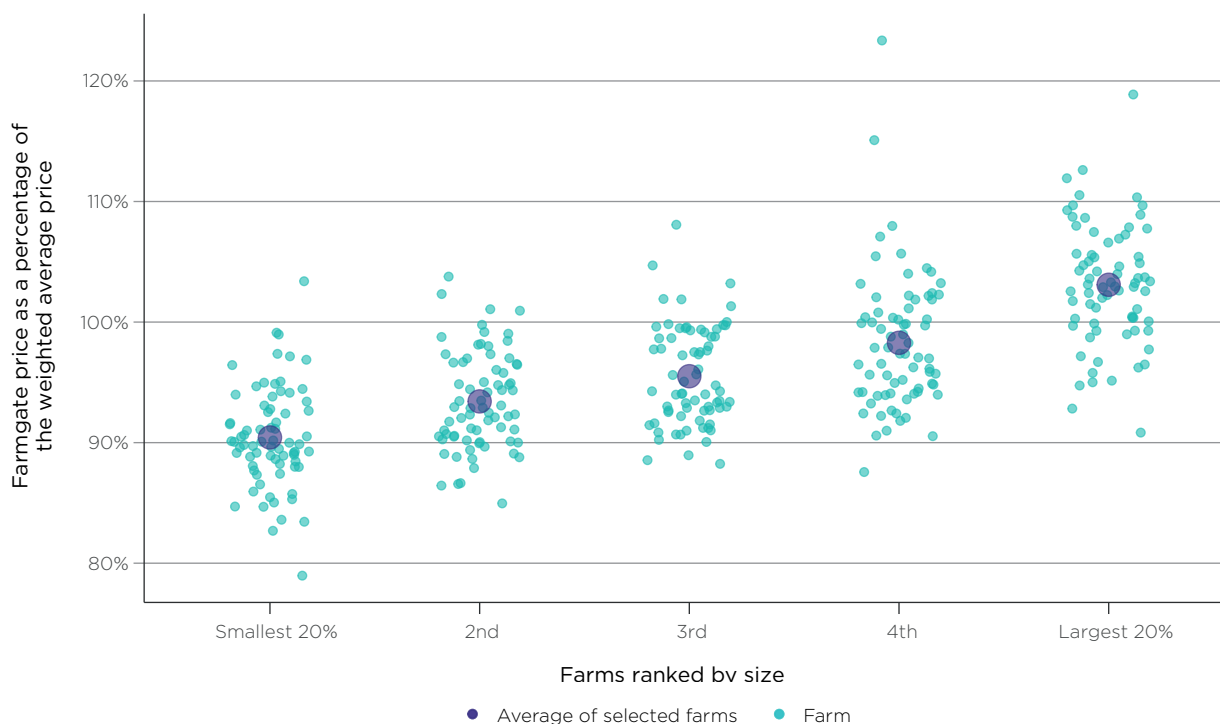
Source: De-identified processor.

3.10.4 The largest farms typically receive better farmgate milk prices than smaller farms

At forums and in submissions, some farmers expressed concern that larger farms receive a higher average farmgate milk price than smaller farms.

The ACCC analysed the relationship between farm size and farmgate milk prices received. This revealed that the largest farms typically receive higher farmgate milk prices than smaller farms. This observation is consistent across processors and regions. This is illustrated in figure 3.10, which shows the distribution of prices paid by a processor in a dairy region to different sized farms. In describing large and small farms in this section, the size of the farm is relative to the raw milk acquisition volume of the processor.

Figure 3.10: Distribution of prices paid to farms according to size by a processor in 2016



Source: de-identified dairy processor, ACCC analysis.

There were some exceptions where smaller scale farms were paid more than the average farmgate milk price and vice versa. However, generally speaking, the largest farms received the highest farmgate milk prices.

In general, this reflects that:

- larger scale farmers are sometimes offered special or individualised contract terms (and sometimes prices) compared with smaller farmers
- the same contract is offered to all farmers but pricing incentives/bonuses or deductions are structured in a way which delivers a higher price to larger scale farmers
- larger scale farmers may be more likely to have a flatter production profile or higher quality milk, resulting in higher prices.

3.10.5 Milk quality is an important influence on the price received by farmers

Each vat of milk collected by a processor is tested to determine the milk quality. The quality of milk produced, based on the quantity and types of solids and the BMCC, influences the price that a farmer receives. The quality factors and the pricing mechanisms based on them vary between processors. They can be very detailed and are typically set out in full in a Supplier Handbook.

Concerns about milk quality testing practices

Processors typically provide the results of milk quality testing to farmers on a regular basis, and this is beneficial to farmers. Farmers can adjust their production as needed in response to the results they receive.

Some farmers and farmer representative groups submitted there is a lack of objectivity and accountability in milk testing, and questioned the accuracy of some of the testing. The ACCC is aware that while some farmers obtain independent testing to verify results produced by processors, but this can be logistically challenging as independent laboratories are often located a long distance from the farm. These issues give rise to the concern that there is limited scope for most farmers to dispute the accuracy of quality test results.

Some farmers also raised concerns about the consistency of quality testing between different processors. A farmer in Queensland who supplies two processors submitted that the quality test results, specifically the BMCC, reported by the two processors for the same milk were materially different.

The ACCC understands that there is not currently any independent auditing of the quality results produced by processors. Further, as discussed in chapters 7 and 8, there are few options for effective dispute resolution in the dairy industry, which makes it very difficult to challenge any results a farmer considers to be inaccurate.

It is unclear how problematic a lack of independent testing is. However, the ACCC believes that the industry should consider whether an independent auditing process for milk testing would be beneficial.

Challenges in comparing quality factors

A second concern raised by farmers is that the quality factors set by processors vary widely, and this can impede the proper consideration of pricing offers.

Different processors have different product mixes and therefore have different milk quality requirements. The ACCC considers this to be reasonable. However, the ACCC recognises that comparing potential prices using a range of different quality factors may be challenging for many farmers. The price penalties which a farmer might incur for not meeting quality requirements should be communicated clearly to farmers through an online farmgate price portal and/or other simplified, and industry standardised, price comparison tool.

4. Competition for raw milk

Key Points

- Competition between processors for the acquisition of raw milk primarily takes place in nine regions.
- The markets for the acquisition of raw milk are highly concentrated in all regions except for central NSW. While processors appear to closely monitor one another's prices, price competition would be improved by reducing farmer switching costs that are imposed by some contract terms.
- Loyalty bonuses can prevent farmers from switching processors and soften competition. These bonuses should not be conditional on continued supply.
- Raw milk swaps among processors have the potential to soften competition, however this risk is likely to be low. Most swaps appear to have some benefits, such as improving milk collection efficiencies.
- Raw milk trades between processors could lessen farmgate competition. However, the specific trades that we have analysed do not appear to have had a significant impact on competition.

This chapter analyses competition for raw milk, including:

- the key features and market concentration in each dairy region
- how processors compete on price and non-price terms
- the extent of farmer switching between processors and how supply agreements create barriers to switching
- the extent of raw milk swaps and trades and their effect on competition.

Ongoing rivalry between firms means commercial behaviour is constrained by current and potential competitors. In a competitive raw milk market, processors must make compelling offers to farmers, or they risk losing supply. Farmers receive offers on price and service terms that entice them to stay or switch.

4.1 Key issues identified by industry participants

The following key issues were identified by industry participants:

- Farmers in Queensland and WA told the ACCC that they have few options available to them for selling milk; while farmers in Victoria and SA indicated that their ability to change processors is usually limited by barriers to switching. Farmers also submitted, and processors have confirmed, that farmers' ability to change processors depends largely on the processors' capacity to take on additional milk supply.
- Some farmers believe complex contracts and payment structures are significant barriers to switching processors, and this reduces the effectiveness of competition for their raw milk. Conversely, processors hold the view that barriers are not high and that farmers can and do change processors with relative ease.
- There is a perception that processors do not truly compete against each other when determining farmgate prices, but instead 'follow' the price announcements of the market leader (which was frequently identified as Murray Goulburn). Industry participants are concerned that this practice suppresses price competition for raw milk. This issue was analysed in chapter 3.
- Farmers are concerned that bulk raw milk swaps and trades between processors reduce competition and therefore the farmgate price in some regions. It has been alleged that processors have informal arrangements to not compete for raw milk and share the market. These concerns amount to allegations of illegal cartel conduct between processors.

4.2 Interim report feedback

The ACCC received mixed feedback in relation to the interim report findings and analysis of competition for raw milk:

- **Market definition:** a number of processors submitted that the distance over which they compete to acquire raw milk was significantly broader than 150 km from their facilities.¹
- **Competition:** there was feedback that there is very limited competition between the three processors in southeast Queensland, as they rarely seek to attract farmers away from each other.²
- **Loyalty bonuses:** stakeholders generally agreed that loyalty bonuses present barriers to switching.³ one processor submitted that they require consistent milk supply throughout the year, and that it is reasonable to expect that when processors and farmers commit to a contract for a set period of time, that both parties will honour their contractual obligations.
- **Exclusive supply clauses:** Mixed feedback was received on the ACCC's interim finding that exclusive supply clauses have the potential to harm competition, but also provide the mutual benefit of assuring farmers that all of their milk will be collected, and volume certainty for processors. We found no evidence that these clauses have substantially lessened competition to date. Some stakeholders disagreed with our analysis, and submitted that:
 - exclusive supply should be prohibited to enable farmers to generate competition for any surplus milk produced⁴
 - exclusive supply clauses are a barrier to switching between processors⁵
 - farmers rarely have the bargaining power to negotiate a non-exclusive supply agreement.⁶
- Some stakeholders agreed with our analysis, and confirmed that:
 - exclusive supply clauses can be detrimental for small processors who only require a portion of a farm's milk⁷
 - some processors use exclusive supply to ensure consistent milk volumes and milk quality assurance and see it as a sharing of risk between farmers and processors.⁸
- **Swaps and trades:** some stakeholders disagreed with our analysis and consider that milk swaps have had a negative impact on farmgate prices.⁹

1 Fonterra Australia Pty Limited, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 8

2 Queensland Dairyfarmers' Organisation, *QDO response to ACCC Interim Report into dairy industry*, 7 February 2018, p. 5.

3 SA Dairyfarmers' Association Inc., *SADA Response to the ACCC Interim Report into the Dairy Industry in Australia*, 6 February 2018, p. 4; United Dairy Farmers of Victoria Wannon Branch, *submission to the ACCC interim report of the inquiry into the Australian dairy industry*, 24 January 2018, p. 2.

4 Scott Briggs, *Comments in relation to the ACCC's Dairy inquiry—interim report*, 18 January 2018, p. 3; Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, p. 2; The Western Australian Farmers Federation (Inc.), *Submission to: ACCC Inquiry into the Australian Dairy Industry Dairy inquiry interim paper*, 7 February 2018, p. 5; United Dairy Farmers of Victoria, *UDV Submission—ACCC Interim Report into the Dairy Industry in Australia*, 7 February 2018, p. 3.

5 United Dairy Farmers of Victoria, *UDV Submission—ACCC Interim Report into the Dairy Industry in Australia*, 7 February 2018, p. 3; United Dairy Farmers of Victoria Wannon Branch, *submission to the ACCC interim report of the inquiry into the Australian dairy industry*, 24 January 2018, p. 2.

6 Scott Briggs, *Comments in relation to the ACCC's Dairy inquiry—interim report*, 18 January 2018, p. 2; United Dairy Farmers of Victoria, *UDV Submission—ACCC Interim Report into the Dairy Industry in Australia*, 7 February 2018, p. 3; United Dairy Farmers of Victoria Wannon Branch, *submission to the ACCC interim report of the inquiry into the Australian dairy industry*, 24 January 2018, p. 2.

7 Philip and Elisabeth Beattie, *Submission to Interim Report of the ACCC Dairy inquiry*, 9 March 2018, p. 1.

8 Norco Co-operative Limited, *Inquiry into the Australian dairy industry—Submission in response to the Dairy inquiry interim report November 2017*, 31 January 2018, p. 2.

9 Dairy Farmers milk co-operative, *Dairy Farmers Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, published 23 February 2018, p. 3; Queensland Dairyfarmers' Organisation, *QDO response to ACCC Interim Report into dairy industry*, 7 February 2018, p. 5.

Box 4.1: Saputo's proposed acquisition of Murray Goulburn

On 4 April 2018 the ACCC announced it will not oppose Saputo's proposed acquisition of Murray Goulburn's assets, after accepting an undertaking from Saputo to divest Murray Goulburn's Koroit plant.

Both companies acquire milk from farmers in south-west Victoria and south-east South Australia, including in areas around Warrnambool and Mt Gambier. Saputo (at Allansford) and Murray Goulburn (at Koroit) currently own the two largest processing plants in this region, both near Warrnambool.

While Fonterra and some smaller players will remain, we considered competition would be likely to be substantially lessened in the region as a result of the acquisition. Our concern was that farmers would consequently be paid less for their milk or offered worse contractual terms, at least in the medium term.

In response to our concern, Saputo offered an undertaking that it will divest the Koroit plant within a specified period to a buyer that will be approved by the ACCC.

The undertaking seeks to ensure the approved buyer will be able to compete for farmers' milk, and includes independent management for the plant until it is sold and details in relation to the transitional milk supply arrangements.

Separate to the ACCC's process, the sale of the Murray Goulburn assets to Saputo is subject to conditions that include approval by the Foreign Investment Review Board.

We will issue a Public Competition Assessment in due course that will outline the reasons for our decision in more detail.

Further information regarding the ACCC's consideration of the proposed acquisition is available on the ACCC's mergers [public register](#).

4.3 Relevant areas of competition in the dairy industry

A market includes goods and services that are substitutable for, or otherwise competitive with, the goods or services being considered.¹⁰ Substitution involves switching from one product or service to another in response to a change in relative price, service or quality.¹¹ When identifying substitutes, the geographic sources are considered, as well as actual and potential substitution.

The ACCC has analysed competition at three stages of the dairy supply chain:

1. Farmgate competition: where buyers (usually processors) compete to acquire raw milk from farmers for processing into a range of dairy products. This competition takes place within various geographic regions.
2. Wholesale competition: where processors supply drinking milk and other processed dairy products to customers including supermarkets and other retailers, food service companies, export customers, and in some cases rival processors.
3. Retail competition: where retail businesses including supermarkets sell a range of dairy products to consumers. This inquiry focuses primarily on the nature of competition between supermarkets for the supply of dairy products.

This chapter analyses farmgate competition. Chapter 5 analyses competition for the wholesale and retail supply of dairy products.

¹⁰ *Competition and Consumer Act 2010* (Cth), s. 4E.

¹¹ Australian Competition and Consumer Commission, *Merger Guidelines*, 2008, p. 16.

4.3.1 Analysis of farmgate competition

The ACCC estimated the geographic boundaries of competition for raw milk acquisition using information submitted by industry participants. This included processors' raw milk purchase records, which showed movements of milk between farms and processing facilities; and transport cost data. We analysed the costs of transporting raw milk relative to total processing costs.

The ACCC then considered the following key indicators of rivalry between processors in those areas:

- the number of processors in a region that a dairy farm can supply to
- the degree of market concentration, including changes to processors' market shares over time
- the ease of switching between processors by farmers
- price and non-price offers made to farmers (including whether offers are targeting flatter or seasonal milk production)
- entry and expansion of processing capacity, including conditions for new entry and expansion.

The ACCC also considered key industry characteristics which influence competition between processors. These include the size of the market, the dairy products manufactured, whether the products are exportable, and climate and seasonal factors.

4.3.2 Regions of competition

The geographic scope of raw milk markets is primarily determined by the maximum distance it is financially viable for processors to transport milk from farm to factory. Processors submitted this distance is typically 300 to 600 km.

The ACCC considers that processors whose factories are located within around 150 km of a farmer are likely to be the closest competitors for their milk.¹² Processors located beyond 150 km of a farmer may also compete for their milk, but are unlikely to be as strong a competitive constraint.

This is supported by the ACCC's analysis of processors' milk purchase records, where we found:

- approximately 80 per cent of processors' raw milk purchases come from farms located within 150 km of the processing plant
- in excess of 95 per cent of raw milk is acquired from farms within 300 km of a processing plant.

A number of processors disagreed with this analysis, noting that milk can and is transported across some of the regions identified by the ACCC if there is an economic incentive to do so. However, evidence obtained from processors' documents and testimony in hearings conducted under s. 95ZK clearly demonstrated that they primarily compete to acquire milk from farms located nearest to their processing plants.

Analysis of evidence obtained during the inquiry indicated that the cost of transporting milk is likely to limit the incentive for a processor to compete for farmers in a region where it does not have processing capacity.

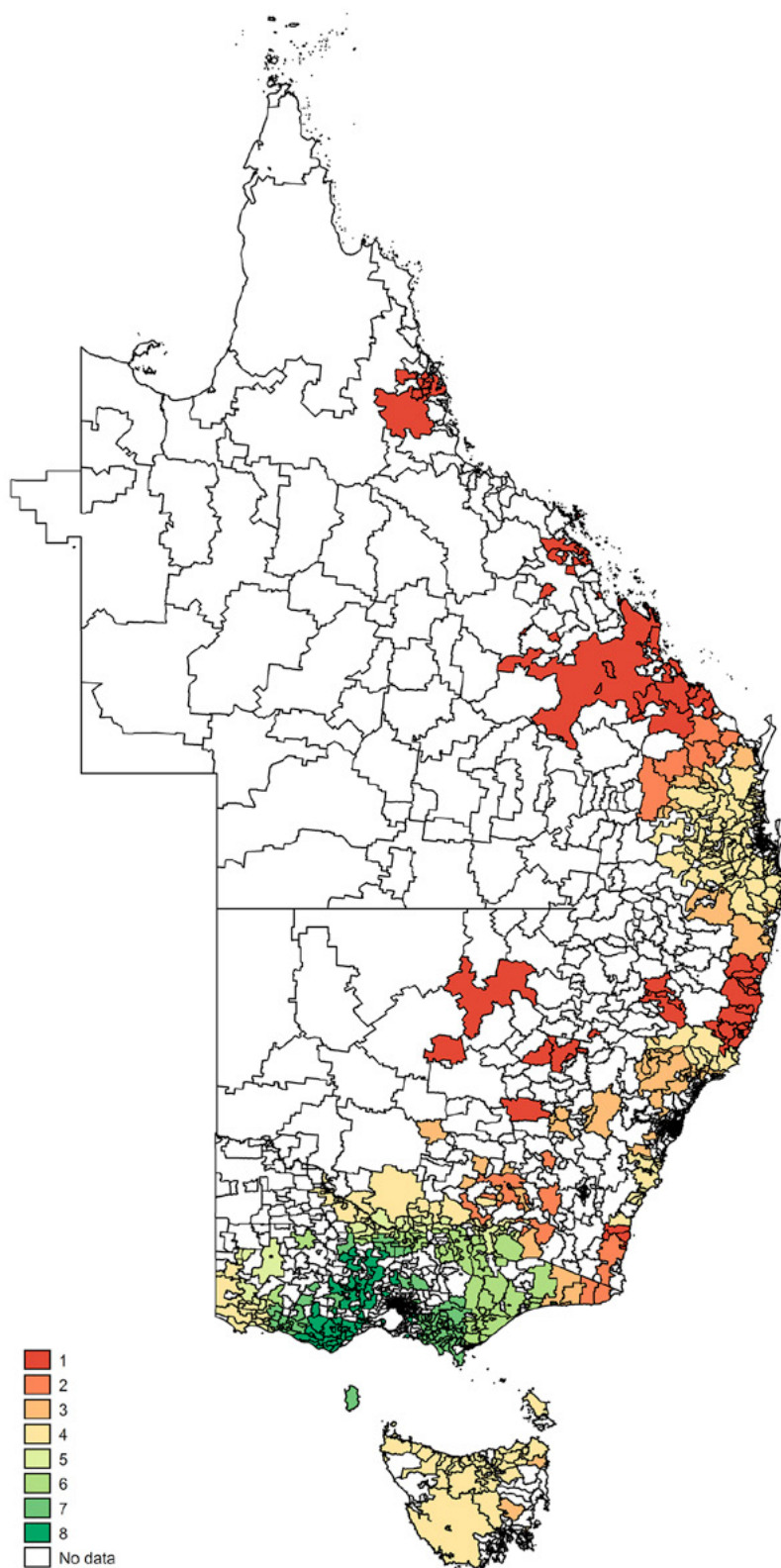
Therefore, the ACCC considers that processors located within around 150 km of a farm are likely to be the strongest competitors for that farm's milk, and processors located further away generally provide limited competitive constraint in that market.

It should be noted that these regions have been adopted for the purpose of analysing competition between processors at a general level for this inquiry. If the ACCC were to consider a proposed acquisition or merger of dairy processors in the future, or examine the market power of any given firm, different market boundaries may be relevant.

Figure 4.1 shows the ACCC's analysis of the number of processors located within 250 km of each postcode area where at least one farm operates on the east coast of Australia. 250 km represents the distance within which approximately 90 per cent of milk is sourced by most processors. The colour of each area shows the number of processors within 250 km of that area (for example, red indicates one processor and green indicates eight processors).

12 This analysis does not take into consideration how milk swaps or trades can extend, or limit, the boundaries of competitive constraint.

Figure 4.6: Number of processors located within 250 km of a farm¹³



Source: ACCC analysis of processors' purchase data

Note: 250 km represents the distance within which approximately 90 per cent of milk is sourced by most processors, and does not reflect of ACCC market definition

¹³ The information used to create this figure may include some business addresses in the place of of farm locations. This may highlight some postcodes where there are no dairy farms. However, there are very few instances where this occurs, and therefore it is unlikely to significantly influence the conclusions drawn from the figure.

At least one farm is located in each coloured area, and in some large areas in central NSW and further north there may be only one or two farms present.¹⁴ The ACCC notes that just because a processor is located within 250 km of a farm does not necessarily mean that they are actively competing for that farmer's milk.

Farmers in Victoria have significantly more options to sell raw milk than farmers in other states. For example, farmers located around Bundaberg in Queensland have only one processor within 250 km of their farm. In contrast, there are up to eight processors in the Warrnambool area of Victoria, but some are relatively small in scale.¹⁵ Further, not all processors within a region will have the capacity to take on additional milk supply¹⁶, nor will their payment structures necessarily suit each farm's production system (for example, spring, autumn, split or year-round calving).

Farmers in FNQ and WA have the least number of major processors to choose from. Due to their limited options, the ACCC considers that there is likely to be less competition in these regions than elsewhere.

Table 4.1 shows the dairy regions defined by the ACCC for the purposes of this inquiry. The table shows the major processors operating within each region, and the processors that acquire over 10 per cent of local production in each region and accordingly are most likely to influence competition. The number of farmers in each region is also shown.

The majority of milk is processed within the region where it is produced, but there is some movement of raw milk between regions on the east coast. This occurs where:

- a farmer has options to sell their milk to processors that operate in different regions due to the location of their farm
- processors acquire milk in one region and transport it to their processing plant in another region
- processors swap or trade milk between regions.

14 Although not shown in figure 4.1, the majority of farmers in WA have two to three processors within 250 km of their farm, and for SA the majority of farmers have three processors within 250 km of their farm.

15 For the purposes of this inquiry, the ACCC has defined a major processor as acquiring over 500 million litres of raw milk per season.

16 At the time of writing, the ACCC is aware of processors in Western Victoria and Tasmania not recruiting farmers. For example, Fonterra announced in September 2017 that it was near capacity, and had a supplier waiting list.

Table 4.1: Summary of key features of dairy regions

Region	Major processors buying within region	Processors that acquire over 10% of total volume produced (2015–16)	Number of farmers ¹⁷
Eastern Victoria (Gippsland)	Bega Fonterra Lion Murray Goulburn Parmalat Warrnambool Cheese and Butter	Burra Foods Fonterra Murray Goulburn	1480
Murray (encompassing northern Victoria and the New South Wales Murray region)	Bega Fonterra Lion Murray Goulburn Parmalat Warrnambool Cheese and Butter	Bega Fonterra Murray Goulburn Parmalat	1515
Western Victoria (including southeast SA)	Bega Fonterra Murray Goulburn Parmalat Warrnambool Cheese and Butter	Fonterra Murray Goulburn Warrnambool Cheese and Butter	1370
South Australia (excluding southeast SA)	Lion Murray Goulburn Parmalat Warrnambool Cheese and Butter	Lion Murray Goulburn Parmalat Warrnambool Cheese and Butter	268 ¹⁸
Tasmania	Fonterra Lion Murray Goulburn	Fonterra Lion Murray Goulburn	437
Central New South Wales	Bega Fonterra Lion Murray Goulburn Parmalat	Bega Lion Murray Goulburn Parmalat	490
Northern New South Wales/ Southern Queensland ¹⁹	Fonterra Lion Parmalat	Lion Norco Parmalat	680
Far North Queensland (Atherton tablelands)	Lion	Lion	Included above
Western Australia	Lion Parmalat	Brownes Lion Parmalat	160
Total			6400

Source: Processors' purchase data, Dairy Australia data, and ACCC analysis.

¹⁷ Dairy Australia, *Our regions*, accessed 21 August 2017, <http://www.legendairy.com.au/dairy-farming/our-industry/our-regions>.

¹⁸ Includes farms in southeast SA which are in the western Victoria region.

¹⁹ Given low milk production volumes and farm numbers in central Queensland, it has not been defined as a distinct region.

4.4 Market concentration

4.4.1 There is a high level of market concentration in some regions

The level of concentration in a market is a useful indicator of the degree of competition over time, and of the potential for firms to have market power. It measures the number of firms and the distribution of market share amongst those firms in a market. The higher the concentration, the lower the degree of competition, and the more likely it is that firms have market power. However, even firms in highly concentrated markets may have little market power if they are effectively constrained by the threat of entry or expansion of rivals.

A highly concentrated dairy market has a small number of large processors with high market shares. An analysis of changes in concentration over time can show shifts in the market and provide an insight into the ability of new entrants and smaller competitors to constrain large processors.

The ACCC used two measures of concentration for the acquisition of raw milk, the 'n' firm concentration ratio by milk volume for each region and season from 2013–14 to 2015–16, and the Herfindahl-Hirschman index (HHI).²⁰ These are shown in table 4.2.

Analysis of market concentration shows that:

- In most regions, over 85 per cent of raw milk is acquired by the three largest processors. The exception is central NSW, where this figure is 73 per cent. The estimated HHI indicates that central NSW is moderately concentrated, and that all other regions are highly concentrated.
- Market shares were stable across the three seasons, but there was a general slight downward trend for the largest processors in each region:
 - The absence of changes in the overall market share of the largest processors suggests there are significant barriers to entry and/or expansion by new and smaller competitors.
- The degree of concentration raises concerns about the largest processor's market power in eastern Victoria, the Murray region, Tasmania and far north Queensland:
 - In eastern Victoria, the Murray region and Tasmania the largest processor has at least twice the market share of the second largest processor.
 - For farmers in FNQ and central Queensland there is only one major processor within 250 km of their farm.
- Western Victoria, the Murray region and central NSW have the lowest level of concentration, and in each of these regions there are at least three processors with a sizeable market share (over 10 per cent).
- The processor with the largest market share in western Victoria, central NSW and WA has changed in the last three years.

²⁰ The 'n' firm concentration ratio sums the market shares of the 'n' largest firms in a market. Although simple to calculate, the 'n' firm concentration ratio does not take account of the total number of firms in a market or the size distribution of these firms. The HHI overcomes these limitations. The HHI is calculated by adding the sum of the squares of market shares of each firm in the market. If there are a large number of firms with a small market share the HHI will tend towards zero. If there are a small number of large firms the HHI will tend towards 10 000. Although interpretation varies, a HHI of between 1500 and 2500 usually indicates that a market is moderately concentrated and a figure above 2500 indicates that the market is highly concentrated.

Table 4.2: Market concentration by region

Market share of raw milk purchases	Season	Eastern Victoria	Western Victoria	Murray region	Northern New South Wales/				Tasmania	Far North Queensland
					Central New South Wales	Southwest Queensland	South Australia	Western Australia		
Largest processor by volume (%)	2015-16	60	36	54	34	44	37	45	57	100
	2014-15	60	39	54	30	46	44	91	58	100
	2013-14	60	42	54	33	46	44	91	61	100
Top 2 processors by volume (%)	2015-16	76	67	73	55	82	66	72	84	n/a
	2014-15	75	67	71	53	84	69	96	84	n/a
	2013-14	74	73	71	53	73	67	99	85	n/a
Top 3 processors by volume (%)	2015-16	91	90	87	73	95	83	96	100	n/a
	2014-15	89	91	88	73	98	86	95	100	n/a
	2013-14	87	95	87	73	98	87	100	100	n/a
Total volume of milk acquired by major processors (million litres)	2015-16	1812	2326	1972	778	495	204	312	790	53
	2014-15	1811	2333	2074	740	482	178	158	793	52
	2013-14	1717	2230	2079	663	492	178	177	725	52
HHI for volume of raw milk purchased	2015-16	4104	2839	3610	2258	3564	2677	3353	4218	10 000
	2014-15	4019	2897	3604	2156	3728	3046	8389	4275	10 000
	2013-14	4023	3204	3521	2186	3493	3041	8363	4547	10 000

* For the 2013-14 and 2014-15 seasons, the raw milk acquired by Harvey Fresh is not included in the 'top 3' figure. Parmalat acquired Harvey Fresh 2014 and its figures are included in the 'top 3' figures for the 2015-16 season, and therefore give a more accurate indication of the historical level of concentration in WA.

Source: Processors' purchase data, Dairy Australia data, and ACCC analysis.

4.5 Price and non-price dimensions of competition

The analysis of competition includes assessing the price and non-price dimensions of rival firms' offers. The ACCC's observations of these competitive factors are discussed below.

4.5.1 Price competition

Evidence obtained for the inquiry indicates there is close price competition between major processors for the acquisition of raw milk.

The ACCC found that major processors who compete for the same milk supply have generally offered prices within 5 to 10 per cent of their competitors and that they monitor each other closely. There are some variations and qualifications to this:

- in the Southern region, although processors' opening and forecast closing prices may be close, offers can differ significantly in terms of the price paid for milkfat relative to protein across the season. This is because processors attribute different relative values to milk solids and fat production from farmers, depending on the products they manufacture
- co-operative members usually also receive an equity return.

The key period of price-based competition is around the time that opening prices are announced. In circumstances where processors are seeking to grow milk supply, they generally aim to beat their competitors' prices by more than 5 per cent. This process is discussed in chapter 3. In addition, the behaviour of a processor throughout a season, including how step-ups or step-downs in prices compare to rivals, is also likely to influence whether or not a farmer wishes to switch processors in the following season.

Price matching

Some processors' supply agreements included price clauses which referenced competitors' pricing. For example, the Bonlac Supply Agreement, which stems from Fonterra's takeover of Bonlac Foods in 2005, requires Fonterra to pay a benchmark farmgate milk price return.²¹ Lion's Farmgate Agreements in the Southern region contain terms that Lion's price will not fall below Murray Goulburn's opening price, or will be a certain cents per litre higher than Murray Goulburn.²²

Internal documents provided by processors under s. 95ZK of the CCA showed examples of processors increasing their opening prices above those originally planned in response to announcements (or rumours of imminent announcements) of higher than expected opening prices by other processors.

On a number of occasions, processors who made early opening price announcements subsequently increased their prices after competitors offered higher opening prices. For example, in its 2017-18 season pricing Murray Goulburn improved upon its initial opening price to discourage farmer switching and maintain supply.

Some processors, including Saputo, Murray Goulburn and Fonterra have traditionally had a single farmgate price offer which applies across the 'southern region', encompassing Victoria, eastern South Australia, parts of southern NSW and Tasmania. However, as discussed in chapter 3, processors may also make unique offers to farmers in order to retain or recruit them.

4.5.2 Non-price competition

Processors also compete for farmers by offering a range of non-price terms.

Some processors offer financing packages to assist with farm cash flow management or capital investments. This usually involves loans to purchase hay or water, but may also cover storage and refrigeration equipment. Processors typically require ongoing supply until the loan is repaid. The ACCC considers that these financial assistance arrangements may be beneficial to farmers and are unlikely to have negatively impacted competition between processors.

21 Bonlac Supply Company, *Bonlac Supply Company*, accessed 14 November 2017, <http://www.bonlacsupplycompany.com.au/>.

22 Lion Dairy & Drinks Pty Ltd, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 5.

Field service officers are employed by processors to maintain relationships with farmers and to handle disputes or quality issues. They periodically visit farms to give advice on matters such as finances, animal nutrition and agronomy, human resource management or sustainability and quality issues.²³

In addition, processors submitted they regularly provide information to farmers about pricing changes and forecasts through newsletters and farmer supplier meetings.

4.5.3 Processors compete harder for farms with particular characteristics

The ACCC has observed that farms with particular characteristics may be offered additional incentives to switch processor, such as 'no disadvantage' guarantees which compensate for any step-up or loyalty payments foregone as a result of switching, improved freight charges, or (in rare cases) individually higher prices. These characteristics include:

- large scale production²⁴
- close proximity to the processing plant
- potential for the farm to increase milk supply
- an autumn, split or year-round calving pattern.²⁵

Larger farms offer processors the opportunity to collect large quantities of milk at lower average costs than from greater numbers of small farms, which increases collection efficiencies. Large farms also reduce the administrative burden (for example quality testing, field visits) for processors compared to transacting with multiple farms. These farms are therefore preferable to processors, and very large farms appear to have some bargaining power.

Processors also incur lower transport costs if farms are located close to their plant, which makes these farms preferable to those located further away, all else being equal. A farm with the potential to increase production is also desirable as a processor does not have to actively compete to gain further milk supply.

4.5.4 Competition can be soft despite multiple processors in a region

Competition for milk is also impacted by whether processors are producing products for domestic or export markets. In some domestic-focussed regions, such as northern NSW/southern Queensland and WA, competition between processors is subdued compared to the southern, export-focussed region. In domestic-focussed regions, milk supply volumes, prices and market shares are relatively stable. The ACCC heard that when processors in these regions have secured enough milk to fulfil their supply contracts and local demand for dairy products, they do not actively seek more raw milk supply.

Although the ACCC did not find any evidence of coordination between processors or market sharing arrangements, there was feedback that processors in domestic-focussed regions are often unwilling to recruit suppliers from other processors, instead only signing on new dairy farmers. This is indicative of muted farmgate competition.

As set out in chapter 2, the ACCC also considers farmers' weak bargaining position leads to contract terms weighted heavily in favour of processors. This can reduce competitive rivalry between processors.

²³ Fonterra Australia Pty Ltd, *Submission to ACCC's Inquiry into the Australian dairy industry*, 19 December 2016, p. 14.

²⁴ Around 700 to over 1000 head of dairy cattle.

²⁵ See chapter 1 for discussion of seasonality of calving and the impact on milk supply patterns.

4.6 Degree of farmer switching between processors

The extent to which there is effective competition for farmgate milk is influenced by farmers' ability to credibly threaten to switch to another processor with a better offer.

If farmers are able to switch with relative ease and frequency, processors will need to offer competitive prices and terms in order to maintain their share of milk supply. The key issue is whether farmers are able to switch if they want to and the costs of doing so.

The main reason farmers want to switch processors is to secure better price terms or more price certainty. Processors have submitted to the ACCC that barriers to switching are not high, and that farmers can and do switch. They say they need to offer a 5 to 10 per cent higher price to persuade farmers to switch.

The ACCC understands that farmers have historically been loyal to their processor and reluctant to switch. Further, our analysis shows that there is limited switching by farmers when prices for raw milk are high or stable. However, when prices are low or less stable, farmers have a greater incentive to switch to a processor with a better offer and some are able to do so.

The ACCC understands that farmers are increasingly willing to switch processors since the step-down by Murray Goulburn and by Fonterra in the 2015–16 dairy season, which led to substantial erosion in farmers' trust in the companies. This resulted in significant switching in 2016–2017, continuing into 2017–18.²⁶

Based on information provided by processors, it appears that, processors experience 2 per cent to 9 per cent churn of their milk volumes year-on-year.²⁷ Our analysis of processor data, shown in table 4.3, suggests that the degree of switching varies by year and region.²⁸

Table 4.3: Entering and exiting milk volume

Region	Entering milk (% of total purchases)			Leaving milk (% of total purchases)		
	FY2014	FY2015	FY2016	FY2014	FY2015	FY2016
Eastern Victoria	7	7	7	5	4	5
Murray	10	8	5	6	6	7
Western Victoria	6	12	5	7	5	5
South Australia	3	9	1	6	6	4
Tasmania	7	9	8	7	5	7
Central New South Wales	23	11	4	4	12	3
Northern New South Wales/ Southern Queensland	4	9	1	5	11	3
Far North Queensland	0	0	0	1	0	0
Western Australia	8	2	5	7	18	2
Australia	9	9	7	6	6	5

Source: Processors' purchase data, ACCC analysis.

Table 4.3 shows the total volume of milk entering and exiting processors, not the total number of farmers switching. According to processors' data, around 500 to 800 farmers changed processors or ceased supplying in every dairy season from 2013–14 to 2015–16. The majority of switching occurs in

²⁶ Murray Goulburn, *Murray Goulburn increases South Milk Region opening price and 2017/18 FMP range*, press release, 22 June 2017, p. 1.

²⁷ This figure includes the volume of milk supplied by farmers who retire or otherwise cease dairy farming.

²⁸ Table 4.3 shows the volume of milk supply entering and leaving processors as a percentage of their total volume acquired for the 2013–14 to 2015–16 seasons. The 'leaving' figure includes the farmers' volumes that have moved to another processor, as well as volumes that are no longer supplied due to a farmer retiring or otherwise ceasing supply.

Victoria, which has the most dairy production.²⁹ However, in other regions a small number of farmers switching each season can represent a significant percentage of a processor's total supply.

The Northern and WA region has historically had low rates of churn between processors because of the longer duration of supply agreements in those regions. However, based on the data from processors for the 2013–14 to 2015–16 dairy seasons, our analysis indicates that churn rates are generally moderate and steady across most regions except FNQ, where there is only one major processor.

Farmers and processors have acknowledged that the ability to switch depends in part on the capacity of processors to take on further supply, particularly in Southern region. In the Northern and WA region, most opportunities to switch only arise when private label milk contracts move between processors.³⁰

Given the significant effect that private label contracts have on some processors' milk volume requirements, we may expect to see a relationship between the level of farmer switching and private label contracts changing hands. This may occur, for example, where a processor has won a large supply contract and offers farmers in the region a higher price to acquire more volume. The figures in table 4.3 indicate a higher level of switching activity from 2013–14 to 2015–16 relative to previous years, when several private label contracts moved between processors.

4.6.1 Barriers to switching in supply agreements

Some farmers raised concerns with the ACCC about the difficulties of changing processors, including:

- the complexity of supply agreement contracts
- payment structures
- the timing of price announcements
- notice periods
- exclusivity clauses
- financial assistance arrangements tied to milk supply.

Contract complexity

Contracts for milk supply differ significantly between processors in terms of pricing structures and non-price terms, as discussed in chapter 3. This makes it difficult for farmers to compare offers. When they cannot determine which option is best for them, and consequently do not switch, competition can be reduced.

Contract terms can hinder switching

Contract terms, such as different expiry dates between processors and lengthy termination notice periods, can also make it difficult for farmers to switch, even if they are able to compare offers and determine their best supply option.

While most milk supply contracts are based on a dairy season (financial year), Parmalat's contracts are based on a calendar year in Queensland, NSW and WA. Farmers are often unwilling to switch between processors with different seasons as they may face a period without guaranteed milk collection.³¹ Where a processor agrees to collect milk for the period in which a farmer is out of contract, the farmer will often not receive incentive payments. This can further reduce farmers' willingness to switch.

Lengthy termination notice periods are another factor hindering farmers' ability to switch processors. Farmers cannot consider alternative offers as processors have usually not announced an opening price when notice for termination for the following season is required.

29 Dairy Australia, *Dairy In Focus 2017*, p. 5.

30 Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry (Part 2)*, 12 December 2016, p. 4.

31 Queensland Dairyfarmers' Organisation, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 1.

Box 4.2: Parmalat: contract dates

In Queensland, NSW and WA, Parmalat offers supply agreements based on a calendar year (1 January to 31 December). In contrast, competing processors base their supply agreements on a financial year (1 July to 31 June). This can result in a misalignment of the contract expiry date with other processors.

A number of farmer representative bodies or cooperatives in Queensland, NSW and WA made submissions regarding the use of a calendar year season. They submitted that misaligned processor contract expiration dates limit a farmers' ability to switch for the following reasons:

- processors are seldom prepared to offer contracts to individual farmers with different commencement dates
- farmers are limited in their ability to negotiate and compare supply agreements across multiple processors
- farmers risk missing a step-up or seasonality payment if switching processor before the end of a dairy season
- it is risky for farmers to be without a supply agreement if they cease a contract and have to wait until the next one starts.

Parmalat has told the ACCC that it operates on a calendar year basis for two key reasons: firstly, to align with its European parent company which operates on a calendar year basis; secondly, because a calendar year season provides simplicity for its budgeting process. Despite this, Parmalat has adopted a financial year season in Victoria and South Australia, consistent with other processors in those states.

Payment structures—loyalty bonuses and retrospective step-ups

The ACCC identified a number of payments that are effectively loyalty bonuses that were generally paid to farmers that operate on Supplier Handbooks. A loyalty bonus is a payment which is conditional upon the farmer completing a full season of supply, and is generally paid once a dairy season has ended and the new dairy season has begun. Loyalty bonus payments often comprise of retrospective step-ups and other payments farmers have earned over the course of the season.³² These payments are usually made in July or August and require the farmer to be a current supplier to receive the payment, which creates a significant disincentive for the farmer to switch processors.³³

Farmers raised two main concerns with loyalty bonuses: first, it is difficult to quantify how much the loyalty bonus is worth; secondly, their payment after the commencement of the new season creates a barrier to switching.

Farmers who operate under a Supplier Handbook can theoretically switch processors at any time. However, the ACCC understands that some processors have used late loyalty bonuses to discourage switching in order to minimise uncertainty to their supply.

Given the low profit margins for most farmers, retrospective loyalty payments are often what make a season profitable. Farmers are unlikely to switch processor unless they will be better off over the full year³⁴, as the bonuses are an essential component of their total income.³⁵

The ACCC analysed one processor's payment structures from 2010–11 to 2015–16 to measure the extent to which loyalty bonuses and step-ups can be the difference between a farmer being profitable or not. This analysis is shown in figure 4.2.

32 For example, in Murray Goulburn's 2016–17 Southern milk region supplier handbook, a loyalty payment is defined as 'Incentive Payments, the Backpay and Step-ups.' See Murray Goulburn, *Supplier Handbook Southern Milk Region 2016/17*, p. 61, http://www.mgc.com.au/media/36238/2016_17southernmilkregion_supplierhandbook.pdf.

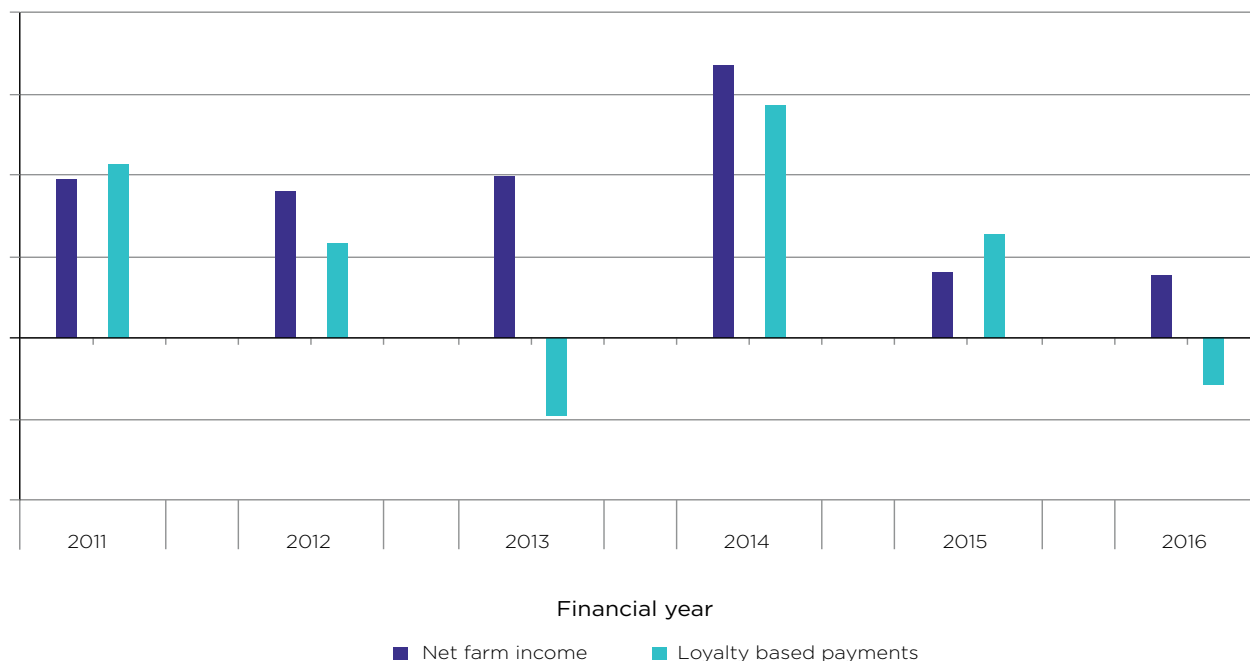
33 Ibid.

34 Dairy Farmers Milk Co-operative, *Submission to the ACCC's Inquiry into the Dairy Industry (Part 2)*, 12 December 2016, p. 5.

35 The ACCC received anecdotal evidence that the amount received by farmers annually due to loyalty bonuses can be up to \$40 000 or \$50 000.

The ACCC compared the step-ups and loyalty incentives offered by this processor with the net farm income for the relevant region.³⁶ The analysis suggests that if a farmer were to switch processor and abandon these payments as a consequence, the farmer would have earned zero or negative net profit in years that would otherwise be profitable, and made a greater loss in years where net farm income was already negative.³⁷ For example, in 2013–14, loyalty based payments made up around 18–19 per cent of total payments, and retrospective loyalty based payments were equivalent to almost 60 per cent of net farm income.

Figure 4.7: Example comparison of net farm income and loyalty based payments, 2010–11 to 2015–16³⁸



Sources: ACCC analysis based on aggregated loyalty based payment data from a processor, and net farm income data from the Dairy Farm Monitor Project (Dairy Australia).

The high proportion of farm income that loyalty payments represent, together with their being accrued in one year and paid the next, indicates that these payments act as a barrier to switching. Some farmers would have to remain with their processor for several weeks into the new season to receive all payments owing from the previous season. While doing so, they risk missing out on accrued loyalty payments with the processor they want to switch to for the new season.

Consequently, the practice of not paying loyalty bonuses to farmers who are no longer contracted in the new season creates a disincentive to changing processors.³⁹ It also provides challenges for farmers seeking to plan for a financial year. Further, withholding loyalty payments to be conditional on supply into the new season increases the price premium that processors need to offer to entice farmers to switch away from their incumbent processor.

A competing processor must offer a price that is not only better than the incumbent processor, but also compensates the farmer for any bonuses they forfeit as a result of switching. This can deter competition as it makes recruiting farmers from competing processors more costly, especially if the pricing offer designed to recruit new farmers applies to all of the processor's existing suppliers as well. The ACCC therefore considers that such payments raise barriers to switching and are likely to soften competition between processors.

³⁶ With net farm income coming from the Dairy Farm Monitor Project

³⁷ Dairy Australia, *Dairy Farm Monitor Program Victoria*, Annual Report 2015–16, accessed 1 November 2017, <https://www.dairyaustralia.com.au/farm/farm-business-management/dairy-farm-monitor-project/vic-dairy-farm-monitor-project>.

³⁸ Absolute values are not shown in order to protect commercially sensitive information.

³⁹ Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry* (Part 2), 12 December 2016, 5.

Processors submitted that in some instances they offer ‘no disadvantage’ payments, where they agree to pay any step-ups or loyalty bonuses that the incoming supplier foregoes if they leave their incumbent processor. While this may reduce the concern around loyalty payments acting as a barrier to switching, it is likely that these deals are offered preferentially to farms based on specific desirable characteristics as discussed in section 4.4.3.

Processors face a greater risk of losing supply to their competitors in regions where there are more processors competing for raw milk. The ACCC’s analysis of a single processor showed that loyalty payments have been most significant as a proportion of total income in Victorian dairy regions compared to other regions. Victoria’s dairy regions have more processors than other regions, suggesting that the processor used these payments to discourage farmers from switching in regions where they had more options to do so.

The ACCC was told by farmers at forums that farmers who switch processor mid-season are often not entitled to future loyalty bonuses or step-ups that are allocated throughout the season after they have switched.⁴⁰ In this circumstance, the ACCC considers this is reasonable. The relationship under a Supplier Handbook creates risks for both farmers and processors, as the farmer may switch processor with very little notice, which will impact on a processor’s milk volumes.

The ACCC does not necessarily have concerns with loyalty bonuses that are paid at the commencement of a new season to reward retrospective or prospective loyalty, so long as the bonus is paid in addition to any step-ups or incentives a farmer has earned over the previous season and the loyalty entitlements for previous supply are not forfeited if the farmer switches processors in the new season. Loyalty bonuses can also provide the benefit of additional farm income, in return for a commitment to supply a processor for a period of time. However, the ACCC considers that loyalty bonuses that are effectively retrospective step-ups are likely to act as barriers to farmer switching when they are conditional on continued supply into a new season. The removal of this barrier to switching is likely to intensify competition between processors, improving welfare of farmers.

Timing of price announcements

As discussed in chapter 3, the ACCC has observed that processors typically do not announce their price until shortly before, or even after, the commencement of a new season, leaving farmers little or no time to decide which processor’s offer is best for them and make a decision to switch.

Financial assistance arrangements tied to milk supply

Some processors offer financial assistance to farmers in the form of support loans, such as to buy fodder or water. These loans must be repaid before the farmer can terminate a contract, effectively tying them to a processor. Farmers in Victoria and SA in particular have raised concerns that financing limits their ability to switch, particularly where the debt is significant. The ACCC notes that these arrangements appear to be more prevalent in areas where farmers would otherwise find it relatively easy to switch processor, suggesting that processors use these loans as a form of non-price competition.

The ACCC considers it is reasonable for processors to require repayment of debt and it is likely that that ongoing milk supply arrangements are the simplest way to organise this. While it may be possible for a debt to be repaid under an arm’s length loan that is not tied to ongoing supply (allowing the farmer to switch processor), this may depend on the extent of risk associated with the farmer’s debt. The ACCC’s view is that financial assistance arrangements are unlikely to materially reduce competition between processors in a market.

Impact of the Voluntary Code of Practice

The Voluntary Code commenced on 30 June 2017, and aims to address practices which are considered to impose undue restrictions and risk onto farmers. The ACCC recognises that changes to some processors’ 2017–18 dairy season contracts following the introduction of the Code may improve farmers’ ability to switch between processors. These changes include removing loyalty payments that are contingent upon a farmer continuing to supply into the new season.⁴¹

40 Senate Economics Reference Committee, Parliament of Australia, *Australia’s dairy industry: rebuilding trust and a fair market for farmers*, (2017), p. 26.

41 The Voluntary Code is discussed further in chapter 9.

4.6.2 Exclusivity clauses

Exclusive supply clauses prevent farmers from supplying more than one processor at a time. Most supply contracts, including fixed term and Supplier Handbooks, require farmers to exclusively supply all of their raw milk in an unspecified volume to a processor, who in return commits to collecting the entire milk production of a farm. These clauses do not have the effect of preventing farmers from switching their entire milk volume to another processor.

Throughout the Inquiry farmers raised concerns that exclusivity clauses are used to the processors' advantage.⁴² Responses to the Interim Report included that exclusive supply should be prohibited in the industry, possibly through a code.⁴³ The ACCC appreciates that some farmers would prefer to have the option of dual supply, as this may earn them a premium from another processor for some of their milk production. Farmers also submitted that dual supply would give them greater control over their milk supply.

On the other hand, processors emphasised the need for processors to retain the ability to enter into exclusive supply contracts with farmers, to ensure milk quality and consistency in supply.

Exclusive contracts can have efficiency benefits. For example, with volume certainty, processing plants can reduce processing costs and realise economies of scale. Exclusivity also reduces transaction and search costs for both processors and farmers.

In practice, the ACCC understands that dual supply is not common. This is primarily because most farmers do not produce sufficient milk volumes to efficiently support a dual supply model. However, for farmers that could supply more than one processor, exclusive supply clauses remove dual supply as an option.

Broadly speaking, an exclusive supply contract is not, in itself, a breach of the law. Exclusive supply clauses are common in many agricultural industries and in many circumstances are not problematic. However, exclusive supply can potentially raise concerns under the CCA as either exclusive dealing which substantially lessens competition, or as an unfair contract term.

Box 4.3: When is exclusive dealing anti-competitive under the CCA?

Exclusive dealing occurs where one party to a transaction imposes some restrictions on the other party's freedom to choose with whom, in what, or where they deal.⁴⁴ Exclusive dealing is against the law when a party has the purpose, or the conduct has is or is likely to have the effect, of substantially lessening competition.⁴⁵

A processor's conduct will only have the 'purpose' of substantially lessening competition where the processor intends to achieve an anti-competitive result. For example, a processor may use exclusive supply clauses to harm a competing processor by restricting their access to milk. Alternatively, a processor may use exclusive supply as a means of securing milk volumes, which is not an anti-competitive purpose.

The conduct can still have the 'effect' of substantially lessening competition where there is no anti-competitive purpose, if competition is substantially lessened as a direct consequence of the processors' conduct.

A 'substantial lessening of competition' means the overall degree of competition in a market is lessened to an extent that is important or material in the context or size of the particular market.

42 Australian Small Business and Family Enterprise Ombudsman *ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, p. 2; NSW Farmers, *ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, p. 5; WA Farmers, *ACCC Inquiry into the Australian Dairy Industry*, 19 December 2016, pp. 3–4; Colin & Rita Gee, Submission, 9 May 2017, p. 1.

43 Scott Briggs, *Comments in relation to the ACCC's Dairy inquiry—interim report*, 18 January 2018, p. 3; Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, p. 2; WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 5; United Dairy Farmers of Victoria, *UDV Submission—ACCC Interim Report into the Dairy Industry in Australia*, 7 February 2018, p. 3.

44 Section 47.

45 Section 47(10)(a).

The purpose or effect of exclusive supply on competition

Exclusive supply can be illegal where it substantially lessens competition in a relevant market.

Based on industry feedback, exclusive supply clauses could affect two markets. Primarily, the clauses occur and can have an effect in regional markets for the acquisition of raw milk (i.e. competition amongst raw milk buyers). Further, by restricting the amount of milk available for purchase, exclusive supply may have an anti-competitive purpose or effect in other markets for the wholesale supply of dairy products.

These markets, which are often confined to regions within Australia, have been considered in detail in chapter 4 and 5.

Anti-competitive purpose?

Processors submitted and the ACCC agrees that in most instances, the purpose of exclusive supply clauses is to guarantee milk volumes, milk quality assurance, efficient milk collection and sampling of milk.⁴⁶ However, the ACCC would review any concerns or behaviour suggesting a processor is using exclusive supply to prevent competing or new processors from entering or expanding in the relevant market.

Anti-competitive effect?

Whether exclusive supply may have the effect of substantially lessening competition will depend on a number of factors, including the state of competition in the relevant market, the general availability of raw milk (how much milk is tied up due to exclusive supply), and the impact on processors seeking to compete.

The ACCC understands that some smaller processors cannot commit to purchasing a farm's entire milk supply and therefore acquire milk from larger processors and milk brokers. Smaller processors pay a premium for this milk.

However, the ACCC also understands that some smaller processors have a strong preference to acquire milk directly from farmers as it can be more convenient, they have greater control over the quality of milk supplied and do not want to source milk from large processors who they also compete with. Smaller processors have raised concerns that exclusive supply clauses have the effect of constraining their ability to compete against larger processors in some markets.

Exclusive supply clauses are more likely to have an anti-competitive effect in more concentrated regional markets. For example, if there is one powerful large processor in a region that can control the milk it supplies and the price it charges to a smaller processor, then exclusive dealing may have the effect of weakening the competitive position of the smaller rival and its ability to compete with larger incumbents in dairy product markets.

In less concentrated raw milk markets, the ability of large suppliers to engage in anti-competitive behaviour is likely to be constrained and small processors will have more milk supply options.

⁴⁶ Lion Dairy & Drinks Pty Ltd, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 8.

Case study: Can exclusive supply clauses effect small processor access to raw milk?

A small specialty cheese processor would like to purchase a portion of a farm's milk to increase its cheese production. However, because all of the farms in the surrounding area are on exclusive supply contracts, the processor cannot acquire a small amount of milk directly from a farm.

Supply options in the area are therefore likely to include acquiring milk from larger processors or milk brokers, buying their own cows, or milk pooling with other small processors. When this is the case, smaller processors can source the milk they require, despite exclusive supply clauses.

If the market is highly concentrated, the smaller processor's only viable milk supply option could be from a large competing processor. If the price charged for milk is too high or the small processor cannot acquire the volume it requires, this could impact on its ability to expand and compete. In these circumstances, exclusive supply could be having an effect on competition and would need to be considered by the ACCC.

It is also relevant to consider the role and importance of the smaller processor in the market in question. Some processors may not be strong and vigorous competitors, therefore their inability to acquire portions of a farmer's milk will not affect the extent of competition in the market overall. Conversely, if small processors do make up a significant proportion of the regional market, a substantial lessening of competition is more likely. The ACCC's view is that the majority of past or existing exclusive supply clauses are unlikely to have substantially lessened competition among processors. However, they have the potential to do so, particularly in more concentrated markets. The ACCC understands the concerns raised by some smaller processors about the detrimental impact exclusivity clauses have had on competition and examines these claims as they arise.

Exclusive supply and unfair contract terms

Exclusive supply clauses can be assessed under the small business UCT laws, where terms which cause a significant imbalance in the parties' rights and obligations, result in detriment to farmers if relied upon, and are not reasonably necessary to protect the interests of the processor, can be deemed unfair and therefore void.

Some individual farmers may be able to show that an exclusive supply clause is weighted in favour of the processor and causes detriment to their business. The ACCC has found however that the use of exclusive supply clauses is typically reasonably necessary for processors, as exclusivity ensures processors receive sufficient milk volumes, milk that meets their quality standards and efficiency in collecting and sampling milk.⁴⁷

If exclusive supply was prohibited in the industry, there is a risk that farmers would no longer have the assurance and convenience that all their milk will be collected, as processors may choose to contract fixed volumes with farmers. Although some farmers would be able to supply excess milk to an alternate processor, not all farmers may be able to, particularly in low demand periods. This could create significant risk for many farmers.

When assessing other terms in milk supply agreements which raise potential UCT concerns, exclusive supply clauses may be relevant when considering the contract as a whole.

