AUSTRALIAN COMPETITION & CONSUMER COMMISSION

Dairy inquiry

Interim report

November 2017

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Australian Competition and Consumer Commission
23 Marcus Clarke Street, Canberra, Australian Capital Territory, 2601

Contents

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	*Competition and Consumer Act 2010*
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.
Domestic-focused regions	includes Far North Queensland (FNQ), northern NSW / southern Queensland, central NSW, South Australia region and Western Australia.
Export-focused regions	includes eastern Victoria, Murray region, western Victoria region, and Tasmania
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.
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 section 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 Australia	includes Far North Queensland (FNQ), northern NSW / southern Queensland, and central NSW.
Notice period	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. for an on-going agreement – the period one party needs to notify another party before the agreement can be terminated.
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.
Queensland Dairy Farmers' Organisation (QDO)	an advocacy organisation that represents and provides services to Queensland dairy farmers.
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 tiled *Australia's dairy industry: rebuilding trust and a fair market for farmers* 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.
Southeastern Australia	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

On 27 October 2016 the Treasurer, the Hon Scott Morrison MP, pursuant to section 95H(1) of the Competition and Consumer Act 2010 (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 Terms of Reference for the inquiry are at *Appendix 1*. The inquiry commenced on 1 November 2016.

Overview

Late-season changes to the farmgate prices paid by Australia's two largest dairy processors in April 2016 caused substantial detriment to the Australian dairy industry and were the catalyst for this inquiry. These 'step-downs', enabled by contract terms, caused severe and unforeseen reductions in the incomes of more than 2000 dairy farmers and the productivity of the industry. Farmers exited the industry and milk production fell substantially.

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. However, these are not new concerns. For several years questions have persisted about whether Australian dairy farmers receive fair prices for the milk they produce. These intensified after supermarkets reduced the retail price of private label milk to $1 per litre in 2011.

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

The dominant picture that has emerged is one of clear 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.

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.

Processors have responded to export and domestic market pressures through major capital investments and adjustments to their business strategies, particularly in the last five to ten years.

In the domestic market, the major Australian supermarkets have exercised their bargaining power over processors to elicit lower wholesale prices and increased efficiency. The most notable illustration of this dynamic is the pricing of private label milk. Supermarkets have leveraged their buying power to drive wholesale prices down and reduce 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 in response to retail competition.

Processors able to supply both export and domestic markets can mitigate their exposure to the 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 no bargaining power and limited scope to reposition their businesses to mitigate this. Larger-scale farmers can 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. Most dairy farmers have very limited bargaining power; limited ability to switch to a different farm enterprise.

Imbalances in bargaining power between processors and farmers result in practices that reduce competition for raw milk and transfer disproportionate levels of risk onto farmers. These include complex and poorly timed pricing information, and contract terms which deter switching. These features make it difficult for farmers to know whether it is in their interests to switch to a rival competitive offer, and also to implement a decision to switch.

The ACCC has identified two main concerns arising from these key findings. First, softened competition between milk processors results in lower farmgate prices than would be the case in a more competitive market. Second, bargaining power imbalances deter productivity-enhancing investments by farmers if they are unable to capture a sufficient share of the returns to make the investment worthwhile.

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. Any increases in margins flowing from an increase in the retail price will simply be captured by the major supermarkets, or at best shared between the supermarkets and processors.

Farmers' ability to capture appropriate share of profits depends on their bargaining power. Measures to improve bargaining power will improve their ability to negotiate a more appropriate share and will also enhance competition between processors for raw milk. This increased competition will also benefit farmers by increasing the minimum price that processors must pay to secure their raw milk supply.

The ACCC is therefore considering options to bring about changed industry practices, to make it easier for farmers to switch to a processor that offers better terms and conditions, and improve production signals and competition at the farmgate. In particular, the ACCC's analysis suggests that a mandatory industry code of conduct to apply to processors is warranted.

This report presents the ACCC's analysis of these and other associated issues in detail. Our interim findings and recommendations are focused on encouraging practices that ultimately facilitate more efficient dairy production.

The ACCC will consult on this Interim Report with submissions due by 31 January 2018.

Interim 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.

Dairy production regions can be broadly grouped as either export or domestic-focused.

Export-focused regions in Victoria and Tasmania largely produce exportable products such as cheese and milk powders. While these regions also produce dairy products for domestic markets, many processors are export orientated.

Domestic-focused regions in Queensland, NSW, WA, and SA mostly produce fresh drinking milk and processors only export a small proportion of regional dairy production, if at all.

The industry has consolidated since deregulation, with the number of dairy farms falling and the average size of dairy farms increasing, along with increases in milk production per cow. This has occurred nationally, and in each state.

Raw milk production has fallen to varying degrees in all states other than Tasmania since deregulation in 2000. National production has decreased by 15 per cent since that time. However, production has also become increasingly stable from year to year both nationally and in each state.

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 wholesale prices processors can 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.

Processors, in turn, have significant bargaining power over farmers. This is reflected in farmgate prices, milk supply contract terms that favour processors and the way in which processors can pass on risk to farmers.

Supply contracts between processors and farmers can vary significantly, ranging from multi-year fixed-price contracts to contracts 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 productivity.

Farmers in export-focused regions especially face uncertainty about the milk price they receive from year to year and within a season. This uncertainty and risk mostly reflects the market uncertainty faced by processors.

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

The Australian Government is procuring 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. This measure will add to the information available to farmers but won't resolve the transparency issues identified by this inquiry.

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

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

The type and extent of the risks that processors are exposed to depends on the products they manufacture and 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.

Farmgate milk prices

Processor discretion to vary prices allocates disproportionate risk to farmers

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

Processors operating in export markets seek to have a number of wholesale contracts settled with international customers before communicating an opening farmgate milk price to their suppliers, to make this price more informed and reliable. Processors which operate in

export markets often diversify their product mix by also selling products into domestic markets.

Processors should therefore 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. Fixed price contracts have the capacity to reduce price uncertainty for farmers, allowing them to make better planning and investment decisions.

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 difficult to interpret. Final pricing is determined by many variables. These can be difficult for processors to forecast accurately at the time when an offer is being considered, meaning that prices received by farmers can vary significantly from both the announced headline farmgate price, and the income estimates provided by processors' field officers. 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' field officers 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 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, and did not find any clear pattern of price leadership. There is no 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 receive different prices from each other despite the processors' 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 different regions and at different times.

- 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. The ability of a farmer to respond to seasonal pricing has a significant impact on the overall farmgate milk price they receive (in some regions).

Competition assessment of relevant dairy markets

The state of competition for raw milk

Most regional markets for the acquisition of raw milk in Australia are concentrated or highly concentrated.[1]

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 and constrain 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.

While the ACCC presently does not have significant concerns about the concentration of markets for raw milk acquisition in most regions, there are many regions where further consolidation could significantly alter the competitive dynamics and would warrant close examination.

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.

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 generally processors 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.

Overly complex milk supply contracts and price offers, delayed loyalty payments, and price announcements which allow farmers insufficient time to compare alternative offers, restrict farmers' ability to compare and switch between processors. Reform of these practices would strengthen competition at the farmgate.

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

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

[1] Based on processors' purchase data, Dairy Australia, and ACCC analysis.

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.

The state of 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.

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. This process encourages dairy processors to continually innovate and ensure that their products meet the needs of consumers.

Recent milk processor capacity expansions and upgrades are an indicator 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.

Competition between the major supermarkets and ALDI for the retail supply of dairy products, in particular fresh milk and block cheddar cheese, has resulted in lower real prices for consumers.

Supply chain profit analysis

The relative bargaining strength of supermarkets, processors and farmers is the main 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 maximise their margins at the expense of the margins of processors. This bargaining power has enabled the supermarkets to profitably supply private label milk at one dollar per litre since 2011.

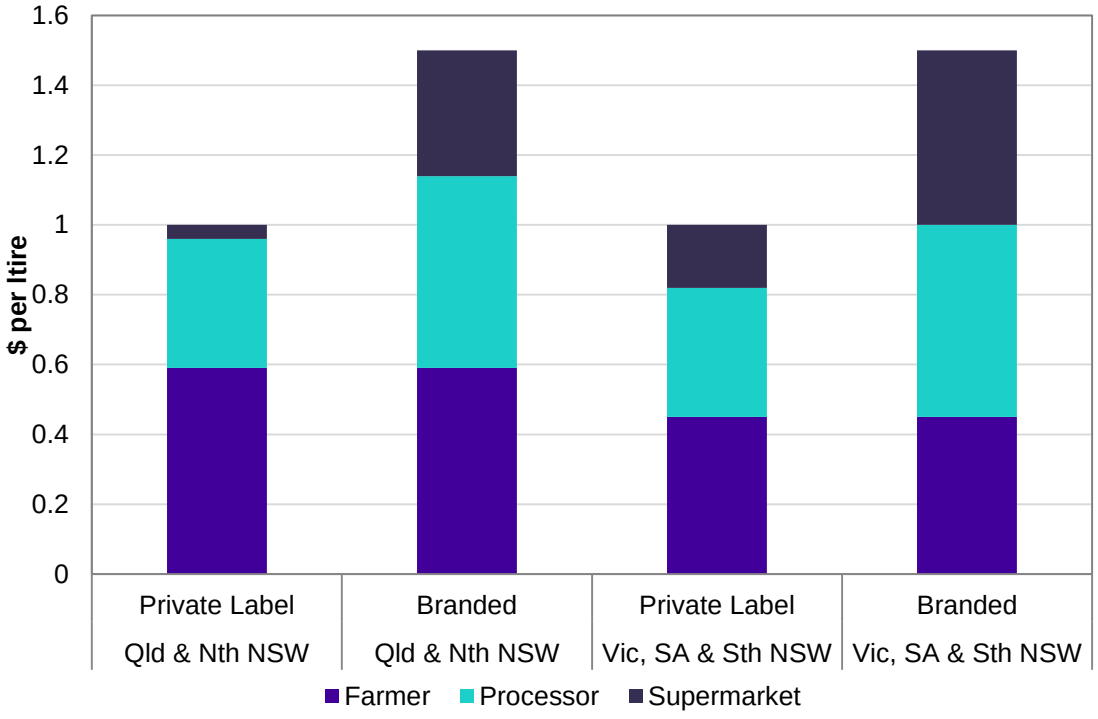
This pricing strategy was introduced by Coles, and quickly followed by Woolworths and ALDI, and subsequently by some other retailers. Many farmers consider that this pricing devalues the work they, their families and staff do to produce high quality milk. To underscore this point, during the forums farmers frequently mentioned the contrast in the price of a bottle of water, a much less labour intensive product, versus a bottle of milk.

While the aforementioned farmer perceptions are understandable, domestic retail pricing strategies, in particular the one dollar per litre private label pricing strategy, are unlikely to have a direct impact on farmgate prices.

Consumption of drinking milk is relatively insensitive to price changes. Total supply chain profits would, therefore, probably 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 will 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 interim finding that farmers do not receive additional benefit from the sale of milk at higher retail prices, such as branded milk. See Figure 1.

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. It had no initial effect on processor margins, or on farmgate milk prices. However, 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. However, private label drinking milk is at times sold at a gross loss by supermarkets in Tasmania and Queensland (once distribution costs are taken into account). Negative margins in regions are subsidised by higher margins achieved in other regions. Cross-subsidisation within diverse businesses such as supermarkets is relatively common.

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 compared to the margins they earn on private label milk. These margins vary significantly between products, states and processors, but range between 30 and 60 per cent. Margins for most other dairy products have been stable or decreasing since 2011.

To date, we have not seen 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.

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.

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. 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 separately investigating potentially unfair terms in current milk supply contracts under the relevant legislation.

Contract termination notice periods and automatic contract rollover clauses are problematic in some circumstances. Notice periods that require farmers to make supply decisions with limited 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, given the large monetary value involved.

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.

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 groups.

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 do not apply more generally to such groups.

Collective boycott arrangements, if authorised by the ACCC, might improve the negotiating strength of collective bargaining groups and help overcome the shortcomings observed to date. 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.

Regulatory responses to the industry's problems

The ACCC has identified a number of problematic practices and outcomes which result from the imbalance of bargaining power in processor-farmer relationships.

Bargaining power imbalances can deter efficient investments if farmers are unable to capture a sufficient share of the returns to make the investment profitable. This can make it hard for some farms to respond to changing market conditions. Imbalances have also resulted in outcomes that farmers perceive to be unfair, including farmgate prices that are close to the minimum that processors need to pay to secure their raw milk supply.

Bargaining power imbalances have also led to practices that make it harder for farmers to switch between processors in response to rival competitive offers. This reduces the effectiveness of competition for raw milk, thus suppressing farmgate prices.

Australia's competition and consumer laws are capable of addressing isolated behaviours and conduct which harms competition and efficiency in the industry. These include the unfair contract terms laws and prohibitions on misleading and deceptive, and unconscionable conduct. However, the problems we have identified in this inquiry emanate from the inherent bargaining power imbalances in the industry, particularly between processors and farmers.

The effects and risks to the performance of the industry arising from this situation are therefore widespread.

The recently developed Voluntary Dairy Code has coincided with improved terms being included in milk supply contracts offered for the 2017-18 dairy season by some processors. However, the Voluntary Code is not enforceable and processors can choose to not participate or not comply at any time. The ACCC is concerned that a Voluntary Code may not adequately address the problematic contracting practices and the detriment capable of being caused to the industry in the long term.

Further, the ACCC considers that collective bargaining does not offer a broad remedy to imbalances in bargaining power in the industry.

The ACCC considers the issues identified and examined in this inquiry are serious enough to warrant being addressed by a mandatory code of conduct to apply to processors. It may be appropriate to exempt certain processors from 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.

Interim recommendations

The ACCC's interim recommendations are below. We will consult on the proposed recommendations before providing our final report to the Treasurer.

Recommendations 1, 3 and 6 refer to actions which the ACCC considers could be obligations under a mandatory code, and additional to the current Voluntary Code's obligations.

Irrespective of a potential mandatory industry code, the ACCC recommends the actions outlined in recommendations 1-7 be undertaken for improved competition between processors, transparency, and more appropriate allocation of risk in the dairy industry. Some of these are already contained in the existing Voluntary Code.

Contracting practices

1. **Processors and farmers should enter into written contracts for milk supply that are signed by the farmer.**

   This recommendation seeks to increase the clarity and transparency of contracts and milk supply agreements by having farmers formally recognise the contract terms they are subject to.

   For the avoidance of doubt, this interim recommendation does not suggest that parties be required to enter into contracts of fixed duration, but aims to increase the formality and clarity of raw milk supply agreements.

   Further, the fulfilment of this would not necessarily require the creation of a new document. It may simply take the form of a signing page in a Supplier Handbook that could be returned to the processor.

2. **All 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.

3. **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.

4. **The industry should establish a process whereby an independent body can administer mediation and act as a binding arbitrator or expert in relation to contractual disputes between farmers and processors.**

   The ACCC seeks feedback about the most appropriate body to establish this dispute resolution framework and the most appropriate body to administer it.

   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 collective bargaining groups and processors.

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

   The average value of a supply contract varies across farms and regions, but in 2015/16 was just under $700 000.[2] 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, most 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 advice about how common contract terms operate and how these can impact farm income. This may include assistance in interpreting contracts, identifying emerging contracting trends and directing farmers to specialist legal and financial advisers.

Farmgate milk prices

6. **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.

Improvements to the voluntary industry code

7. **The Voluntary Dairy Code should be strengthened**

   Notwithstanding Recommendation 8, the Voluntary Code will continue to operate for at least the short-to-medium term. The following amendments should be made:

   Additional obligations

   (a) processors to include a comprehensive dispute resolution process in their milk supply agreements, including where this relates to compliance with the Voluntary Code itself

   (b) processors to provide timely price and other contract information before requiring farmers to make a decision about renewing a contract.

   Other changes

   (c) with regard to section 6 of the Voluntary Code, removal of the incumbent processor's first right of refusal regarding a farmer's supply of milk to an alternative processor.

   A mandatory dairy industry code of conduct

[2] This estimates is based on the following 2015/16 Dairy Australia figures: Average herd size of 273 cows, average per cow production of 5,669 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.

8. A mandatory code of conduct within the Competition and Consumer Act 2010 should be considered for the dairy industry.

A mandatory code could contain obligations on processors aimed at improving the contracting practices which currently result in terms that impede competition and distribute disproportionate levels of risk to farmers.

A mandatory code could, for example, include obligations on processors to:

(a) enter into written contracts with farmers for milk supply

(b) provide timely and transparent information about the terms on which they propose to acquire milk from farmers. This might include:

i. minimising the number of documents which contain terms and conditions of milk supply

ii. ensuring farmers are not required to make decisions about renewing contracts before they have accurate pricing and contractual information

iii. 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

iv. providing an income estimation resource which more accurately takes account of the production characteristics of individual farms

(c) not include contract terms which unreasonably restrict farmers' ability to switch processors

(d) include a dispute resolution process within contracts, supported by reference to an independent process (see Recommendation 4), to apply to disputes about the interpretation and performance of contracts, and alleged contraventions of the code itself.

A mandatory code could also:

(a) prohibit retrospective step-downs and set out the circumstances in which step-downs more generally are appropriate or inappropriate.

The ACCC considers the issues identified and examined in this inquiry are serious enough to warrant being addressed by a mandatory code of conduct to apply to processors. It may be appropriate to exempt certain processors from 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 seeks feedback on the concept and format of a mandatory industry code. Further information and initial considerations of a mandatory code is provided at *Chapter 9*.

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 interim findings, and recommendations for improvements to the operation of the industry. The interim report sets out our analysis, and seeks feedback from stakeholders on our interim findings and recommendations.

Inquiry framework

The ACCC is required to hold an inquiry in public pursuant to section 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.[3]

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.

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 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.[4]

[3] *Competition and Consumer Act 2010* (Cth), s 95ZN(1).

[4] 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 farmers and stakeholders regarding issues in the industry. Forum attendance numbers were high, with approximately 600 interested parties present across all eight forums. 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 section 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 section 95R of the CCA, as part of its compulsory information gathering process. The inquiry Chair summoned witnesses to attend the hearings pursuant to section 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.[5]

Witnesses were required to swear an oath or affirmation before providing information.[6] 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 Sims, Commissioner Court and Commissioner 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

The ACCC held several meetings with stakeholders during the inquiry. These included:

- Australian Dairy Farmers (ADF)
- Queensland Dairyfarmers' Organisation (QDO)
- Port Curtis Milk Suppliers

[5] *Competition and Consumer Act 2010* (Cth), s 95R(2) - (3).

[6] *Competition and Consumer Act 2010* (Cth), s 95S(1).

- 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

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.

Chapter.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 export or domestic-focused.
- 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.[7] More than two-thirds of Australian dairy production occurs in Victoria (see Figure 1.1).

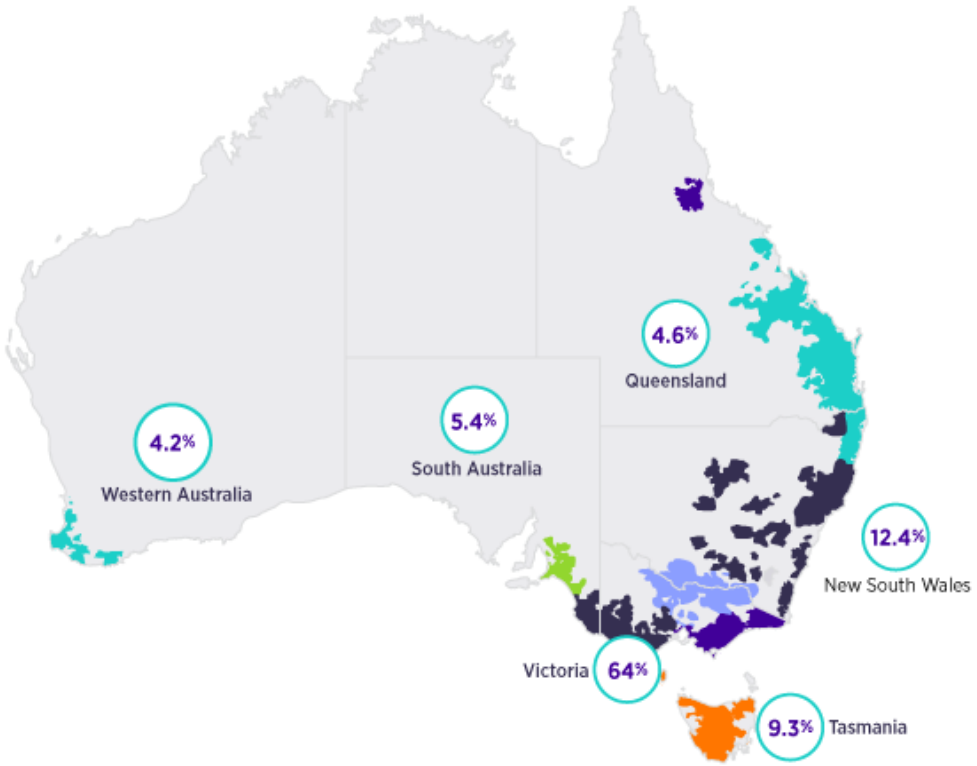
The national dairy cow herd was estimated at one and a half million head in 2016–17 (Figure 1.2).[8] The predominant breed is Holstein (or Holstein-Friesian), making up 75 per cent of Australian dairy cows, followed by Jersey cows.[9] Jerseys are known for producing high fat content milk. The majority 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.

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

[8] Dairy Australia, *Australian Dairy Industry in Focus 2017*.

[9] Dairy Australia, *Cows and Farms,* accessed 4/10/2017, 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

Figure 1.2: Australian dairy herd by state, 2016–17

	Dairy cows ('000 head)	Share of national milk production[10]	Average dairy cows per farm (head)
Victoria	995	64%	256
New South Wales	165	12.4%	250
Tasmania	145	9.3%	330
Queensland	87	4.6%	212
South Australia	65	5.4%	270
Western Australia	55	4.2%	372
Total	1512		261

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

[10] Dairy Australia, *Milk*, accessed 4/10/2017. https://www.dairyaustralia.com.au/industry/production-and-sales/milk.

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.

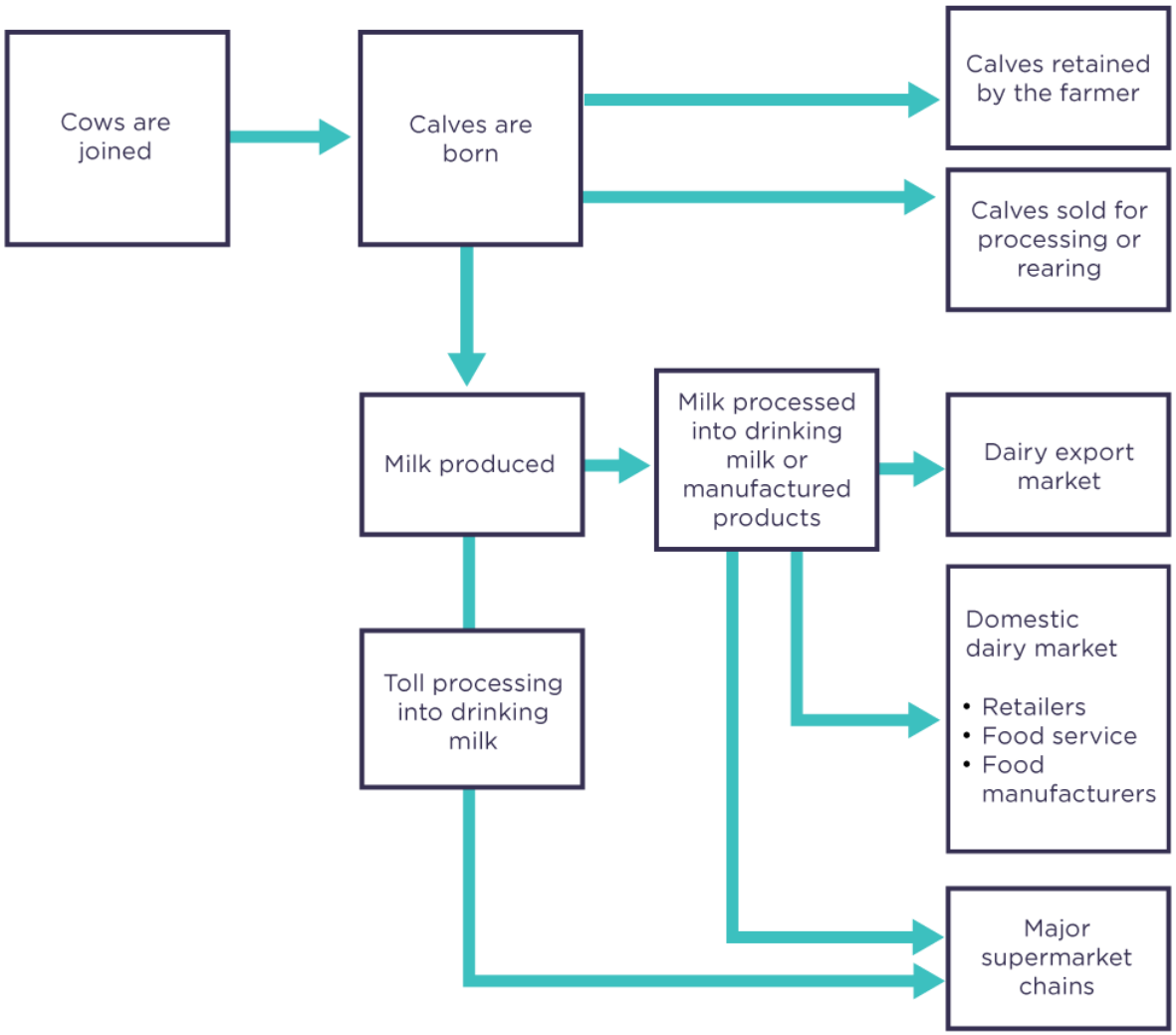
Processors submitted that the maximum distance it is financially viable to transport raw milk ex farm typically ranges from 300 to 600 km. Financial viability depends on a number of factors, including the implications of seasonal conditions on meeting food safety standards (as an appropriate temperature 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 1.3 outlines in broad terms the Australian dairy supply chain.

Figure 1.3: 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.[11]

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:

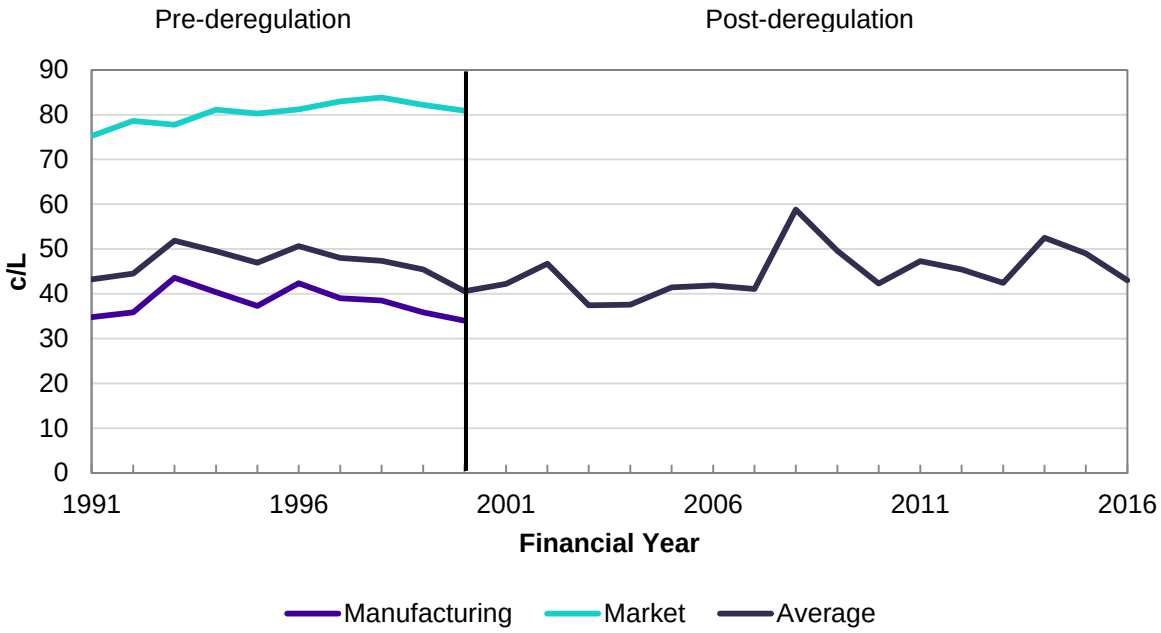
- market milk used to supply the drinking milk market, and

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

- manufacturing milk used to supply manufacturers of dairy products, such as cheese, butter and milk powder.[12]

Raw milk prices were set by state governments, with the price of market milk set significantly above that for manufacturing (Figure 1.4). 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.[13]

Figure 1.4: Australian average farmgate milk prices, by use, real terms (2016 dollars)



Source: ABARES, Australian commodity statistics, accessed 15/09/2017

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.[14]

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.[15]

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12 Ibid.

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

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

15 Ibid.

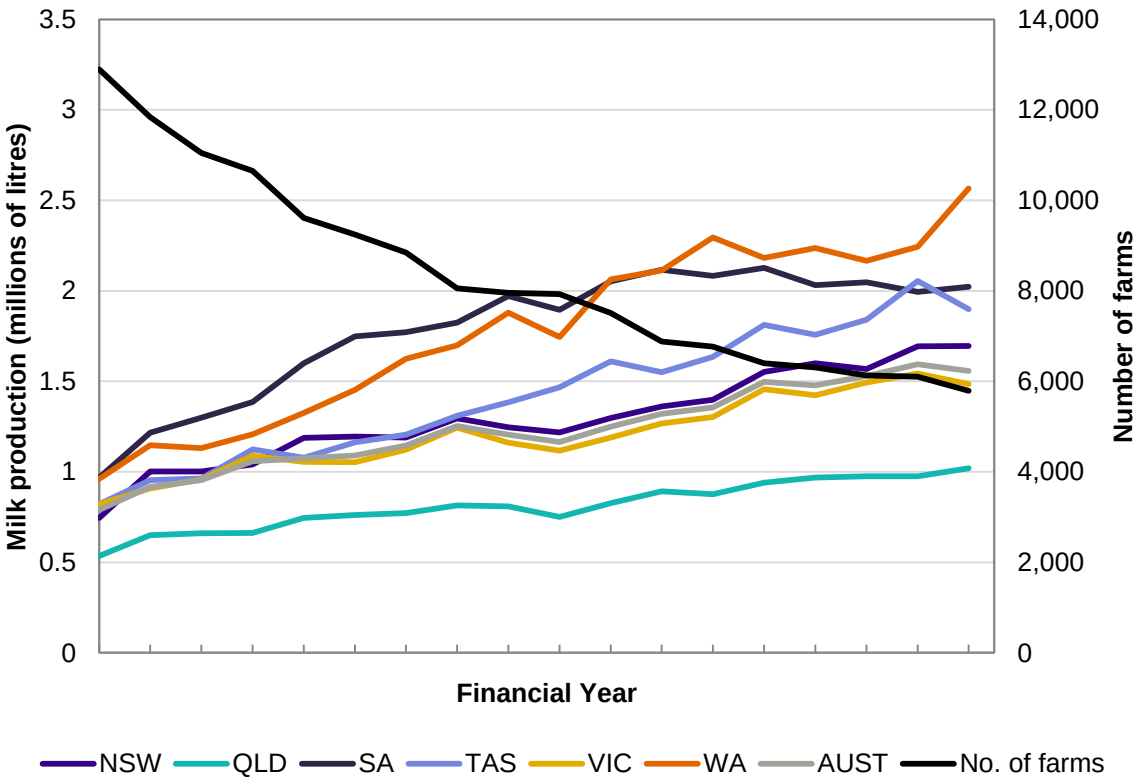
1.2.2. The industry consolidated following deregulation

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.[16]

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.[17] Nationally, the number of dairy farms has fallen 55 per cent over the same timeframe.[18]

Small-scale farms, with total capital of less than $3 million, accounted for the entire decline in dairy farm numbers.[19] Consolidation has resulted in increased average milk production per farm in all states (Figure 1.5). 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.[20]

Figure 1.5: Average raw milk production (per farm)



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

[17] Dairy Australia, *Australian Dairy Industry in Focus 2017*.

[18] Ibid.

[19] 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.

[20] ibid.

Source: Dairy Australia, State milk authorities, Dairy manufacturers, and ACCC analysis

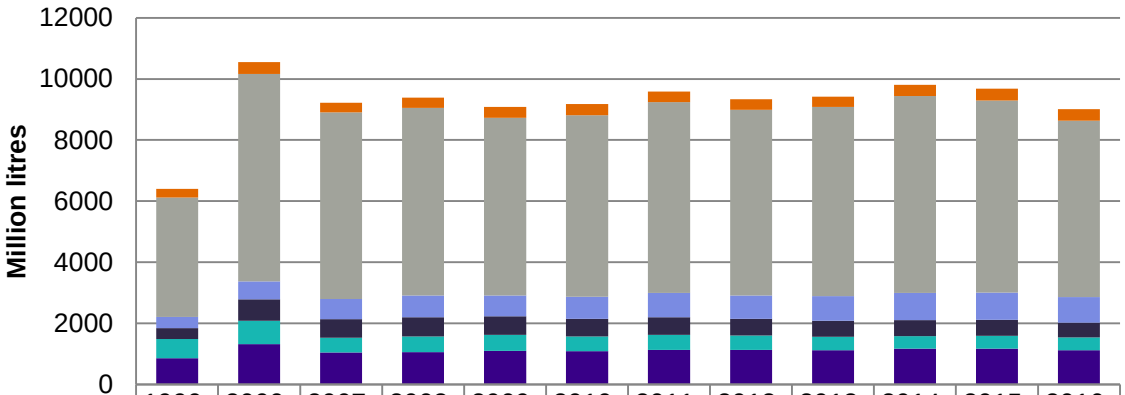
1.2.3. Australia's milk production is increasingly stable

Total national milk production averaged just over 9.3 billion litres per year for the ten years to 2016-17 (Figure 1.6) and was relatively steady year-to-year, fluctuating by no more than four per cent around the 10 year average. Season-to-season, production has risen or fallen between one and four per cent, except in 2016-17, when it was six per cent below the 2015-16 level.

Raw milk production has, however, fallen significantly in some states. In Queensland, 2016-2017 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 1.6: Raw milk production over time



	1990-91	2000-01	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
WA	282	389	319	340	359	372	349	349	340	364	387	380
VIC	3,908	6,784	6,102	6,135	5,813	5,936	6,246	6,076	6,186	6,440	6,290	5,773
TAS	363	590	661	709	677	726	792	765	810	891	883	835
SA	366	699	606	628	605	572	575	542	522	523	528	487
QLD	626	760	486	513	530	487	491	465	444	418	414	418
NSW	858	1,326	1,048	1,064	1,099	1,087	1,136	1,137	1,118	1,170	1,179	1,121

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 Queensland[21], Far North Queensland (FNQ) (Tablelands region), and WA. This analysis is discussed further in *Chapter 4*.

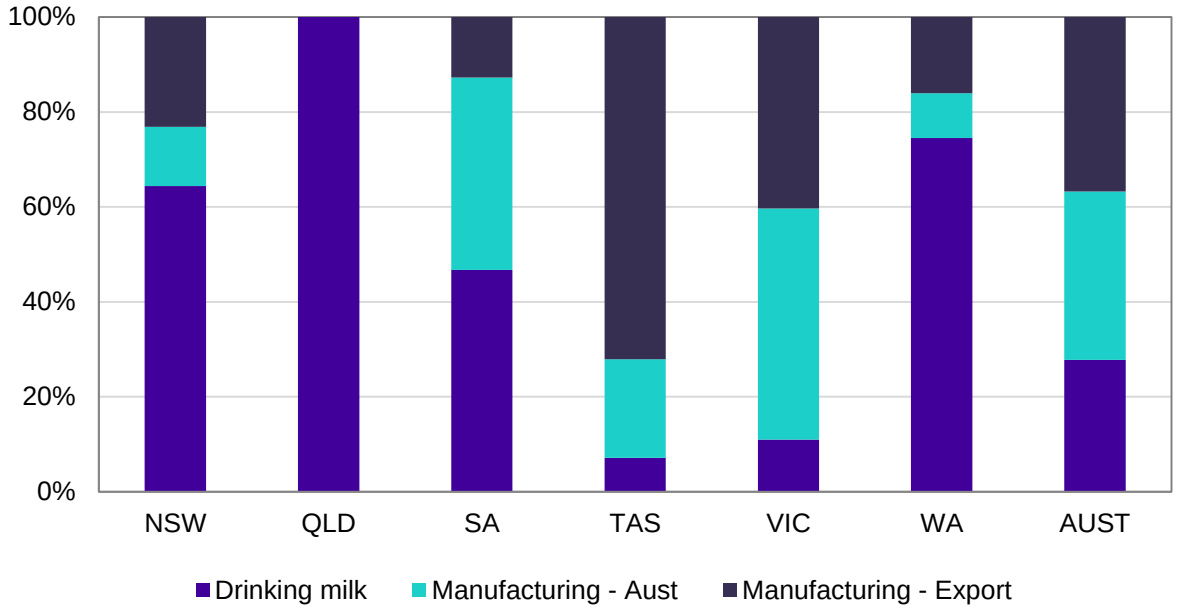
[21] Low milk production volumes and farm numbers in central Queensland mean it has not been defined as a distinct region.