Conclusion

The ACCC acknowledges that some farmers would prefer that exclusive supply was prohibited, whereas many processors have legitimate reasons for its use. As our analysis has indicated, the effects of exclusive supply arrangements are not necessarily harmful to competition and should be assessed case-by-case. Accordingly, we do not recommend that exclusive supply should be prohibited under a code.

The ACCC acknowledges that not all farmers are in a position to negotiate non-exclusive contracts, but particularly larger farms, who are most likely to be able to engage in exclusive supply, may be able to.

⁴⁷ Lion Dairy & Drinks Pty Ltd, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 8.

The ACCC does however consider that processors' 'first right of refusal' to excess milk currently included in clause 6 of the Voluntary Code should be removed. Depending on the supply arrangement, this will result in the processor either collecting all of a farmer's milk, or collecting only a fixed volume of milk, without having the first option to any of the farmer's excess milk.

4.7 Impact of milk swaps and trades on competition for raw milk

The seasonal production and perishability of raw milk creates demand and supply imbalances that must be managed by both farmers and processors.

Processors use swaps and trades to manage logistical and seasonal imbalances and to improve collection and production efficiencies. These efficiencies are shared between processors.

The ACCC heard concerns from many farmers that milk swaps and trades reduce competition at the farmgate, are anticompetitive agreements and potentially give rise to market sharing.⁴⁸

The ACCC analysed information and data provided by processors for their milk swaps and trades for the period 2010–11 to 2015–16.⁴⁹

4.7.1 What is a milk swap?

Milk swaps are exchanges of similar volumes of raw milk between two processors.

There are four main types of milk swap:

1. Geographic swap—Processor A collects milk in a region and swaps it ('swap out') to Processor B. In return, Processor B swaps an equivalent volume of milk to Processor A ('swap in') in a different region. The swap removes the need to transport milk between regions and therefore reduces transport costs, especially if each processor does not have a processing plant in the respective regions. The allocation of transport savings is negotiated between the processors.
2. Milk pick-up swap—a processor collects milk on behalf of another processor, who at a later date (such as at the end of week or month) will deliver milk to that processor to balance the amount received. This swap optimises collection logistics.
3. Intra-week swap—a processor has enough supply to satisfy its total weekly demand, but swaps with another processor throughout the week to meet peaks and troughs as demand from wholesale customers is uneven.
4. Maintenance swap—swaps that are undertaken when a plant is closed for maintenance or repairs.

The ACCC understands that the majority of swaps are geographic. Geographic swap agreements are commonly rolled over by processors each season, with most occurring in the Victorian dairy regions (including the Murray region), but also in SA. There are also some intra-week and milk pick-up swaps that are rolled over.

When a swap (or trade) occurs, the supplying farmers are paid under the pricing structure of the processors with whom they have contracts rather than the processor that receives their raw milk. As farmgate prices differ between processors throughout the year, farmers have raised concerns that processors are profiting from swap or trade arrangements, while exclusive supply arrangements prevent farmers from responding to better offers directly.

⁴⁸ For example, United Dairyfarmers of Victoria, *Submission to the ACCC's Inquiry into the Australian Dairy Industry*, 14 August 2017; New South Wales Farmers, *Submissions to the ACCC's Inquiry into the Australian dairy industry*, 19 December 2016; and Dairy Farmers Milk Co-operative, *Submission to the ACCC Inquiry into the Dairy Industry (Part 2)*, 12 December 2016. Market sharing, where competitors allocate customers and/or geographic regions, is a form of cartel conduct and is illegal under the CCA regardless of its effect on competition. Section 45 of the CCA prohibits corporations from making or giving effect to contracts, arrangements and understandings that have the purpose, effect or likely effect of substantially lessening competition. Since the Competition and Consumer Amendment (Competition and Policy Review) Bill was enacted, s. 45 also prohibits corporations from engaging in a 'concerted practice' that has the purpose or effect of substantially lessening competition.

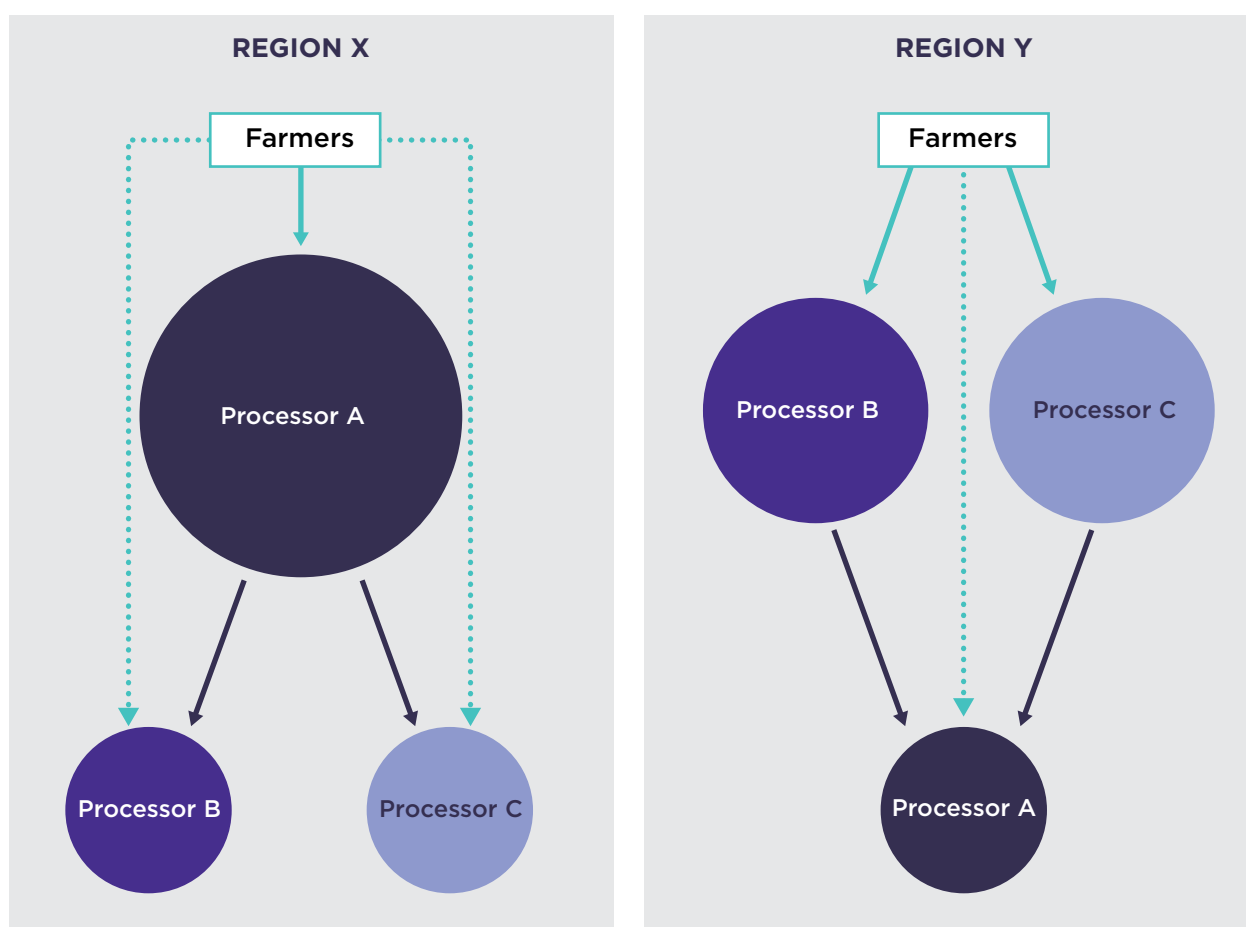
⁴⁹ The information and data received by the ACCC varied between processors. For example, some provided swaps and trade information for the period 2010–11 to 2015–16, others for the period 2013–14 to 2015–16 etc. The ACCC understands that there may be data quality issues that result in higher figures for swap and trade volumes than is actually the case in some regions.

4.7.2 How might milk swaps negatively impact competition?

The ACCC has considered how swaps could potentially be used to market share or lessen competition for the acquisition of milk from farmers.

Swaps could lead to a reduction in the number of competitors at the farmgate or, more seriously, a market sharing agreement in breach of the CCA. An example is illustrated in figure 4.3. One processor acquires the majority of milk in one region, sharing it with their rivals, while receiving milk back in another region in return. The result of the swaps is that the processors will not need to compete with one another at the farmgate in order to receive the volumes of milk they need. This could result in a lower farmgate price than in an environment where processors were competing for milk directly from farmers.

Figure 4.8: Market sharing through swaps



4.7.3 Analysis

To test the effects of swaps, the ACCC examined the following data and information:

- the regions where swaps occur and the market shares of the processors involved
- the volume and frequency of milk swaps in the period 2010–11 to 2015–16, and their size relative to regional production levels
- the purpose and rationale for swaps, as explained by internal company documents and oral testimony provided by some processors.

Location

The majority of swaps occurred between three Victorian regions (for example, swaps occurring in the Murray and eastern Victoria regions). This tends to indicate that swaps are being used to reduce transport costs.

Volume and frequency of swaps

The ACCC examined the volume, timing and locations of swaps between processors.

Based on the ACCC's analysis of the data provided by processors, the overall volume of milk swapped can be significant but is typically not high relative to the total volume of milk produced in the region:

- one processor swapped in between 10 and 17 per cent of the total volume of milk it acquires in the western Victoria region for the last five years
- another processor acquired about 15 per cent of its milk demand in northern Victoria by swaps, and then swapped out the majority of this volume to various processors in eastern Victoria
- significant volumes of swaps occurred between the Victorian regions and Adelaide (primarily with western Victoria) and central NSW (primarily with northern and eastern Victoria)
- a small volume (i.e. less than 5 per cent of total volume produced) was swapped between the northern and southern areas of Tasmania
- the frequency of swaps varied between processors and within individual processors: many of the processors whose data we analysed swapped milk infrequently and the volumes swapped varied; the overall volume swapped was spread evenly across the dairy season, with fluctuations following the supply curve of farmers
- the variances in the timing and volume of swaps is consistent with processors' commercial rationale for engaging in swaps; regular swaps of higher volume are likely to be geographic or milk pick-up swaps, whereas smaller infrequent swaps are likely to be for balancing milk supply or for maintenance.

Purpose of swaps

Internal documents indicate that swaps are primarily used by processors to minimise their milk collection costs, and to manage minor or short-term regional imbalances or weekly fluctuations in supply and demand.

The analysis indicates that swaps can result in milk collection efficiencies through transport cost savings. In some cases, the swaps appear to have enabled processors to compete for raw milk in regions where they otherwise could not because they lack processing facilities in those regions.

The ACCC did not find any evidence of market sharing arrangements, or of processors refusing to enter into supply agreements with farmers.

Other observations

The data and other evidence indicated some insights into the likely outcomes of swaps in relation to milk collection costs and farmgate prices:

- processors who operated across different southern state regions tended to offer a uniform farmgate price to all farmers in these regions. Given the small volume of milk that was swapped, any effect on price from a reduction in competition was likely to be minor
- the transport cost savings realised were around three to six cents per litre.⁵⁰

4.7.4 What is a milk trade?

Milk trades are commercial sale arrangements for the supply of raw milk from one processor to another.⁵¹

The ACCC understands that processors engage in trades to manage contract and plant-related supply and demand imbalances. In particular, processors who supply fresh drinking milk need to access consistent volumes of raw milk year round, and therefore tend to 'trade in' raw milk in autumn and 'trade out' any excess milk in spring. These processors typically trade milk with producers of exportable dairy products who are less reliant on consistent raw milk volumes throughout the year. Small processors (such as boutique cheese manufacturers) who have insufficient demand to commit to acquiring a farm's entire supply for the season also acquire milk from other processors through trades.

⁵⁰ The greater the distance between two processors engaging in a swap, the greater the efficiency gain is likely to be.

⁵¹ Trades differ from swaps as they are a commercial transaction between buyer and seller rather than volume-based exchanges.

4.7.5 How might milk trades negatively impact competition?

The ACCC has considered how trades could soften competition between processors. If a processor sells milk to a rival at a sufficiently low price to deter them from competing to purchase it directly at the farmgate, this could result in a lower farmgate price than if the processors competed for the supply.

This behaviour could also lead to market sharing in multiple regions if a processor agrees to not compete in one region on the basis of a processor supplying it with milk at a low price in return for it doing the same in another region. Such an agreement would be in breach of the CCA.

As with swaps, the ACCC tested the processors' rationale for engaging in trades, including analysis of internal documents. The ACCC looked for evidence of market sharing, including reciprocal commitments and obligations that would prevent processors from competing directly in their farmgate acquisitions. We also looked for, but did not find, evidence of refusals to trade by processors for the purpose of foreclosing rival processors' access to raw milk.

Further, we analysed data from three of the largest processors who engage in trades to consider the volume, timing, parties and locations of trades, as well as the margins earned. These considerations are important because if trades are regular, involve large volumes, or constitute the majority of the milk that a processor acquires in a region, questions arise as to why processors don't compete for these requirements directly. Similarly, regular trades between two processors with similar production capabilities could indicate market sharing rather than management of supply.

4.7.6 The competitive impact of milk trades

The ACCC considers that trades have greater potential to harm competition than swaps. However, there are some mitigating considerations; for instance, trades can:

- enable processors to address supply-demand imbalances, particularly in regard to domestic market demand
- facilitate competition from smaller processors in farmgate and wholesale markets, provided this is not prevented by exclusive supply contracts.

4.7.7 Analysis

As with the framework we adopted for analysing swaps, the ACCC had regard to the following evidence in the analysis of the effects of trades which occurred between 2010-11 and 2015-16:

- the identity and types of processors who engaged in trades, in particular who the trading 'partners' were
- data indicating the profit margins earned from trades
- any indications of foreclosure of rival processors; for this, the ACCC considered internal company documents and other evidence.

Purpose of trades

Processors face demand and supply imbalances throughout the season. The manufacturing focus of a processor (for example, short shelf life products such as fresh drinking milk, or long shelf life products such as milk powder) will influence its incentive to flatten their supply throughout the year by buying or selling milk.

As trades are used to manage demand and supply imbalances, we would expect to see processors of fresh dairy products (such as drinking milk) trading with processors of exportable products, rather than trades between two domestic-focussed or two export-focused processors.

The ACCC found that the majority of trades are between processors with different product focuses. This lessens concerns about trades being used as a mechanism to lessen competition for farmers.

However, the ACCC did see evidence of a processor on occasion using a trade for the purpose of deterring farmgate competition. Documents detailed the processor's consideration of the price at which it would need to supply milk to rivals through a trade, to deter the rivals from sourcing milk directly from farmers. The intention of this strategy was to protect market share without increasing farmgate prices.

Volume and timing of trades

Based on the ACCC's analysis of the data provided by processors, the total volume of milk traded was not large relative to total milk production volumes in any region.

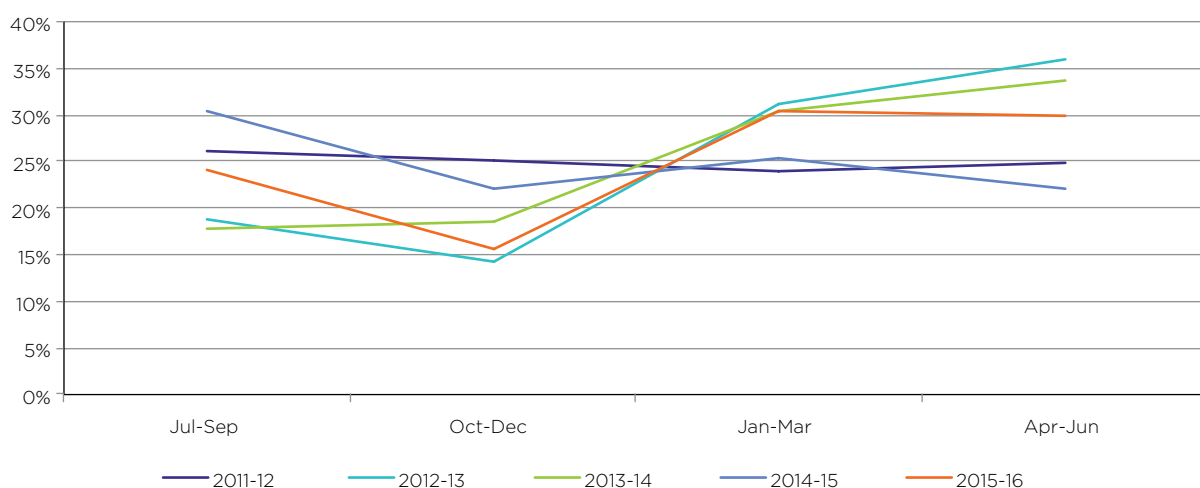
However, the ACCC did identify two processors who acquired a significant volume of their total milk supply in a region through inward trades. For one processor in a Victorian region, the volume acquired via trades represented the majority of its acquisitions in the region for the dairy season. This raises a question of whether, absent the ability to trade milk, these processors would compete more vigorously for direct supply.

Domestic-focused processors require a relatively flat milk supply. These processors told the ACCC that they attempt to contract enough supply to meet their spring demand, and acquire the shortfall they experience in autumn from other processors.

The following figures are based on milk trade data from domestic-focused processors and broadly support these submissions. As can be seen from figure 4.4, these processors make the greatest proportion of their trade purchases in autumn.

However, these processors still acquired 15 to 25 per cent of their total trade purchases during spring. This may be for the purpose of managing demand and supply imbalances, or because they need milk in some regions and not others. However, if these processors' strategy is to contract sufficient supply to meet their spring demand, there is some uncertainty as to why they would need to acquire milk via trades during these months, rather than by competing for it at the farmgate.

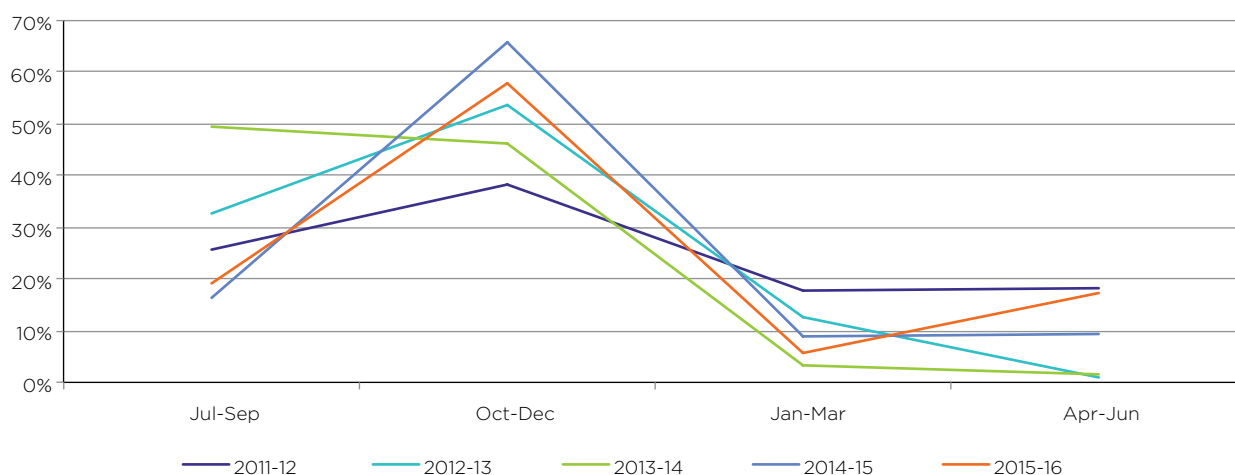
Figure 4.9: Timing of trade purchases by domestic-focused processors (% of total trade purchases)



Source: Processors' milk purchase data and ACCC analysis

These same processors also traded out (sold) milk to rivals; however, the volume was small relative to the total volume of milk they acquired through trades, and to the volume of milk they acquired in total (averaging about two per cent for the past three seasons). As can be seen from figure 4.5, these processors most often engaged in trade sales to other processors during spring. In autumn, they appear to have sold small volumes of milk. This supports the processors' rationale for trading milk being to balance milk volumes.

Figure 4.10: Timing of trade sales by domestic-focused processors to other processors (% of total trade sales)



Source: Processors' purchase data and ACCC analysis

Trades may distort price signals to farmers

As milk is traded between processors at prices that are different to farmgate prices, price signals to farmers about the value of their supply at particular times of the year could be distorted. This could lead to inefficiencies in the market, such as ongoing misalignment of the supply and demand between farmers and the processor they supply⁵², and discourage processors from developing better methods of managing their milk supply.

The ACCC understands that raw milk is traded between processors for around five to 10 cents per litre more than the farmgate price. By preventing farmers from realising this extra value, trades are potentially distorting the real value of milk to farmers.

However, processors (in particular those processors producing fresh drinking milk) can make losses through trades compared to acquiring milk directly from farmers because they pay a premium over the farmgate price to acquire milk through trades. They may do this because it is the most efficient way for them to balance their milk supply given the current industry structure.

Current exclusive supply agreements restrict farmers from supplying more than one processor. This prevents farmers from splitting their supply between multiple processors to access different pricing structures for autumn and spring supply. If farmers were able to do this, it may lead to more accurate price signals from processors to farmers, and hence flatter raw milk supply, reducing the need for trades.

4.7.8 Conclusion on swaps and trades

Raw milk swaps have the potential to soften competition; but the risk does not appear to be high.

The ACCC considers that trades can be used to lessen farmgate competition and has some concerns that processors have traded milk with the purpose of protecting their own supply within a region. However, the trades we analysed are unlikely to have had a significant adverse impact on competition. Further, it is apparent that trades have some benefits by allowing processors with insufficient aggregate demand to contract directly with farmers to access raw milk and hence compete in wholesale markets, and that they provide means of managing milk supply imbalances.

In response to the Interim Report, the ACCC received submissions from some industry participants expressing general disagreement with the conclusions drawn from the above analysis⁵³. However, the ACCC did not receive any additional information or evidence of swaps and trades raising concerns beyond those outlined in this report.

⁵² For example, farmers that autumn calve who supply an export-focused processor when it could be more efficient for them to supply a fresh drinking milk processor.

⁵³ Dairy Farmers milk co-operative, *Dairy Farmers Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, published 23 February 2018; Queensland Dairyfarmers' Organisation, *QDO response to ACCC Interim Report into dairy industry*, 7 February 2018.

5. Other competition in the dairy industry

Key Points

- Wholesale prices for dairy products are competitively constrained by competition between processors, imports, and the bargaining power of major supermarkets.
- There has been entry, expansion and innovation in wholesale dairy markets, particularly for the supply of products such as yoghurts, flavoured drinking milk and premium brand cheeses.
- Competition between supermarkets for supply of dairy products, in particular fresh drinking milk and block cheddar cheese, has resulted in lower real prices for consumers.

This chapter examines the general state of competition for the wholesale supply of dairy products. The ACCC's assessment has taken into account:

- market concentration and changes to market shares in the supply of dairy products, particularly fresh white drinking milk
- changes in the suppliers of private label drinking milk and cheese
- evidence of capacity expansions and entry by new processors into the industry (albeit small) and existing processors into the supply of new product categories
- competition from imports for processed products, especially cheese
- countervailing power of supermarkets (sponsoring new entry and expansion to increase competition)
- bargaining power of supermarkets.

This chapter also discusses how aspects of supermarket competition affect how they compete to sell dairy products.

5.1 Interim report feedback

The ACCC received the following industry feedback in relation to the interim report:

- some stakeholders considered that there was a lack of analysis of retail behaviour¹, and that at a minimum two distinct product markets (one for fresh milk and one for value add dairy products) should have been defined and analysed more closely²
- Some processors submitted that the capital requirements for entry and expansion in dairy processing were not significant and could be overcome by large scale international players.³

5.2 Competition for the wholesale supply of dairy products

For the purposes of the inquiry, the ACCC considered the general state of competition for the wholesale supply of dairy products in Australia. We do not consider it necessary to precisely determine relevant markets for the purposes of the inquiry, however, the analysis has considered the different characteristics of dairy products (for example, fresh versus longer life exportable products).⁴

Our assessment has taken into account:

- market concentration and changes to market share in the supply of dairy products, particularly fresh white drinking milk
- changes in the supply arrangements for private label drinking milk and cheese

1 Dairyfarmers' Association Inc, SADA Response to the ACCC Interim Report into the Dairy Industry in Australia, 6 February 2018, p. 1.

2 NSW Farmers' Association, *Submission on the ACCC Dairy inquiry interim report*, February 2018, p. 14.

3 Fonterra Australia Pty Limited, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 9.

4 Assessments of actual merger proposals or market power in the industry could mean that different market boundaries are relevant.

- evidence of capacity expansions and new entry
- import competition for processed products, especially cheese
- countervailing power of supermarkets and their ability to sponsor new entry and expansion to increase competition
- the bargaining power of supermarkets.

The ACCC's analysis indicates that there is effective competition at the wholesale level of the dairy industry. Processors compete to supply different dairy products to the grocery retail channel, the food service channel, the food manufacturing channel and to international markets.⁵

Competition between processors, from imported products, and the bargaining power of major supermarkets in the grocery retail channel means that wholesale prices for dairy products are competitively constrained. Competition for the wholesale supply of fresh drinking milk is predominantly regional or state based. The supply of products with a longer shelf life tends to have a national dimension and in some circumstances is subject to competition from imports, particularly for cheese and butter. The wholesale supply of dairy products for export markets is constrained by international competitors.

There has been entry, expansion and innovation in the wholesale supply market, particularly for products such as yoghurts, desserts and differentiated milk.

Our assessment of these issues is outlined below.

5.2.1 Wholesale market concentration

Table 5.1 identifies the types of dairy products supplied in Australia by processors and by importers.

Table 5.1: Type of dairy products supplied by processors and importers

	Drinking milk	Fresh Dairy	Cheese	Butter/AMF	Whey/Powders
Murray Goulburn					
Fonterra					
Lion					
Parmalat					
Warrnambool Cheese and Butter					
Bega					
Brownes					
Norco					
Importers					

Source: Dairy Australia data and ACCC analysis

Share of dairy production varies by product, reflecting processor specialisation

Although the processing sector has the ability to manufacture a wide range of dairy goods, most processors focus on making and marketing products within specific categories. Producers of the same or similar products are likely to be each other's closest competitors.

Although only accounting for a relatively small share of milk intake, Bega is the market leader in the production of cheese in Australia. IBIS world estimates that Bega's share of cheese manufacturing revenue is around 23 per cent, followed by WCB (14 per cent) and Lion (13 per cent).⁶

5 Different dairy products may be their own market, and groups of dairy products may form separate markets (e.g. fresh and long-life dairy products). Further, a number of wholesale markets for the supply of dairy products through different channels are likely to be relevant to any future merger investigations.

6 Brooke Tonkin, *The big cheese: The popularity of gourmet cheeses is projected to aid revenue growth*, IBISWorld, January 2017, accessed 14 November 2017, clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=1856.

In the drinking milk market, Lion and Parmalat are the first and second largest players, accounting for around 20 per cent and 19 per cent of industry revenue, respectively.⁷ Murray Goulburn now has the third largest share of the drinking milk market with 16 per cent. Murray Goulburn has the highest market share for the production of milk powder⁸, butter⁹, and other dairy products and is the fourth largest for cheese production.¹⁰ The diversity of this product offering largely reflects Murray Goulburn's large Victorian milk supply base and exposure to export markets. Consequently, it has production flexibility to minimise risks associated with fluctuations in export prices. Fonterra has a similar product mix and production strategy but its milk intake has historically been around half that of Murray Goulburn.

5.2.2 Vigorous competition for wholesale supply to retailers

Retailers have a superior bargaining position when negotiating with processors because they are large acquirers of dairy products and an important channel for the supply of dairy products to consumers. For example:

- approximately 54 per cent of domestic drinking milk sales are through major supermarkets¹¹
- approximately 53 per cent of domestic cheese sales are through major supermarkets.¹²

The ACCC has found that competition between processors to have their products stocked by the major supermarkets has been a significant constraint on wholesale prices in addition to the bargaining power held by the major supermarkets. This has resulted in lower retail prices for consumers. This is discussed further in chapter 6.

Private label contracts shift between processors

Private label contracts often change hands following tender processes in most regions, which shows that rival firms have the ability to out-compete the incumbent processor. Although price is an important consideration for the major supermarkets, evidence obtained during the inquiry indicates that product quality and efficiency in production and distribution are also important considerations when the retailers are evaluating tenders.

Presently, contracts for the supply of private label fresh white drinking milk are relatively long term, such as five to 10 years. Between 2013 and 2015, several contracts shifted between processors in several states (tables 5.2 and 5.3).¹³

7 Samuel Johnson, *Cream of the crop: Strong export growth has significantly boosted the industry's performance*, IBISWorld, October 2017, accessed 14 November 2017, <http://clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=94>.

8 Bao Vuong, *Sour circumstances: Fluctuating global milk powder prices have led to industry volatility*, IBISWorld, August 2017, accessed 14 November 2017, <http://clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=1857>.

9 Brooke Tonkin, *Spilt milk: Industry revenue is expected to decline due to plummeting global dairy prices*, IBISWorld, November 2016, accessed 14 November 2017, <http://clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=96>.

10 Brooke Tonkin, *The big cheese: The popularity of gourmet cheeses is projected to aid revenue growth*, IBISWorld, January 2017, accessed 14 November 2017, clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=1856.

11 Dairy Australia, *Australian Dairy Industry in Focus 2016*, pp. 24, 43, and ACCC analysis.

12 Dairy Australia, *Australian Dairy Industry in Focus 2016*, p. 42, and ACCC analysis.

13 The public announcement of the successful tender was sometimes delayed for a month after the processor was notified.

Table 5.2: Coles private label fresh drinking milk contracts¹⁴

State	Supplier	Former supplier	Contract duration		Winning tender announced
			Start	End	
Victoria	Murray Goulburn	Lion	July 2014	June 2024	April 2013
NSW	Murray Goulburn	Lion	July 2014	June 2024	April 2013
Queensland (excl. FNQ)	Norco	Parmalat	July 2014	June 2023	April 2013
WA	Lion	Parmalat	September 2015	September 2020	June 2015
SA	Lion	Parmalat	September 2015	September 2020	June 2015
NT	Lion	Parmalat	July 2015	July 2020	June 2015
FNQ	Lion	Lion	July 2015	July 2020	June 2015
Tasmania	Lion	Lion	July 2015	July 2020	June 2015

Table 5.3: Woolworths private label fresh drinking milk contracts¹⁵

State	Supplier	Former supplier	Contract duration		Winning tender announced
			Start	End	
Victoria	Fonterra	Lion	February 2015	February 2025	April 2014
NSW	Parmalat	Parmalat	July 2016	July 2020	July 2015
Queensland	Parmalat	Parmalat	September 2014	September 2019*	April 2014
WA	Brownes	Lion	July 2014	July 2022	April 2014
SA	Parmalat	Lion	July 2015	July 2020	July 2015
NT	Parmalat	Lion	July 2015	July 2020	July 2015
Tasmania	Lion	Lion	July 2014	Retained July 2015	July 2015

* Five-year contract with option to extend for a further five years¹⁶

The shift of private label contracts during 2016 also demonstrates robust competition between processors:

- Murray Goulburn won a five-year national private label contract to supply Coles brand Australian cheese in February, stating that, “The national cheese contract will generate approximately \$130 million in additional sales per annum and importantly deliver a stable stream of profits to MG over the life of the contract”.¹⁷
 - (a) Coles’ previous supplier was Bega. Media reports estimated that the company would need to find an alternative market for up to \$60 million worth of cheese. Bega CEO, Aiden Coleman

14 Sue Mitchell and Tim Binsted, *Fonterra wins Woolies’ 10-year contract for private label milk in Victoria*, *Sydney Morning Herald*, 4 April 2014, accessed 23 October 2017, <http://www.smh.com.au/business/fonterra-wins-woolies-10-year-contract-for-private-label-milk-in-victoria-20140403-361fw.html>;

Brad Thompson, *Coles poised for Lion’s share*, *The West*, 1 July 2015, accessed 23 October 2017, <https://thewest.com.au/countryman/news/coles-poised-for-lions-share-ng-ya-391980>;

Damon Kitney, *Coles deal puts Lion back in favour*, *The Australian*, 16 June 2017, accessed 23 October 2017, <http://www.theaustralian.com.au/business/companies/coles-milk-deal-puts-lion-back-in-favour/news-story/7aa99bfeff60c50310befb38271d8fe8?login=1>.

15 Sue Mitchell and Tim Binsted, *Fonterra wins Woolies’ 10-year contract for private label milk in Victoria*, *Sydney Morning Herald*, April 4 2014, accessed 23 October 2017, <http://www.smh.com.au/business/fonterra-wins-woolies-10-year-contract-for-private-label-milk-in-victoria-20140403-361fw.html>;

John Durie, *Parmalat wins Woolworths house brand milk deal for NSW*, *The Australian*, 14 July 2015, accessed 23 October 2017, <http://www.theaustralian.com.au/business/companies/parmalat-wins-woolworths-house-brand-milk-deal-for-nsw/news-story/4ba852b550160042a30ed291b01aa445>.

16 Woolworths Group Ltd, *Woolworths offers certainty in new milk contract*, 3 April 2014, accessed 23 October 2017, https://www.woolworthsgroup.com.au/page/media/Press_Releases/Woolworths_offers_certainty_in_new_milk_contract.
Jasmine O’Donoghue, *Woolworths dumps Lion for Fonterra and Brownes*, 3 April 2014, accessed 26 November 2017, <https://foodmag.com.au/woolworths-dumps-lion-for-fonterra-and-brownes/>.

17 Murray Goulburn Co-operative, *Murray Goulburn wins Coles cheese supply contract*, 1 February 2017, accessed 23 October 2017, <http://www.mgc.com.au/media/31128/MG-Coles-Contract-ASX-Announcement-final.pdf>.

stated, “We went into a competitive tender process .. and Coles have chosen an alternative supplier based solely on pricing I should imagine.”¹⁸

- Murray Goulburn then lost the Woolworths private label cheese contract to Bega in July 2016, while retaining contracts for shredded mozzarella and butter.¹⁹
- Murray Goulburn lost contracts to supply Woolworths with:
 - (a) milk powder (awarded to Fonterra)
 - (b) UHT milk (awarded to Harvey Fresh for WA and SA, and Freedom Foods in all other states)
 - (c) cream (awarded to Fonterra for Victoria, Parmalat for Queensland, and Bulla elsewhere).²⁰

In the Southern region where fresh drinking milk and domestic dairy sales account for a relatively small proportion of total production, changes in private label contracts do not strongly influence wholesale market shares. In Northern and WA region, however, a change in a fresh white drinking milk private label contract with Coles or Woolworths has a pronounced effect on wholesale market shares.

5.2.3 Limited supply-side substitution

A processor’s ability to exercise power in wholesale markets is constrained if it is relatively easy for rivals to switch existing production resources between different dairy products. This concept is known as supply-side substitution.

The ACCC understands that it is generally difficult for processors to readily switch between manufacturing different types of dairy products, and even different types of products within the same category (for example, different types of cheese). This is due to the specific nature of equipment: processing plants are generally dedicated to the manufacture of a particular dairy category (such as fresh drinking milk or specialty cheese) or a number of complementary categories (such as skim milk powder and cheese).

However, processors with multiple plants or product options have the ability to vary their production by allocating the raw milk they acquire to the most profitable use, subject to capacity constraints. Processors with this flexibility are generally located in the Southern region.

The ACCC therefore considers that there is only a weak competitive constraint on the major processors from the threat of supply-side substitution.

5.2.4 High barriers to entry for large-scale processing

A processor’s ability to exercise market power will depend on the extent to which it is constrained by the threat of new entrants, or the expansion of an existing competitor. If new entrants are able to offer farmers an alternative option for the supply of their milk, any attempt by incumbent firms to exercise market power will be unsustainable. Similarly, the threat of expansion by competing processors acts as a constraint on incumbents.

The ACCC considers that there are barriers to large-scale entry into milk processing. There has been substantial rationalisation in the industry over the last decade and large-scale entry into the processing sector has been limited.

Entry on a smaller scale is feasible but is unlikely to constrain incumbents in the short term. However, incumbent processors may be constrained by the threat of expansion by rival firms, as evidenced by ongoing expansion and upgrade projects in several regions.

The following factors affect the likelihood of large-scale entry:

- access to raw milk
- large capital requirements
- economies of scale

18 Joshua Becker, *Bega Cheese loses Coles contract to Murray Goulburn*, ABC Rural, 1 February 2016, accessed 23 October 2017, <http://www.abc.net.au/news/rural/rural-news/2016-02-01/bega-loses-coles-cheese-contract/7129520>.

19 Murray Goulburn Co-operative, *Murray Goulburn Announcement*, 29 July 2016, accessed 23 October 2017, <http://www.mgc.com.au/media/38504/ASX-Announcement-Woolworths-private-label-business-29-July-2016.pdf>.

20 Clint Jasper and Nikolia Beilharz, *Murray Goulburn loses out as Woolworths hands private label dairy contracts to rival processors*, ABC Rural, 29 July 2016, accessed 23 October 2017, <http://www.abc.net.au/news/rural/2016-07-29/woolworths-drops-mg-lines-of-private-dairy/7671532>.

- historical contractual arrangements
- access to export markets
- excess processing capacity.

Access to raw milk

As detailed in chapter 4, exclusivity clauses in supply agreements can act as barriers to entry or expansion.

Rather than seek to acquire raw milk directly from farmers, small or new entrants sometimes purchase milk from existing processors (either directly or through a broker). However, the ability to control the cost of a key input can provide an incumbent with a competitive advantage.

As discussed above, the ACCC has observed vigorous competition between processors for private label contracts. This indicates that accessing enough raw milk to fulfil these contracts is not such a significant barrier that it prevents wholesale contracts switching or processors expanding.

Capital requirements

Entry into dairy processing requires capital investment for specialised equipment and logistics capabilities to transport raw milk efficiently. Entrants also require capital to establish distribution channels for their products and to build their brand's presence in the market. While high capital costs are not necessarily a barrier to entry, the proportion of the costs which are sunk, and uncertainty about cash flows arising from fluctuations in market conditions, can increase the risk and cost of entry.

Murray Goulburn's \$150 million investment to build two new processing plants in Victoria and NSW after securing a large private label milk contract with Coles demonstrates the magnitude of capital requirements to establish processing facilities.²¹

Potential difficulties with divesting costly, specialised assets can represent barriers to exit for the dairy processing market. Processors may face uncertainty about locating a potential buyer for their assets in the event they want to exit a market. While recent examples indicate that there is significant interest in purchasing relatively modern dairy processing assets in desirable locations (as demonstrated by buyer interest in Murray Goulburn during 2017), it can be more difficult to divest older processing equipment or facilities (as seen in the case of United Dairy Power, which went into receivership in 2014–15).^{22, 23} However, such facilities are already substantially depreciated. Overall, the capital required to enter the industry does not appear to present an insurmountable barrier for new entrants.

Economies of scale and scope

In addition to an established presence in the industry, including consumer awareness of their products and brands, incumbent processors enjoy efficiencies created by economies of scale and scope. This can act as a barrier to new entrants because they must achieve a scale that makes their average costs competitive with those of incumbents.

Contractual arrangements with retailers

Long-term private label supply agreements can also impede an entrant's ability to compete in the retail sector, due to limited shelf space for new products. Few of these contracts come up for renewal each year. The scale required to fill the contracts could preclude entrants from securing them. Conversely, long-term supply agreements may facilitate entry by providing a higher degree of certainty on the firm's return on investment. Securing long-term agreements would reduce the risk associated with the capital investment required to establish a large processing business.

21 David Pearce and Julian Sakowski, *Devondale Murray Goulburn secures \$150 million structured leasing arrangement to build milk processing plants*, Commonwealth Bank of Australia, 3 April 2014, accessed 8 October 2017, <https://www.commbank.com.au/content/dam/commbank/theme/corporate/change-the-game/docs/Devondale-Murray-Goulburn.pdf>.

22 Farm Online, *Down to the wire for UDP*, 11 February 2015, accessed 2 October 2017, <http://www.farmonline.com.au/story/3380216/down-to-the-wire-for-udp/>.

23 Meredith Booth, *South Australian milk plants deal with Beston Global Food Company*, *The Australian*, 17 June 2015, <http://www.theaustralian.com.au/business/news/south-australian-milk-plants-deal-with-beston-global-food-company/news-story/733d7c5bcb1deaed9491db0775dfd3cf?nk=bbe5591c40777abac695ad22f54cf363-1510819951>.

The ACCC observes that supermarkets have embraced smaller processors entering the market with innovative and premium products, indicating the potential for small-scale entry as new players are able to compete in the retail sector. This places increased pressure on existing processors to continue to be innovative in the development of new products and the improvement of existing ones, in order to retain shelf space in supermarkets.

Access to export markets

Gaining access to export markets may also present a challenge for new entrants in processing markets. Examples of obstacles faced by Australian dairy processors in major export markets include pooled quotas for cheese exports to Japan²⁴, and Chinese requirements for factory registration, with even stricter certification and accreditation requirements for infant formula.²⁵

Establishing a presence and customer base can also be a challenge, and Australian firms adopt various strategies to counter these issues. For example, the Midfield Group's managing director noted that its joint venture with Louis Dreyfus to establish a processing plant in SA combined Midfield's expertise in dairy farming and processing with Louis Dreyfus' global reach, helping Midfield achieve an immediate competitive presence in export markets.²⁶

Excess processing capacity

Some excess processing capacity is needed to handle fluctuations in raw milk supply during the year and in supply and demand over time. In theory, however, incumbents' excess capacity may act as a deterrent to entry if it can be used to rapidly increase production (supply of goods).

The ACCC analysed data provided by major processors to consider capacity utilisation. Over time, total national processing capacity for drinking milk, powder and cheese has increased as facilities have been expanded and new plants have been commissioned. Substantial investment in fresh drinking milk processing capacity has been observed in several states, which is likely a result of large private label contracts being secured. Cheese capacity has fallen slightly in Queensland, while increasing in Tasmania and Victoria, leading to an overall increase nationally. Powder capacity has also risen over time alongside strong demand from Asia. Capacity to produce butter has been relatively steady.

Aggregate annual national production is consistently below total capacity. In particular, the analysis revealed significant excess capacity for milk powders in Victoria and Tasmania throughout much of the year. This is primarily due to the seasonal nature of production in these regions; the spring peak is handled by manufacturing milk powder in high volumes, at which time processing capacity is more fully utilised. These plants are then partially or fully shut down between January and August.²⁷ As a result, processors can only spread the fixed costs of their asset over a relatively short period of time, effectively increasing their processing cost compared to a scenario where they can run the facility at full capacity year-round.

Consequently, the ACCC considers that excess capacity is unlikely to be a significant barrier deterring new entry, but rather a characteristic of an industry subject to substantial fluctuations in production both within and between seasons.

5.2.5 Lower barriers to entry for small-scale processing

There has not been large-scale entry into the processing sector in recent years and future entry is unlikely given the factors discussed above. Small-scale entry (for example, entry with a limited processing capacity that would only have a marginal impact on the broader competitive dynamics in a region) may be feasible as illustrated by the examples below. However, due to the expansion barriers outlined above, the ACCC considers these new players are unlikely to expand in the foreseeable future to a scale sufficient to compete with existing major processors.

24 Dairy Australia, *Market Brief Japan*, version 2, August 2016.

25 Dairy Australia, *Market Brief China*, version 2, August 2016.

26 Kate Zwagerman, *Midfield Group enters joint venture with global food giant*, *The Standard*, 4 August 2016, accessed 7 August 2017, <http://www.standard.net.au/story/4074975/midfield-group-enters-joint-venture-with-global-food-giant/>.

27 Australian Dairy Industry Council and Dairy Australia, *Response to the Productivity Commission Study: Costs of Doing Business: Dairy Product Manufacturing*, 2014, p. 3.

Examples of relatively small-scale entry into dairy processing in recent years include:

- The Midfield Group, a meat processing business, expanded into dairy in a joint venture with Louis Dreyfus Company, completing construction of a milk processing plant near Penola, SA in mid-2017. Costing over \$80 million²⁸, the plant has capacity to process 220 million litres of raw milk which will be sourced from farmers in SA and western Victoria. The volume of raw milk sought by this new entrant represents about nine per cent of the approximately 2.5 billion litres of milk produced in the region each year.²⁹ The Midfield Group plans to produce about 30 000 tonnes per year of whole and skim milk powder, primarily for export. Any potential effect on competition is likely to be localised to the western Victoria dairy region.
- In 2016, Chinese-owned Blue Lake Dairy announced a \$65 million project to convert a mothballed potato chip factory in south east SA into a milk processing and packaging facility from which to export milk products.³⁰ The plant was opened in January 2017 and produces 20 000 tonnes of milk powder for export to the Chinese market.³¹ Any potential effect on competition is likely to be localised to the western Victoria dairy region. Blue Lake Dairy is currently constructing a milk drying facility and after its completion will require over 100 million litres of liquid milk from local suppliers in the surrounding area.³²
- Chobani entered Australia in 2011 with the acquisition of Bead Foods' facility in Victoria, before undertaking a \$30 million expansion of the plant.³³ The Dandenong South facility has production capacity of 30 000 tonnes of yoghurt a year and serves both domestic and export markets.

Milk brokers

The increasing presence of milk brokers and intermediaries in raw milk acquisition markets also has the potential to promote competition. However, their impact has been limited to date. There are a number of milk brokering businesses in operation, including Australian Consolidated Milk (ACM) in Victoria and Milk2Market (M2M) which operates in several states. Nevertheless, the ACCC considers that the current volume of raw milk traded through brokers is insufficient to materially impact competition.

Further, any impact would likely be localised to the regions where ACM and M2M acquire milk. ACM has established a UHT plant in a joint venture with Pactum Dairy Group, providing the broker with an alternative use for its raw milk.³⁴ ACM is also building a milk processing plant in Girgarre, Victoria, with the ability to process up to 200 million litres a year.³⁵ ACM plans to make cheese, butter and powder. The additional flexibility this affords is likely to be a useful bargaining tool for ACM in negotiating with their customers.

Although entry on a small scale is feasible, with the primary requirement being contracts with transport companies, milk brokers have not achieved a large presence in the market for raw milk acquisition. This may be a result of major processors selling excess milk directly to smaller processors, reducing the need for a broker. As processors appear to be moving away from trading milk, there may be a greater role for brokers in the future.

28 Belinda Willis, *New Penola factory milks global demand for powder products*, *The Advertiser*, 30 May 2017, accessed 12 October 2017, <http://www.adelaidenow.com.au/business/new-penola-factory-milks-global-demand-for-powder-products/news-story/13856768539572bf6a723a4b33427eab?nk=831e2d491eba134c3f7af34c8c0c9c68-1509074846>.

29 The Midfield Group, *The Midfield Group and Louis Dreyfus Company Dairy Asia announcement joint venture*, 4 August 2016, accessed 18 October 2017, <https://www.midfield.com.au/the-midfield-group-and-louis-dreyfus-company-dairy-asia-announce-joint-venture/>.

30 Cassandra Steeth, *Chinese Blue Lake Dairy Company to invest \$65 million for milk processing plant in South Australia's Tantanoola*, ABC Rural, 18 March 2016, accessed 2 October 2017, <http://www.abc.net.au/news/rural/2016-03-17/blue-lake-dairy-invest-millions-converting-potato-chip-factory/7253834>.

31 David Sparkes, *New facility moves closer to first export of powdered milk products to China*, ABC Rural, 5 August 2016, accessed 2 October 2017, <http://www.abc.net.au/news/rural/2016-08-04/blue-lake-dairy-ready-to-process-first-test-batch-of-milk-powder/7687920>.

32 Nigel Austin, *New SE dairy deal with China to create 60 jobs*, 17 March 2016, accessed 2 October 2017, <http://www.adelaidenow.com.au/business/new-se-dairy-deal-with-china-to-create-60-jobs/news-story/1bc773efc0688b3750c0fb978d6b139c>.

33 Australian Food News, *Australian Chobani factory to serve as "dairy export hub" into Asia*, 6 December 2012, accessed 2 November 2017, <http://www.ausfoodnews.com.au/2012/12/06/australian-chobani-factory-to-serve-as-%E2%80%9Cdairy-export-hub%E2%80%9D-into-asia.html>.

34 ACM sold its half-share in the JV in December 2016. ACM currently has a long-term supply agreement with Pactum Dairy Group. Australian Consolidated Milk Pty Ltd, *About Us*, accessed 20 October 17, <http://www.australianconsolidatedmilk.com.au/about-us.html>.

35 Simone Smith, *Australian Consolidated Milk to build milk processing plant at Girgarre*, *The Weekly Times*, 31 October 2017, accessed 5 March 2018, <https://www.weeklytimesnow.com.au/agribusiness/dairy/australian-consolidated-milk-to-build-milk-processing-plant-at-girgarre/news-story/7952db7b0b07be4c7cd6528c1a3d8f45?nk=30ec34f507d0287aa6ef5d6906cfb60d-1520214848>.

Vertical integration

There has been some vertical integration in the industry with farmers setting up processing facilities on site and producing branded milk in small volumes. These include capital investments ranging from a \$40 000 crowd-funded investment by a Queensland dairy farmer in a batch processor³⁶, to a \$5 million investment in an organic dairy processing plant in Victoria.³⁷

Vertically integrated dairy farms that expand into the market for processed products to some extent reduce the contestable milk supply for incumbent processors, requiring them to compete harder for a smaller milk pool. However, the small scale of these developments is such that they are unlikely to make a major difference to the degree of competition for milk at the farmgate.

Processing capacity expansions

Where existing processors can secure additional milk supply and the required capital needed for investment, they appear likely to pursue expansion activities to secure more market share and grow their business.

There have been several examples of existing processors investing in expanding their operations in recent years:

- As noted in tables 5.2 and 5.3, larger processors have pursued opportunities for expansion by securing contracts to supply milk to supermarkets:
 - In 2013, Norco secured a branded milk contract with Coles that saw it produce 60 million litres annually from its Labrador plant in Queensland. Norco reportedly spent \$6.4 million in capital expenditure to refurbish the factory and purchase capital equipment required to service the contract. This expansion saw Norco take on over 50 additional farmers as a result of the increased fresh drinking milk processing capacity.³⁸
 - In 2013 Murray Goulburn secured a 10-year supply contract with Coles for its private label brands in Victoria and NSW. Murray Goulburn secured \$150 million in capital to construct two purpose-built processing facilities to service the contract.³⁹
 - In 2014, Fonterra won a 10-year fresh white drinking milk contract with Woolworths, which instigated a \$30 million upgrade to its Cobden processing facility in Victoria.⁴⁰ The milk plant reportedly increased Fonterra's processing capacity by around 100 million litres.⁴¹
- Beston Pure Dairies (BDP) is undertaking a \$25 million expansion at its Murray Bridge cheese processing facility, with the aid of a \$2.5 million grant from the South Australian government.⁴² BDP will begin producing premium cheese products for sale in both domestic and export markets. Upon completion of the facility upgrade in 2018, BDP will require an additional 100 to 150 million litres of raw milk, primarily from South Australian farmers.
- In 2017, Saputo completed an upgrade of its Allansford processing facility at a cost of \$40 million, potentially increasing WCB's demand for raw milk by 250 million litres.⁴³

36 Meecham Philpott and Lara Webster, *North Queensland dairy farmer raises enough money for a milk processor*, ABC Rural, 20 October 2016, accessed 7 August 2017, <http://www.abc.net.au/news/rural/2016-10-20/north-queensland-dairy-farmer-crowdfunding-success/7946688>.

37 Laura Poole, *Organic Dairy Farmers of Australia cooperative starts production at new \$5m processing plant at Geelong, Victoria*, ABC Rural, 23 September 2015, accessed 7 August 2017, <http://www.abc.net.au/news/rural/2015-09-23/new-organic-dairy-processing-plant-at-geelong/6797344>.

38 Norco, *New 5-year contract drives growth for Norco*, 2 December 2014, accessed 17 October 2017, <http://www.norco.com.au/news-detail.php?New-5-year-contract-drives-growth-for-Norco-1>.

39 David Pearce and Julian Sakowski, *Devondale Murray Goulburn secures \$150 million structured leasing arrangement to build milk processing plants*, Commonwealth Bank of Australia, 3 April 2014, accessed 8 October 2017, <https://www.commbank.com.au/content/dam/commbank/theme/corporate/change-the-game/docs/Devondale-Murray-Goulburn.pdf>.

40 Sue Mitchell and Tim Binsted, *Woolworths inks milk deal with NZ dairy giant Fonterra*, *Sydney Morning Herald*, 3 April 2014, accessed 13 October 2017, <http://www.smh.com.au/business/retail/woolworths-inks-milk-deal-with-nz-dairy-giant-fonterra-20140403-3600n.html>.

41 Everard Himmelreich, *Fonterra opens new Cobden plant*, *The Land*, 2 September 2015, accessed 9 November 2017, <http://www.theland.com.au/story/3376685/fonterra-opens-new-cobden-plant/>.

42 Valerina Changanathil, *Beston's Murray Bridge revamp to boost milk demand*, *The Advertiser*, 15 June 2017, accessed 18 October 2017, <http://www.adelaidenow.com.au/business/bestons-murray-bridge-revamp-to-boost-milk-demand/news-story/292a542ea8221a2249f46df62cccaae6?nk=831e2d491eba134c3f7af34c8c0c9c68-1509072752>.

43 Everard Himmelrich, *Saputo says co-ops need to do better*, *Industry News*, 13 July 2017, accessed 11 October 2017, <http://adf.farmonline.com.au/news/magazine/industry-news/general/saputo-says-coops-need-to-do-better/2755551.aspx>.

- Burra Foods is undertaking a \$24.5 million expansion at its processing facility at Korumburra, Victoria.⁴⁴ The expansion will enable Burra Foods to produce 400 g and 800 g tins of powdered milk for export markets in addition to the 25kg bulk powder it currently produces.
- Freedom Foods is investing \$50 million to expand the capacity of its UHT plant and nutritional plant in Shepparton, Victoria over the next 18 months.⁴⁵
- In January 2018, Fonterra announced that it has committed \$165 million to increase capacity and efficiencies across its seven sites. The investment will increase capacity by 500 million litres, with \$125 million earmarked for its Stanhope facility to increase cheese production from 45 000 metric tonnes to 80 000 metric tonnes.⁴⁶
- On a smaller scale, Maleny Dairies in Queensland is also pursuing expansion by increasing its processing capacity from 200 000 litres of milk per week to 300 000 litres.

In general, significant expansion or entry into a region will put upward pressure on the farmgate price as processors compete to attract more milk to utilise their increased capacity.

On the other hand, the closure of three processing plants owned by Murray Goulburn in Tasmania and northern Victoria may have some impact on competition at the farmgate.⁴⁷ In the face of competitive pressure in the raw milk acquisition market, and financial losses associated with the 2016 step-down, Murray Goulburn was unable to compete on price in these regions and subsequently lost a substantial volume of milk supply. Murray Goulburn decided to close these plants and consolidate its processing facilities.

Media reports indicate that Murray Goulburn has closed its Rochester plant⁴⁸ and sold its Edith Creek plant.⁴⁹ The sale of a plant to another processor may enhance competition as the result of another processor entering the region by acquiring any of the plants. Alternatively, the closure of a plant reduces options for farmers and therefore farmgate competition.

While the ACCC has considered possible coordination among processors in respect of opening farmgate prices (as discussed in chapter 3), the expansion activity observed in the market for dairy processing indicates a degree of independent rivalry between firms competing to acquire raw milk.

5.2.6 Competitive pressure between firms drives product innovation

The pricing strategy of each firm is not necessarily its primary competitive strategy, and generally firms in competitive markets distinguish their products from competing products using non-price factors. Product innovation for processed dairy products is an important form of non-price competition—firms face intense rivalry in the development of new products and the improvement of existing ones. This is ultimately of benefit to consumers who get greater product choice and quality.

Consumer-focused innovation is an important part of the business models of dairy processors, primarily in branded value-added categories and niche fresh white drinking milk offerings. These firms view innovation capabilities as critical to their profitability, as the creation of differentiated value-added products can drive sales at higher prices. Innovation can also be a platform to enter, or create, new product categories.

44 Kath Sullivan and Simone Smith, *Burra Foods \$24.5 expansion expected to create 40 jobs*, *The Weekly Times*, 5 December 2017, accessed 5 March 2018, <https://www.weeklytimesnow.com.au/agribusiness/dairy/burra-foods-245m-expansion-expected-to-create-40-jobs/news-story/ff841c6d341070147fd2aabc5d78922c?nk=30ec34f507d0287aa6ef5d6906cfb60d-1520217421>.

45 Geoff Adams, *Freedom Foods seeks more suppliers*, *Dairy News Australia*, 16 November 2017, accessed 5 March 2018, <https://www.dairynewsaustralia.com.au/2017/November/16/61363/freedom-foods-seeks-more-suppliers>.

46 Fonterra, *Strong show of confidence in \$165 million Australian expansion*, 24 January 2018, accessed 6 March 2018, <https://www.fonterra.com/au/en/news-and-media/announcements/strong-show-of-confidence-in-165-million-australian-expansion.html>.

47 Brett Worthington, *Murray Goulburn to close factories and shed staff in Tasmania and Victoria*, *ABC Rural*, 2 May 2017, accessed 24 October 17, <http://www.abc.net.au/news/rural/2017-05-02/murray-goulburn-closes-factories-kiewa-rochester-edith-creek/8488628>.

48 Clint Jasper, *Closure of Murray Goulburn's Rochester dairy factory an 'eerie feeling' for locals*, *ABC News*, 31 January 2018, accessed 2/03 2018, <http://www.abc.net.au/news/2018-01-31/murray-goulburn-rochester-closes-its-doors/9377574>.

49 Peter Hemphill, *Murray Goulburn sells Edith Creek dairy factory to Thai firm Dutch Mill*, *The Weekly Times*, 29 November 2017, accessed 2 March 2018, <https://www.weeklytimesnow.com.au/agribusiness/dairy/murray-goulburn-sells-edith-creek-dairy-factory-to-thai-firm-dutch-mill/news-story/1dfeafbaacdb5ab54994cc896eda286f?nk=30ec34f507d0287aa6ef5d6906cfb60d-1519943723>.

Several varieties of value-added dairy products have emerged on the market in recent years to address a diverse range of consumer trends and concerns. For example:

- Milk products now offer added health benefits to consumers such as high calcium, low saturated fat, and added omega-3 or proteins.⁵⁰
- Growth in yoghurt sales has been underpinned by regular product innovation in the areas of packaging, flavour combinations and the use of probiotic cultures, as well as new products such as drinking yoghurts.⁵¹
- Sales of flavoured milk are increasing year-on-year and it is a highly profitable product for processors. As a result, there has been innovation in flavours, formats and formulations in line with consumers' desire for convenient and healthy flavoured milk products.
- Organic milk products feature prominently on supermarket shelves and as organic milk processors grow their sales, organic products will likely have a growing presence in other dairy product categories.