The production focus of each region affects competition for raw milk. These regions are broadly grouped as:

- Export-focused - regions in Victoria and Tasmania which are generally focused on exportable products such as cheese and powders.
- Domestic-focused – regions in Queensland, NSW, WA and SA which mostly produce fresh drinking milk and only export in small quantities, if at all.

For example, Figure 1.7 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.[22]

Figure 1.7: 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.

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

Domestic-focused regions

In northern NSW, Queensland and WA, 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.[23]

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 3 cents per litre difference.[24] 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.

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[23] *Dairy Industry Adjustment Bill 2000*, Explanatory Memorandum.

[24] Dairy Australia, *Australian Dairy Industry in Focus 2016*, 10.

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. 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

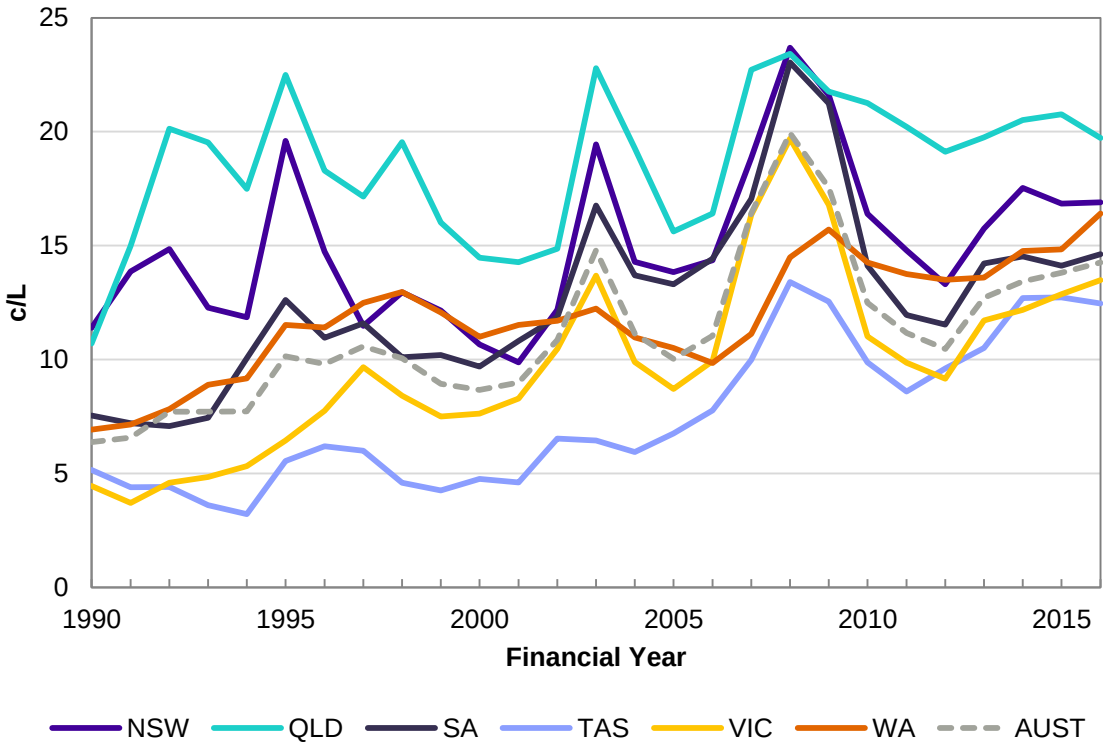
Dairy production mainly occurs in high rainfall areas in coastal regions, with inland production supported by irrigation. Year round pasture growth is supported in Victorian production systems by relatively high rainfall in Gippsland and Western Victoria, and irrigation in northern Victoria and southern 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 southeastern Australia comparative cost advantages. Figure 1.8 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.

Figure 1.8: Fodder costs per litre of milk produced



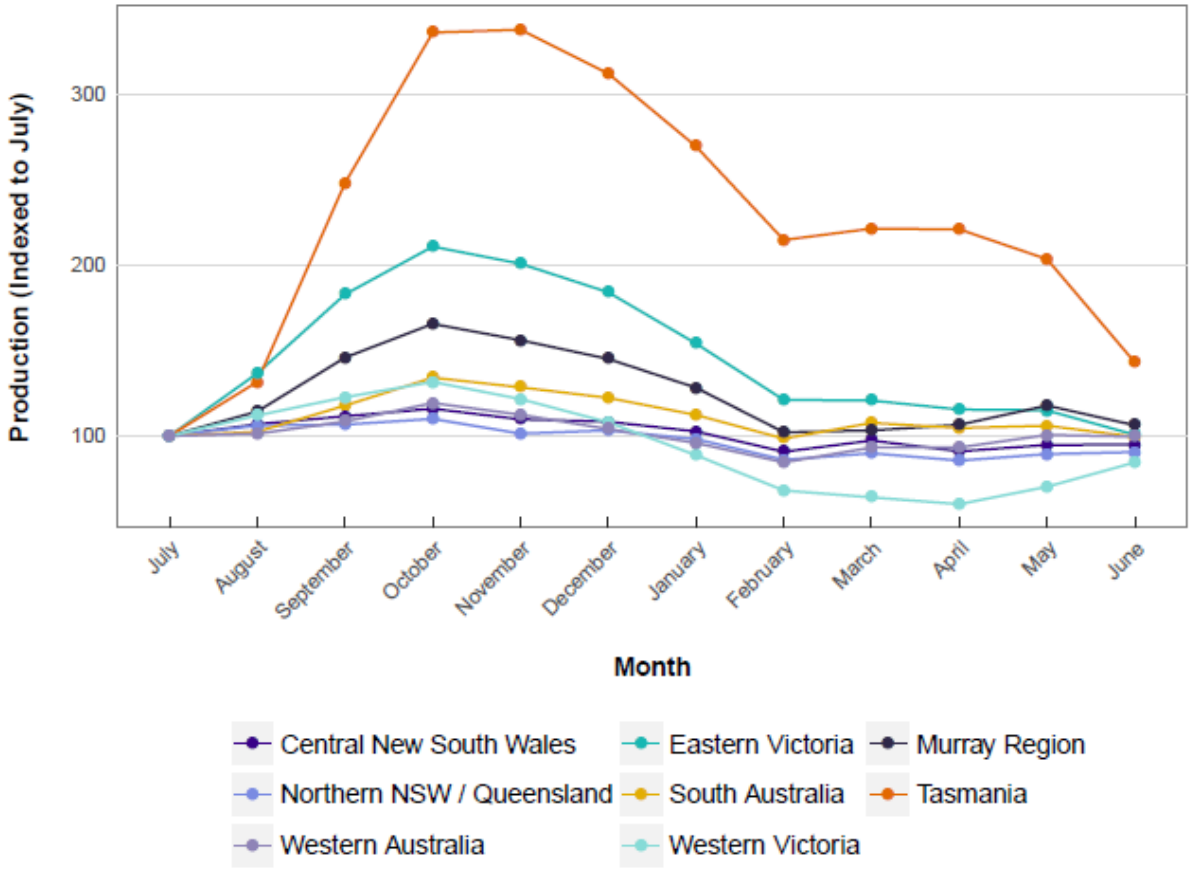
Source: ABARES Agsurf database

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 1.9, 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 1.9: Relative variation in raw milk production throughout the season



Note: 5 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.[25] 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. Export-focused 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.

[25] 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 1.10). 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-products[26] butter (85 869 tonnes) and SMP (222 109 tonnes) in the 2016-17 financial year.[27]

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.[28]

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.[29]

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.[30] See *section 1.5.2* for further discussion of sales channels.

[26] 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.

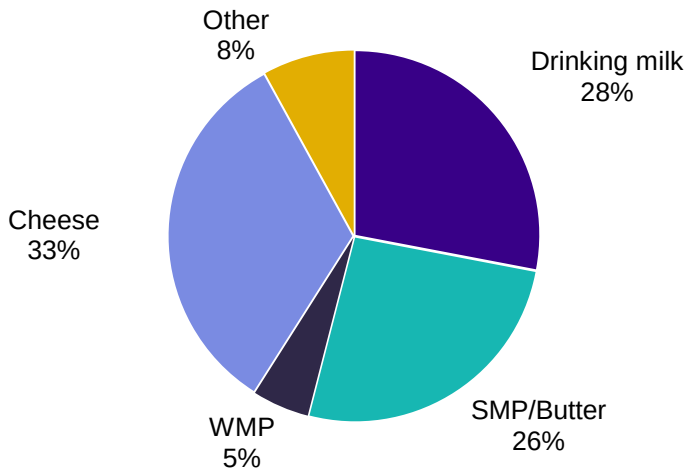
[27] Dairy Australia, *Australian Dairy Industry in Focus 2017*.

[28] Dairy Australia, *Australian Dairy Industry in Focus 2017*.

[29] ibid.

[30] ibid.

Figure 1.10: 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 1.11).[31]

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.[32] 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.[33] 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.[34]
- **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.[35]

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

32 Murray Goulburn Co-operative Co. Limited, *Supplier handbook, Southern milk region 2016/17*, accessed 01/02/2017, mgc.com.au/media/36238/2016_17southernmilkregion_supplierhandbook.pdf.

33 Murray Goulburn Co-operative Co. Limited, *Facts at a glance*, accessed 01/02/2017, mgc.com.au/media/30385/mg_facts_at_a_glance_web_9112015.pdf.

34 John Durie and Sue Neales, *Murray Goulburn to close three facilities, 'forgive debt'*, The Australian, May 2 2017, accessed 23/10/2017, http://www.theaustralian.com.au/business/companies/murray-goulburn-to-close-three-facilities-forgive-debt/news-story/ad45fe547f3c42df336c420768ab25a8?nk=bbe5591c40777abac695ad22f54cf363-1510806674.

35 Fonterra, Fonterra *in Australia*, accessed 01/02/2017, 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 1 billion litres of milk a year. The company produces a full range of dairy products servicing domestic and export customers.[36]
- **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.[37]
- **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.[38] 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.[39]

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.[40]
- **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.[41]
- **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

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36 Lion Pty Ltd, *Milk beverages &* alternatives, accessed 01/02/2017, , lionco.com/our-brands/milk-beverages/white-milk.

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

38 Grant Thornton, *Warrnambool Cheese and Butter Factory Company Holdings Limited*, Independent expert's report and financial services guide, 2015, accessed 01/02/2017 , wcbf.com.au/Content/INVESTORS/Annual-General-Meeting/Warrnambool-Cheese-and-Butter_IER_FINAL_2015-03-26.aspx.

39 Bega Cheese Limited, *Contact Us*, accessed 01/02/2017, begacheese.com.au/contact-us/; Bega Cheese Limited, *Annual report 2016*, accessed 01/02/2017, begacheese.com.au/wp-content/uploads/2012/10/00-Bega-Cheese-2016-Annual-Report_interactive.pdf.

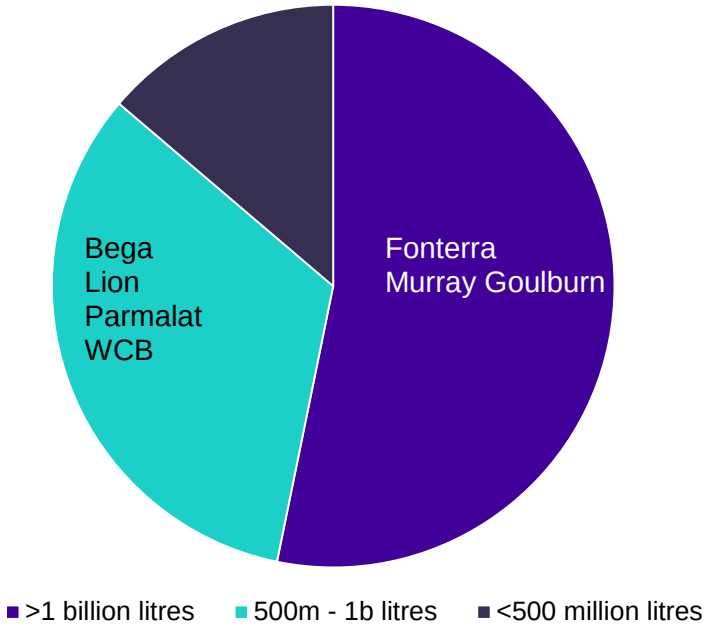
40 Burra Foods Australia, *Operational capability*, accessed 01/02/2017, http://www.burrafoods.com.au/our-business/operational-capability.

41 Norco, *Annual report 2016*, accessed 01/02/2017, norco.com.au/wolfAdmin/uploads/norco-annual-report-2016-web_001.pdf.

limited volumes of cheese.[42] In November 2017, Brownes' parent company Archer Capital announced the sale of the company to Shanghai Ground Food Tech.[43]

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 1.11: 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.[44] Another notable acquisition was of Dairy Farmers by National Foods (now Lion) in 2008, which added significant capacity to National Foods' dairy operations.[45] Over this period there were also a number of smaller acquisitions, including the divestment of assets[46] and processors seeking growth opportunities in a specific region or product category.

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42 Brownes Dairy, *Our story*, accessed 01/02/2017, brownesdairy.com.au/our-family/.

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

44 Phillip Hopkins , *Fonterra set to milk Australia*, The Age, 8 June 2005, accessed 01/02/2017, theage.com.au/news/Business/Fonterra-set-to-milk-Australia/2005/06/07/1118123840030.html.

45 New York Times, *National Foods makes offer for Dairy Farmers*, 25 August 2008, accessed 01/02/2017, nytimes.com/2008/08/25/business/worldbusiness/25iht-dairy.1.15599774.html,

46 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 01/02/2017, 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 2014[47] and Fuyuan Farming Co's acquisition of a controlling interest in Burra Foods in 2016[48]), and businesses seeking to vertically integrate (for example Beston Global Foods acquisition of United Dairy Power assets[49]). In November 2017 it was announced that Shanghai Ground Food Tech acquired Brownes Dairy.[50]

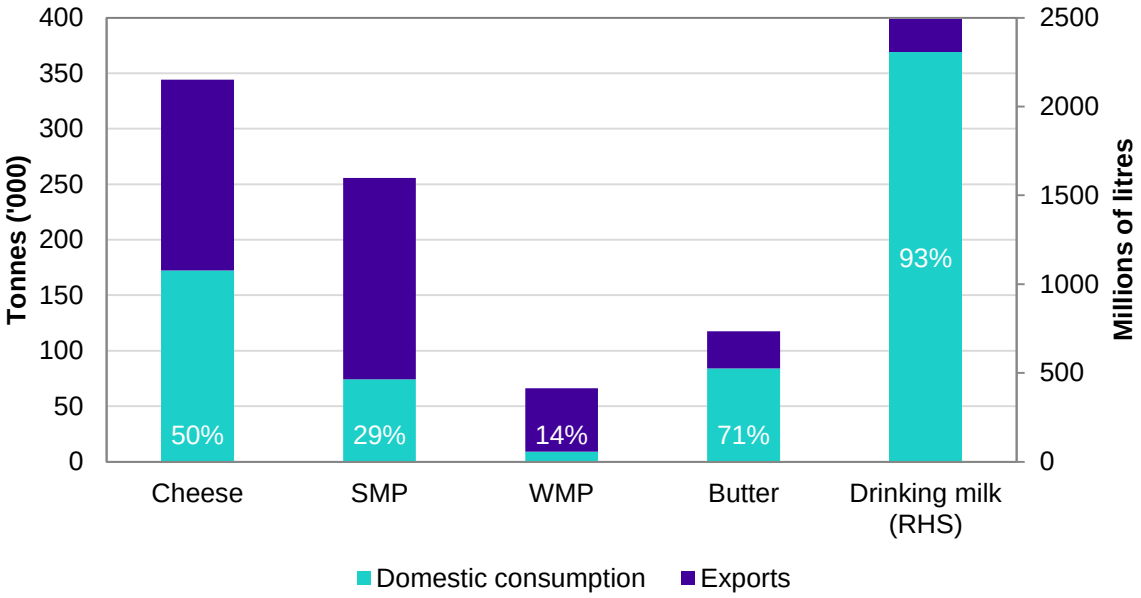
Since 2009-10, total national processing capacity for fresh drinking milk, milk powder and cheese has increased as facilities have been expanded and new plants have been commissioned. Capacity to produce butter has been relatively steady.

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 1.12).

Figure 1.12: 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

[47] Warrnambool Cheese and Butter, *About Us*, accessed 17/10/2017, http://www.wcbf.com.au/About-Us/About-Us.

[48] 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.

[49] Simone Smith, *Beston investment into South Australian dairy industry welcome*, The Weekly Times, 05 August 2015, accessed 01/02/2017, weeklytimesnow.com.au/agribusiness/dairy/beston-investment-into-south-australian-dairy-industry-welcomed/news-story/9caf41ad2f98b9ee118cc1af1243ff2f.

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

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.

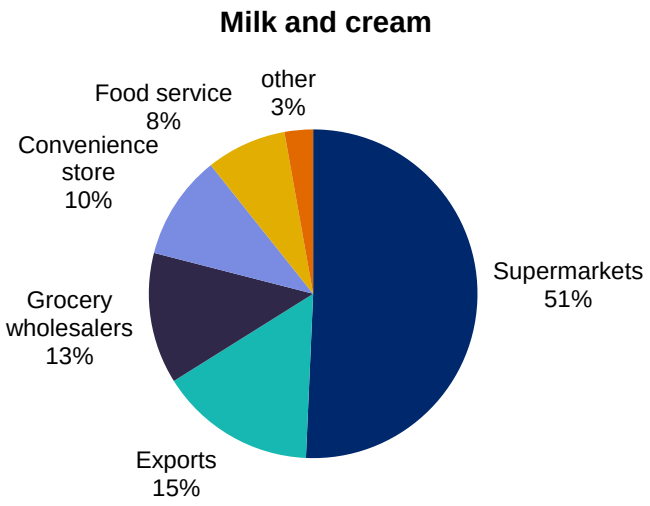
1.5.2. Domestic sales channels

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 1.13 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.[51] 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 1 litre cartons and bottles have fallen from 33 per cent to 16 per cent, offset by increased sales of 3 litre bottles.[52]

Private label cheese accounted for around 35 per cent of supermarket cheese sales in 2014.[53]

Figure 1.13: Sales channels for domestically manufactured dairy products[54]



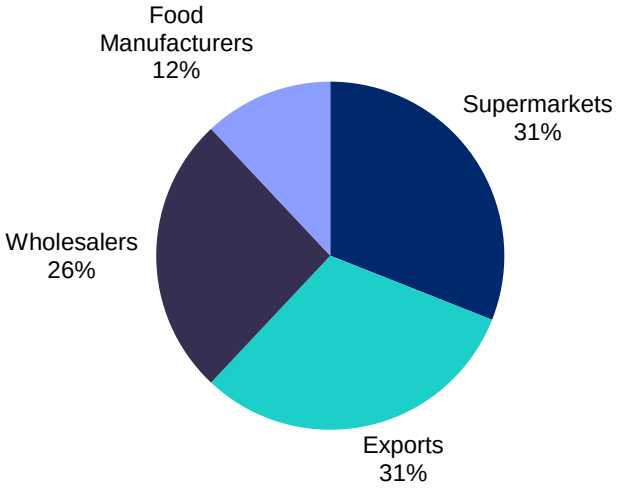
[51] Dairy Australia, *Australian Dairy Industry in Focus 2017.*

[52] Dairy Australia, *Domestic sales summary*, accessed 01/02/2017, dairyaustralia.com.au/Markets-and-statistics/Production-and-sales/Domestic-Sales-Summary.aspx.

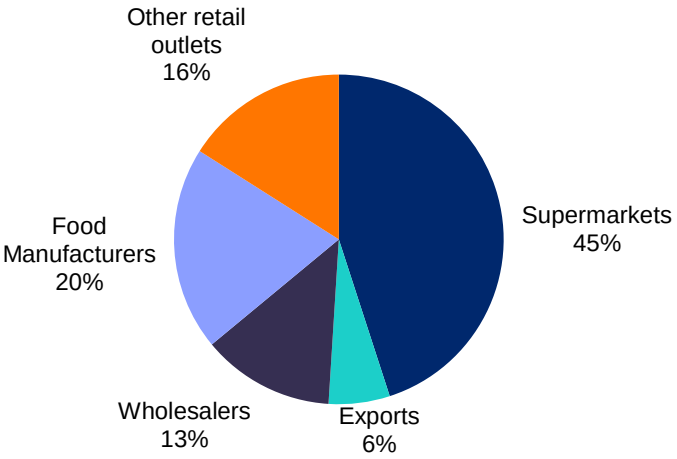
[53] Dairy Australia, *Dairy situation and outlook, February 2014 update*, Melbourne, dairyaustralia.com.au/~/media/Documents/Stats%20and%20markets/S%20and%20O/S%20and%20O%20Feb%202014/LANDSCAPE%20SO%20FebWEBFINAL3.pdf, accessed 01/02/2017.

[54] IBISWorld industry reports, *Cheese Manufacturing in Australia*, accessed 31/01/2017, clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=1856; IBISWorld industry reports, *Butter and Dairy Product Manufacturing in Australia*, accessed 31/01/2017, clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=96; IBISWorld industry reports, *Milk and Cream Processing in Australia*, accessed 31/01/2017, http://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.[55] 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.[56]

[55] Dairy Australia, *Australian Dairy Industry in Focus 2016*.

[56] ibid.

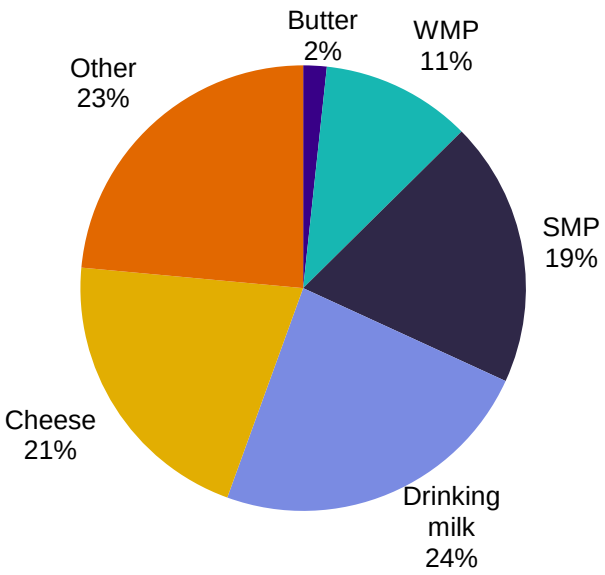
1.5.3. Exports

A large proportion (37 per cent in 2016-17[57]) 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.[58] Australia accounts for around 6 per cent of world dairy product exports.[59] 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 1.14 shows the share of Australian exports by volume for some major dairy products.

Figure 1.14: 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

Australia exported almost 167 000 tonnes of cheese in 2016-17, with Japan accounting for just under half of all shipments.[60] The majority of exports to Japan are fresh and cheddar

[57] Dairy Australia, *Australian Dairy Industry in Focus 2017*.

[58] Food and Agriculture Organization, *Dairy production and products*, accessed 01/02/2017, fao.org/agriculture/dairy-gateway/the-dairy-chain/markets-and-trade/en/#.WJE7Y9Jf2Uk..

[59] Dairy Australia, *Australian Dairy Industry in Focus 2017*.

[60] ibid.

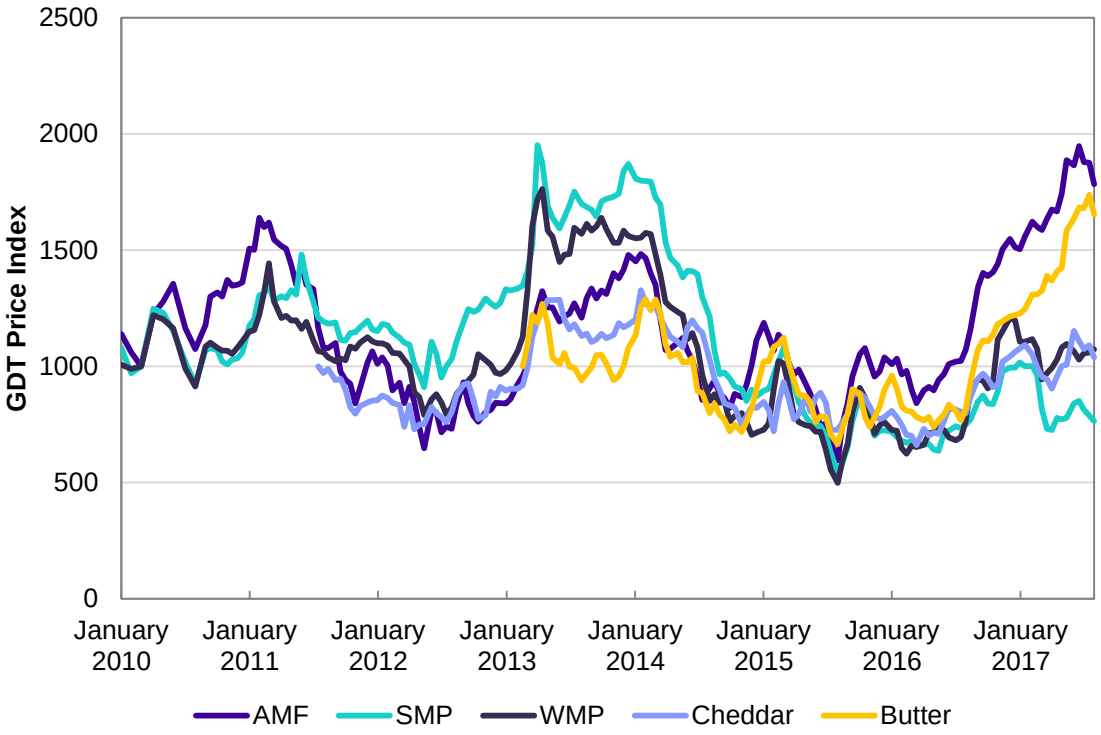
cheeses, primarily used in food manufacturing.[61] Other major destinations for Australian cheese exports are China and Hong Kong (15 per cent), South Korea (6 per cent) and Malaysia (5 per cent).[62]

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.[63]

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 1.15). Strong demand growth from developing markets, particularly Chinese milk powder imports, underpinned the rapid increase in world prices from mid-2012.

Figure 1.15: GDT Price Index Components[64]



Source: Global Dairy Trade

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

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61 Dairy Australia, *Market brief: Japan*, accessed 01/02/2017, dairyaustralia.com.au/Home/Standard-Items/~/media/Documents/Stats%20and%20markets/Exports%20and%20trade/2016%20Market%20briefs/Market%20briefs_Japan.pdf,

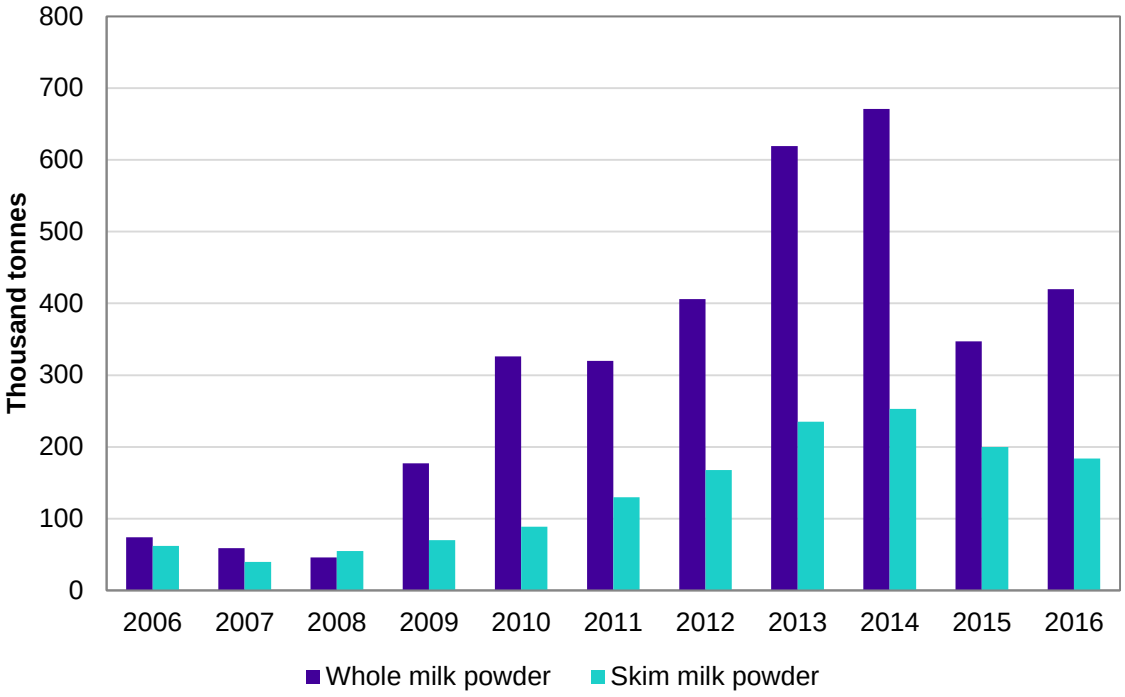
62 Dairy Australia, *Australian Dairy Industry in Focus 2017,* 30.

63 ibid.

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

powder stocks, weakening domestic retail sales and increased domestic milk production.[65] 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 1.16).[66]

Figure 1.16: 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.[67] During 2016-17, global prices for key dairy commodities such as butter, cheese and WMP improved, reflecting more balanced supply-demand dynamics.

[65] Owen McCarthy, *Australian Commodities,* ABARES, 2015, vol. 5 no. 4, 118-125..

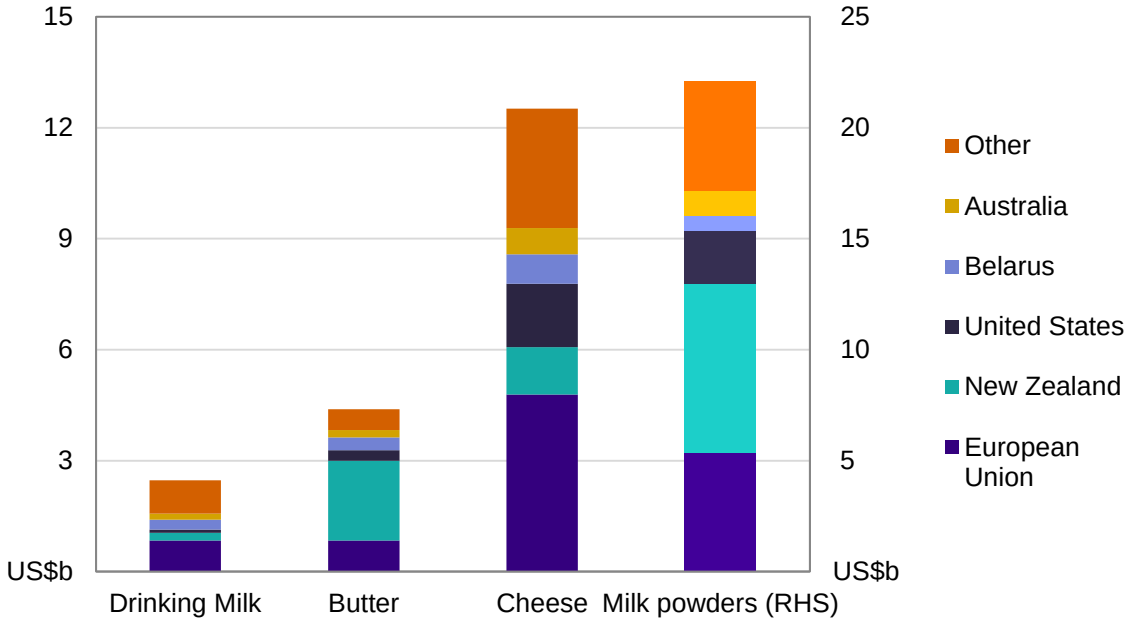
[66] Tim Whitnall, *Agricultural commodities,* ABARES, 2016, vol. 6 no. 2, 107-114.

[67] Owen McCarthy, *Agricultural commodities,* ABARES, 2015, vol. 5 no. 4 p. 118-125.

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 1.17).

Figure 1.17: 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 1kg 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.[68]

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.[69] 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.[70]

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

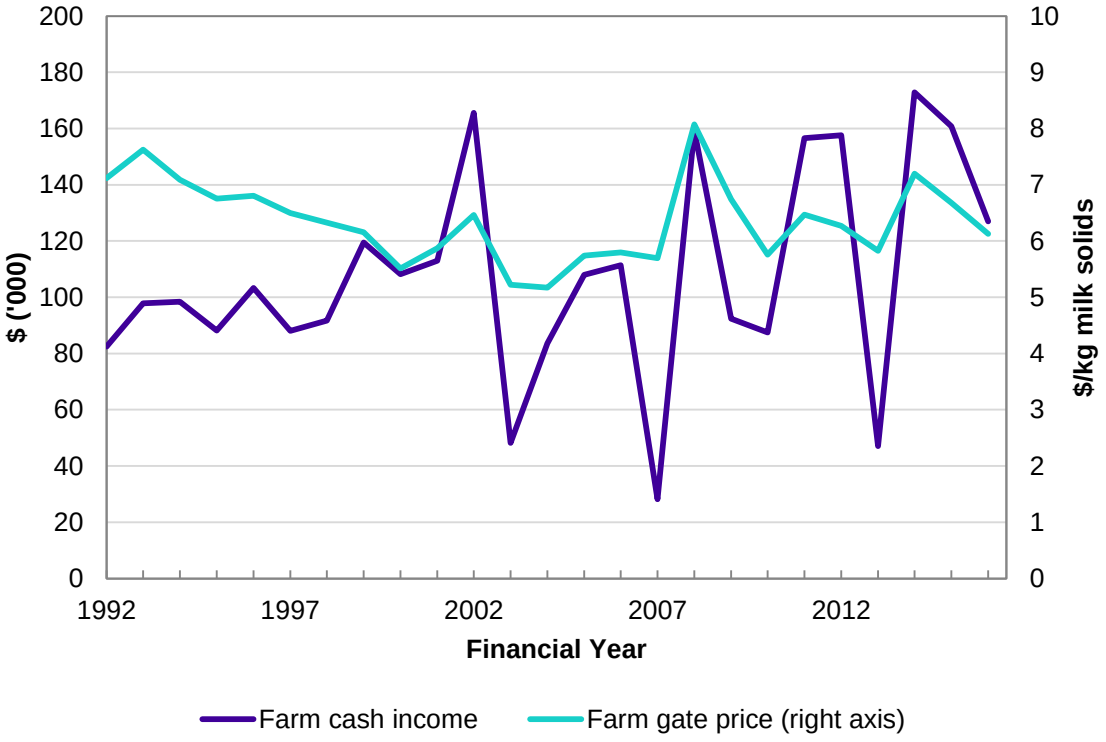
[69] Bureau of Labor Statistics, *International comparisons of hourly compensation costs in manufacturing*, 19 December 2012, accessed 01/02/2017, https://www.bls.gov/news.release/pdf/ichcc.pdf/..

[70] European Union Commission, *Milk and milk product statistics,* October 2016, accessed 10/8/2017, 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 2015-16[71], resulting in an average per farm cash income of around $133 000 per year (in 2016-17 dollars) (Figure 1.18).[72] 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).[73]

Figure: 1.18: 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).[74]

Rates of return on managed assets vary significantly between regions. The average annual rate of return in south west Victoria was 3.4% over the 10 years to 2015-16, followed by northern Victoria (3.4%) and Gippsland (3.3%). This compares with 1.9% in Queensland.[75] In Queensland, this lower rate of return largely reflects generally higher farm cash costs and

[71] Note: with the exception of 2012/13, when cash incomes fell due to a decline in milk price and increased production costs.

[72] ABARES, *Agsurf database*, accessed 15/09/2017, apps.daff.gov.au/agsurf/.

[73] Ibid.

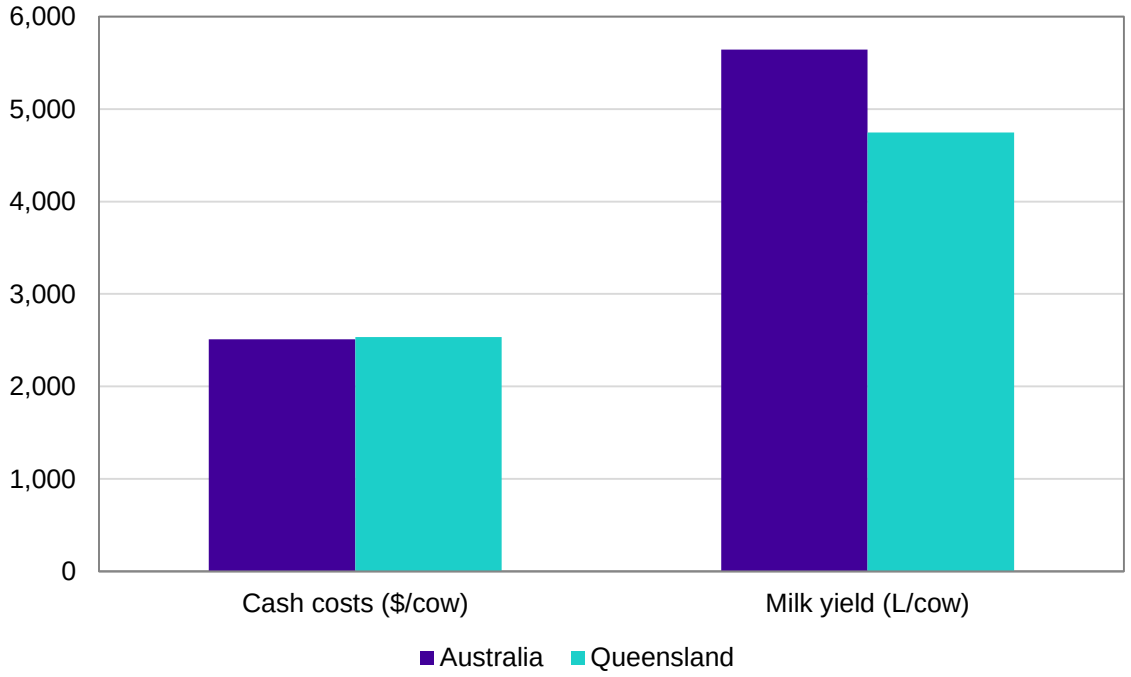
[74] Ibid.

[75] Dairy Australia, *DairyBase Farm Data Output Report,* 17 May 2017.

lower milk yields per cow compared to the southern states, which more than offset the effect of typically higher farmgate milk prices (Figure 1.19).

Shorter time series shows rates of return for SA (2.5%, four year average), NSW (2.6%, five year average), WA (5.6%, three year average) and Tasmania (6. 8%, three year average).[76]

Figure 1.19: Selected dairy production indicators, 5-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 ten years to 2015-16, livestock trading profit made up an average of 7.5% of gross income per year in south west Victoria. This percentage was 7.1% in northern Victoria, 6.9% in Gippsland and 5.4% in Queensland.[77] Shorter time series[78] show the contribution of livestock trading to gross income in SA (7.9%, four year average), NSW (8.5%, five year average), WA (12.5%, three year average) and Tasmania (8.3%, three year average).[79]

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.

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76 ibid.

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

78 Note: 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.

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

Chapter.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 bargaining power over processors, and processors have substantial bargaining power over farmers.
- The transfer 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 farmers
    - dairy processors have discretion to pass on risk to farmers
    - farmers appear to be exposed to a high degree of uncertainty.
- Clearer and more certain market price information would help farmers to make better production choices and to judge which processor it is in their interest to supply.

This chapter considers the bargaining power dynamic 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.

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

i. the setting and negotiation of wholesale prices paid by supermarkets to processors
ii. the setting of farmgate milk prices paid to farmers and the transparency of this process
iii. the distribution of value and profits through the supply chain
iv. the allocation of risk through the supply chain
v. the transparency and fairness of how non-price supply terms are set and negotiated.

Farmgate prices and contracting practices are discussed in *Chapters 3, 4 and 7*. The implications of bargaining power on allocation of profits in the industry are discussed in *Chapter 6.*

The ACCC considers that while it is unavoidable that processors will pass some degree of risk on to farmers, the current degree of uncertainty that farmers face is excessive. In particular, processor discretion to adjust farmgate prices mid-season means that farmers bear business risk which they play no part in.

2.1. Introduction

The Australian dairy industry contains thousands of farmers, six major processors[80] (and a series of smaller processors), three national supermarket chains dominating the retail channel, and a highly competitive global market. This gives rise to tiers of bargaining power through the supply chain, with supermarkets and the internationally traded market at the top, farmers at the bottom, and processors in between.

[80] Bega, Fonterra, Lion, Murray Goulburn, Parmalat, Warrnambool Cheese and Butter.

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 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, this also impacts their bargaining power.

Processors face risk and uncertainty as price-takers in the global market, and their weaker bargaining position relative to supermarkets in the domestic market. The type and extent of risk depend on the variety of dairy products they manufacture and nature of their wholesale supply agreements. These may include export contracts, long term private label contracts, or short term domestic supply agreements. Producing a variety of products and supplying a mixture of international and domestic customers reduces exposure to specific risks.

The bargaining dynamic between farmers and processors 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. However, the number of farms is generally highest where there are a greater number of processors, reducing the prospect of individual bargaining power. The largest farms in a region appear to have some level of bargaining power with processors (see *Chapter 4*).[81]

One consequence of the imbalance of bargaining power is that farmers are often faced with standard form contracts weighted heavily in favour of processors. Prices and terms in these contracts provide processors with considerable discretion and leave farmers with significant uncertainty in both the price they will receive for the supply of their milk and the costs they incur to produce milk.

The milk price uncertainty and risk faced by farmers mostly reflects the wholesale supply uncertainty faced by processors. Cost uncertainties are often a reflection of unpredictable climate conditions and the flow-on effects this has on feed and water availability.

2.2. Supermarkets' bargaining power over processors

As discussed in *Chapter 1*, supermarkets are the primary 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 contracts, where the recognition and goodwill of a processor brand is largely insignificant.

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 to processors, and subsequently farmers.

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

2.3. 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 unfairness in contract negotiations and terms, which are weighted heavily in favour of processors
- there is a lack of information and communication from processors.[82]

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

2.3.1. The relative size of processors and farmers

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 is approximately 1.5 million litres[83] per farm, 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, and achieved sales revenues of $2.5 billion.[84]

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.

2.3.2. The generic nature of raw milk

Farmers supply a product (raw milk) that is essentially generic, which means that processors can acquire the same product from many farmers in a region, and there is little differentiation between products.

Processors therefore have many more 'outside options'[85] to purchase milk than farmers have options to sell their milk, which makes it possible for a processor to threaten to switch between farmers in negotiations. In some regions, with only one processor, farmers have only one option to sell their milk.

2.3.3. The perishable nature of raw milk

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. Farmers may be more likely to accept poor terms and a lower price in order to avoid the risk of their milk not being collected, rather than attempt to negotiate or hold out for a better price. The ACCC heard at forums that the perishable nature of raw milk makes farmers vulnerable, and more likely to accept poor agreements.[86]

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

[83] Dairy Australia, *Dairy in Focus 2017*, 2.

[84] Murray Goulburn, *Murray Goulburn Annual Report 2017*, 28 September 2017, 1.

[85] Note: 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 of seller is willing to accept for the deal to take place.

[86] For example, at the Dairy Inquiry forum in Toowoomba.

2.3.4. Access to information

Finally, processors have better access to information than farmers, which puts them in a stronger bargaining position. Processors have access to pricing, market and information about large numbers of farmers, together with knowledge of likely product demand for the coming season which individual farmers do not have. Processors are therefore better able to estimate the prices farmers are likely to accept, in comparison to farmers who may be unable to determine what maximum price a processor may pay.

2.4. The impact of bargaining power on contractual negotiations

The imbalance in bargaining power is such that farmers are rarely able to negotiate contracts or prices with processors. Many problematic contracting and pricing industry practices are outcomes of this imbalance.

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 one per cent of milk supply contracts that are negotiated are those with the largest volume farms.[87]

The ACCC accepts that the transaction costs of negotiating individual agreements would be high, and this reduces the scope for effective negotiations between processors and individual farms. Some processors have over 1000 suppliers, which would result in substantial costs to the processor if each contract was negotiated individually.

Industry culture also discourages individual negotiations. The ACCC heard at a number of forums and in submissions that many farmers prefer uniform pricing offers and supply agreements, considering it is unfair when some farmers negotiate individual agreements. Processors are wary 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 ways to increase farmer bargaining power and lead to better outcomes for farmers. For example, farmers may increase their production and farm size, which may enhance their competitive position. In some circumstances, collective bargaining can help to increase farmer bargaining power, as discussed in detail in the *Chapter 8*.

However, due to the imbalance in bargaining power, transaction costs and unequal information, it is unlikely there will be effective contract negotiations between most individual farmers and processors in the near future. This means that, without intervention, contractual outcomes are likely to remain largely weighted in favour of processors rather than farmers.

2.5. The benefits of transparency and minimising uncertainty

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

[87] Note: this figure does not include contracts that have been negotiated by a collective bargaining group on behalf of its members.

- farmgate prices for the major input of raw milk, including general information about. the prices being paid by their competitors the price and availability of inputs for farmers (such as supplementary feed and water), which can be sourced from Dairy Australia and other publically available sources.

Farmers also have access to some of this, but in general have less price information and certainty compared to processors. Farmers can readily obtain access to:

- prevailing prices and trends for globally traded dairy products (through sources such as GDT and rural newspapers). However, the way prices affect the revenues of processors is not clearly visible to farmers
- farmgate prices paid by processors in a region. This information is available directly from some processors, through public statements, and from neighbouring farmers supplying different processors. However, the farmgate price a farmer receives may be subject to change without notice and may vary significantly from the opening price (as discussed in detail in *Chapter 3*)
- tailored income estimates. To assist in interpreting what the farmgate price means for a specific farm, processors send field officers to prepare income estimates. The ACCC understands that this is an important source of information for farmers. As discussed *Chapter 3*, there are concerns from some farmers that these estimates are not accurate, and that their sensitivities to certain assumptions is not always clear
- input cost and availability, such as for supplementary feed and water. This information can be sourced from Dairy Australia and other publically available sources. However, as noted below, feed prices can be volatile.

Greater certainty and transparency over market price information would allow farmers to make better 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
- 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.

Additionally, the Australian Government is procuring 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. This measure will add to the information available to farmers but won't resolve the transparency issues identified by this inquiry.

Despite the availability of the above price information outlined above, farmers, processors and retailers of dairy products 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 inquiry[88] and is relevant to the efficient allocation of resources in the supply chain.

2.6. Risks are reallocated based on bargaining power

At the forums, farmers in all regions raised concerns about the allocation of risk across 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 commodity risks to farmers rather than facing and managing that risk
- the push by most processors towards a flatter milk supply (that is, away from spring calving) adds risks to farming for which they are not adequately compensated
- longer term private label contracts should result in processors offering more price certainty to farmers.

These concerns are discussed in more detail in *Chapter 2*.

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 of bargaining power; a party with more can reallocate some or all of their risks to a party with less.

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 discretion to pass on risk to farmers
- farmers appear to be exposed to a high degree of uncertainty.

2.6.1. Major Supermarkets face limited dairy retailing 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 commitments to processors. Processors however, must generally be able to guarantee supply volumes to supermarkets in order to be stocked in-store. As discussed in *Chapter 2,* processors must collect all milk produced by supplying farmers for the duration of their contract, which is an example of risk being transferred from farmers to processors. Therefore, having products 'de-ranged' or losing a private label contract can cause a processor to be committed to purchase more milk than it requires.

Such arrangements largely protect supermarkets from commercial risks by shifting uncertainty to suppliers.

Contracts for private label milk have recently involved longer term agreements[89], giving processors some greater certainty. However, investing to win or retain significant private

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

89 Australian Food News, *Woolworths announces 10-year milk deals, but Lion is the loser in Victoria and WA*, 7 April 2014, accessed 14/9/2017, http://www.ausfoodnews.com.au/2014/04/07/woolworths-announces-10-year-milk-deals-but-lion-is-the-loser-in-victoria-and-wa.html.

label contracts can also create risk. As supermarkets demand lower wholesale prices from processors in exchange for longer term contracts[90], it is common for processors to incur substantial capital expenditure to obtain and/or retain these arrangements. For example, Murray Goulburn recently invested over $150 million to secure a major private label milk contract with Coles.[91]

These investments can be profitable and efficiency-enhancing. 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 beyond the initial term.

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 adopt some exposure to volatility in the form of farmgate milk prices and international commodity dairy prices through agreements for the supply of private label and branded dairy products.

For example, global prices for butter increase when there is scarce international trade. At these times, supermarkets agree to pay higher prices to secure supply volumes rather than risk the processor exporting the volumes 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 often absorb the rise and fall in the cost price while maintaining a stable retail price over the course of the year, and in other circumstances may pass on a cost increase to its customers.

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[92].

The 'processing' component of longer term private label contracts commonly contains clauses which allow supermarkets to periodically test or benchmark processing costs. Costs of packaging resin may be benchmarked quarterly, while production costs may be benchmarked annually or on an ad-hoc basis. 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 strength of bargaining power that supermarkets have relative to

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

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

[92] This is discussed in detail in *Chapter 6*

processors. The bargaining power of supermarkets is used not just to reduce costs and increase profitability but also to reduce and reallocate risks they may otherwise face.

2.6.2. 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. Processors therefore are cautious about exercising any discretion they have to pass on price and volume risk to farmers.

The price step-downs of 2016 (discussed in *Chapter 3)* highlighted some of this discretion, and gave rise to a greater level of mistrust between farmers and processors. The ACCC considers that this mistrust and heightened uncertainty may lead to underinvestment in dairy farming.

The ACCC considers that processors often have significant discretion to shift the risk they face from their wholesale supply arrangements to dairy farmers and that as a result, farmers are ultimately exposed to most of the risk in the supply chain.

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

The ACCC notes that farmers who supply processors structured as cooperatives may expect to participate in the commercial risk faced by the processor (whether through fluctuations in cooperative earnings or in the milk price).

However, even as the industry has shifted away from cooperatives, privately owned or listed processors 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 to benefit from unanticipated improvements in commodity prices.

Either way, the processor is likely to be much better placed than individual farmers to face and manage market risks.

The primary ways in which farmers have indicated that processors pass on risk are explored in *Chapter 3*. Namely:

- processors often have the ability to unilaterally adjust farmgate milk prices during a season if dairy commodity prices, foreign exchange rates and milk production volumes during the season do not align with the processors forecasts
- processors in the southern regions push farmers towards flatter milk production profiles.

2.6.3. Risk transfers through other contract mechanisms

As discussed in *Chapter 7*, the ACCC is reviewing concerns about the use of extended notice periods for the termination of milk supply agreements. While processors may have reciprocal obligations, long notice periods are likely to impede farmers' ability to properly assess their options, and transfer disproportionate risk to farmers.

By requiring long notice periods, processors are able to ensure consistency in their supply of raw milk. Dairy farmers, however, have argued that choosing a new processor long before the end of their existing contract is difficult. This is because they do not have the price or contractual information available at the time they need to make a decision.

Farmers therefore bear a considerable amount of price risk as a result of extended notice periods imposed by processors to protect the consistency of their milk supply.

The use of undersupply penalties in contracts, while not widespread, also gives rise to concerns. These contract terms expect dairy farmers to assess at the start of the year their total production and milk quality for the season. This is despite there being many unknowns, such as the necessary amounts and costs of supplementary feed, and weather conditions.

Undersupply penalties more often arise in contracts offered by processors that are primarily fresh drinking milk manufacturers. These processors can face significant consequences if they do not have sufficient milk volume to fulfil commitments to major customers.

Undersupply penalties are a way of shifting risk on to farmers, despite their having no input into the extent of risk the processor commits to in its supply contracts.

Length of supply contracts

As noted above, processors who supply substantial volumes to major retailers risk having their products removed from the supermarkets' range. This can occur at short notice, and result in excess milk supply which the processor has committed to collecting from farmers for the season. This is of particular concern for processors who have invested in manufacturing equipment for the supply of fresh dairy products, which cannot be easily exported.

While this risk is largely borne by the processor within a season, processors have also indicated that this can be a key rationale for not offering longer term contracts to dairy farmers. When given the choice, many dairy farmers have shown a preference for longer term contracts as a means of reducing risk (depending on the terms of the contract).

Uncertainty of supply contracts

Another risk that some farmers have identified is the uncertainty of being offered a supply contract. This was particularly a concern for farmers in WA. The ACCC understands that some farmers in WA were not offered contract renewals by processors in 2016 due to an oversupply of milk.

Uncertainty regarding whether a farmer will be able to find a supply contract may lead to underinvestment by those farmers affected. Historically there are relatively few examples of farmers having their contracts terminated by a processor.

Processors submitted to the ACCC that they would rarely cease to acquire milk from an existing farmer supplier, unless the milk repeatedly failed to meet minimum quality standards. Farmers in other regions of Australia did not raise contract renewal as an area of great concern.

2.6.4. Farm income uncertainty

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)
- 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 during a year. Price uncertainty can

weaken confidence in the outlook for many farmers 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.*

Feed cost movements

Farmers can also face considerable uncertainty in relation to their 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 move away from spring calving systems.

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

Figure 2.1: Dairy farming costs – proportion of total 2016

	>10%	10% > 5%	5% > 2%	<2%

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%

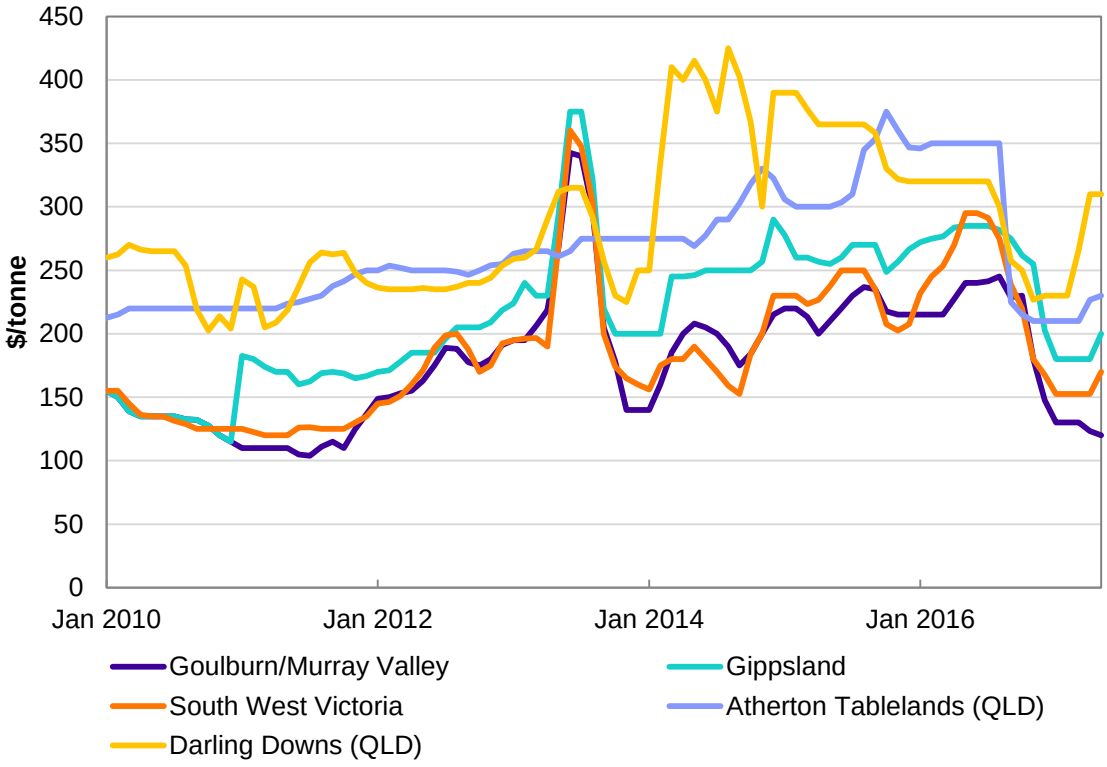
Source: ABARES data, ACCC analysis

As discussed in *Chapter 1*, the extent to which farmers in the southern states depend on supplementary feed for milk production can largely depend on calving systems. Farmers in regions such as northern NSW and Queensland are highly reliant on supplementary feed.

Price volatility in feed 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.[93]

Figures 2.2 and 2.3 below show the price volatility of some primary feed inputs in Queensland and Victoria.

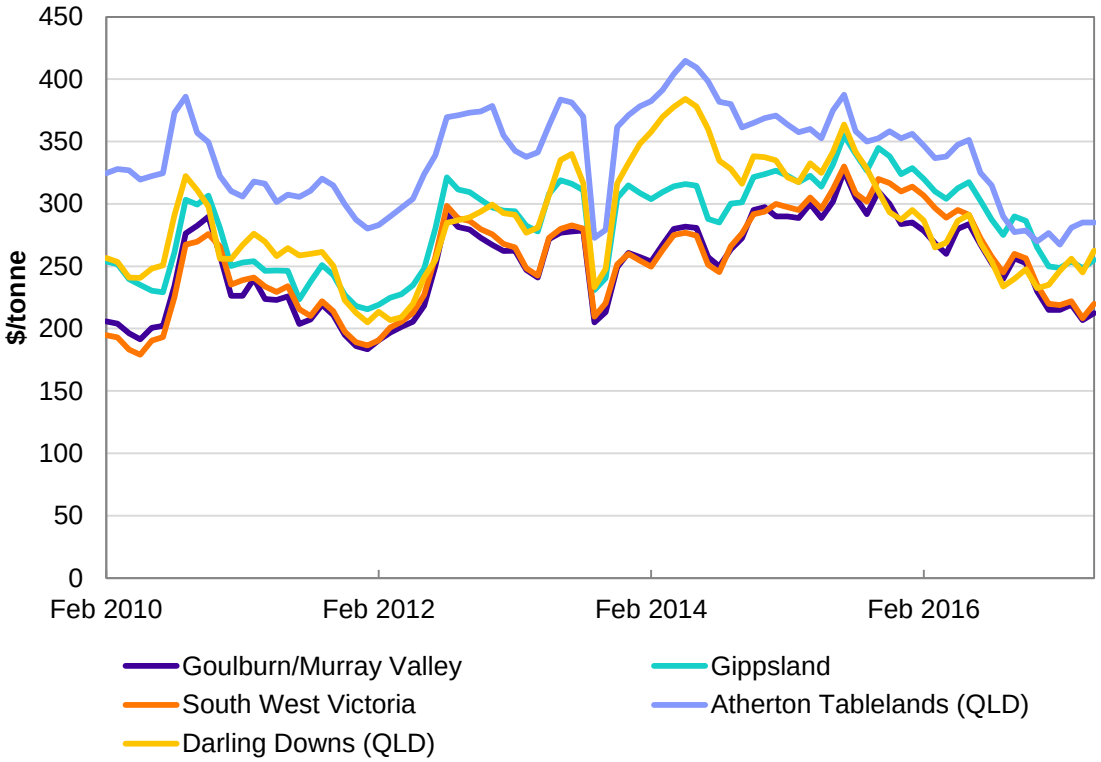
Figure 2.2: Monthly average cereal hay prices



Source: Dairy Australia data, AFIA

[93] Dairy Australia, *Buying Feed – Fact Sheet*, accessed 6/9/2017, 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 (and hence fodder) 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.

Other sources of risk

Other input costs, such as fertiliser, fuel and water can also be volatile and, collectively, another source of uncertainty and price 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 surplus feed, the price of which is also affected by water availability more generally.

2.7. Limited risk management tools

2.7.1. Processors can limit commodity risks to some extent

The ACCC has considered the availability of market price information, and its effectiveness for forecasting movements in farmgate milk prices.

The ACCC notes that processors attempt to manage 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 determine and announce farmgate prices
- 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.

Chapter 3 examines the correlation between global dairy commodity prices and farmgate prices in the export-focused regions. If processors are 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.

To some extent processors can forward-sell dairy product for the upcoming year before they manufacture them, providing some certainty of supply and pricing. This is a common way for processors to reduce the commodity price uncertainty the face throughout the year.

Some processors have started trialling the effectiveness of dairy derivatives contracts, such as futures contracts for WMP, to hedge against risks from falls in export prices, and have indicated that the liquidity of dairy derivatives has been very limited.

A processor also commented that the farmgate prices it offers to suppliers are considerably more stable than global dairy markets as it shields farmers from some of the volatility by absorbing and managing it themselves.

The ACCC considers that dairy processors are better placed than farmers to manage unexpected price movements in commoditised dairy prices. However there are few specific hedging instruments available to dairy processors in Australia.

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 risks from currency movements.

The ACCC further considers that while dairy processors have discretion to pass on risk exposure to dairy farmers through the use of mid-season step-downs in practice this rarely occurs. Processors are hesitant to act and often absorb volatility in order to preserve the goodwill in their relationship with farmers. Consequently, the opening price is commonly accepted as representing a minimum price that farmers can expect to receive for the year.

2.7.2. Farm management of input cost risks

The ACCC spoke with a number of profitable farmers who 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 feed requirements on-farm
- keeping reserves of fodder and feed available
- locking in feed 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 in the medium term 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 increased use 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 derive more borrowing power from this. Dairy farm consultants suggest that farms with an equity position of below 50 per cent are extremely vulnerable. However such targets are unlikely to be achievable for some farmers, especially younger farmers early in their careers.

Additional risk management tools available to farmers include:

- the Government's Farm Management Deposits scheme-this is designed to manage income volatility by allowing producers to set aside pre-tax income from production in years of good cash flow to draw on in years of lesser cash flow
- diversification of income streams reduces exposure to volatility in returns on milk sales. Alternative income sources including livestock sales and off-farm investments.

Chapter.3. Farmgate milk prices

Key Points

- Farmers have limited visibility over how farmgate prices are set.
- Actual prices received by farmers can vary significantly from the announced farmgate price.
- The largest farms typically receive higher farmgate milk prices than smaller farms
- 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.
- Farmgate price movements in export focused regions are primarily driven by global dairy market conditions
- There appear to be few differences between the contracting options and terms offered by corporate processors and 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. Introduction

The farmgate milk step-downs implemented by Murray Goulburn and Fonterra in 2016 placed significant focus on pricing practices in the dairy industry. 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 discretion that processors have to alter prices, and the detriment that can be caused to farmers when prices do not align with processors' forecasts.

The dairy industry has a unique approach to pricing linked to the history of the industry. The use of variable pricing (including step-ups and step-downs) has in part evolved from cooperative models that historically characterised the industry. Traditionally a cooperative processor set a conservative farmgate milk price at the commencement of each year and increased this price throughout the year as the likely profits that could be returned to its farmer members became clear. While some fixed-price contracts exist (particularly in certain regions), variable price arrangements are still common, despite most processors now trading as corporations.

Co-operatives have been a feature of the Australian dairy industry since the 1880s. They provide services to members, such as necessary infrastructure, or help improve conditions where farmers are disadvantaged.[94] A co-operative is an entity registered under the Co-operatives National Law (CNL) and adheres to the 'co-operative principles'.[95]

Co-operatives are typically run by elected directors and profits are returned to members.[96] Where a 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.[97] 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. The ACCC notes that the ACCC is currently

[94] William van Caenegem, Madeline Taylor, Jen Cleary and Brenda Marshall, *Collective Bargaining in the Agricultural Sector*, Rural Industries Research and Development Corporation, June 2015, p. 35.

[95] *Co-operatives (Adoption of National Law) Act 2012 No 29* (NSW), s 10.

[96] Van Caenegem, *Collective Bargaining in the Agricultural Sector*, RIRDC, June 2015, p. 1.

[97] Ibid.

reviewing the proposed acquisition of Murray Goulburn's operating assets by Saputo Dairy Australia Pty Ltd.

Norco commenced operations in 1895 and achieved total sales in 2016 of $541 million.[98] Norco is member owned and governed by a Board of elected farmer directors.[99] It acquires milk from 218 farms across northern NSW and southern Queensland.[100]

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.[101]

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.[102]

3.1.1. Co-operatives and corporate processors offer farmers similar commercial terms

In the course of this inquiry the ACCC analysed a large number of contracts between processors and farmers, including those offered by both co-operative and corporate processors. This analysis has indicated that the contracting options offered by co-operatives and corporate processors to farmers are not significantly different, and generally contain similar pricing components, bonuses and deductions. In addition, both co-operatives and corporate processors use exclusive supply clauses and step-ups and step-downs.

Processors of either persuasion rarely negotiate contract terms with farmers, and co-operatives in particular generally prefer not to negotiate individual terms given the co-operative ethos of providing equal benefits to all. Therefore, being a member of a co-operative will not necessarily improve an individual farmer's bargaining position.

Co-operatives are often seen by farmers as playing an important role in the market, as by returning all profits not reinvested (via the farmgate price or dividends), they will provide a price that reflects market returns, which corporate processors will need to match in order to compete for supply.

[98] Norco*, Annual Report 2016*, Norco Co-operative Limited, p. 2.

[99] Ibid, p. 2.

[100] Ibid.

[101] Ibid.

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

3.2. Setting the farmgate milk prices

Processors use a range of measures to estimate the volume of milk they need to fulfil product orders and maximise profits. 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 but subject to the number of farmers switching to and from other processors)
- 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 cooperative dairy processors, how returns to members will be allocated, in the form of either the farmgate price or dividends.

The impact of global and domestic demand will vary by processor, as all processors 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.

3.2.1. Competition is an important input into farmgate prices

In *Chapter 2* the ACCC explored the bargaining position of farmers in negotiations with processors. This analysis found that farmers are typically in a weak bargaining position and as a result are price takers for their milk.

Competition between processors is a key factor overlaying price determinations. As in any market, purchasers with bargaining power, in this case processors, aim to minimise their milk acquisition costs, while ensuring that they can secure sufficient supply volumes. Processors therefore aim to set milk prices high enough to obtain the volume of raw milk that 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 each other. Therefore, the greater degree of competition between processors in a market, the higher farmgate prices will be as processors try to capture the volumes of milk that they want.

The degree of competition between processors in Australia varies from region to region (as discussed in *Chapter 4*) and therefore so does the impact of competition on farmgate prices.

Internal processor documents obtained by the ACCC clearly demonstrate that processors pay close attention to competitors' prices within a dairy region with a view to maintaining or increasing their share of the regional milk supply.

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 its share of the total raw milk supply available.

Processors who want to grow their acquisitions of milk need to offer 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.

3.2.2. Limited transparency of pricing information

There are clear information imbalances between processors and farmers in relation to the setting of the farmgate price. For example:

- farmers rely on market information provided by processors
- processors hold better information than farmers and have discretion over when and how this information is disclosed
- processors often communicate information in complicated formats.

This means farmers have limited visibility as to how farmgate prices are set. 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 insight as to the specific exposure that one processor or another has to specific market factors.

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

While the ACCC does not consider it desirable for processors to publicly disclose how their prices are determined, 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 may therefore benefit from increased transparency to better understand if 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.

After considering the various issues across the industry, while farmers may benefit from increased transparency, the ACCC considers that problems experienced by farmers may be better addressed through:

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

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

3.3. 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.

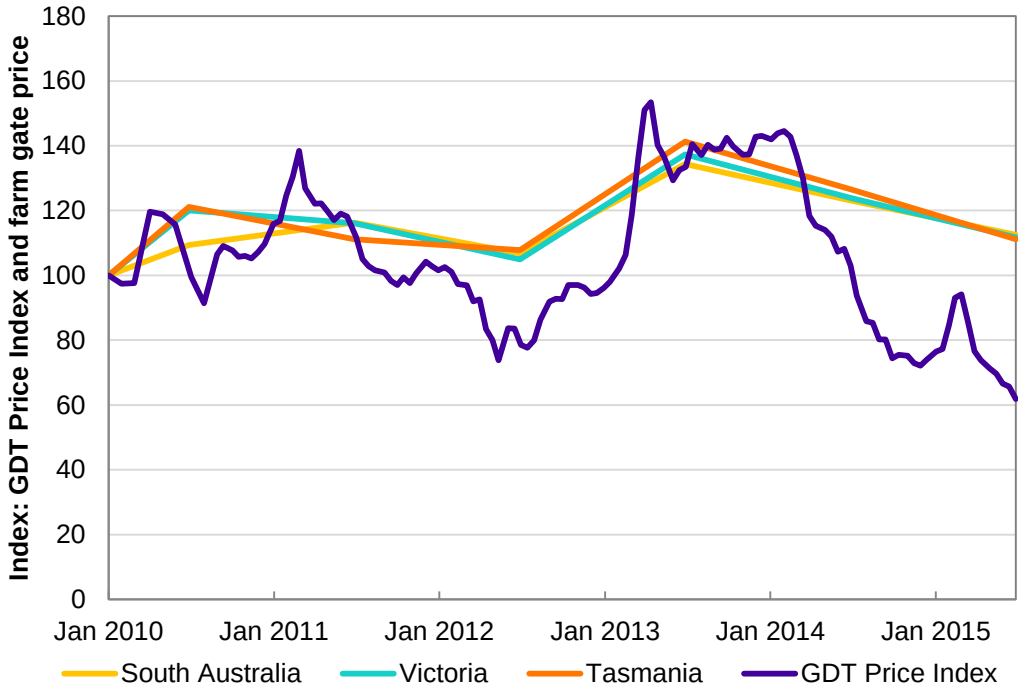
Acquiring raw milk from farmers is the main cost of production for processors and also a cost over which they have significant influence. Broadly speaking, when global prices for dairy products decline in response to subdued international demand, processors in export-focused regions seek to adjust their 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 re-directed into domestic sales, as domestic demand is relatively stable.

Conversely when global prices increase, expected profits for export-focused processors increase and the valuation and demand for raw milk also increases, which is reflected in higher farmgate prices.

Figures 3.1 and 3.2 below, using the GDT Price Index[103], show this effect and demonstrate that farmgate prices in export-focused regions are linked to global commodity prices, whereas farmgate prices in domestic-focused regions are not.

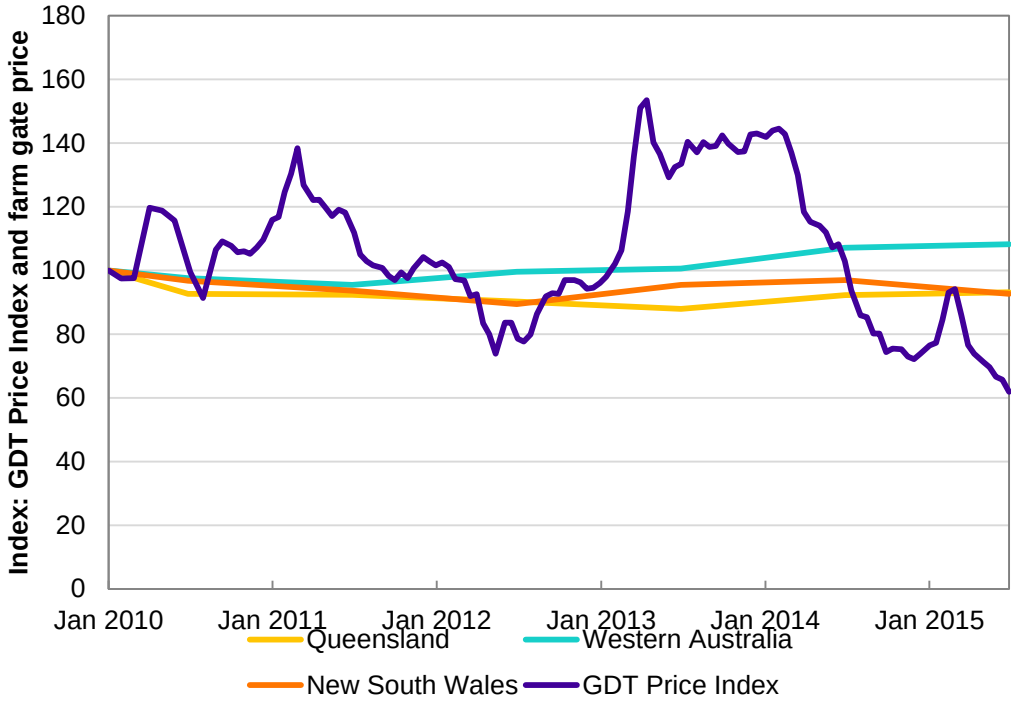
[103] Note: GlobalDairyTrade*'s price index is a widely-cited trade-weighted index of globally traded dairy prices.*

Figure 3.1: GDT Price Index and farmgate milk prices, indexed to base 5 January 2010 – export-focused regions (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 – domestic-focused regions (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.[104] 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.

As raw milk can be transported from one region to another, farmgate milk prices in domestic-focused regions such as Queensland can still be, to a degree, influenced by prices in export-focused regions such as Victoria. However, this influence is only likely when global commodity prices (and therefore farmgate prices in export regions) 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.

The ACCC notes that an issue raised by farmers and farmer representative groups is the perceived lack of correlation between processor payments for milkfat and global prices for butter. Farmers argue that, in this respect, fluctuations in the relative global prices for protein and milkfat are not reflected in farmgate prices for protein and milkfat. The ACCC will analyse this issue further in the final inquiry report.

3.4. Pricing to encourage flat production

Raw milk production has historically been seasonal, particularly in export-focused regions, with peak production in spring. While this is still the case, some processors now place a higher value on flatter production in order 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.