Product innovation is a common entry strategy for small firms. Small-scale entry is often targeted at providing consumers with new innovative products in niche markets. Firms are more likely to enter a market with specialty dairy products as there is less imperative for scale economies, and a new innovative product that is differentiated from the rest of the market can command higher prices. The business model of these small entrants is often focused on producing natural, less processed dairy products than have historically been available, such as non-homogenised full cream milk, additive-free dairy products and cultured dairy products.

Risk of private label products to innovation

A potential barrier to innovation for processed dairy products is the risk of private label products free-riding on the innovation of branded products and ultimately cannibalising sales. History suggests that innovation follows a cycle where branded players launch new value-added products in the flavoured and speciality milk categories, and private label products then replicate the innovation on lower value products such as white milk and cream.

Private label products, which are often packaged similarly and positioned prominently on supermarket shelves, may pose a threat to manufacturers of branded products. The ability to leverage branded product innovation in order to drive growth in private label sales allows retailers to take sales away from and possibly even de-list some branded products.

Free-riding on innovation and marketing investment in brands can act as a disincentive to processors for further product development, and may ultimately reduce the quality and variety of products available in the market. Alternatively, processors may try to develop new or improved products at a faster rate to maintain their position in the market, leading to socially excessive product development and a waste of resources.

5.2.7 Competition from imports

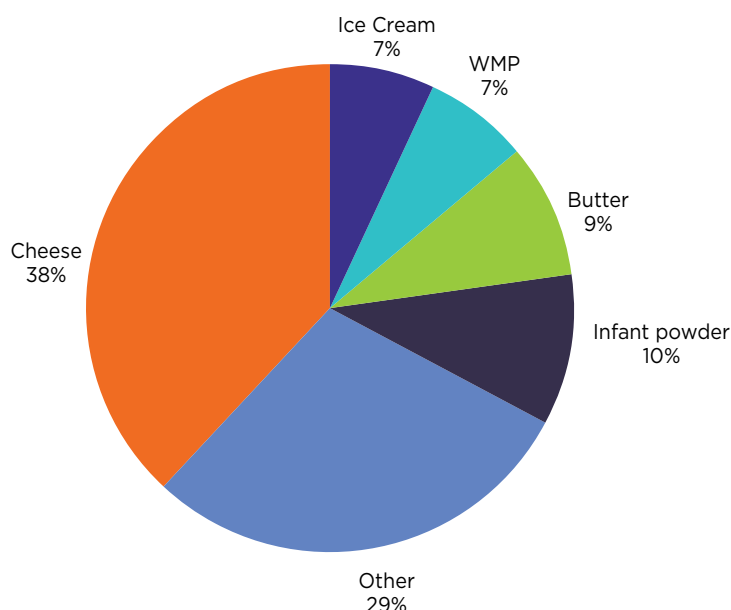
Australia imports a broad range of processed dairy products. They are typically easy to transport and have long shelf lives. This increases the range of options for consumers for a number of dairy product categories.

The most significant imports by volume in recent years have been of cheese, butter, whole milk powder, infant powder and ice cream (figure 5.1). Cream, long life milk and yoghurt are imported in much smaller volumes along with various other dairy powders and ingredients.

50 Non-homogenised milk is also increasingly available, in which the fat molecules rise to the top of the bottle and form a layer of cream. This is marketed as a more natural form of milk.

51 Dairy Australia, *Australian Dairy Industry in Focus 2016*, p. 27.

Figure 5.1: Imports of dairy products in 2016-17



Source: Dairy Australia, *Australian Dairy Industry in Focus 2017*

In recent years, imports have increased substantially, particularly from the US, EU and NZ, due to factors such as changing trade policies, international investment in the Australian dairy processing sector, and increased demand for European cheese.

Imports constrain the domestic price of some dairy products

Actual or potential competition from imported goods constrains the prices that can be achieved by domestic dairy processors to some extent, as retailers can credibly threaten to substitute local with imported products if domestic prices are not competitive. The degree to which retailers can make this threat depends on the extent to which consumers consider imports to be a substitute for Australian products, and may be impacted by customer preferences for particular brands or local produce.

Substantial cheese imports

The price of domestically-produced cheese is likely to be constrained by imports. In 2016-17, imports totalled 112 120 tonnes, comprising cheddar, ingredient and specialty cheeses, representing 42 per cent of domestic cheese sales. This is equivalent to approximately 33 per cent of total domestic production (336 742 tonnes).⁵² Imports have grown substantially over the past 10 years, increasing by 75 per cent (figure 5.2).⁵³ The market share of imported cheese has risen by over 10 per cent since 2012-13.

As part of its growth strategy, ALDI introduced tasty block cheese at \$6 per kg in early 2014, which was quickly matched by Coles and Woolworths. The price decrease was enabled by low global prices. Since the introduction of \$6 per kg cheddar cheese, cheddar imports have increased significantly. This has enabled retailers to maintain the retail price of \$6 per kg, constraining the price domestic processors receive.

Butter represents a relatively large portion of Australian dairy imports

The quantity of butter imported into Australia has increased significantly in recent years relative to the quantity produced domestically (figure 5.2).

In 2016-17, Australia imported just over 27 000 tonnes of butter, primarily from New Zealand, a large increase from 18 621 tonnes the previous year. This corresponded with a fall in domestic butter production.⁵⁴ Imports were equivalent to approximately 32 per cent of domestic butter production, which has increased year on year from about 15 per cent in 2012-13 (with a large jump from 2015-16

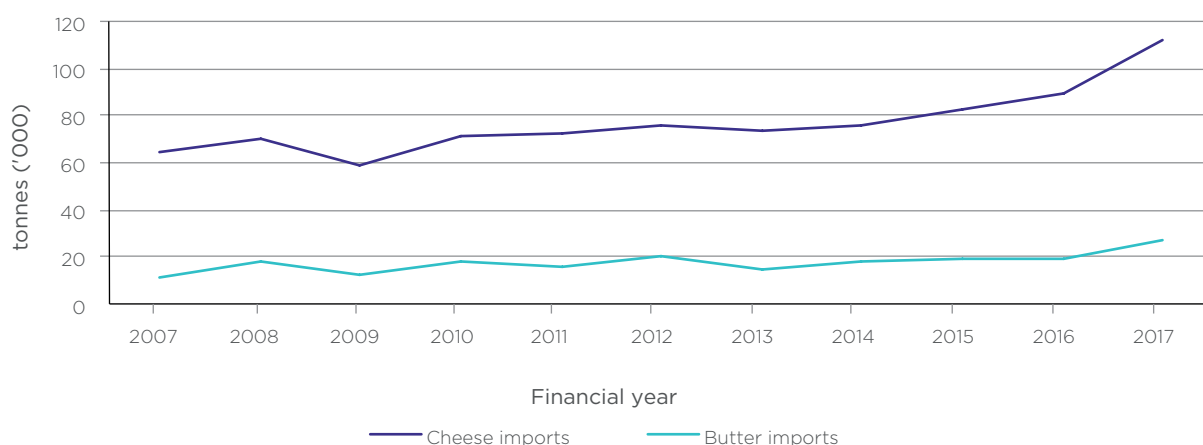
⁵² Dairy Australia, *Australian Dairy Industry in Focus 2017*.

⁵³ Dairy Australia; Note: total cheese imports grew from 64 270 tonnes in 2006-07 to 112 120 tonnes in 2016-17.

⁵⁴ Dairy Australia, *Australian Dairy Industry in Focus 2017*.

to 2016–17), and to 34 per cent of domestic butter sales. The relative quantity of butter imports to domestic sales was steady until 2016–17 when butter imports rose significantly relative to domestic sales.⁵⁵

Figure 5.2: Total cheese and butter imports, 2006–07 to 2016–17



Source: Dairy Australia data and ACCC analysis

Milk powder is both exported and imported

Australia imports a large significant amount of infant formula and some WMP, mostly to use in the manufacturing of products to be re-exported. As a result, exports of WMP and infant powder often exceed domestic production, as was the case in 2016–17. Australia's WMP production (including infant powder) has fallen over the last 10 years. Meanwhile, imports of infant powder have risen dramatically from less than 7000 tonnes in 2006–07. Infant powder was Australia's second largest import in 2016–17 by both volume and value, with close to 30 000 tonnes imported. Australia imported over 20 000 tonnes of whole milk powder.⁵⁶

The majority of Australia's skim milk powder production is sold into export markets.

Long life milk imports could be a substitute for fresh drinking milk

As fresh dairy products (in particular fresh drinking milk) cannot be economically imported, local market conditions have a much stronger influence on retail prices, with imported products providing negligible constraint. It is possible, however, that some consumers may regard long life milk as a substitute for fresh drinking milk, and therefore imports may provide some constraint on domestic fresh drinking milk prices. For example, over time, if the price gap between the two products widens, the number of consumers prepared to switch to long life milk may increase.

The volume of drinking (primarily long life) milk imported into Australia has increased since 2012–13 from about 1.33 million litres to 2.94 million litres in 2016–17.⁵⁷ The volume of imported long life milk is very small relative to the volume sold domestically, although it has grown in recent years (from approximately half a per cent to over 1 per cent). Long life milk from New Zealand has historically made up the largest portion of imported drinking milk, with the volume and price per tonne fluctuating. Overall, the price per tonne of milk imports from New Zealand has risen.⁵⁸

Supermarket sales of long life milk have increased in recent years. The retail price per litre has fallen slightly over this period. In 2014–15, the price gap between branded regular whole milk and long life milk increased to 36 cents, from 24 cents the previous year⁵⁹, which may account for increased sales resulting from substitution by price-sensitive consumers.

⁵⁵ Dairy Australia, *Australian Dairy Industry in Focus 2017*.

⁵⁶ Dairy Australia data and ACCC analysis.

⁵⁷ *ibid.*

⁵⁸ Dairy Australia data and ACCC analysis.

⁵⁹ Dairy Australia, *Australian Dairy Industry in Focus 2016*, p. 43.

5.3 Retail competition for the supply of dairy products

Australian consumers spend an estimated \$90 billion each year in supermarkets.⁶⁰

This section outlines how aspects of supermarket competition affect the way retailers compete to sell dairy products. The impact of retailers' bargaining power on risk allocation in the dairy industry is discussed in chapter 2, and the effect of retail pricing on margins across the industry is examined in chapter 6.

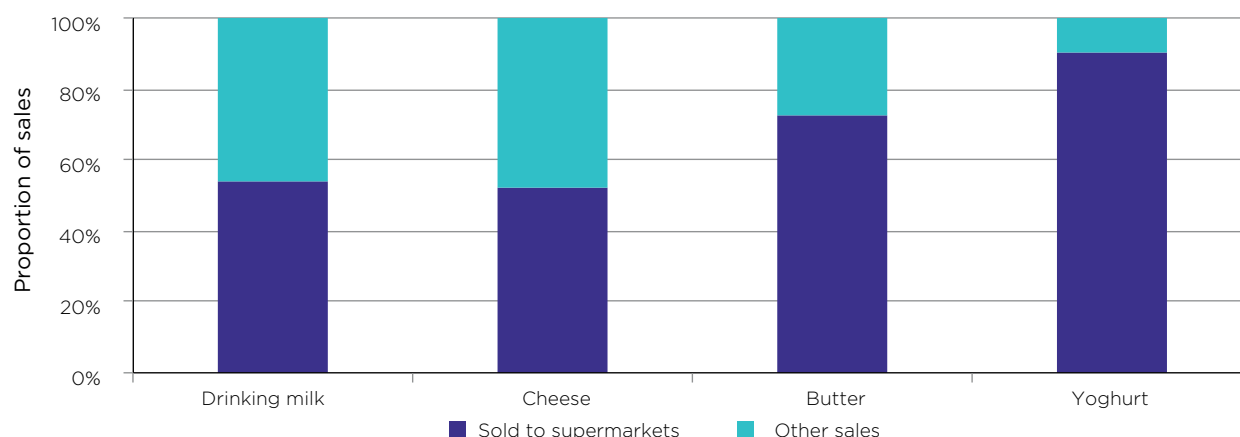
5.3.1 Types of supermarkets

There are a range of supermarket chains in Australia; these include small independent local supermarkets, ALDI, warehouse stores like Costco, and full-line supermarkets including Coles, Woolworths and Supa IGA.

In Australia in 2015–16:

- approximately 54 per cent of total domestic drinking milk sales were through major supermarket chains.⁶¹
- dairy manufacturers sold approximately 245 000 tonnes of cheese to domestic customers, of which about 53 per cent was sold to major supermarket chains.⁶²
- dairy manufacturers sold a total of 55 575 tonnes of butter to major supermarket chains, equating to approximately 73 per cent of the total amount of butter sold domestically.⁶³
- dairy manufacturers sold a total of 130 555 tonnes of yoghurt to domestic customers, of which 91 per cent was sold through major supermarket chains.⁶⁴

Figure 5.3: Proportion of dairy products sold to major supermarket chains, 2015–16



Notes: This is dairy company sales to distributors/warehouses/retailers; other sales refer to other retailers including convenience stores, the foodservice and industrial channels

Source: Dairy Australia, *Australian Dairy Industry in Focus 2016*

Full line supermarkets

Coles and Woolworths are the predominant full-line supermarket retailers in Australia. They account for approximately 36 per cent and 33 per cent of total sales respectively.⁶⁵ Other full-line supermarkets include retailers operating under the Supa IGA brand.

60 Roy Morgan Research, *Supermarket weep: Woolies' share continues to fall and Coles and Aldi split the proceeds*, 24 October 2016, accessed 23 October 2017, <http://www.roymorgan.com/findings/7234-woolworths-coles-aldi-iga-supermarket-market-shares-australia-march-2017-201705171406>.

61 Dairy Australia, *Australian Dairy Industry in Focus 2016*, 23.

62 Dairy Australia, *Australian Dairy Industry in Focus 2016*, 42.

63 Ibid.

64 Ibid.

65 Roy Morgan Research, *Aldi hits new high in supermarket wars*, 17 May 2017, accessed 23 October 2017, <http://www.roymorgan.com/findings/7234-woolworths-coles-aldi-iga-supermarket-market-shares-australia-march-2017-201705171406>.

Independent local supermarkets

The most prominent example of an independent local supermarket is a local IGA. These stores have most of their packaged groceries supplied by the grocery wholesaler Metcash. Collectively, IGA supermarket sales currently represent approximately 9.3 per cent of total retail sales.⁶⁶

ALDI

ALDI is a privately owned global supermarket operator that entered Australia in 2001. Since entering, it has expanded its operation to 470 stores across NSW, ACT, Queensland, Victoria, WA and SA.⁶⁷ ALDI has a different retailing model to full-line supermarkets such as Coles and Woolworths, with an emphasis on private label products and a limited depth of range (or a limited choice of varieties of each product).

ALDI's price discounts on dairy products have correlated closely with similar price discounts by the full-line supermarkets.⁶⁸ The ACCC considers this is indicative of ALDI's increasing significance as a competitor in the retailing of dairy products.

ALDI's popularity with consumers has grown over time and its share of total retail revenue has increased from only 6 per cent⁶⁹ of total grocery sales in 2006–07 to approximately 13.2 per cent today.⁷⁰

Warehouse stores

Costco Wholesale (Costco) is an example of a membership only warehouse supermarket and operates seven warehouse supermarkets in Australia. Costco offers a broad range of bulk grocery, fresh and liquor products, both branded and private label.

5.3.2 Competitive Dynamics

The ACCC has examined the dynamics of competition between supermarkets on many occasions in the past, most notably in the Grocery inquiry in 2008⁷¹, but also in previous investigations and merger reviews.

The ACCC considers that supermarkets compete primarily with other supermarkets which offer a broadly similar retail experience. The ACCC does not consider that specialist stores such as butchers and fruit markets provide a strong competitive constraint on supermarkets, due to their different retail offering.⁷² The ACCC has also found that supermarket competition occurs at both a national and local level.

Retail competition

Information obtained during the inquiry has indicated that supermarkets compete against each other's nationwide offers, but also respond to offers made locally.

Supermarkets often price dairy products nationally and in response to this, competitors may seek to match prices nationally. This pricing strategy helps to reduce operating costs for the supermarkets, in addition to reinforcing a consistent value proposition to consumers.

There has been strong price competition between the major supermarkets and ALDI for the retail supply of dairy products, in particular fresh white drinking milk and block cheese. This has seen retail prices for dairy products decrease over time to the benefit of consumers.

However, private label retail pricing has been a matter of strong public interest. The idea that supermarkets use private label dairy products as loss-leaders is a source of frustration for many in the industry, who are concerned about the impact of intense retail competition on farmer confidence in farming investments and sustainability. This issue is discussed in detail in chapter 6.

66 *ibid.*

67 ALDI, *Who We Are*, accessed 12 October 2017, <https://corporate.aldi.com.au/en/about-aldi/>.

68 *ibid.*

69 ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p. 48.

70 Roy Morgan Research, *Aldi hits new high in supermarket wars*, 17 May 2017, accessed 23 October 2017, <http://www.roymorgan.com/findings/7234-woolworths-coles-aldi-iga-supermarket-market-shares-australia-march-2017-201705171406>.

71 ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008.

72 This does not mean that specialist retailers do not have any impact on retail competition for the sale of groceries, but it reflects the fact that they impose a weaker, more distant and less consistent competitive constraint on supermarkets.

While supermarket competition at the retail level has benefitted consumers by providing lower prices for dairy products, the degree of concentration at the retail level results in an inferior bargaining position for suppliers of wholesale dairy products.

Supermarkets have been able to leverage bargaining power from their scale and the concentrated market structure to negotiate decreased wholesale prices with processors. This is also discussed in detail in chapter 6.

Despite national constraints, retailers also compete on a local level

Supermarkets also compete at the local level, and localised ranging decisions are an example of this competition. The ACCC has seen evidence, particularly at a state level, that the popularity of certain dairy product brands (such as flavoured milks) varies between states due to different consumer preferences. These preferences influence the products offered by the major supermarket chains in various locations.

The ACCC has also found that retailers sometimes source higher cost local dairy products in preference to lower cost products from other states. In particular, the ACCC notes that retailers in Queensland have entered into agreements for the supply of fresh white drinking milk at a significantly higher cost than it can be acquired from alternative locations.

In these instances, retailers' decisions have been driven primarily by their perception of consumer preference for locally sourced dairy products.

6. Supply chain profit analysis—supermarkets, processors and farmers

The ACCC used its compulsory information gathering powers to obtain data and documents from supermarkets and processors from FY2010 to FY2016 as well as summoning witnesses to give evidence under oath in private hearings. The ACCC used this information and other data available from public sources to create a dairy supply chain database to analyse the levels and trends of prices and profit margins over time throughout the supply chain.

Key points

- The relative bargaining position of supermarkets, processors and farmers is an important determinant of profits that each earns in the dairy supply chain.

Supermarkets

- Supermarkets have leveraged their buying power to drive wholesale prices down and reduce the profit margins of processors. This has particularly been the case with private label drinking milk and private label cheese.
- Supermarkets generally sell private label milk at a gross profit but at times sell it at a loss in Tasmania and Queensland, once distribution costs are taken into account. The ACCC does not consider this amounts to predatory pricing as there is no indication that it has done substantial damage to competitors of the major supermarkets.
- The variation in supermarket margins on private label milk across regions is primarily a result of differences in the cost of acquiring raw milk which can be more than 20 cents per litre at times.
- The \$1 per litre price represents a real 12 per cent decline in the retail price of private label milk since its inception in 2011. It is an arbitrary 'cap' imposed by retailers on private label milk which does not reflect the costs of production and supply.

Processors

- The profitability of branded products has declined in recent years as private label prices have put downward pressure on branded wholesale prices and processors have had to compete harder for reduced shelf space.
- Private label milk contracts allow processors to pass through changes in farmgate prices to supermarkets. Therefore, processor margins on private label milk are not affected by the farmgate price they pay.
- Most processors make very low margins on private label milk contracts but compete to win these contracts as they increase the scale and efficiency of the rest of their drinking milk production, making sales of other drinking milk products more profitable.
- Retail private label milk prices also limit the ability of processors in high cost regions to be profitable in other sales channels. While non-grocery customers may not have as much bargaining power over processors as supermarkets, processors need to offer wholesale prices which are low enough to be reasonably competitive with private label prices.
- In recent years there has been investment in processing facilities in the Southern region. This suggests a degree of industry confidence in the future of dairy processing in the south. In contrast, there is less investment in the Northern and WA regions where production is predominantly for drinking milk. Some processors are uncertain about the long term viability of sourcing milk from high cost regions.

- Stable per capita consumption of domestically consumed dairy products means processor demand for raw milk in the Northern and WA regions is also relatively static. As a result, even if processors experience an increase in wholesale prices and margins, they are faced with relatively fixed demand and thus have little incentive to invest in expanding capacity. As such, increases or decreases in domestic retail and wholesale prices for dairy products do not affect processors' incentives to secure more milk or defend their share of the milk pool and therefore do not influence farmgate prices in the Northern and WA regions.
- In the Southern region, processor demand for raw milk fluctuates with changes in global prices as processors can compete to supply into the export market where total demand and supply fluctuates significantly from year to year. This provides an incentive to increase farmgate prices when global prices rise in order to secure more milk or defend their raw milk supply, and encourages increased milk production. Lower farming costs and the ability to compete in export markets also provides greater incentives for processors in the Southern region to invest in expansion relative to the Northern and WA regions.

Farmers

- Farmers earn the same prices and profits regardless of whether their milk ends up as private label milk, branded milk or any other dairy product.
- The processors set a farmgate price only as high as they need to in order to acquire the volume of raw milk production that meets their demand in that region. The minimum price that processors need to pay will generally be higher where there is stronger competition for the milk pool. The intensity of competition for raw milk is influenced by factors such as the number of competing processors, the barriers to farmers switching processors and whether global prices are rising or falling (for prices in the Southern region).
- The farmgate price paid by a processor is not negotiated with the supermarket. The ACCC found no evidence of supermarkets seeking to influence farmgate prices. No processors submitted that wholesale prices for private label milk directly influenced farmgate prices.
- Increases and decreases in processors' and retailers' margins on private label drinking milk have not had any observable impact on farmgate prices, or trends in farm profitability and farm exits.

6.1 Introduction

The ACCC heard significant concerns from farmers and their representatives about the impact of the supermarkets' \$1 per litre milk pricing strategy on the dairy industry.¹

In broad terms, the concerns raised were to the effect that the introduction and retention of \$1 per litre milk has reduced the overall value of the dairy industry, both in monetary terms and public perception², which over time has impacted farmgate milk prices and the viability of the sector.

Some farmers were also concerned that supermarkets sell private label drinking milk below cost as a loss leader.

The ACCC also heard concerns about the impact of private label cheddar cheese which has recently been sold in the three major supermarkets for as low as \$6 per kilogram. The ACCC understands that it requires roughly 10 litres of raw milk to produce one kilogram of cheddar cheese. Accordingly, cheddar cheese sold at this retail price point is comparable to selling drinking milk at 60 cents per litre.

The terms of reference relevant to this analysis require the ACCC to consider:

- the nature of retail pricing arrangements for milk and dairy products, and their impact up the supply chain
- the effect (direct or indirect) of domestic retail and export prices, and level of domestic and overseas demand, for Australian processed milk and dairy products on dairy producers and processors
- any other factors affecting farm profitability.

¹ Coles introduced dollar litre milk pricing on Australia Day 2011, and Woolworths and ALDI followed soon afterwards.

² For example, the perception that milk is less expensive than bottled water.

6.2 The ACCC's approach

This chapter analyses the following issues:

Supermarkets

- the impact of supermarket pricing strategies and retail grocery competition on consumption and on other retailers and wholesale customers (section 6.4)
- supermarket margins across the dairy category over time (section 6.4.7)
- the potential for supermarket pricing to directly or indirectly affect farmgate milk prices, including an analysis of \$1 per litre milk and \$6 per kilogram cheese (section 6.5)
- how supermarket bargaining power and export prices influence processor margins, including how this varies between regions and between private label and branded products (section 6.6).

Processors

- trends in processor prices and margins over time (section 6.6.2 and 6.6.3)
- the relative importance of product categories and sales channels for processor revenues and profitability (section 6.6)
- the sustainability of processors in higher cost regions (section 6.8).

Farmers

- analysis of the broader trends of farmer profitability over time and the impact of deregulation on the industry and the bargaining position of farmers (section 6.7.1)
- the differences in profitability for farms in the Northern and WA regions and those in the Southern region (section 6.7.2)
- the margins earned by farmers, processors and supermarkets are reflective of their relative bargaining positions in the industry. We finally discuss possible future milk production outcomes (section 6.8).

To properly consider the impact of \$1 per litre milk, and the dairy value chain more broadly, the ACCC analysed a large amount of data, reviewed documents and heard oral evidence from executives of the major supermarkets³ and processors. The ACCC also sought non-confidential information from Dairy Australia and ABARES.

Due to the historical nature of some of the data we requested and different companies' record keeping practices, some parties were unable to provide the ACCC with complete data sets. Where raw data was not available, the ACCC required industry participants to provide alternative information so we could approximate the missing data, such as internal sales reports and board papers. The ACCC is satisfied that it has obtained enough information and data to substantially complete our analysis and fulfil the terms of reference.

Much of the information provided in submissions, at hearings and in response to compulsory notices is commercially sensitive. While the ACCC has relied on this material for the purpose of preparing this report, the information has been aggregated for reasons of confidentiality.

³ References to supermarkets in this chapter collectively means the retailers ALDI, Woolworths and Coles. Independent supermarkets and warehouse retailers like COSTCO are also significant competitors in retail grocery markets. However, the ACCC obtained data from ALDI, Woolworths and Coles to conduct this analysis given the size of these supermarket chains and their presence throughout Australia.

6.3 Industry feedback on the interim report

Industry feedback on the ACCC's supply chain profit analysis is summarised below.

Some stakeholders agreed with points made in the interim report, such as:

- margins are not shared equitably across the supply chain due to retailer bargaining power⁴
- \$1 per litre milk has constrained the price processors receive for branded milk which constrains processor profitability⁵
- some stakeholders, including processors and farmer representative groups, agreed that an increase in the retail pricing of \$1 per litre milk would not result in higher farmgate prices paid to farmers as a result of the bargaining power imbalance in the supply chain.⁶

Some stakeholders, particularly farmer representative groups, strongly disagreed with the finding that retail pricing of private label milk at \$1 per litre is unlikely to have a direct impact on farmgate prices. These stakeholders submitted that:

- \$1 per litre milk (and low retail and wholesale prices generally) is deterring investment in the supply chain by processors which in turn reduces demand for raw milk, resulting in lower farmgate prices⁷
- \$1 per litre milk threatens the long-term sustainability of the dairy industry, particularly in the higher cost Northern and WA regions. Some stakeholders argued that supermarkets' retail pricing is forcing dairy farmers out of business⁸
- if supermarkets passed on more revenue to processors, farmers would see higher farmgate milk prices⁹
- supermarkets should not be able to sell dairy products at a loss in some stores and regions and recover the loss in other regions where margins are higher¹⁰
- national pricing by supermarkets prevents smaller players from competing in some regions¹¹
- consumers are not better off as a result of discounted private label dairy products as supermarkets recover the lost margin on other products.¹²

Further, one stakeholder submitted that the introduction of \$1 per litre milk had a direct, observable impact on farm exits and production in Queensland.¹³ Another stakeholder asserted that WA has been more affected by \$1 per litre milk than any other state.¹⁴ Some stakeholders put forward support for

4 Australian Dairy Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 6; Port Curtis Milk Suppliers' Cooperative, *ACCC Dairy inquiry interim report feedback*, 31 January 2018, p. 3.

5 Farmer Power, *Comments on the ACCC interim report on the Australian dairy industry*, 18 January 2018, p. 42; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 4.

6 Farmer Power, *Comments on the ACCC interim report on the Australian dairy industry*, 18 January 2018, p. 4; Port Curtis Milk Suppliers' Cooperative, *ACCC Dairy inquiry interim report feedback*, 31 January 2018, p. 3; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 3; Tasmanian Farmers and Graziers Association, *Submission to the ACCC Dairy inquiry interim report*, 7 February 2018, p. 1; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 7.

7 Australian Dairy Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2; WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 3.

8 Dairy Farmers Milk Cooperative, *Response to the interim report into the Australian dairy industry*, 29 January 2018, p. 2; Farmer Power, *Comments on the ACCC interim report on the Australian dairy industry*, 18 January 2018, p. 5; Niche Agribusiness, *Notes and comments on the ACCC's interim report on the dairy industry*, 25 January 2018, p. 9; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 7; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 8; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 7; WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 3.

9 Duncan McInnes, *Submission on the ACCC Dairy inquiry interim report*, 30 January 2018, p. 1; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 15; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 4.

10 Farmer Power, *Comments on the ACCC interim report on the Australian dairy industry*, 18 January 2018, p. 11; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 16; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 3.

11 Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 3.

12 NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 16; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 7.

13 Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 6.

14 WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, p. 3.

regulatory measures such as removing or limiting the amount of \$1 per litre milk that can be sold; or other measures to direct consumers away from \$1 per litre milk such as labelling.¹⁵

While a number of stakeholders agreed with the ACCC's interim finding that an increase in the retail price of drinking milk was unlikely to benefit farmers, some suggested that if the price increase took the form of a levy, the proceeds of which were passed on to farmers, this would be beneficial to the industry.¹⁶

6.4 Supermarket pricing strategies and their impact on consumption

6.4.1 The major supermarkets are the largest sellers of dairy products in Australia

The Australian dairy industry produces products for both export and domestic consumption. On average, approximately 60 per cent of dairy products produced in Australia each year are consumed domestically.¹⁷ Supermarkets represent the largest retail channel for domestic dairy sales (38 per cent) followed by route/convenience stores (33 per cent) and food services/hospitality (27 per cent).¹⁸ The percentage reliance on the domestic market has increased from 2003–04 when approximately only 45 per cent of volume was consumed domestically.¹⁹

The proportion of regional raw milk production which is sold domestically either as drinking milk or other dairy products varies by region. For example, figure 1.6 in chapter 1 shows that raw milk in the Northern and WA regions is predominantly used for domestic drinking milk, whereas raw milk in the Southern region is mostly turned into products for export.

This means that domestic demand for milk and dairy products, which is serviced predominantly by the major supermarkets, is more important to processors and farmers in the Northern and WA regions than it is in other states. It also means that retail and wholesale prices for drinking milk have a limited potential to financially impact farmers in the Southern region.

6.4.2 Supermarkets' pricing strategies

Supermarkets price most dairy products, including private label products, on a national basis.²⁰ National pricing was introduced following deregulation of the dairy industry in 2000. Retail prices across many dairy products are the same in each store and location regardless of differences in the cost of supply. Supermarkets use national pricing to reinforce their branding and perceptions of affordability and competitiveness.

Consumers also benefit from national pricing as they know they will pay the same price regardless of the store they shop at. Some consumers also benefit from being able to purchase products at a cheaper price than if products were retailed on a full cost basis. This is especially the case in remote or regional areas which sometimes have high production and/or transport costs.

Supermarkets with national pricing make lower, and in some cases negative, margins on certain products in some higher cost regions. Conversely, higher margins are achieved in low cost areas from more profitable products. Varying margins across products within diverse businesses such as supermarkets are common.

15 Farmer Power, *Comments on the ACCC interim report on the Australian dairy industry*, 18 January 2018; Styx River Farm, *Submission to interim report of the ACCC Dairy inquiry*, 31 January 2018, p. 2; Port Curtis Milk Suppliers' Cooperative, *ACCC Dairy inquiry interim report feedback*, 31 January 2018, p. 5.

16 Farmer Power, *Comments on the ACCC interim report on the Australian dairy industry*, 18 January 2018.

17 Dairy Australia, *Australian Dairy Industry in Focus 2017*.

18 IBISWorld, Australia Industry Reports, Dairy Produce Wholesaling, Products and Markets. The route/convenience stores channel include convenience stores, petrol stations, milk bars and small grocery stores, and food services/hospitality includes major fast food franchises as well as small restaurants and cafés.

19 National Competition Council 2004, *NCC Occasional Series: Dairy—Now and Then: The Australian Dairy Industry Since Deregulation*, AusInfo, Canberra.

20 The major exception to this are regional brands which are only sold in particular areas of Australia.

The impact of national pricing is particularly relevant to the dairy industry because milk production costs vary across regions. These cost differences lead to differences in farmgate prices in order to continue to encourage milk production in each region (farmgate prices and their determination is discussed in detail in chapter 3). Different farmgate prices, when combined with nationally consistent retail prices, leads to differences in processor and retailer margins across regions. Processors and retailers achieve lower margins in areas with higher farmgate prices compared to regions with lower farmgate prices.

A number of farmer representative groups did not accept the ACCC's conclusion that consumers benefit from \$1 per litre milk and lower retail prices for dairy more generally, as, they submit, supermarkets make greater profits on other products that consumers may purchase when in the store. However, evidence obtained by the ACCC does not indicate that supermarkets have increased prices and margins on other dairy or grocery items to compensate for lower unit margins on dairy products such as private label milk. Rather, low prices on key value items (including \$1 per litre milk) are part of a wider strategy to increase customer visits to supermarkets and overall sales.

6.4.3 Retail grocery competition

As discussed in chapter 5, there is a range of supermarket chains in Australia. These include independent local supermarkets, ALDI, warehouse stores like Costco, and full-line supermarkets including Coles, Woolworths and Supa IGA.

Over the past decade, competition in the supermarket sector has increased with the entry and expansion of new retailers such as ALDI and Costco.

Supermarkets compete strongly on products of key importance to their customers. These items are priced as competitively as possible. In 2011, Woolworths stated publicly that in relation to drinking milk prices, "where the market price is on key value items is where the retail sales will be".²¹ The supermarkets' evidence to this inquiry shows that the key value items in the dairy sector include fresh drinking milk and cheddar cheese.

This evidence also confirms that each supermarket closely follows the pricing and promotional activities of its competitors on dairy products. In particular, supermarkets have been quick to follow each other's pricing strategies such as national pricing, the introduction of \$1 per litre milk and, more recently, the introduction of \$6 per kilogram private label cheese. The supermarkets are reluctant to increase prices on these key value items as any price increase risks a loss of sales.

Supermarkets' internal documents indicate that this competition was a key reason for introducing \$1 per litre milk in 2011. Coles identified milk as a key product for consumers and included it as part of its wider 'Down Down' campaign. This was designed to introduce longer term price reductions across its range, rather than large intermittent discounting, which it considered had eroded consumer trust in its brand over time. Woolworths, on the other hand, based its pricing decision heavily on the move by Coles and stated publicly in 2011 that it "would not have dropped the price of milk" but for the price drop by Coles.²² Despite this initial reluctance, Woolworths has maintained this price point for the following seven years.

21 Australia, Senate, Economics References Committee, *Reference: Impacts of supermarket price decisions on the dairy industry* (2011), Canberra, 29 March 2011 Mr Pat McEntee, General Manager, Fresh Foods, Woolworths, p. 11

22 *ibid*, p. 13

6.4.4 The impact of supermarket competition on retail prices for dairy products

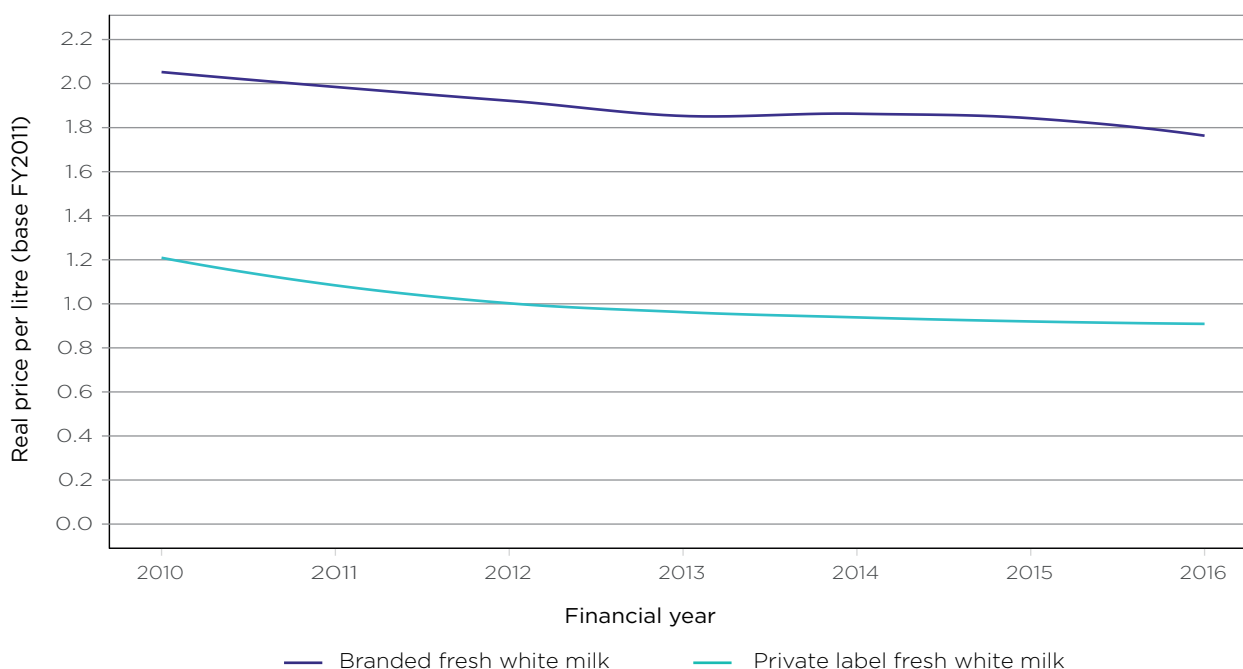
Deregulation led to substantial decreases in retail milk prices

Prior to the deregulation of the dairy industry, wholesale and retail prices as well as the distribution of milk were regulated. Deregulation gradually removed these controls through the 1990s and this had a strong impact on domestic retail prices. Importantly, deregulation of the dairy industry led initially to significant reductions in the wholesale price of drinking milk for supermarkets, which in turn led to large reductions in the retail price of drinking milk.²³ Immediately following deregulation, both branded drinking milk and private label drinking milk fell by approximately 11 and 15 per cent respectively.

The introduction of '\$1 per litre milk'

When \$1 per litre milk was introduced in January 2011,²⁴ private label milk prices fell by about 5 per cent. Since 2011, prices have been held at \$1 per litre, which has resulted in a decrease in real terms of 12 per cent (in addition to the initial 5 per cent reduction). This trend is shown in figure 6.1.

Figure 6.1: Retail prices of private label and branded label milk in real terms



Source: Coles, Woolworths and ALDI data

Since 2011, the real price of branded drinking milk has also decreased in line with private label drinking milk. This indicates that the price of most branded drinking milk is constrained by the price of private label drinking milk.

The introduction of '\$6 per kilogram cheese'

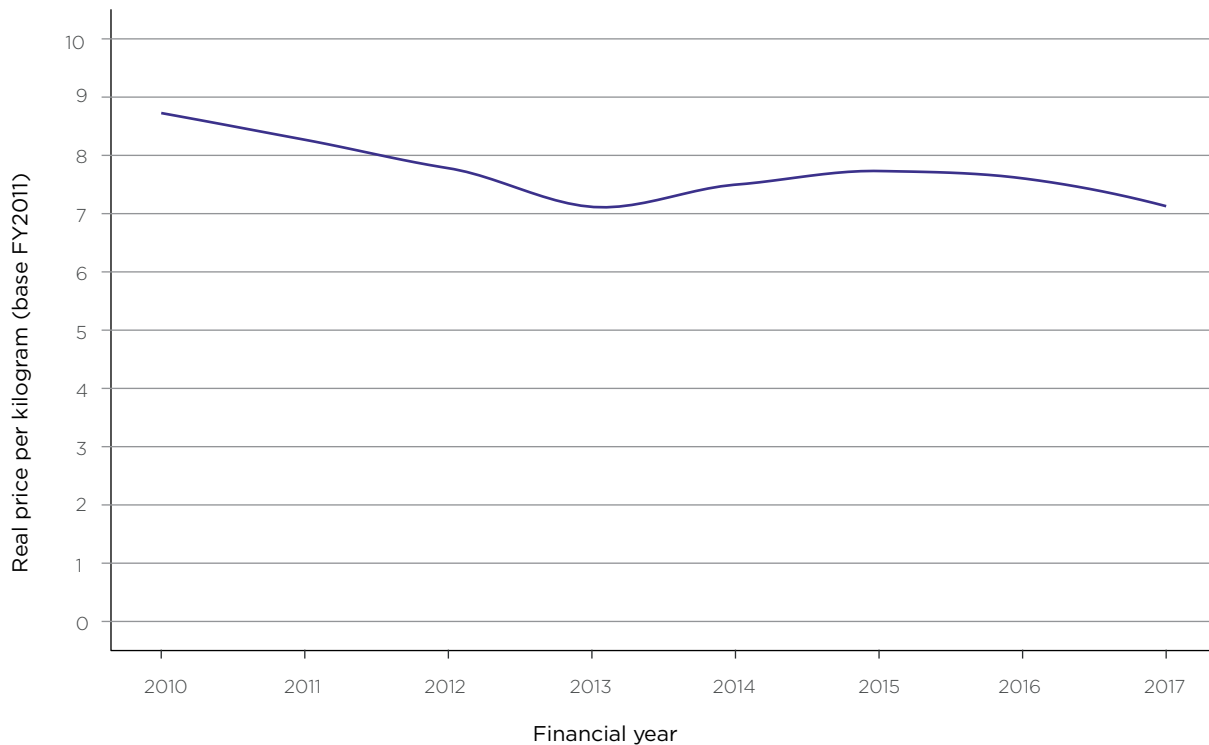
In 2014, intense retail competition for dairy products continued with ALDI's introduction of \$6 one kilogram blocks of cheddar cheese. As with reductions in private label drinking milk, the other major supermarkets quickly followed ALDI to the same price point. It is difficult to tell whether this has had an impact on cheddar cheese consumption in Australia.²⁵ However, overall consumption of cheese per capita has not changed, and has been relatively constant since at least 2010. More recently, Coles and Woolworths have increased the price of their cheapest one kilogram blocks of cheddar cheese to \$6.60.

23 National Competition Council 2004, *NCC Occasional Series: Dairy—Now and Then: The Australian Dairy Industry Since Deregulation*, AusInfo, Canberra.

24 For two litre and three litre bottles.

25 The ACCC does not have data specific to cheddar cheese necessary to analyse the impact of pricing on consumption of this product.

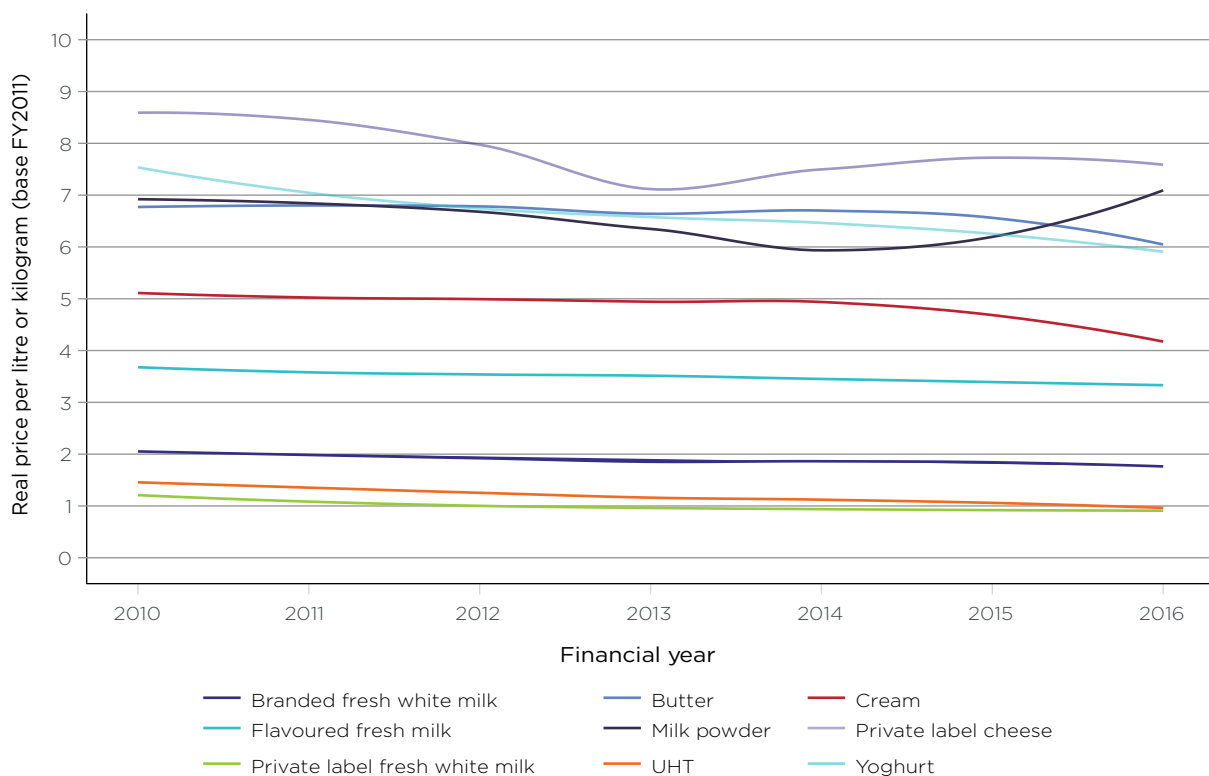
Figure 6.2: Retail price of private label cheddar cheese in real terms



Source: Coles, Woolworths and ALDI data

In addition to drinking milk and private label cheese, average retail prices for both branded and private label dairy products more generally have decreased in real terms since 2010, as shown in figure 6.3. Consumers have been the major beneficiaries of this pricing shift with reductions in margins typically being passed on as lower retail prices.

Figure 6.3: Average real prices for dairy products



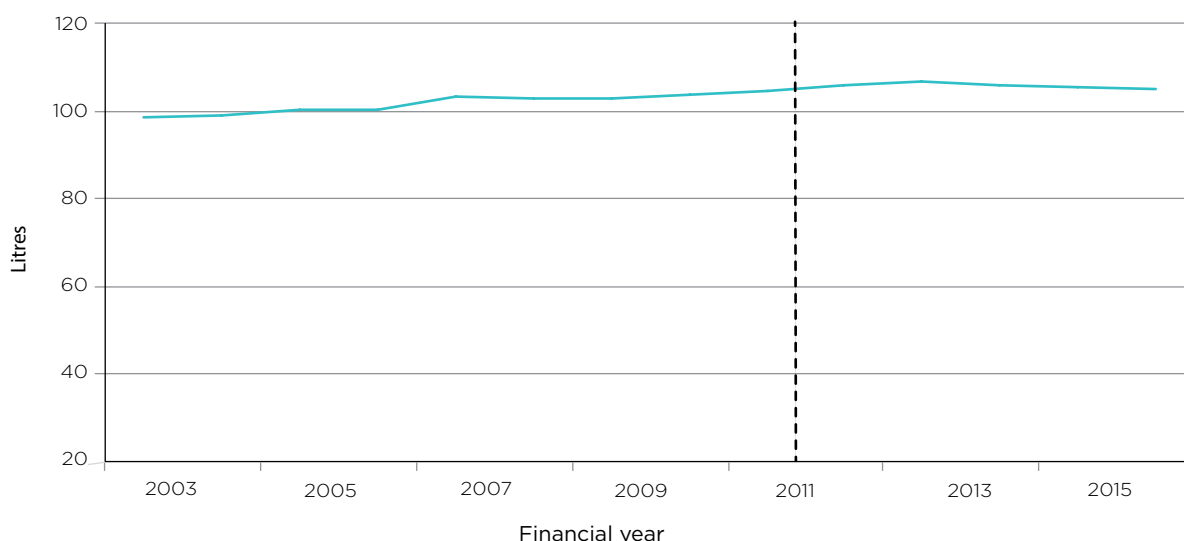
Source: Coles, Woolworths and ALDI data

6.4.5 Impact of retail pricing on milk consumption

When \$1 per litre milk was introduced Coles claimed that “low prices for consumers will make the dairy industry stronger”, implying that an increase in consumption would create additional demand for processors and dairy farmers.²⁶

However, total domestic consumption of drinking milk has increased in line with population growth, from just under 2 billion litres per year in 2003 to 2.5 billion litres in 2016, and per capita consumption has remained stable. This is illustrated in figure 6.4, and shows that the introduction of \$1 per litre private label milk has not had a meaningful impact on total consumption.

Figure 6.4: Consumption of drinking milk per capita



Source: Dairy Australia, *Australian Dairy Industry in Focus 2010, 2015, 2016, 2017*

Wider real reductions in retail prices also do not appear to have had an impact on consumption of other dairy products per capita, with cheese, yoghurt and butter consumption also remaining generally stable on a per capita basis.²⁷

Impact on consumption of branded products

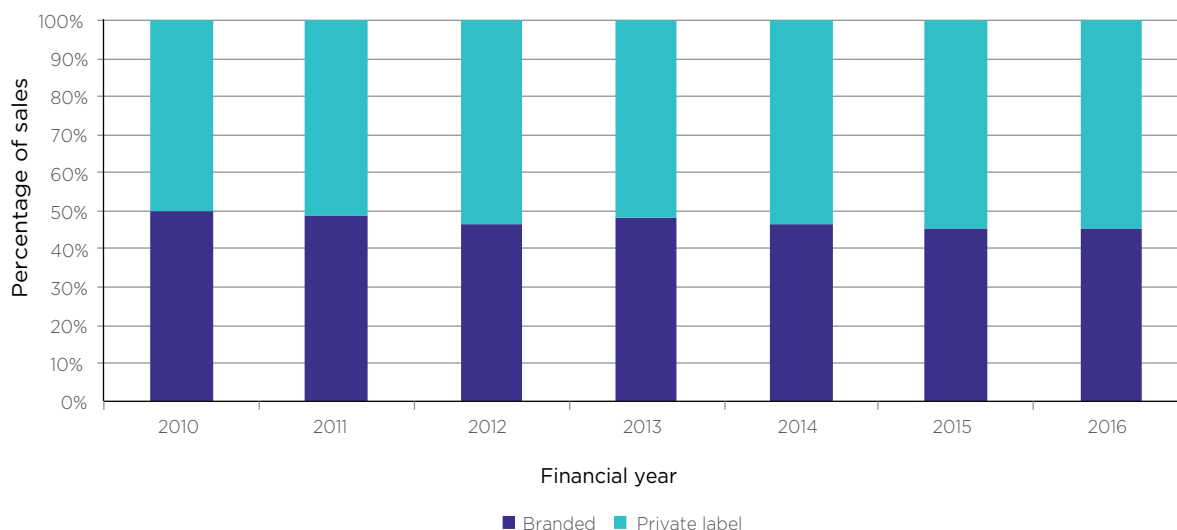
Some consumers have switched to purchasing private label milk at the expense of branded milk. This shift over time is shown in figure 6.5.

In 2009–10, supermarket sales of fresh drinking milk were split approximately half and half between private label and branded product. In 2010–11, private label accounted for 51 per cent and branded 49 per cent, and by 2015–16 private label accounted for 55 per cent and branded 45 per cent.

²⁶ Australia, Senate, Economics References Committee, *Reference: Impacts of supermarket price decisions on the dairy industry* (2011), Canberra, 29 March 2011 Mr John Durkan, Merchandise Director, Coles Supermarkets, p. 39

²⁷ Dairy Australia, *Australian Dairy Industry in Focus 2016, 2015, 2014, 2010*.

Figure 6.5: Supermarket Milk Sales by Milk Product Category, 2010–11 to 2016–17



Source: Dairy Australia, *Australian Dairy Industry in Focus* (Dairy Australia analysis and data from Information Resources (Australia) Pty Ltd)

Branded milk sales temporarily increased following the events of April 2016 when Murray Goulburn and Fonterra announced large step-downs in their milk prices. These events are discussed in more detail in chapter 3.

This change in consumption is attributed to media coverage and social media campaigns at the time which encouraged consumers to purchase branded milk to support Australian dairy farmers. Processors submitted to the ACCC that since the public attention has subsided, consumption of private label milk has returned to pre-2016 levels.

The ACCC also heard that branded milk sales have been partially underpinned by the growth in innovative milk products, such as A2 milk and lactose free milk, which are differentiated from fresh drinking milk. This would mean that the decline in branded plain milk sales in supermarkets may be greater than Figure 6.5 suggests.²⁸ Product innovation in dairy is discussed more in chapter 5.

6.4.6 Impact of supermarket pricing on other retailers and wholesale customers

Retailers in the route and convenience sector submitted that they have lost sales since \$1 per litre milk pricing was introduced, as consumers have increased their purchases of milk from supermarkets.²⁹

There was a small increase in the volume and overall proportion of milk sold at supermarkets compared to other channels following the introduction of \$1 per litre milk, as shown in Figure 6.6. However, this trend started prior to the introduction of \$1 per litre milk and does not appear to have accelerated since 2011. It is therefore not apparent that lower supermarket milk prices have led to higher sales of milk in supermarkets.

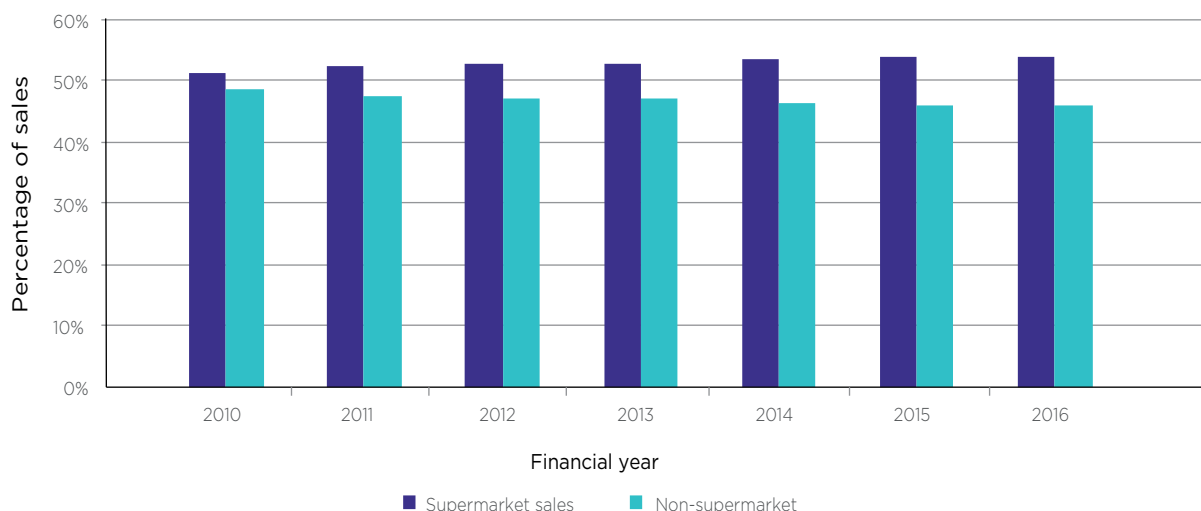
In response to \$1 per litre milk, some processors supply milk at wholesale prices that allow convenience store retailers to offer “price fighter” brands which can be also be sold at \$1 per litre.

Processors who sell to non-grocery retailers such as convenience stores must offer a wholesale price that makes it profitable for these stores to keep selling fresh milk.

²⁸ DFMC, *Submission to ACCC’s Dairy inquiry interim report*, 29 January 2018, p. 5.

²⁹ Australasian Association of Convenience Stores, *Submission to ACCC inquiry into the Australian dairy industry*, 23 February 2017, p. 1; Master Grocers Australia, *Submission to the ACCC inquiry into the Australian dairy industry*, 12 December 2016, p. 3; Retail Guild of Australia, *Submission to ACCC Inquiry into the Australian dairy industry*, 13 December 2016, p. 2.

Figure 6.6: Percentage of sales via supermarket compared to alternative channels



Source: Dairy Australia, *Australian Dairy Industry in Focus* (Dairy Australia analysis and data from Information Resources (Australia) Pty Ltd)

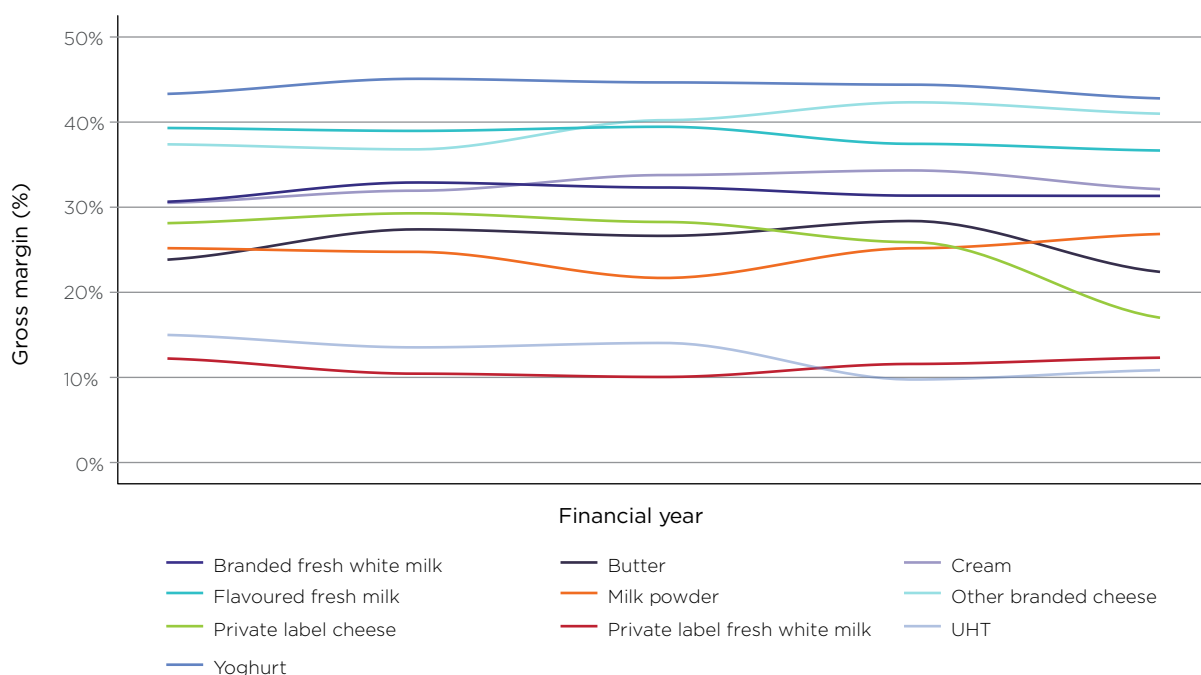
Route and convenience stores in the higher cost Northern and WA regions may face greater challenges in competing with supermarket retail prices as the national pricing strategy enables supermarkets to accept low or sometimes negative margins in regions with higher costs.

Another important wholesale sales channel for fresh drinking milk is the food service industry, including fast food restaurants and cafés. Some processors submitted that the wholesale price they charge non-grocery customers is also constrained by the retail price of private label milk because some customers, such as coffee chains, will buy private label milk from the supermarkets if their wholesale price exceeds \$1 per litre. This is not likely to be an option for many larger food service businesses.