Processors predominantly manufacturing fresh dairy products (such as fresh drinking milk, yoghurts, and fresh cheese) with a relatively short shelf life require a flatter milk supply in order 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 have therefore traditionally placed a higher value on flatter production.

Processors producing dairy products for export face a trade-off in terms of whether to encourage seasonal or flatter milk production. On the 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 will then be 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, thereby leading to lower production costs, but at the expense of higher milk prices.

[104] Dairy Australia, *Dairy In Focus 2017*, p. 20.

Dairy farmers in the export-focused regions have raised concerns with the ACCC about a perceived push by most processers 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 season[105] is typically encouraged by processors in two ways.

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

However, for farmers, flatter milk production often results in higher costs of production, through increased purchases of supplementary feed, and greater volatility in costs of production, due to volatility in feed prices.

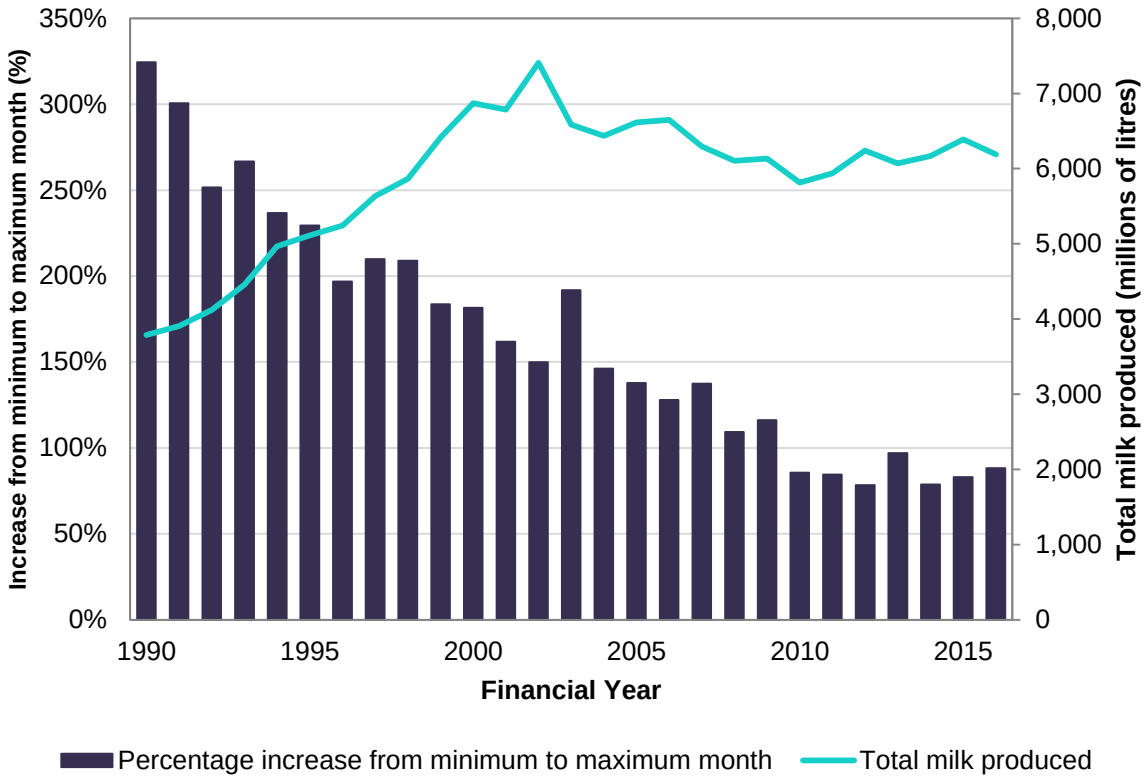
However, in most cases, farmers still have discretion to choose their calving patterns and whether or not they wish to flatten their production profile. In the course of this inquiry the ACCC has spoken with a number of efficient and profitable dairy farmers who have adjusted their calving patterns to take partial advantage of higher milk prices in winter while limiting the level of risk they are subject to from volatile feed costs.

The ability of farmers to manage this issue varies from region to region. For example, many farmers in Victoria are able to choose the processor with demand that 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 are unlikely to have this option and contracts and pricing in these locations will favour farmers 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 3.3 below 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.

[105] Discussion about how seasonality operates is included in *Chapter 1*

Figure 3.3: Seasonality of milk production in Victoria

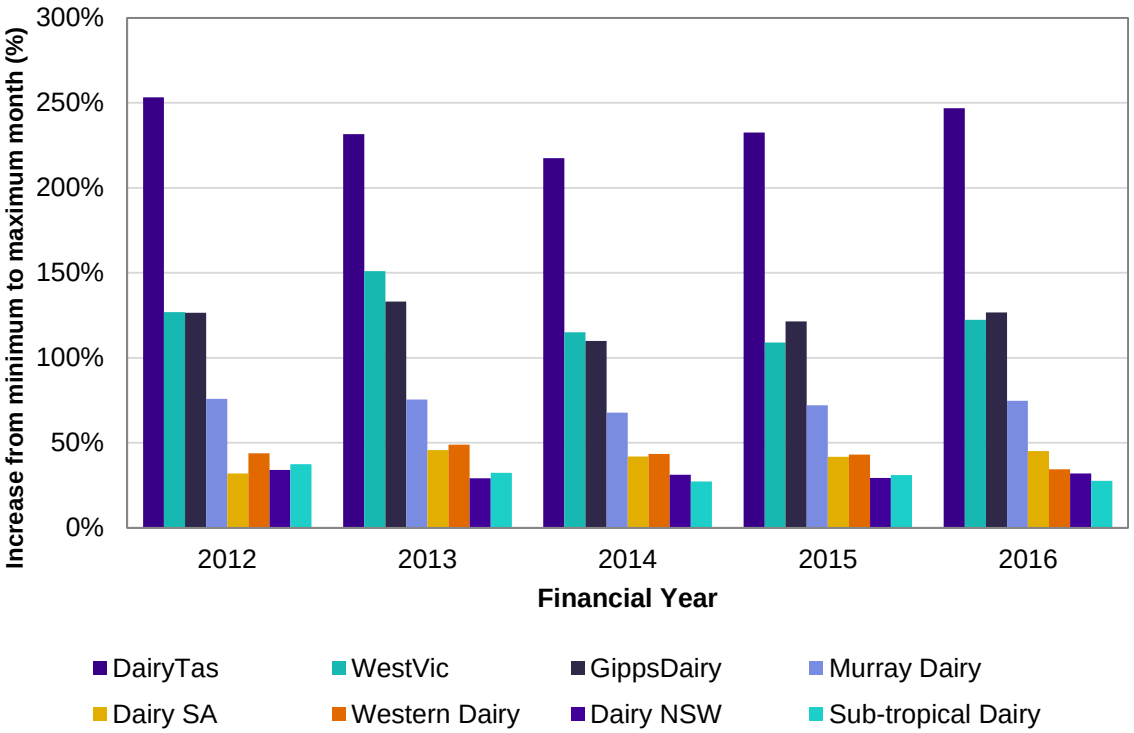


Source: Dairy Australia data, and ACCC analysis

Figure 3.4 below illustrates the highly seasonal milk production of Tasmania and to a lesser extent Victoria relative to the predominantly fresh drink milk market in Queensland, and 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 3.4: Seasonality of milk production across Australia



Source: Dairy Australia data, and ACCC analysis

3.5. The complexity of the components that make up the farmgate milk price

Farmers have 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 that farmers:

- have difficulty in estimating their projected incomes for the year
- have difficulty comparing the offers of different processors
- face difficulty identifying 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.[106] The industry has seen a significant change in the formality and structure of supply arrangements offered by processors.[107]

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

[106] National Competition Council, *Dairy – Now and Then: The Australian Dairy Industry Since Deregulation*, AusInfo, (2004), 35.
[107] Ibid.

producers with more choice concerning their production systems in response to the incentives available'.[108]

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 ($/kgMS), 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 milkfat and protein content that will be delivered by any particular farm, or the particular bonuses and deductions that the farm will receive.

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

Figure 3.5 below shows the types of pricing mechanisms in supply agreements and the prevalence of these terms in offers from major processors.[109] The relative importance of the various incentives, bonuses and penalties on the price paid for milk can vary a great deal between processors.

Figure 3.5 - Type of terms in 2016 processor supply agreements

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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 that are available, further adding to farmers' difficulties in identifying the best offer for them.

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

[108] Ibid.

[109] 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 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 is 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 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.
- A volume charge: a flat rate charge incurred 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. The ACCC contends that 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 below.

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, good quality production data needs to be collected and retained by the business. 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.

3.6. 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.[110]

In contrast, the vast majority of farmers are price-takers with no pricing discretion. A farmer's only discretion is their 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.

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/kgMS down to $5.00/kgMS. 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 in 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, or whether the global conditions and communication with farmers could have been better managed.

ACCC proceedings against Murray Goulburn's conduct.

[110] Note: in 2016, a number of processors other than Murray Goulburn and Fonterra chose not to step-down.

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 alleges that the former managing director Gary Helou and former chief financial officer Bradley Hingle were knowingly concerned in Murray Goulburn's conduct.

The ACCC alleges 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 that was not in fact 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 that was not in fact the case. The ACCC also alleges that, in all the circumstances, Murray Goulburn's conduct towards farmers was unconscionable.

The proceedings are before the Court.

Following the 2016 price step-downs, their use, particularly retrospectively, has been a contentious issue in the dairy industry.

Both farmers and some processors were critical of the use of step-downs in submissions to the inquiry:

- 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[111]
- NSW Farmers submitted that step-downs can be unfairly applied to mitigate business risk encountered by processors[112]
- Norco states it 'does not use step-downs or claw back provisions as part of its pricing system'[113]
- 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.'[114]

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…..'[115]
- 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.'[116]

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

[112] NSW Farmer's Association,, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, p. 8.

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

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

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

[116] Fonterra Australia Pty Ltd, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, p. 8-9.

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, it 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.[117] 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.'[118]

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 processors manufacturing exportable products often lock-in prices for a substantial volume of their exports for the upcoming year. Furthermore, exportable product processors often diversify into fresh dairy products for the Australian domestic market.

3.6.1. 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.[119]

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

3.6.2. Should processors set minimum guaranteed prices?

The 2016 step-downs have shaken farmer confidence in their ability to rely on opening prices as the minimum price that they will receive for the year. If farmers were able to rely on

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

[118] Ibid.

[119] See Charts *Chapter 3*.

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 able to offer fixed prices for the majority of the milk that they acquire, and manage the residual risk rather than passing it on to farmers
- the fixed price may be lower than the variable price to reflect the sharing of risk.
- 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
- contractual barriers to switching are an important consideration in this context, as the ability to exit an agreement if a step-down is announced is likely to reduce the potential harm to farmers and discourage processors from imposing step-downs due to the possibly of losing large volumes of milk supply.

Box 3.4: The Voluntary Code

The Voluntary Code proposes changes 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 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. The communication of farmgate prices to farmers

In export-focused regions, 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 domestic-focused regions, it is more usual for processors to offer fixed-price milk supply agreements for a defined period. 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 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 highlights that the opening average milk price for the 2017-18 season is $5.50 per kilogram milk solids. As is usual practice, it does not provide any information about how this figure was calculated.

In the public announcement WCB provides 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 gives a quick update on WCB's business outlook, noting that WCB has welcomed many new suppliers and increased its capacity to produce cheese and other products. WCB also notes it is seeking new milk supply for the coming season.

3.8. The timing of price announcements

3.8.1. Competition for raw milk and the announcement of farmgate prices

Concerns have been raised with the ACCC in the course of this inquiry that processors do not actively compete against one another, but simply 'follow-the-leader' in respect of opening farmgate prices, thereby restricting price competition. The ACCC particularly heard this concern in relation to other processors following opening prices set by Murray Goulburn.

The 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, the UDV observes that processors typically set a similar opening price to the first processor to announce.[120]

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

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 (Figure 3.6).

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 (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 announce an opening price and forecast closing price (assuming step-ups), while others announce one price that is subject to variations
- the first processor to announce an opening price typically offered the lowest opening price.

[120] United Dairy farmers of Victoria, *Submission to ACCC's Inquiry into the Australian dairy industry*,12 December 2016, 7.

Figure 3.6: Processor opening price announcements (Victoria)

Announcement 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/kgMS*	**WCB** 1/07/10 $4.72/kgMS	**Murray Goulburn** 1/07/10 $4.75/kg MS		
FY2012	**Fonterra** 12/05/11 $4.65/kg MS	**Bega** 6/06/11 $4.82/kgMS	**Lion** 20/06/11 $5.70/kgMS	**WCB** 21/06/11 $4.90/kgMS	**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/kgMS	**Lion** 29/06/12 $5.12/kgMS	**Fonterra** 4/07/12 $5.99/kg MS*	**Parmalat** 10/07/12 $5.20/kgMS*	**DFMC** 1/09/12 $4.60/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/kgMS	**Bega** 25/06/13 $5.62/kgMS **	**Parmalat** 25/06/13 $5.21/kg MS	**WCB** 29/06/13 $5.65/kg MS	**DFMC** 2/08/13 $5.52/kg MS
FY2015	**Fonterra** 25/06/14 $5.80/kgMS	**Murray Goulburn** 25/06/14 $6.00/kgMS	**WCB** 26/06/14 $5.86/kgMS	**Lion** 27/06/14 $6.35/kgMS	**Bega** 27/06/14 $6.00/kg MS	**Parmalat** 1/07/14 $6.09/kgMS	**DFMC** 2/07/14 $5.92/kg MS
FY2016	**Bega** 23/06/15 $5.60/kgMS	**Murray Goulburn** 24/06/15 $5.60/kgMS	**WCB** 26/06/15 $5.60/kgMS	**Fonterra** 29/06/15 $5.60/kgMS	**DFMC** 30/06/15 $5.70/kg MS	**Parmalat** 1/07/15 $5.91/kgMS	**Lion** 2/07/15 $5.80/kgMS
FY2017	**WCB** 10/06/16 $4.80/kg MS	**Bega** 21/06/16 $5.00/kg MS	**Murray Goulburn** 28/06/16 $4.31/kgMS	**Fonterra** 29/06/16 $4.75/kgMS	**Lion** 30/06/16 $5.00/kg MS	**DFMC** 30/06/16 $5.00/kgMS	**Parmalat** 1/07/16 $5.46/kg MS
FY2018	**Murray Goulburn** 6/6/2017 $4.70/kgMS	**Bega** 8/6/2017 $5.50/kgMS	WCB 9/6/2017 $5.50/kgMS	Fonterra 14/6/2017 $5.30/kgMS	Lion 23/6/2017 $5.40/kg MS	DFMC 26/6/2017 $5.40/kgMS	

** 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 Figure 3.6 above, meaningful variation in opening prices suggests there is price competition between processors.

3.8.2. The impact of announcement timing on processors and farmers

Farmers have 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. For example, feedback 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, although
- 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.'[121]

There are also concerns 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 export-focused regions, often delay announcing prices until they have greater certainty from locking-in a number of export contracts. However, processors have also often delayed making pricing announcements due to waiting for other processors to move first (as discussed in further detail in *Chapter 4*).

Further, 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 they are generally willing to take on new supply throughout a season, and farmers therefore do not need to switch at the start. These farmers therefore may not be substantially impacted by the timing of price announcements, although some contract terms present barriers to efficient switching between processors. These are discussed below.

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.

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

The use of ‘loyalty bonus’ provisions and notice periods in processor contracts have historically presented barriers for farmers seeking to switch between farmers. These two issues are examined in detail in *Chapter 4.*

3.8.3. Barriers to switching exacerbate 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 is no evidence to suggest that processors are deliberately delaying the announcement of prices in order 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).

3.9. Distribution of prices received by farmers

As previously discussed, 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.

3.9.1. Announced farmgate prices do not reflect actual prices received for many farmers

The ACCC has analysed farmer 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 has adopted the forecast closing price as the announced price.

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 four 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:

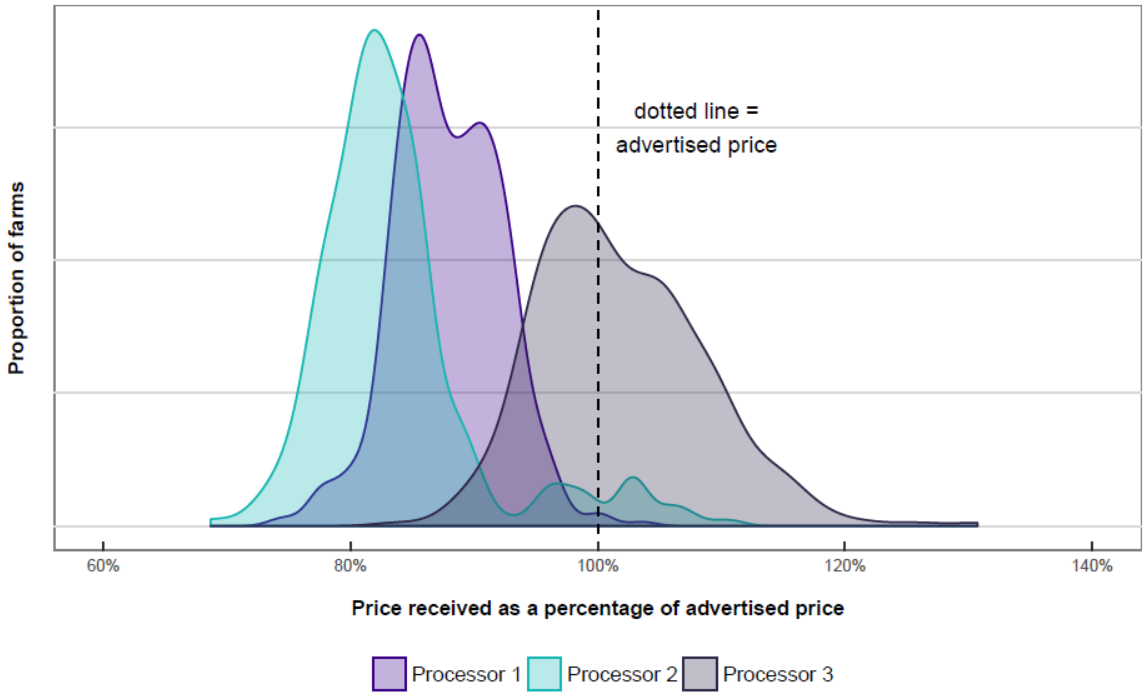
- four of the six processors paid prices that were typically even with, or greater than, their announced price
- the prices of two of the processors were typically quite variable and could range from substantially above to substantially below their announced price.

This may demonstrate that some processors are:

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

Figure 3.8 below 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. The height of the curves indicates the proportion of farmers who receive the corresponding price. As can be seen from the figure, two of processors paid the vast majority of their farmers a price that was less than their announced price.

Figure 3.8 – 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.

3.9.2. 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.

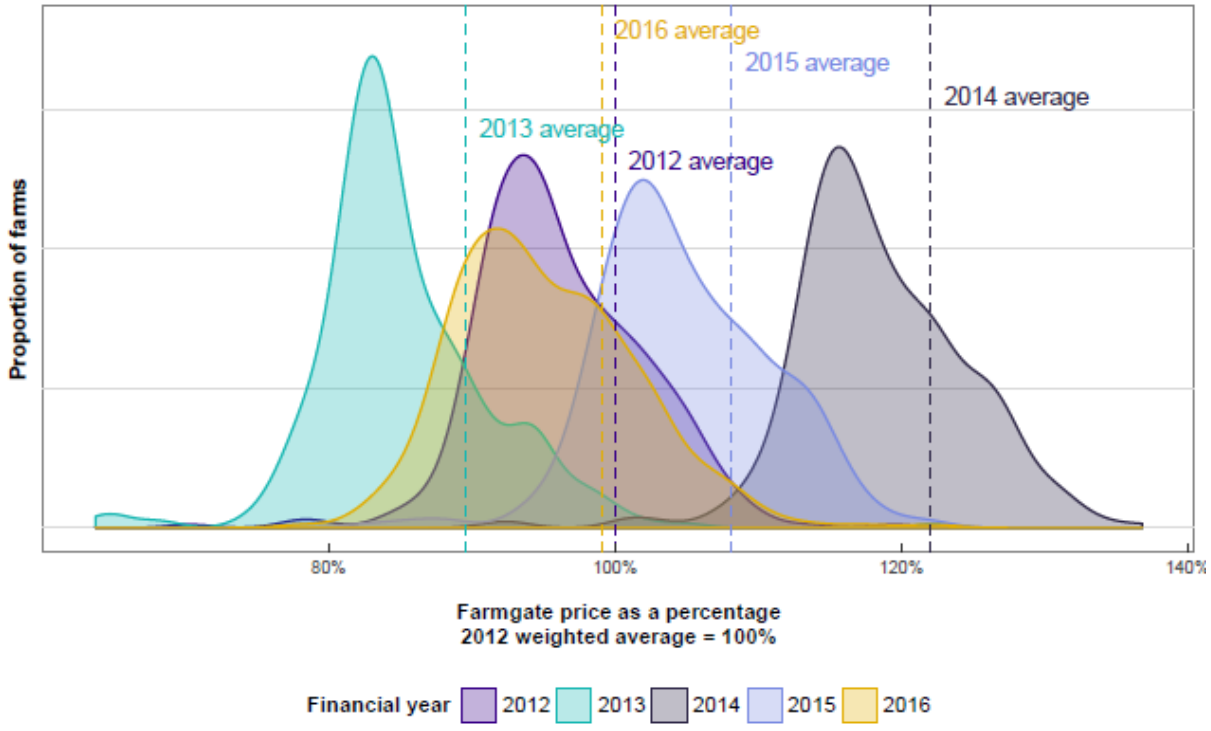
In the ACCC's hearings, processors indicated that the vast majority of farmers would achieve a price within five per cent of the weighted average farmgate price.

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 5 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 3.9 (below) 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 is indicative of the proportion of farmers who receive the corresponding price shown on the x-axis.

Figure 3.9 – Distribution of prices paid to farmers for unidentified processor



Source: De-identified processor, ACCC analysis

In addition to the above, 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.

3.9.3. The impact of seasonal pricing on farmgate prices

In some regions, and particularly in southeast Australia, 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 average farmgate price, with the biggest determinant being whether the farm has:

i. 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

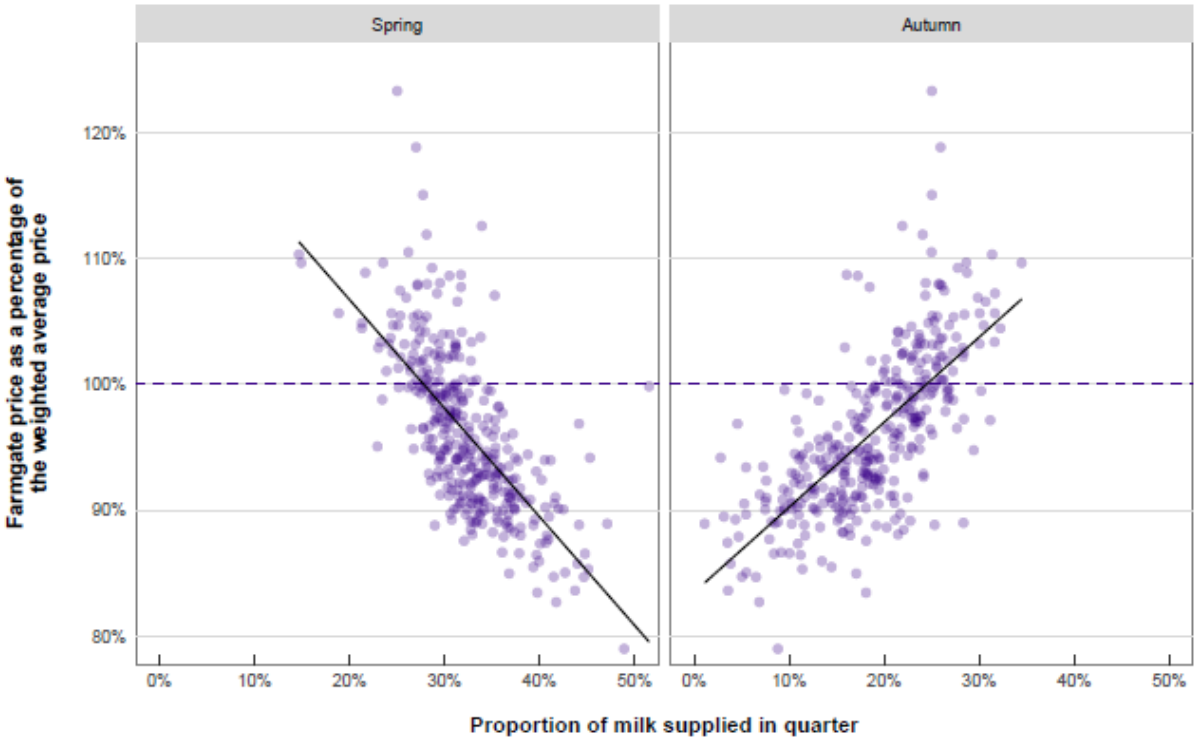
ii. a supply profile which peaks in spring (primarily spring calving), in which case they would generally earn a slightly lower average price for the season than the average farmgate price.

The ACCC's analysis of milk payments in southeast Australia 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 3.10 presents the average weighted prices paid to individual farms by a processor for an export-focused region 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 southeast Australia.

The chart shows that there is a positive relationship between the average price received by a farm over a 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 receives and the proportion of milk produced in spring.

Figure 3.10 – The impact of seasonal production on milk prices for farms in an exporting region

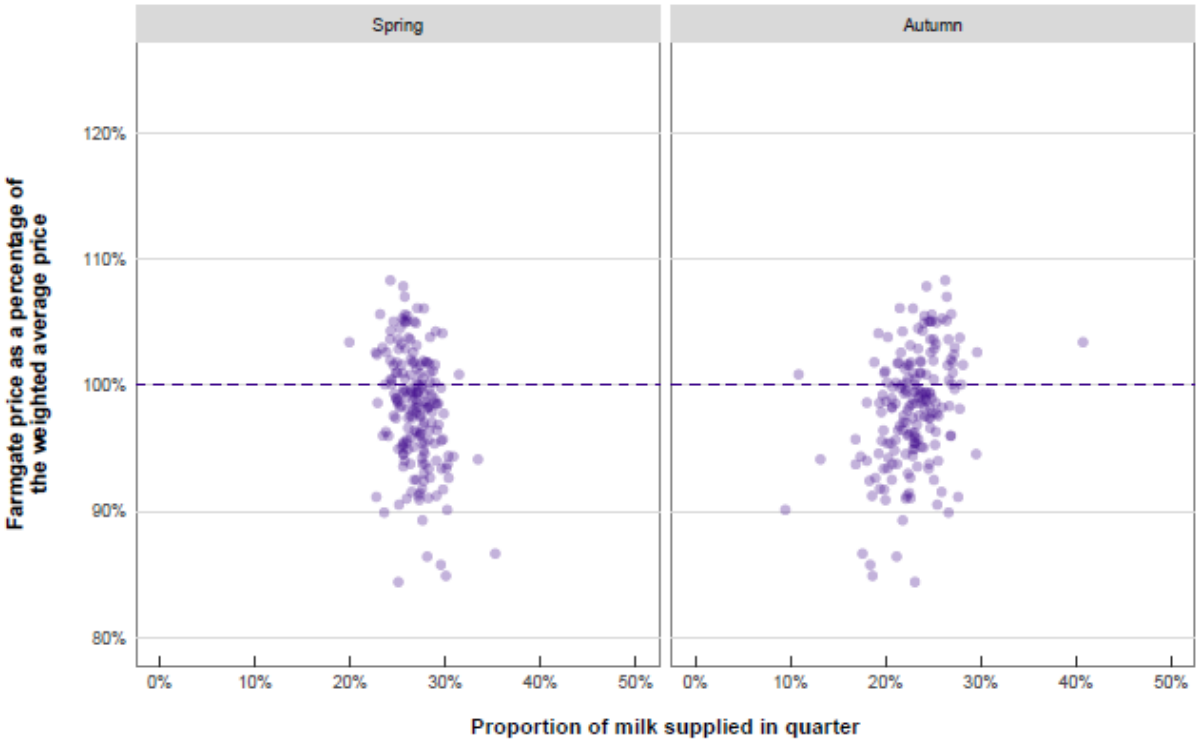


Source: de-identified processor

This indicates that in export-focused regions whether a farmer chooses spring, autumn, split or year-round calving will play an important role in the overall price received.

Alternatively, in domestic-focused regions, there is not typically a strong link between the prices farmers receive and variations in calving systems. This is demonstrated below in Figure 3.11. This chart presents the average farmgate milk price paid to farmers by a processor in a domestic-focused region 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 3.12 – The impact of seasonal production on milk prices in a domestic focused region



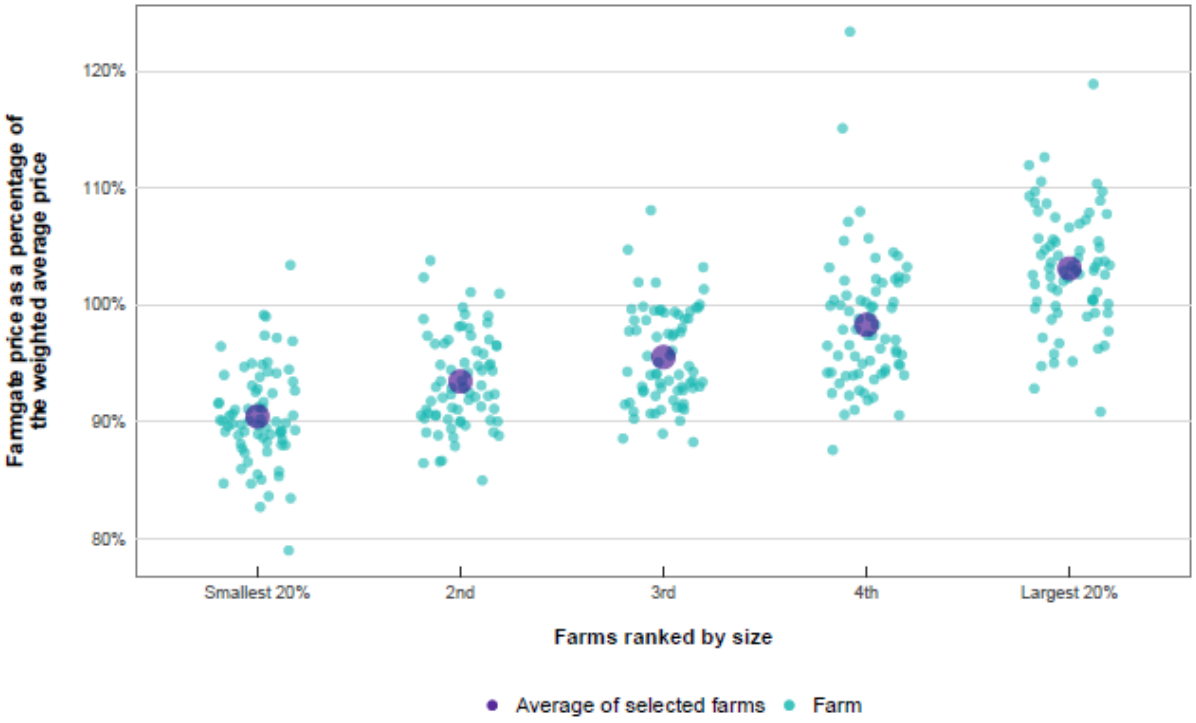
Source: De-identified processor

3.9.4. 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 do typically receive higher farmgate milk prices than smaller farms. This observation is consistent across processors and regions. This is illustrated in Figure 3.13 below, 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 3.13: Distribution of prices paid to farms according to size by a processor in 2016



Source: de-identified dairy processor, ACCC analysis

There are some exceptions where smaller scale farms earn 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.

Chapter.4. Competition for raw milk

Key Points

- Competition between processors for the acquisition of raw milk primarily takes place in nine distinct regions.
- The markets for the acquisition of raw milk are highly concentrated in all regions except for central NSW, but there appears to be close price competition.
- Loyalty bonuses can prevent farmers from switching processors. 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.
    (a) 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. 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.[122] Substitution involves switching from one product or service to another in response to a change in relative price, service or quality.[123] 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.

4.2.1. Analysis of farmgate competition

The ACCC determined 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
- 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 final products supplied to customers, and climate and seasonal factors.

[122] *Competition and Consumer Act 2010* (Cth), s 4E.

[123] Australian Competition and Consumer Commission, *Merger Guidelines,* 2008, 16.

4.3. 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 150 km of a farmer are likely to be the main source of competition for their milk.[124]

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.

The number of processors located within these geographic boundaries provides a general indication of the potential strength of competition for raw milk, with competition likely to be stronger where there are more processors. 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 below shows the ACCC's analysis of the number of processors located within 250 km of each postcode area where a farm operates on the east coast of Australia. The colour of each area shows the number of processors operating in the area (for example, red indicates one processor and green indicates eight processors). At least one farm is located in each coloured area.[125]

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, farmers in the Warrnambool area of Victoria have up to eight processors, although some may be relatively small in scale.[126] Further, not all processors within a region will have the capacity to take on additional milk supply[127], 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 unlikely to be vigorous competition between processors for farmers in these regions.

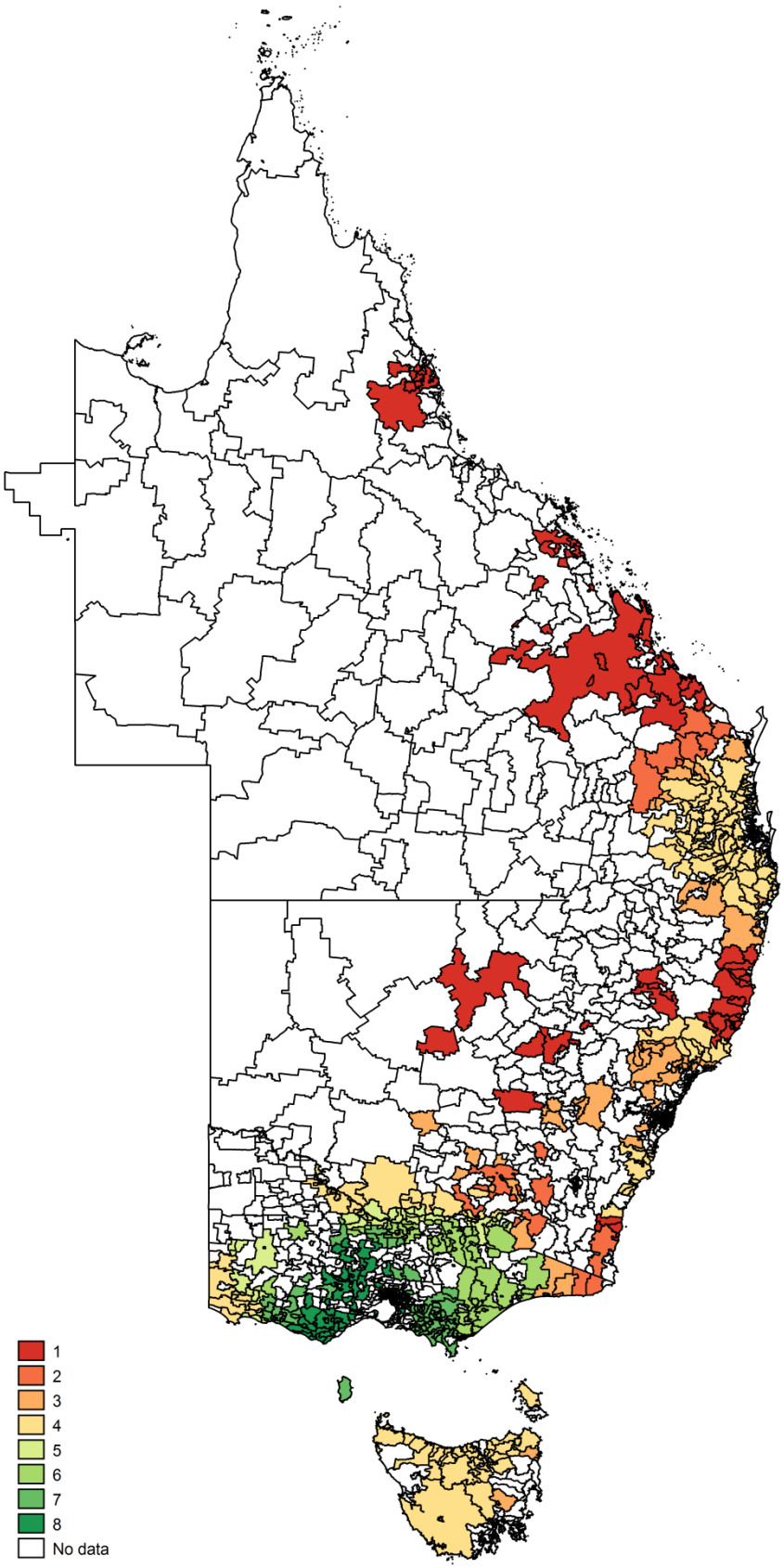
[124] This analysis does not take into consideration how milk swaps or trades can extend, or limit, the boundaries of competitive constraint, which is discussed below.

[125] 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.

[126] For the purposes of this inquiry, the ACCC has defined a major processor as acquiring over 500 million litres of raw milk per season.

[127] 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.

Figure 4.1 - Number of processors located within 250 km of a farm



Source: ACCC analysis of processors' purchase data

Figure 4.2 shows the dairy regions defined by the ACCC for the purposes of this inquiry. The figure 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 reach 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.

Figure 4.2 - 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[128]
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	Lion Murray Goulburn	268[129]

[128] Dairy Australia, *Our regions,* accessed 21 August 2017, *http://www.legendairy.com.au/dairy-farming/our-industry/our-regions.*

[129] Includes farms in southeast SA which are in the western Victoria region.

	Parmalat Warrnambool Cheese and Butter	Parmalat Warrnambool Cheese and Butter	
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[130]	Fonterra Lion Murray Goulburn Parmalat	Lion Norco Parmalat	680
Far North Queensland *(Atherton tablelands)*	Lion	Lion	Included above
Western Australia	Lion Parmalat Murray Goulburn	Brownes Lion Parmalat	160
Total			6400

Source: Processors' purchase data, Dairy Australia data, and ACCC analysis

4.4. Market concentration

4.4.1. There is a high level of market concentration in some regions

The degree of concentration in a market is a useful indicator of its structure, 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.

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

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).[131] These are shown in Figure 4.3 below.

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 table across the three seasons, but there was a general slight downward trend for the largest processors in each region:
    (a) 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:
    (a) In eastern Victoria, the Murray region and Tasmania the largest processor has at least twice the market share of the second largest processor
    (b) 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.

[131] Note: 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. It there are a small number of large firms the HHI will tend towards 10 000. Although interpretation varies, a HHI of between 1,500 and 2,500 usually indicates that a market is moderately concentrated and a figure above 2,500 indicates that the market is highly concentrated.

Figure 4.3 - Market concentration by region

Market share of raw milk purchases	Season	Eastern Victoria	Western Victoria	Murray region	Central New South Wales	Northern New South Wales / southeast Queensland	South Australia	Western Australia	Tasmania	Far North Queensland
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

When assessing competition it is important to look at 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:

- while opening and forecast closing prices may be close, processors' 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 flat 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 next season.

Price matching

Processors' supply agreements commonly include price clauses which reference competitors' pricing. For example, the Bonlac Supply Agreement, which stems from Fonterra's takeover of Bonlac Foods, requires Fonterra to pay a benchmark farmgate milk price return.[132] Lion's Farmgate Agreements in the southern regions 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.[133]

The ACCC's analysis of processors' internal documents identified examples of opening prices being increased above those originally planned, in response to announcements or rumours of imminent announcements of higher than expected opening prices from 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 switching and maintain supply.

[132] Bonlac Supply Company, *Bonlac Supply Company,* accessed 14/11/2017, http://www.bonlacsupplycompany.com.au/.

[133] Lion Dairy & Drinks Pty Ltd, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, 5.

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 cover storage and refrigeration equipment. Processors typically require ongoing supply until the loan is repaid. As discussed in section 4.4.3, the ACCC considers that these financial assistance arrangements may be beneficial to farmers and are unlikely to have negatively impacted competition between processors.

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.[134]

In addition, processors have submitted they regularly provide information to farmers about pricing changes and forecasts through newsletters and farmer supplier meetings.

Most processors also offer agronomy advice services to farmers.

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, compensation 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 production[135]
- close proximity to the processing plant
- potential for the farm to increase milk supply
- an autumn, split or year-round calving pattern.[136]

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 the very largest 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.

[134] Fonterra Australia Pty Ltd, *Submission to ACCC's Inquiry into the Australian dairy industry*, 19 December 2016, 14.

[135] Note: around 700 to over 1000 head of dairy cattle.

[136] 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.

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.[137]

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.[138] Our analysis of processor data, shown in Figure 4.4 below, suggests that the degree of switching varies by year and region.[139]

Figure 4.4 - 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

[137] Murray Goulburn, *Murray Goulburn increases South Milk Region opening price and 2017/18 FMP range,* press release, 22 June 2017, 1.

[138] This figure includes the volume of milk supplied by farmers who retire or otherwise cease dairy farming.

[139] Figure 4.4 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.

Our analysis also shows that 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 Victoria, which has the most dairy production.[140] However, in other regions a small number of farmers switching each season can represent a significant percentage of a processor's total supply.

Domestic-focused regions have 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. Dairy Farmers Milk Co-operative submitted that most opportunities to switch, particularly in northern Australia, only arise when private label milk contracts move between processors.[141]

Given the significant effect that private label contracts have on processors' milk volume requirements, we 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. Figure 4.4 illustrates 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 difficulties with 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.

As noted above, barriers to switching reduce the intensity of competition between processors to attract and retain raw milk.

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 processor and option is best for them, and consequently do not switch, the result can be that competition is 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.

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[140] Dairy Australia*, Dairy In Focus 2017,* 5.

[141] Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry (Part 2)*, 12 December 2016, 4.

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.[142] 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.

Box 4.1- 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 has identified a number of payments that are effectively loyalty bonuses. 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 had ended and the new dairy season has begun. These payments are usually made in July or August and require the farmer to be a current supplier to receive the payment.[143] Retrospective step-ups can be subject to similar conditions. Farmers have raised two main concerns with loyalty bonuses: first, it is difficult to know how much they are worth, and second their payment after the commencement of the new season creates a switching barrier.

Farmers who operate under a Supplier Handbook can theoretically switch processors at any time. However, the ACCC understands that some processors have used late step-ups and loyalty bonuses to discourage switching in order to minimise uncertainty to their supply.

[142] Queensland Dairyfarmers' Organisation, *Submission to ACCC's Inquiry into the Australian dairy industry* ', 12 December 2016, 1.

[143] 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.'

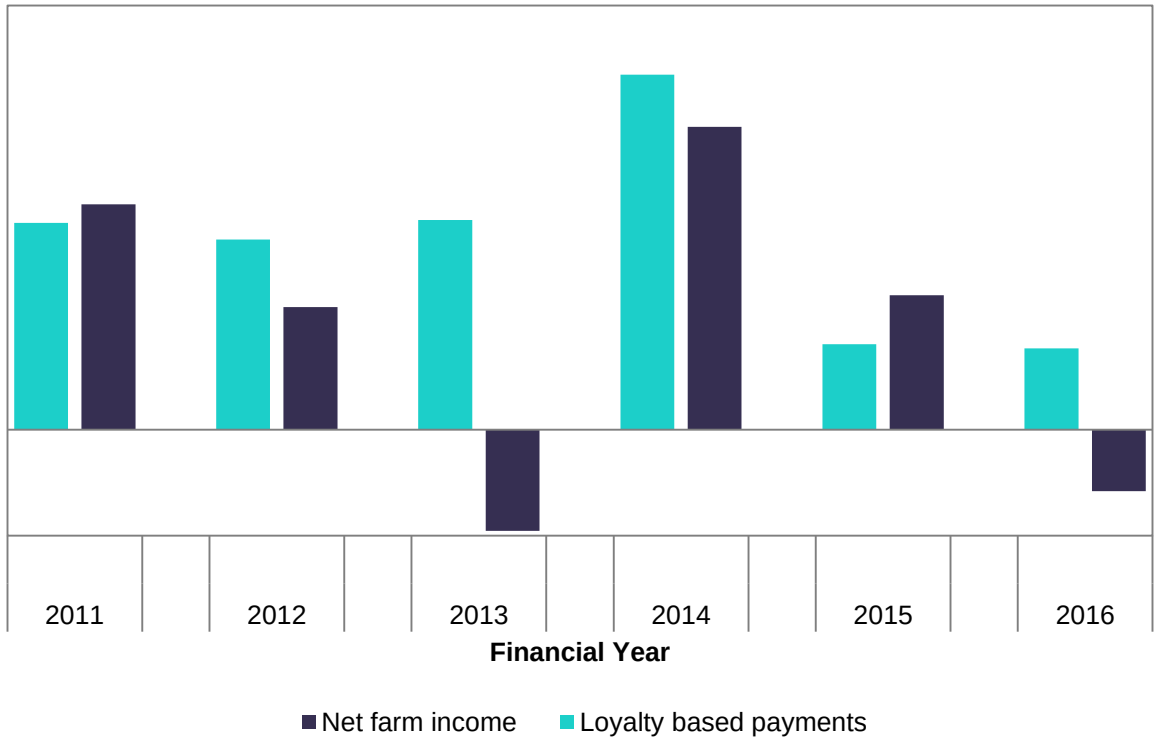
See Murray Goulburn, *Supplier Handbook Southern Milk Region 2016/17,* 61, http://www.mgc.com.au/media/36238/2016_17southernmilkregion_supplierhandbook.pdf.

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 year[144], as the bonuses are an essential component of their total income.[145]

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 4.5.

The ACCC compared the step-ups and loyalty incentives offered by this processor with the net farm income for the relevant region[146]. 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.[147] 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 4.5: Example comparison of net farm income and loyalty based payments, 2010-11 to 2015-16[148]



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)

[144] Dairy Farmers Milk Co-operative, *Submission to the ACCC's Inquiry into the Dairy Industry (Part 2)*, 12 December 2016, 5.

[145] Note: 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.

[146] With net farm income coming from the Dairy Farm Monitor Project

[147] Dairy Australia, *Dairy Farm Monitor Program Victoria*, Annual Report 2015/16, accessed 1/11/2017, https://www.dairyaustralia.com.au/farm/farm-business-management/dairy-farm-monitor-project/vic-dairy-farm-monitor-project.

[148] Absolute values are not shown due to the information being commercially sensitive.

The significance of loyalty payments accrued in one year and paid the next as a proportion of a farm's income supports the view 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 would wish to switch to for the new season.

Consequently, the practice of not paying loyalty bonuses or retrospective step-ups to farmers who are no longer contracted creates a disincentive to changing processors.[149] It also provides challenges for farmers seeking to plan for a financial year. The ACCC considers that such payments are likely to soften competition between processors.

Processors submit that in some instances they offer 'no disadvantage' payments to incoming suppliers, where they agree to pay any step-ups or loyalty bonuses that the farmer would forego if they left their current 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 4.4.2.

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 considers that loyalty bonuses and retrospective step-ups are likely to act as barriers to farmer switching, and should not be conditional on continued supply.

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, 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.

Exclusivity clauses

Farmers raised concerns that exclusivity clauses are used to the advantage of processors.[150]

Exclusive supply clauses in milk supply contracts 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.

Where exclusive supply is included in a Supplier Handbook, farmers generally have the freedom to leave the processor at any time. However, this is not the case in fixed term contracts, which generally require exclusive supply for the duration. Approximately 60 per cent of Australia's farmers are on Supplier Handbooks and are mostly located in export-focused regions. The majority of farmers in domestic-focused regions, such as WA and Queensland, operate on fixed term contracts.

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[149] Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry* (Part 2), 12 December 2016, 5.

[150] See submissions from Australian Small Business and Family Enterprise Ombudsman, NSW Farmers, WA Farmers, Phillip Richard Denniston and Colin & Rita Gee.

A number of processors submitted that exclusivity clauses also provide benefits for farmers, including certainty that their milk will be collected, milk quality assurances and efficient milk collection and sampling.[151]

In practice, the ACCC understands that dual supply rarely occurs. This is partly due to exclusive supply clauses, but is primarily because most farmers do not produce sufficient milk volumes to support a dual supply model.

To date, the ACCC has not received any evidence to suggest that competition has been restricted to any significant degree as a result of exclusive supply clauses.

We understand that smaller processors that cannot commit to purchasing a farm's entire milk supply are able to acquire milk from larger processors and milk brokers. It is likely that smaller processors pay a premium for this milk. If the price charged to small processors for raw milk is considerably higher than the price paid to farmers, exclusive supply clauses may have the effect of weakening the competitive position of smaller processors and their ability to compete with larger incumbents.

The ACCC's preliminary view is that past or existing clauses are unlikely to have substantially lessened competition among processors.[152] The ACCC welcomes industry feedback on the impact of exclusive supply clauses on small processors.

Box 4.2: Exclusive dealing

Arrangements which involve one party refusing to transact goods or services unless the other party agrees not to deal with a competitor, is a form of exclusive dealing. Exclusive dealing is a 'vertical restraint' as the parties have a vertical supply chain relationship.[153]

Exclusive contracts can have efficiency benefits. For example, with volume certainty, processing plants can reduce processing costs and realise economies of scale. Farmers also receive assurance and convenience that all their milk will be collected. This is important as farmers may face penalties or financial loss for 'dumping' any milk which is not collected. Exclusivity also reduces transaction and search costs for both processors and farmers.

However, in some cases, exclusive arrangements can harm competition. Under the CCA, exclusive dealing is prohibited where it has the effect of substantially lessening competition in a relevant market.[154]

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 preliminary view is that financial

[151] Lion Dairy & Drinks Pty Ltd, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, 8.

[152] Previous ACCC investigations have concluded that small-scale processors do not generally see exclusive supply clauses as a significant barrier to acquiring milk, as they can acquire it from other sources.

[153] Note: This is different to horizontal relationships amongst competitors, which is discussed in *Chapter 5*.

[154] *Competition and Consumer Act 2010* (Cth), s 47.

assistance arrangements are unlikely to affect competition between processors to a large degree.

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' new 2017-18 dairy season contracts following the implementation 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.[155]

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.[156] The ACCC has carefully considered these issues.

We analysed information and data provided by processors for their milk swaps and trades for the period 2010-11 to 2015-16.[157]

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.

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[155] The voluntary Code of Conduct is discussed further in *Chapter 10*.

[156] For example, United Dairyfarmers of Victoria, S*ubmission 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.

Note: 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, section 45 also prohibits corporations from engaging in a 'concerted practice' that has the purpose or effect of substantially lessening competition.

[157] Note: 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.

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.

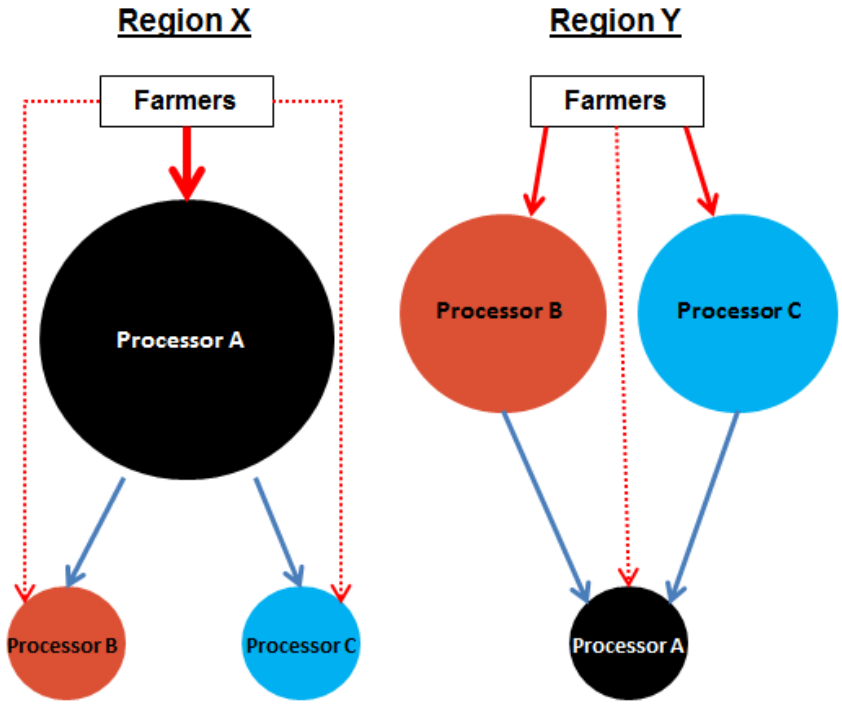
When a swap (or trade) occurs, the supplying farmers are paid under the pricing structure of the processors with whom they have contracts rather than the processor that receives their raw milk. As farmgate prices differ between processors throughout the year, farmers have raised concerns that processors are profiting from swap or trade arrangements, while exclusive supply arrangements prevent farmers from responding to better offers directly.

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.

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 4.6 below. 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 4.6 - 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 which occurred 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 the 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.[158]

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.[159]

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.

4.7.5. How could 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

[158] Note: The greater the distance between two processors engaging in a swap, the greater the efficiency gain is likely to be.

[159] Note: Trades differ from swaps as they are a commercial transaction between buyer and seller rather than volume-based exchanges.

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 fresh dairy 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

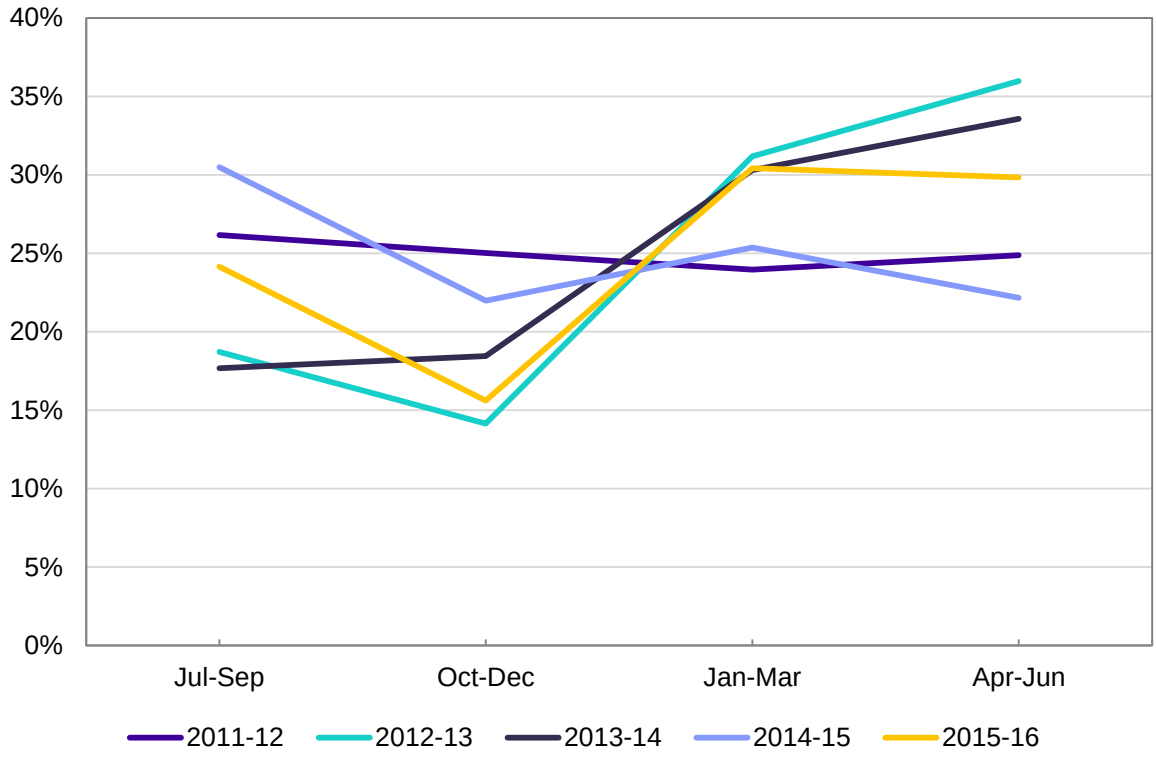
the dairy season. This raises a question of whether, absent the ability to trade milk, these processors would compete more vigorously for direct supply.

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 4.7 below, 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.

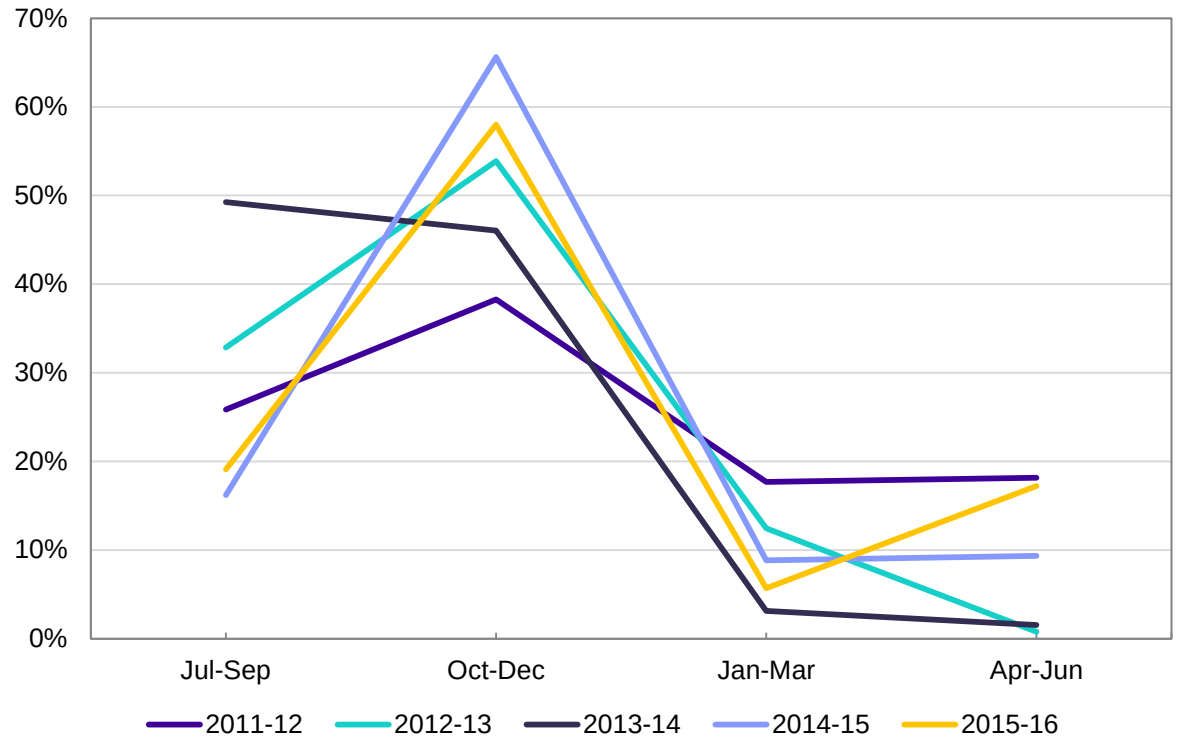
Figure 4.7 - Timing of trade purchases by domestic-focused processors (% of total trade purchases)



Source: Processors' milk purchase data & 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 4.8 below, 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' submissions that the rationale for trading milk was to balance milk volumes.

Figure 4.8 - Timing of trade sales by domestic-focused processors to other processors (% of total trade sales)



Source: Processors' purchase data & 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 supply[160], and discourage processors from developing better methods of managing their milk supply.

The ACCC understands that raw milk is traded between processors for around 5 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.

[160] 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.

4.7.8. Conclusion on swaps and trades

The ACCC's interim view is that swaps have the potential to soften competition; but the risk does not appear to be high.

The ACCC has also considered concerns that trades between processors reduce farmgate competition. We have also considered whether trades distort price signals, leading to supply inefficiencies.

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 ACCC's preliminary view is that 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.

Chapter.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. Competition for the wholesale supply of dairy products

For the purposes of this inquiry, the ACCC has considered the general state of competition for the wholesale supply of dairy products in Australian markets.[161]

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
- 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 dairy products to the grocery retail channel, the food service channel, the food manufacturing channel and to international markets.[162]

[161] We do not consider it necessary to precisely determine relevant markets for the purposes of the inquiry; however, future assessments of merger proposals or market power in the industry could mean that different market boundaries are relevant.

[162] 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.

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 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.

5.1.1. 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.

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).[163]

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.[164] Murray Goulburn now has the third largest share of the drinking milk market with 16 per cent.

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[163] Brooke Tonkin, *The big cheese: The popularity of gourmet cheeses is projected to aid revenue growth*, IBISWorld, January 2017, accessed 14/11/2017, clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=1856.

[164] Samuel Johnson, *Cream of the crop: Strong export growth has significantly boosted the industry's performance,* IBISWorld, October 2017, accessed 14/11/2017, http://clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=94.

Murray Goulburn has the highest market share for the production of milk powder[165], butter[166], and other dairy products and is the fourth largest for cheese production.[167] 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.

5.1.2. 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 supermarkets[168]
- approximately 53 per cent of domestic cheese sales are through major supermarkets.[169]

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. 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 during the tender process in most regions, which shows that rival firms are willing to out-compete the incumbent processor. Although price is an important consideration for the major supermarkets, information obtained by the ACCC 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 contracts shifted between processors in several states (Table 5.2 and Table 5.3).[170]

[165] Bao Vuong, *Sour circumstances: Fluctuating global milk powder prices have led to industry volatility*, IBISWorld, August 2017, accessed 14/11/2017, http://clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=1857.

[166] Brooke Tonkin, Spilt milk: Industry revenue is expected to decline due to plummeting global dairy prices, IBISWorld, November 2016, accessed 14/11/2017, http://clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=96.

[167] Brooke Tonkin, The big cheese: The popularity of gourmet cheeses is projected to aid revenue growth, IBISWorld, January 2017, accessed 14/11/2017, clients1.ibisworld.com.au/reports/au/industry/default.aspx?entid=1856.

[168] Dairy Australia, *Australian Dairy Industry in Focus 2016*, 24, 43, and ACCC analysis.

[169] Dairy Australia, *Australian Dairy Industry in Focus 2016*, 42, and ACCC analysis.

[170] 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 contracts[171]

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 contracts[172]

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

Notes: *Five year contract with option to extend for a further five years.[173]

[171] Sue Mitchell and Tim Binsted, *Fonterra wins Woolies' 10-year contract for private label milk in Victoria*, Sydney Morning Herald, 4 April 2014, accessed 23/10/2017, http://www.smh.com.au/business/fonterra-wins-woolies-10year-contract-for-private-label-milk-in-victoria-20140403-361fw.html;

Brad Thompson, *Coles poised for Lion's share*, The West, 1 July 2015, accessed 23/10/2017, 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 23/10/2017, http://www.theaustralian.com.au/business/companies/coles-milk-deal-puts-lion-back-in-favour/news-story/7aa99bfeff60c50310befb38271d8fe8?login=1.

[172] Sue Mitchell and Tim Binsted, *Fonterra wins Woolies' 10-year contract for private label milk in Victoria*, Sydney Morning Herald, April 4 2014, accessed 23/10/2017, http://www.smh.com.au/business/fonterra-wins-woolies-10year-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 23/10/2017, http://www.theaustralian.com.au/business/companies/parmalat-wins-woolworths-house-brand-milk-deal-for-nsw/news-story/4ba852b550160042a30ed291b01aa445.

[173] Woolworths Group Ltd, Woolworths offers certainty in new milk contract, 3 April 2014, accessed 23/10/2017, https://www.woolworthsgroup.com.au/page/media/Press_Releases/Woolworths_offers_certainty_in_new_milk_contract.

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.”[174]
    (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 stated, "We went into a competitive tender process … and Coles have chosen an alternative supplier based solely on pricing I should imagine."[175]
- Murray Goulburn then lost the Woolworths private label cheese contract to Bega in July 2016, while retaining contracts for shredded mozzarella and butter.[176]
- 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).[177]

In export-focused regions 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 domestic-focused regions, however, a change in a fresh white drinking milk private label contract with Coles or Woolworths has a pronounced effect on wholesale market shares.

5.1.3. 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 export-focused regions.

Jasmine O’Donoghue, *Woolworths dumps Lion for Fonterra and Brownes*, 3 April 2014, accessed 26/11/2017, https://foodmag.com.au/woolworths-dumps-lion-for-fonterra-and-brownes/.

[174] Murray Goulburn Co-operative, *Murray Goulburn wins Coles cheese supply contract,* 1 February 2017, accessed 23/10/2017, http://www.mgc.com.au/media/31128/MG-Coles-Contract-ASX-Announcment-final.pdf.

[175] Joshua Becker, *Bega Cheese loses Coles contract to Murray Goulburn,* ABC Rural, 1 February 2016, accessed 23/10/2017, http://www.abc.net.au/news/rural/rural-news/2016-02-01/bega-loses-coles-cheese-contract/7129520.

[176] Murray Goulburn Co-operative, *Murray Goulburn Announcement,* 29 July 2016, accessed 23/10/2017, http://www.mgc.com.au/media/38504/ASX-Announcement-Woolworths-private-label-business-29-July-2016.pdf.

[177] 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 23/10/2017, http://www.abc.net.au/news/rural/2016-07-29/woolworths-drops-mg-lines-of-private-dairy/7671532.

The ACCC therefore considers that there is only a weak competitive constraint on the major processors from the threat of supply-side substitution.

5.1.4. 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
- 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.[178]

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).[179,180] 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. As noted above, these are generally long-term and 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 processing business.

The ACCC observes that supermarkets have been embracing 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 Japan[181], and Chinese requirements for factory registration, with even stricter certification and accreditation requirements for infant formula.[182]

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[178] 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 8/10/17, https://www.commbank.com.au/content/dam/commbank/theme/corporate/change-the-game/docs/Devondale-Murray-Goulburn.pdf

[179] Farm Online, *Down to the wire for UDP,* 11 February 2015, accessed 2/10/2017, http://www.farmonline.com.au/story/3380216/down-to-the-wire-for-udp/.

[180] 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.

[181] Dairy Australia, *Market Brief Japan*, version 2, August 2016.

[182] Dairy Australia, *Market Brief China,* version 2, August 2016.

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.[183]

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.[184] 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.

5.1.5. 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 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.

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 million[185], the plant has capacity to process

[183] Kate Zwagerman, *Midfield Group enters joint venture with global food giant,* The Standard, 4 August 2016, accessed 7/8/2017, http://www.standard.net.au/story/4074975/midfield-group-enters-joint-venture-with-global-food-giant/.

[184] Australian Dairy Industry Council and Dairy Australia, *Response to the Productivity Commission Study*: *Costs of Doing Business: Dairy Product Manufacturing*, 2014, 3.

[185] Belinda Willis, *New Penola factory milks global demand for powder products,* The Advertiser, 30 May 2017, accessed 12/10/2017, http://www.adelaidenow.com.au/business/new-penola-factory-milks-global-demand-for-powder-products/news-story/13856768539572bf6a723a4b33427eab?nk=831e2d491eba134c3f7af34c8c0c9c68-1509074846.

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.[186] 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.[187] The plant was opened in January 2017 and produces 20 000 tonnes of milk powder for export to the Chinese market.[188] 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.[189]
- Chobani entered Australia in 2011 with the acquisition of Bead Foods' facility in Victoria, before undertaking a $30 million plant expansion.[190] 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 relatively localised, given 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.[191] 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.

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[186] The Midfield Group, *The Midfield Group and Louis Dreyfus Company Dairy Asia announcement joint venture*, 4 August 2016, accessed 18/10/2017, https://www.midfield.com.au/the-midfield-group-and-louis-dreyfus-company-dairy-asia-announce-joint-venture/.

[187] 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 2/10/2017, http://www.abc.net.au/news/rural/2016-03-17/blue-lake-dairy:-invest-millions-converting-potato-chip-factory/7253834.

[188] David Sparkes, *New facility moves closer to first export of powdered milk products to China,* ABC Rural, 5 August 2016, accessed 2/10/2017, http://www.abc.net.au/news/rural/2016-08-04/blue-lake-dairy-ready-to-process-first-test-batch-of-milk-powder/7687920.

[189] Nigel Austin, *New SE dairy deal with China to create 60 jobs,* 17 March 2016, accessed 2/10/2017, http://www.adelaidenow.com.au/business/new-se-dairy-deal-with-china-to-create-60-jobs/news-story/1bc773efc0688b3750c0fb978d6b139c.

[190] Australian Food News, *Australian Chobani factory to serve as "dairy export hub" into Asia,* 6 December 2012, accessed 2/11/2017, 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.

[191] 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 20/10/17, http://www.australianconsolidatedmilk.com.au/about-us.html.

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 processor[192], to a $5 million investment in an organic dairy processing plant in Victoria.[193]

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

The discussion above indicates that small-scale entrants and milk brokers do not impose a strong competitive constraint on large processors, particularly in the market for raw milk acquisition. However, 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 above (Tables 5.3 and 5.3), larger processors have pursued opportunities for expansion by securing contracts to supply milk to supermarkets:
    (a) In 2013, Norco was successful in securing 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.[194]
    (b) Similarly, in 2013 Murray Goulburn secured a ten 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 fill the contract.[195]
    (c) Fonterra won a ten-year fresh white drinking milk contract with Woolworths in 2014 that instigated a $30 million upgrade to its Cobden processing facility in

[192] Meecham Philpott and Lara Webster, *North Queensland dairy farmer raises enough money for a milk processor*, ABC Rural, 20 October 2016, accessed 7/8/ 2017, http://www.abc.net.au/news/rural/2016-10-20/north-queensland-dairy-farmer-crowdfunding-success/7946688.

[193] Laura Poole, *Organic Dairy Farmers of Australia cooperative starts production at new $5m processing plant at Geelong, Victoria,* ABC Rural, 23 September 2015, accessed 7/8/ 2017, http://www.abc.net.au/news/rural/2015-09-23/new-organic-dairy-processing-plant-at-geelong/6797344.

[194] Norco, *New 5-year contract drives growth for Norco*, 2 December 2014, accessed 17/10/17, http://www.norco.com.au/news-detail.php?New-5-year-contract-drives-growth-for-Norco-1.

[195]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 8/10/17, https://www.commbank.com.au/content/dam/commbank/theme/corporate/change-the-game/docs/Devondale-Murray-Goulburn.pdf

Victoria.[196] The milk plant reportedly increased Fonterra's processing capacity by around 100 million litres.[197]

- 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.198 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 from South Australian farmers.
- Warrnambool Cheese and Butter completed an upgrade of its Allansford processing facility in 2017, at a cost of $40 million, potentially increasing WCB's demand for raw milk by 250 million litres.[199]
- 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 by the end of 2017.

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.[200] 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 considerable supply, eventually deciding to close these plants and consolidate their processing facilities. Media reports indicate that the fate of these plants is part of ongoing discussions.[201] The overall impact on competition for the acquisition of raw milk will depend on whether the net result is that there are fewer processors operating in the area, reducing supply options for farmers, or enhanced competition as the result of another processor entering the region by acquiring any of the plants.

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.

5.1.6. 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. In the market for processed dairy products, product innovation is an important form of non-price competition and firms face intense rivalry in the development of new products and the improvement of existing ones. This is ultimately of benefit to consumers who enjoy greater product choice and quality.

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[196] Sue Mitchell and Tim Binsted, *Woolworths inks milk deal with NZ dairy giant Fonterra,* Sydney Morning Herald, 3 April 2014, accessed 13/10/2017, http://www.smh.com.au/business/retail/woolworths-inks-milk-deal-with-nz-dairy-giant-fonterra-20140403-3600n.html.

[197] Everard Himmelreich, *Fonterra opens new Cobden plant*, The Land, 2 September 2015, accessed 9/11/2017, http://www.theland.com.au/story/3376685/fonterra-opens-new-cobden-plant/.

[198] Valerina Changarathil, *Beston's Murray Bridge revamp to boost milk demand,* The Advertiser, 15 June 2017, accessed 18/10/17, http://www.adelaidenow.com.au/business/bestons-murray-bridge-revamp-to-boost-milk-demand/news-story/292a542ea8221a2249f46df62ccccae6?nk=831e2d491eba134c3f7af34c8c0c9c68-1509072752.

[199] Everard Himmelrich, *Saputo says co-ops need to do better,* Industry News, 13 July 2017, accessed 11/10/17, http://adf.farmonline.com.au/news/magazine/industry-news/general/saputo-says-coops-need-to-do-better/2755551.aspx.

[200] Brett Worthington, *Murray Goulburn to close factories and shed staff in Tasmania and Victoria,* ABC Rural, 2 May 2017, accessed 24/10/17, http://www.abc.net.au/news/rural/2017-05-02/murray-goulburn-closes-factories-kiewa-rochester-edith-creek/8488628.

[201] Johanna Baker-Dowdell, *Murray Goulburn's Edith Creek plant is not part of the sale,* The Advocate, 27 October 2017, accessed 9/11/17, http://www.theadvocate.com.au/story/5017348/edith-creek-plant-not-part-of-murray-goulburn-sale/.

Evidence obtained by the ACCC confirms that 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.

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.[202]
- 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.[203]
- Flavoured milk claims an increasingly large share of the market and has become a profitable product for processors. As a result, the market has seen 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 share of the market, these products will likely have a growing presence in all 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 the 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 in the market 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 would likely 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.

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[202] 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.