6.4.7 Supermarkets' margins across the dairy category

The margins earned by supermarkets vary considerably across dairy products and time. In general, supermarkets make higher margins on branded dairy products than on private label products. For example, in 2015–16 supermarkets earned average gross margins of 28 per cent on branded fresh drinking milk but only 12 per cent on private label fresh drinking milk. This same observation is also true for other categories of dairy products, such as yoghurt, cream and cheese.

Figure 6.7: Gross margins for supermarkets 2012–16³⁰



Source: ALDI, Coles and Woolworths data

As shown by figure 6.7, the gross margin earned by supermarkets on a range of dairy products varies from approximately 12 per cent to 45 per cent on average. Figure 6.7 also shows that, despite variation in margin by product category and between branded and private label products, supermarkets' aggregate gross margins for most dairy products, excluding private label milk, cheese, UHT and butter, have been either relatively stable or increasing since 2009. This is despite real retail prices decreasing over the same period.

A change of approach in 2014

From 2011, the date from which the ACCC has observable data and when \$1 per litre private label milk was introduced, supermarket margins on this product decreased.

In 2014, some supermarkets began to explore ways in which they could recover their shrinking private label milk margins. They found that considerable cost savings could be made in private label milk supply and that these could be extracted if competition between processors for the supply of private label milk was increased.

Proposed cost savings included reducing the range of products produced at processing plants, having processors develop more efficient processing equipment and developing new packaging and bottle caps to prevent spillage and wastage. The supermarkets who sought these changes awarded new private label contracts to processors willing to make these efficiency investments.

Supermarkets also encouraged greater competition between processors by changing the format of their private label milk contract tenders and increasing the duration of contracts from annual to multi-year contracts. This encouraged processors to invest in capital to either increase the efficiency of existing facilities, or to build new and more efficient plants.

In addition to extending contract durations, one supermarket also began offering contracts for single regions and product categories instead of for supply across multiple regions and products. It was anticipated that this would attract smaller processors to the tender process and increase the number of competitors.

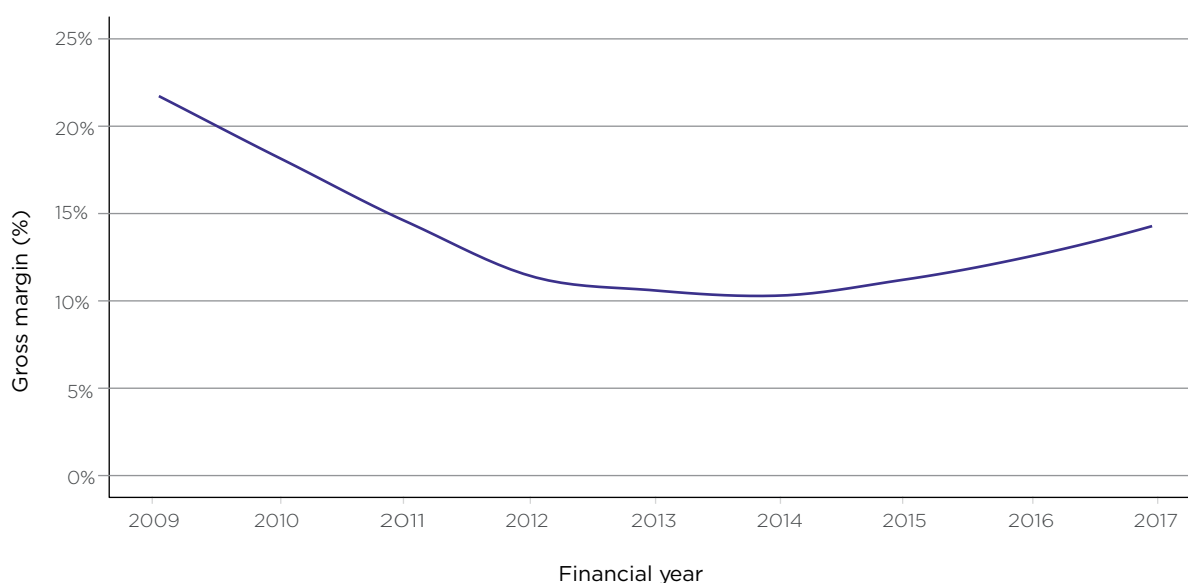
³⁰ Gross margin in this particular figure refers to the retail price less the cost of acquiring the dairy product in question. This does, depending on the retailer and the product in question, include the cost of transporting the dairy products to supermarket's distribution centre. However, it does not include the cost of transporting the products in question from the distribution centre to the retail store or other costs of retailing dairy products.

Some processors' evidence indicates that this change has been beneficial by providing increased certainty for investment and throughput volumes. However, the increased competition between processors that has been facilitated by the supermarkets has also reduced the margins and profits of the incumbent processors supplying them.

Supermarket margins on private label milk have recovered

Since competition between processors for private label milk contracts increased in around 2014, supermarkets have used their superior bargaining power to negotiate decreased wholesale prices. This has in turn increased supermarkets' margins on private label milk. This shift is shown in figure 6.8.

Figure 6.8: Private Label Fresh Milk Gross Margins for Supermarkets, 2009–10 to 2016–17³¹



Source: ALDI, Coles and Woolworths data

Current private label milk price and margins

The ACCC has found that nationally, on average, private label milk is sold by supermarkets at a positive gross margin. In particular, gross margins are positive in Victoria, NSW and SA. However, private label drinking milk is at times sold at a gross loss in Tasmania and Queensland once distribution costs are taken into account. In Tasmania and Queensland supermarkets with uniform national pricing choose to absorb lower and, in some cases, negative margins while making higher margins in low cost states and from more profitable products.

National pricing policies and low or sometimes negative margins on items considered to be 'key value items' are common for businesses with diverse product ranges, such as supermarkets. As noted above, consistent pricing is part of a wider competitive strategy to build trust in the supermarkets among consumers. In some instances, this includes supermarkets stocking locally-sourced produce as a show of support for farmers in the region, even if this involves higher cost products when the goods could be sourced more cheaply from other regions.

The variation in margin is due to differences in the wholesale cost of private label milk across regions. The price difference between regions is due predominantly to differences in the cost of acquisition of raw milk and can be more than 20 cents per litre at times. Below cost retail pricing in some areas and the impact, if any, on the farmgate milk price is discussed in section 6.6 below.

³¹ Gross margin in this particular figure refers to the retail price less the cost of acquiring the dairy product in question. This does, depending on the retailer and the product in question, include the cost of transporting the dairy products to the supermarkets' distribution centre. However, it does not include the cost of transporting the products in question from the distribution centre to the retail store or other costs of retailing dairy products.

Supermarket margins on private label cheddar cheese

As highlighted above, in 2014 Coles and Woolworths followed ALDI in reducing private label cheddar cheese prices to \$6 per kilogram. In the period following the price reduction of private label cheese in 2014, average supermarket margins on this product declined immediately. The ACCC heard evidence that at least one supermarket has at times sold private label cheddar cheese below cost, noting that this cheese was imported from New Zealand. This suggests that supermarkets have absorbed at least some of the lost retail value of these products and passed savings to consumers. As with private label milk, lower private label cheese prices have constrained the price of branded cheese.

The ACCC understands that cheddar cheese does not have the same 'basket penetration' as milk, but it is considered a key value item for retailers to make a value proposition to customers.³² Basic private label cheese is therefore priced as competitively as possible.

The ACCC has observed that Coles and Woolworths have recently increased the price of basic one kilogram blocks of cheddar to \$6.60. This may be indicative of private label cheese being less important as a key value item than private label milk, or reflect a limited appetite of supermarkets to make a loss on products, even if they are key value items.

As with private label drinking milk, low margins on private label cheese have encouraged supermarkets and processors to explore alternative options for acquiring and supplying cheese. These include importing cheese from New Zealand in bulk blocks and contracting processors to cut and wrap these imports into retail packaging for sale. As can be seen in figure 5.2 in chapter 5, imports of cheese into Australia have increased since the introduction of this new price point. While many processors still compete to acquire private label cheese contracts, at least one processor provided evidence that it recently declined to tender for these contracts due to the low margins on offer.

6.5 Impact of supermarket pricing on the dairy industry

Farmers have raised two broad concerns with the ACCC about the retail pricing of dairy products:

- low retail prices for private label milk are directly impacting the farmgate milk price
- low retail prices for private label dairy products have decreased the value of dairy products generally, which has in turn put downward pressure on the farmgate milk price.

The ACCC has considered these concerns in detail below.

6.5.1 Direct impact of private label milk on the farmgate price

The ACCC has considered whether an increase in private label retail prices would result in an increase in farmgate milk prices more broadly.

In general, dairy farmers have milk acquisition contracts with processors rather than with supermarkets.³³ This means that farmgate milk prices are ultimately determined by the processor, and not the supermarket.

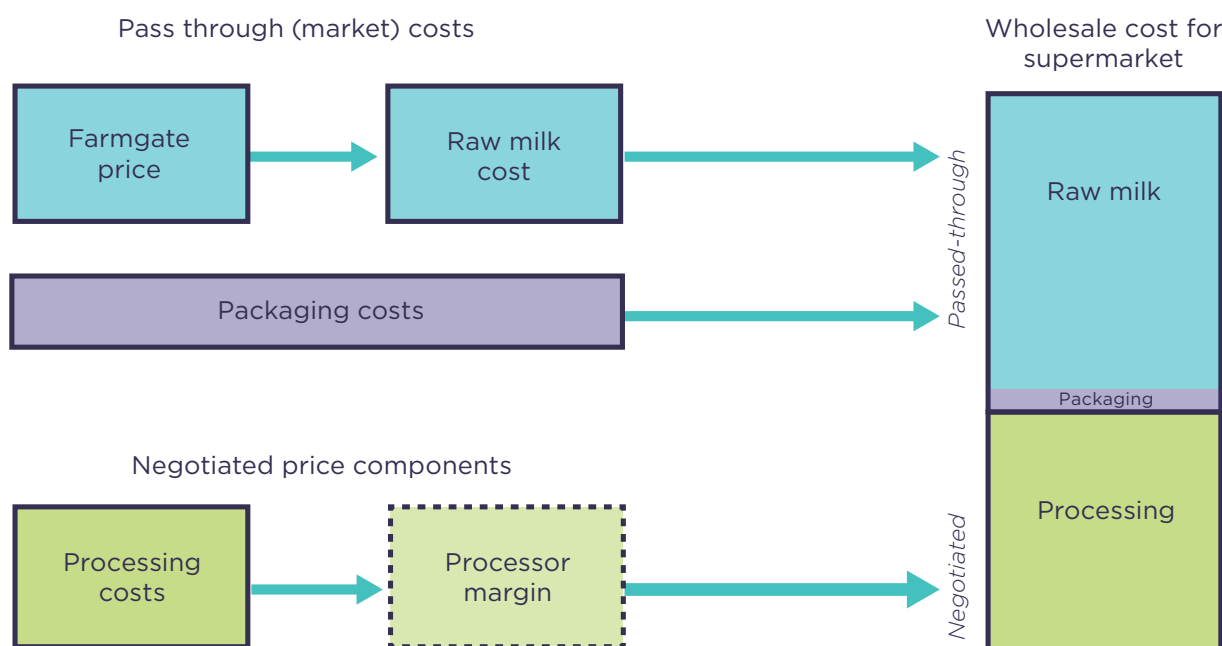
Almost all private label milk supply contracts between supermarkets and processors have component pricing which isolates the farmgate milk price and passes this price directly through to the supermarket. This means that each supermarket pays the prevailing farmgate milk price, and that processor profitability is not directly influenced by the farmgate milk price it pays to farmers.

In other words, a private label contract does not, of itself, give processors an incentive to reduce farmgate milk prices because raw milk acquisition costs are directly passed through to the wholesale prices charged to supermarkets. Other aspects of the contract, for example processing costs, are subject to negotiation between the supermarkets and the processors. Figure 6.9 depicts the negotiation process between a supermarket and a processor for a typical private label milk supply contract.

³² Basket penetration refers to the proportion of supermarket transactions which include an item.

³³ There are few exceptions to this; the Manning Valley collective bargaining group is one example.

Figure 6.9: Typical supermarket private label milk contract



The farmgate price component paid by supermarkets is the prevailing farmgate price of the processor who holds the private label contract. This price is either verified by independent third parties and/or benchmarked against publicly announced prices in the region.

As a result of these contract mechanisms, the farmgate price paid to farmers for milk used to fulfil private label milk contracts is not directly correlated with private label milk retail prices, but rather the prevailing farmgate price in the region.

Further, as discussed in chapter 3, farmgate price movements in the Southern region are largely driven by global commodity price movements, as drinking milk accounts for a small percentage of raw milk use. Some major processors in the Southern region produce very little or no drinking milk. These factors indicate that fresh drinking milk retail prices are particularly unlikely to have any impact on farmgate prices in the Southern region.

6.5.2 Potential indirect impact of private label milk on the farmgate price

Having found no direct link between retail prices and farmgate milk prices, the ACCC also considered whether the retail price of private label milk and other private label products has an indirect impact on farmgate milk prices. Farmers raised concerns that low private label prices have removed value from the industry, reduced processor margins, and resulted in less money being available for processors to pay to farmers or invest in expanding the industry.

The impact of national pricing on the Northern and WA regions

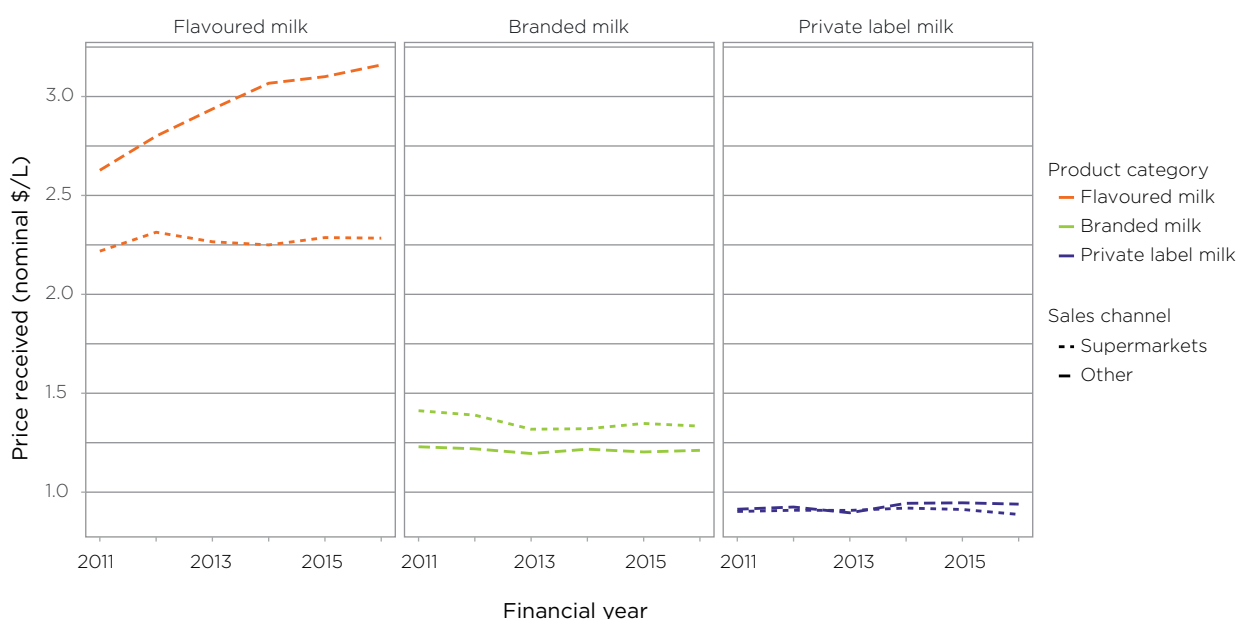
As discussed in section 6.4.2, national pricing has particular significance for the Australian dairy industry because of the regional differences in raw milk production costs. Regions with higher farmgate prices have less margin available for processors and retailers to capture, compared to regions with lower farmgate prices. As a result, the higher costs of production in the Northern and WA regions, as well as steady per capita consumption of fresh milk, has constrained margins and made it difficult to sustain multiple processors.

Further, the national pricing policies of the major supermarkets may have a more significant impact on processors who do not have the volume and certainty provided by private label contracts and operate in other sales channels. This is because, as the ACCC was informed during the inquiry, the retail price of private label milk constrains, to an extent, the prices set by non-grocery retailers (for example, convenience stores). Processors who rely significantly on the route trade to sell their products therefore

must offer a wholesale price that makes it profitable for these customers to do so. Further, in contrast to private label contracts, processors cannot pass through higher farmgate prices to these customers. Given the supermarket shares of drinking milk sales, low national retail prices for drinking milk are likely to put the most profit pressure on processors who do not have a private label milk contract. This is particularly problematic for processors in the Northern and WA regions who already face high costs of production.

Figure 6.10 shows that fresh milk processors receive lower wholesale prices for branded milk and similar wholesale prices for private label milk supplied to the non-grocery channel relative to the prices received by major supermarkets. The impact of lower prices for fresh milk is somewhat offset by higher prices received for flavoured milk, a particularly profitable product for fresh milk processors. Further, the ACCC understands that processors incur higher logistics costs to supply non-grocery customers relative to the cost of delivering to supermarket distribution centres, as they are required to make more frequent deliveries directly into stores.

Figure 6.10: Average wholesale price received for milk by channel



Source: Processor data, ACCC analysis

Potential impact on investment in the Northern and WA regions

The ACCC received submissions that low retail and wholesale prices are deterring investment in the supply chain by processors in the higher cost Northern and WA regions. While the ACCC has not found clear evidence to support this, we acknowledge that low wholesale prices coupled with relatively high raw milk costs may deter investment in northern NSW, Queensland and WA, particularly if processors consider their sustainability in these regions is at risk.

There are two categories of investments that processors might undertake:

- Improving production efficiencies to lower costs: processors may not have sufficient equity to make efficiency-enhancing investments or they may be deterred from making these investments if they are concerned supermarkets will capture the benefits of any cost savings they achieve. Processors may also be deterred from making efficiency-enhancing investments if they consider the risk of being de-ranked by a supermarket is too high. The ACCC notes that investment in production efficiencies would not necessarily provide benefits to farmers as, all else equal, it would be unlikely to lead to increased demand by processors for raw milk.

- Expanding production: given that per capita consumption of fresh drinking milk is stable, and most of the raw milk produced in the Northern and WA regions is already used for drinking milk, processors may have limited incentive to invest in capacity and expand production in these regions. Manufactured dairy products (such as cheese) will face competition from those made in the lower cost Southern region. There is some production of dairy desserts in these regions and low processor profits or uncertainty of ranging decisions by supermarkets may be deterring investment in this area. However, desserts typically represent a very small proportion of raw milk use so this investment may be of relatively little impact to the local industry.

As discussed above, given that domestic demand for products such as fresh drinking milk is relatively stable on a per capita basis, changes in retail prices have a limited effect on total consumption. As a result, wholesale demand for domestically consumed dairy products and processor demand for raw milk in the Northern and WA regions is also relatively static.

In other industries, a wholesale price increase and associated profit increase may encourage manufacturers to expand production. Domestic focused processors, however, do not have an incentive to increase production, even if wholesale prices increase, as demand does not change.

Further, market shares for particular brands of product are fairly stable, except where a product is de-ranged or a private label contract changes hands. Retailers change private label suppliers infrequently and the ACCC saw only a few examples of significant brands being de-ranged in any given year. Therefore, in addition to flat aggregate demand for raw milk in these regions, individual processors' requirements are also relatively stable over the short to medium term.

This has implications for industry growth potential in the Northern and WA regions. Processors have little incentive to invest in expanding capacity when faced with flat demand and higher costs of farming which makes these processors unable to produce exportable products in the Northern and WA regions at competitive prices. Investment has generally only occurred when a processor has secured a private label fresh drinking milk contract and thus has long term certainty as an incentive for investment in efficiency saving measures.

This lack of incentive to expand production also limits the incentive of processors to send price signals to farmers to produce additional milk or to increase or defend their share of the milk pool from competitors. As such, if processors in the Northern and WA regions were to experience an increase in wholesale prices and margins, they would not have an incentive to increase farmgate prices.

The experience of processors in the Northern and WA regions differs significantly from that of processors in the Southern region. In the Southern region, demand for raw milk fluctuates with changes in global commodity prices and processors can compete to supply an infinitely large market where total demand and supply can fluctuate significantly year to year. When global prices rise, export focused processors have an incentive to increase production to take advantage of the higher prices on the export market, and therefore will seek to secure more raw milk from farmers both through signalling to farmers to produce more, and by increasing and defending their share of the milk pool. Consequently, these processors have the incentive to increase farmgate prices when global prices rise.

A greater scale of potential customers on the export market also results in these processors in the Southern region having a greater incentive to invest in capacity expansions and efficiency improvements, relative to those in the Northern and WA regions.

As detailed in chapter 5, there are a number of recent examples of investment and expansion in the Southern region, including in fresh drinking milk production facilities. This indicates that domestic wholesale prices and processor margins are sufficiently high to encourage investment in these locations. In contrast, there are relatively few examples of investment in the higher cost states in recent years and the most significant of these, Norco's expansion of its Labrador facility, was directly linked to obtaining a private label contract with Coles.

Processors in the Northern and WA regions rely heavily on supermarkets for distribution of their product (see figure 6.12) and are therefore more exposed to supermarkets' bargaining power than processors who have access to selling products on the export market. This bargaining power imbalance could further deter investment by these processors if they lack the ability to capture a sufficient share of the returns to make the investment worthwhile. That is, even if a processor considers the expected savings are sufficient to justify an investment, they are unlikely to proceed with it if the supermarkets are able to use their power to appropriate an excessively large share of those returns.

While long term private label contracts provide some certainty and perhaps investment opportunities for processors, the long term duration of contracts might also prevent investment by those who miss out, as they don't have significant volumes of throughput to achieve efficiencies. At the same time, these processors face constrained wholesale prices for their products due to private label retail pricing and have no ability to pass on changes in the farmgate price.

While processors have fewer incentives to invest in the Northern and WA regions and this has raised concerns about the future of the industry, it is not in the interests of supermarkets to force wholesale prices down to a point which causes processors to exit. However, supermarkets' national pricing practices, including \$1 per litre milk, places pressure on the profitability of processors in the Northern and WA regions where farmgate prices are high. This includes processors who do not have a private label contract. Some processors have submitted to the ACCC that these factors lead to uncertainty about the long term viability of sourcing milk from high cost regions.

Removal of value from the industry

The ACCC examined whether, as submitted by various stakeholders, there has been a removal of value from the industry. The margin analysis in this chapter confirms there has been a reduction of some value from the industry since the reduction in private label milk prices in 2011. However, this reduction has been experienced by retailers and processors in the form of lower margins and has mainly been passed onto consumers in the form of lower retail prices.

While this removal of value has reduced the profits of processors, most remain profitable overall and remain able to compete to acquire the raw milk they need to satisfy demand for their dairy products. One processor speculated that if its profitability continued to decline, profitable supply of fresh drinking milk in high cost regions may eventually require sourcing milk from farms in lower cost regions. However, this remains speculative until their cost-reduction measures have had time to play out. The ACCC did not receive evidence indicating that current levels of profitability would be likely to result in processors exiting a market.

Farmgate prices are determined by the degree of competition faced by processors and their demand for raw milk, rather than their absolute profitability. Further analysis on this issue and detailed discussion of the factors which have had an impact on farmgate prices and farm profitability is provided further below in this chapter and in chapter 3.

Impact of a change in the retail price of private label milk

Some stakeholders have submitted that if processors received more revenue from supermarkets, they would share this with farmers in the form of higher farmgate prices.

In a well-functioning market, rational manufacturers seek to minimise their costs no matter how great their profits are. This means processors will always have an incentive to pay as low a farmgate price as possible. As such, even if processor margins did rise following an increase in retail prices, processors would continue to set farmgate prices just high enough to secure the milk volumes they require. Further, as demand for fresh milk does not change significantly with price, all other things equal the processor would not need to pay any more or less for the raw milk that they need.

The ACCC acknowledges the view that farmers supplying a cooperative could benefit from an increase in the retail price of fresh milk. As discussed in chapter 3, cooperatives are designed to return profits back to farmers, generally via the farmgate price and dividends. When a cooperative has the capacity to pass on higher profits to farmers, however, we consider it is more likely to distribute higher dividends than increase its farmgate price.

In any case, the immediate impact of an increase in the retail price of private label milk would most likely be an increase in supermarket margins. Consumers would pay more for their milk and be worse off, while supermarkets would continue to use their bargaining power to negotiate low wholesale prices with processors. It is likely that processors would not see any meaningful change in their margins.

The ACCC has therefore concluded that given the relative bargaining position of supermarkets, processors and farmers, farmers would likely see no meaningful benefit from an increase in retail milk prices.

Future of private label milk pricing

The ACCC is unable to speculate on how much longer private label milk will be priced at \$1 per litre or how private label contracts will be structured in the future. The \$1 per litre price represents a real 12 per cent decline in the retail price of private label milk since its inception in 2011. It is an arbitrary 'cap' imposed by retailers on private label milk which does not reflect the costs of production and supply. Supermarkets, driven by consumer demand and competition with each other, are largely in control of future retail prices for private label milk and how these are achieved.

Evidence obtained by the ACCC indicated that supermarkets have considered various options in relation to private label milk. These have included:

- Adjusting the retail price. Although, as discussed above, any increase in the price of private label milk would be unlikely to be passed on to processors or farmers. Increases in the price of branded milk may potentially see some margin passed through to processors, but it is unlikely to benefit farmers' margins.
- Reducing retail margins. Again, this is unlikely to have any significant impact on processors or farmers, as even with supermarkets' superior bargaining power they must still provide an adequate price to processors in order to drive production to meet demand.
- Restructuring the supply chain to reduce retail costs and engage toll processors. It is not clear exactly what impact this would have for farmers in the long run. However, such an arrangement could provide another alternative for a top tier of farmers who are able to consistently provide high quality raw milk.

Impact of retail price of private label cheese

The ACCC understands that it requires approximately 10 litres of raw milk to produce one kilogram of cheddar cheese.³⁴ Accordingly, concerns have been voiced that \$6 per kilogram cheddar cheese equates to selling drinking milk at 60 cents per litre.

Cheese represents a significant portion of both manufactured and exported products. In 2016–17, 33 per cent of Australian raw milk was used to produce cheese (a total of 336 742 tonnes) and over half of this milk was used to produce cheddar cheese. Australia exported 167 000 tonnes of cheese in 2016–17 (close to half of total cheese production) but also imported approximately 112 000 tonnes of cheese in 2016–17. This means that Australian processors have options to sell cheese both domestically and/or in export markets, depending on the expected returns, but also face competition from imports for domestic sales in Australia.

Approximately 50 per cent of cheese sold in Australia is through the grocery channel. Of the cheese sold in the major supermarkets, approximately 35 per cent is private label, and is growing over time as a percentage of total cheese sales.³⁵

Processors submitted that with private label cheese taking up more shelf space, there has been growing competition between branded cheese products to remain on the shelf as retailers rationalise the number of brands. This has led to downward pressure on both prices and processor margins for premium brand cheese.

Private label cheese contracts

Private label cheddar cheese is a mixture of bulk cheese imported from New Zealand, cut and wrapped in Australia, and Australian produced cheese.

In recent years, supermarkets have moved to national supply contracts for private label cheese. The ACCC has found that private label cheese contracts generally link the wholesale price, directly or indirectly, to some measure of either:

- global commodity prices such as the GDT cheddar price or the Dairy Australia cheddar spot price
- farmgate prices (including benchmarks published by Dairy Australia), or
- a combination of the two.

³⁴ Production of cheddar cheese also results in some by-products which can also be sold.

³⁵ Dairy Australia, *Australian Dairy Industry in Focus 2014*, 2017.

The ACCC understands that some retailers prefer to link wholesale prices to a global commodity price. This allows their wholesale costs to move in line with the market and makes them competitive with retailers who have shorter term supply agreements with processors, or who buy imported cheddar in bulk on the spot market.

This pricing mechanism means that private label cheese wholesale prices and margins are somewhat isolated from retail prices. However, importing relatively cheap cheese from New Zealand has enabled supermarkets to maintain low retail prices which can constrain the price that domestic processors receive for Australian cheese.

At the same time, supermarkets are exposed to fluctuations in the global cheddar commodity price and thus bear the risk of low or negative profits on private label cheese when the commodity price rises, particularly if they are reluctant to raise the retail price.

While many processors still compete to acquire private label cheese contracts, at least one processor gave evidence that it recently declined to tender for a private label contract due to the low margins on offer and a preference not to import products for secondary processing. This indicates that processors are not necessarily bound by the supermarkets' demands and will only tender for private label contracts when it is commercially appealing. In particular, as cheese is an exportable product, processors can mitigate their exposure to supermarkets' bargaining power by focusing on other sales channels.

Overall, our analysis shows that margins on private label cheese are slim relative to many other dairy products and processors earn higher margins on branded cheese. It is evident that supermarkets have pressured processors to improve their cost competitiveness in order to secure private label contracts, while wholesale prices of private label cheese appear relatively stable in general.

At the same time, there has been a trend in processors shifting away from cheddar cheese and producing other higher margin cheese. Cheddar's share of total cheese production has decreased from around 70 per cent three decades ago to between 50 and 55 per cent in recent years. Consumption of cheese has been stable in recent years, as has the split between cheddar and non-cheddar varieties with cheddar types remaining slightly more popular.³⁶

Importing cheddar cheese

As noted above, supermarkets import some cheese from New Zealand in bulk blocks and contract processors to cut and wrap these imports into retail packaging for sale as the lowest priced private label cheese. Imports of cheese into Australia have increased since 2014 when \$6 per kilogram became a competitive price point between the major supermarkets. In 2016-17, Australia imported significantly more cheddar than in previous years at 41 000 tonnes. This represents 37 per cent of total cheese imports in 2016-17.

Farmers have raised concerns that New Zealand cheddar is being dumped in the Australian market.³⁷ Dumping occurs when an exporter sells goods to Australian customers at a price that is below the 'normal value' of the goods. The normal value will usually be the domestic price of the goods in the country of export. Retailers and processors have been able to import cheddar into Australia at low cost in recent years as a result of comparatively low farmgate prices in New Zealand and favourable exchange rates. The Anti-Dumping Commission administers Australia's anti-dumping system and is responsible for investigating dumping concerns.³⁸

Having regard to the above, the ACCC does not consider that the sale of private label cheese at \$6 per kilogram is likely to have had an impact on farmgate prices. The vast majority of cheddar cheese production in Australia occurs in Victoria where farmgate price movements are largely dictated by changes in global commodity prices.

Furthermore, the private label cheese contracts are typically structured in a way which, directly or indirectly, either allows processors to pass through farmgate prices (similar to private label drinking milk contracts) or which links wholesale prices to global commodity price movements.

³⁶ Dairy Australia, *Australian Dairy Industry in Focus 2017*.

³⁷ Farmer Power, *Comments on the ACCC interim report on the Australian dairy industry*, 18 January 2018, p. 3; Brian Schuler & Karrinjeet Singh-Mahil, *Submission to the ACCC interim report of the inquiry into the Australian dairy industry*, 2 February 2018.

³⁸ For more information, see www.adcommission.gov.au.

Importantly, the ACCC has seen that as margins on private label cheese and other cheddar cheese sold to supermarkets have declined, processors have demonstrated their ability to shift production towards other, differentiated cheese products and also have the option of focusing on exports over domestic supermarket sales.

Box 1: Private label milk and predatory pricing claims

Predatory pricing

Businesses compete with each other by offering a more compelling offer to consumers than their competitors. This often involves businesses under-cutting the prices offered by rivals. In almost all circumstances, low pricing is beneficial for consumers and a reflection of healthy competition.

However, in rare circumstances, very low pricing over a sustained period by a firm with a substantial degree of market power may be predatory. Anti-competitive predatory pricing occurs when a firm with substantial market power reduces its prices below its own cost of supply for a sustained period with the aim of:

- causing competitors to exit a market
- disciplining or damaging competitors for competing aggressively, or
- discouraging potential competitors from entering the market.

Predatory pricing might result in a firm losing money in the short to medium term. However, as a result of its competitors exiting the market or new entrants failing to enter the market, the firm may be in a position in the longer term to charge higher prices, recoup its losses from the low prices charged and maintain or increase its market share.

Substantial market power

Substantial market power comes from the lack of effective competitive constraint. A firm with market power is able to act with a degree of freedom from competitors, potential competitors, suppliers and customers. The most observable manifestation of market power is the ability of a firm to profitably sustain prices above competitive levels. Substantial market power may also enable a firm to reduce the quality of goods and services, raise barriers to entry or slow innovation.³⁹

The 2011 investigation into Coles pricing of private label milk

In 2011 the ACCC investigated whether Coles' discounting of private label milk was predatory pricing in breach of s. 46 (1) of the CCA.

During this investigation, the ACCC found that the major impact of the reduction in milk prices was a reduction in the supermarkets' profit margins on private label milk. In turn, these price reductions benefited consumers who purchased private label milk.

The ACCC found that Coles had not engaged in this strategy for an anti-competitive purpose, and instead found that Coles intended to win market share from Woolworths/ALDI.

Private label milk prices now

As noted above, the ACCC has found that private label milk is at times sold at a gross loss by supermarkets in Tasmania and Queensland (once distribution costs are taken into account). The ACCC has considered whether this is likely to raise any concerns under the provisions of the *Competition and Consumer Act 2010*.

The ACCC has found no indication that private label milk pricing, in and of itself, has done substantial damage to competitors of the major supermarkets. The ACCC heard some complaints that private label milk pricing may be harming convenience store retailers, but figure 6.6 demonstrates that there has been minimal transfer in volume of drinking milk sales from the route/convenience trade to the supermarket channel.

Changes to s. 46 of the Competition and Consumer Act

On 6 November 2017 changes to s. 46 came into effect. Section 46 now provides that a firm with a substantial degree of power in a market must not engage in conduct that has the purpose, or has or is likely to have the effect, of substantially lessening competition in that market; or any other in which that firm acquires or supplies goods or services.

Section 46 no longer requires an 'anti-competitive purpose' or 'taking advantage' as an element of establishing a contravention. Instead the focus of the provision is now on whether conduct involves a 'substantial lessening of competition'.

While there is no legislative definition of 'substantially lessen competition', the term is well understood within Australia's competition laws. In essence, conduct substantially lessens competition when it interferes with the competitive process in a meaningful way by deterring, hindering or preventing competition. This can be done by raising barriers to competition or to entry into a market.

'Lessening competition' means that the field of rivalry is diminished or lessened, or the competitive process is compromised or impacted. 'Lessening competition' extends to 'preventing or hindering competition'.

When assessing whether the conduct has the purpose, effect or likely effect of substantially lessening competition, the ACCC will consider the commercial rationale for the conduct and any other purpose of the conduct. If a firm is engaging in conduct solely to make its products more attractive to customers, the conduct is unlikely to substantially lessen competition.

6.6 The impact of supermarkets' bargaining power and export prices on processors' margins

6.6.1 The importance of supermarkets as customers varies between processors and regions

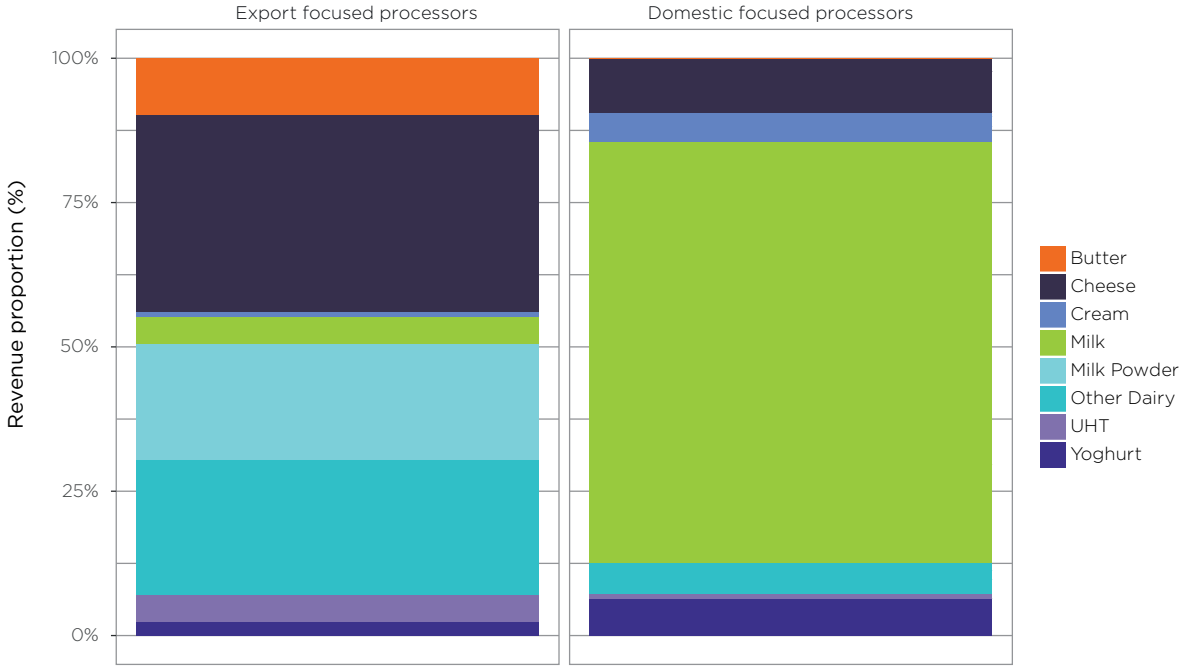
In the Southern region, fresh drinking milk and domestic dairy sales account for a relatively small proportion of total production. This is because processors have access to selling products on the export market and tend to focus their production on a range of exportable products, including cheese and milk powders. Processors operating in the Northern and WA regions, however, generally direct most raw milk into the production of fresh products, predominantly drinking milk. As discussed previously, these processors in these regions are subject to higher raw milk costs and their reliance on supermarkets may limit their bargaining power, potentially putting pressure on their sustainability.

Figure 6.11 shows the proportion of processors' sales revenue made up by various dairy products, aggregated across export focused processors and across domestic focused processors over multiple years:

- Revenue earned by export focused processors was made up of a variety of products in relatively similar shares, with the largest share being cheese at over 35 per cent, followed by other dairy products and milk powder.
- Fresh milk represented less than 10 per cent of sales revenue on average for these processors. Domestic focused processors, however, earned on average over 70 per cent of their revenue from fresh drinking milk over this multi-year period. Yoghurt, cheese, cream, other dairy products and a relatively small amount of UHT milk made up the remaining revenue.

39 See discussion on market power in Kaysen and Turner, *Antitrust Policy* (1959), p. 75 in QWI at [200].

Figure 6.11: Processors' revenue for dairy products⁴⁰

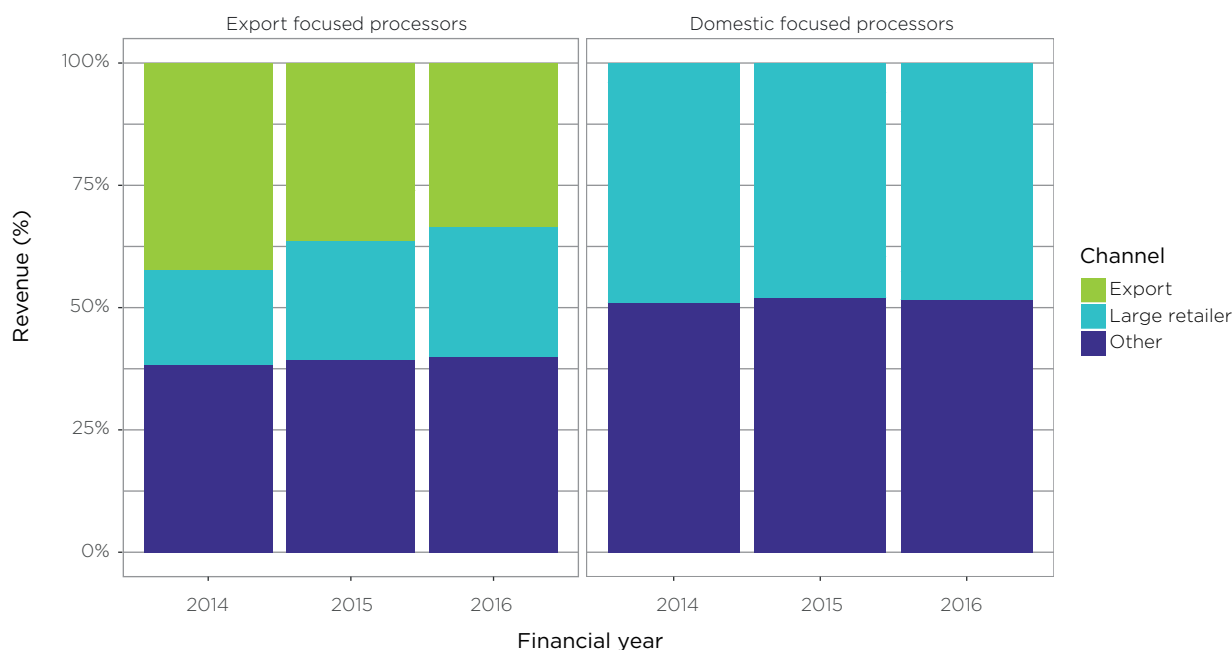


Source: Processor data, ACCC analysis

Figure 6.12 further illustrates that the importance of different sales channels varies between processors and regions. This shows the proportion of processors' sales revenue, separated again into export focused and domestic focused processors, made up by the export channel, large retail customers and 'other', which includes customers such as route trade and convenience stores and food service industries. This demonstrates the importance of domestic sales channels for processors of fresh products relative to export focused processors who earn sales revenue from a mix of export customers, supermarkets and other domestic customers.

40 Figure 6.11 comprises data aggregated across multiple years which we have not identified for confidentiality reasons.

Figure 6.12: Processors' revenue proportion by channel over time



Source: Processor data, ACCC analysis

6.6.2 Processor margins on private label products

Evidence provided to the inquiry relating to private label milk contracts covers many processors and regions. The evidence shows that, while these contracts are profitable for some processors, many private label contracts operate at close to cost, effectively at a break-even level. The ACCC heard evidence and reviewed documents that suggest that when overall business overheads are included, some of these contracts may operate at a net loss. Despite this, processors still actively compete for private label contracts as they consider that they provide production efficiencies, as discussed in more detail later in this chapter.

Processors' gross margins on private label milk have been decreasing since the 2011 retail price reduction, and processors typically earn higher margins on branded milk than private label milk. As explained earlier in the chapter, the decrease in the retail price of private label milk has led to substitution by consumers away from branded milk and further impacted processors' overall returns on fresh drinking milk.

In addition, processors have had to offer lower wholesale drinking milk prices to customers who compete with supermarkets or who can source milk from supermarkets, such as the hospitality and convenience industry. This has increased the impact that cheaper private label retail milk prices have had on processors' profitability.

Despite falling profit margins, evidence to this inquiry from both processors and supermarkets indicates that private label milk contracts are highly sought after by some processors. Processors have indicated that despite low margins, the throughput of high volumes of milk for private label contracts decreases the overall costs of production per unit and allows processors to earn higher margins on other value-added products. Processors also value the long term, secure volume of private label products. This can in turn assist in accurately forecasting the level of raw milk they need to acquire.

Some processors have responded to lower margins on private label contracts by attempting to reduce their costs of production. The strategies adopted include streamlining manufacturing processes and investing in new, more efficient technology. While some processors have succeeded in reducing their production costs, these savings appear to have been largely captured by supermarkets. As a result, processors' margins have continued to decline. The ACCC attributes this outcome to the supermarkets' superior bargaining power over processors.

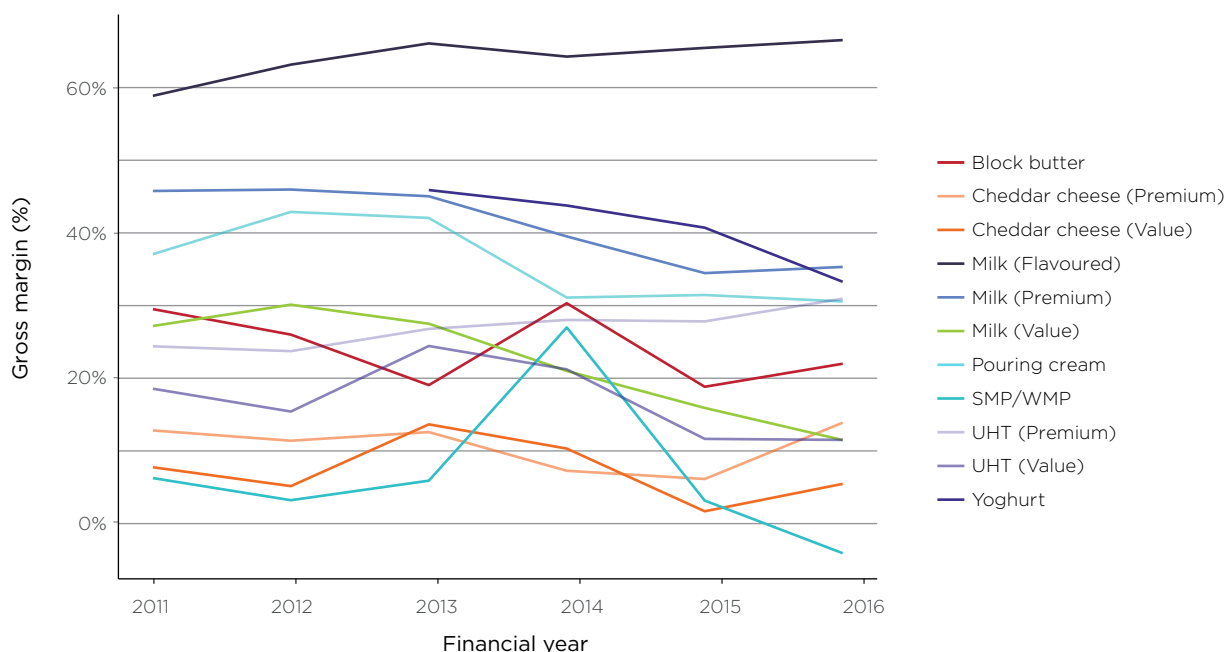
6.6.3 Processors' margins on branded products

Processors' gross and net margins vary by type of dairy product and by individual processor. Key influences include the type of dairy product and the geographic source of supply. In general:

- processors typically earn higher gross and net margins for branded label products than for private label products within the same category of product (e.g. branded milk earns a net margin of up to 30 per cent for some processors, whereas private label milk often earns a low, or at times a negative, net margin)
- processors earn their highest gross and net margins on sales of flavoured fresh drinking milk, yoghurt, branded fresh drinking milk and premium brand cheese. Generally gross margins vary across products and processors but range between 30 and 60 per cent.

Figure 6.13 shows the average gross margins earned by processors on various dairy products.

Figure 6.13: Processors' average gross margins for dairy products over time



Source: Processor data, ACCC analysis

The data and other evidence obtained by the ACCC indicates that processors appear to offset lower gross margins earned on private label contracts with the higher gross margins earned on branded products. It is a common business strategy for businesses to produce high volumes of undifferentiated products which earn low gross margins but decrease the overall costs of production per unit, and earn higher gross margins on differentiated or otherwise value-added products.

Key drivers of processors' profitability

Bargaining power goes some way to explaining the difference in margins earned on private label products versus branded products. Private label products are often not differentiated from each other and therefore command low levels of consumer loyalty, with purchasing decisions based primarily on price. Branded products, however, command higher consumer loyalty and demand due to innovative flavour profiles or brand strength. This increases the bargaining power of individual processors in relation to these products, as supermarkets and other retail outlets have more of a desire to stock them.

As shown in figure 6.13, despite the relatively high gross and net margins on some products, processors' average gross margins on key products have been either stable or decreasing since 2009. In some cases this is due to wholesale prices declining at a faster rate than costs, such as for yoghurt. However, average wholesale prices appear relatively flat for fresh drinking milk, indicating that lower margins have been driven by increasing costs. The average gross margin for flavoured milk and premium cheddar cheese have risen over time due to increasing wholesale prices.

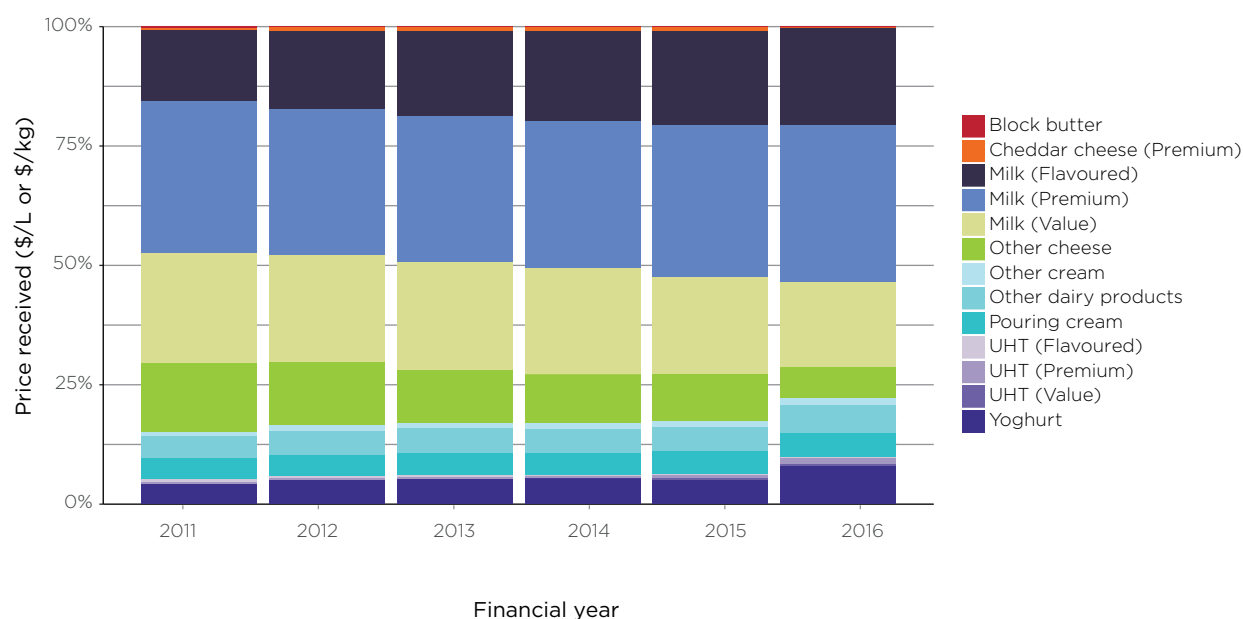
Importance of flavoured milk to domestic focused processors

Flavoured milk is a strong and growing segment of the dairy milk category, with strong sales outside the grocery channel in particular, such as in convenience stores and petrol stations. For domestic focused processors, flavoured milk sales contribute significantly to overall profitability.

Flavoured milk products are ready to drink beverages that compete with soft drinks and energy drinks in the non-grocery channel, and appear to be less significant on supermarket shelves. The ACCC understands that some supermarkets have trialled private label flavoured milk, but consumer loyalty to flavoured milk brands has meant this product has not been successful to date.

As shown in figure 6.14 below, domestic focused processors earn a significant proportion of their revenue from flavoured milk. Given that fresh drinking milk generates relatively low margins, processors have submitted that they rely heavily on flavoured milk sales to be profitable.

Figure 6.14: Domestic focused processors' revenue by product



Source: processor data, ACCC analysis

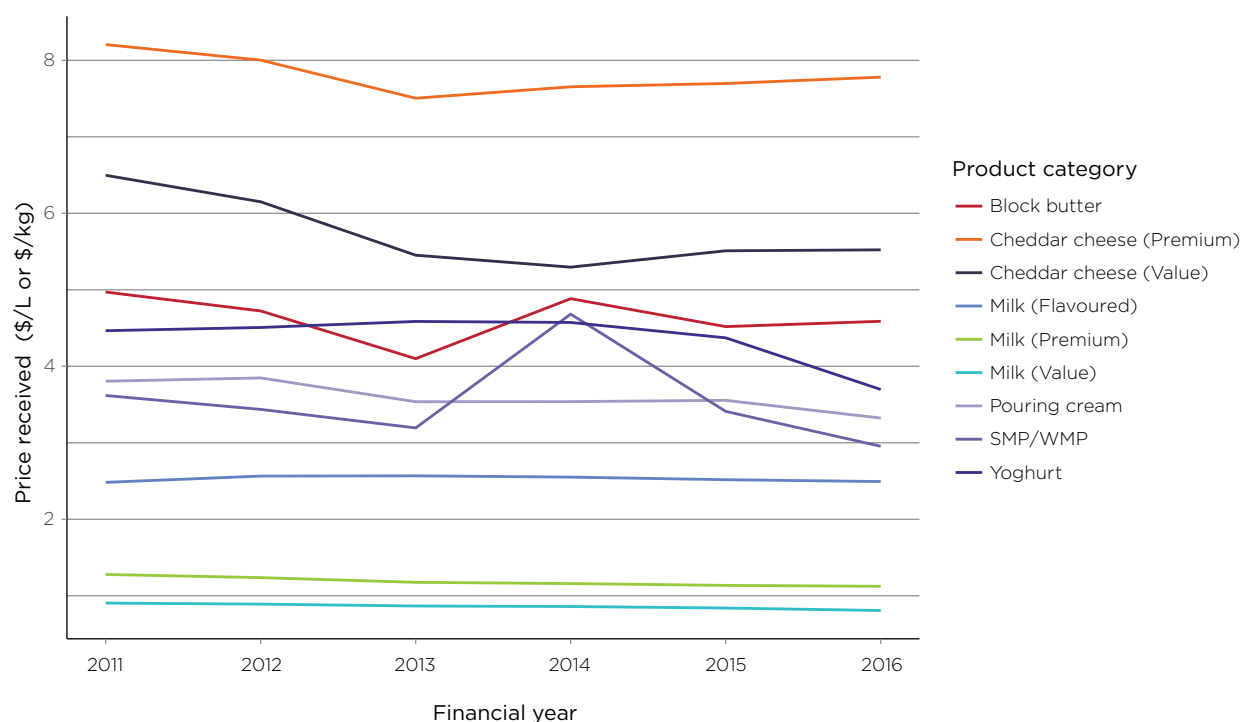
As discussed, processors have indicated that there is pressure on the wholesale price of fresh drinking milk sold to non-grocery customers. The ACCC has found that processors generally receive a better wholesale price for flavoured milk sold to non-grocery customers compared to supermarkets. However, wholesale prices for branded and private label milk are lower or similar relative to the prices received by supermarkets. Accordingly, as previously discussed, domestic focused processors focus on flavoured milk to grow their business as it is a key driver of overall profitability.

Wholesale price variations across products and processors

Figure 6.15 demonstrates that processors generally experience more volatility in wholesale prices for exportable products, such as milk powder, branded cheese and butter:

- Almost all the milk powder produced in Australia is sold into the export market and global prices for powder have been volatile, as reflected in the movements in the wholesale price.
- Butter and cheese are exportable products but most are sold domestically and processors have received flatter prices relative to the global price.
- Processors' margins for fresh dairy products are driven more by cost changes which are predominantly influenced by movements in the farmgate price. Wholesale prices for fresh products have been relatively flat.

Figure 6.15: Average wholesale price of dairy products over time



Source: Processor data, ACCC analysis

The ACCC has found that not all processors have experienced falling margins over time. This indicates that some processors may have more bargaining power than others and subsequently have not suffered such great reductions in wholesale revenues. The ACCC considers it is likely to be bargaining power rather than increased efficiencies of the processors that is driving this outcome, as with some products (such as private label milk), increased processor efficiencies have been captured by the supermarkets.

There are a number of reasons for variations in processors' bargaining power:

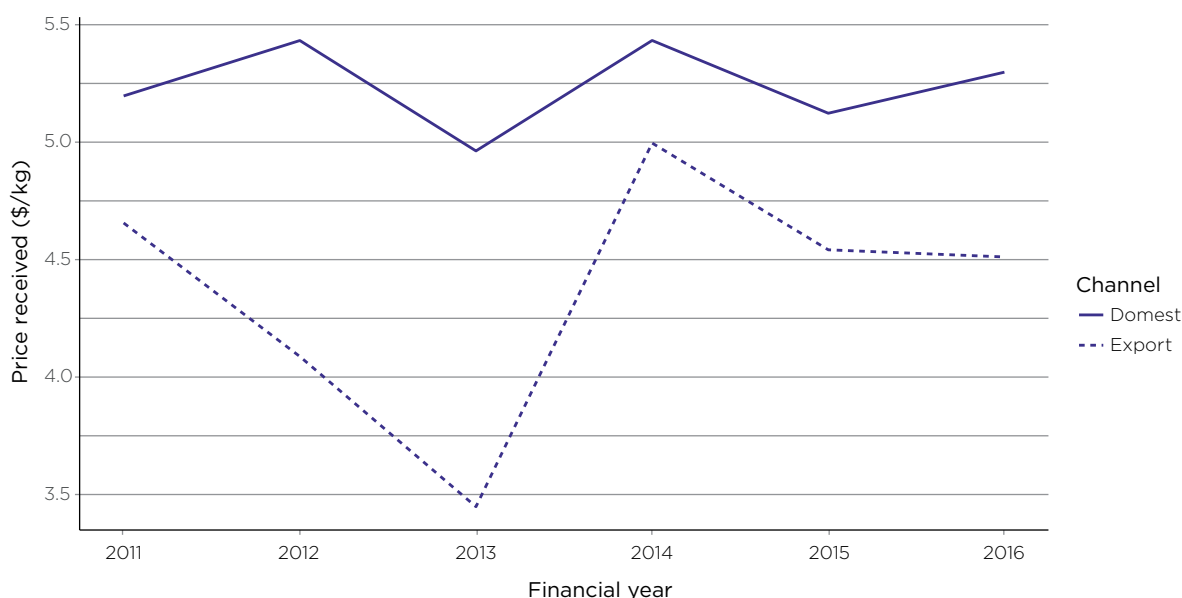
- Processors that have access to selling products on the export market have more options for selling their products than just the domestic market. In contrast, processors with a stronger focus on manufacturing fresh drinking milk are more reliant on the supermarkets for distribution of their product. Consequently, they are more exposed to supermarket bargaining power, particularly since the introduction of \$1 per litre milk and consumers' substitution from branded milk.
- Relatively low milk production costs in Victoria and central NSW can place pressure on processors in northern NSW and Queensland at times, and increase supermarkets' supply options. There are instances where it would cost less to freight raw milk from NSW and Victoria to Queensland for processing than to use locally sourced milk. As discussed in section 1.3.1 of chapter 1, the current cost to transport raw milk from Victoria to Queensland is approximately 17 cents per litre and in recent years the average farmgate price in Queensland has been 10 to 16 cents higher than the Victorian price. This difference in farmgate prices between regions suggests that it is at times likely to be cheaper to purchase raw milk in Victoria and freight it to Queensland for processing.
- Some processors benefit from consumer sentiment regarding the source of dairy products. Specifically, there is evidence that supermarkets have a strong preference for procuring locally produced drinking milk from co-operatives. This is driven primarily by the supermarkets' belief that many consumers prefer to drink locally sourced milk. This reduces the supply options for supermarkets and consequently their bargaining power. There is evidence that shows certain processors earn higher wholesale prices than those who cannot supply locally produced drinking milk.
- Finally, processors who face limited competition for the products they produce negotiate higher wholesale prices. The ACCC has seen evidence of processors earning higher margins on products supplied to supermarkets in regions where there is limited processing competition for those products.