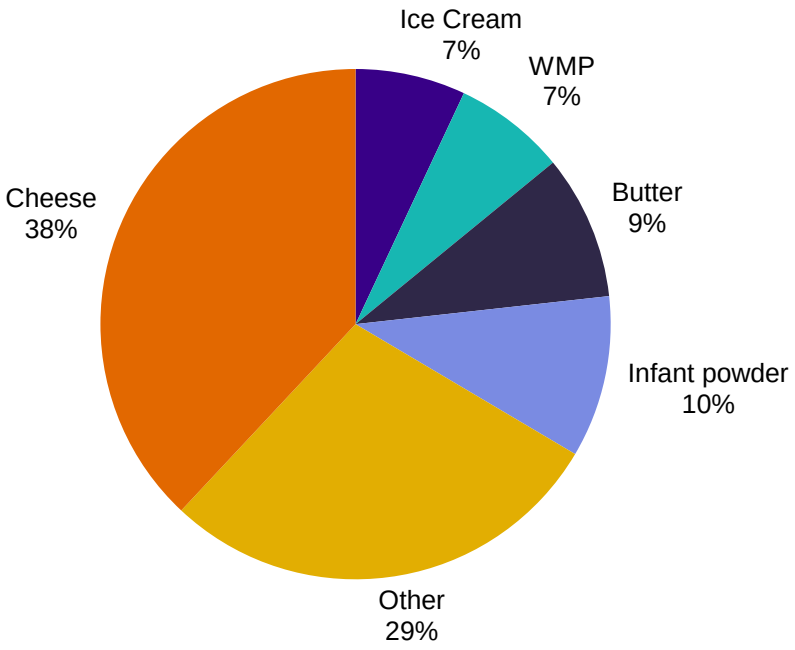
[203] Dairy Australia, *Australian Dairy Industry in Focus 2016*, 27.

5.1.7. Competition from imports

Australia imports a broad range of processed dairy products. They are typically easy to transport and have a long shelf life. These factors, combined with Australia's relatively liberal trade policies, enable the importation of many dairy products. 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.

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. This is because imports provide retailers with the ability to 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).[204] Imports have grown substantially

[204] Dairy Australia, *Australian Dairy Industry in Focus 2017*.

over the past 10 years, increasing by 75 per cent (Figure 5.2).[205] The market share of imported cheese has risen by over 10 per cent since 2012-13.

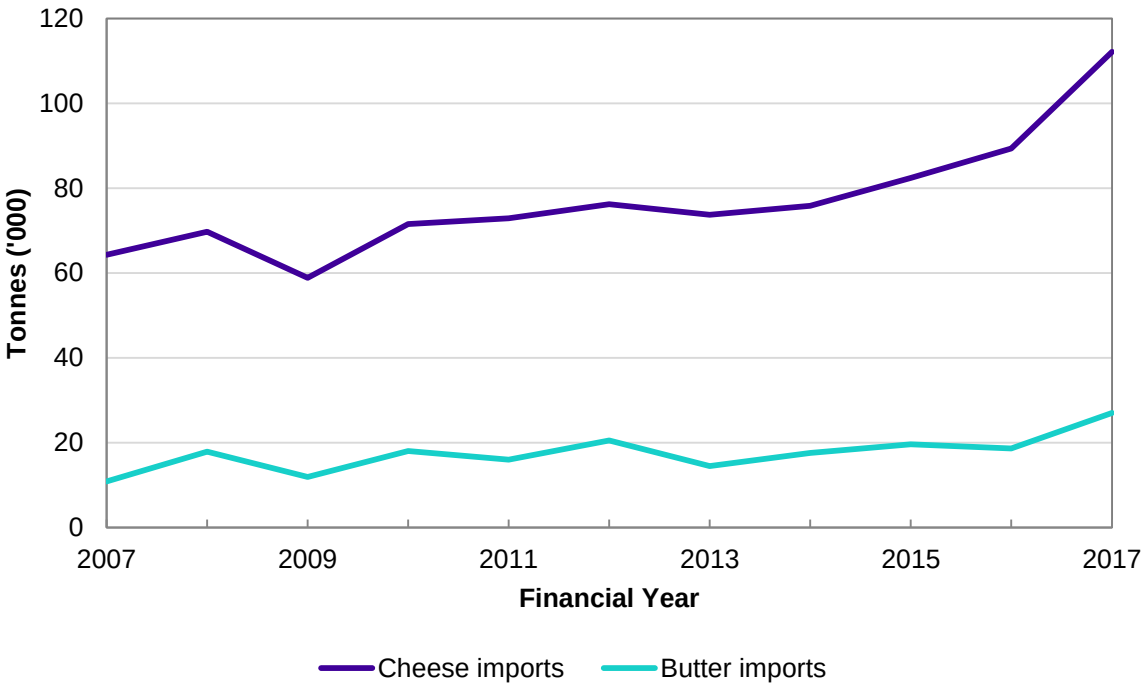
As part of its growth strategy, ALDI introduced tasty block cheese at $6 per kg in early 2014, which was quickly matched by Coles and Woolworths. The price decrease was enabled by low global prices. Since the introduction of $6 per kg cheddar cheese, cheddar imports have increased significantly. This has enabled retailers to maintain the retail price of $6 per kg, which constrains 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, and accompanied by a fall in domestic butter production.[206] 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 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.[207]

Figure 5.2 Total cheese and butter imports, 2006-07 to 2016-17



Source: Dairy Australia data and ACCC analysis

[205] Dairy Australia; Note: total cheese imports grew from 64 270 tonnes in 2006-07 to 112 120 tonnes in 2016-17.

[206] Dairy Australia, *Australian Dairy Industry in Focus 2017*.

[207] Ibid.

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 in 2016-17.[208] Australia's WMP production (including infant powder) has fallen over the last ten years.[209] Meanwhile, imports of infant powder have risen dramatically from less than 7000 tonnes in 2006-07.[210] 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.[211]

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 neglibile 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, as 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.[212] 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.[213]

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 year,[214] which may account for increased sales resulting from substitution by price-sensitive consumers.

5.2. Retail competition for the supply of dairy products

Australian consumers spend an estimated $90 billion each year in supermarkets.[215]

This section outlines how aspects of supermarket competition affect the way retailers compete to sell dairy products. The effect of retail pricing on margins across the industry is explored in detail in *Chapter 6.*

[209] Dairy Australia data and ACCC analysis

[210] Ibid.

[211] Ibid.

[212] Ibid.

[213] Ibid.

[214] Dairy Australia, *Australian Dairy Industry in Focus 2016*, 43.

[215] Roy Morgan Research*, Supermarket weep: Woolies' share continues to fall and Coles and Aldi split the proceeds*, 24 October 2016, accessed 23/10/2017, http://www.roymorgan.com/findings/7234-woolworths-coles-aldi-iga-supermarket-market-shares-australia-march-2017-201705171406.

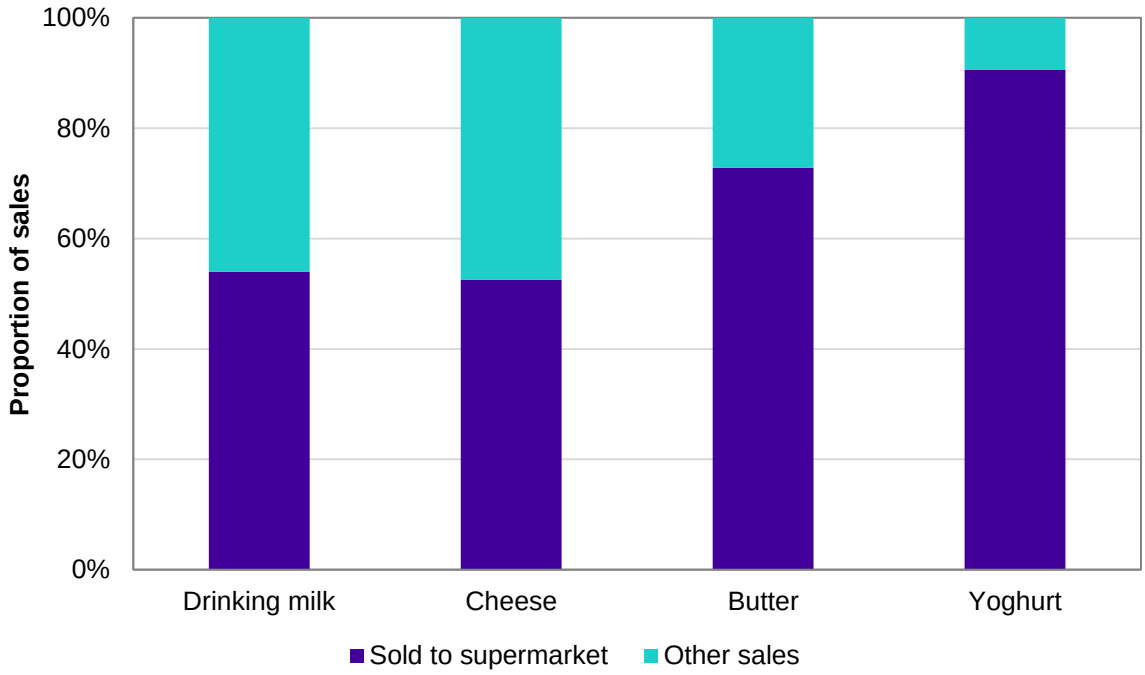
5.2.1. Types of supermarkets

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.[216]
- Dairy manufacturers sold approximately 245 000 tonnes of cheese to domestic customers, of which about 53 per cent was sold to major supermarket chains.[217]
- 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.[218]
- Dairy manufacturers sold a total of 130 555 tonnes of yoghurt to domestic customers, of which 91 percent was sold through major supermarket chains.[219]

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.[220] Other full-line supermarkets include retailers operating under the Supa IGA branding.

[216] Dairy Australia, *Australian Dairy Industry in Focus 2016*, 23.
[217] Dairy Australia, *Australian Dairy Industry in Focus 2016,* 42.
[218] Ibid.
[219] Ibid.

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.[221]

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.[222] 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.[223] 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 six per cent[224] of total grocery sales in 2006-07 to approximately 13.2 per cent today.[225]

Warehouse stores

Costco Wholesale (Costco) is an example of a membership only warehouse supermarket and operates seven warehouse supermarkets in Australia. Costco's business model is to offer a broad range of bulk grocery, fresh and liquor products, both branded and private label.

5.2.2. 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 2008[226] 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.[227] The ACCC has also found that supermarket competition occurs at both a national and local level.

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[220] Roy Morgan Research, *Aldi hits new high in supermarket wars*, 17 May 2017, accessed 23/10/2017, http://www.roymorgan.com/findings/7234-woolworths-coles-aldi-iga-supermarket-market-shares-australia-march-2017-201705171406.

[221] Ibid.

[222] ALDI, *Who We Are,* accessed 12/10/2017, https://corporate.aldi.com.au/en/about-aldi/.

[223] Ibid.

[224] ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, 48.

[225] Roy Morgan Research, *Aldi hits new high in supermarket wars*, 17 May 2017, accessed 23/10/2017, http://www.roymorgan.com/findings/7234-woolworths-coles-aldi-iga-supermarket-market-shares-australia-march-2017-201705171406.

[226] ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008.

[227] 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.

Competition in relation to dairy products

Information obtained during the inquiry has indicated that supermarkets compete against each other's nationwide offers, as well as against 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 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*.

While supermarket competition at the retail level has benefitted consumers by providing lower prices for dairy products, the competitive environment does not seem to be effective from a wholesaler perspective.

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.

Chapter.6. Supply Chain Profit Analysis – Supermarkets Processors and Farmers

Key points

- The relative bargaining position of supermarkets, processors and farmers is the main determinant of profits that each earns in the dairy supply chain.
- 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.
- Supermarkets have used some of these wholesale cost savings to reduce real retail prices for Australian consumers.
- Processors earn higher gross margins on branded products than private label products. Branded product margins are a key driver of processors' overall profitability.
- Farmgate prices are quarantined from other costs which affect the prices paid by supermarkets, and the margins earned by processors, for private label milk.
- Farmers earn the same regardless of whether their milk ends up as private label or branded milk.
- Farmgate prices are reflective of farmers' weak bargaining position with processors. 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 demand.
- 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.

Introduction

In the course of this inquiry the ACCC has heard significant concerns from farmers and their representatives about the impact to the industry from the introduction of $1 per litre milk pricing by the major supermarkets in January 2011.[228]

In broad terms, the concerns raised with the ACCC are 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 perception,[229] which over time has impacted the viability of the sector and farmgate milk prices.

Some farmers are also of the view that supermarket retailers are pricing private label drinking milk below cost, as a loss leader.

The ACCC also heard evidence about the impact of private label cheddar cheese which is currently retailed 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, concerns have been voiced that cheddar cheese sold at this retail price point has some comparison to selling drinking milk at 60 cents per litre, even lower than its current retail price.

The terms of reference for this inquiry, which are of relevance to this chapter, 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

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228 Coles introduced dollar litre milk pricing on Australia Day 2011, and Woolworths and Aldi followed soon afterwards.

229 For example, the perception that milk is less expensive than bottled water.

The ACCC's approach

To properly consider the impact of $1 per litre milk, and the dairy value chain more broadly, the ACCC has undertaken extensive document review and analysis, and heard evidence from executives of the major retailers and processors. In conducting this analysis the ACCC has sought to understand:

- the margins earned by supermarkets and processors on various dairy products, in particular private label milk, and how these have changed over time230 in each region of Australia
- whether any changes to processors' margins have impacted their ability to continue to operate profitably overall, as opposed to becoming unprofitable or experiencing periods of unprofitability
- whether any changes to the level of processors' profitability have impacted farmgate milk prices and the profitability of dairy farmers over time.

To facilitate this analysis the ACCC obtained a large volume of information and data from the major supermarkets[231] and processors through use of compulsory notices. The ACCC has also sought non-confidential information from Dairy Australia and ABARES. The information and data covered the 2010 to 2016 period and included:

- locations and processing capacities of each processing plant in Australia
- volumes of raw milk purchased by supermarkets and processors, total prices paid, the suppliers of that milk, the prices paid to each individual farmer, any deductions made, and the average fat and protein content of this milk
- volumes of dairy products produced from raw milk, the wholesale prices of these products and where they were sold
- costs of processing raw milk into a range of dairy products, and the volumes of raw milk required to produce each kilogram or litre of the processed product
- volumes of dairy products purchased by supermarkets, the wholesale and retail prices for these products
- costs incurred in retailing dairy products.
- farm cost, revenue and exit data, and
- consumer consumption data

Due to the historical nature of much of the requested data and different record keeping practices amongst the parties, some parties were unable to provide data to the extent requested. Where raw data was not available, the ACCC required industry participants to provide other relevant information and documents such as internal reports and board papers to approximate the missing data. The ACCC is satisfied that it has obtained enough information and data to substantially complete our analysis and fulfil the terms of reference.

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230 The ACCC has analysed data from 2010-11 to 2015-16 for the purposes of this interim report.

231 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.[231]

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.

This analysis is ongoing but our preliminary findings are set out below.

6.1. Supermarket pricing strategies and their impact

6.1.1. 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[232] of dairy products produced in Australia each year are consumed domestically. 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).[233] The percentage reliance on the domestic market has increased from 2003-04 when approximately only 45 per cent of volume of was consumed domestically.[234]

The proportion of regional raw milk production which is sold domestically either as drinking milk or other dairy products varies by the region. For example, Figure 1.7 in *Chapter 1* shows that raw milk in Queensland, WA and NSW is predominantly used for drinking milk on the domestic market, whereas raw milk in Victoria, Tasmania and SA raw milk 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 Queensland, WA and northern NSW than it is in other states.

6.1.2. Supermarkets' pricing strategies

Supermarkets price most dairy products, including private label products, on a national basis.[235] This means that the retail price is the same in each store and location regardless of the cost of supply.

National pricing of dairy products was introduced immediately following the deregulation of the dairy industry in the early 2000s. Supermarkets use national pricing to reinforce their branding, and perceptions of affordability and competitiveness. For consumers, particularly those in remote or regional areas, national pricing can be of particular benefit if production and/or transport costs are higher than in other areas of the country. Those consumers benefit from being able to purchase products at a cheaper price than they would be able to if products were retailed at a full cost basis.

In high cost areas, supermarkets with uniform national pricing cross-subsidise lower, and in some cases negative, margins with the higher margins achieved in low cost states and from more profitable products. Cross-subsidisation within diverse businesses such as supermarkets is relatively common.

The impact of national retail pricing is of particular significance to the Australian dairy industry because of the regional differences in costs of raw milk production. These cost

[232] Dairy Australia, *Australian Dairy Industry in Focus 2017*

[233] Ibisworld, Australia Industry Reports, Dairy Produce Wholesaling, Products and Markets

[234] National Competition Council 2004, *NCC Occassional Series: Dairy – Now and Then: The Australian Dairy Industry Since Deregulation,* AusInfo, Canberra

[235] The major exception to this are regional brands which are only sold in particular areas of Australia

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*). This variance in farmgate prices, when combined with nationally consistent retail prices for private label milk, results in substantial differences in the margins available for processors and retailers across different regions. Regions with higher farmgate prices have less margin available for processors and retailers to capture, compared to regions with lower farmgate prices.

6.1.3. Retail grocery competition

As mentioned in *Chapter 5* 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.

Generally the ACCC considers that supermarkets compete primarily with other supermarkets, which offer a broadly similar retail experience. Specialist stores such as butchers and fruit markets do not provide a strong competitive constraint on supermarkets, due to their different retail offering.[236] The ACCC has also found in its previous work in the supermarket sector that supermarket competition occurs at both a national and local level..

Over the past decade, competition in the supermarket sector has been increasing with the entry and expansion of new players such as ALDI and COSTCO and concentrated efforts by Coles to reposition itself in the eyes of consumers. The supermarkets have told the ACCC over the course of this inquiry that they compete particularly 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".*[237] Evidence from the supermarkets to this inquiry indicates that these 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 litremilk and, more recently, the introduction of$6 per kg kg private label cheese. Supermarket documents also indicate they are each highly reluctant to increase prices on these key value items as any price increase may be viewed negatively by consumers.

Supermarkets' internal documents indicate that this competition was a key driver in 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"[238] but for the price drop by Coles. Yet, despite this initial reluctance, Woolworths has held this per litre price for the following six years.

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[236] 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.

[237] 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

[238] ibid., p.13

6.1.4. The impact of supermarket competition on retail prices for dairy products

Deregulation led to substantial decreases in retail milk prices

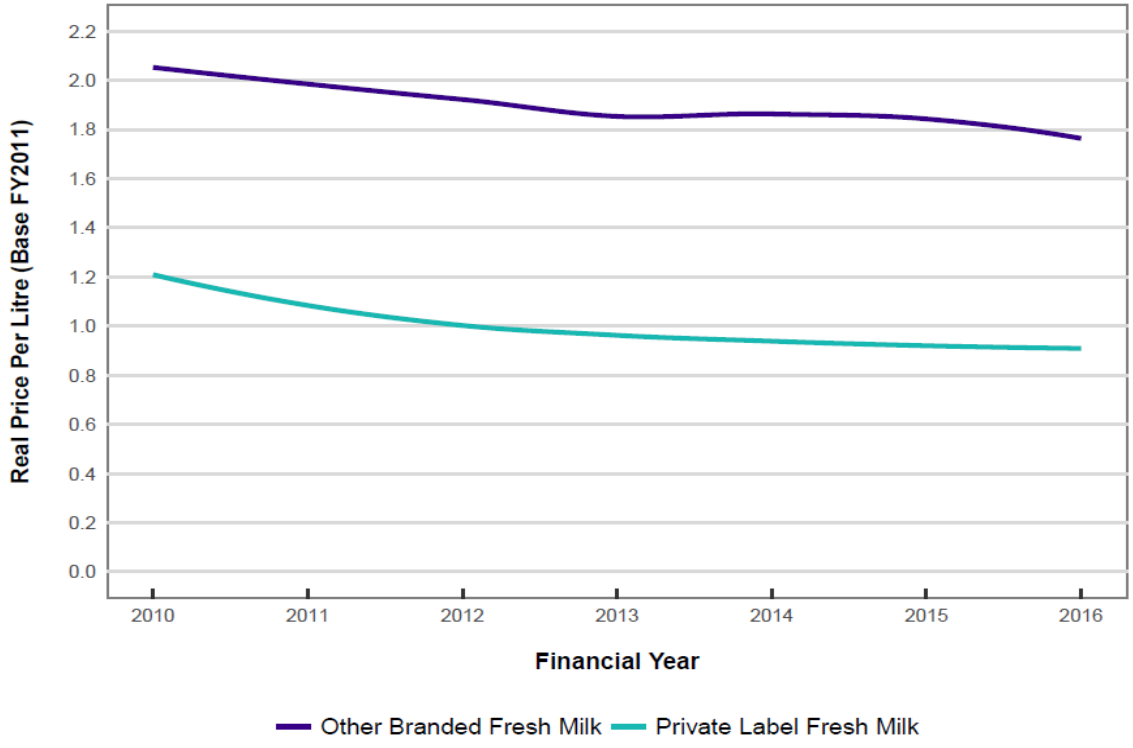
Prior to the deregulation of the dairy industry, wholesale and retail prices as well as the distribution of milk were regulated. Deregulation gradually removed these controls through the 1990s and this had a strong impact on domestic retail prices. Importantly, deregulation of the dairy industry led initially to significant reductions in the wholesale price of drinking milk for supermarkets[239], which in turn led to large reductions in the retail price of drinking milk. Immediately following deregulation, branded label drinking milk fell in price by up to 11 per cent and private label drinking milk fell by approximately 15 per cent.

The introduction of '$1 per litre milk'

In the decade after deregulation, and in particular following Wesfarmers acquisition of Coles in 2007, close competition between the major supermarkets resulted in the introduction of $1 per litre milk in January 2011.[240]

At the time $1per litre milk was introduced it represented a 5 per cent decrease in average private label milk prices. 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

[239] National Competition Council 2004, *NCC Occassional Series: Dairy – Now and Then: The Australian Dairy Industry Since Deregulation,* AusInfo, Canberra

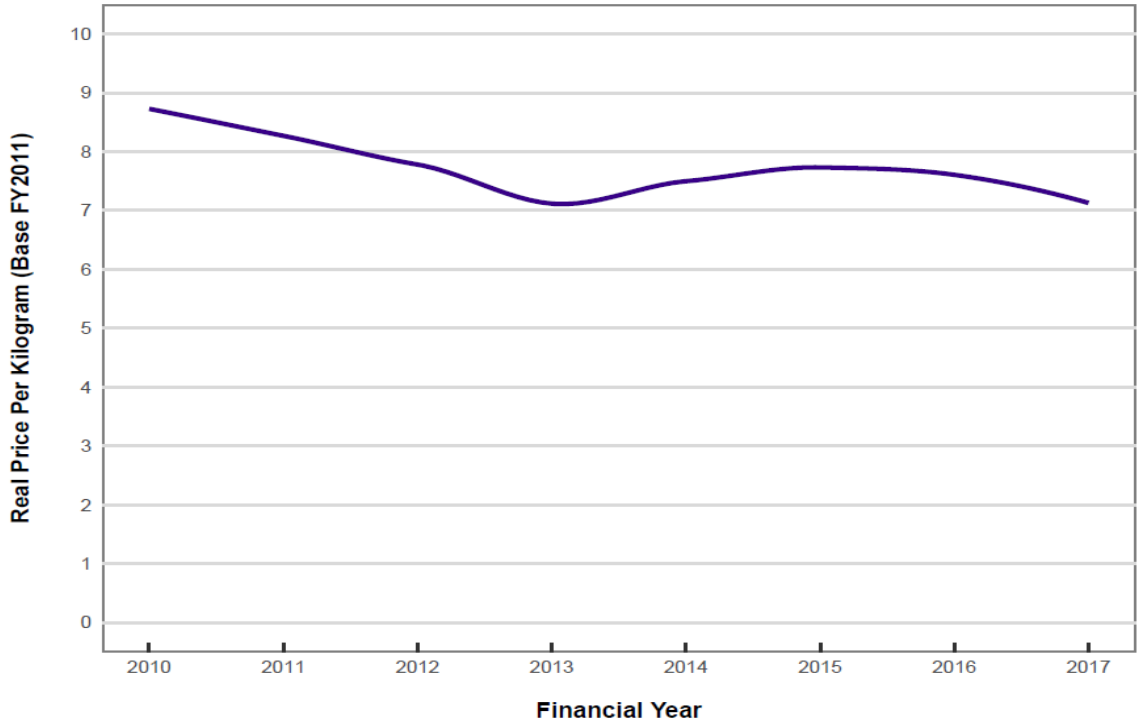
[240] For two litre and three litre bottles.

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 one kilogram blocks of cheddar cheese for the retail price of $6. As with reductions in private label drinking milk, other supermarkets quickly followed ALDI to the same price point. It is difficult to tell whether this has had an impact on cheddar consumption in Australia, as the ACCC does not have data available at this product level. However, overall consumption of cheese per capita has not changed, and has been relatively constant since at least 2010.

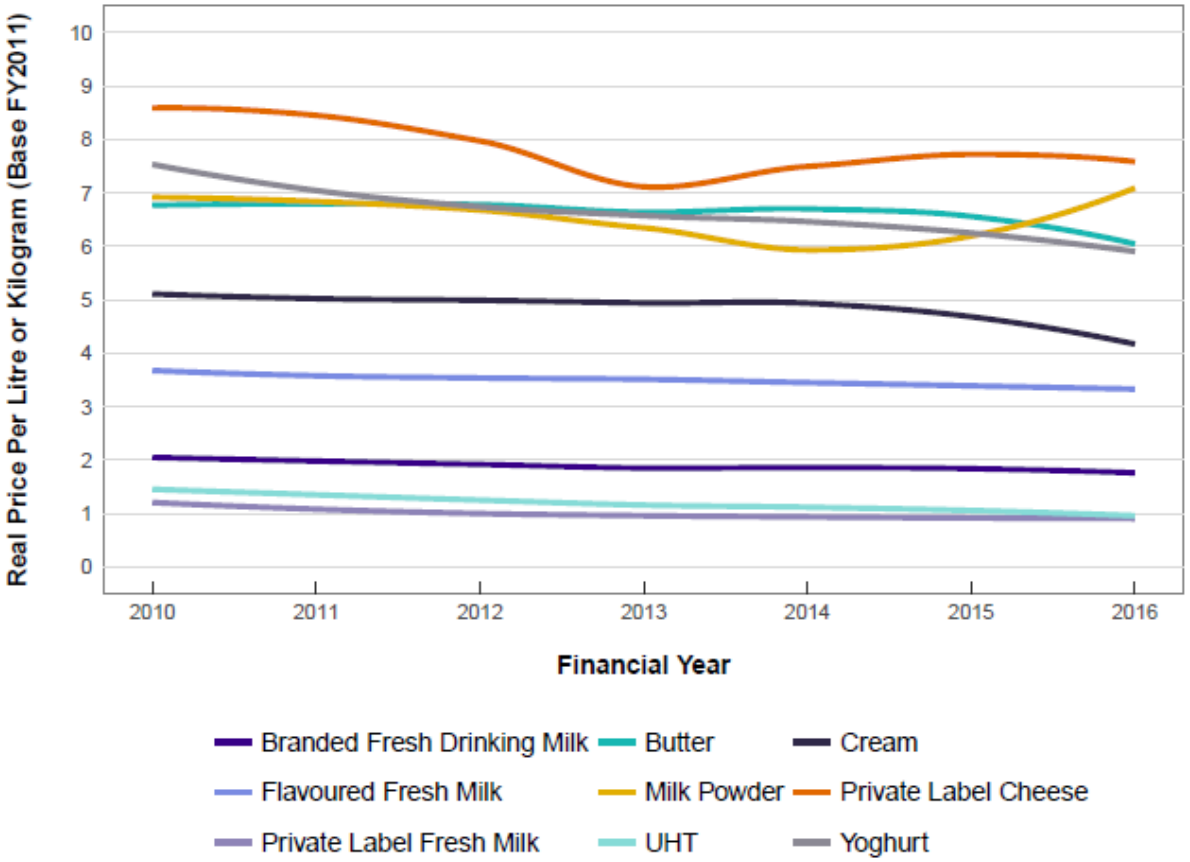
Figure 6.2: Retail price of private label cheddar cheese in real terms



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 also been decreasing in real terms since 2010. This decrease is shown in Figure 6.3. Consumers have been the major benefactors from this pricing shift with reductions in margins typically being passed on as retail price savings.

Figure 6.3: Average real prices for dairy products



Source: Coles, Woolworths and ALDI data

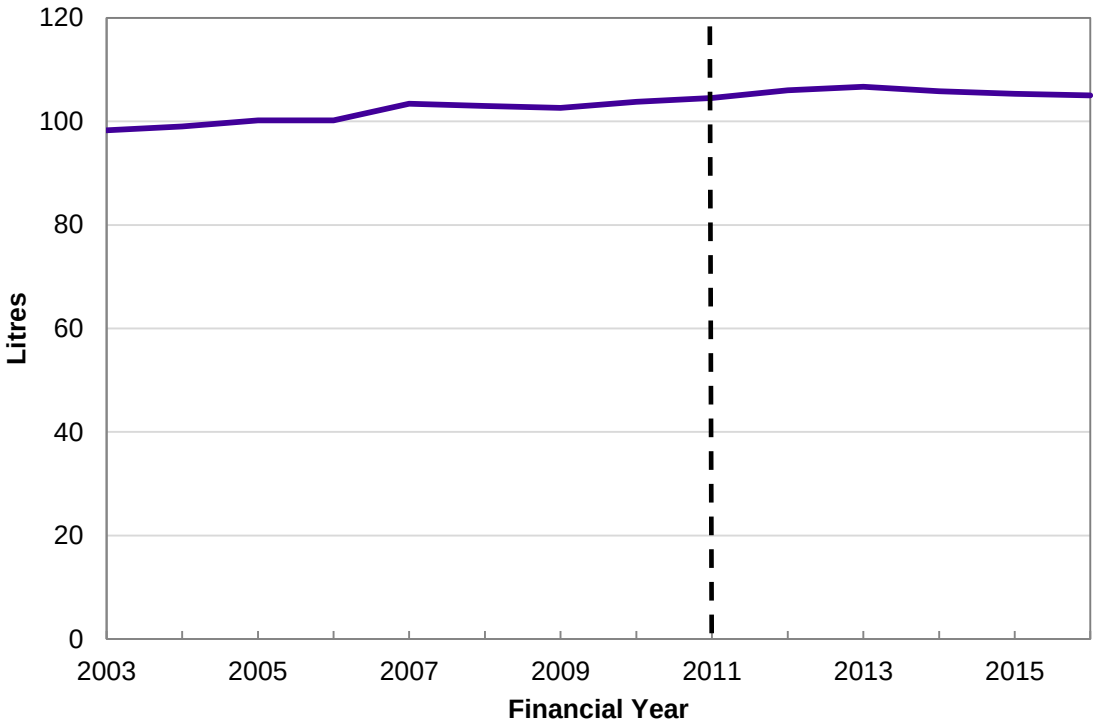
6.1.5. Impact of retail pricing on consumption patterns

When $1 per litre milk was introduced Coles claimed that "low prices for consumers will make the dairy industry stronger"[241] , implying that an increase in consumption would create additional demand for processors and dairy farmers.

However, data obtained for this inquiry shows that while total domestic consumption of drinking milk has increased, from just under 2 billion litres per year in 2003 to 2.5 billion litres in 2016, this is almost entirely due to population growth, and percapita consumption has remained stable. This is demonstrated by Figure 6.5 below, and suggests that the introduction of $1 per litre private label milk did not appear to have any meaningful impact on national consumption.

[241] 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

Figure 6.5 – Consumption of drinking milk per capita



Source: Dairy Australia, 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.[242]

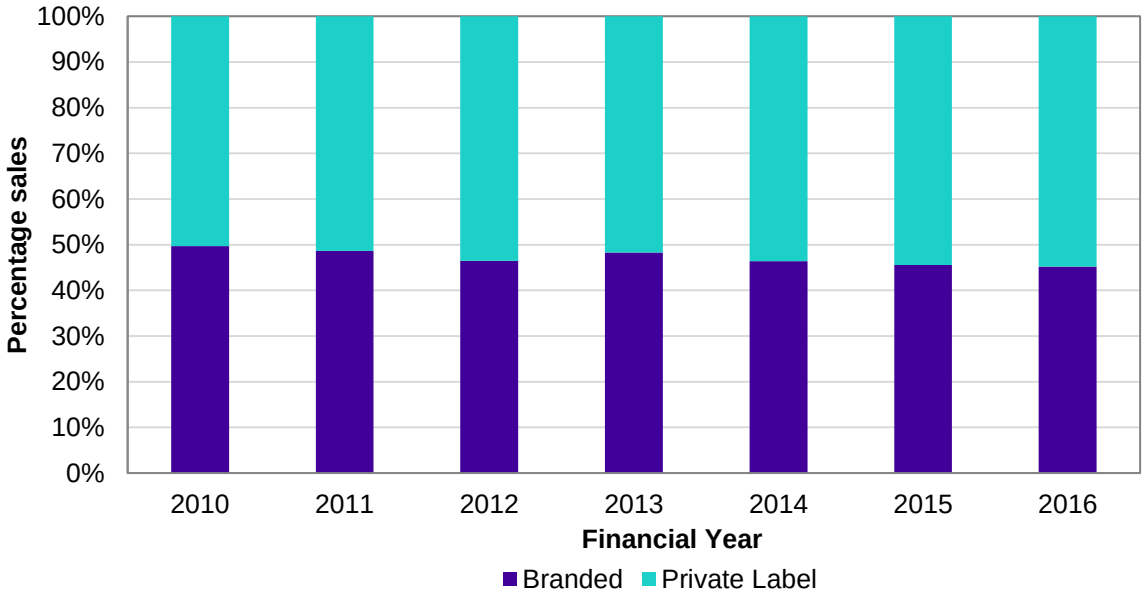
Impact on branded products consumption

In response to the introduction and maintenance of $1 per litre milk, some milk consumers have switched to purchasing private label milk at the expense of branded milk. This shift over time is shown in Figure 6.6.

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.

[242] Dairy Australia In Focus 2016/2015/2014/2010.

Figure 6.6: Supermarket Milk Sales by Milk Product Category, 2010–11 to 2016–17



Source: Dairy Australia Dairy In Focus (Dairy Australia analysis and data from Information Resources (Australia) Pty Ltd,).

The ACCC heard in the course of this inquiry that several processors observed an increase in branded milk sales following the events of April 2016 where 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 patterns by consumers is attributed to media coverage and social media campaigns at the time which encouraged consumption of branded milk over private label milk to support Australian dairy farmers. Processors have told the ACCC that since this coverage has subsided consumption of private label milk has returned to pre-2016 levels.

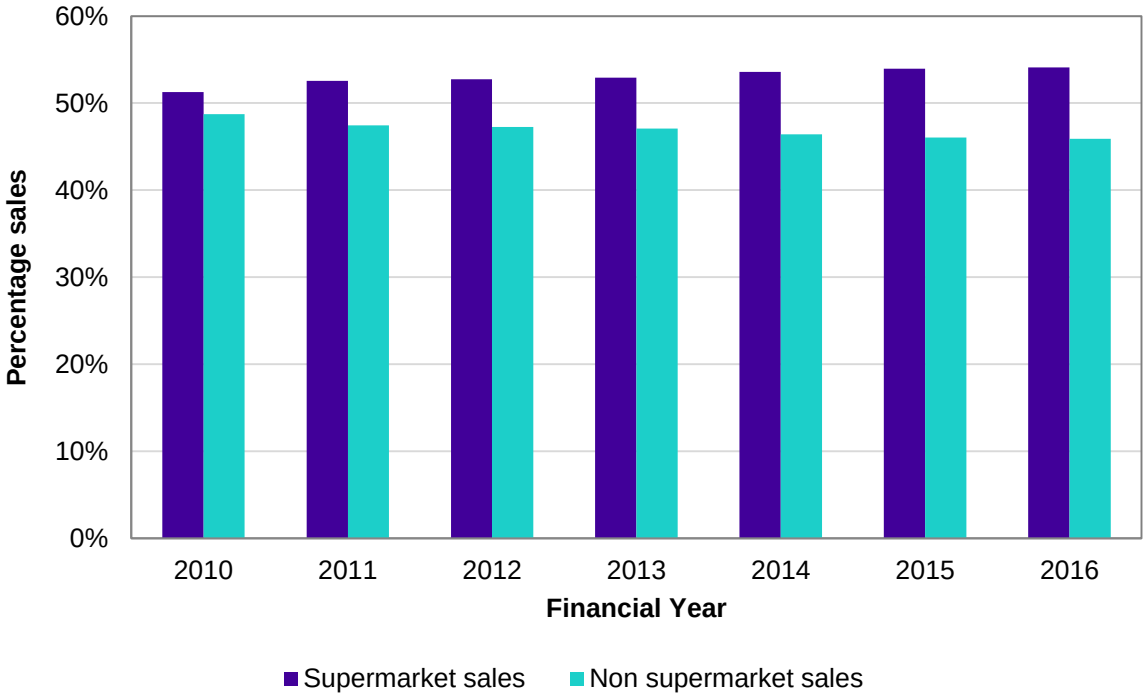
6.1.6. Impact on route and convenience store retailers

The ACCC also heard submissions from retailers in the route and convenience sector to the effect that $1 per litre milk pricing has reduced trade for these smaller retailers. This is because, consumers have switched to buying their milk (and therefore other supermarket purchases) from supermarkets at the expense of smaller retailers.