The ACCC has also considered whether processors have been able to leverage bargaining power as a result of product shortages, such as butter:

- The global demand for butter has increased in recent years as consumers are turning away from more processed low-fat spreads, such as margarine and vegetable spreads, in favour of more natural products. The increase in demand has led to higher global butter prices.
- Processors generally have more bargaining power when it comes to exportable products, like butter, compared to non-exportable products such as fresh milk. This is because the potential to export the product gives rise to an alternative source of returns that a domestic customer needs to be able to match or better in the longer term.
- A butter shortage may improve a processor's position in negotiating with supermarkets in the short term; however, they might not seek to exploit a temporary supply shortage if it risks their ongoing supply relationship with a major supermarket. Supermarkets can also import butter from overseas to meet consumers' demand which acts as a constraint on the pricing of Australian processors in the longer term.
- More than 80 per cent of butter produced in Australia is supplied domestically.⁴¹ More than half of this is acquired by the major supermarkets. The ACCC understands that supermarket contracts for the supply of butter generally include rise and fall price mechanisms which link the wholesale price for butter to the global commodity price. Retailers want these provisions in order to keep their costs in line with the market and as such will accept some of the commodity risk. Processors also share in the exposure to commodity price fluctuations in their domestic sales under these contract arrangements.

The ACCC observed that Australian wholesale butter prices are correlated with the global prices, while costs are driven by changes in the farmgate price. Figure 6.16 shows the average price received by processors for block butter sold on the export market and the domestic market. This demonstrates that processors tend to receive a more stable price from domestic retailers, including large retailers and other non-grocery customers, than when selling on the export market. As noted elsewhere, manufacturing butter also results in the production of skim milk powder. Global skim milk powder prices have been low in recent years which has reduced the incentive of processors to increase butter production relative to other dairy products such as cheese. We observed a similar trend in the wholesale price of premium cheddar cheese as for block butter, with processors receiving a slightly more stable price on the domestic market relative to the export market.

Figure 6.16: Wholesale price of block butter over time



Source: Processor data, ACCC analysis

⁴¹ Dairy Australia, *Australian Dairy Industry in Focus 2017*.

6.7 Key determinants of farmers' profitability

As set out in section 6.4.4, deregulation led to a substantial reduction in the retail price of milk as well as other dairy products. This in turn has led to reduced wholesale prices and margins for processors, with many private label contracts operating at close to average cost for processors. Farmers and farmer representative groups expressed their concern that Australian farmers would be more profitable but for this retail price behaviour and the reduced margins of processors.

The ACCC considered the factors which have affected farmer profitability over time. We examined movements in farmgate prices, farm exits, raw milk production volumes and revenue generated by farmers. We have looked at the most likely causes for these movements. In doing so, we considered a range of potential factors, including deregulation, climate events, the geographic source of raw milk, and changes in the retail and processing sectors of the supply chain

As discussed above, the ACCC heard many concerns from farmers that retail prices of private label milk have negatively impacted farmgate milk prices. We have explored this issue by analysing the correlation between movements in retail prices, farm gate milk prices, reduced production volumes and a subsequent increase in farm exits in response to lower profitability.

The ACCC has concluded that the introduction of \$1 per litre milk or reductions in other dairy retail prices did not have an observable direct impact on farm numbers, output or profitability. Rather, we have found that movements in farmgate prices can be attributed to changing demand conditions within the export or domestic market. Analysis of processor documents did not indicate that farmgate price movements were directly influenced by prevailing retail or domestic wholesale prices.

Queensland Dairyfarmers' Organisation's (QDO) response to the interim report disagreed with the ACCC's finding on this issue, and submitted its own analysis of farm exits and milk production in Queensland.

QDO's analysis indicated an observable slowing of farm exits and milk production declines between 2008–09 and 2011–12, after which the rate of farm exits and decline in milk production accelerated, albeit at slower rates than between 1999–2000 and 2007–08. QDO attributed the rate of declines from 2012–13 onwards to the introduction of \$1 per litre private label milk in January 2011.⁴²

The ACCC notes that farmgate prices in Queensland declined significantly from 2008–09 to 2010–11, prior to the introduction of \$1 per litre milk. A further decline in the farmgate price in Queensland in 2012–13 was relatively small compared to the previous declines and the farmgate price increased again in 2013–14.

In addition, weather conditions, including the severe drought experienced in Queensland in 2014, had a major impact on milk production and the profitability of farmers relying on supplementary feed, as most dairy farmers in Queensland do. The ACCC also understands that dairy farmers may endure multiple years of negative profits before making the difficult decision to exit the industry. Therefore, farm exits attributable to declines in the farmgate price or seasons that are particularly difficult for other reasons may not occur until years later. For the reasons outlined above, the ACCC does not agree with QDO's interpretation of the trends in Queensland farm exits and milk production.

The broader trends of farmer profitability and exits are largely explained by the impact of deregulation of the industry and the bargaining position of farmers. The following sections of this chapter discuss this in detail.

6.7.1 Long term trends show that deregulation has strongly influenced farm exits

As explained in chapter 1, deregulation of the dairy industry started in the 1990s and was completed in June 2000.

Deregulation removed various levies supporting farmers as well as removing a regulated pricing system for raw milk and some drinking milk. For all states for which ABARES holds data on farm profitability, there was a dip in profits immediately following deregulation.

⁴² Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 6.

In addition, farm exits spiked and the total volume of milk production in Australia began to fall after 2000.⁴³ As can be seen in the charts in *Appendix 4*, average farm profits recovered within a few years following deregulation, but the long term trend of farm exits across Australia has continued.

As shown in figure 1.3 in chapter 1, despite declining farm numbers, milk production stabilised in 2007 at approximately 9 billion litres per year. Therefore, while the total number of farms in Australia has decreased, average production per farm has increased. The introduction of \$1 per litre private label milk in 2011 does not appear to have had accelerated the ongoing trends for production in any of the states, or the numbers of farm exits.

6.7.2 Farm profitability is variable, but movements can be explained mainly by factors other than retail pricing

Dairy farm profitability in Australia is volatile, as a result of significant movements in either:

- farming costs, the main driver of which is the cost of fodder and/or
- farmgate prices, which are determined by competition between processors for milk and the ability to fulfil domestic and global demand for products.

Movements in both costs and farmgate prices vary across states, due to differing climatic conditions and the degree to which dairy products in that particular state are sold into export markets versus the domestic market.

While profitability is highly volatile and varies by region and farmer, no long term negative trend is observable. In particular, the charts below (and in *Appendix 4*) indicate there are no significant trends or movements in farmgate prices or profitability which can be linked to private label milk moving to \$1 per litre in 2011. Further charts relating to the ACCC's analysis of farmers' profits can be found in appendix 4.

Victoria, southern NSW, Tasmania and South Australia

As discussed in chapter 3, farmgate prices in Victoria/southern NSW, Tasmania and SA are strongly correlated with global commodity prices, which reflect global supply and demand conditions.⁴⁴ The movements in farmgate price against movements in global commodity prices can be seen clearly in figure 3.1 in chapter 3. Movements in global commodity prices are predominantly driven by worldwide factors, such as drought in major dairy exporting countries, trade bans, changes in farmer subsidies in other countries, and increased demand due to increases in economic prosperity.

As a result, farm profitability in these regions is strongly correlated with movements in the farmgate price, which in turn are correlated with movements in global commodity prices. This is shown in Figures 31 to 33 in appendix 4, where periods of high profitability coincide closely with periods of high farmgate and commodity prices. Importantly, in these regions we see no observable impact on profitability, farm exits, or milk production following the introduction of \$1 per litre drinking milk in 2011.

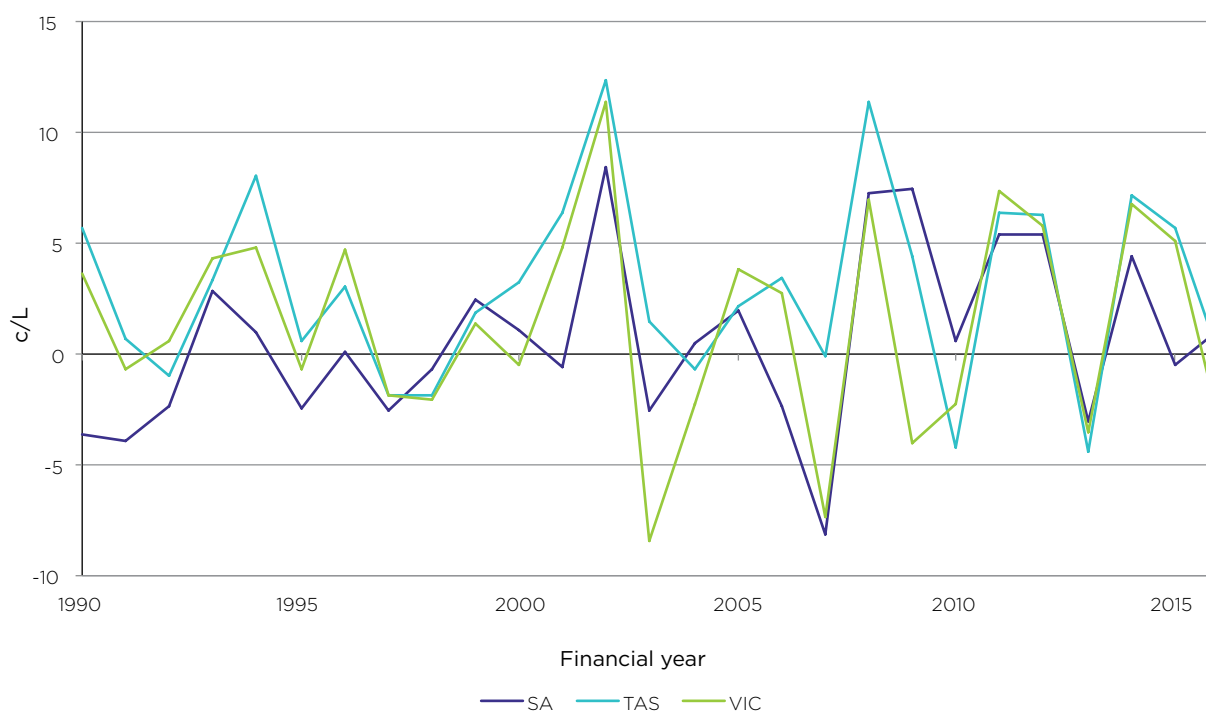
Farm exits have continued to trend down (Figures 19, 20 and 21 in appendix 4). Farm profitability has shown a similar level of volatility with no observable trend up or down (figures 7, 12, 13, 14 in appendix 4) and milk production has remained relatively steady at just above six billion litres per annum (figure 5 in appendix 4). As discussed, the pass-through pricing mechanism of private label milk contracts means there is no direct impact on farmgate prices from \$1 per litre drinking milk.

Farm exits in these regions tend to peak following periods of low pricing, with limited entry encouraged during periods of price increases. The total number of exits has been trending down since deregulation and the total number of farms has stabilised since around 2012.

43 See chapter 3, figures 3.1 and 3.2.

44 This is discussed in more detail in chapter 3.

Figure 6.17: Farm profits over time, SA, Tasmania and Victoria, real terms (2016 dollars)



Source: ABARES data, ACCC analysis

Western Australia, Queensland and northern NSW

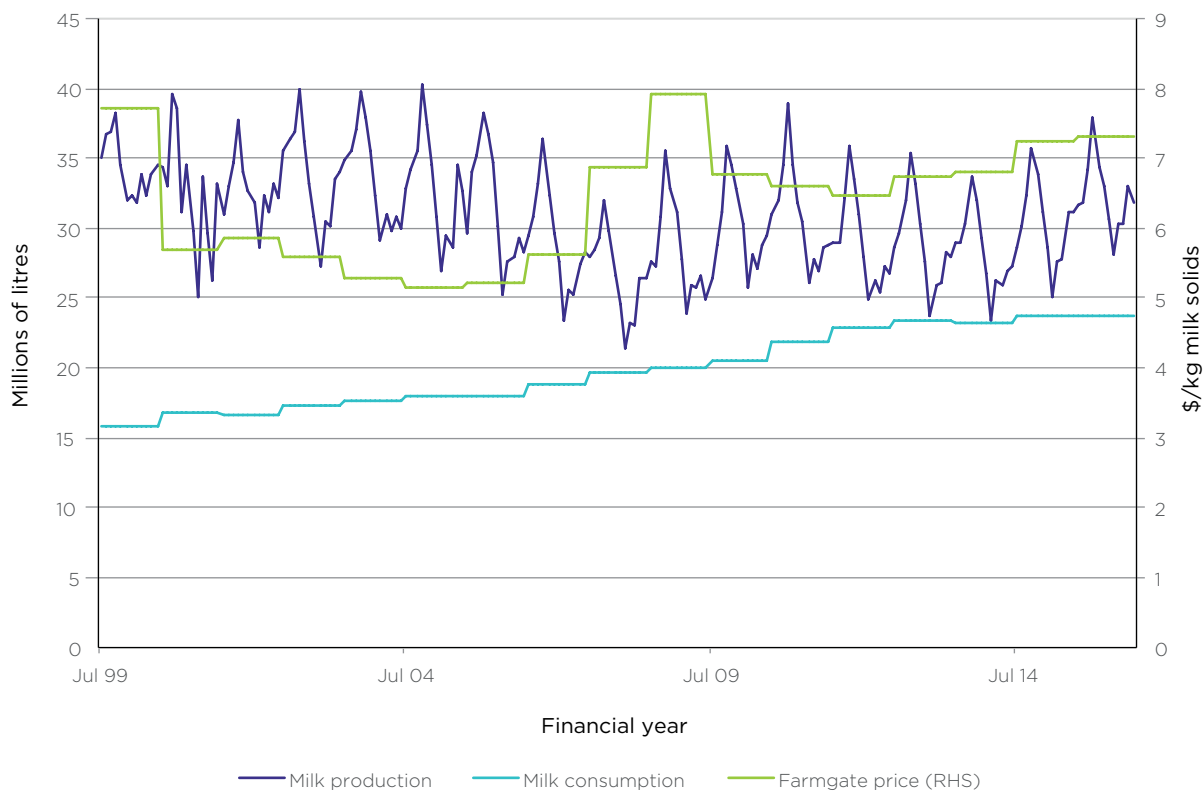
In WA, Queensland and northern NSW, demand is driven predominantly by the domestic consumption of drinking milk, as products in these regions are rarely exported. In these regions, farmgate prices are a reflection of the state of competition between processors, overall domestic demand for raw milk and the relative bargaining positions of farmers and processors. There is no observable correlation between changes in farmgate prices and movements in the retail pricing of drinking milk.

In both Queensland and WA, processors quickly decreased the farmgate price they offered for raw milk following deregulation. This encouraged a large number of marginal farmers to exit the industry and created incentives for the remaining farmers to improve their productivity.

Prior to deregulation, government subsidies meant that raw milk prices on average were too high in high cost regions to accurately reflect local demand. As a result, excess milk was produced and this was converted into products for export or non-perishable domestic consumption. Following deregulation, it was no longer economically feasible to convert excess milk production in these states into non-perishable products and overall production needed to decrease to a point where it could fulfil the required level of domestic demand that the market was willing to pay for.

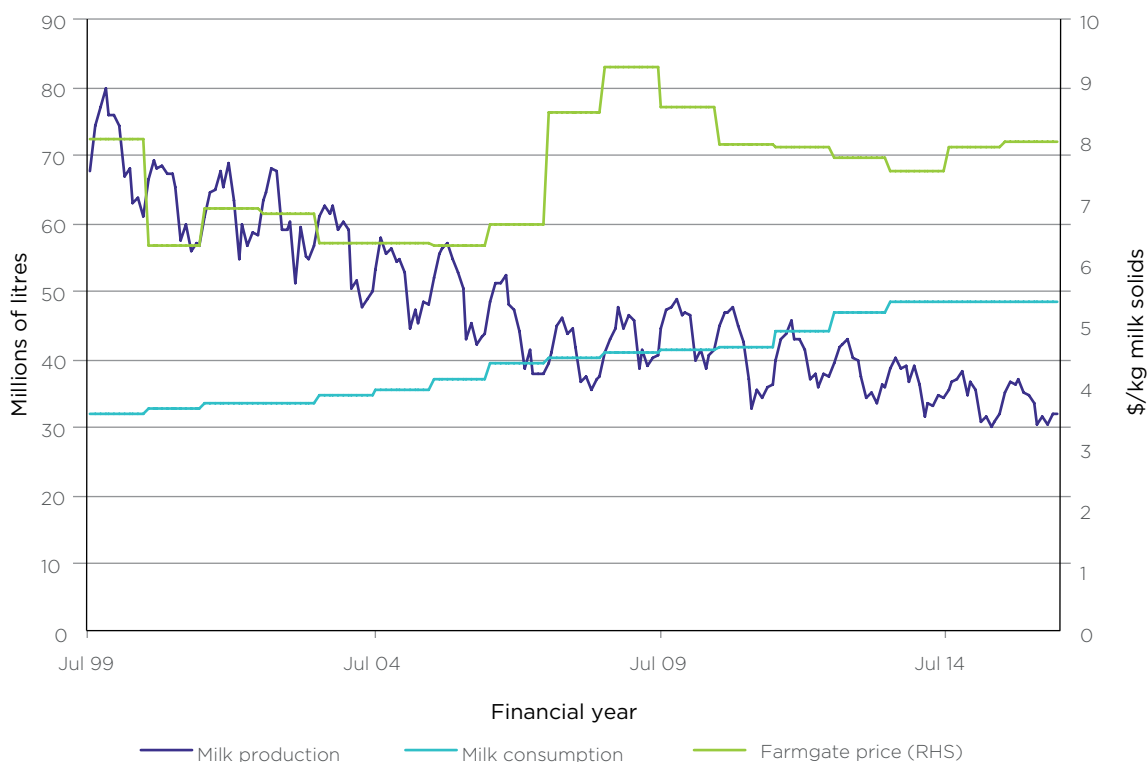
However, at the same time that processors were encouraging some farmers to leave the industry and to reduce the volume of raw milk, milk consumption in both states grew, due mainly to increases in population. In around 2007-08, raw milk production in both states began approaching the minimum levels required to keep up with demand. At this point in time processors increased the farmgate price substantially to encourage an increase in milk production. These effects are shown in figures 6.18 and 6.19.

Figure 6.18: Production and consumption of milk in WA against farmgate milk price, real terms (2016 dollars)



Source: Dairy Australia data, ACCC analysis

Figure 6.19: Production and consumption of milk in Queensland against farmgate milk price, real terms (2016 dollars)



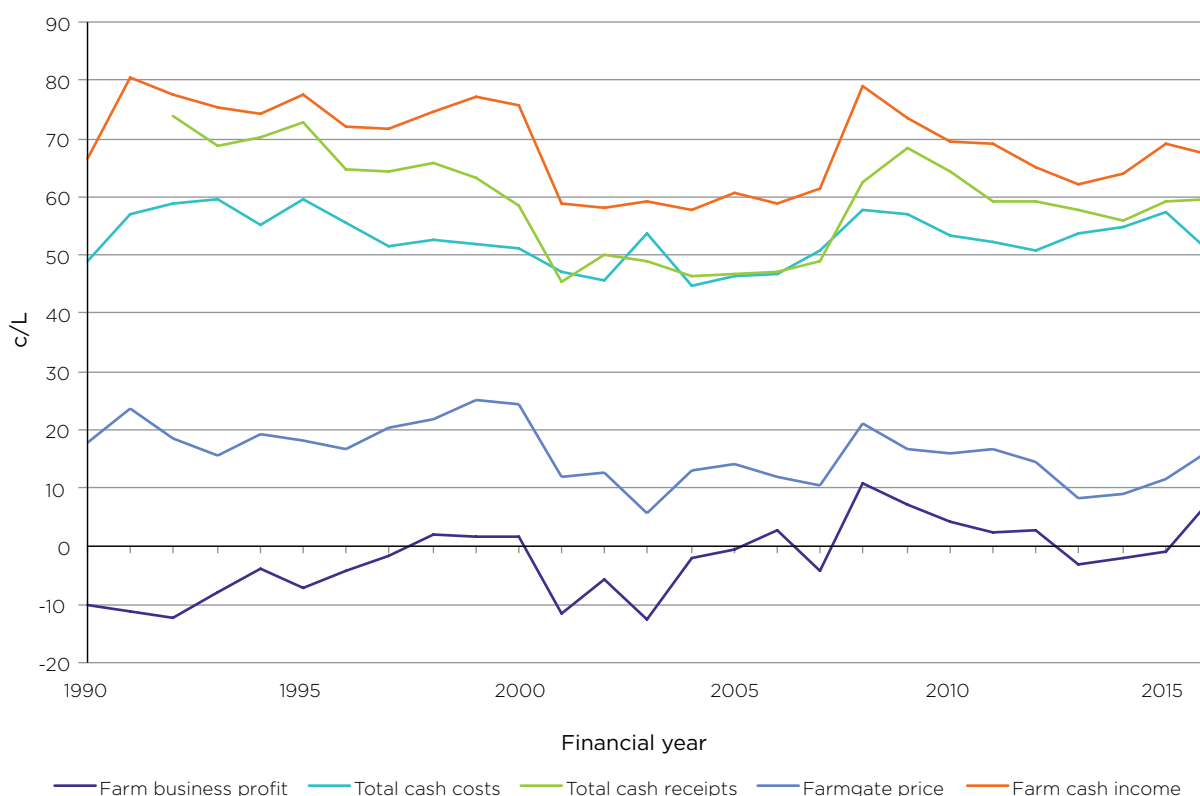
Source: Dairy Australia data, ACCC analysis.

This rise in prices reduced farm exits, increased the profitability of farmers and sparked an increase in production in Queensland from 2007 until 2009 and in WA from 2008 until 2011. From this point in time, milk production, demand and farmgate pricing trends in each state began to differ.

Queensland farmgate prices and farm profitability from 2009

Milk production in Queensland decreased following a reduction in farmgate prices in 2009. Farmgate prices in real terms in Queensland were at similar levels in 2015–16 as they were in 2010–11. However, in 2011–12 Queensland farmers experienced increased costs and decreased productivity due to dry weather conditions. The combination of weather factors and steady milk prices reduced farm profit margins, as shown in figure 6.20. This trend subsided in 2015–16 as costs decreased.

Figure 6.20: Queensland farm profits over time, real terms (2017 dollars)



Source: ABARES data, Dairy Australia data, ACCC analysis

As can be seen in figure 6.19, this combination of factors has led to a continual decline in raw milk production in Queensland and in 2010–11 supply in Queensland began to fall below demand. Processors in Queensland have been importing raw milk from NSW to make up for this shortfall.

The importation of lower cost raw milk from interstate has impacted farmers in Queensland by reducing demand for Queensland produced raw milk and reducing the farmgate price (relative to the price it may have been had imports not been possible). This has forced some higher cost farmers out of the industry. However, the transfer of raw milk from lower cost regions does not signify a market failure as long as total production (including imports) is enough to meet total demand.

The cost of transporting large volumes of raw milk or processed milk long distances is prohibitive and limits the volume of raw milk that can economically be supplied to Queensland from interstate.⁴⁵ In the long term, based on the evidence seen in this inquiry, the ACCC does not consider it to be likely that processors will switch to importing all or even a majority of their raw milk requirements from outside Queensland.

⁴⁵ This is discussed in more detail in chapter 5.

WA farmgate prices and farm profitability since 2009

WA exhibited year-on-year growth in raw milk supply from 2009. As production levels comfortably accounted for demand, WA processors subsequently reduced farmgate prices until 2014, when raw milk supply again fell to the point where it only just covered demand in summer months (see figure 6.18). Processors increased farmgate prices once again in 2012–13. Milk supply increased from 2012–13 to 2015–2016, where the ACCC’s farmgate price and consumption data set ends.

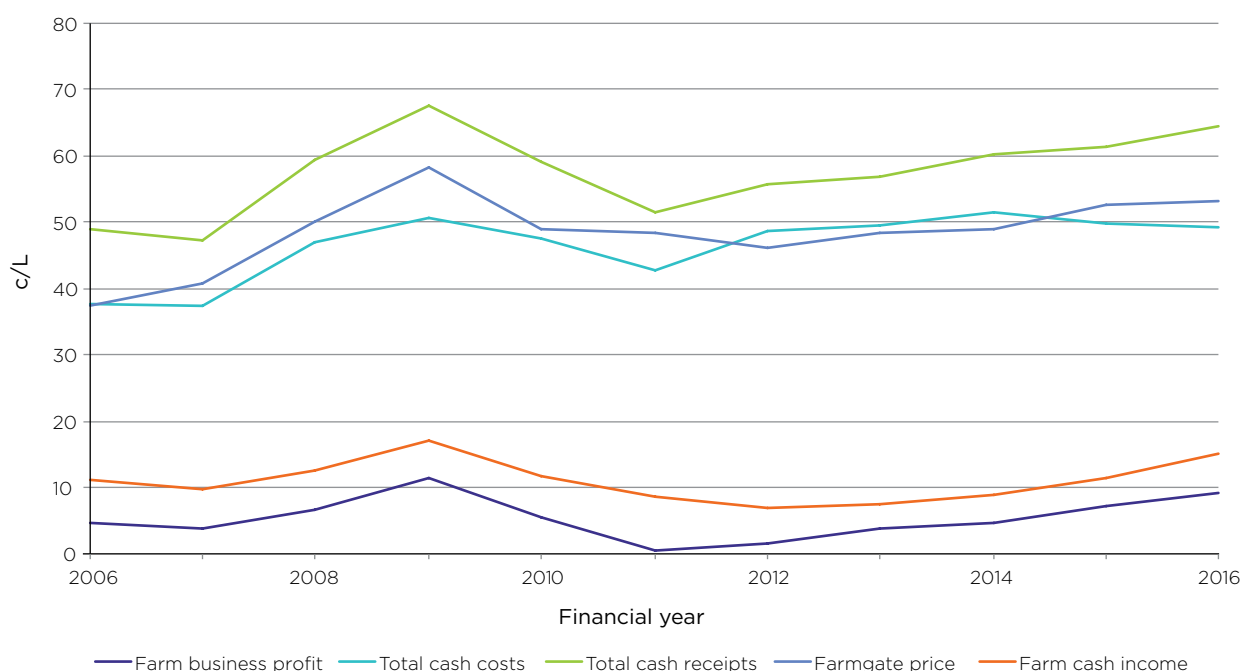
It is likely that pricing trends in WA differ to Queensland because of its distance from east coast markets, and the significant extra cost involved in importing milk from interstate.

The ACCC is aware that since 2015, population growth in WA has stagnated. Given long term consumption trends, this most likely indicates that demand for milk has also been flat. It is likely that this has led to the oversupply of raw milk in WA (consistent with the trend at the end of figure 6.18). This is consistent with reports that the ACCC has heard about reduced farmgate prices and an oversupply of milk in the state. It is also consistent with evidence from processors over this period, which indicates that they had substantial excess raw milk supply which was converted into products such as cheese that made a net loss.

All of the information available to the ACCC indicates that farmgate prices in WA are driven primarily by demand for dairy products in that state (which is predominantly drinking milk), rather than movements in retail pricing or the profitability of supermarkets and processors.

Figure 6.21 shows that the average farmer in WA has experienced increasing profitability at times when farmgate prices have increased. Particularly since 2012, cash costs for farmers in WA have been relatively stable and increasing demand for raw milk between 2012 and 2016 has seen higher returns.

Figure 6.21: WA farm profits over time, real terms (2017 dollars)



Source: ABARES data, Dairy Australia data, ACCC analysis

6.8 Conclusion

6.8.1 The distribution of profits reflects bargaining power

The data and information available to the ACCC indicates that the margins earned by farmers, processors and supermarkets are reflective of their relative bargaining positions in the industry.

For domestic dairy supply, supermarkets have superior bargaining power in negotiations with processors. Supermarkets use their bargaining power with processors to maintain their margins, despite lowering retail prices. This is particularly evident in relation to private label milk, where wholesale prices have been approaching average costs of production. As detailed in chapter 2, the ACCC does not currently consider that the bargaining power imbalance between supermarkets and processors required any intervention beyond the Food and Grocery Code of Conduct.

It is in the supermarkets' interest to maintain healthy competition between processors as this competition is in part responsible for the ability of the supermarkets to extract low wholesale prices. As margins on private label milk contracts are already very thin, it is unlikely that supermarkets will seek to push processors' margins much lower and risk processors exiting this segment.

The poor bargaining position of dairy farmers relative to processors means that processors are able to capture a larger share of the value created by farmers. This is discussed in detail in chapter 2.

However, the ACCC's analysis does not suggest that increasing the retail price of private label milk would substantially change outcomes for farmers. Instead, the immediate impact would be to increase supermarket margins. Consumers would therefore be worse off, but would likely continue to buy similar amounts of milk. Supermarkets would continue to use their bargaining power to negotiate low wholesale prices for private label milk and processors would not see a change in their margins. Even if processors were able to negotiate higher wholesale prices with supermarkets, farmers would be unlikely to capture any of this margin unless they could improve their bargaining position.

6.8.2 Future milk production outcomes

The industry may have reached a point where wholesale prices of private label milk cannot be further reduced and farmgate prices in the Northern and WA regions are just high enough for farmers to supply the volumes demanded by processors.

There is conjecture about the long term viability of sourcing milk from high cost regions. Some domestic focused processors expect volumes and prices for the supply of white milk to non-grocery customers to continue to fall. In regions where the cost of raw milk is already high relative to wholesale prices, it is difficult for processors to supply customers profitably. This situation would be especially challenging for a processor without a private label contract and the associated volumes.

The domestic focused processors are therefore under pressure to reduce costs. One processor speculated that profitable supply of fresh drinking milk to customers in high cost regions may eventually require sourcing milk from farms in lower cost regions. However, this remains speculation until their cost-reduction measures have had time to play out.

The profitability of sales in a region will influence the number of processors that region is able to viably sustain. Finally, the number of processors in a region directly influences the extent of competition for raw milk which directly influences farmgate prices.

7. Contracting practices

Key Points

- Milk supply agreements are favourable to processors and reinforce farmers' poor bargaining position.
- Many farmers are not well informed about the terms and conditions in their supply contracts with processors.
- Following the introduction of business-to-business unfair contracts terms (UCT) laws in 2016, several processors revised their milk supply contracts. However, some terms in supply agreements for the 2017–18 season have the potential to breach the UCT laws. The ACCC's consideration of these is ongoing.
- Contract termination notice periods and automatic rollover clauses impede farmer switching and increase the bargaining power imbalance between farmers and processors. Long notice periods result in farmers not having access to pricing and contract information that they need to make informed and timely supply decisions before the notice period deadline.
- There is need for a cost effective dispute resolution process in the industry. The establishment of an independent body to manage disputes that arise under contracts between farmers and processors would provide farmers with a simple avenue to resolve disputes.

7.1 Introduction

The approach to contracting between dairy processors and farmers in many ways reflects the history of the industry. The industry evolved with most processors operating as cooperatives, and milk supply agreements reflected this. Some terms in modern contracts still assume processors will make decisions in the best interests of their farmers. However, most processors are no longer cooperatives, and the interests of farmers and processors often do not align.

In some regions, milk supply agreements have traditionally been informal, and even based only on a 'handshake'. A farmer at the Warrnambool forum told the ACCC that he had supplied Murray Goulburn for over 30 years and had never signed a contract. This was typical of many farmers who the ACCC consulted. These historical factors heavily influence modern contracting practices in the industry.

The interim report examined the ways that contracting practices and terms can be detrimental in terms of transparency, competition or the appropriate allocation of risk between processors and farmers, as well as their potential to raise concerns under the UCT laws.

This chapter provides the ACCC's conclusions on these issues, taking responses to the Interim Report into account.

7.1.1 Feedback on the interim report

Complexity/transparency of contracts

- Farmers reiterated that contracts are long, complex and often difficult to interpret.
- Many farmer groups supported the ACCC's interim recommendation that all farmers should sign written contracts.¹ Some processors disagreed with this:
 - one processor noted it would place an undue administrative burden on farmers and processors, and could result in farmers losing collection of their milk if they failed to sign the contract²
 - one processor suggested that a requirement to have signed contracts with farmers will result in compliance obligations on processors that lie outside of their ability to control. This is because some farmers do not wish to (and would not) sign the contract.

1 United Dairyfarmers of Victoria Wannon, *UDV Wannon Branch Submission to the ACCC Interim Report of the inquiry into the Australian Dairy Industry*, 24 January 2018, p. 2; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 3.

2 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 2.

- Many stakeholders agreed with our interim recommendation that contracts should be simplified and more transparent,³ but noted it is important that farmers are provided with enough information to enable them to run their businesses.⁴
- Farmer groups noted our finding that given the large monetary value of supply contracts, farmers should obtain legal or financial advice. However, most of these groups submitted they are not in a position to provide farmers with legal or financial contract advice, as they do not have the resources or expertise.⁵

Unfair contract terms

- Some farmer groups submitted the UCT laws should be reviewed as they do not currently apply to all dairy farmer contracts.⁶

Notice termination periods

- Some processors disagreed with our interim finding that long notice termination periods restrict farmer switching. They submitted for some processors, these are necessary to manage milk supply volumes to meet long term fresh milk contracts.
- Some processors also submitted the notice termination periods in their contracts are not used in practice, and that farmers rarely are required to give as much notice as the contract states.

Dispute resolution

- Stakeholders generally supported the recommendation that the industry establish an independent body to manage disputes between farmers and processors, so long as it is low cost and easily accessible.⁷
- Farmer groups submitted that the model used by Grain Trade Australia or the Horticulture Code Mediation process could be appropriate templates to utilise.⁸
- Fonterra supported the establishment of a body to manage disputes under a mandatory code, but submitted it should not review disputes unrelated to the code, such as contractual disputes.⁹

3 Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, pp. 1–2; SA Dairyfarmers Association Inc., *SADA Response to the ACCC Interim Report into the Dairy Industry in Australia*, 6 February 2018, p. 2.

4 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 2.

5 NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, pp. 12–13; Tasmanian Farmers and Graziers Association, *Submission to the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 4; Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, p. 4.

6 Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 2; Farmer Power, *Comments on the ACCC Interim Report on the Australian Dairy Industry*, 23 February 2018, p. 8.

7 United Dairyfarmers of Victoria Wannon, *UDV Wannon Branch Submission to the ACCC Interim Report of the inquiry into the Australian Dairy Industry*, 24 January 2018, p. 3; Farmer Power, *Comments on the ACCC Interim Report on the Australian Dairy Industry*, 23 February 2018, pp. 7–8; Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, pp. 3–4; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 3; Dairy Farmers Milk Co-operative Limited, *Dairy Farmer Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, 23 February 2018, p. 2.

8 WA Farmers, *Submission to ACCC Dairy inquiry interim paper*, 7 February 2018, pp. 5–6; NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, p. 12; SA Dairyfarmers Association Inc., *SADA Response to the ACCC Interim Report into the Dairy Industry in Australia*, 6 February 2018, p. 25; Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, pp. 3–4; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 3; Dairy Farmers Milk Co-operative Limited, *Dairy Farmer Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, 23 February 2018, p. 2.

9 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 4.

7.1.2 The differing nature of supply agreements

There is a wide range of supply agreements in the industry. The nature of contracts typically varies by supply region, and sometimes within particular regions:

- Farmers in export focussed regions primarily operate on Supplier Handbooks, where farmers do not have a signed contract and supply processors under the conditions of a Supplier Handbook.
- Farmers in domestic focussed regions typically enter into contracts with a specified duration. These contracts sometimes have a fixed price for all or part of milk supplied (subject to quality and incentive adjustments). Such contracts are often for one, three or five year periods, although the ACCC is aware of a very small number of 10-year contracts.

There was some confusion in the industry that Supplier Handbooks and other documents that do not require a signature are not formal contracts. A contract is an agreement made between two or more parties that is legally enforceable. It can be oral or in writing, with or without a signature. A contract arises where one party makes an offer and the other party communicates an intention to accept it. It is possible to accept a contract by action (such as commencing the performance of obligations under the contract). The ACCC therefore considers that a Supplier Handbook and any accompanying documents that make up the terms and conditions of the agreement, such as milk quality guidance, are all part of the contract between the farmer and processor.

7.1.3 Examples of terms of concern

The ACCC examined past and current milk supply agreements.

Set out below is a snapshot of historical terms that the ACCC considered could cause significant detriment to farmers if they were relied upon, depending on the circumstances. Some of these terms were amended in 2017–18 season contracts, while others were not. These terms, and a number of other issues, are discussed throughout this chapter.

Box 7.1: Terms of concern in past contracts

Following issues raised by farmers and the ACCC's review of past season contracts, the ACCC identified a number of terms in some processor contracts with the potential to cause significant detriment to farmers. These include terms which:

- allow for unilateral variation of the price paid to farmers (including retrospective price decreases), particularly in multi-year contracts
 - For example, a term may provide that the processor 'may, at its discretion but acting reasonably, vary (including reduce) the Opening Price at any time provided that [processor] gives the Supplier at least 10 Business Days prior notice of any reduction in the Opening Price.'
- broad terms allowing unilateral changes to a Supplier Handbook, particularly with respect to price and quality requirements
 - For example, a past term may allow a processor to 'update the Handbook when necessary.'
- allow for bonuses or other payments to be withheld if farmers do not continue to supply a processor into a new contract period.
 - For example, a past term states that 'The Growth Incentive is paid on Qualifying Milk Solids following the completion of the financial year..on or around 15 August 2017. To receive the Growth Incentive payment, the Supplier must..be actively supplying MG at the time the payment is made.'
- require significant notification periods (often well ahead of the provision of any pricing information) before a farmer can terminate a contract with a processor.
 - For example, one processor had a 12-month termination period.

The ACCC also found that many contracts did not include dispute resolution provisions. As discussed below, this can be detrimental to farmers and reinforce their bargaining disadvantage.

7.1.4 The Voluntary Code

The Code of Practice: For Contractual Arrangements between Dairy Farmers and Processors in Australia (the Voluntary Code), commenced on 30 June 2017. The Voluntary Code is administered by Australian Dairy Industry Council (ADIC). The ACCC did not have a role in the development of the Voluntary Code and does not have any compliance or enforcement functions in relation to it.

The Voluntary Code is discussed in more detail in chapter 9.

7.2 Supply agreements are complex and often governed by multiple documents

The form and content of many milk supply agreements is complex, resulting in poor transparency for farmers. This is illustrated by the fact that supply terms are often set out in multiple and lengthy documents, which makes them difficult to interpret.

Importantly, the pricing components of contracts typically involved multiple variables and conditions. These issues were exacerbated by various other contract terms which acted as barriers to switching for farmers.

7.2.1 Industry feedback

Farmers and farmer representative groups raised concerns that supply agreements are overly complex and difficult to interpret. For example:

- Farmer Power argues that ‘Contracts are deliberately complex so that price transparency is avoided’¹⁰
- a farmer at the Shepparton forum argued that the length of contracts made them difficult to interpret
- the WA Collective Bargaining Group submitted ‘We note that processor contracts being offered to farmers are significantly different from what they were in the past with more complexity and less transparency.’¹¹

Farmers also indicated that the range of price components can make contracts difficult to understand and compare. This issue is discussed further in chapter 3.

Lion submitted that it recently ‘substantially amended and simplified’ its general terms of milk supply, including providing a ‘cover note setting out a plain English explanation of key terms.’¹² The ACCC’s analysis demonstrated that some other processors also used ‘plain English’ Supplier Handbooks, but these documents were still lengthy, which can make interpretation difficult. Processors indicated they use field officers to explain the details of contracts to farmers in person.

7.2.2 The form of contracts

In many cases, agreements consist of multiple documents. Terms and conditions, including price information, can be set out in:

- a Supplier Handbook—typically includes the majority of terms and conditions that govern an overall supply agreement. It does not generally include the processor’s farmgate milk price, which is usually provided to farmers in an Opening Price Letter:
 - A Supplier Handbook arrangement does not generally require a farmer to sign an agreement.
 - A Supplier Handbook applies to a large number of farmers and is not specific to an individual farmer.
 - Approximately 60 per cent of farmers supplying major processors operate under the terms of a Supplier Handbook.
 - A Supplier Handbook includes detailed terms and conditions, including on price components and quality requirements.

10 Farmer Power, *Submission to ACCC’s Inquiry into the Australian dairy industry*, December 12, pp. 4–5.

11 Western Australia Collective Bargaining Group, *Submission to ACCC’s Inquiry into the Australian dairy industry*, 12 December 2016, p. 3.

12 Lion Dairy and Drinks, *Submission to ACCC’s Inquiry into the Australian dairy industry*, 12 December 2016, p. 9.

- a Milk Supply Agreement—a formal written contract:
 - The existence of a Milk Supply Agreement generally indicates the contract has a fixed duration.
 - A Milk Supply Agreement may contain supplementary terms not commonly found in a Supplier Handbook, for example, terms relating to a financing arrangement.
 - Approximately 40 per cent of farmers supplying major processors are on Milk Supply Agreements or similar fixed duration contracts.¹³
- an Opening Price Letter—an Opening Price Letter is sent to farmers in mid-late June or early July and usually provides the processor's opening farmgate milk price, projected end year farmgate milk price and monthly price schedule for that dairy season:
 - An Opening Price Letter may also contain brief commentary on the global market conditions forecast for the coming year.
 - Further correspondence may be sent during the season to notify farmers about any price step-ups.

One or more of the documents typically governs a milk supply agreement, and in many cases, all three will apply. Where multiple documents apply, they typically refer to one another, and provide a priority order for the documents where a conflict may exist.

Box 7.2: Murray Goulburn 2016–17 Supplier Handbook (case study)

The Murray Goulburn 2016–17 Southern Milk Region Supplier Handbook is a 68-page document that provides a wide range of information and terms and conditions to farmers. The document also references a range of other documents that may apply, such as:

- additional terms (if any) as agreed in writing between Murray Goulburn and the supplier
- a Milk Supply Agreement Details document
- the Flat Milk Incentive Election Form, and
- Opening Price Circular.

A priority order for considering these documents is included in the Supplier Handbook.

The Supplier Handbook has nine chapters, and the core terms that govern the arrangement between processor and farmer are in the last chapter, which commences at page 47. This chapter includes a number of critical terms, including, among others, those relating to exclusivity, the payment of incentives, milk collection, Murray Goulburn's ability to alter the price paid for raw milk and amend other terms, risk and title, confidentiality and termination.

The milk payment system is explained in chapter 3. Elements contributing to the price paid to farmers include the base price, any applicable step-ups or step-downs, a Flat Milk Incentive, a Growth Incentive, a Productivity Incentive, volume and collection charges and quality deductions. However, information about the actual milk price to be paid to farmers (such as the opening farmgate milk price) is contained in the separately provided Opening Price Circular.

The case study shows the complicated and detailed nature of supply agreements. The complexity of these terms is an issue because they affect clarity regarding factors that influence farm income. Contracts across processors are also not uniform in structure or terminology, making it difficult for farmers to compare contracts.

7.2.3 Informal approaches to contracting

It is evident that many farmers are not fully aware of the terms and conditions of the contracts that apply to them. For example:

- a number of farmers contacted the ACCC about multi-year agreements they had entered with Murray Goulburn after its change of ownership structure in 2015. These agreements were tied to share offerings, but some farmers were unaware that they had entered three-year supply agreements.

¹³ The ACCC notes that many of this 40 per cent will also be subject to the terms and conditions of a Supplier Handbook.

- a farmer at the Traralgon forum said that in Victoria most farmers do not sign written agreements and that until the 2016 step-downs, many were unaware that processors could retrospectively step-down the farmgate milk price.

The average value of a supply contract in 2015–16 was just under \$700 000.¹⁴ The ACCC's view is that contracts of such significant value should be carefully considered before they are entered into, but understands that in general, many farmers do not seek professional legal or financial advice before agreeing on supply terms.

Further, farmers told us that contract documents are often provided to them at different times, and sometimes after the season has commenced. Such practices make it difficult for farmers to receive advice and understand their contracts before a season commences.

To address these issues, the ACCC considers steps need to be taken by both farmers and processors:

- processors should simplify their contracts to make the key terms clearer and in general more accessible, to their suppliers
- processors should provide farmers with all contract documents simultaneously and with sufficient time to consider them before the season or contract term commences
- farmers and farmer representative groups should more actively engage with and embrace formal contracting practices
- farmers should read their supply agreements each season, and seek financial and legal advice as appropriate.

The Senate Inquiry raised concerns that individual farmers do not receive sufficient legal advice on contracts. The Committee queried what ADF and state associations do to provide farmers with that basic level of assistance.¹⁵

Most farmer representative groups submitted to the interim report that they do not have the resources or expertise to provide farmers with legal or financial contractual advice.¹⁶ Nevertheless, contractual issues can significantly impact farmers' operations, and understanding these at a general level should be a priority for all farmer representative groups.

The ACCC considers that farmer groups should, where necessary, commit resources to acquiring the necessary assistance and developing the expertise to provide broad guidance about how common contract terms generally operate and how these can impact farm income. This could include assistance in identifying emerging contracting trends and encouraging farmers to obtain specialist legal and financial advisers.

Farmers' awareness and understanding of contracts would also increase if they are required to sign or acknowledge a Milk Supply Agreement or Supplier Handbook. Farmers are more likely to read the contracts they are provided each season if they must formally acknowledge them. This would not require farmers to enter into fixed term contracts, but could include a signature page in the most primary document of a farmers contract (e.g. the Supplier Handbook) to be signed to signify a farmer's acceptance of the agreement.

One processor suggested this would create an undue administrative burden on both parties and that some farmers will not sign the contract.¹⁷ The ACCC considers requiring farmers to sign or formally acknowledge a contract once a year (or less often for multi-year contracts) is not unreasonable, and that the industry will adapt to signing and returning contracts to processors. It will be farmers' responsibility to sign or acknowledge the contract, and processors' responsibility to keep a record of this.

14 This estimate is based on the following 2015–16 Dairy Australia figures: Average herd size of 273 cows, average per cow production of 5669 litres per annum and an average price of 44.9 cents per litre. Dairy Australia, *Dairy in Focus*, 2016, <https://dairyaustralia.com.au/publications/australian-dairy-industry-in-focus-2016?id=4801EB12663D4FDF93150963BE85B614>. The average annual farm income varies greatly across farms and regions.

15 Senate Economics Reference Committee, Parliament of Australia, *Australia's dairy industry: rebuilding trust and a fair market for farmers*, (2017), p. 40.

16 NSW Farmers, *Submission on the ACCC Dairy inquiry interim report*, 7 February 2018, pp. 12–13; Tasmanian Farmers and Graziers Association, *Submission to the ACCC Dairy inquiry interim report*, 7 February 2018, p. 2; United Dairyfarmers of Victoria, *Submission to ACCC interim report into the dairy industry in Australia*, 7 February 2018, p. 4; Dairy Connect Ltd, *Australian Competition and Consumer Commission's Interim Report into the Dairy Industry*, 31 January 2018, p. 4.

17 Fonterra Australia Pty Ltd, *Inquiry into the Australian Dairy Industry—Submission in response to the Interim Report*, 31 January 2018, p. 2.

7.3 ACCC consideration of potential unfair contract terms

7.3.1 About the unfair contract terms laws

The small business unfair contract term laws (UCT laws) were introduced to assist small businesses and farmers that may have limited bargaining power, by declaring void any UCTs in standard form small business contracts. To be a “small business contract”, at least one party to the contract must employ fewer than 20 persons and the upfront price payable under the contract must not exceed \$300 000 or, if the contract has a duration of more than 12 months, \$1 000 000.¹⁸ The vast majority of supply agreements are standard form, involving no negotiation of terms.

The UCT laws apply to a standard form small business contract entered into or renewed on or after 12 November 2016.¹⁹

To be unfair, a term must cause a significant imbalance in the parties’ rights and obligations under the contract and cause detriment (financial or otherwise) to a party if it were to be applied or relied upon.²⁰

A term will not be unfair where it is reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term.²¹ A court must consider the contract ‘as a whole’ when determining whether a term is unfair.²²

Where a term is found by a court to be unfair, it is void and unenforceable. The contract will continue to bind the parties if it is capable of operating without the unfair term. The identification and removal of unfair terms therefore increases the fairness of the affected contracts.

UCT laws do not require that the term has caused detriment to be unfair, it is sufficient that the term would cause detriment if it were to be applied or relied on.

7.3.2 The application of the unfair contract terms laws

There has been some uncertainty in the dairy industry about the application of UCT laws to supplier agreements. Separately from this inquiry, the ACCC is considering potential unfair contract terms in a number of milk supply agreements, including the extent to which those milk supply agreements meet the business size and transaction value thresholds.

A number of processors indicated they reviewed and revised their contracts after the UCT laws commenced. For example:

- Murray Goulburn submitted it ‘has already undertaken a comprehensive review of the Standard Milk Payment Terms for compliance with the Unfair Contract laws which came into effect on 12 November 2016.’²³
- Fonterra Australia submitted it has ‘has reviewed and amended its Handbook in preparation for the commencement of the new unfair contract laws.’²⁴

Further, the Voluntary Code has ‘been agreed to address a number of issues with dairy contracts under the Australian Consumer Law, Unfair Contract Terms (small business contracts) laws which came into effect on the 12th November 2016.’²⁵

The ACCC acknowledges the UCT laws will not assist farmers where certain beneficial terms are left out of a contract. In this instance, a code of conduct is well placed to require that certain terms should be included in a contract. For this reason as well, the UCT laws are unlikely to address all contracting issues in the industry which have the potential to frustrate transparency of key trading terms or inappropriately transfer risk from processors to farmers.

18 *Competition and Consumer Act 2010* (Cth), s. 23(4).

19 *ibid.*, s. 290A.

20 *ibid.*, s. 24(1).

21 *ibid.*, s. 24(1).

22 *ibid.*, 24(2)(b).

23 Murray Goulburn Co-operative Co. Limited, *Submission to ACCC’s Inquiry into the Australian dairy industry*, 12 December 2016, p. 10.

24 Fonterra Australia Pty Ltd, *Submission to ACCC’s Inquiry into the Australian dairy industry*, 12 December 2016, p. 9.

25 Code of Practice: *Contractual Arrangements between Dairy Farmers and Processors in Australia*, p. 3.

7.3.3 Analysis of potential unfair terms

The ACCC's review of 2017-18 season contracts found that processors removed or altered a number of terms which could cause concern under the UCT laws, including terms relating to retrospective step-downs and loyalty bonuses.

However, the ACCC continues to consider the potential for some terms in a number of supply agreements for the 2017-18 season to be unfair. These include terms relating to:

- the unilateral variation of contract terms and conditions, including:
 - step-downs to the price paid to farmers
 - changes to Supplier Handbooks
- notice periods, in which farmers are required to make a decision about terminating or renewing an agreement when having very limited price and other contract information
- broad or one-sided indemnities
- terms that restrict farmers from selling, transferring or leasing their farms
- excessive penalties for contract termination
- one-sided termination rights.

The ACCC's consideration of possible unfair terms necessarily occurs in the context of the contract as a whole and the balance of risks faced by the contract parties.

7.4 Potential effects of notice periods and 'rollover' clauses

This section primarily considers the potential impact of notice periods in three contexts:

- Milk Supply Agreements with a fixed term (typically one, three or five years) that contain an automatic 'rollover clause', which means that the agreement will continue for a further fixed term at the end of the initial term unless either party gives notice otherwise.
- Milk Supply Agreements with a fixed term and without an automatic 'rollover clause', where the processor gives notice to the farmer in advance if it does not intend to enter into a further Milk Supply Agreement.
- Milk Supply Agreements without a fixed term but that continue until the farmer or processor gives notice to the other that the agreement will come to an end (ongoing Milk Supply Agreement).

In these contexts, the length of time required between the notice and the end of the Milk Supply Agreement (**notice period**) can impede farmers' ability to make an informed and timely choice of processor. The amount of notice that a farmer must provide to a processor in these contexts is referred to below as the 'farmer notice period'. The amount of notice that a processor must provide to a farmer is referred to below as the 'processor notice period'.

The length of notice periods varies across the industry. In southern states, where the majority of farmers operate on Supplier Handbooks, farmers are free to switch processors at any time. Examples of the diversity of the length of notice periods in Milk Supply Agreements include:

- DFMC, which requires its members to give 90 days' notice of their intention to change supply arrangements, which can end on or after the contract end date²⁶
- Brownes, whose contracts generally impose a 12 month termination notice requirement on both parties²⁷
- a number of other contracts which contain three and six month notice periods which are reciprocal, meaning either party must provide three or six months' notice before exiting the contract.

Some further examples of notice periods are discussed below.

²⁶ Dairy Farmers Milk Co-operative, *Submission to the ACCC's Inquiry into the Dairy Industry (Part 2)*, 12 December 2016, p. 7

²⁷ Brownes Food Operations, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, p. 5.

Box 7.3: Notice period scenarios

Scenario 1—A fixed term Milk Supply Agreement with an automatic ‘rollover clause’, a six month farmer notice period and a six month processor notice period:

- While such a term may appear to have reciprocal rights and obligations, there are significant information asymmetries that balance the term in favour of the processor. This is because the farmer would typically be required to provide notice before 1 April. As pricing information is not generally released by processors until mid-June, the farmer has no information upon which to base a decision to switch processors at the time of giving notice.
- Due to the lack of information available to the farmer at the relevant time, the ACCC considers that the clause does not provide a fair basis on which the farmer must decide on a contract offer.

Scenario 2—An ongoing Milk Supply Agreement with a notice period of 12 months:

- A 12-month processor notice period may benefit a farmer if a processor is ceasing or reducing its acquisition of raw milk.
- However, a 12-month farmer notice period is problematic because the farmer is required to make a decision about the prospects of switching processors significantly before any price or other market information is available.
- The ACCC considers this term involves an excessive farmer notice period.

Scenario 3—An agreement contains a processor notice period of 30 days for a fixed term contract:

- The ACCC has not received evidence of processors on short processor notice periods.
- However, such a term could be highly detrimental to farmers, who may find it difficult to find another supplier in such a short timeframe.

The ACCC considers that the key factor in determining whether a notice period or roll over clause is of concern is the level of information available to the farmer. Where no information is available at the time notice must be given, terms such as these allow processors to shift risk to the farmer, despite them being in a less informed position from which to manage this risk.

Feedback on the interim report has indicated that although some contracts require long notice periods, in practice processors do not require farmers to confirm they are switching processor until days before the commencement of the new season. The ACCC acknowledges this may provide farmers with sufficient time to consider relevant information before confirming they will switch. However, processors could enforce the terms in their contracts.

Farmer notice period clauses could also reduce competition in the market for the acquisition of raw milk, as they represent a barrier to switching between processors by restricting farmers from accessing information about rival offers.

Box 7.4: An alternative to current notice periods

Instead of requiring farmers to provide notice of their intention to switch processor months in advance of the new dairy season, the ACCC considers farmers should be given a set 21 day 'switching period' under a code.

Once a farmer's incumbent processor has made a pricing announcement, as well as providing all contract documents simultaneously by this date, farmers could use the switching period to give their processor notice, even if the last day of the switching period falls after the new season commences. This will give farmers sufficient time to consider prospective contracts, seek advice and evaluate price offers between different processors before deciding to leave or remain with their current processor.

Farmers should be permitted to give notice to cease their relationship with their incumbent processor or confirm they will remain before the switching period deadline.

The ACCC sees this system is beneficial as:

- processors will no longer be able to impose long notice termination periods on farmers on fixed term contracts
- farmers will have sufficient time to make switching decisions based on relevant information despite late opening price announcements
- processors can make opening price announcements when they are ready.

Potential issues include:

- because processors typically announce opening prices on different days, farmers may not have access to competing processors information for the full switching period. Further consideration would need to be given to how such a switching period may operate where, for example, a processor makes a particularly late or early pricing announcement
- if price announcements are made late and farmers switch processor after the new season commences, they may lose potential step-ups and bonuses from the new processor for the number of days they remained with their incumbent processor
- processors would have less certainty of supply. However, of the farmers on fixed term contracts, only a proportion would have the opportunity to switch at the end of each season. Processors can also confirm supply volumes by making pricing announcements as early as possible.

The ACCC considers this concept should be included in a mandatory code of conduct but that the industry should be consulted on the appropriate length of a switching period.

7.5 Dispute resolution

Very few supply agreements for past dairy seasons contained dispute resolution clauses.

For dispute resolution provisions to be effective, they should be fair to all parties, simple to follow and seek to achieve an outcome in a cost efficient and timely manner. Effective dispute resolution can mitigate imbalances in bargaining power, improve transparency and lead to fairer contract terms.

7.5.1 Dispute resolution clauses in supply agreements

Some previous milk supply agreements have included reasonably effective dispute resolution processes. One example provides that:

- If a dispute arises, the party raising the issue will write to the other party to describe the nature of the dispute, the desired outcome and preferred action.
- As a first step, the parties agree to use their best efforts to negotiate a resolution to any disputes.
- If the dispute is not resolved within 28 days of writing to the other party, then either party can require that the parties submit the dispute to mediation. Within 21 days of advising that mediation is required, both parties must agree on the choice of mediator. Mediation must start within 30 days of appointing the mediator.

- Both parties will pay an equal share of the mediation costs and pay their own costs (including legal costs) for attending the mediation.
- If the dispute has not been resolved 60 days after mediation has started, either party can start legal proceedings to resolve the matter.

Nothing prevents either party from seeking an urgent injunction related to the contract. In its submission to this inquiry, the Australian Small Business and Family Enterprise Ombudsman stated, 'To enable industry to deal with disputes in an efficient, timely and low cost manner, alternative dispute resolution clauses should exist in all agreements.'²⁸

The collective bargaining agreements between Parmalat and Premium, and Lion and DFMC, contain dispute resolution provisions. At the forums, members of collective bargaining groups indicated that they value certain aspects of the collective bargaining agreements, particularly the provision for an independent expert to be called in to assess disputes over prices. DFMC also considers the capacity for an independent expert to make a binding decision has been a key factor in the effectiveness of the collective bargaining arrangement.²⁹

Box 7.5: Parmalat-Premium price dispute

Premium is a collective bargaining group consisting of farmers from Queensland and northern NSW who supply raw milk to Parmalat. Premium is authorised as a collective bargaining group by the ACCC until 2020.

During negotiation of the supply contracts for Parmalat's 2017 dairy season, a dispute arose between Parmalat and Premium about the price that Parmalat would pay.

Farmers continued to supply Premium under the terms of the prior agreement pending the resolution of the dispute. As the dispute could not be resolved through negotiation, the matter was referred for expert determination.

In this case, the matter was resolved through the arbitration process. However, the ACCC understands that Parmalat and Premium experienced a number of challenges throughout the dispute resolution process. These included:

- identifying an appropriate individual or body to conduct the expert determination
- the high financial cost of some independent experts or arbiters and the cost of the process more generally
- significant time delays, with the matter not being resolved until August-September 2017.

The inclusion of the dispute resolution process in the collective bargaining agreement provides important advantages.

First, in the absence of the dispute resolution process, Parmalat likely would have set the price at its sole discretion. This is because the vast majority of direct supply agreements involve no negotiation.

Further, for the processor, the dispute resolution framework provides a clear pathway for the resolution of the matter. The fact that the final decision was made by an independent third party is likely to allow for an understanding that the matter was resolved fairly. This may reduce ongoing tensions between processor and farmers.

Resolving disputes in the dairy industry can also be costly and resource intensive due to the lack of established dispute resolution pathways. The ACCC received evidence that alternative dispute resolution, namely arbitration, can be costly for both farmers and processors. This indicates there is a need for an established, cost effective dispute resolution process in the industry.

28 Australian Small Business and Family Enterprise Ombudsman, *Submission to ACCC's Inquiry into the Australian dairy industry* 12 December 2016, p. 2.

29 Dairy Farmers Milk Co-operative, *Submission to the ACCC's Inquiry into the Dairy Industry (Part 1)*, 12 December 2016, p. 7.

Box 7.6: Grain Trade Australia dispute resolution process

The grains industry has a well-developed dispute resolution framework. Grain Trade Australia (GTA) is an organisation established to ensure that commercial transactions across the supply chain occur in an efficient and fair manner for both parties to a contract. One of GTA's core functions is to administer a dispute resolution process. Decisions are made by independent arbiters, rather than GTA itself.

A dispute can only be brought to GTA if there is an arbitration agreement in writing. These are generally contained in a supply agreement, but ad-hoc arbitration agreements can also be formed.

GTA publishes detailed Dispute Resolution Guidelines that set out the procedure when parties are seeking to have a dispute resolved. A complainant who submits an application to GTA can pursue:

- expert determination (not binding)—GTA appoints an independent expert
- fast track arbitration (binding and for claims of less than \$25 000)—GTA appoints an arbitrator
- full arbitration (binding and involves a panel of three arbitrators)—the claimant, respondent and GTA each nominator an arbitrator.

GTA publishes the decisions of arbitrators on its website (removing the parties' identities) to allow industry participants to share in the findings and possibly modify their commercial behaviours as appropriate.

There are vast differences between the grains and dairy industries, particularly given the perishability of raw milk. However, the GTA process exemplifies a well-developed dispute resolution framework that currently does not exist in the dairy industry.

Given the significant imbalance in bargaining power between processors and farmers, the ACCC considers that the industry should develop a dispute resolution process that allows for mediation, arbitration or expert determination, for disputes that cannot be resolved through negotiation. This recommendation in the Interim Report was well supported by the industry. However, the industry has stressed the importance that the process should involve industry expertise and be independent. The ACCC agrees with this feedback.

A dispute resolution process administered by an independent body would provide a simple process for industry participants and ensure that experts have the relevant dairy expertise. This would allow parties to have disputes resolved quickly, and not waste time and money seeking an appropriate dispute resolution service or expert.

The industry would need to give consideration to the most appropriate, cost effective manner for a dispute resolution process. Such a process may not need to be administered full time. For example, a list of independent experts could be compiled and referred to when disputes arise.

In order for the parties to be bound by the outcome of the process, they must be contractually bound to do so. Therefore, contracts between processors and farmers, or established contracts between collective bargaining groups and processors, would need to include a contractual obligation that if a dispute arises, it will be referred to binding dispute resolution (such as the clauses in DFMC and Premium's milk supply agreements).³⁰

The decisions of the independent arbiter or expert, or the outcome of mediation, would also help develop best practice guidance for the industry. This could further reduce the number of disputes that arise over time, lead to fairer contracts, increase transparency and strengthen processor-farmer relationships.

The ACCC considers that the inclusion of effective dispute resolution clauses in contracts should be an obligation under the mandatory code recommended by the ACCC.

³⁰ Dispute resolution would not be possible for collective bargaining groups and processors who have not entered a contractual agreement to negotiate.

7.5.2 Who should be responsible for establishing a dispute resolution process?

The ACCC sought feedback on who should be responsible for establishing and operating the dispute resolution process.

The feedback received by the ACCC indicates there is not an appropriate existing body that could facilitate an effective dispute resolution process in the dairy industry. As such, a new body or process should be established.

The ACCC considers that the industry should progress this recommendation. In particular, ADIC, working closely with the state farmer representative groups and processors, is well-positioned to consult with farmer representative groups and processors to determine the scope and procedure of the dispute resolution process. Industry feedback on the Interim Report indicated some support for a model such as that employed by Grains Trade Australia or that in the Horticulture Code of Conduct.

7.5.3 The Voluntary Code

Section 10 of the Voluntary Code states that:

A contract must include a clause which describes the process on how disputes between the parties to the contract will be managed.³¹

Following the commencement of the Voluntary Code, the ACCC has observed that more milk supply agreements commonly include dispute resolution frameworks. However, some of these are unlikely to be effective. For example, some clauses merely state that the parties can negotiate when a dispute arises. Given the imbalances in bargaining power and resources between processors and farmers, such provisions are unlikely to substantially change current practices.

Further, the Voluntary Code lacks a process for dealing with non-compliance with the Code itself and this would extend to dispute resolution.

³¹ Code of Practice: Contractual Arrangements between Dairy Farmers and Processors in Australia, p. 5

8. Collective bargaining and boycotts

Key Points

- Some collective bargaining groups have worked well in the dairy industry, but this is because they were formed in circumstances that are unlikely to arise often.
- Due to the perishable nature of milk, a collective boycott may be a less effective tool to achieve a better outcome for farmers than in other industries.
- While collective bargaining can be effective, it does not offer a broad remedy to the issues arising from the imbalance in bargaining power between processors and farmers.

This chapter explores the use of collective bargaining in the dairy industry and use of collective boycotts as an alternative tool for achieving outcomes that are mutually beneficial for dairy farmers and processors or other buyers of raw milk.

8.1 Industry feedback on the interim report

Industry feedback on this issue was largely in support of our interim analysis and findings. Stakeholders submitted that collective bargaining:

- can be viable in certain circumstances, despite it not being a widespread remedy to the bargaining power imbalances in the industry¹
- can be challenging and ineffective for many farmers, particularly when processors are not required to negotiate with a CBG²
- is more necessary for farmers in regions where competition between processors is weaker³
- should be strengthened so that the weak are not taken advantage of.⁴

8.2 The role of collective bargaining in the dairy industry

Most individual farmers have little opportunity to negotiate contracts with processors, who instead offer standard form contracts.⁵ As previous chapters have explained, this is due to the imbalance of bargaining power and high transaction costs associated with individual processor-farmer negotiations.

There are also cultural obstacles to farmers negotiating individually with processors. During the inquiry the ACCC heard that some farmers consider it unfair if others have individually negotiated contracts with different prices and conditions, given that the milk collected by the processor is undifferentiated.

The absence of contract negotiations means that many farmers are effectively forced to accept complex contracts that contain potentially unfair terms that are weighted in favour of processors. This can result in farmers being exposed to unreasonable levels of risk without being aware of it, as the events of April 2016 demonstrated.

While collective bargaining has the potential to improve the efficiency of contracting and lead to mutually improved outcomes for both parties, various issues have limited its effectiveness in the dairy industry.

1 Farmer Power, *Comments on the ACCC Interim Report on the Australian Dairy Industry*, 23 February 2018, p. 6; Dairy Farmers Milk Co-operative Limited, *Dairy Farmers Milk Co-op's Response to the Interim Report into the Australian Dairy Industry*, 23 February 2018, p. 3.

2 Philip and Elisabeth Beattie, *Submission to Interim Report of the ACCC Dairy inquiry*, 9 March 2018, pp. 1-2; Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 7; Graeme Muldoon, *ACCC Dairy inquiry*, 9 March 2018, pp. 1-2; SA Dairyfarmers' Association Inc., *SADA Response to the ACCC Interim Report into the Dairy Industry in Australia*, 6 February 2018, p. 8.

3 Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 7.

4 *ibid* p. 2.

5 Standard form contracts are often referred to as 'take it or leave it' contracts.

8.3 The collective bargaining and boycott process

Australian competition law prevents competitors in a market, such as dairy farmers, from collaborating to agree on prices or supply arrangements, and a breach of this law can result in substantial penalties being imposed. The law recognises, however, that in certain circumstances there are public benefits arising from collective negotiations, and therefore enables groups to seek approval from the ACCC to collectively bargain, either through an application for authorisation or the lodgement of a notification.

An authorisation or notification gives members of a collective bargaining group (CBG) legal protection from action under the CCA. The ACCC may permit collective bargaining where it is satisfied that the likely public benefit outweighs the likely public detriment from the conduct, including from a substantial lessening of competition.⁶

The ACCC commonly accepts that collective bargaining by small businesses, including farmers, who frequently negotiate with much larger and well-resourced processors, is generally in the public benefit.

Although the ACCC can authorise CBGs to engage in collective action, the ACCC cannot compel processors to negotiate with them. Both CBG members and processors must voluntarily decide to enter negotiations for collective bargaining to be effective. The ACCC recognises that a collective boycott can be a useful negotiation tool to bring the processor to the table, but its effectiveness will depend on the circumstances.

Box 8.1: Collective bargaining authorisations and notifications

Authorisation is available for all forms of conduct prohibited by Part IV of the CCA. Notification is available for a more limited set of conduct, including small business (which includes farmers) collective bargaining. Recent amendments to the CCA have minimised the differences between these processes and made it easier for small businesses to obtain legal protection through the (comparatively simpler) notification process in a wider range of circumstances.

Where a proposed CBG's members reasonably expect the value of their transactions with the target business will be less than \$5 million per annum per member, a notification is the best option to receive legal protection to collectively bargain. A notification can cover current and future members of the CBG and cover multiple target businesses.

Authorisation is a longer process than notification but does not have a maximum transaction threshold.

CBGs are permitted under authorisation and notification to negotiate with multiple target businesses at the same time.

The public benefits that may arise from collective bargaining must outweigh the public detriment. Detriments may arise, for example, from the impact of collective bargaining arrangements on competition between farmers, processors, or third parties. Generally there is likely to be little difference between the extent of competition between farmers to supply a processor with or without collective bargaining arrangements.

Collective bargaining can result in contracts that better reflect the interests of negotiating parties that lead to public benefits such as by:

- reducing transaction costs through sharing the time and cost of negotiating supply arrangements
- creating opportunities to negotiate terms of supply that better reflect the group's needs
- improving the information available to farmers, including about key terms of supply
- creating new marketing opportunities by combining volume.

Collective bargaining can also create mutually beneficial outcomes for both the group and processors, by guaranteeing a substantial volume of supply or providing a unique product.

⁶ The term 'public benefit' is not defined in the CCA, but the ACCC has generally given it a broad meaning. As noted by the Australian Competition Tribunal, public benefits are 'anything of value to the community generally, any contribution to the aims of society including as one of its principle elements..the achievement of economic goals of efficiency and progress.'

Conversely, collective bargaining arrangements can reduce competition that might otherwise have occurred by:

- increasing the potential for coordination between CBG members more than is necessary to improve the efficiency of contracting
- shifting the balance of power too far in favour of the CBG which reduces the efficiency gains from collective bargaining, or
- providing for negotiated contracts that reflect the needs of the average CBG member. This may have the effect of shielding inefficient members and distorting investment decisions.

Sometimes, improvements in bargaining power simply result in monetary transfers between industry participants without creating additional economic value. The ACCC does not generally accept monetary transfers between participants in a market as public benefits or detriments. For example, a farmers CBG might be able to negotiate higher farmgate milk prices than is possible without collective bargaining. But for the arrangement to have public benefits, it must increase the size of the total benefits available to the industry. If higher farmgate milk prices enabled farmers to make investments to improve the quality of their raw milk, this may provide benefits to both farmers and processors, and be considered a public benefit.

8.4 Collective bargaining in the dairy industry

Currently, there are 20–30 authorised CBGs in the Australian dairy industry. Most of these were formed under an “umbrella” collective bargaining authorisation granted by the ACCC to Australian Dairy Farmers (ADF) until 2021. This provides farmers who wish to form a CBG with a simple and straightforward authorisation process.⁷ Conditions of the ADF authorisation include that:

- processors can choose whether to negotiate with CBGs
- individual farmer participation in a CBG is voluntary
- CBGs or farmers are not permitted to prevent or restrict other farmers from supplying a particular processor.⁸

Only a small number of farmers are registered to collectively bargain under ADF’s authorisation, as shown in table 8.1. The ACCC understands that these groups have negotiated with a variety of processors over time, although they do not all remain active.

Table 8.1: ADF authorisation—registered CBGs

State	Number of registered CBGs	Approximate number of CBG members in State	Number of farms per State ⁹
New South Wales	8	128	661
Victoria	3	23	3889
South Australia	2	39	241
Tasmania	2	58	440
Queensland	1	60	410
Western Australia	1	47	148
Total	17	355	5789

There are also a number of other CBGs operating in the dairy industry that have obtained individual authorisations, or notification from the ACCC. These CBGs have sought and been granted an authorisation specific to their circumstances, such as Dairy Farmers Milk Co-operative Limited (DFMC)

⁷ Dairy Australia, *Collective Bargaining for Dairy Farmers*, July 2014, 5.
Potential CBG members each pay a \$50 fee to ADF and the authorisation allows farmers with a shared community of interest (such as similar supply patterns or supply of a similar specialty raw milk product) to form groups and register with the ADF without the need to separately seek ACCC approval.

⁸ Australian Competition and Consumer Commission, *Determination Application for revocation of A90966 and substitution with A91263*, 4 August 2011, p. 33.

⁹ Dairy Australia, *Dairy in Focus 2017*,

and Premium Milk Ltd (Premium). The Manning Valley Dairy Farmers Collective Bargaining Group lodged a notification with the ACCC to negotiate directly with Woolworths Limited. These groups are discussed in appendix 5.

The ACCC has also been informed that the Port Curtis Milk Suppliers Co-operative is conducting a feasibility study into a single co-operative to market and vest milk for Queensland and northern NSW, which will require applying for authorisation under the CCA.¹⁰

The ACCC has not granted authorisation to all dairy CBG applicants. Each authorisation or notification submitted to the ACCC is assessed individually to determine the likely net public benefit or detriment.

The ACCC notes stakeholder concerns that representative groups cannot be involved in collective bargaining negotiations.¹¹ We have found that:

- as collective bargaining is a voluntary process, processors are entitled to refuse to negotiate with a CBG that has representative group involvement
- notwithstanding this, under the CCA there are no restrictions on representative groups' involvement in CBGs
- restrictions on representative group involvement in a CBG may be found in a notification or authorisation, but this is uncommon; for example, condition 1 of the ADF authorisation provides that third parties may represent CBGs in negotiations, but only if they have not represented a different CBG in the previous two years.¹²

8.4.1 The use of collective bargaining varies between regions.

The prevalence of dairy CBGs varies throughout Australia.

Few Victorian farmers make use of authorised collective bargaining arrangements. Farmers in Victoria have more processor and production options than farmers in many other regions, and there is generally a competitive market for milk, lowering the necessity of collective bargaining. A contributor to the Senate Inquiry Report reinforced this, explaining that collective bargaining may not be prevalent in Victoria because of:

*'the farmgate competition for milk. I think Barry Irvin talked about seven or eight different people hunting for milk in northern Victoria at the moment—the sense that a farmer can provide their milk to a number of different companies has given them the sense that they have a certain control in the process that perhaps the northern or western dairy farmers do not have, which is why they are looking for collective bargaining agreements.'*¹³

The ACCC understands the situation in south east SA is largely similar to Victoria, whereas there is more CBG activity in other areas of SA.

Dairy farmers in northern NSW and southern Queensland are more commonly involved in collective bargaining via membership of Premium or DFMC (DFMC also represents some farmers in other regions). The combination of a milk deficit in Queensland, and unique collective bargaining arrangements (discussed below) may explain why collective bargaining has endured in these regions.

10 Port Curtis Milk Suppliers Co-operative Association Limited, *ACCC Dairy inquiry interim report Feedback*, 31 January 2018, p. 4.

11 Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 2.

12 Australian Competition and Consumer Commission, *Determination—Application for Revocation of A90966 and Substitution with A91263*, 4 August 2011, p. 32.

Condition 1 of the ADF authorisation in full provides: 'Collective bargaining groups may be represented in negotiations with a processor by a member (or members) of the collective bargaining group or by (one or more) third parties. However, a collective bargaining group must not be represented in negotiations with a processor by a third party who represents or has represented another collective bargaining group in negotiations with a processor in the previous 2 years.'

Under this condition, representative groups can participate in collective negotiations as a third party. Further, condition 1 does not deem representative groups providing general advice, training and assistance to farmer members regarding the collective bargaining process as disqualifying them from potentially representing a CBG.

This condition is in place to limit multiple CBGs from being represented by the same representative in negotiations with a processor, which could result in anti-competitive coordinated conduct between groups.

13 Senate Economics Reference Committee, Parliament of Australia, *Australia's dairy industry: rebuilding trust and a fair market for farmers* (2017), p. 41.

The ACCC is not aware of any active CBGs in WA, which is discussed further in appendix 5. There has been a surplus of milk recently in the WA market, and processors there have few options for its use other than the drinking milk market.¹⁴ WA milk processors have not been able to develop significant export markets, and the WA domestic market is isolated by distance from the rest of Australia. The recent surplus of supply has meant that WA processors have little incentive to negotiate with CBGs.

There are at least two active CBGs in Tasmania, The Tasmanian Suppliers Collective Bargaining Group and King Island Collective Bargaining Group. These groups negotiate milk price and supply arrangements with milk processor Lion.¹⁵ Despite the Tasmanian market having some similar supply dynamics to Victoria, these groups have maintained ongoing engagement with Lion.

In markets where there is relatively stronger competition between processors such as regions in Victoria, CBG participation is quite low. This may have been due to the historical dominance of the dairy farmer owned Murray Goulburn co-operative in that market, and the Bonlac supply agreement under which milk pricing has been managed for suppliers to Fonterra. The presence of both of these, or the relative competitiveness of the region, may have negated the perceived need for farmers to form CBGs. Membership of CBGs has remained higher in regions with limited processor competition, indicating farmers may perceive such groups to create more benefits for farmers.

8.5 Has collective bargaining been effective in the dairy industry?

Despite the experiences of some CBGs (see appendix 5), the ACCC has found that, due to some fundamental limitations, collective bargaining arrangements are not a broad remedy to imbalances in bargaining power in the dairy industry.

The process of establishing a CBG in the dairy industry is a relatively simple process, especially with the ADF authorisation. However, the ACCC received submissions that some processors refuse to negotiate with CBGs or cease negotiating when negotiations become difficult.¹⁶ Farmers at the Taree and Traralgon forums expressed the view that without the ability to compel a processor to engage in negotiations with a CBG, processors will continue to retain strong bargaining power.¹⁷

The ACCC has observed that dairy processors generally do not have sufficient incentives to enter into negotiations with a CBG. In some instances, processors can acquire raw milk from other farmers and do not need to deal with the CBG. It is also easier for processors to offer farmers standard form contracts than negotiate with a group. Farmers can and have formed large, cohesive CBGs, but this has not necessarily resulted in the processor being incentivised to enter negotiations. Dairy farmers submitted that there are a number of different factors that they believe limit the incentive for processors to negotiate with CBGs. These may include:

- the size of a CBG—farmers at Warrnambool and Hahndorf submitted that some CBGs are not large enough to represent a compelling negotiating group
- milk demand-supply balance—farmers in Bunbury and Burnie submitted that negotiations are only possible when milk supply is limited, relative to total demand.
- limited competition—farmers in Bunbury submitted that processors are more likely to negotiate with a CBG when farmers have the ability to switch to other processors.¹⁸

14 Brownes Food Operations Pty Ltd, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, pp. 1–2.

15 Lion Dairy & Drinks, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 13.

16 Australian Dairy Farmers, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 24.

17 DFMC submitted: *'in the absence of a compulsory obligation to collectively bargain, collective bargaining arrangements are entirely dependent upon the goodwill of the processor with whom the group is negotiating. The problem is that a processor may or may not choose to deal with a CBG..This means that the processor still has all the power in the relationship—if they think the CBG is a threat or has some real 'power' or negotiating expertise, they simply say they are not interested in dealing with the collective bargaining group and deal with the individual farmers directly'*.

Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 5.

18 This sentiment was reinforced by WA Farmers Federation, who noted that they are 'supportive of the Collective Bargaining Arrangements but success is limited to competition in the market place, which is a real issue in WA.'
Western Australia Farmers Federation, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 5.

Collective bargaining is also not designed to address unilateral bargaining power imbalances and their effects on farmers throughout the industry. While the outcomes of collective negotiations can apply to all farmers in a region who supply a processor, including those who are not members of the CBG, benefits to farmers from collective bargaining are usually limited to a group or region, particularly where a CBG is small.

Further, despite the availability and use of collective bargaining in the dairy industry since deregulation, problematic contract terms and imbalances in bargaining power continue to exist. The process of collective bargaining has not addressed issues that it theoretically could have, such as step-downs, delayed loyalty bonuses, extended notice periods and other potentially unfair contract terms for the majority of farmers in the industry.

8.5.1 Features of effective collective bargaining

There is some evidence of collective bargaining working well in the dairy industry by creating mutual benefits for farmers and processors, while at the same time mitigating imbalances in bargaining power. Some CBGs have negotiated contract terms and price that better reflect farmer needs (see appendix 5). However, these groups have often arisen in relatively unique circumstances.

For example, the Premium CBG was formed from several cooperatives that made up a significant amount of Queensland's milk supply.¹⁹ This may have acted as a strong incentive for Parmalat (at the time Pauls) to enter into a legally and mutually binding agreement to negotiate with Premium, and to be bound by the decision of an independent expert in the event negotiations fail.

Other large and smaller CBGs have worked effectively in the dairy industry in specific situations. Factors that may contribute to success include:

- a strong CBG: a group with clear objectives, which is cohesive, communicates regularly with members, has skilled leaders and is well-resourced is more likely to be durable. Having sufficient resources will enable the CBG to engage lawyers and remunerate effective leaders on the groups behalf
- a CGB offering a compelling value propositions such as:
 - a unique or differentiated product or the ability to guarantee the supply of a substantial volume of milk a strong commercial position—both DFMC and Premium entered long term milk supply agreements with their respective processors in advantageous circumstances, which require the processor to negotiate with them for the duration of the agreement²⁰. DFMC's arrangement originated from the acquisition of Dairy Farmers by Lion, which allowed DFMC to obtain favourable negotiating and contract outcomes in return for supporting the transaction (see appendix 5 for further details)²¹
 - the agreement between Premium and Parmalat commenced following the amalgamation of a number of co-operatives which created a large CBG whose members represented a very significant volume of milk, relative to total regional supply²²
- dispute resolution processes—compulsory dispute resolution processes have proved useful for DFMC and Premium and their respective processors. Both groups have dispute resolution clauses in the legal agreements which govern the relationship between the CBG and processor.²³ How CBGs could utilise dispute resolution processes is discussed in further detail in chapter 7.

The ACCC has found that experience to date suggests that collective bargaining does have a role to play in the dairy industry, but its success depends on some specific factors that will not necessarily be present in many circumstances.

19 Australian Competition and Consumer Commission, *Determination Application for revocation of A90966 and substitution with A91263*, 4 August 2011.

20 Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 1; Australian Competition and Consumer Commission, *Premium Milk Supply Pty Ltd—Authorisation—A90745*, (2000) p. 16.

21 Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 2.

22 Australian Competition and Consumer Commission, *Premium Milk Supply Pty Ltd—Authorisation—A90745*, (2000) p. 1.

23 Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, p. 1; Australian Competition and Consumer Commission, *Premium Milk Supply Pty Ltd—Authorisation—A90745*, (2000) p. 18.

8.6 Collective boycotts in the dairy industry

8.6.1 What is a collective boycott?

A collective boycott is a mechanism that can be included as part of a collective bargaining group authorisation or notification, and can be used to encourage processors to enter negotiations with a CBG. It involves CBG participants agreeing not to deal with a processor with whom the group is negotiating, until the group is satisfied with the processor's offer. Historically, the ACCC has authorised very few collective boycotts.²⁴

For collective boycott conduct to be an effective negotiation tool for dairy CBGs, it must be possible for the group to credibly threaten to withhold milk if their requirements are not met. A boycott threat will be credible if two conditions hold. First, the expected benefits to farmers if their demands are met need to be greater than the expected costs of carrying out a boycott. Second, the expected cost of a boycott for a processor must be greater than the cost of accepting the CBGs demands.

However, for the following reasons, a collective boycott authorisation may not be an effective mechanism to incentivise negotiations between a CBG and a dairy processor:

- the perishable nature of raw milk—dairy cows continually produce milk and cannot be 'switched off', and if milk is not pasteurised within 24 to 48 hours, it is unusable, and farmers may have to pay to dispose of it or face fines for 'dumping' milk
- exclusive supply clauses—farmers may be penalised by their original processor if they attempt to supply a different processor when engaging in a collective boycott. Depending on the dairy region, there may also be no alternative processors for CBG members to supply raw milk to
- late farmgate price announcements—it may be impractical for farmers to threaten a boycott in response to perceived low prices, as farmgate milk prices are typically only announced a few weeks (if not less) before the new season commences
- higher risk compared to other industries—other agriculture industry suppliers may face less risk when threatening a boycott as they likely have alternative supply channels or preservation methods for their products.

In contrast, processors may be able to use milk swaps and trades to secure milk supply from an alternative source, which could minimise the expected cost of a threatened boycott and hence its credibility.

Farmers who choose to engage in collective boycott may achieve their desired outcome, but they may also face a significant risk of having no processor to collect their milk for a period or a full season as a result of a boycott. Although boycotters would generally expect to incur a loss during a boycott, these losses could be exacerbated in the dairy industry due to the perishable nature of milk and supply dynamics.

Despite these difficulties, a collective boycott in the dairy industry may be possible in limited circumstances. A boycott may be useable:

- by farmers who are not subject to exclusive supply contracts
- in a high demand period
- in a region with multiple processors
- in a period where processors are less likely to be able to trade milk
- if CBG members can legally dispose of their milk at a relatively low cost.

Recent changes to the notification process provide safeguards that make it more feasible to have collective boycotts approved by the ACCC.²⁵ However, it is unclear whether these changes will assist dairy farmers, as the previous analysis has identified that a collective boycott may be a particularly high risk strategy for dairy farmers to adopt.

²⁴ In 2006 the ACCC's decision to authorise chicken meat growers to collectively bargain with and boycott processors was set aside by the Australian Competition Tribunal, as it was not satisfied that a collective boycott would result in a net public benefit. This decision created a high threshold for the authorisation of collective boycott conduct and has had the effect of limiting their use, even in circumstances where they could be efficiency-enhancing.

²⁵ These amendments to the CCA allow the ACCC to issue a 'stop notice' to stop boycott conduct if there has been a material change in circumstances since the notification was lodged and the boycott conduct is likely to result in serious detriment to the public.

8.7 The future of collective bargaining in the dairy industry

The ACCC has found that although collective bargaining has worked in some circumstances in the dairy industry, it should not be considered as a broad remedy to imbalances of bargaining power and market failures within the industry.

Limitations of collective bargaining include that there is no obligation and few incentives for processors to enter into negotiations with a CBG. Nevertheless, receiving approval to engage in collective bargaining in the dairy industry is generally straightforward. Groups can register with ADF, or can now lodge a more flexible notification with the ACCC following recent amendments to the CCA.

The ACCC acknowledges some stakeholders' submissions that collective bargaining laws should be strengthened.²⁶ We note however that the CCA's collective bargaining regime was recently amended in November 2017 and that collective bargaining is a voluntary process that provides all parties with the discretion to deal with who they choose to.

The ACCC does not recommend that amendments should be made to the collective bargaining regime, in light of the recent changes and issues identified that have resulted in collective bargaining not addressing imbalances in bargaining power for all farmers. Rather, we consider the recommended mandatory code discussed in chapter 9 is better suited to address these issues.

26 Queensland Dairyfarmers' Organisation, *QDO response to ACCC interim report into dairy industry*, 7 February 2018, p. 2.

9. Proposed mandatory code of conduct

Key Points

- The ACCC recommends a mandatory code of conduct be prescribed for the dairy industry.
- A mandatory code of conduct is necessary to address the market failures we have identified in the industry resulting from the bargaining power imbalance and information asymmetry in farmer-processor relationships. Existing provisions of the act do not sufficiently correct these market failures.
- The ACCC explored ways to address issues in the dairy industry and considers that the non-enforceability of the Voluntary Code is an inherent weakness that cannot be addressed by adding obligations to the code through a review process.
- A prescribed voluntary code would also be ineffective as it would not cover processors who choose not to sign up to the code.
- The scope of the recommended mandatory code would be targeted at addressing specific contractual and transparency issues and gaps.
- A code, along with the ACCC's other recommendations, is the best way to improve the position of farmers in the dairy supply chain. It will help to better allocate risk, strengthen competition between processors and make it easier for farmers to make efficient investment decisions.

9.1 Introduction

The ACCC recommends that a mandatory code of conduct be prescribed for the dairy industry. The ACCC has considered feedback on the Interim Report, and our final view is that a mandatory code is required to address the market failures in the industry as highlighted in previous chapters.

The recommended code would mitigate problems arising from the significant imbalance in bargaining power and information between processors and farmers. These lead to inappropriate allocation of risk, inefficiencies in investment decision making by farmers and less effective competition between processors. These issues are considered in detail in chapters 2, 3 and 7 of this report and accordingly this chapter should be read in conjunction with those.

The recommended code should be designed to improve transparency and certainty in contracts, set minimum standards of conduct and provide for dispute resolution processes.

This chapter discusses responses to the Interim Report, the types and functions of industry codes, and why a mandatory code is the only effective option for addressing the problems the ACCC has identified through this inquiry.

This chapter also provides recommendations about what should be included in a mandatory code, and discusses the process for creating one.

It is important to note that ultimately, it is the Commonwealth Government's decision whether to implement a mandatory code, and to determine what should be included in such a code.

9.2 Feedback on the Interim Report

The Interim Report recommended that a mandatory code of conduct under the CCA be considered for the dairy industry, and sought feedback on the concept and scope of such a code.

Responses from state farmer bodies and other farmer representatives mostly expressed support for the mandatory code. In general, they emphasised the lack of enforceability of the existing Voluntary Code¹ and agreed with the ACCC's view that measures are required to create industry change through enforcement and deterrence:

- Port Curtis and Farmer Power described the mandatory code as 'essential, given the extent of poor past practices', and DFMC described it as 'required'.
- SADA 'strongly agreed' that the mandatory code be considered.
- NSW Farmers described the move to a mandatory code as a 'natural progression', and both WA Farmers and QDO submitted that the voluntary code has not worked and that more action is required.
- TGFA's submission was supportive of the mandatory code on the basis that details of the code are clarified.
- UDV expressed reservations about the flexibility of the mandatory code and submitted it will not support the mandatory code without further analysis of its likely impact on the industry, although it recognised that the 'strength of a mandatory code is desirable'.
- Some farmer groups also suggested that the Voluntary Code be strengthened as an interim step.

In addition, the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) submitted that there is a 'need for the code to be strengthened by making it both mandatory and requiring a far higher degree of specificity'.

Processors do not support a prescribed mandatory code, and instead favour retaining and reviewing the existing Voluntary Code. In contrast to most other farmer groups, ADF and UDV also support this position. These parties submitted that the Voluntary Code is more flexible and responsive to industry change than a prescribed code, that it has the benefit of being an industry-driven initiative, and (at that time) had only been in operation for less than one year and is due for review in mid-2018. ADPF also suggested the industry has not had a chance to fully test the effectiveness of the Voluntary Code and to improve it.

The ACCC has considered stakeholder feedback on the recommendation. The ACCC recognises the significant efforts made by the industry in developing the Voluntary Code and that improvements to current-year contracts have been achieved. However, for the reasons outlined in this chapter, we consider that neither the Voluntary Code, other forms of industry self-regulation, nor the existing provisions of the CCA are likely to effectively address the issues we have identified.

9.3 Market failure in the Australian dairy industry

Market failure occurs when industry characteristics prevent a market from operating in a way that maximises efficiency and welfare. Correcting market failure improves the overall efficiency of a supply chain while also improving the total welfare of supply chain participants.

Market failure in the Australian dairy industry results from the inherent bargaining power imbalance between processors and dairy farmers, combined with unequal availability of information between them (information asymmetry). As previous chapters have shown, these result in contracting and industry practices that are weighted heavily in favour of processors and make it hard for farmers to make efficient investment decisions; in particular by making it difficult for farmers to compare rival offers and to switch processors if it is in their interest to do so.

¹ Australian Dairy Industry Council (ADIC), *Code of Practice for Contractual Arrangements Between Dairy Farmers and Processors in Australia*, 30 June 2017 ('the Voluntary Code').

The following are examples of inefficient contracting and industry practices arising from the identified market failures:

- As detailed in chapter 7, contract terms weighted heavily in favour of processors including:
 - terms that enable inefficient allocation of risk such as the ability to unilaterally vary handbooks, and loyalty bonuses and excessively long required notice periods for farmers switching which hinder farmers' ability to properly compare offers and switch between processors
 - overly complex contracts that are difficult to understand and make it more likely that farmers will make a 'good' choice rather than the 'best' choice for them
 - an absence of effective dispute resolution processes which means that farmers have limited formal avenues through which to raise and resolve contracting concerns.
- As detailed in chapter 3:
 - the significant degree of discretion processors have to pass on risks to farmers, such as through the use of variable pricing in Southern region supply agreements and the ability to vary prices across years in multi-year contracts without restriction. This discretion means that farmers do not have a proper view of the degree of risk that is associated with the farmgate price offers being made to them.
 - industry practices that make it harder for farmers to compare offers and switch, such as the late provision of pricing and contract information at the start of each season.

These practices reinforce the bargaining power imbalances and reduce the effectiveness of competition between processors. The outcome is sub-optimal allocation of farmer resources resulting from under- or over-investment in particular production volumes or systems. This can result in inefficiencies when farmer outputs do not align with processor requirements, or when farmers are unable to determine which processor's requirements are most compatible with their farm's production profile.

However, even if sufficient information were available, the bargaining power imbalance means that there are contractual and industry practices that make it harder for farmers to evaluate offers and to switch to another processor if they wish to do so.

9.4 Evaluation of other options for dealing with market failure in the dairy industry

As discussed above, the ACCC is of the view that a mandatory code of conduct is necessary for remedying the identified market failures in the dairy industry. We have reached this view having considered alternative remedies, including relying on the existing provisions and mechanisms of the CCA (including collective bargaining), and other types of industry codes of conduct, namely a voluntary code or prescribed voluntary code of conduct.

The ACCC's key considerations in this regard were the scope of substantive issues likely or capable of being addressed, the likely coverage of the industry under measures other than a mandatory code, the ability for widespread market failures to be addressed in an ex ante way, and the enforceability of alternative measures.

9.4.1 Existing mechanisms in the CCA

The ACCC considers that reliance on the CCA alone is unlikely to be sufficient to address the identified market failures.

In particular:

- The collective bargaining provisions of the CCA, including collective boycott, can be an effective remedy to market failures caused by bargaining power imbalances, such as those identified in the dairy industry. In particular, collective bargaining can help to remedy market failures arising from imbalances of bargaining power and information asymmetry. However, collective bargaining is less likely to be successful in the dairy industry because the perishability of raw milk and environmental laws prevent farmers from giving effect to a boycott by storing or dumping their milk. Dairy processors therefore have little incentive to engage with collective bargaining groups.
- Enforcement action under the competition provisions of the CCA can only be taken after the event, and typically in relation to specific instances of conduct. The ACCC considers that an effective

remedy of the identified market failures requires systemic, industry-wide changes to the way that processors and farmers deal with each other rather than enforcement action in response to individual events.

- Recently enacted Unfair Contract Terms laws are an effective tool in some instances but, like the competition laws, they apply to specific contracts and circumstances after they occur. These laws cannot address information asymmetries by ensuring timely and transparent communication of key pricing information, or contracting practices which suppress competition. Nor can these laws address the absence of dispute resolution provisions in contracts.

9.4.2 Voluntary and prescribed voluntary industry codes of conduct

Industry codes of conduct set out minimum obligations and standards of commercial conduct for industry participants. Industry codes can address industry-specific market failures that have not otherwise been addressed by industry participants or by other regulation.

Industry codes can be a voluntary form of industry self-regulation, or they can be prescribed under the CCA and given the force of law. Prescribed codes can be voluntary (only binding on participants who choose to become and remain a signatory to the code) or mandatory (binding on all industry participants to which they apply).

Table 9.1: Key features of different types of industry codes

	Voluntary	Prescribed voluntary	Prescribed mandatory
Development and administration	Developed and administered by industry participants.	Developed by Government, in consultation with industry participants and the public. Administered by ACCC.	
Application	Only applies to industry participants who voluntarily sign up. Signatories can choose to withdraw and cease to be bound at any time (although they will still be liable for breaches that occurred while they were signatories).	Legally binding on all industry participants specified within the code.	
Enforceability	Enforceable only to the extent that the code includes an enforcement mechanism and process and that participants choose to be bound by the code. The ACCC has no power to enforce a voluntary code.	<p>ACCC can take enforcement action against parties the code applies to. Remedies include injunctions, damages, non-punitive orders and other compensatory orders.</p> <p>Penalties and infringement notices may apply, but are more likely in a mandatory code than a prescribed voluntary code.</p> <p>Any person who suffers loss or damage due to a contravention of a prescribed code can also bring a court action for damages.²</p>	

² See *Competition and Consumer Act 2010*, s. 82, s. 51ACB.

Examples	Current Dairy Voluntary Code	Food and Grocery Code ⁴	With penalty provisions
	Australian Wine Industry Code of Conduct ³		Franchising Code ⁵
	Other voluntary industry codes		Horticulture Code ⁶
			Without penalty provisions
			Oil Code ⁷
			Wheat Port Code ⁸
			Sugar Code ⁹
			Unit Pricing Code ¹⁰

9.4.3 The voluntary code of conduct

In response to the farmgate milk price step-downs announced by Murray Goulburn and Fonterra Australia in 2016, ADIC developed a voluntary code of conduct for the Australian dairy industry ('the Voluntary Code').¹¹ The Voluntary Code represents an agreed position between ADF and the Australian Dairy Products Federation (ADPF). Signatories are not legally obliged to comply with the Voluntary Code. The ACCC was not involved in the development of the Voluntary Code, and does not have any administrative or enforcement role in relation to it.

On 1 July 2017, the terms of the Voluntary Code were agreed and endorsed by many, but not all industry participants.¹² Most major processors are now signatories to the code, but Norco and Brownes are not.

The Voluntary Code is designed to govern key aspects of commercial relationships between dairy processors and farmers. It is intended to apply to standard form contracts provided to farmers by participating processors, but does not apply to the small number of directly negotiated agreements between processors and dairy farmers.

The Voluntary Code has had an initial positive impact on some contract terms offered by some processors to farmers for the 2017-18 dairy season. In particular, improvements were made to mechanisms for setting and varying prices, exclusivity supply clauses and loyalty and other bonus payments (see box 9.1).

However, the industry has been subject to heightened scrutiny over recent years, which is likely to have resulted in modified behaviour by processors. The extent to which the changes observed as a result of the Voluntary Code will continue in the future remains uncertain.

³ See *Competition and Consumer Act 2010*, s. 82, s. 51ACB.

⁴ Wine Grape Growers Australia (WGGA) and Winemakers' Federation of Australia (WFA), Australian Wine Industry Code of Conduct, December 2008.

⁵ *Competition and Consumer (Industry Codes - Food and Grocery) Regulation 2015* ('Food and Grocery Code').

⁶ *Competition and Consumer (Industry Codes - Franchising) Regulation 2014* ('Franchising Code').

⁷ *Competition and Consumer (Industry Codes - Horticulture) Regulations 2017* ('Horticulture Code').

⁸ *Competition and Consumer (Industry Codes - Oil) Regulations 2017* ('Oil Code').

⁹ *Competition and Consumer (Industry Code - Port Terminal Access (Bulk Wheat)) Regulation 2014* ('Wheat Port Code').

¹⁰ *Competition and Consumer (Industry Code - Sugar) Regulations 2017* ('Sugar Code').

¹¹ Australian Dairy Industry Council (ADIC), *Code of Practice for Contractual Arrangements Between Dairy Farmers and Processors in Australia*, 30 June 2017.

¹² At the time of writing, the processors who are signatories to the Code are Murray Goulburn, Fonterra Australia, Bega Cheese, Lion Dairy & Drinks, Warrnambool Cheese & Butter, Burra Foods, Australian Consolidated Milk, Freedom Foods and Parmalat. On behalf of farmers, all state-based dairy farmer representative organisations are signatories: UDV, NSW Farmers, QDO, SADA, WA Farmers and TFGA.

Box 9.1: Contract terms for the 2017-18 dairy season under the Voluntary Code

Step-downs

Section 4 of the Voluntary Code prohibits retrospective step-downs. Forward looking step-downs are still permitted, but farmers can exit their milk supply agreements if a step-down is announced, as provided for by the following clause:

Contracts must allow the dairy farmer to terminate their contract with the processor without penalty on a maximum of 30 days written notice from the date of [the step-down] notification to the farmer.

The ACCC's review of 2017-18 season contracts suggests that Voluntary Code signatories have largely reflected this provision in their contracts. However, in some cases it is not explicitly stated that farmers can exit an agreement without penalty if a step-down occurs.

Loyalty bonuses

Section 5 of the Voluntary Code states that:

A farmer is entitled to all accrued loyalty and other payments where they have supplied to the end of a contract term, irrespective of whether they remain a supplier post a contract expiry.

The removal of such 'conditional' loyalty bonuses would reduce barriers to switching. By requiring processors to pay farmers accrued payments regardless of whether they continue as a supplier, processors can no longer use this as a strategy to increase their bargaining power and retain suppliers. It is unclear how this part of the code would apply to multi-year contracts extending over more than one year. As written, it would still allow a processor to delay the payment of loyalty bonuses in all but the final year of a multi-year contract.

A review of 2017-18 dairy season contracts shows that signatories to the Voluntary Code have largely reflected this position in their contracts.

In some 2017-18 Supply Handbooks, processors still require a farmer to be supplying that processor on the date of the announcement in order to receive a mid-season step-up or incentive payment. The ACCC considers that this may be reasonable, as the Supply Handbook relationship creates risks for both farmers and processors. Under these agreements, the processor accepts the farmer may switch processor with very little notice, and the farmer assumes the risk that if they switch processor mid-season, they may be ineligible for any potential step-ups or other incentives. Further, the ACCC acknowledges that such provisions should not restrict the ability of processors to offer longer term contracts.

Termination

The Voluntary Code has also addressed the termination of contracts by farmers. Section 9 provides that:

The contract must allow either party to terminate the contract with immediate effect if the other party fundamentally breaches the terms of the contract.

If adhered to, this section may provide farmers with more bargaining power as they will be able to exit a contract due to a fundamental breach. While such a right would exist under contract law, there is benefit in having this explicitly expressed. Processors should have a greater incentive to observe the terms of their contracts, as farmers should now have a clear entitlement to terminate the contract if they do not, although the process for determining whether a 'fundamental breach' has occurred is not specified.

Exclusive supply clauses

Section 6 of the Voluntary Code states:

Where a farmer has a contract with a processor and wishes to expand their production and a processor does not want to purchase the additional milk under the same contractual terms and conditions, the contract between the farmer and processor must allow the farmer to supply the additional milk to other processors.

This clause will apply if the primary processor is prepared to take milk in addition to the contracted volume at a lower price.

This section addresses the issue of two-tier pricing, which we understand ceased in 2012–13. Two-tier pricing occurs where a much lower price is paid for milk supplied in excess of a farmer's allocated supply volume. The effect of two-tier pricing is to disincentivise farmers from increasing milk production.

Section 6 of the Voluntary Code provides the processor with the first right of refusal to any milk that is additional to the contracted volume. This does not restrict a farmer from selling additional milk to a competing processor, but requires they first offer it to the incumbent processor.

9.4.4 Inherent weaknesses of the Voluntary Code

The ACCC notes the submissions of some stakeholders that insufficient time has elapsed to assess the effectiveness of the Voluntary Code and that an upcoming review of the code will address the identified deficiencies.

However, the Voluntary Code will remain, by its very nature, an ineffective way to address the problems identified above.

The non-enforceability of the Voluntary Code is an inherent weakness that cannot be addressed through a review process:

- At the current time, two major processors (Norco and Brownes) and many smaller processors have not signed up to the Voluntary Code despite there being no penalty for signatories that breach the code. Some non-signatory processors continue to use delayed loyalty payments, have the ability to reintroduce two-tier pricing and have inadequate dispute resolution clauses.
- Processors who are not signatories are unlikely to become signatories to the Voluntary Code if it is strengthened.
- It would be challenging to include a mechanism under the Voluntary Code for monitoring compliance or determining whether a breach has occurred, such as a review of processor contracts for problematic terms. In particular, difficulties arise in identifying an appropriate body to undertake the task. In contrast, the ACCC can monitor compliance with a prescribed code.
- Signatories to the Voluntary Code can breach the code with little or no consequences. Although the Voluntary Code is not legally enforceable, any confirmed breaches of the Code would be indicative of processors' ability to not comply with particular provisions if a business need or an opportunity arises:
 - In particular, there have been varying degrees of compliance with clause 10, which requires processors to include a process for handling disputes between the parties. Some contracts appear unlikely to comply with clause 10, particularly those which do not provide for an independent party to moderate disputes.¹³

¹³ Murray Goulburn's 2017/18 Supplier Handbook Southern Milk Region, clause 20.5.

- Allegations were made about potential breaches of clause 5 (relating to loyalty payments). Delayed loyalty bonus provisions are not present in current contracts but may have resurfaced under the proposed Saputo/ Murray Goulburn arrangement. Murray Goulburn informed farmers that if the transaction were completed, active Murray Goulburn suppliers would receive a step-up and loyalty payment totalling \$0.80 per kilogram of milk solids on completion of the transaction, as long as they remained suppliers at that time.¹⁴

Other shortcomings of the voluntary code:

- The Voluntary Code does not contain a mechanism for resolving disputes that arise under the Voluntary Code, including about compliance with the code itself.
- Despite provisions which require transparency when setting and varying farmgate prices, processors appear to retain full discretion over the method of 'price notification' they can use.

While there is scope to improve the Voluntary Code, any further development of it is susceptible to dominant influence from the processing sector, which is comparatively better resourced for regulatory and policy development than representatives of the dairy farming sector.

The processing sector is also in a powerful position of influence over the national dairy farmers' representative body, through the model by which ADF is funded. Significant ADF funding is sourced from the Australian Dairy Industry Council (ADIC) which is funded by eleven major dairy processors (who contribute \$120 per million litres of milk processed, under a 3-year agreement, due to expire in 2018). Some dairy farmers claim this compromises ADF's independence from processors.

The process of creating a mandatory code would involve extensive industry consultation, but government involvement in the development of a prescribed code would mitigate the imbalance between processor and farmer influence.

9.4.5 A prescribed voluntary code would not overcome the shortcomings of the Voluntary Code

The main difference between a prescribed voluntary code and a non-prescribed voluntary code is that a prescribed voluntary code can be legally enforced against its signatories.

The level of uptake and compliance with the existing Voluntary Code may be indicative of the likely uptake of a prescribed voluntary code. As described above, not all processors have signed up to the Voluntary Code and there appear to be instances of non-compliance.

Insights into the likely level of uptake can also be drawn from the Food and Grocery Code of Conduct. The Food and Grocery Code is the only current prescribed voluntary code. Although four supermarkets signed up to the code in May-July 2015, major grocery wholesaler Metcash has not become a signatory.

In contrast to businesses such as grocery retailers, processors are not, to a large extent, public-facing businesses. The ACCC expects that dairy processors are unlikely to face strong moral suasion from the general public to sign up to a prescribed voluntary code. In addition, many farmers will have limited or no ability to leave a processor that has not signed up to the code due to the same contractual difficulties that code seeks to address, as well as the limited number of processors operating in some regions.

¹⁴ Murray Goulburn Co-operative Co Limited, *News Release: Murray Goulburn Co-operative Co Limited ("MG") today announces that it has entered into a binding agreement with Saputo Dairy Australia Pty Ltd ("Saputo")*, 27 October 2017, <http://www.mgc.com.au/media/49638/20171027-asx-announcement-mg-sale-to-saputo.pdf>. 'Active suppliers' means farmers that supplied 'milk to MG as at the date of its annual general meeting, as at the completion of the Transaction, and, if required, as at 15 August 2018.' These payments are likely in breach of clause 5 of the Voluntary Code, as they may require the farmer to be supplying Murray Goulburn at least six weeks into the new season before becoming entitled to them. This demonstrates that if a commercial need arises, processors can easily not comply with the Voluntary Code.

9.5 Advantages of a prescribed mandatory code

A mandatory code is likely to be stronger than a voluntary code in terms of both the coverage of its enforceability and the potential for its substantive obligations to address issues which lead to market failures in the dairy industry.

9.5.1 A mandatory code would likely contain the most effective content

A mandatory code would include substantive obligations that would address market failures in the industry, but that would otherwise deter processors from signing up to a voluntary or prescribed voluntary code. Processors are unlikely to volunteer to be covered by a voluntary or prescribed voluntary code that is strong enough to address the identified market failures.

9.5.2 A mandatory code would have the best coverage

All processors that fall under the application of the mandatory code would be required to adhere to it, and there would be consequences for noncompliance. This would address market failures and create industry certainty as participants could rely on adherence to the code.

9.5.3 Strong enforcement options

The ACCC would use its powers to take enforcement action under the mandatory code where necessary. ACCC enforcement action can include administrative resolutions, court enforceable undertakings or court action.¹⁵ Courts can issue a range of orders including injunctions, damages, other non-punitive orders and other compensatory orders in relation to a breach of a mandatory code.

In addition, if the mandatory code contains civil penalty provisions, courts could impose fines of up to \$63 000 for breaches of those provisions. The ACCC could also issue infringement notices of up to \$10 500 for a body corporate and \$2100 for an individual if the ACCC has reasonable grounds to believe there has been a breach of a penalty provision of the code.¹⁶

An extensive policy process would determine whether the code would contain civil penalty provisions. However, the ACCC considers the code would be most effective if key provisions are civil penalty provisions, similar to the Franchising Code and the Horticulture Code. This would allow the ACCC to achieve a timely, cost-efficient enforcement outcome where appropriate, and would increase the deterrent effect by creating a financial disincentive for breaching key provisions of the code.

Individuals and businesses could also bring their own court actions to recover loss or damage that they have suffered due to a contravention of the mandatory code.¹⁷

9.5.4 The ACCC would monitor compliance with a mandatory code

Ultimately, the Government would be responsible for deciding whether to implement a mandatory code and for drafting the code (as described below), while the ACCC would administer the code.

The ACCC would monitor compliance by assessing reported breaches of the code and conducting compliance checks. Sections 51ADD–51ADG of the CCA give the ACCC an audit power to make a compulsory request for information or documents that businesses are required to keep, generate or publish under an applicable industry code.

The potential compliance costs associated with the mandatory code for processors (and potentially farmers) would include:

- a likely requirement that documents such as signed contracts are kept for a minimum time period, similar to requirements in other industry codes.¹⁸

¹⁵ For more information on ACCC enforcement action see ACCC, *Compliance & enforcement policy & priorities*, February 2018, <https://www.accc.gov.au/about-us/australian-competition-consumer-commission/compliance-enforcement-policy-priorities>.

¹⁶ CCA s. 51ACD. For more information on infringement notices see ACCC, *Guidelines on the use of infringement notices*, April 2013, <https://www.accc.gov.au/publications/guidelines-on-the-use-of-infringement-notices>.

¹⁷ See *Competition and Consumer Act 2010*, s. 82, s. 51ACB.

¹⁸ See Franchising Code s. 19, Horticulture Code ss. 53–54, Wheat Port Code ss. 31–33, Food and Grocery Code . 42.

- a requirement to participate in any compliance checks the ACCC undertakes under ss. 51ADD–51ADG of the CCA.
- an initial burden to inform themselves of the code's requirements and update their practices to ensure they are compliant.

The ACCC acknowledges these administrative costs, but considers they are unlikely to be excessive.

9.6 Recommended mandatory code: proposed substantive content

9.6.1 Application and commencement

The mandatory code should apply to the supply of raw milk from farmers to processors.

Potential exemptions should be considered during the Government's development process. The ACCC does not want disproportionate compliance costs to deter entry or expansion. For example, it may be appropriate to exempt small processors who do not have strong bargaining power relative to farmers from the code. The exemption could be defined, for example, by reference to processing volume, number of staff or annual revenue.

The development process should also determine whether the code will create obligations on farmers in order to avoid unnecessary burdens on processors where farmer cooperation is required. This would be similar to the Horticulture Code which places similar obligations on growers and traders to enter into written agreements and to keep written records.

In addition, the development process should consider the commencement of the code and the applicable transition period.

9.6.2 General limitations on the scope of the recommended mandatory code

Best practice regulation involves the minimum necessary intervention to address industry problems. The mandatory code should be confined in scope and limited to addressing specific contractual and transparency issues and gaps.

The mandatory code should not interfere with the legitimate business interests of processors. As is the case under the Voluntary Code, the mandatory code should recognise processors' rights to terminate contracts upon a fundamental breach of contract by a farmer, to enact a non-retrospective step-down in some circumstances and to set farmgate milk prices.

The code should also avoid disadvantaging processors with particular business models. The ACCC acknowledges there are different types of processing businesses, and complexities within those businesses, that will need to be considered when developing the code and formulating obligations. For example:

- Norco and Lion emphasised that they operate on a demand-driven business model and must therefore manage their supply more carefully than supply-driven processors like Fonterra and Murray Goulburn. As a result, Norco and Lion argue that exclusivity clauses are more necessary for them than for other processors because they need greater certainty of supply. As such, while the ACCC recommends introducing restrictions on the use of exclusive supply clauses, such as to prohibit provisions that allow for two-tier pricing, it does not recommend banning exclusivity clauses altogether.
- Norco noted the position of farmer cooperatives which are farmer owned and run, as opposed to privately owned or listed processors, due to the 'shared risk between [a cooperative] and its farmer members and owners.'

The recommended code would not directly address the prices paid to farmers. It would also not directly address the timing of farmgate price announcements. While the ACCC believes that earlier farmgate price announcements would be beneficial, and recommends a prescribed 'minimum switching period' for consideration of farmgate price offers, it appears unlikely that a more prescriptive requirement on timing could be set out in a code due to external factors impacting on the timing of price

announcements. The code is also unlikely to be an appropriate way to directly deal with the complexity of contracts. However, we consider that an effective mandatory code will improve the effectiveness of competition between processors and thus improve incentives for other problems to be addressed. For example, processors who make earlier announcements or offer simpler contracts may have a competitive advantage over those who do not.

9.7 Potential substantive obligations of a mandatory code

While the content of any code would be subject to further consultation, the ACCC considers the code should address issues identified in the industry as outlined in Table 9.2.

Table 9.2: How a code should address issues identified in the industry

Identified industry problem	Potential solution
Lack of timely and transparent information about the terms on which processors propose to acquire milk from farmers	<p>Written acknowledgment of contract terms: Requirement that farmers acknowledge contract terms, in writing, when they agree to supply milk to processors.</p> <p>Notice: Prohibition on requirements placed on farmers to give notice of their intent to exit a contract before any clear market information is available to the farmer.</p> <p>Price guidance and commitments: For non-fixed price contracts, obligation to provide ex ante guidance and commitments regarding the basis for changes in prices during a dairy season.</p>
Farmers are unreasonably restricted from switching	<p>Loyalty bonuses: prohibition on loyalty bonuses that are reliant on continuing supply into a future dairy season.</p> <p>Two-tier pricing: restrictions on the use of exclusive supply clauses in association with two-tier pricing. The ACCC does not recommend that the use of exclusive supply clauses be prohibited entirely.</p>
Processors have an unfair ability to change key trading terms including price	<p>Retrospective step downs: prohibition on terms in milk supply agreements that allow retrospective step-downs.</p> <p>Other step downs: requirement that farmers be provided with adequate notice of a step down and the opportunity to terminate the agreement within a reasonable period of that notice without penalty.</p> <p>Unilateral variation: prohibition or limitation on the unilateral variation of agreement terms by processors without the consent of a farmer.</p> <p>Multi-year contracts: requirement that processors provide farmers with a specified price for the term of a contract. If the price for a particular year falls below this price, farmers should have the ability to exit the contract without penalty.</p>
Farmers lack the resources to effectively resolve disputes with processors	<p>Contractual dispute resolution process: requirement that contracts contain an effective independent and cost-effective dispute resolution process for disputes arising between processors and farmers.</p> <p>Code dispute resolution process: prescription of an independent process for resolving disputes that arise under the Code.</p>

Identified industry problem	Potential solution
There is potential for conduct to be conducted in poor faith	Good faith: requirement that processors and farmers act in good faith during negotiations, performance of the contract, dispute resolution and the ending of an agreement.

9.7.1 Requirements addressing lack of transparency

Obligation on processors to give timely and transparent information to farmers about the terms on which they propose to acquire milk from farmers. These obligations may include:

- **Written contracts:** the mandatory code should require that farmers acknowledge, in writing, written terms of supply when they enter into a contract with processors:
 - Written contracts or acknowledgement of the provision of information are common in prescribed industry codes.¹⁹ Providing trading terms and conditions in writing increases transparency, and written acceptance of the terms requires a clear and conscious commitment by the parties. This measure would increase certainty for both parties by clarifying their legal obligations, and would assist in resolving disputes.
 - The requirement could take the form of an obligation on processors, or on both processors and farmers, to retain signed or acknowledged copies of agreements. Applying the requirement to farmers as well as processors would incentivise farmers to cooperate with processors to ensure the process is carried out correctly. The appropriate allocation of the obligation would be considered during the development of the code.
 - A mandatory code need not require the milk supply agreement itself (or other incorporated documents like Handbooks) be signed. It may be sufficient for parties to accept the terms through a written notice of offer and a written notice of acceptance, as is the case under the Horticulture Code.²⁰
 - Potential exemptions would also be considered during the development of the code. For example, it may be appropriate to create an exemption for oneoff contracts that are entered into under time pressure to deal with a surplus of milk.
- **Notice periods:** requirements ensuring farmers are not required to make decisions about renewing contracts before they have pricing and contractual information. For example:
 - a prohibition on requirements placed on farmers to give notice of their intent to exit a contract before any clear market information is available to the farmer. Such provisions exist in some fixed term dairy contracts
 - a requirement that farmers must be able to switch to a different processor during a minimum switching period of 21 days from the date that their processor's opening price is announced. This would give farmers an opportunity to assess pricing and contract terms, and seek professional advice if required, before making a decision about renewing their contract.
- **Price guidance and commitments:** this could include:
 - for non-fixed price contracts, providing ex ante guidance and commitments regarding the basis for changes in prices which may occur during a dairy season.