The ACCC has reviewed the data available to determine whether there has been any observable impact on milk purchases from smaller retailers associated with the introduction of $1 per litre milk. The data shows a small increase in the volume of milk sold at supermarkets, compared to other channels, following the introduction of $1per litre milk, as shown in figure 6.7 below. However, the ACCC notes that this trend had started prior to the introduction of $1 per litre milk and does not appear to have accelerated after 2011. It is therefore not clear that lower supermarket milk prices have necessarily led to higher purchases of milk through supermarkets.

An alternative impact on the route and convenience store retailers is not simply a reduction in sales, but their need to compete with $1 per litre milk in their own stores. In reaction to this, some processors have been pressured to develop “price fighter” brands which can be stocked in convenience stores and sold at $1per litre. Some evidence provided to the ACCC suggested that convenience stores retailing milk at one $1 per litre still do so at a loss and accordingly they try to limit the sales of these products by providing them with reduced shelf space compared to branded products.

Figure 6.7 – Percentage of sales via supermarket compared to alternative channels

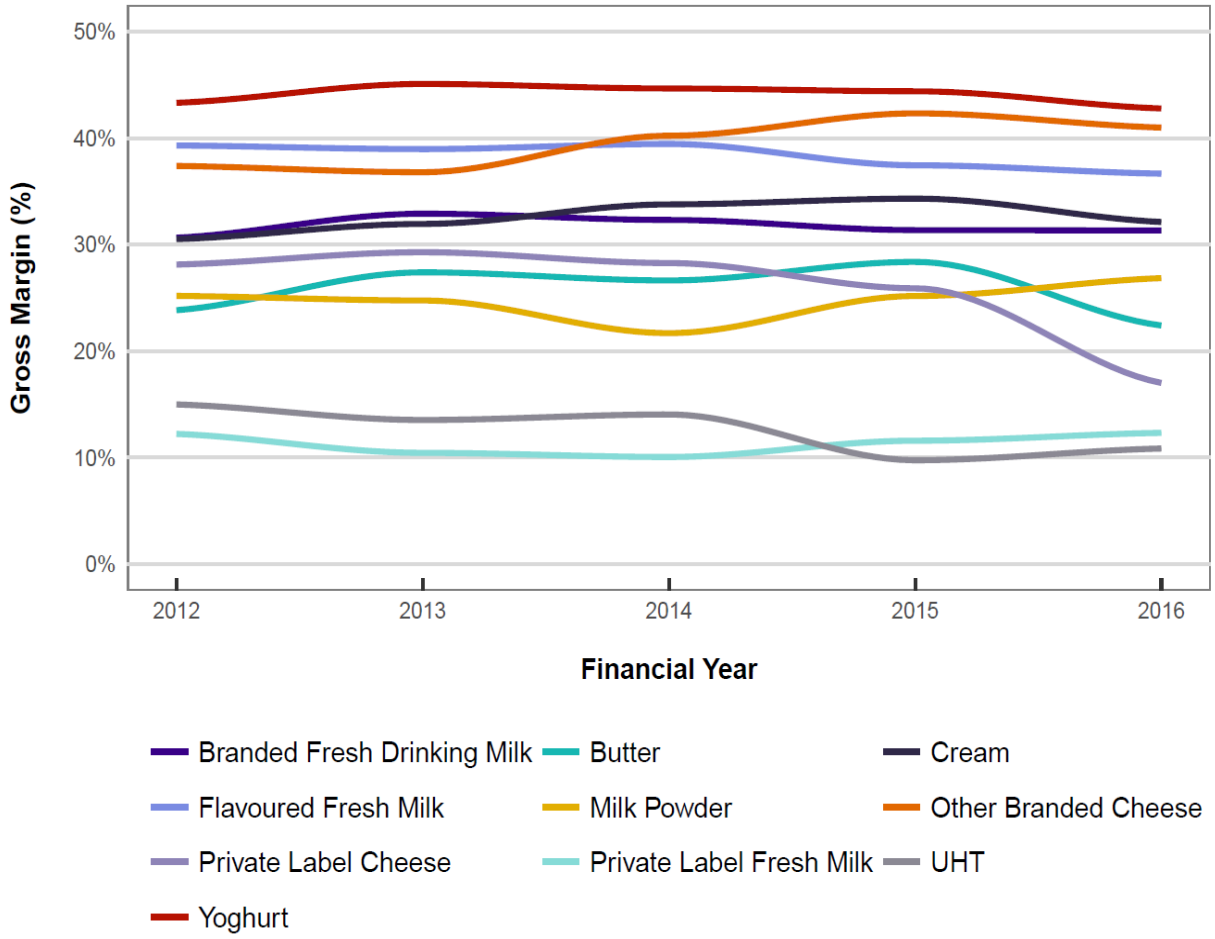


Source: Dairy Australia Dairy In Focus (Dairy Australia analysis and data from Information Resources (Australia) Pty Ltd,).

6.1.7. Supermarkets’ margins across the dairy category

The margins earned by supermarkets vary considerably across dairy products and time. However, the ACCC has found that, in general, when considering the same category of dairy product, supermarkets make higher margins on branded dairy products than on private label products. For example, in 2015-16 supermarkets earned on average gross margins of 28 per cent on branded fresh white drinking milk but only 12 per cent on private label fresh white drinking milk. This same pattern has been seen across other categories of dairy products, such as yoghurt, cream and cheese.

Figure 6.8: Gross margins[243] for supermarkets 2012–2016



Source: ALDI, Coles and Woolworths data

As shown by Figure 6.8 above, the gross margin earned by supermarkets on a range of dairy products varies from approximately 12 per cent to 45 per cent. Figure 6.8 also shows that, despite variation in margin by product category and between branded and private label products, supermarkets' aggregate gross margins for all dairy products (save for 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.

When $1 per litre private label milk was introduced in January 2011 supermarkets' margins on private label milk initially decreased until 2014. At this point in time, supermarkets changed their approach to sourcing private label milk in ways which enabled them to recover some of this lost margin. This change in approach is discussed in the section below.

In relation to margins earned on private label cheese, the ACCC does not yet have sufficient data to reach a final conclusion. However, the preliminary analysis indicates that supermarket margins on this product have decreased since the introduction of retail price reductions in 2014.

[243] 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.

In relation to margins earned on butter, the ACCC is conducting further investigation. However, it currently appears that, despite rising retail prices due to rising wholesale costs, supermarkets absorbed at least some of the wholesale price rises.

From 2011, the date from which the ACCC has observable data, supermarket margins on $1 per litre private label milk began to decrease. The ACCC understands that supermarket margins actually began decreasing immediately following the introduction of $1 per litre private label milk. The ACCC has based this opinion on public statements by the Supermarkets, as well as internal documents which indicate that wholesale prices for private label drinking milk were likely to be similar and retail prices were higher immediately prior to the price drop.

A change of approach in 2014

From 2014 some supermarkets began to explore ways in which they could recover their shrinking private label milk margins. They considered that considerable cost savings could be made in the manufacturing of private label milk, and that these could be extracted if competition between processors for the supply of private label milk were increased. Proposed savings included new packaging, a reduction in the range of products produced at processing plants, more efficient processing equipment and new bottle caps to prevent spillage and wastage. The supermarkets who sought these changes awarded new private label contracts to processors willing to make the efficiency investments.

Supermarkets encouraged greater competition between processors by changing the format of their private label milk contract tenders. The duration of these contracts was increased 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.

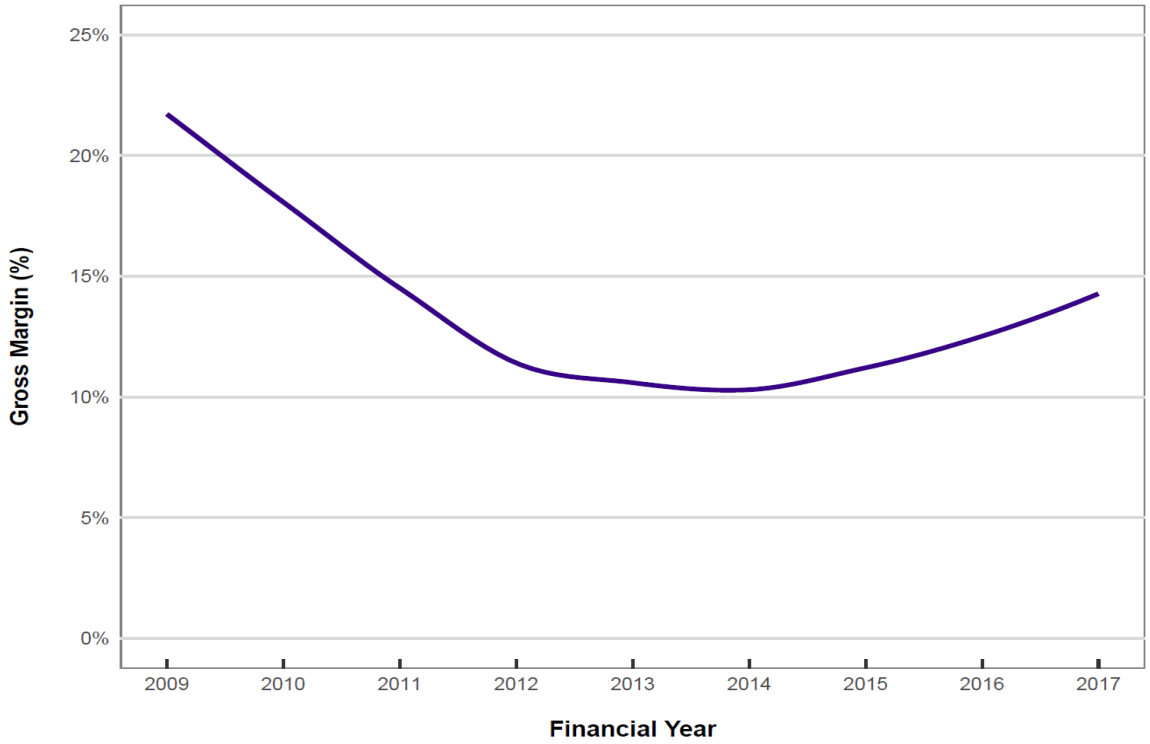
In addition to extending contract durations, one supermarket also began offering contracts for single regions and product categories instead of for supply across multiple regions and products. It was anticipated that this would attract smaller processors to the tender process and increase the number of competitors.

Some processors' evidence indicates this change has benefited them 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 supermarkets.

Supermarkets margins on private label milk have recovered

Since competition between processors increased around 2014, supermarkets have used their superior bargaining power to negotiate decreased wholesale prices with processors. This has in turn increased supermarkets' margins on private label milk. This movement is shown in figure 6.9 below.

Figure 6.9: Private Label Fresh Milk Gross Margins[244] for Supermarkets, 2009-10 to 2016-17



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 cross-subsidise lower and in some cases negative, margins with the higher margins achieved in low cost states and from more profitable products. Cross-subsidisation within diverse businesses such as supermarkets is relatively common. This is part of a wider strategy to create trust in the supermarkets and remain competitive in the market, and in some instances to support regions with higher cost milk production.

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 50 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 6.3 below.

[244] 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 earlier in this chapter, in 2014 supermarkets followed ALDI in reducing private label cheddar cheese prices to $6 kg. Average supermarket margins on this product declined immediately after the price cut, and the ACCC heard evidence that at least one supermarket has at times sold private label cheddar cheese below the wholesale cost. This indicates that supermarkets have absorbed at least some of the lost retail value of these products and passed savings to consumers.

As with private label drinking milk, low margins on private label cheese have encouraged supermarkets and processors to explore alternative options for acquiring cheese. This includes 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, 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.

Evidence to the inquiry also indicates that, as with private label milk, lower private label cheese prices have constrained the price of branded cheese. The ACCC is still analysing and seeking further data in relation to private label cheese and intends to present more detailed findings on this product in our final report. Retail prices and the farmgate milk price

Impact of retail price of private label milk

Farmers have raised two broad concerns with the ACCC over the course of this inquiry 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 paid to farmers.

The ACCC has carefully considered these issues, in particular whether an increase in private label retail prices would result in an increase in farmgate milk prices more broadly.

First, the ACCC notes that dairy farmers generally have milk acquisition contracts with processors rather than with supermarkets. This means the prices that farmers are paid for farmgate milk are ultimately determined by the processor, rather than the supermarket. In regard to private label milk contracts, the ACCC has found that almost all 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 thus processor profitability is not directly influenced by the farmgate milk price it pays to farmers. In other words, processors do not have a direct incentive to reduce farmgate milk prices because raw milk acquisition costs are directly passed through to the supermarkets. Other aspects of the contract, for example processing costs, are subject to negotiation between the supermarkets and the processors.

The farmgate price paid by the supermarkets as a component of private label milk contracts is the prevailing farmgate price of the relevant processor who holds the private label contract. This price is either verified by independent third parties and/or benchmarked with the publicly announced prices in the region. In some instances this includes verification against publicly announced prices of competing processors and prominent cooperatives. This means that the farmgate milk price that processors pay to farmers for milk used to fulfil private label milk contracts is not directly correlated with the retail price of private label milk, but rather the prevailing farmgate price in the region.

The ACCC has also considered whether the retail price of private label milk and other private label products has an indirect impact on farmgate milk prices. The ACCC has heard concerns from farmers that low private label dairy product prices have decreased the price of dairy products on average, removed value from the industry, reduced processor margins and resulted in less money available for processors to pay to farmers.

The ACCC examined the question of the 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, and that this value has mainly been passed on to consumers in the form of reduced retail prices.

This removal of value has reduced the profits of some processors. However, the ACCC has concluded that it is unlikely to have had a strong impact on farmgate milk prices. While processors have experienced reductions in profits, most processors remain profitable overall and are still able to compete to acquire the raw milk they need to satisfy demand for their dairy products. It is this degree of competition faced by processors and the demand for raw milk, rather than the absolute profitability of processors, that determines farmgate prices. There is further analysis on this point, and detailed discussion of the factors which have had an impact on farmgate prices and profitability in both *Chapter 3* and the end of this chapter.

Accordingly, the ACCC does not consider that increasing the retail price of private label milk would substantially change outcomes for farmers. Instead, the immediate impact 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. Even if processor margins did rise, given the bargaining power imbalance between processors and farmers, processors would continue to be able to use their bargaining power to set farmgate prices just high enough to secure sufficient raw milk to meet demand.

Further, as demand for 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. Therefore, the ACCC has 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.

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 competitor's 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.[245]

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 section 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 we have received no evidence to demonstrate this is the case. In addition, Figure 6.7 above demonstrates that there has been minimal transfer in volume of drinking milk sales from the route/convenience trade to the supermarket channel.

Changes to section 46 of the Competition and Consumer Act

On 6 November 2017 changes to s46 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'.

[245] See discussion on market power in Kaysen and Turner, Antitrust Policy (1959), p. 75 in QWI at [200].

There is no legislative definition of 'substantially lessen competition' however 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.

6.2. The impact of supermarkets' bargaining power on processors' margins

6.2.1. Processor margins on private label products

Evidence provided to this inquiry on private label milk contracts cover many processors and regions. The evidence shows that, whilst some processors make money, many private label contracts operate at close to cost, effectively as a break even proposition for some processors. The ACCC has heard evidence and reviewed documents that suggest that when overall business overheads are included, some of these contracts may operate at a net loss for some processors. Despite this, processors still actively compete for these contracts as they consider that they provide significant benefits to their business, as discussed in more detail later in this chapter.

Processors' gross margins on private label milk for processors have been decreasing since the 2011 retail price reduction, and processors typically earn higher margins on branded milk compared to private label milk. However, as we saw 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 white 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 contracts are highly sought after by some processors, including for private label milk supply. The ACCC also obtained evidence of increased competition between existing providers of private label milk, as well as from processors who have not previously supplied private label milk. Reasons given by processors for the strong competition for private label contracts, despite low margins, include decreasing the overall costs of production per unit and earning 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 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.

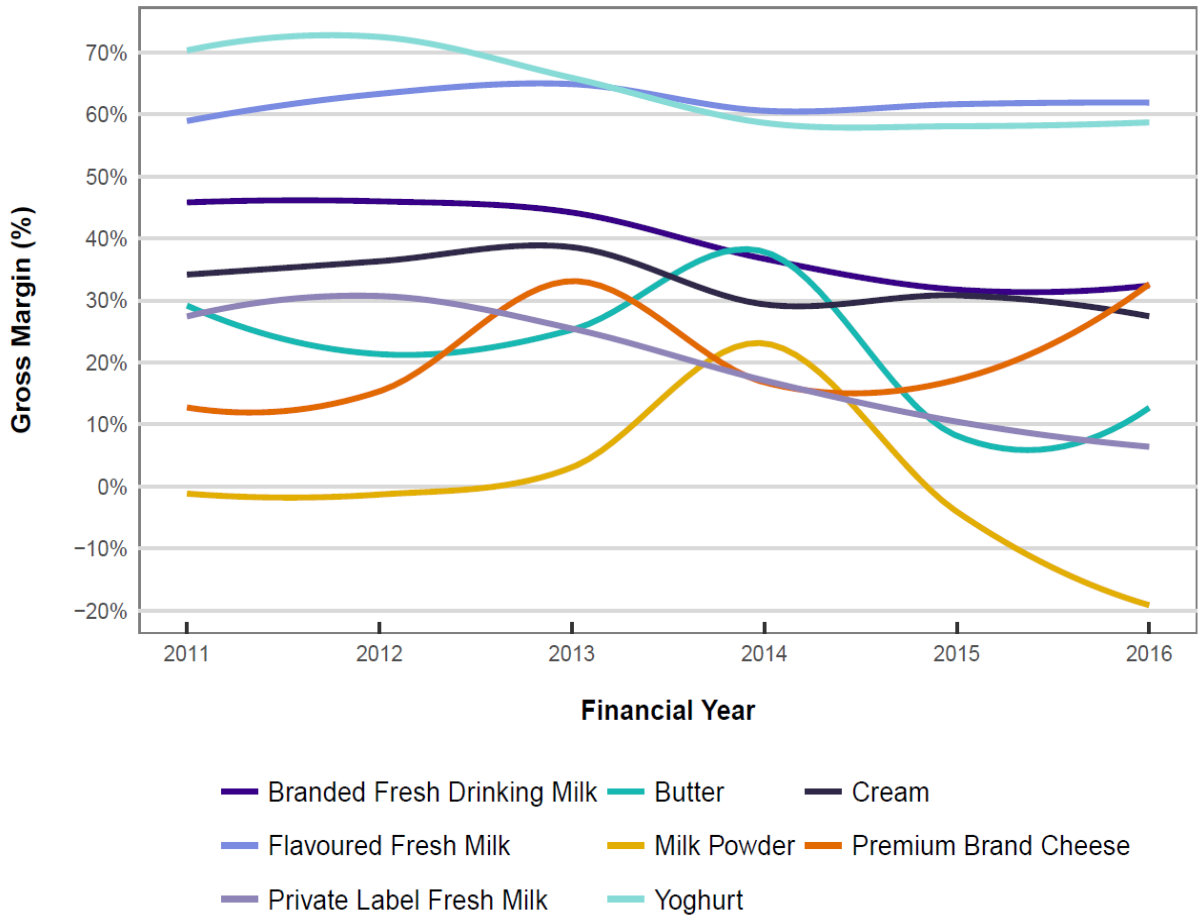
6.2.2. Processors' margins on branded products

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. Generally:

- 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 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 6.10 below shows the average gross margins earned by processors on various dairy products.

Figure 6.10 – processors' average gross margins for dairy products over time



Source; Processor data

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 margin, but decrease the overall costs of production per unit, and earn higher gross margins on differentiated or otherwise value-added products.

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, are able to 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.

Despite the relatively high gross and net margins on some product types identified above, as wholesale price have generally declined at a faster rate than costs, processors' average gross margins on key dairy product types have been either stable or decreasing since 2009.

However, 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, as with some products (e.g. private label milk), increased processor efficiencies have been captured by the Supermarkets. To date, the ACCC has identified a few reasons for the relatively higher bargaining power of some processors than others. 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. In addition, 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. The ACCC has found there are certain instances where it would cost less to process milk in NSW and Victoria and freight it to Queensland, than to produce drinking milk locally.

The ACCC has also seen evidence that 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 some consumers prefer to drink locally sourced milk. This preference 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 achieve better outcomes with wholesale prices. The ACCC has seen evidence of processors' earning much higher margins on products supplied to supermarkets in regions where there is limited processing competition for those products. The ACCC is also looking at whether processors have been able to leverage bargaining power as a result of product shortages. The ACCC suspects that this may have been the case recently with butter, which has experienced a supply shortage.

6.3. Key determinants of farmers' profitability

The above analysis indicates that 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 farming representative bodies expressed their concern that Australian farmers would be more profitable but for this retail price behaviour and the reduced margins of processors.

The ACCC has 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 what the most likely causes for these movements have been. 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 has 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 impact on farm numbers, output or profitability. Rather, the ACCC has found that movements in farmgate prices can be attributed to changing demand conditions within the export or domestic market. 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.

6.3.1. 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 (see *Chapter 1*).

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.

In addition, farm exits spiked and the total volume of milk production in Australia begin to fall after 2000.[246] 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 1.4 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.

6.3.2. 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.

[246] *Chapter 3* Figures 3.1 and 3.2

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, Tasmania, South Australia and Southern NSW

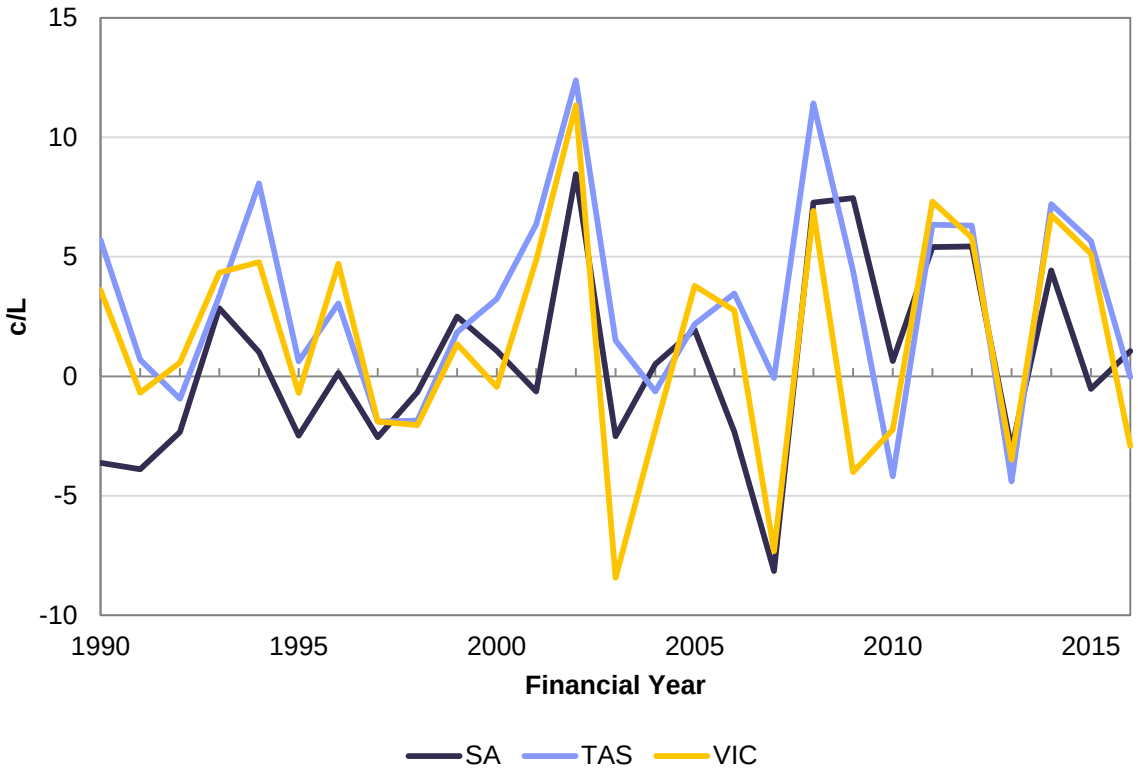
As discussed in *Chapter 3,* farmgate prices in Victoria/southern NSW, Tasmania and SA, are strongly correlated with global commodity prices, which reflect global supply and demand conditions.[247] The movements in farmgate price, against movements in global commodity prices can be seen clearly in Figure 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 can be seen in the Figures 31 to 33 in *Appendix 4*, where periods of high profitability co-inicide 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 $1per 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 6 billion litres per annum (Figure 5 in *Appendix 4*). As discussed in *Chapter 3*, the pass through pricing mechanism of private label milk contracts mean that 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 regulation and the total number of farms appears to have been stabilising since around 2012.

[247] This is discussed in more detail in *Chapter 3*.

Figure 6.13: Farm profits over time, SA, Tasmania and Victoria, real terms (2016 dollars)



Source: ABARES data, ACCC analysis

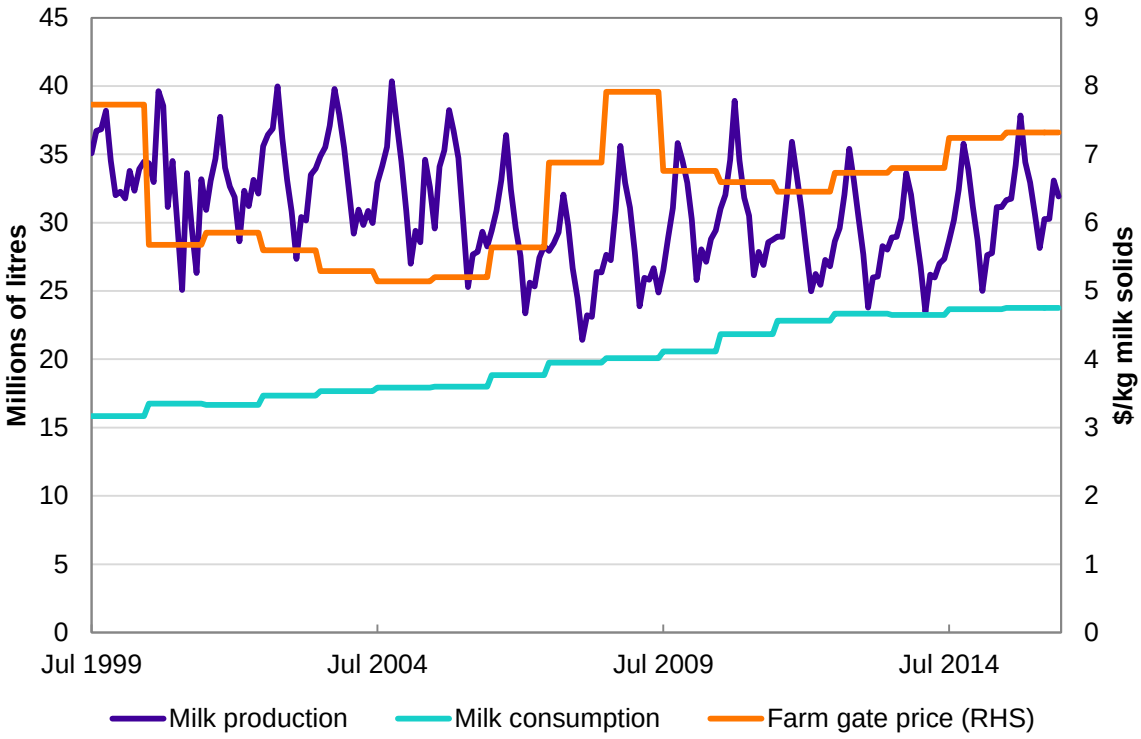
Western Australia, Queensland and northern NSW

In WA, Queensland and northern NSW, demand is driven predominantly by the domestic consumption of drinking milk, as little to none of the products in these regions are 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 farmgate price changes are largely explained by these factors and don't show any strong correlation with 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 subsequently this was converted into products for export or non-perishable domestic consumption.. As it was no longer economically feasible to convert excess milk production in these states into non- perishable, thus 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.

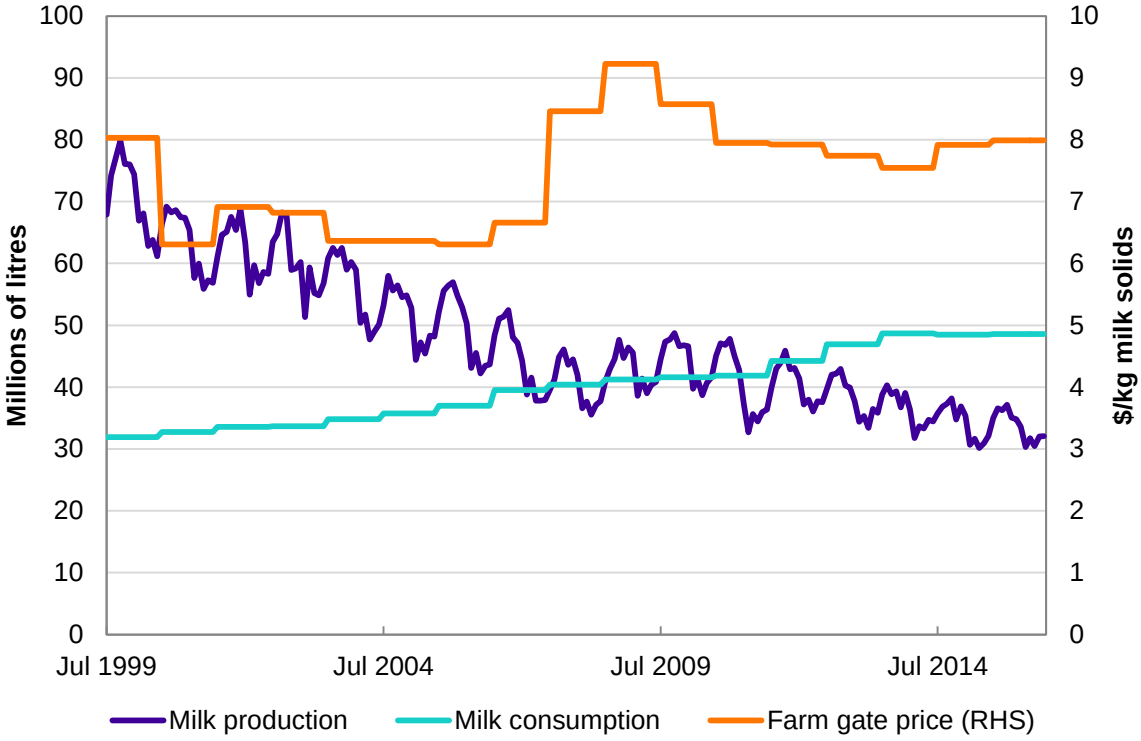
However, at the same time that processors were encouraging some farmers to leave the industry and to reduce the volume of raw milk, milk consumption in both states grew, due mainly to increases in population. In around 2007–08 raw milk production in both states began approaching the minimum levels required 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 14 and 15.

Figure 14: Supply and consumption of milk in WA against farmgate milk price, real terms (2016 dollars)



Source: Dairy Australia data, and ACCC analysis

Figure 15: Supply and consumption of milk in WA against farmgate milk price, real terms (2016 dollars)



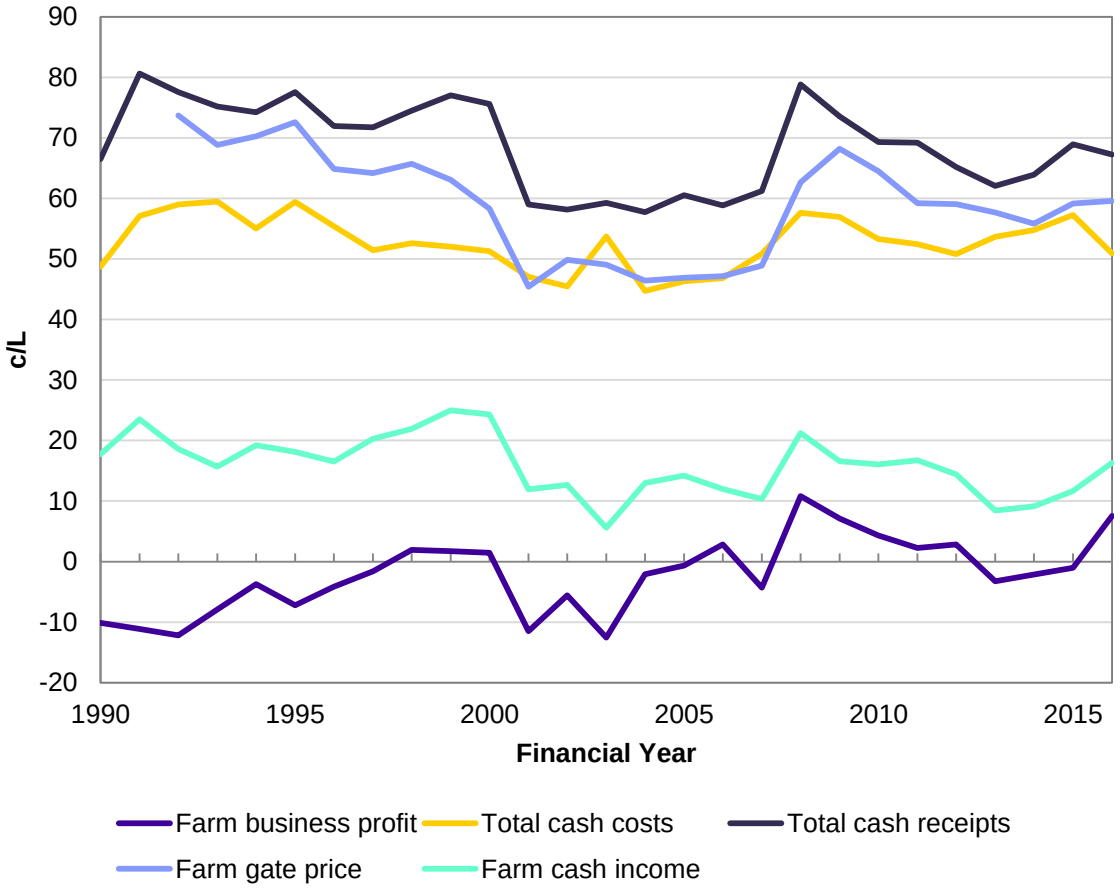
Source: Dairy Australia data, and ACCC analysis

This rise in prices reduced farm exits, increased profitability of farmers and sparked an increase in production in Queensland from 2007 through until 2009 and in WA from 2008 until 2011. From this point in time, milk production, demand and farmgate pricing trends in each state begin to differ.

Queensland farmgate prices and farmer profitability from 2009

Milk production in Queensland decreased following a reduction in farmgate prices in 2009. Since 2010 farmgate prices have been relatively stable in real terms in Queensland. 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 6.16 below. This trend subsided in 2015-16 as costs decreased.

Figure 16: Queensland farm profits over time, real terms (2017 dollars)



Source: ABARES data, Dairy Australia data, ACCC analysis.

As can be seen in figure 6.15, 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 on farmers in Queensland by reducing demand for Queensland produced raw milk, reducing the farmgate price (relative to the price it may have been had imports not been possible), and thus forcing some higher cost farmers out the industry. However, the transfer of raw milk from lower cost regions does not signify a market failure in the industry 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 than can economically be supplied to Queensland from interstate. In the long term, based on the evidence that seen in this inquiry, the ACCC does not consider it is likely that processors will switch to importing all or even a majority of their raw milk requirements from outside Queensland.

WA farmgate prices and 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 6.14). Processors increased farmgate prices once again in 2012–13. Milk supply increased from 2012–13 to 2016, where the ACCC's farm gate price and consumption data set ends.