9.7.2 Requirements that make it easier for farmers to switch processors

The mandatory code should include obligations on processors not to include contract terms which unreasonably restrict farmers' ability to switch processors. For example:

- **Loyalty bonuses:** a prohibition on loyalty bonuses that are reliant on supply into a future dairy season.
- **Two-tier pricing:** Restrictions on the use of exclusive supply clauses in conjunction with two-tier pricing. The ACCC does not recommend that the use of exclusive supply clauses be prohibited entirely. Two-tier pricing is not currently being used in the industry, although one processor has scope in its contracts to introduce such a practice at any time.

¹⁹ Food and Grocery Code s. 7, Sugar Code s. 7, Horticulture Code s. 12, Franchising Code ss. 8-10

²⁰ Horticulture Code s. 15

9.7.3 Requirements addressing processors' ability to change key trading terms

The mandatory code should address processors' ability to change key trading terms through:

- **Multi-year contracts:** requirement that processors provide farmers with a specified price for the term of a contract. If the price for a particular year falls below this price, farmers should have the ability to exit the contract without penalty.
- **Retrospective step-downs:** prohibition of terms in milk supply agreements that allow retrospective step-downs.
- **Other step-downs:** prescription of circumstances in which step-downs more generally are appropriate or inappropriate. For example, by specifying that farmers must be provided with adequate notice and can terminate the agreement within a reasonable period of that notice without penalty. This requirement is currently reflected in the Voluntary Code and in some current processor agreements.
- **Unilateral variation:** prohibition or limitation on the unilateral variation of agreement terms by processors without the consent of a farmer. Any changes to the contract would need to be agreed to by both parties.

9.7.4 Dispute resolution process

The mandatory code should require that contracts contain an effective independent dispute resolution process for disputes arising between processors and farmers, including referencing an independent process to apply to disputes about the interpretation and performance of contracts.

Most prescribed industry codes provide for a dispute resolution process. The process often involves the parties attempting to agree to resolve the dispute, and participating in mediation or arbitration if they are unable to resolve the dispute themselves.

The ACCC uses its compliance and enforcement tools to encourage compliance with the codes that it administers, but it is selective in the matters it investigates and is not a complaint handling body.²¹ A specialised complaint handling process would be necessary in order to consistently and economically resolve individual disputes arising under contracts.

An independent third party should be nominated to conduct the dispute resolution process. The Australian Small Business and Family Enterprise Ombudsman is an example of such a body.

9.7.5 Good faith requirement

The mandatory code should explicitly require processors and farmers to act in good faith during negotiations, performance of the contract, dispute resolution and the ending of an agreement.

Good faith obligations are a common feature of prescribed industry codes.²² They require parties to an agreement to exercise their powers reasonably and not arbitrarily or for some irrelevant purpose. Conduct may lack good faith if one party acts dishonestly or for some ulterior motive, fails to have regard to the legitimate interests of the other party, or acts in a way that undermines or denies the other party the benefits of the contract.²³

9.8 Process for creating a mandatory code

If the Government agrees to pursue the creation of a prescribed mandatory code, the process will involve several stages, including stakeholder consultations. Businesses, consumers and relevant government agencies will have the opportunity to make written submissions and possibly to attend meetings to put forward their views.

21 For more information about the ACCC's role see ACCC, *Compliance & enforcement policy & priorities*, February 2018, <https://www.accc.gov.au/about-us/australian-competition-consumer-commission/compliance-enforcement-policy-priorities>.

22 Food and Grocery Code s. 28, Sugar Code s. 4-5, Wheat Port Code s. 6, Horticulture Code s. 8-9, Franchising Code s. 6.

23 For more information on good faith in the context of an existing industry code see ACCC, *Acting in good faith*, <https://www.accc.gov.au/business/industry-codes/franchising-code-of-conduct/acting-in-good-faith>

If public consultation and a cost-benefit analysis support the need for a prescribed code, the Department with policy carriage will work with the Office of Parliamentary Counsel to draft the text of the code to ensure it meets Commonwealth legislative standards. This will then be released as exposure draft legislation (with a draft explanatory statement) to seek public feedback and comment. The draft code may undergo drafting changes as a result of this process.

At the conclusion of the process, the Governor General will make a regulation prescribing the code. The code regulation will then be registered and tabled in each House of Parliament, where it can be disallowed within 15 sitting days in each House.²⁴

²⁴ For more information see: The Treasury, *Industry Codes of Conduct Policy Framework*, November 2017, p. 14-15.

Appendix 1: Terms of reference

On 27 October 2016 the Treasurer, the Hon. Scott Morrison MP, pursuant to s. 95H(1) of the CCA issued a notice requiring the ACCC to hold an inquiry into the competitiveness of prices, trading practices and the supply chain in the Australian dairy industry. The inquiry commenced on 1 November 2016.

The Terms of Reference for the inquiry include, but are not restricted to:

- the nature of competition between processors for both the acquisition of raw milk and the supply of processed milk and dairy products
- the nature of retail pricing arrangements for milk and dairy products, and their impact up the supply chain
- the effect (direct or indirect) of domestic retail and export prices, and level of domestic and overseas demand, for Australian processed milk and dairy products on dairy producers and processors
- the nature of the commercial relationships between dairy producers and acquirers of raw milk and the impact of corporate structures adopted (including cooperative structures) upon those relationships
- the mechanisms used by acquirers of raw milk to determine prices paid when acquiring raw milk and the transparency of those mechanisms
- the availability, transparency and accessibility of market price information, and its effectiveness for forecasting movements in farm gate milk prices
- the terms on which raw milk is acquired from dairy producers and the means by which such terms are agreed
- the allocation of commercial risk across the dairy supply chain
- the role of collective bargaining in the dairy industry and its effectiveness
- the existence of, or potential for, anti-competitive conduct and the possible impacts of any such conduct on businesses within the dairy supply chain
- any other factors affecting farm profitability.

Appendix 2: Corporate transactions in the dairy industry

Year	Transaction
2018	Saputo Dairy Australia Pty Ltd—acquisition of Murray Goulburn's operating assets
2017	Shanghai Ground Food Tech—acquisition of Brownes Dairy, including processing plants at Brunswick and Balcatta, WA
2016	Fuyuan Farming Co Ltd—acquisition of controlling interest in Burra Foods, including a processing plant at Korumburra, Victoria
2016	Australian Dairy Farms—acquisition of Camperdown Dairy Company
2015	Beston Global Food—acquisition of United Dairy Power assets (processing plants at Murray Bridge and Jervois, SA)
2015	Murray Goulburn—acquisition of Tasmanian Dairy Products (remaining 24.1 per cent stake in the joint venture, a processing plant at Smithton, Tasmania)
2015	Parmalat—acquisition of Fonterra assets (processing plants at Launceston, Tasmania and Echuca, Victoria)
2014	Saputo—acquisition of controlling interest in Warrnambool Cheese and Butter
2014	Parmalat—acquisition of Harvey Fresh (including processing plant at Harvey, WA)
2013	Fonterra—acquisition of Tamar Valley Dairy (including processing plant at Launceston, Tasmania)
2011	United Dairy Power—acquisition of Lion assets (processing plants at Murray Bridge and Jervois, SA)
2011	Dairy West—acquisition of Brownes (including processing plants at Balcatta and Brunswick, WA)
2011	Bega Cheese—acquisition of Tatura Milk (processing plant at Tatura, Victoria and infant formula facility at Derrimut, Victoria)
2009	Itochu Corporation—acquisition of interest (45 per cent of shares) in Burra Foods (including processing plant at Korumburra, Victoria)
2009	National Foods (Lion) and Warrnambool Cheese and Butter enter into joint venture (50/50 cheese manufacture, cut, wrap, and sales, in Jervois, SA, and Allansford and Simpson, Victoria)
2009	Regal Cream Products (Bulla)—acquisition of Cadbury ice cream range from Fonterra
2009	Nestlé Australia—proposed acquisition of part of Fonterra's ice cream business
2009	Bega Cheese—acquisition of certain assets from Kraft Foods, including a cheese manufacturing plant at Strathmerton, Victoria
2008	Fonterra—acquisition of Ski yoghurt brand licence from National Foods
2008	National Foods acquisition of Dairy Farmers, a milk processing co-operative
2008	Fonterra—licensing arrangement and acquisition of the chilled dairy assets of Nestlé Australia
2007	Kirin Holdings—acquisition of National Foods (Lion), including processing plants in eastern Australia and WA

2006	Murray Goulburn—acquisition of Classic Foods, a processor in Tasmania
2006	National Foods—acquisition of Lactos in Tasmania (cheese and drinking milk)
2005	Fonterra—acquisition of Nestlé Australia's Dennington (Victoria) processing plant and associated exclusive milk component supply agreement
2005	San Miguel—acquisition of National Foods
2003	National Foods—acquisition of the Bonlac's UHT plant at Cobden, Victoria
2000	New Zealand Dairy Board (now trading as Fonterra)—acquisition of Bonlac Foods

Note: includes processing plants that may no longer operate; transactions do not necessarily include sales of brands, production licences etc. and does not list separate transactions of brands and production licences.

Appendix 3: Parties that made public submissions to the inquiry

Submissions in response to Issues Paper

- Arbuthnot, Alex
- Australian Dairy Farmers
- Australian Small Business and Family Enterprise Ombudsman
- Australasian Association of Convenience Stores Limited
- Beale, Jim
- Bega Cheese Limited
- Bennett, Belinda
- The Hon Leon Bignell SA, Minister for Agriculture, Food and Fisheries, Forests, Tourism, Recreation and Sport and Racing
- Bills, Rachel
- Bonlac Supply Company
- Brownes Foods Operations Pty Ltd
- Brooks, Greg
- Burgess, Max
- Christensen, Phillip
- Clarke
- Connolly, Patrick
- Country Women's Association of NSW
- Crosby, Kathryn
- Dairy Connect
- Dairy Farmers Milk Co-operative Limited
- Dennis, Greg
- Department of Agriculture & Water Resources
- Fairbrae Milk Co Pty Ltd
- Farmer Power
- Fonterra Australia Pty Ltd
- Gee, Colin & Rita
- Gee, Di
- Kennebury, Alan
- Goulding, Bridget
- Glass, Patrick
- Hunter River Group, Country Women's Association of NSW
- Khan, Safiq
- Lion Dairy & Drinks
- Lubitz, Bernhard
- Macallan, Ian
- Maher, Kevin
- Marshall, Lachlan
- MGA Independent Retailers
- Murray Goulburn Co-operative Co. Limited
- Neal, James

- Niche Agribusiness Consulting
- NSW Farmers' Association
- Olssan, Rebecca
- Pattison, Alan and Leanne
- Phelan, Tom
- Port Curtis Milk Suppliers Cooperative Association Limited
- Queensland Dairyfarmers' Organisation Ltd
- Retail Guild of Australia
- SA Dairyfarmers Association Inc
- Sherborne, Jane
- Tasmanian Farmers & Graziers Association
- Telopea Group
- United Dairyfarmers of Victoria
- Vegan Australia
- Wannon Branch, United Dairyfarmers of Victoria
- Warrnambool Cheese and Butter Factory Company Holdings Limited
- Western Australian Collective Bargaining Group
- Western Australia Department of Agriculture and Food
- Western Australian Farmers Federation Inc
- White, Glenn
- Wieck, Fay

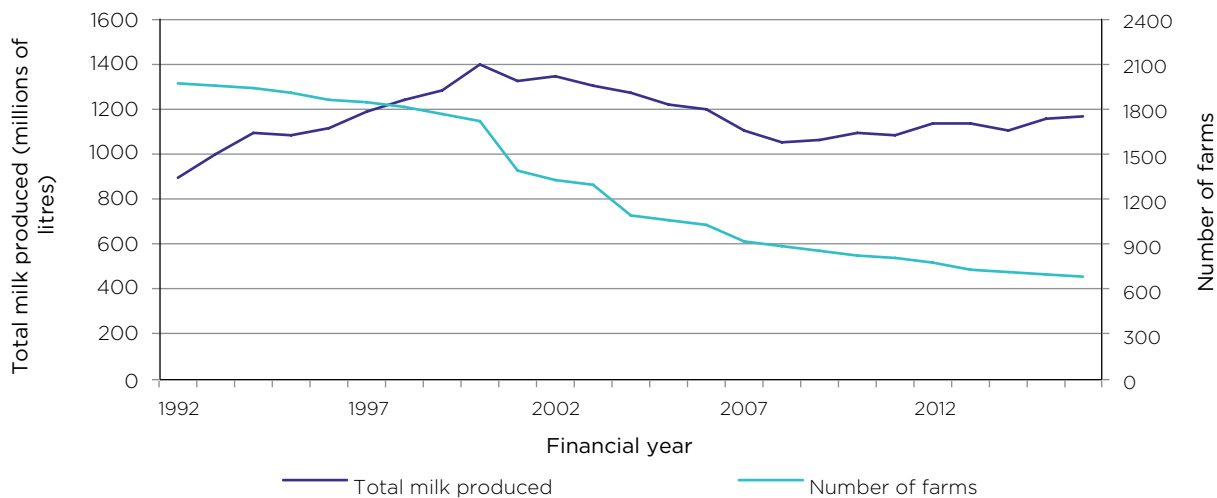
Submissions in response to Interim Report

- Arbuthnot, Alex
- Australian Dairy Farmers
- Australian Dairy Products Federation Inc.
- Australian Small Business and Family Enterprise Ombudsman
- Beattie, Philip and Elisabeth
- Bega Cheese Limited
- Briggs, Scott
- Dairy Connect Ltd
- Dairy Farmers Milk Co-operative Limited
- Farmer Power
- Fonterra Australia Pty Ltd
- Lion Dairy & Drinks Pty Ltd
- McInnes, Duncan
- Muldoon, Graeme
- NSW Farmers' Association
- Norco Co-operative Limited
- Niche Agribusiness Consulting
- Port Curtis Milk Suppliers Co-operative Association Limited
- Priebe, Robin M
- Queensland Dairyfarmers' Organisation
- SA Dairyfarmers' Association Inc.
- Sherborne, Jane
- Schuler, Brian & Singh-Mahil, Karrinjeet
- Small Business Commissioner South Australia

- Tasmanian Farmers & Graziers Association
- United Dairyfarmers of Victoria
- United Dairyfarmers of Victoria Wannon
- Western Australian Farmers Federation Inc.

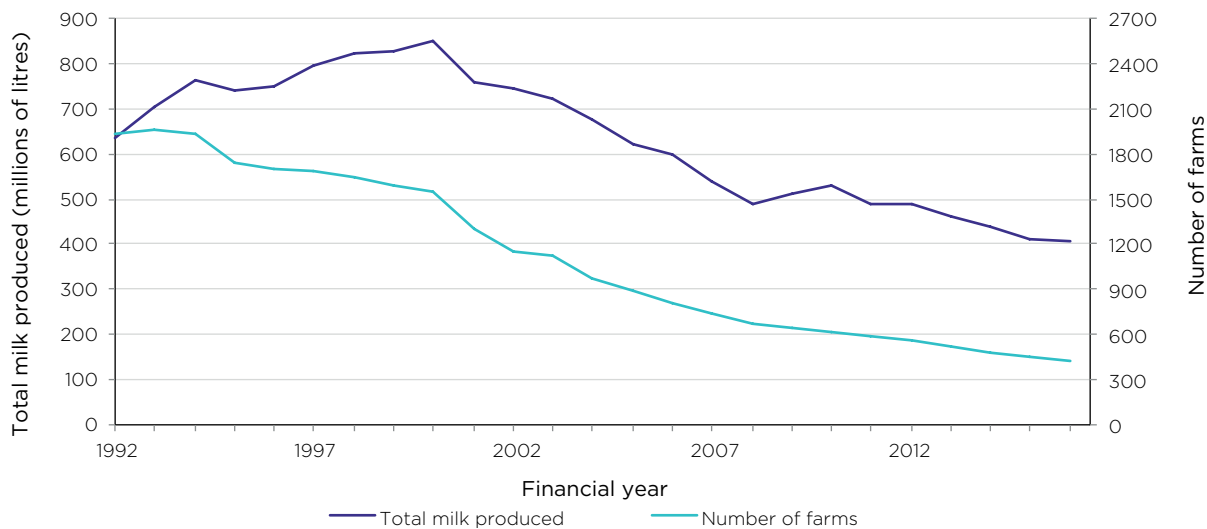
Appendix 4: Additional chart analysis

Figure A4.1: Total milk production and farm numbers, New South Wales



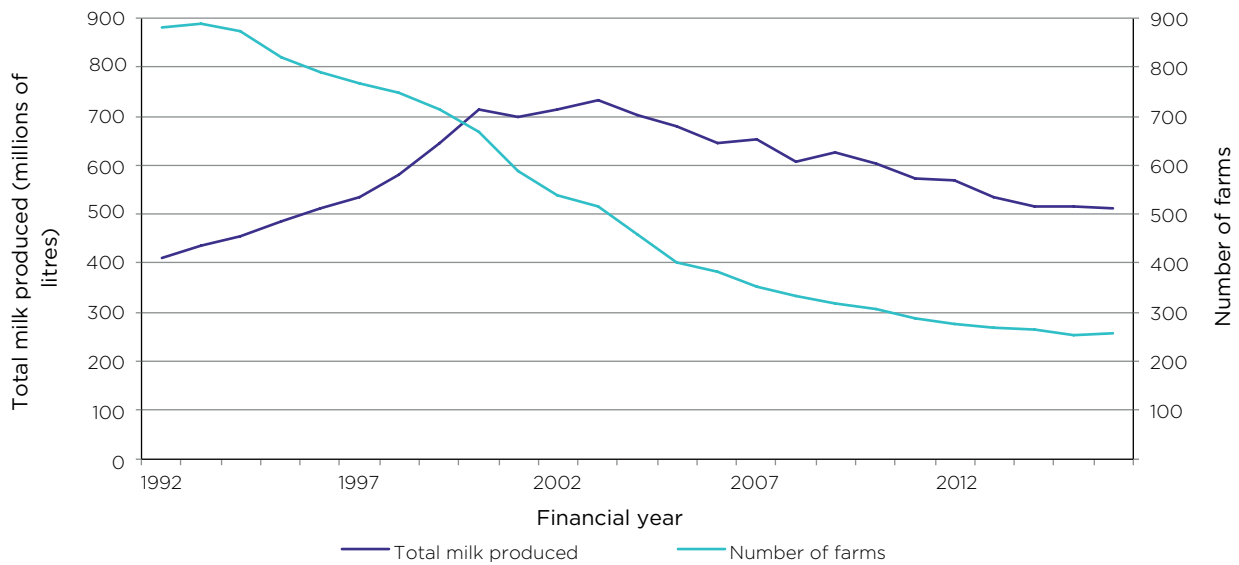
Source: Dairy Australia, ACCC analysis.

Figure A4.2: Total milk production and farm numbers, Queensland



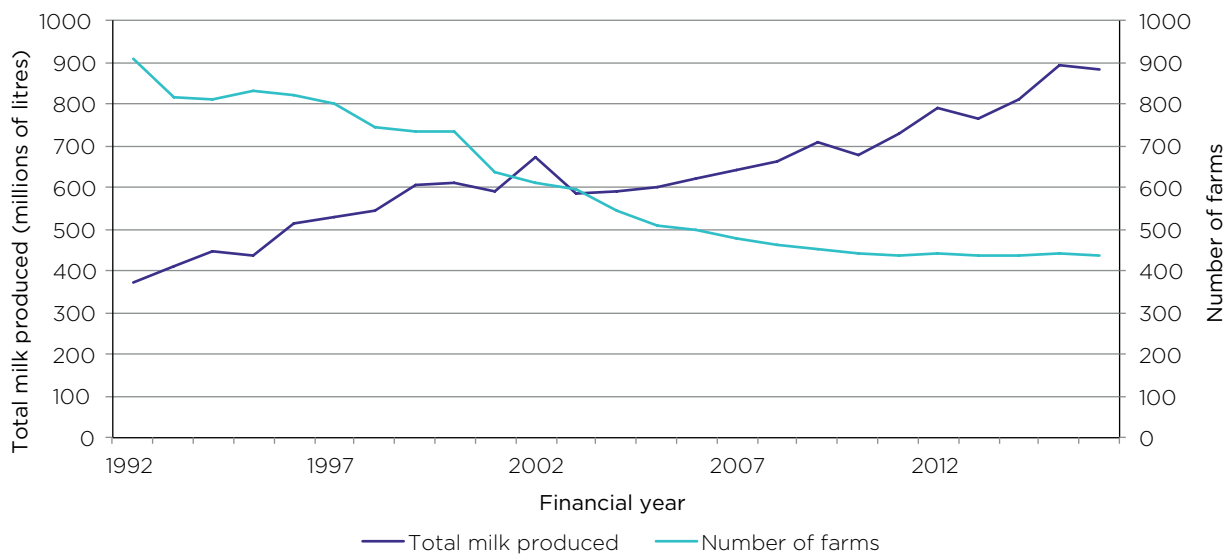
Source: Dairy Australia, ACCC analysis.

Figure A4.3: Total milk production and farm numbers, South Australia



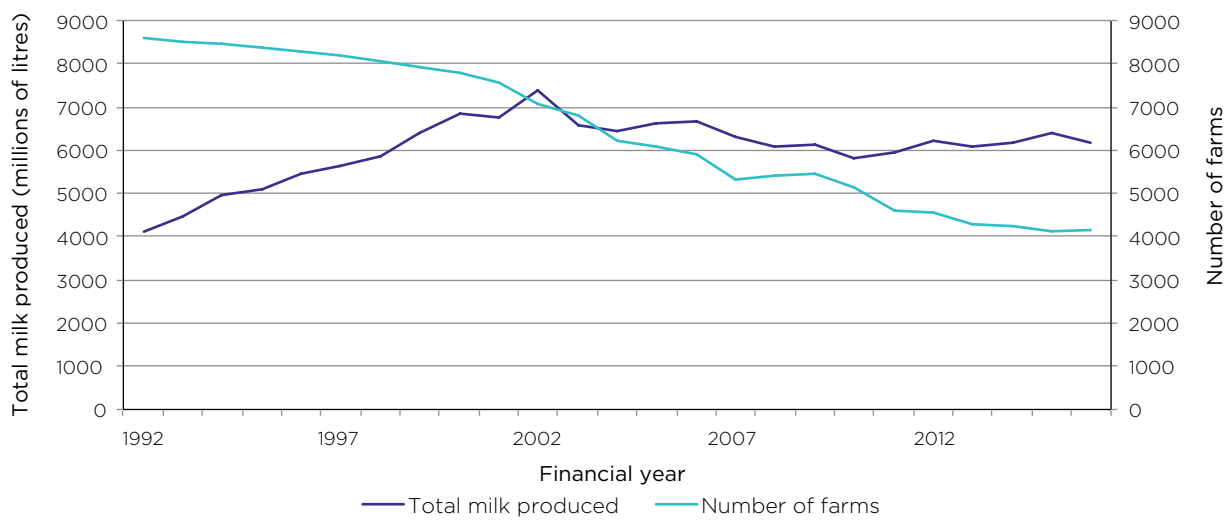
Source: Dairy Australia, ACCC analysis.

Figure A4.4: Total milk production and farm numbers, Tasmania



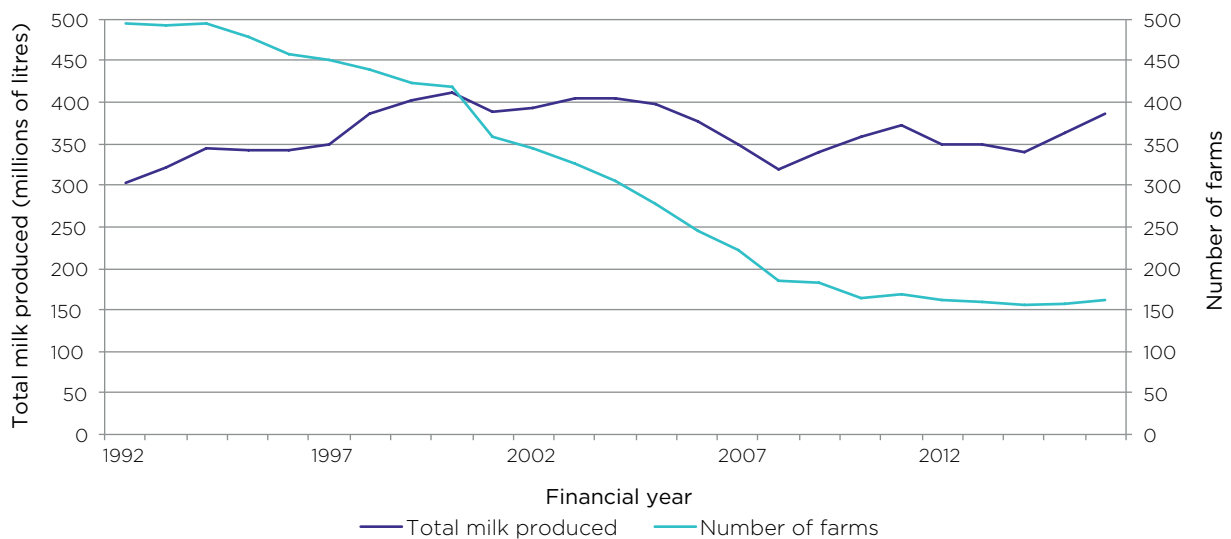
Source: Dairy Australia, ACCC analysis.

Figure A4.5: Total milk production and farm numbers, Victoria



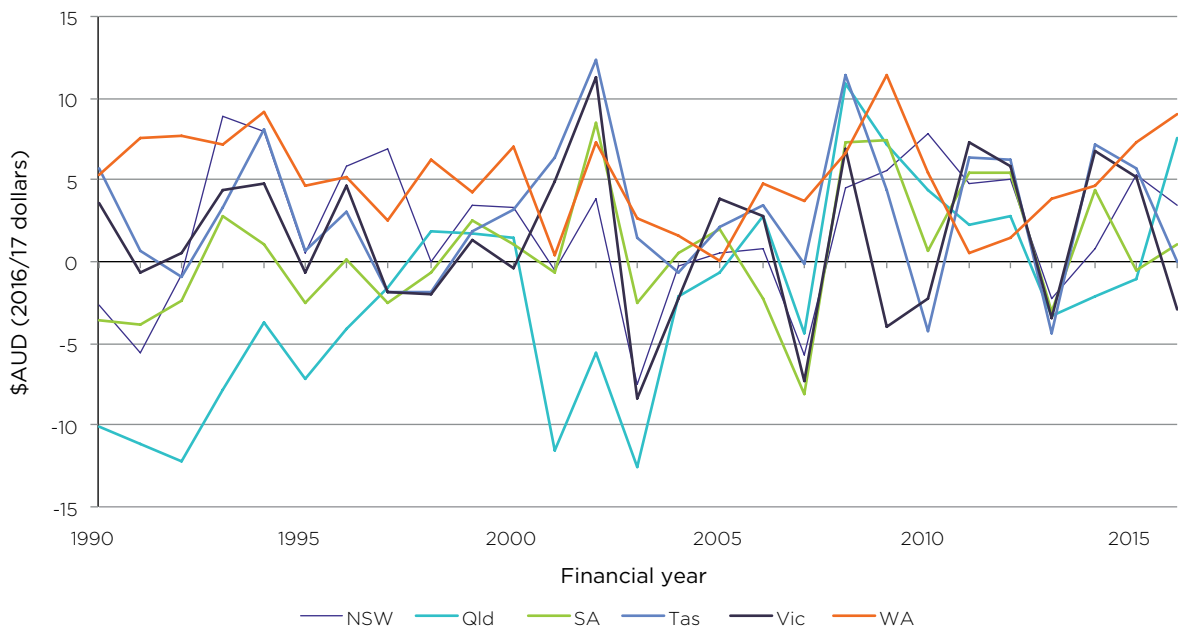
Source: Dairy Australia, ACCC analysis.

Figure A4.6: Total milk production and farm numbers, Western Australia



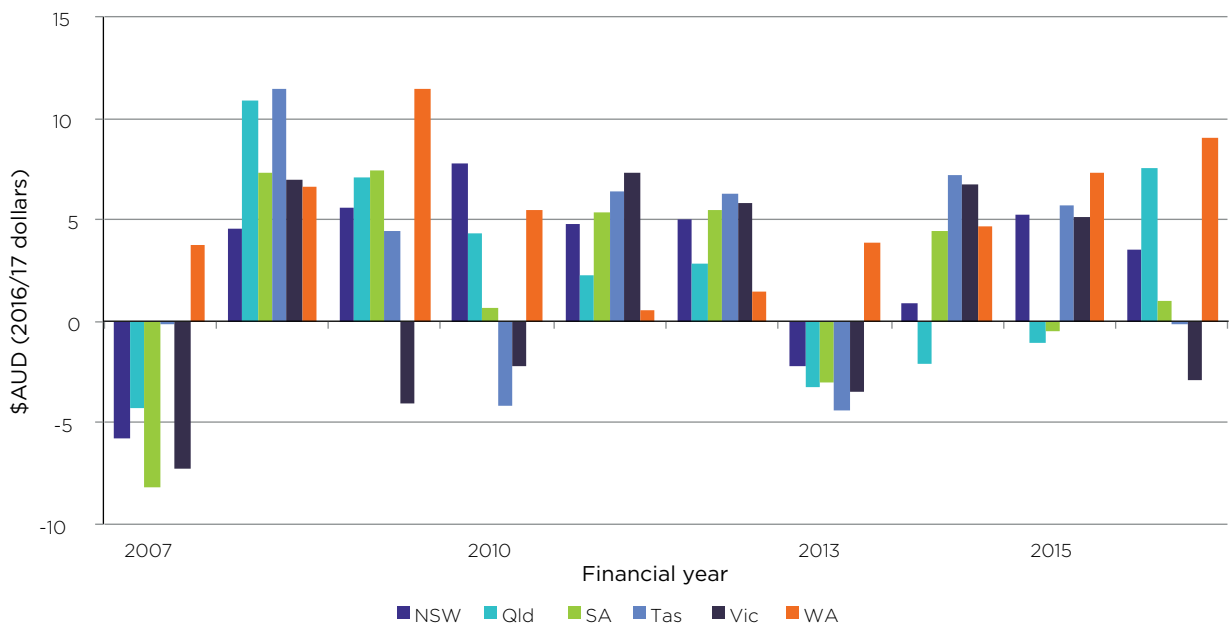
Source: Dairy Australia, ACCC analysis.

Figure A4.7: Farm business profit, by state, real terms (2017 dollars)



Source: ABARES, ACCC analysis.

Figure A4.8: Farm business profit, by state, real terms (2017 dollars)



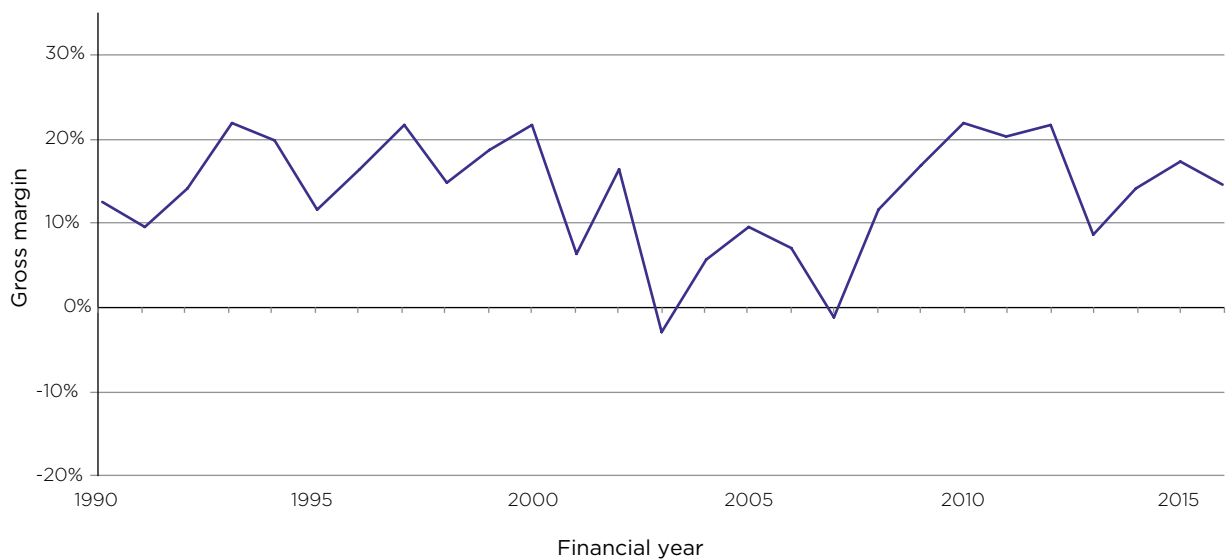
Source: ABARES, ACCC analysis.

Figure A4.9: Gross margin, Australia



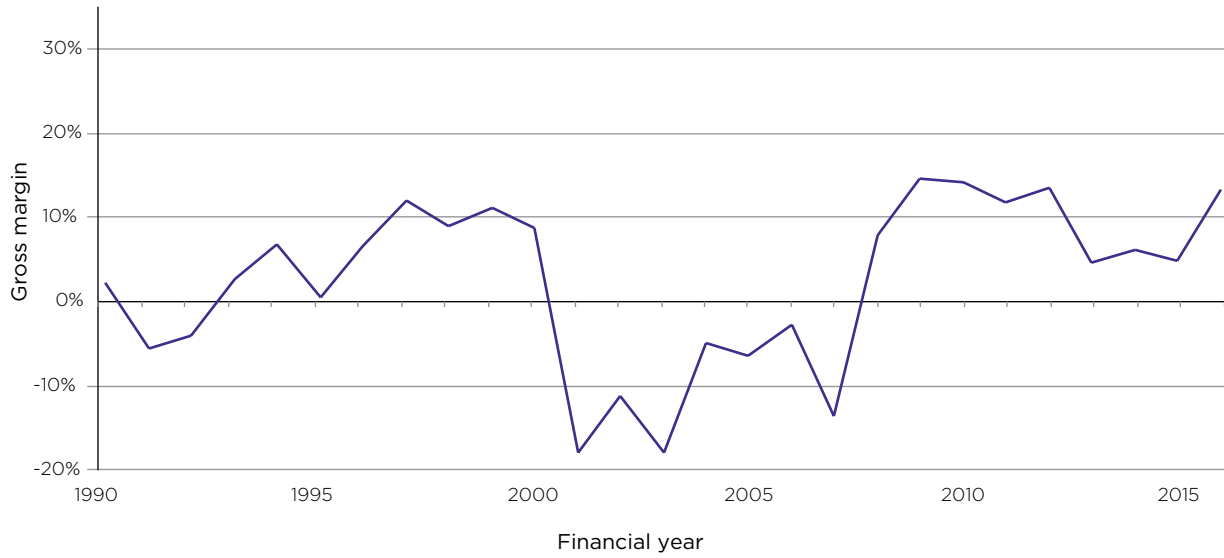
Source: ABARES, ACCC analysis.

Figure A4.10: Gross margin, New South Wales



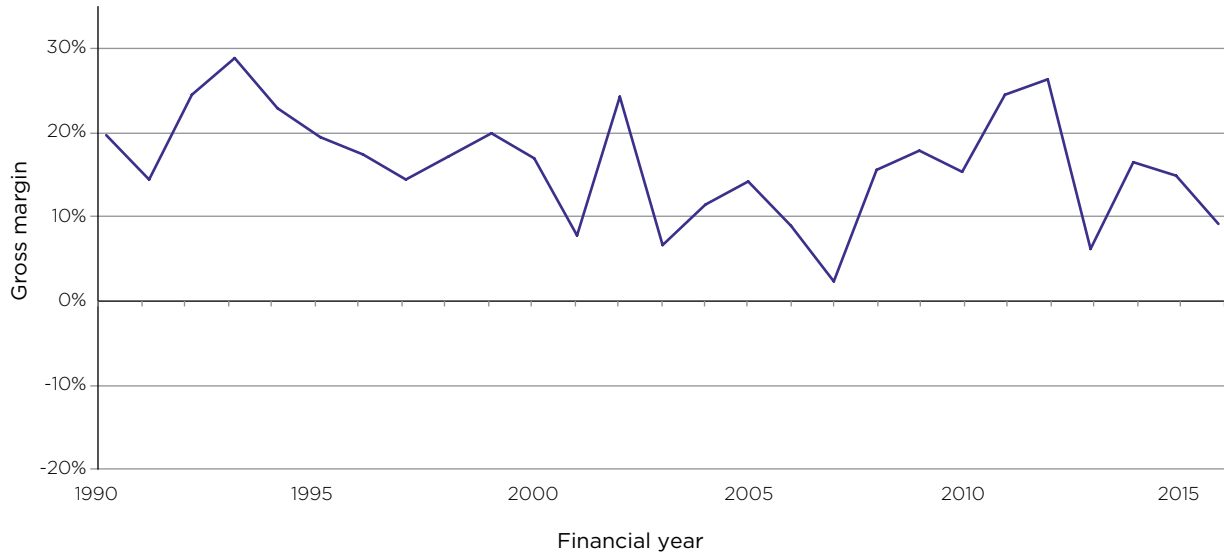
Source: ABARES, ACCC analysis.

Figure A4.11: Gross margin, Queensland



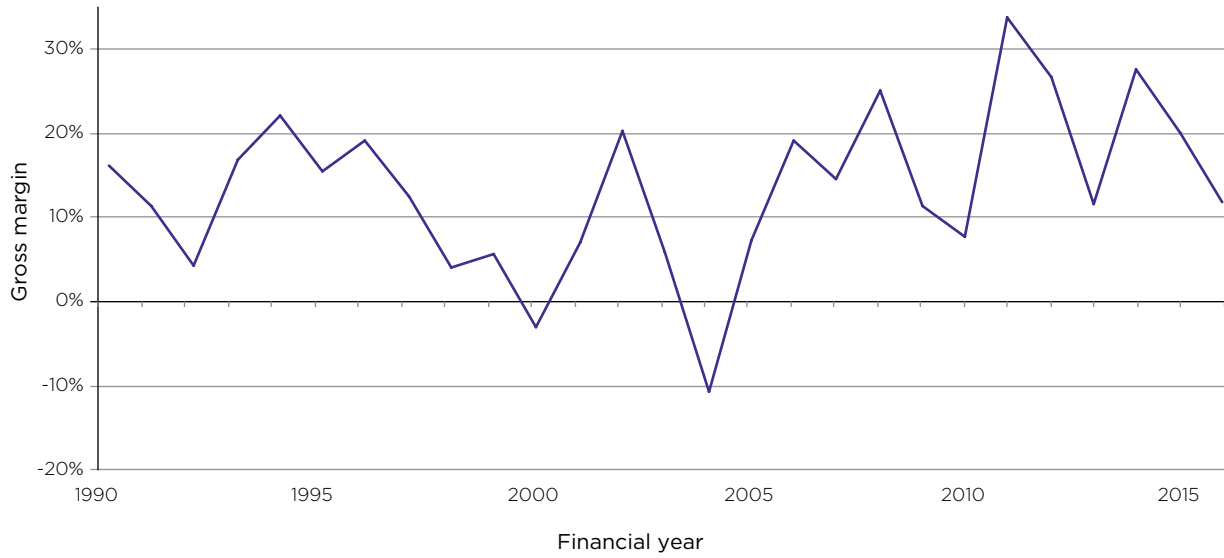
Source: ABARES, ACCC analysis.

Figure A4.12: Gross margin, South Australia



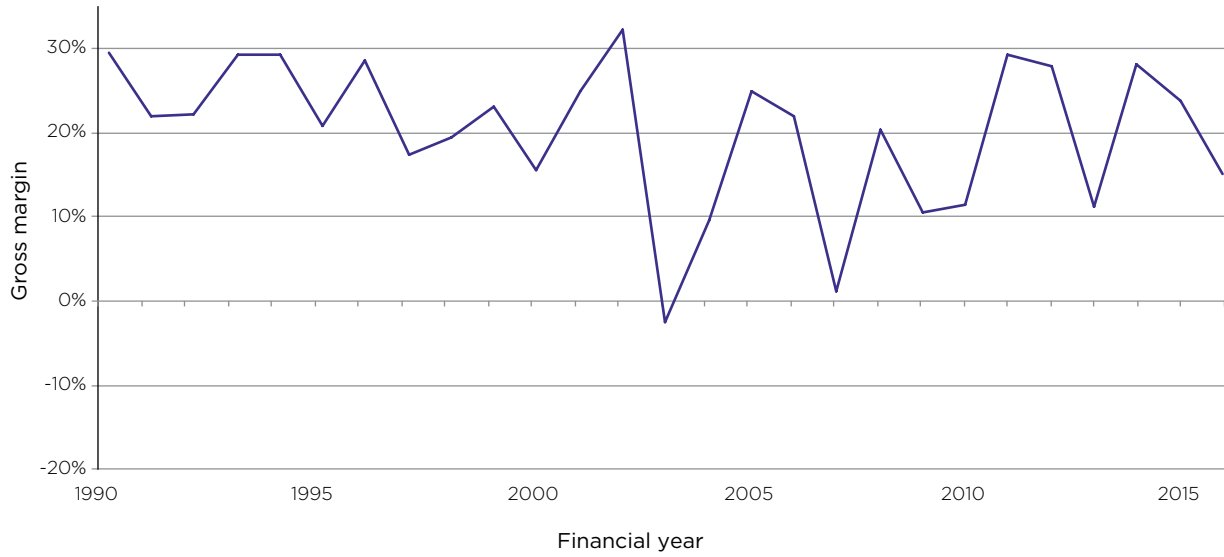
Source: ABARES, ACCC analysis.

Figure A4.13: Gross margin, Tasmania 3: Gross margin, Tasmania



Source: ABARES, ACCC analysis.

Figure A4.14: Gross margin, Victoria



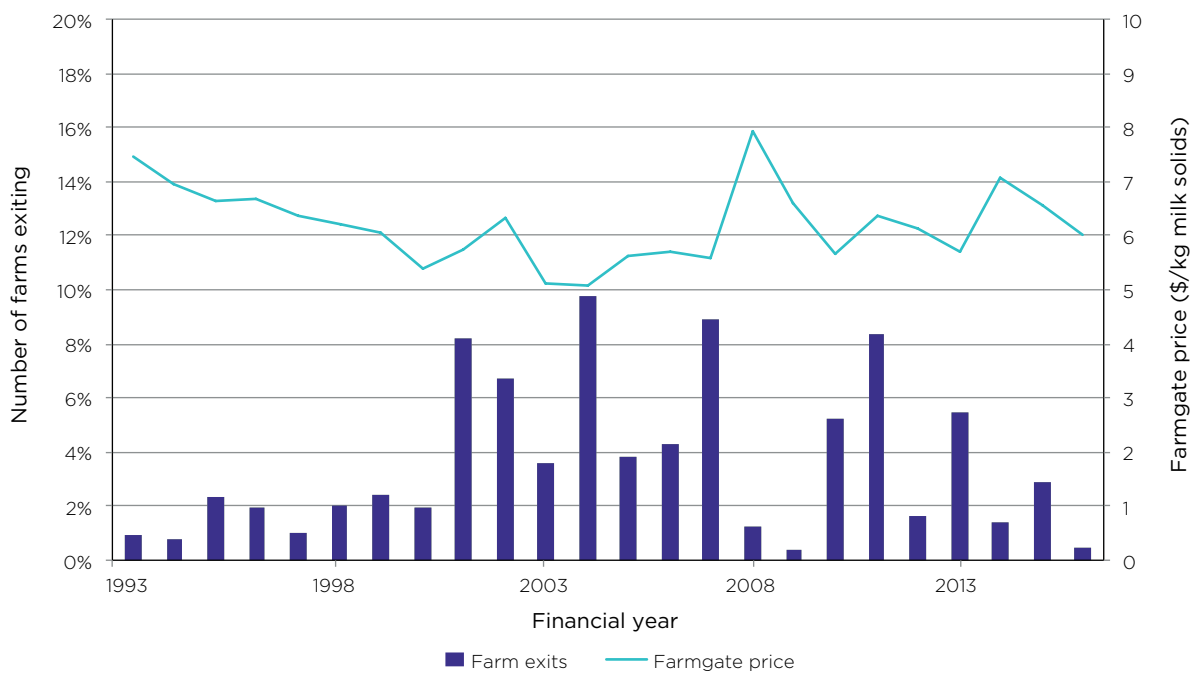
Source: ABARES, ACCC analysis.

Figure A4.15: Gross margin, Western Australia



Source: ABARES, ACCC analysis.

Figure A4.16: Farm exits and farmgate price, Australia, real terms (2016 dollars)



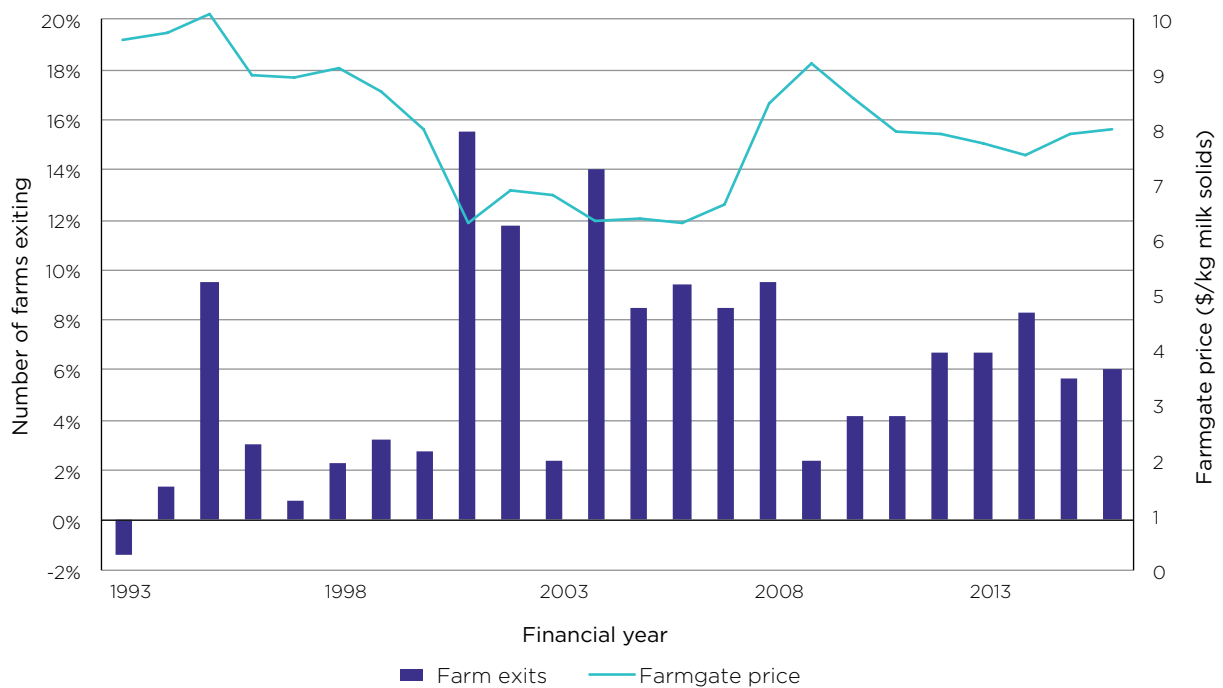
Source: Dairy Australia, ACCC analysis.

Figure A4.17: Farm exits and farmgate price, New South Wales, real terms (2016 dollars)



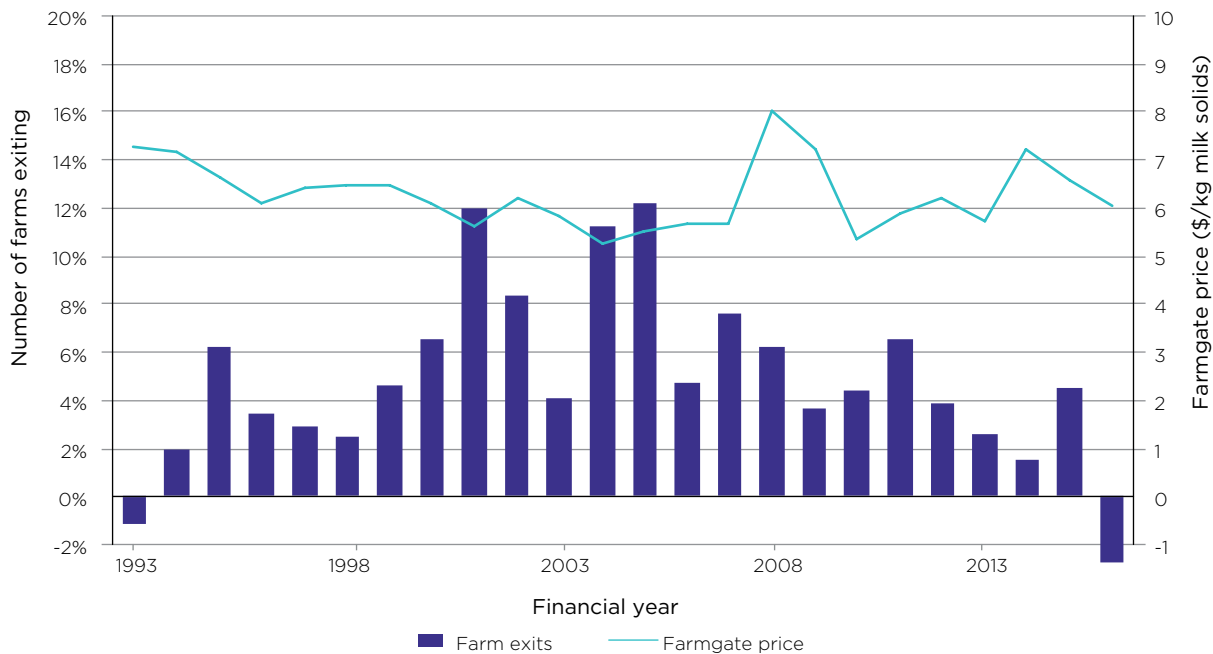
Source: Dairy Australia, ACCC analysis.

Figure A4.18: Farm exits and farmgate price, Queensland, real terms (2016 dollars)



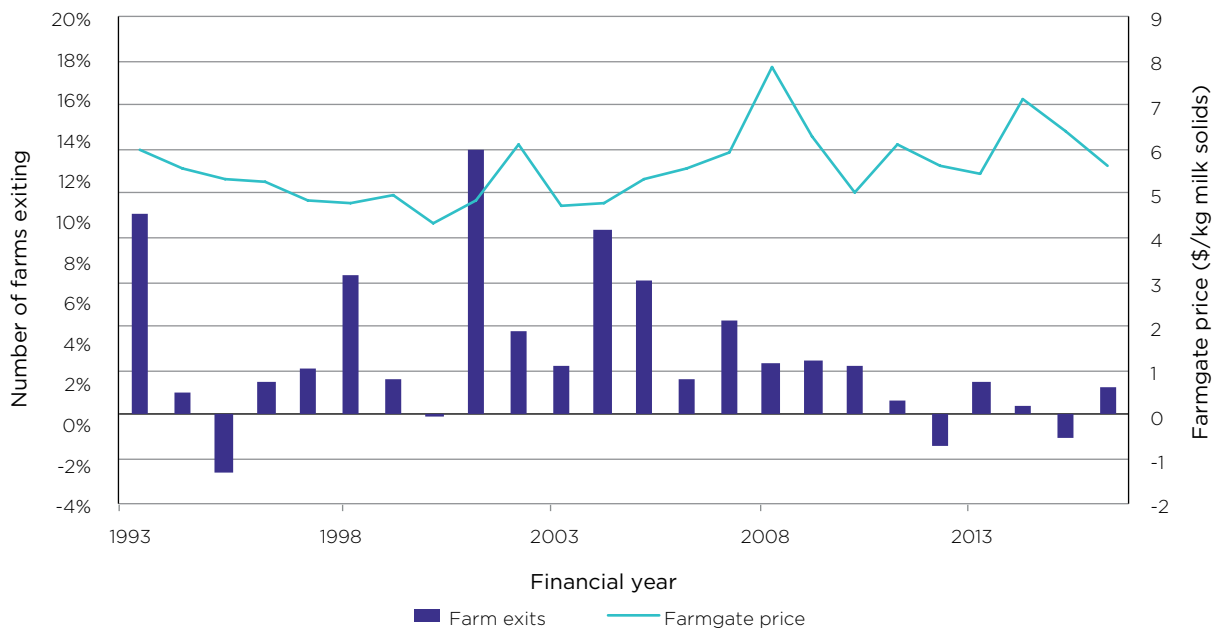
Source: Dairy Australia, ACCC analysis.

Figure A4.19: Farm exits and farmgate price, South Australia, real terms (2016 dollars)



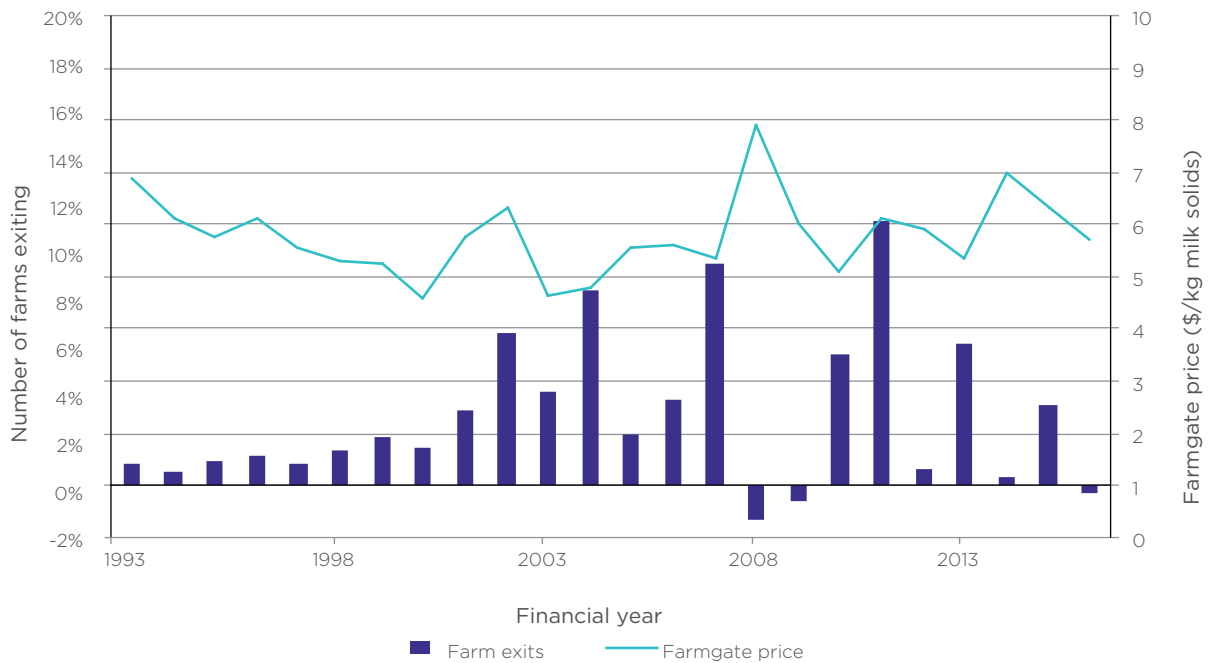
Source: Dairy Australia, ACCC analysis.

Figure A4.20: Farm exits and farmgate price, Tasmania, real terms (2016 dollars)



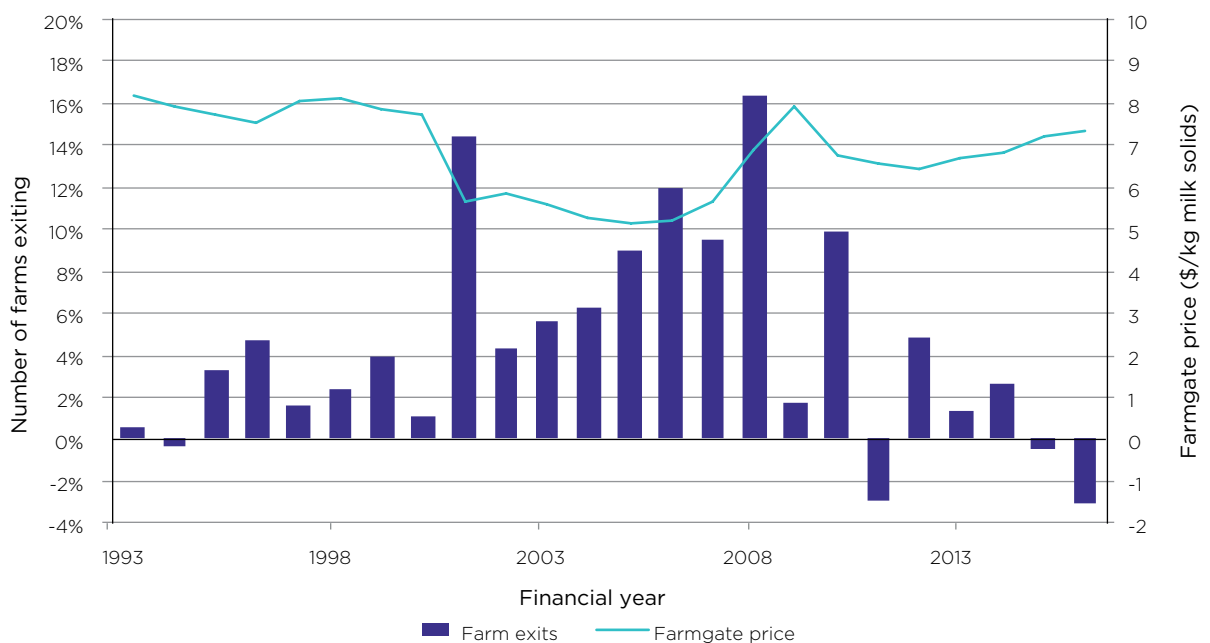
Source: Dairy Australia, ACCC analysis.

Figure A4.21: Farm exits and farmgate price, Victoria, real terms (2016 dollars)



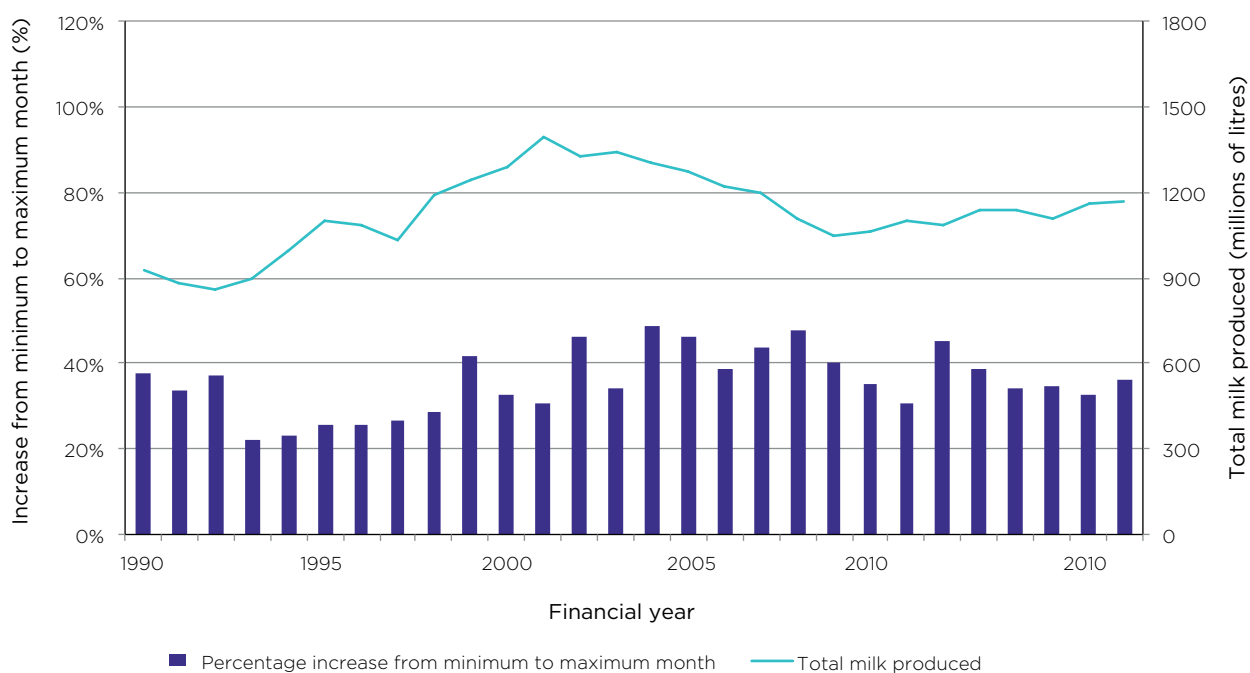
Source: Dairy Australia, ACCC analysis.

Figure A4.22: Farm exits and farmgate price, Western Australia, real terms (2016 dollars)



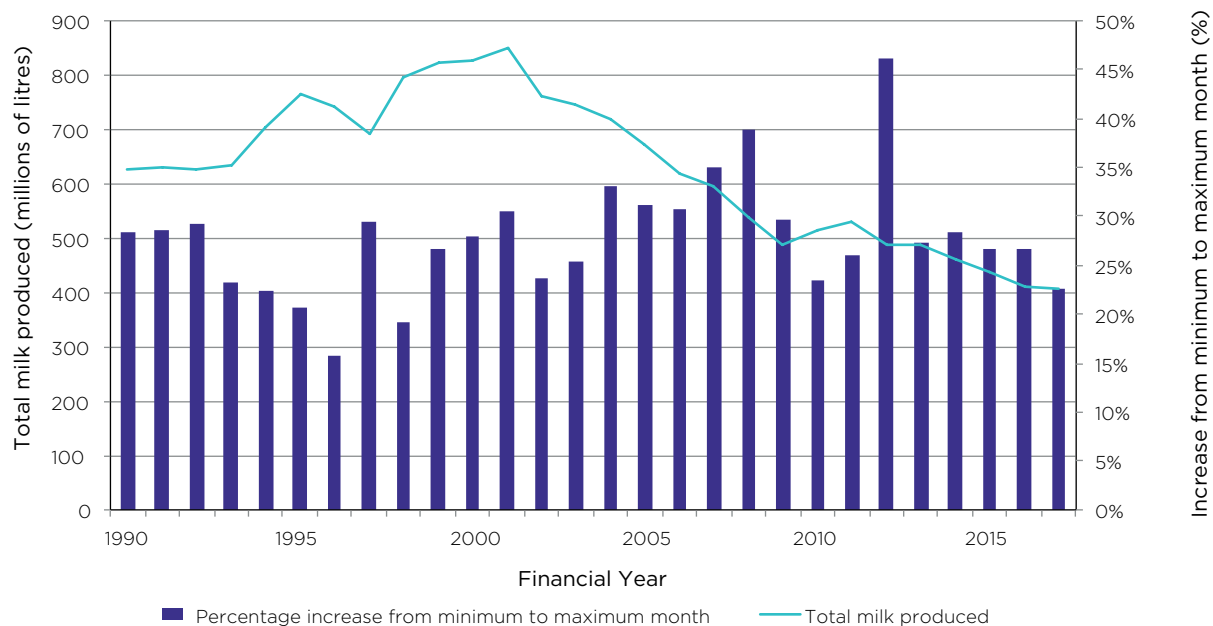
Source: Dairy Australia, ACCC analysis.

Figure A4.23: Seasonality of milk production, New South Wales



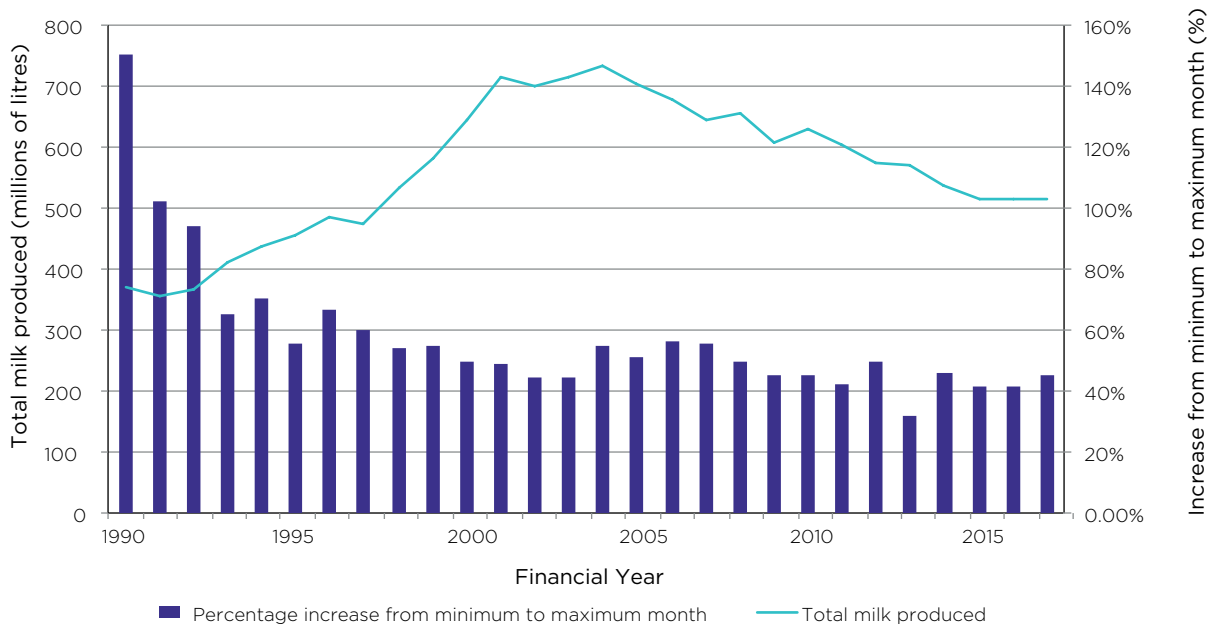
Source: Dairy Australia, ACCC analysis.

Figure A4.24: Seasonality of milk production, Queensland



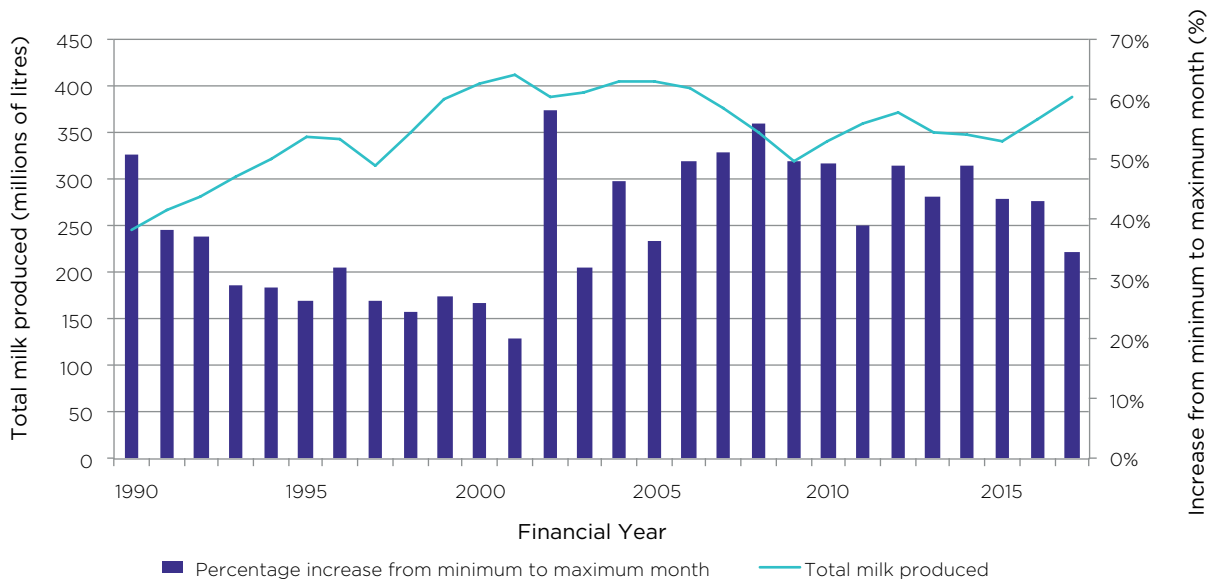
Source: Dairy Australia, ACCC analysis.

Figure A4.25: Seasonality of milk production, South Australia



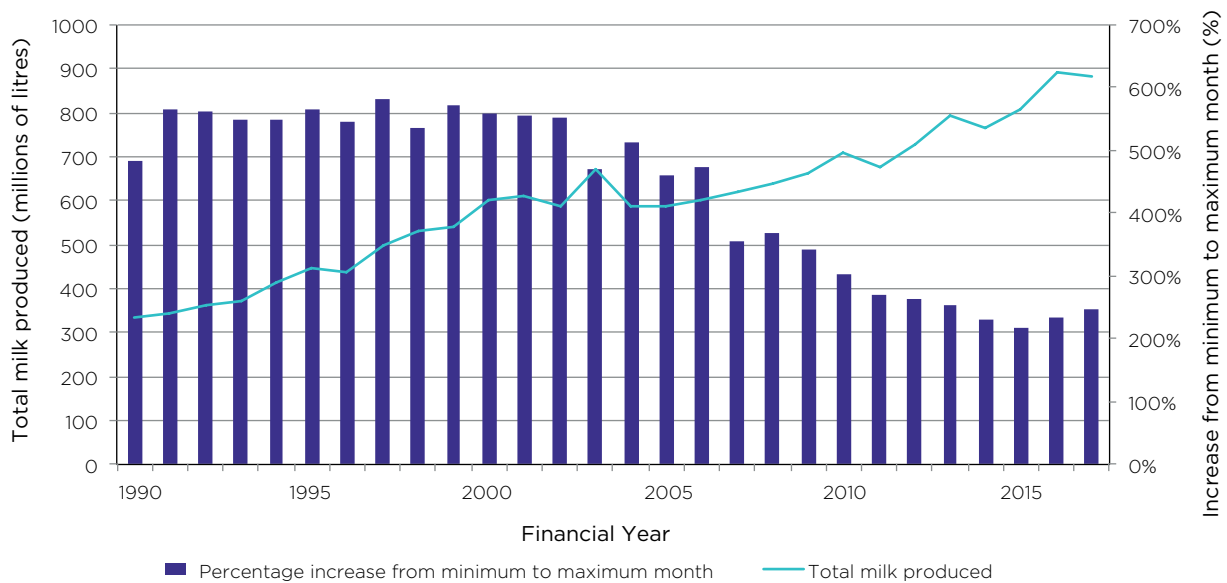
Source: Dairy Australia, ACCC analysis.

Figure A4.26: Seasonality of milk production, Western Australia



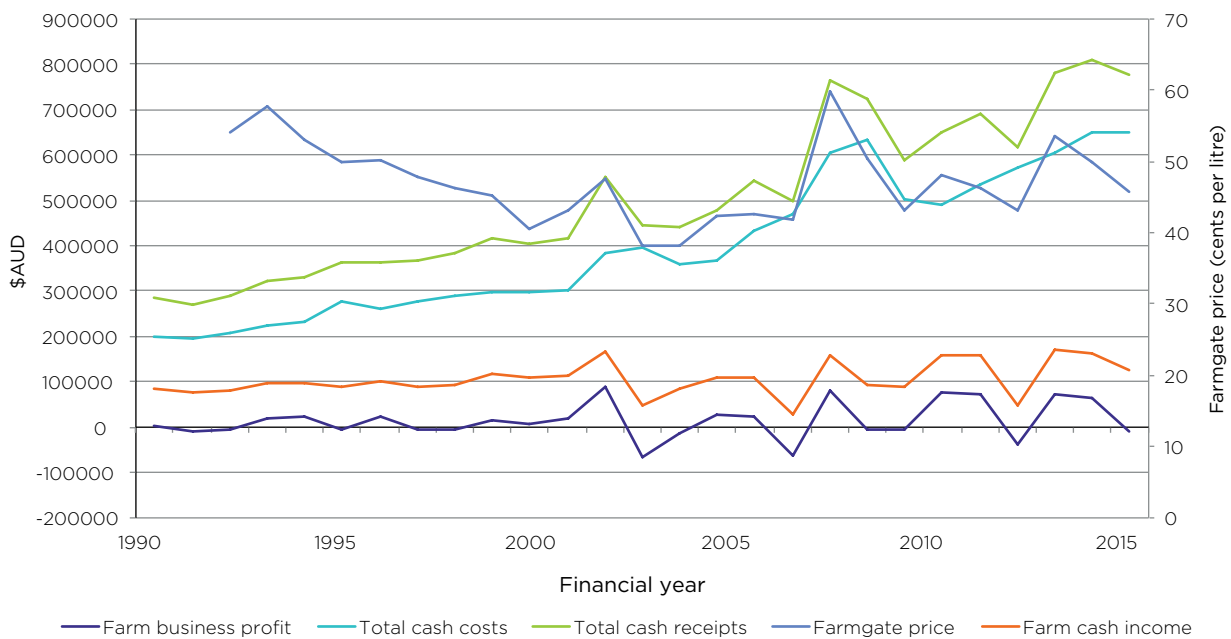
Source: Dairy Australia, ACCC analysis.

Figure A4.27: Seasonality of milk production, Tasmania



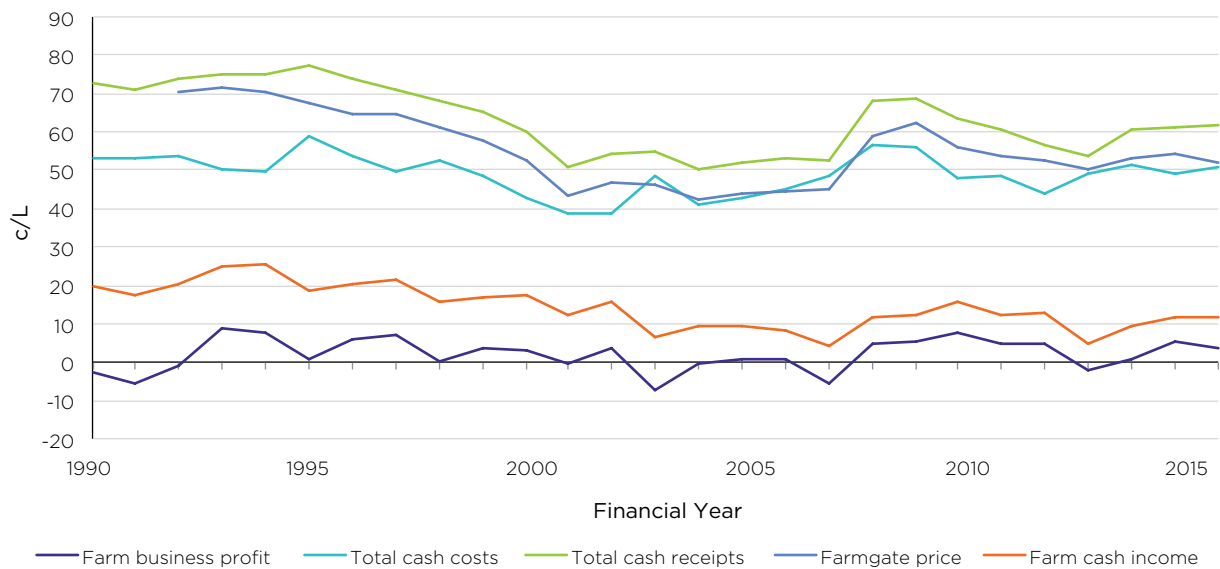
Source: Dairy Australia, ACCC analysis.

Figure A4.28: Farm profitability, Australia, real terms (2017 dollars)



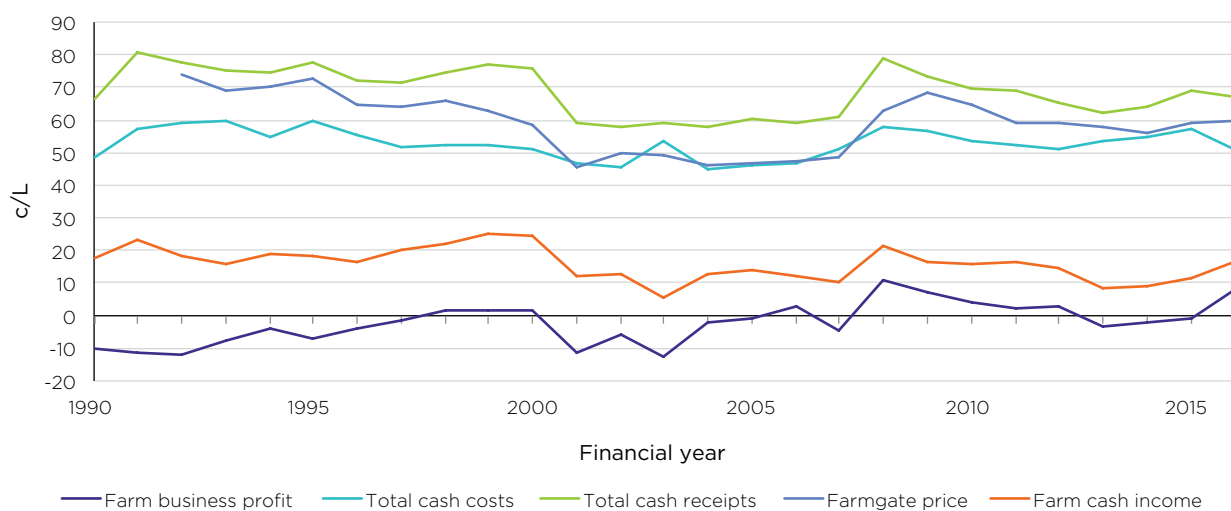
Source: ABARES, Dairy Australia, ACCC analysis.

Figure A4.29: Farm profitability, New South Wales, real terms (2017 dollars)



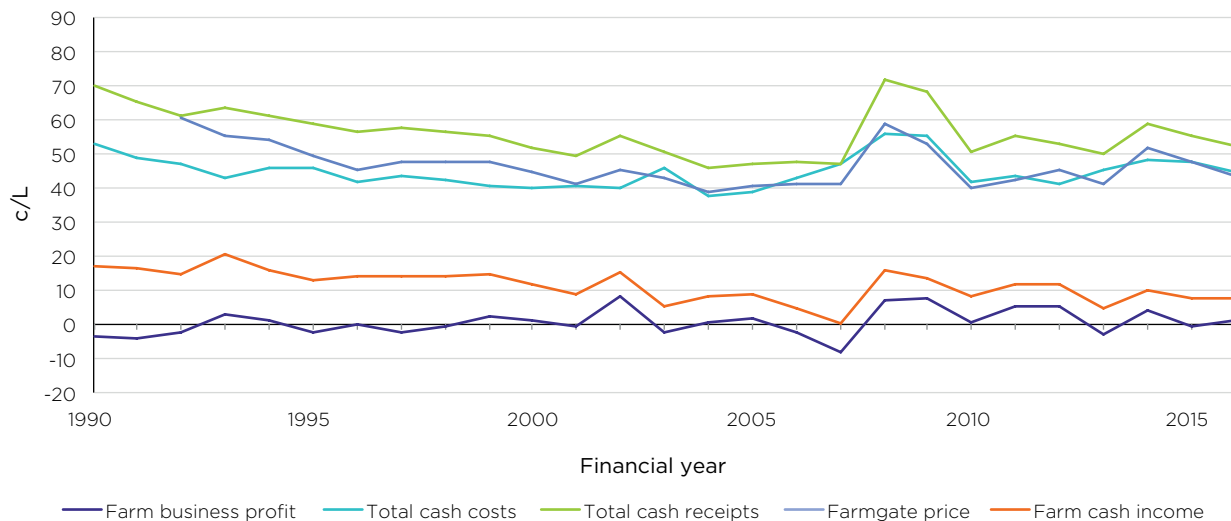
Source: ABARES, Dairy Australia, ACCC analysis.

Figure A4.30: Farm profitability, Queensland, real terms (2017 dollars)



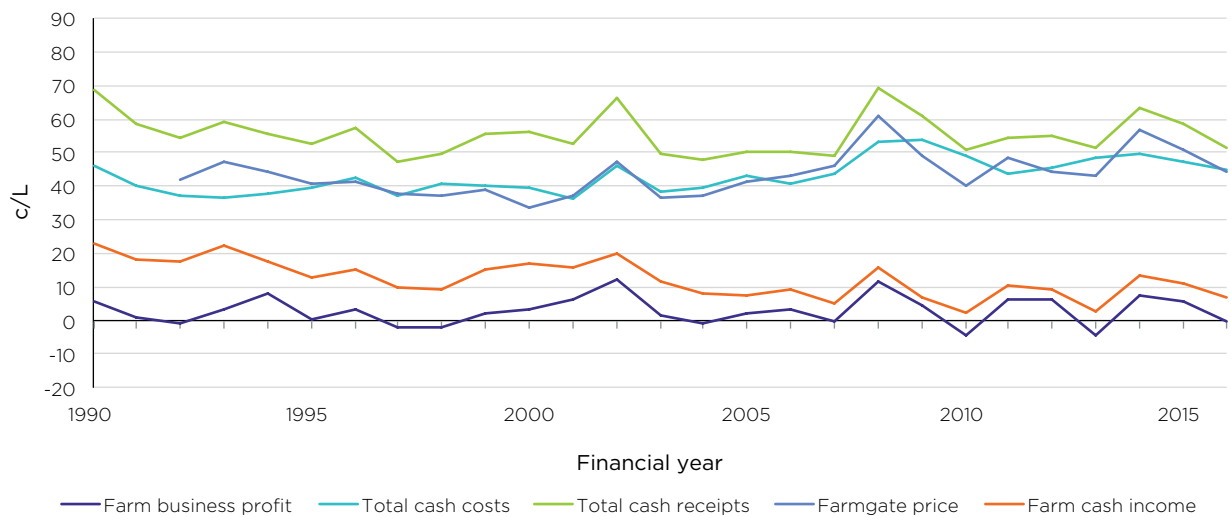
Source: ABARES, Dairy Australia, ACCC analysis.

Figure A4.31: Farm profitability, South Australia, real terms (2017 dollars)



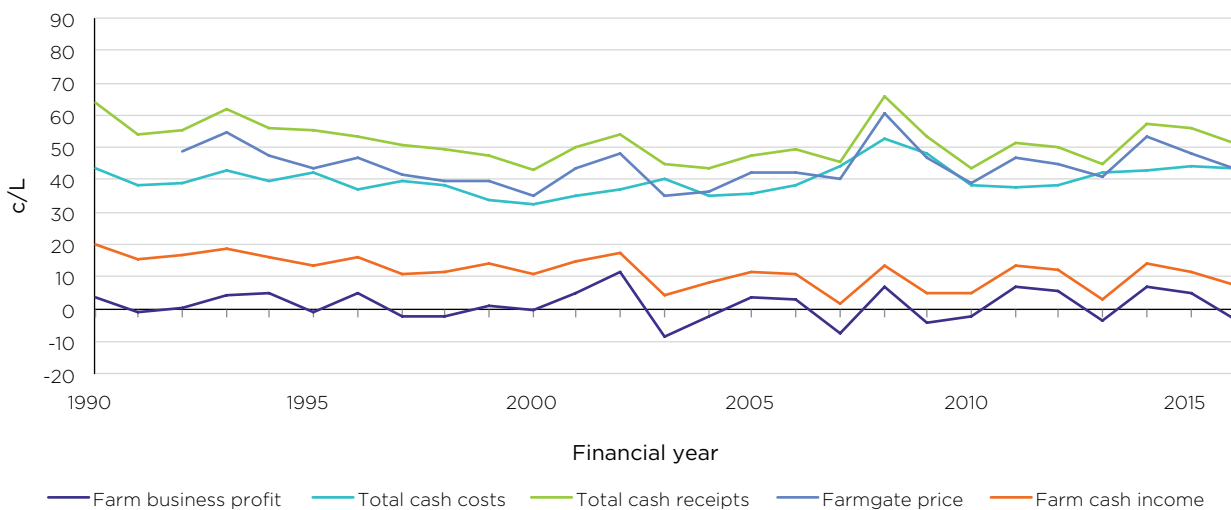
Source: ABARES, Dairy Australia, ACCC analysis.

Figure A4.32: Farm profitability, Tasmania, real terms (2017 dollars)



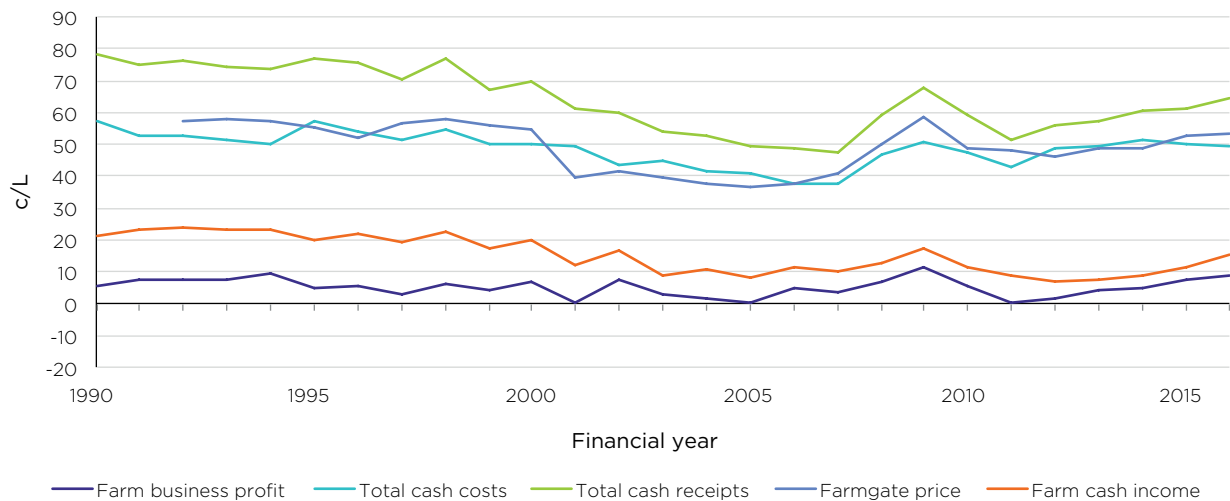
Source: ABARES, Dairy Australia, ACCC analysis.

Figure A4.33: Farm profitability, Victoria, real terms (2017 dollars)



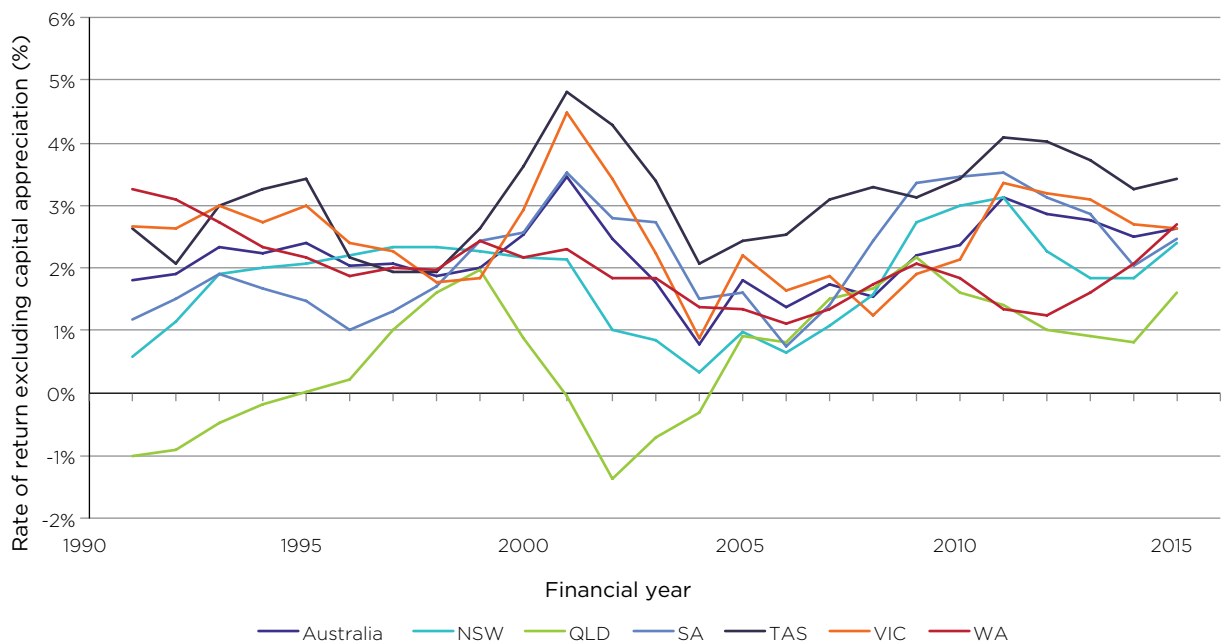
Source: ABARES, Dairy Australia, ACCC analysis.

Figure A4.34: Farm profitability, Western Australia, real terms (2017 dollars)



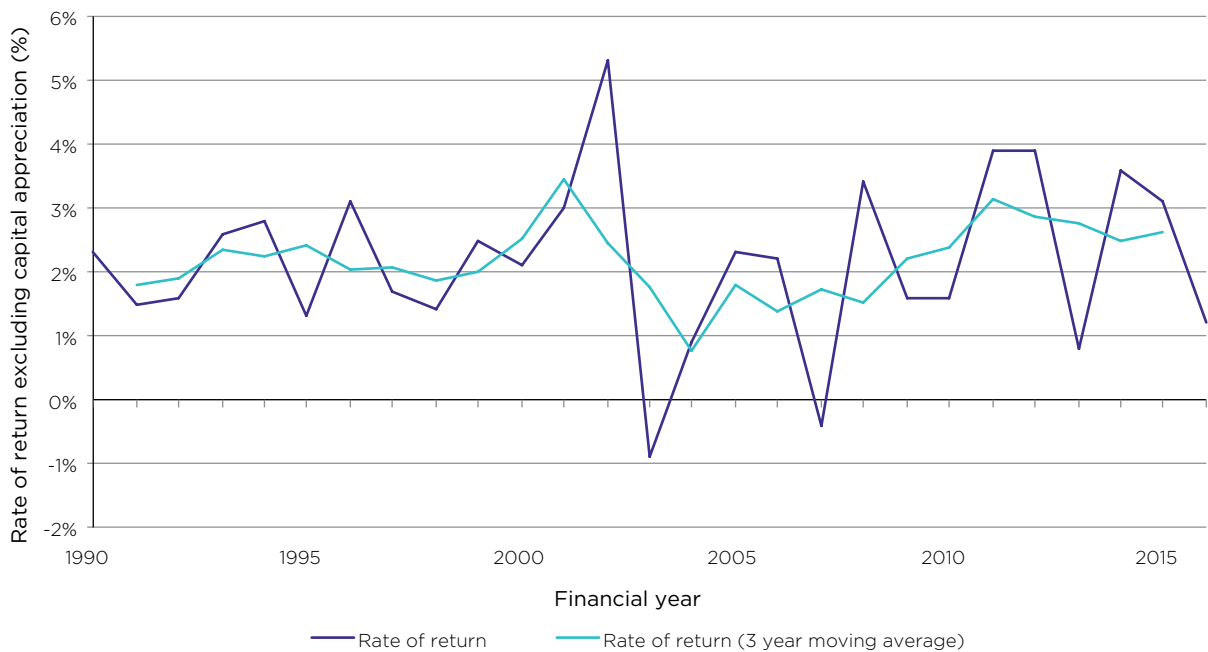
Source: ABARES, Dairy Australia, ACCC analysis.

Figure A4.35: Rate of return excluding capital appreciation, 3 year moving average



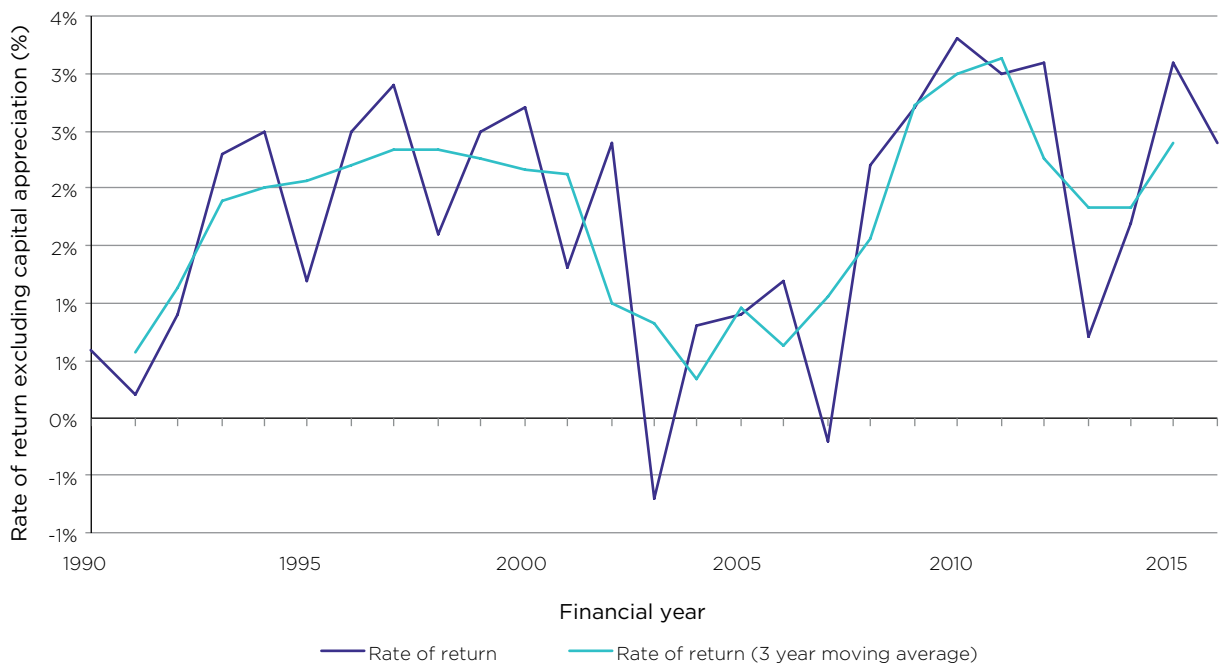
Source: ABARES, ACCC analysis.

Figure A4.36: Rate of return excluding capital appreciation, Australia



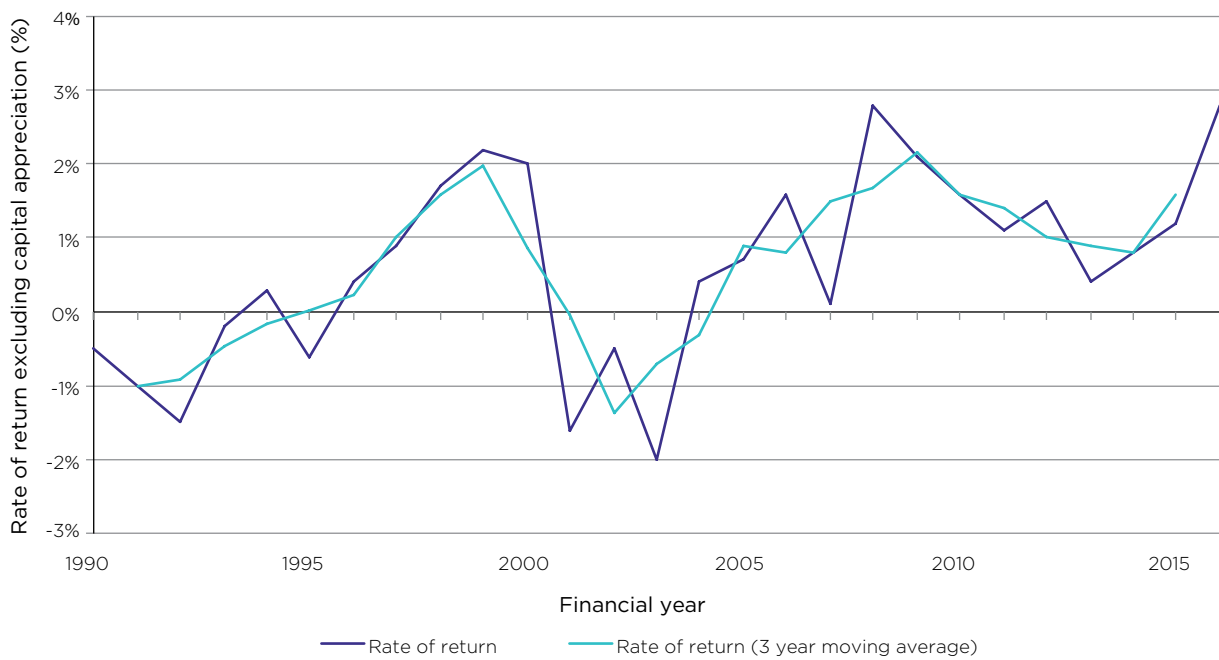
Source: ABARES, ACCC analysis.

Figure A4.37: Rate of return excluding capital appreciation, New South Wales



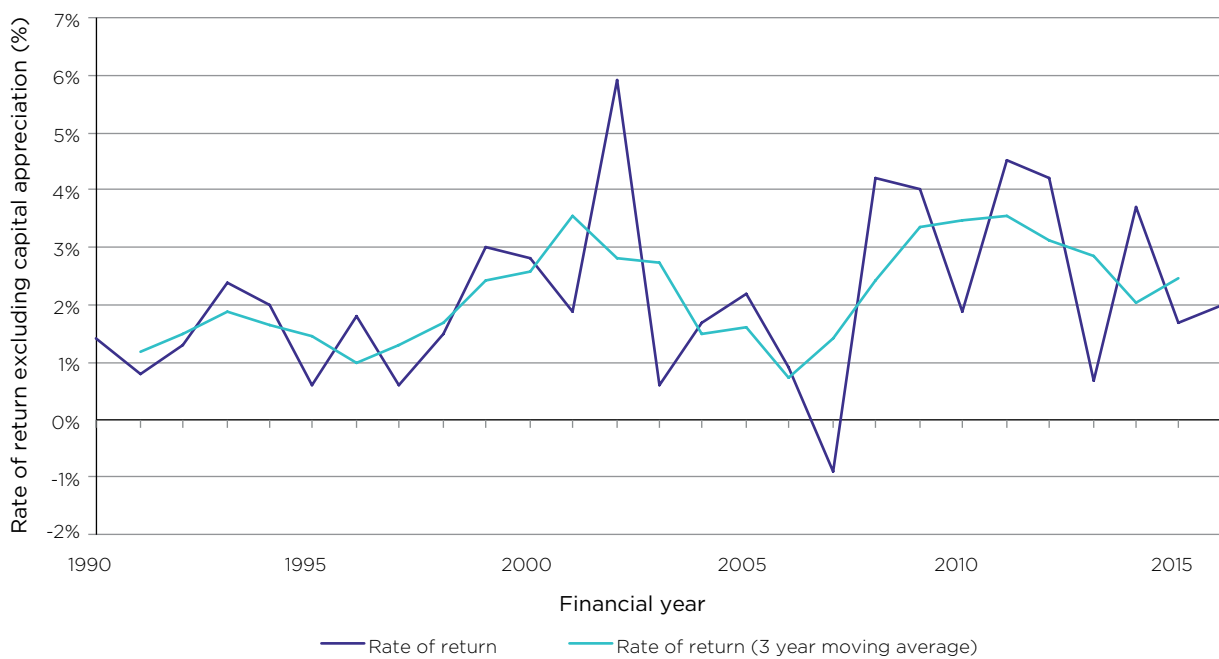
Source: ABARES, ACCC analysis.

Figure A4.38: Rate of return excluding capital appreciation, Queensland



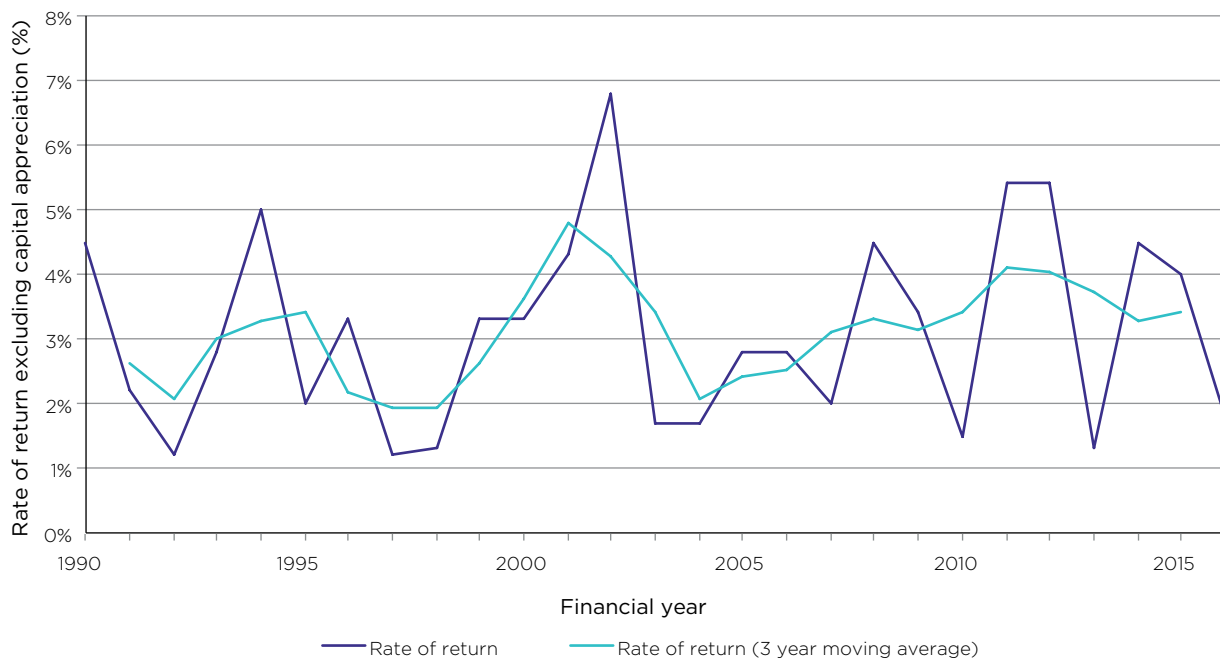
Source: ABARES, ACCC analysis.

Figure A4.39: Rate of return excluding capital appreciation, South Australia



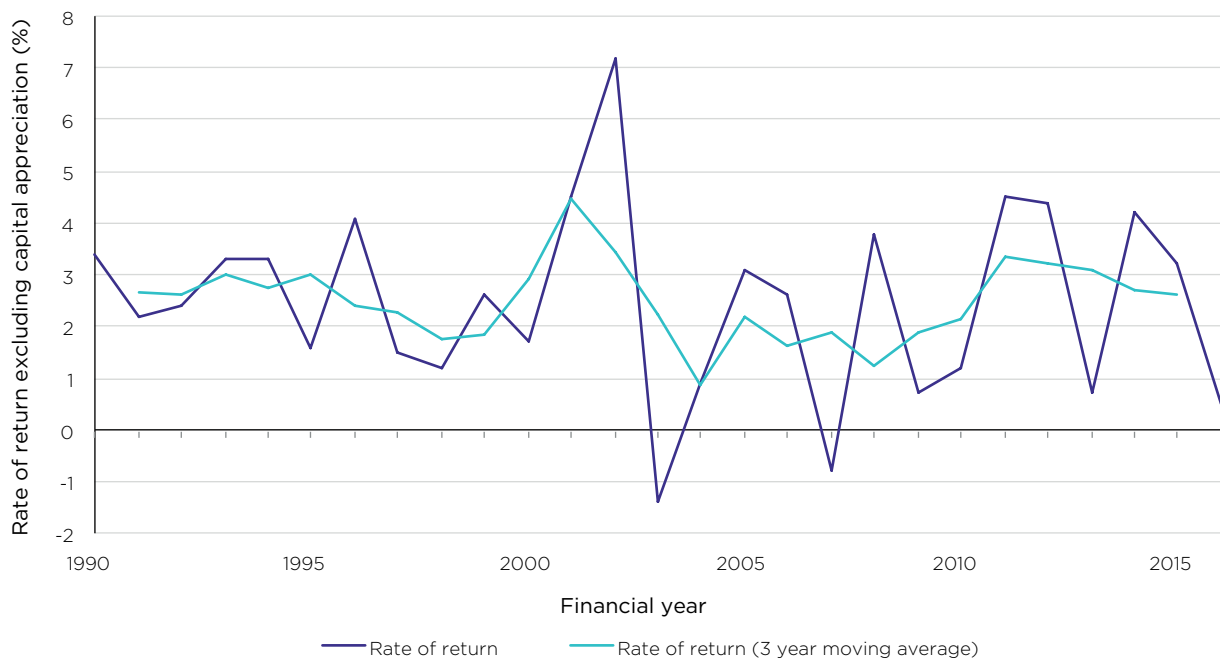
Source: ABARES, ACCC analysis.

Figure A4.40: Rate of return excluding capital appreciation, Tasmania



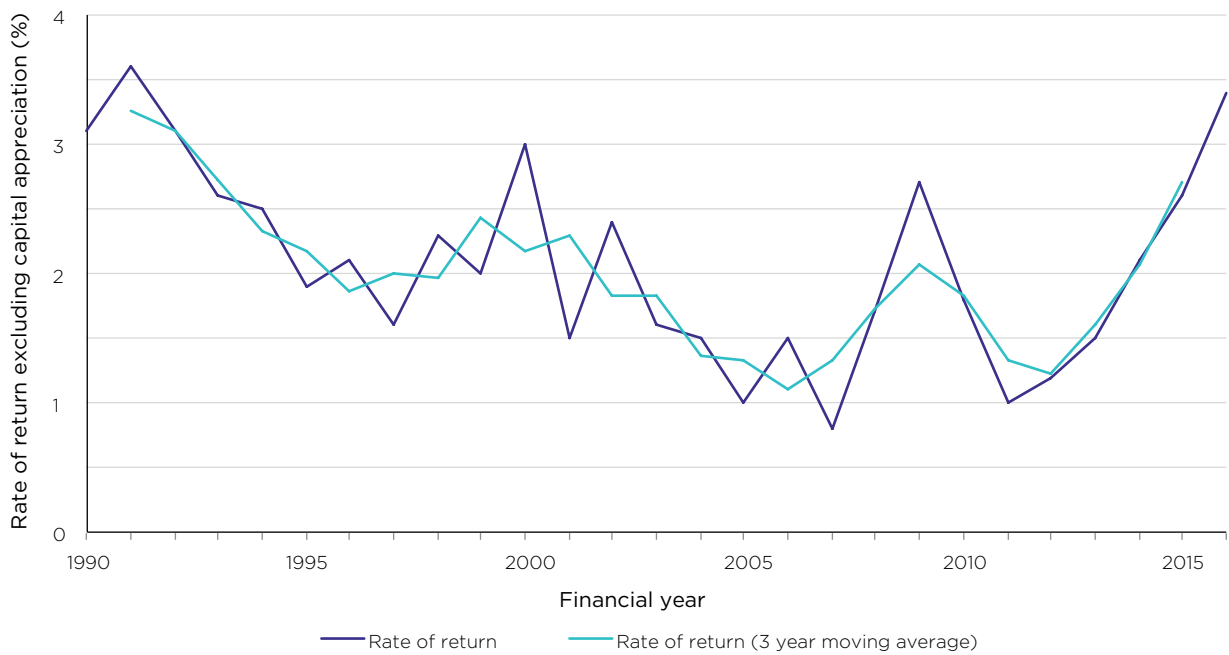
Source: ABARES, ACCC analysis.

Figure A4.41: Rate of return excluding capital appreciation, Victoria



Source: ABARES, ACCC analysis.

Figure A4.42: Rate of return excluding capital appreciation, Western Australia



Source: ABARES, ACCC analysis.

Appendix 5: Collective Bargaining Group case studies

Case studies

The following case studies explore some active CBGs in the dairy industry.

Case study: Dairy Farmers Milk Co-operative Limited

DFMC represents 345 members across Australia and has a long-term, legally-enforceable milk supply agreement with Lion, which expires in 2019.¹ DFMC's members account for approximately 50 per cent of Lion's milk pool in the regions it operates in.² The agreement requires Lion to collect all of the raw milk supplied by each of DFMC's members and to negotiate a commercially reasonable price for milk with DFMC.³ Lion considers that the arrangement can provide time savings through the ability to negotiate consistent contracts for a group.⁴

DFMC has a board of eight directors. Seven of the directors are farmer representatives from each of the regions where DFMC operates and one director is independent.⁵ Members of DFMC have individual milk supply contracts with DFMC, and not with Lion.⁶ The arrangement is effectively a 'back-to-back pricing/milk policy', which requires that:

- DFMC adopt the same milk purchasing policy as Lion in relation to its acquisition of milk⁷
- DFMC sells the milk it acquires to Lion on the same terms and conditions relating to payment, pricing, collection and quality as contained in its farmer contracts⁸
- DFMC charges Lion the same price for milk that it pays to its members.⁹

The origins of this agreement, and the negotiating rights that DFMC gained with it, appear to be unusual in the dairy industry. DFMC commenced operating in 2004 when Australian Co-operative Foods Ltd (trading as Dairy Farmers) prepared to sell the marketing and processing division of its business.¹⁰ DFMC became a co-operative that supplies raw milk, and entered a long-term milk supply agreement with Lion when Australian Co-operative Foods Ltd was acquired by Lion in 2008.¹¹ It is unlikely that DFMC's members would have voted to approve the sale without this milk supply agreement in place.

The agreement requires Lion to pay DFMC an 'aggregation fee' to cover the costs of aggregating the farmers' milk.¹² The back-to-back pricing/milk policy, which is part of its milk supply agreement with Lion, is authorised by the ACCC.¹³

From DFMC's perspective, the key benefit of the agreement for DFMC members is the ability to negotiate and ensure a competitive farmgate milk price and other terms and conditions.¹⁴ The agreement also requires Lion to negotiate with DFMC each year, and allows for an independent expert

1 Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC inquiry into the Australian Dairy Industry*, 12 December 2016, p. 2.

2 Far north Queensland, south east Queensland, central NSW, northern Victoria and central SA.

3 Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC inquiry into the Australian Dairy Industry*, 12 December 2016, p. 32.

4 Lion Dairy & Drinks, *Submission to the ACCC inquiry into the Australian Dairy Industry*, 12 December 2016, p. 12.

5 Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC inquiry into the Australian Dairy Industry*, 12 December 2016, p. 2.

6 Lion Dairy & Drinks, *Submission to the ACCC inquiry into the Australian Dairy Industry*, 12 December 2016, p. 12.

7 *ibid*, pp. 12–13.

8 *ibid*.

9 *ibid*.

10 The conduct was initially authorised in 2008 and was re-authorised in 2013 for a 10-year term; Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC inquiry into the Australian Dairy Industry*, 12 December 2016, p. 2.

11 *ibid*.

12 *ibid*.

13 *ibid*, pp. 2–3.

14 Lion Dairy & Drinks, *Submission to the ACCC inquiry into the Australian Dairy Industry*, 12 December 2016, p. 12.

to determine disputes when they arise.¹⁵ DFMC submitted that it is these two factors, as well as the fact that DFMC is well-funded and resourced (as a consequence of membership fees and the aggregation fee received under the agreement), that enable it to operate effectively.¹⁶

Case study: WA Collective Bargaining Group

The WA Collective Bargaining Group was established in the mid-2000s under the ADF authorisation, and nearly all farmers in the region were members. The group split into three sub-groups to negotiate with each of the three milk processors in WA.

The group had some initial success bargaining with processors when there was a milk shortage and competition to acquire raw milk was strong. However, since that time changes in processor ownership and a surplus of milk supply in WA have reduced the incentive of processors to negotiate with CBGs.

The majority of farmers in WA currently operate on standard form contracts. The collective bargaining group still exists, but no longer negotiates contracts or price with any processors.

Some members expressed concern that if they are actively involved in the CBG, the processor may discontinue collecting their milk, leaving the farmer without alternative supply options. These concerns have some basis, as a number of farmers in WA had their supply arrangements terminated by a processor in 2016.¹⁷

It is unclear whether the group has a future representing farmers in the Western Australian dairy industry.

Case study: Premium Milk Ltd

Premium is a Queensland and northern NSW-based CBG that has a long-term milk supply agreement with Parmalat, which will expire in 2022.¹⁸ It is authorised to collectively bargain until October 2020 and currently has approximately 132 members.

Premium and Parmalat's milk supply agreement has operated since 2001 and has been renewed twice since then.¹⁹ Under the agreement, Parmalat agrees to purchase milk from Premium's members. The agreement governs the negotiations between Parmalat and Premium and includes a dispute resolution mechanism.²⁰ If a dispute cannot be resolved, an independent expert can determine the matter.²¹

The Premium group was created after industry deregulation in July 2000, when a number of smaller co-operatives and companies in south east Queensland joined together.²² It initially had 360 members, which represented a substantial volume of the available Queensland milk.²³

A key feature of this arrangement is that both parties had an incentive, and willingly chose to enter into, a long-term milk supply agreement. The ACCC understands that the leadership of both Premium and Pauls (the former name of Premium) were of the view that a collective bargaining relationship would benefit both parties.

Premium participates in a Milk Management Committee (MMC) with Parmalat, which comprises three members from each organisation.²⁴ The MMC meets as required, at least one month before the

15 Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC inquiry into the Australian Dairy Industry*, 12 December 2016, p. 1.

16 *ibid.*

17 Belinda Varischetti, *WA dairy farmers reeling after processors Brownes confirms it will not be renewing four farmer contracts*, ABC Rural, 19 May 2016, accessed 11 September 2017, <http://www.abc.net.au/news/rural/2016-05-19/wa-dairy-processor-brownes-terminates-milk-contracts/7429998>.

18 Premium was initially authorised by the ACCC to collectively bargain with Parmalat (Pauls Limited at the time) in 2001 for a five-year term. The authorisation has been renewed on two occasions, and currently authorises Premium to collectively bargain until October 2020.

19 Australian Competition and Consumer Commission, *Premium Milk Ltd - Revocation and Substitution - A91236*, 22 June 2010, p. 1.

20 *ibid.*, p. 2.

21 *ibid.*

22 Australian Competition and Consumer Commission, *Premium Milk Supply Pty Ltd - Authorisation - A90745*, 12 December 2001, p. 1.

23 However, membership was offered to 580 farmers; *ibid.*

24 Port Curtis Milk Suppliers Co-operative Association Limited, *Submission to the ACCC inquiry into the Australian Dairy Industry*, 12 December 2016, p. 5.

commencement of a new supply year, and negotiates supply volumes, delivery requirements, quality standards and prices.²⁵

As discussed in chapter 7, Premium and Parmalat sought the assistance of an independent expert to resolve a price dispute for the 2017 season.²⁶ The ACCC understands this was the first time Parmalat and Premium were unable to negotiate a price.²⁷

Case study: Manning Valley Dairy Farmers Collective Bargaining Group

The Manning Valley Dairy Farmers Collective Bargaining Group (Manning Valley) formed in 2012, as a sub-division of the Taree Collective Bargaining Group.²⁸ Manning Valley has seven farmer members located in NSW.²⁹

Following the introduction of \$1 per litre milk in 2011 and the concern this caused for the dairy industry, the Manning Valley group approached Woolworths with a proposal to promote local, high quality milk in Woolworths' stores.³⁰ Negotiations resulted in Woolworths establishing the 'Farmers Own' brand, the milk for which is now supplied by farmers in Queensland, Victoria, WA and SA.³¹ The suppliers in SA are also a CBG.³²

Manning Valley lodged a notification to collectively negotiate with Woolworths and separately with Milk2Market.³³ Milk2Market is a milk supply management business that assists Woolworths with the logistics of acquiring raw milk.³⁴

Negotiations with Woolworths took two years to complete.³⁵ The parties established a three-year rolling agreement, which is renewed every three years subject to any concerns. The latest agreement commenced in 2016.³⁶

Manning Valley engaged a competition lawyer to assist with the negotiation process, which the group submits was an invaluable investment. The cost of the legal assistance was \$60 000, and it is estimated that this cost was recovered by group members in the first year of the agreement.

The availability of legal support meant that the group had significant input into the final milk supply agreement that was negotiated. The group reviewed previous contracts they had operated under and removed terms they considered unfair, such as exclusive supply and step-down clauses. Woolworths accepted the majority of the group's contract modifications, which resulted in what the dairy farmers consider to be a fair contract.

Manning Valley submits the arrangement with Woolworths creates mutual benefits. The farmers have secured favourable contract terms and a favourable price for their milk, while Woolworths has a differentiated, local product with a provenance story that appeals to consumers.

25 Australian Competition and Consumer Commission, *Premium Milk Ltd—Revocation and Substitution—A91236*, 22 June 2010.

26 Kalleen Buchanan, Parmalat and Queensland dairy farmers unable to reach contract agreement, ABC Rural, 13 January 2017, accessed 14/9/2017, <http://www.abc.net.au/news/rural/2017-01-13/parmalat-milk-arbitration-with-dairyfarmers/8180828>.

27 *ibid.*

28 Australian Dairy Farmers, *Collective Bargaining for Dairy Farmers*, July 2014, p. 10.

29 *ibid.*

30 *ibid.*

31 Woolworths, *Our Background*, accessed 4 August 2017, <https://www.woolworths.com.au/shop/discover/our-brands/farmers-own-milk>.

32 Australian Competition and Consumer Commission, *NSW MidCoast & SA Barossa Mid North Co-operative Dairymen Limited Collective Bargaining Groups—Collective Bargaining Notification—CB00287*, 3 February 2015.

33 Australian Dairy Farmers, *Collective Bargaining for Dairy Farmers*, July 2014, p. 10.

34 *ibid.*

35 *ibid.*

36 Australian Competition and Consumer Commission, *Manning Valley Dairy Farmers—Collective Bargaining Notifications—CB00326 & CB0032*, 16 March 2016.