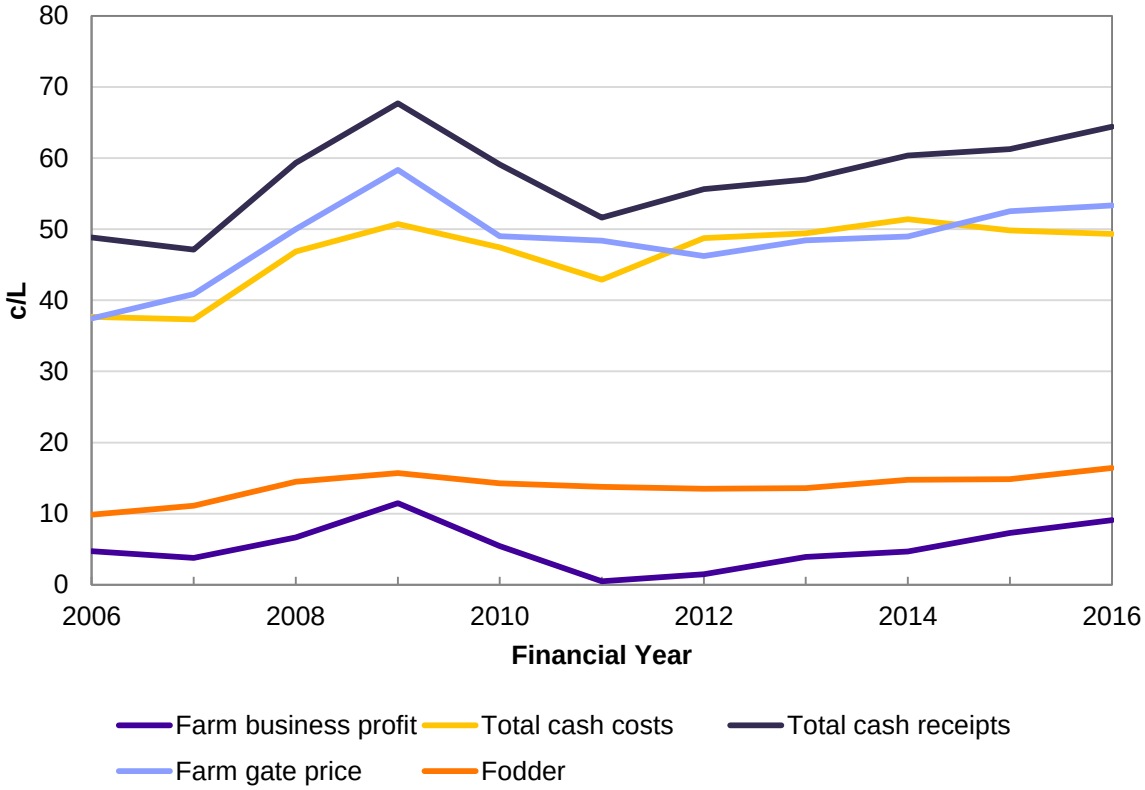
It is likely that pricing trends in WA differ to Queensland because of its distance from east coast markets, and the significant extra cost involved in importing milk from interstate.

The ACCC is aware that since 2015, population growth in WA has stagnated, which given long term consumption trends, 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 14). 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 the state (which is predominantly drinking milk), rather than movements in retail pricing or the profitability of supermarkets and processors.

Figure 6.17 below 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 6.17: WA farm profits over time, real terms (2017 dollars)



Source: ABARES data, Dairy Australia data, and ACCC analysis.

6.4. 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.

However, it is in the supermarkets interest to maintain healthy competition between processors, as this competition is in part responsible for their ability to extract low wholesale prices. As margins on private label milk contracts are already very thin it is, the ACCC considers 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 is discussed in detail in *Chapter X* This weak bargaining position means that processors are able to capture a larger share of the value created by farmers.

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 increase their bargaining position.

6.4.1. Future milk production outcomes

The industry may have reached a point where wholesale prices of private label milk cannot be reduced any further and farmgate prices in WA, Queensland and Northern NSW are just high enough for farmers to supply the volumes required to reach demand. This means that the supermarkets are largely in control of future retail prices for private label milk and how these are achieved.

Supermarkets have considered various options in relation to private label milk. These have included:

1. 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 pass through to processors, but it is unlikely to benefit farmers' margins.
2. Reducing retail margins. Once 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.
3. Restructuring its 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 may provide an alternative option for a top tier of farmers who are able to consistently provide high quality raw milk.

Chapter.7. Contracting practices

Key Points

- Milk supply agreements are favourable to processors and exacerbate 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 have reviewed their milk supply contracts. However, the ACCC still has concerns about some potential UCTs in supply agreements for the 2017-18 season.
- Contract termination notice periods and automatic rollover clauses can limit farmers' ability to make informed and timely supply decisions.
- There is a need for a cost effective dispute resolution process in the industry.

This chapter explores the approach to contracting in the dairy industry, including:

- contract types
- unfair contract terms laws
- notice periods and 'rollover' clauses
- dispute resolution processes
- farmers' approach to contracting.

7.1. Introduction

The approach to contracting in dairy 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.

7.1.1. Industry feedback

The terms and conditions of milk supply agreements was a key issue raised by farmers with the ACCC, particularly at the forums.

Specific concerns include:

- contracts are long, complex and often difficult to interpret
- signing a contract has little utility when the processor's Supplier Handbook can override the agreement
- some Supplier Handbooks deem farmers to have renewed supply if they have not given notice of intention to discontinue within a specified time, even if the farmer has not signed a contract
- long notice periods make it difficult for farmers to switch to another processor.

The ACCC has considered these and other issues, and examined processors in relation to concerns raised by farmers at the Inquiry hearings. Views put forward by processors include:

- processors find that farmers consider that all farms should receive the same price and contract terms
- notice periods are necessary so that processors can maintain a consistent supply of raw milk and plan their contracts for the supply of dairy products.

7.1.2. The differing nature of supply agreements

There is a wide range of different supply agreements in the industry. The nature of contracts typically varies by supply region, and sometimes within particular regions:

- Farmers in export-focused regions primarily operate on Supplier Handbook contracts, where farmers do not have a signed contract and supply under the conditions of a Supplier Handbook.
- Farmers in domestic-focused regions typically enter into contracts with a specified duration. These contracts sometimes have a fixed price for all or part of the contract (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 ten-year contracts.

7.1.3. Examples of terms of concern

The ACCC is examining past and current milk supply agreements.

Set out below is a snapshot of historical terms that the ACCC considers could cause significant detriment if they were relied upon. Some terms have been amended in 2017-18 season contracts, while others have not. These areas of concern, 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 of concern. 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.'
- allow for 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 reduce their bargaining power.

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 developed following negotiations between the Australian Dairy Industry Council (ADIC) and ADF. 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.[248]

7.2. Supply agreements are complex and often governed by multiple documents

The ACCC has found that 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 involve multiple factors and conditions. These issues are exacerbated by various other contract terms which act 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'[249]
- a farmer at the Shepparton forum argued that the length of contracts makes 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.'[250]

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 recently it has 'substantially amended and simplified' its general terms of milk supply, including providing a 'cover note setting out a plain English explanation of key terms.'[251] The ACCC's analysis has demonstrated that some other processors also use 'plain English' Supplier Handbooks, but these documents are 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:

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[249] Farmer Power, *Submission to ACCC's Inquiry into the Australian dairy industry,* December 12, 4-5.

[250] Western Australia Collective Bargaining Group, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016, 3.

[251] Lion Dairy and Drinks, *Submission to ACCC's Inquiry into the Australian dairy industry,* 12 December 2016,9.

- a Supplier Handbook – this typically includes the majority of terms and conditions that govern an overall supply agreement. It does not generally include the processors' 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% 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.
- 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 Handbookfor example, terms relating to a financing arrangement.
    - Approximately 40% of farmers supplying major processors are on Milk Supply Agreements or similar fixed duration contracts.[252]
- 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 MG 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 9 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

[252] The ACCC notes that many of this 40% will also be subject to the terms and conditions of a Supplier Handbook.

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.

7.3. ACCC review 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.[253] 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.[254]

- 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.255
- 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.256
- A court must consider the contract 'as a whole' when determining whether a term is unfair.257

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.

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. The ACCC is currently considering the extent to which milk supply contracts meet the business size and transaction value thresholds, and will comment further on this issue in its Final Report.

A number of processors indicated they have reviewed their contracts in light of the commencement of the UCT laws. 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.'258

[253] *Competition and Consumer Act 2010* (Cth), s 23(4).
[254] Ibid, s 290A.
[255] Ibid, s24(1).
[256] Ibid, s 24(1).
[257] Ibid, 24(2)(b).

- Fonterra Australia submitted it has 'has reviewed and amended its Handbook in preparation for the commencement of the new unfair contract laws.'259

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.'[260]

Analysis of potential unfair terms

As noted above, the UCT laws only apply to contracts entered into or renewed on or after 12 November 2016. The laws therefore began to apply for 2017-18 dairy season contracts. The ACCC's review of 2017-18 season contracts has demonstrated that processors have removed or altered a number of terms of concern, including those relating to retrospective step-downs and loyalty bonuses.

However, the ACCC still has concerns about some terms in supply agreements for the 2017-18 season. The ACCC is considering specific 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 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 farmers
- excessive penalties for contract termination
- one-sided termination rights.

7.4. Notice periods and 'rollover' clauses can disadvantage farmers

This section primarily considers the 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'.

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[258] Murray Goulburn Co-operative Co. Limited, *Submission to ACCC's Inquiry into the Australian dairy industry*, 12 December 2016,10.

[259] Fonterra Australia Pty Ltd, *Submission to ACCC's Inquiry into the Australian dairy industry,* 12 December 2016, 9.

[260] Code of Practice: *Contractual Arrangements between Dairy Farmers and Processors in Australia*, 3.

The length of notice periods varies across the dairy industry. In southern states, where the majority of farmers operate on Supplier Handbooks, farmersare 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 date.261
- Brownes, whose contracts generally impose a 12month termination notice requirement on both parties.262
- a number of other contracts contain three and six month notice periods which are reciprocal, meaning either party must provide three or six months notice before exiting the contract.

Farmer notice period clauses will not always be problematic. Due to the different types of notice period clauses that exist, whether the ACCC would have concerns about them will depend on the nature of the clause and circumstances.

Some examples of notice periods are discussed below.

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.

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 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.

Farmer notice period clauses may reduce competition in the market for the acquisition of raw milk, as they represent a barrier to switching between processors. The ACCC continues to assess a number of notice period clauses in supply agreements for potential unfair contract terms.

[261] Dairy Farmers Milk Co-operative*, Submission to the ACCC's Inquiry into the Dairy Industry (Part 2)*, 12 December 2016, 7

[262] Brownes Food Operations, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 5.

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 reduce imbalances in bargaining power, improve transparency and lead to fairer contract terms. This can improve the efficiency of farmer production decisions and therefore provide benefits to the industry.

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.'[263]

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 price when there is a dispute. 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.[264]

[263] Australian Small Business and Family Enterprise Ombudsman, *Submission to ACCC's Inquiry into the Australian dairy industry*12 December 2016, 2.

[264] Dairy Farmers Milk Co-operative*, Submission to the ACCC's Inquiry into the Dairy Industry (Part 1)*, 12 December 2016, 7.

Box 7.4: Parmalat-Premium price dispute

Premium is a collective bargaining group consisting of farmers from Queensland and northern NSW that supply raw milk to Parmalat. Premium is authorised as a collective bargaining group by the ACCC until 2020.

When negotiating the supply contracts for Parmalat's 2017 dairy season, a dispute arose between Parmalat and Premium about the price that Parmalat would pay to farmers that were part of the Premium collective bargaining group for 2017. A number of farmers at the Toowoomba and Taree forums raised the dispute with the ACCC.

Farmers continued to supply Premium farmers under the terms of the prior agreement pending the resolution of the dispute. After the dispute could not be resolved through negotiation, the matter was referred for expert determination.

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.

However, the existence of a dispute resolution process provides important advantages.

First, for farmers, if such a dispute had arisen and no dispute resolution process existed, evidence from across the industry indicates that Parmalat would have simply 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.

In this case, the matter was resolved through the arbitration process.

Resolving disputes in the dairy industry can also be costly and resource intensive due to the lack of established dispute resolution pathways. The ACCC has 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.

Box 7.5: 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 to both parties to a contract. A core function of GTA is the dispute resolution process it administers. Decisions are made by the 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 submits an application to GTA and 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 (after removing the parties identities) to allow industry participants to share in the findings and possibly modify their commercial behaviours as appropriate.

There are large 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, where disputes cannot be resolved through negotiation.

A dispute resolution process administered by a dairy industry 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 speedily, 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, 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).265

Parties that do not have such a contractual obligation could still have their disputes resolved by the body through mediation, but there would be no obligation on the parties to comply with the outcome. However, having a specific body to resolve disputes even when binding decisions are not made will still be of value to participants in the industry.

The decisions made by the independent arbiter or expert would also help develop best practice guidance for the industry. This may further reduce the number of disputes that arise over time, lead to fairer contracts, increase transparency and strengthen processor-farmer relationships.

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.*[266]

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 where 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, presently the Voluntary Code lacks a process for dealing with non-compliance with the Code itself. For the Voluntary Code to be effective, compliance needs to be at the forefront. Where there is evidence of non-compliance, an effective dispute resolution process should be available to the parties so that any disagreements can be addressed appropriately and an outcome reached.

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[265] Note: Dispute resolution would not be possible for collective bargaining groups and processors who have not entered a contractual agreement to negotiate.

[266] Code of Practice: *Contractual Arrangements between Dairy Farmers and Processors in Australia*, .5

7.5.2. Farmers often take an informal approach 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 entered into 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.
- 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.[267] The ACCC considers 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.

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
- farmers and farmer representative groups, should more actively engage with and embrace formal contracting practices.

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.[268]

While the ACCC recognises that federal and state farmer representative groups should provide specialised legal and financial advice, farmer representative groups are well placed to provide general advice about how common contract terms operate and how these can impact farm income. This could include assistance in interpreting contracts, identifying emerging contracting trends and directing farmers to specialist legal and financial advisers.

[267] Note: This estimate is based on the following 2015/16 Dairy Australia figures: Average herd size of 273 cows, average per cow production of 5,669 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.
Note: the average annual farm income varies greatly across farms and regions.

[268] Senate Economics Reference Committee, Parliament of Australia, *Australia's dairy industry: rebuilding trust and a fair market for farmers,* (2017),40.

Chapter.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.
- The ACCC's interim view is that 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. 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.[269] This is partly because of the high transaction costs associated with individual processor-farmer negotiations.

There are also cultural obstacles to farmers negotiating individually with processors. The ACCC has heard that farmers consider it unfair if some farmers 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, the ACCC considers that there are various barriers that reduce its effectiveness in the dairy industry.

8.2. 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 the imposition of substantial penalties. The law recognises, however, that in certain circumstances there can be public benefits arising from collective negotiations, and therefore enables groups to seek approval from the ACCC to collectively bargain, either via an authorisation application 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.[270]

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.

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[269] Note: standard form contracts are often referred to as 'take it or leave it' contracts.

[270] Note: 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.'

Although the ACCC can authorise CBGs to engage in collective action, the ACCC cannot compel processors to negotiate with CBGs. Both CBG members and processors must voluntarily decide to enter negotiations, in order 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 particular 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.

Where a proposed CBG intends to negotiate with a single business, has a known group of members that is unlikely to change and each of the members reasonably expect the value of their transactions with the target business will be less than $5 million per annum, a notification is the best option to receive legal protection to collectively bargain.

Authorisation is a longer process than notification but it is currently more flexible. It is available where the membership of the group may fluctuate and there are multiple target businesses that the CBG may wish to negotiate with. There are no transaction thresholds that apply.

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.

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.

8.3. Collective bargaining in the dairy industry

There are 20-30 authorised CBGs in the Australian dairy industry. The majority 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.[271] 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.[272]

Only a small number of farmers are registered to collectively bargain under ADF's authorisation, as shown in Figure 8.1. The ACCC understands that these groups have negotiated with a variety of processors over time, although they do not all remain active.

Figure 8.1: ADF authorisation – registered CBGs

State	Number of registered CBGs	Approximate number of CBG members in State	Number of farms per State[273]
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. These CBGs have sought and been granted an authorisation specific to their circumstances, such as Dairy Farmers Milk Co-operative Limited (DFMC), 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 4*.

[271] 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.

[272] Australian Competition and Consumer Commission, *Determination Application for revocation of A90966 and substitution with A91263*, 4 August 2011, 33.

[273] Dairy Australia*, Dairy In Focus 2017.*

8.3.1. 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.'*[274]

The ACCC understands the situation in SA is similar to Victoria.

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.

The ACCC is not aware of any active CBGs in WA, which is discussed further in the *Appendix 4*. 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.[275] 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 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.[276] 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 be due to the dominant presence 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 collective bargaining groups. Membership of CBGs has remained higher in regions with limited processor competition, indicating farmers may perceive such groups to create more benefits for farmers.

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[274] Senate Economics Reference Committee, Parliament of Australia, *Australia's dairy industry: rebuilding trust and a fair market for farmers,* (2017),41.

[275] Brownes Food Operations Pty Ltd, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 1-2.

[276] Lion Dairy and Drinks, *Submission to ACCC's Inquiry into the Australian dairy industry,* 12 December 2016,13.

8.4. Has collective bargaining been effective in the dairy industry?

Despite the experiences of some CBGs (see *Appendix 4*), the ACCC has formed the view that, due to some fundamental limitations, collective bargaining arrangements are not a broad remedy to imbalances in bargaining power in the dairy industry.

We have received feedback that some processors refuse to negotiate with CBGs or cease negotiating when negotiations become difficult.[277] 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.[278]

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.[279]

Collective bargaining is also not designed to address unilateral bargaining power imbalances and the conduct that results from this for all farmers in 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.

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[277] Australian Dairy Farmers, *Submission to ACCC's Inquiry into the Australian dairy industry,* 12 December 2016, 24.

[278] 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, 5.

[279] 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, 5.

Features of effective collective bargaining

There is evidence of collective bargaining working well in the dairy industry by creating mutual benefits for farmers and processors, while at the same time addressing imbalances in bargaining power. Some CBGs have negotiated contract terms and price that better reflect farmer needs (see *Appendix 4*). 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.[280] 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 renumerate 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 agreement.[281] 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 4* for further details).[282]
    - 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 supply.[283]
- 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.[284] How CBGs could utilise dispute resolution processes is discussed in further detail in *Chapter 7*.

The ACCC considers 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.

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[280] Australian Competition and Consumer Commission, *Determination Application for revocation of A90966 and substitution with A91263*, 4 August 2011.

[281] Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry,* 12 December 2016, 1; Australian Competition and Consumer Commission, *Premium Milk Supply Pty Ltd - Authorisation - A90745*, (2000) 16.

[282] Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry,* 12 December 2016, 2.

[283] Australian Competition and Consumer Commission, *Premium Milk Supply Pty Ltd - Authorisation - A90745*, (2000) 1.

[284] Dairy Farmers Milk Co-operative, *Submission to ACCC's Inquiry into the Australian dairy industry,* 12 December 2016, 1; ; Australian Competition and Consumer Commission, *Premium Milk Supply Pty Ltd - Authorisation - A90745*, (2000) 18.

8.5. Collective boycotts in the dairy industry

8.5.1. 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.[285]

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 reasons outlined below, 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 – 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 may 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

[285] 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.

- 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.[286] 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.

The ACCC seeks industry feedback on whether boycotts are practical in the dairy industry and whether the impediments noted here can be overcome. We note that all potential boycotts are subject to an assessment of public benefits and detriments under the CCA.

8.6. The future of collective bargaining in the dairy industry

The ACCC considers that although collective bargaining has worked in some circumstances in the dairy industry, it should not be considered as the solution to addressing unilateral imbalances of bargaining power and market failures within the industry.

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.

Despite this, there is no obligation and few incentives for processors to enter into negotiations with a CBG.

[286] 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.

Chapter.9. Potential responses to identified dairy industry issues.

Key Points

- The ACCC is considering options to bring about improvements in industry practices, to improve price and production signals, stop practices that transfer risk inappropriately and make it easier for farmers to take up more competitive offers.
- The ACCC acknowledges improvements made to dairy contracts since the voluntary code of practice for the dairy industry was established. However, the voluntary code is unlikely to fully address the issues that cause detriment in the industry in the longer term
- Our interim analysis suggests that a mandatory code of conduct should be considered to address the bargaining power imbalance between farmers and processors

The chapter explains the roles and different types of industry codes of conduct, identifies some of the benefits and deficiencies in the recently developed voluntary code, and details how a mandatory code could potentially improve the bargaining power imbalance between farmers and processors.

This inquiry has identified that bargaining power imbalances in the Australian dairy industry have the potential to result in long-term economic damage to the entire industry, and especially to dairy farmers, unless they are addressed.

This has also been recognised by participants in the industry more broadly, who have responded by developing a voluntary industry code of conduct that seeks to establish minimum commercial standards that should apply throughout the industry, in particular in relation to negotiated agreements between dairy processors and their farmer suppliers.

9.1. Introduction

9.1.1. What is an industry code?

Industry codes of conduct set out minimum standards of commercial conduct for industry participants. Broadly speaking, industry codes can exist in three forms:

- **Non-prescribed voluntary industry codes** - these voluntary codes are developed and administered by industry participants. They are only enforceable to the extent that the industry includes an enforcement mechanism and process in the code. Examples include the current dairy industry voluntary code and the Australian Wine Industry Code of Conduct.[287]
- **Prescribed voluntary codes** - these are voluntary codes that industry participants have the option of signing up to, with signatories subject to enforcement action by the ACCC in the event of a breach.. The Food & Grocery Code is an example of a prescribed voluntary code.[288]
- **Mandatory codes** - these codes are binding on all industry participants and are enforced by the ACCC. The ACCC can take action against parties that breach a mandatory code, including in the form of financial penalties or infringement notices. The Horticulture Code of Conduct is an example of a mandatory code.

Industry codes can address industry-specific market failures that cannot otherwise be addressed, either by industry participants, or by regulation.

[287] Australian Wine Industry, *Code of Conduct,* December 2008, http://www.wineindustrycode.org/.

[288] 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.

9.2. The Dairy Voluntary Code

On 1 July 2017, the terms of a voluntary code of conduct for the Australian dairy industry were agreed and endorsed by many, but not all industry participants.[289] The Voluntary Code is designed to govern key aspects of commercial relationships between dairy processors and farmers. Signatories are not legally obliged to comply with the requirements of the Voluntary Code.

The Voluntary Code was developed by ADIC in response to the 2016 farmgate milk price step-downs announced by Murray Goulburn and Fonterra Australia. [290] It represents an agreed position between ADF and the Australian Dairy Products Federation (ADPF). The ACCC was not a participant in the development of the Voluntary Code, and does not have any administrative or enforcement role in relation to it.

The Voluntary Code is intended to apply to standard form contracts provided to farmers by processors that are signatories. The Voluntary Code does not apply to the small number of directly negotiated agreements between processors and dairy farmers. It does not require processors to negotiate contract terms with farmers, nor discourage the use of standard form contracts.

Industry codes, if adopted by industry participants, can improve transparency, efficiency and the allocation of risk in a supply chain with minimal regulatory burden. To achieve success, a code must be targeted at the key problems, and be properly administered and enforced.

The ACCC considers that the Voluntary Code has the potential to address several of the common contracting issues that have been identified in the sector. The Voluntary Code has provisions which govern contract terms relating to mechanisms for setting and varying prices, exclusivity of supply, loyalty and other bonus payments, termination of contracts, and dispute resolution.[291]

However, aspects of the Voluntary Code's design are likely to limit its effectiveness. For example:

- despite provisions which require transparency when setting and varying farmgate prices, processors appear to retain full discretion over the method of 'price notification' they may use[292]
- processors have wide discretion over the design of dispute resolution processes to be included in milk supply agreements
- further and very significantly, the Voluntary Code does not contain a mechanism for resolving disputes that arise under the Voluntary Code, including about compliance with the code itself. the Voluntary Code is not legally enforceable and there are no penalties for non-compliance. Therefore, the effectiveness of the Voluntary Code depends entirely on the continuing willingness of processors to adhere to it. Processors may choose to stop complying with the Voluntary Code at any time, and some have elected not to become signatories to it
- lastly, there are issues that are not dealt with by the Voluntary Code that the ACCC considers should be included in a code in the future. The content of a future code is discussed further below.

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[289] *The Code of Practice for Contractual Arrangements between Dairy Farmers and Processors in Australia*.

[290] See *Chapter 3* for discussion of the 2016 step-downs.

[291] Note: these are transparency, pricing, pricing mechanisms, contractual variations, loyalty payments, exclusivity, contract durations, conditions for termination of contracts including notice periods, dispute resolution and a future review of the Code.

[292] Note: The ACCC is concerned that this would not overcome problems associated with farmers not having timely access to critical information before a new dairy season commences, and therefore not address the processors' ability to unfairly allocate risk to them.

9.3. The impact of the Voluntary Code

The Voluntary Code has been adopted by most major processors and dairy farmer representatives.[293] At the time of this Interim Report, Norco and Brownes were not signatories to the Voluntary Code.

Box 9.1: Contract terms for the 2017-18 dairy season under the Voluntary Code

Step-downs

Section 4 of the Voluntary Code prohibits signatories from applying retrospective step-downs. This is a positive development if adhered to. 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.

Adherence with Section 4 of the Voluntary Code may discourage processors from stepping down prices unless necessary, as in some regions they will risk losing milk supply.

This will provide some farmers with the option of switching to a different processor, if they can secure a better price and an alternative process has capacity and demand for their milk.

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 ACCC considers that, if adhered to, this is a positive development. 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 reflected this position in their contracts.

We note that 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.

The ACCC does however recognise this can create barriers to switching. Loss of potential step-ups may disincentivise farmers from switching mid-season. By doing so they forfeit the opportunity to participate in any market upside for milk already delivered, except in (relatively unusual) circumstances where they receive a no-disadvantage guarantee from the processor they move to.
Termination of contracts

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.

[293] Note: 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.

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 right 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.

Exclusive supply clauses

Section 6 of the Voluntary Code states that:

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.294

This section addresses the issue of tier-two pricing, which we understand ceased in 2012-13. Tier-two pricing occurs where a much lower price is paid for milk produced in excess of a farmers allocated supply volume. The effect of tier-two pricing is to disincentive 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.

For farmers whose operations could support dual supply, exclusivity clauses have the potential of restricting the sale of, and competition for, milk. The ACCC considers section 6 should be altered to remove the first right of refusal from the incumbent processor to ensure the competitive process is unimpeded. Farmers should be aware this arrangement may be accompanied by the risk that in low demand periods, a second buyer may not be found for their milk.

The introduction of the Voluntary Code appears to have had a positive impact on contract terms offered to farmers for the 2017-18 dairy season by some processors.

It should be noted, however, that the industry has been subject to heightened scrutiny over recent times, which is likely to have resulted in modified behaviour by processors. The extent to which the changes observed will be adhered to in the future remains uncertain. It is also observed that not all processors have become signatories to the Voluntary Code, and that there are no penalties or consequences for signatories that breach code provisions, or even a process to determine if a breach has occurred.

The Voluntary Code will be reviewed after its first year of operation, and each three years after that. The Senate Inquiry recommended that an independent body conduct the review of the Voluntary Code.[295] The ACCC agrees with this recommendation. The ACCC also recommends that the reviewers of the Voluntary Code consider the findings and recommendations of this report.

9.4. Possible introduction of a mandatory code

Some stakeholders have the view that a mandatory code is required to bring about the necessary changes in the industry. In its report, the Senate Inquiry stated that 'The committee remains concerned that a voluntary code may not be sufficient to bring about widespread change in milk supply arrangements and contracting practices.'[296]

Farmer Power submitted to the ACCC that 'Farmers will not be satisfied unless the standard contracts are demonstrably fair to farmers, and there is a mandatory code of conduct with

[294] *The Code of Practice for Contractual Arrangements between Dairy Farmers and Processors in Australia*, 4.

[295] Senate Economics Reference Committee, Parliament of Australia, *Australia's dairy industry: rebuilding trust and a fair market for farmers,* (2017), Recommendation 3.

[296] Ibid, 36.

accessible (fast and free of cost for farmers) remedies for farmers if the code is breached by processors.'[297]

Conversely, the Small Business Ombudsman stated that 'Our overall position is that industry issues are best addressed, wherever possible, by the participants in the industry.'[298]

The ACCC agrees that in general it is ideal if industry issues can be resolved without recourse to regulation. Industry-based solutions have the appeal of being designed by those who know the industry best, and are therefore likely to be designed to achieve desired outcomes while minimising additional costs.

However, the ACCC's analysis suggests that a mandatory code is warranted to address the issues identified throughout this inquiry.

The dairy industry's problematic features primarily manifest through unbalanced risk sharing, potentially unfair contract terms, and communications about matters critical to farm production and income which are not transparent.

Processors have little incentive to make the changes to their contracting practices given their bargaining power advantages. This means that without intervention:

- competition between processors will continue to be softened
- farmers will continue to face excessive uncertainty and risk.

The history of bargaining and contracting in the industry since deregulation suggests that intervention is needed to address the identified market failures.

Given that the ACCC does not foresee any changes in this bargaining power imbalance, the ACCC has serious concerns about the capacity of a Voluntary Code to address the problematic contracting practices that exist in the industry. The ACCC is also concerned that the Voluntary Code cannot be enforced and that processors can abandon it at any time.

A prescribed voluntary code is unlikely to be effective for all farmers as all processors are not required to become signatories. Necessary clauses that seek to reduce barriers to farmer switching and improve risk allocation, as well as the costs of complying, are likely to reduce the incentives for processors to become signatories.

The ACCC's analysis of these issues suggests that a mandatory code of conduct with penalties is necessary for the dairy industry. Because processors would be required to comply, a mandatory code could ensure that issues of concern are fully addressed.

[297] Farmer Power, *Submission to ACCC's Inquiry into the Australian dairy industry,* 12 December 2016, 6.

[298] Australian Small Business and Family Enterprise Ombudsman, *Submission to ACCC's Inquiry into the Australian dairy industry,* 12 December 2016, 1; Senate Economics Reference Committee, Parliament of Australia, *Australia's dairy industry: rebuilding trust and a fair market for farmers,* (2017).

9.4.1. Factors to consider with a mandatory code

Best practice regulation includes the minimum necessary intervention to address industry problems. The following sections outline some important issues to be considered with respect to the form of an industry code.

Scope of regulation

A mandatory code prescribes the way that parties subject to the code interact with each other. In the dairy industry context, this could involve obligations on processors aimed at improving contracting practices which result in contract terms that impede competition and distribute disproportionate levels of risk to farmers.

A mandatory code could include obligations upon processors to:

(a) enter into written contracts with farmers for milk supply

(b) provide timely and transparent information about the terms on which they propose to acquire milk from farmers. This may include:

i. minimising the number of documents which contain terms and conditions of milk supply

ii. ensuring farmers are not required to make decisions about renewing contracts before they have accurate pricing and contractual information

iii. 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

iv. providing an income estimation resource which more accurately takes account of the production characteristics of individual farms (as discussed in *Chapter 3*)

(c) not include contract terms which unreasonably restrict farmers' ability to switch processors

(d) include a dispute resolution process, supported by reference to an independent process, to apply to disputes about the interpretation and performance of contracts, and alleged contraventions of the code itself.

A mandatory code could also prohibit contract terms in milk supply agreements (some of which are addressed in the Voluntary Code), which:

(e) prohibit retrospective step-downs, and instead set out the circumstances in which step-downs more generally are appropriate or inappropriate

(f) combine tier-two pricing with exclusive supply clauses.

Processors' rights under a mandatory code:

A mandatory code should not interfere with the legitimate business interests of processors. For instance, as is the case under the Voluntary Code, mandatory code should recognise processors' rights:

- to terminate contracts upon a fundamental breach of contract by a farmer (this should be a reciprocal right between processors and farmers)
- to enact a non-retrospective step-down, so long as farmers are provided adequate notice and can terminate the agreement within a reasonable period without penalty
- to set farmgate milk prices.

Compliance costs

The compliance costs of a mandatory code can be significant. All parties covered by a mandatory code must keep necessary records and respond to random compliance checks.

The mandatory nature of a code therefore raises questions about the distribution of compliance costs across the processing sector, where the capacity of processors to manage regulatory compliance is likely to vary. For example:

- The burden of compliance costs may be substantial for small processors who do not have strong bargaining power relative to farmers or retailers. The application of a code to those processors could be an disproportionate regulatory burden that could deter them from entering or expanding in the industry
    - An exemption from application of a mandatory code based on market share, revenues etc. may be necessary. This might be based on an accepted definition of small business – for example, a business that employs less than a certain number of people or has an aggregated turnover below a certain threshold.
- A prescribed voluntary code would be enforceable by the ACCC in relation to any party who was a voluntary signatory. In contrast, a mandatory code, which would also be enforced by the ACCC, would apply to all industry participants.[299]

Likelihood of addressing identified problems

A prescribed voluntary code is voluntary in that it is optional to become a signatory, but is enforceable by the ACCC for any parties that are signatories. In contrast, a mandatory code would be enforced by the ACCC and would apply to all industry participants.

Prescribed voluntary and mandatory codes of conduct therefore have different implications in terms of their effectiveness in addressing issues which lead to market failures, and costs of regulatory compliance for the businesses subject to the code.

A prescribed voluntary code arguably has a benefit of reduced regulatory burden. However, its inherent voluntary nature gives rise to concerns about the reduced likelihood that identified problems in the industry will be addressed, and equality among competitors in terms of regulatory burden:

- the enforceable status of a prescribed voluntary code may reduce the incentives for suppliers to become signatories particularly if the compliance costs are high
- the degree of prescriptiveness and compliance costs are likely to reduce the incentives for processors to become signatories. The effectiveness of a prescribed voluntary code is lessened unless it is has widespread support.

Improvements to the Voluntary Code

Notwithstanding the ACCC's view that a mandatory code appears necessary under the CCA, the Voluntary Code will continue to operate for at least the short-to-medium term. The ACCC considers that the Voluntary Code requires improvements through the following changes:

Additions

- a mechanism for resolving disputes that arise under the Voluntary Code, including compliance with the code itself
- an obligation on processors to provide price and other contract information before requiring them to make a decision about renewing a contract

[299] Note: although application of the code to industry participants may be subject to a defined threshold.

- an obligation on processors to include a comprehensive dispute resolution process in their milk supply agreements

Other changes

- with regard to Section 6 of the Voluntary Code, removal of the incumbent processor's first right of refusal regarding a farmer's supply of milk to an alternative processor
- this is to ensure farmers who can support dual supply are not restricted from having processors compete for their excess milk.

The ACCC seeks feedback on the concept and scope of a mandatory industry code for the Australian dairy industry.

Appendix 1 - Terms of reference

On 27 October 2016 the Treasurer, the Hon Scott Morrison MP, pursuant to section 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:

i. the nature of competition between processors for both the acquisition of raw milk and the supply of processed milk and dairy products

ii. the nature of retail pricing arrangements for milk and dairy products, and their impact up the supply chain

iii. 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

iv. 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

v. the mechanisms used by acquirers of raw milk to determine prices paid when acquiring raw milk and the transparency of those mechanisms

vi. the availability, transparency and accessibility of market price information, and its effectiveness for forecasting movements in farm gate milk prices

vii. the terms on which raw milk is acquired from dairy producers and the means by which such terms are agreed

viii. the allocation of commercial risk across the dairy supply chain

ix. the role of collective bargaining in the dairy industry and its effectiveness

x. the existence of, or potential for, anti-competitive conduct and the possible impacts of any such conduct on businesses within the dairy supply chain

xi. any other factors affecting farm profitability.

Appendix 2 - Corporate transactions in the dairy industry

Year	Transaction
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.

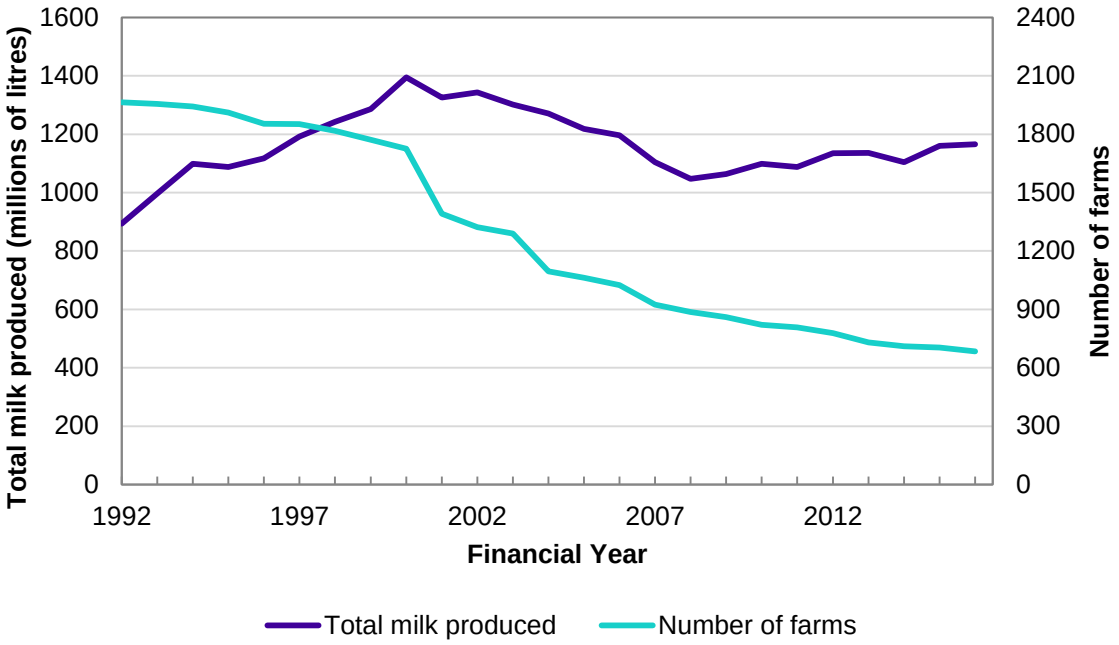
Appendix 3 – Parties that made public submissions to the Inquiry

- 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 and 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

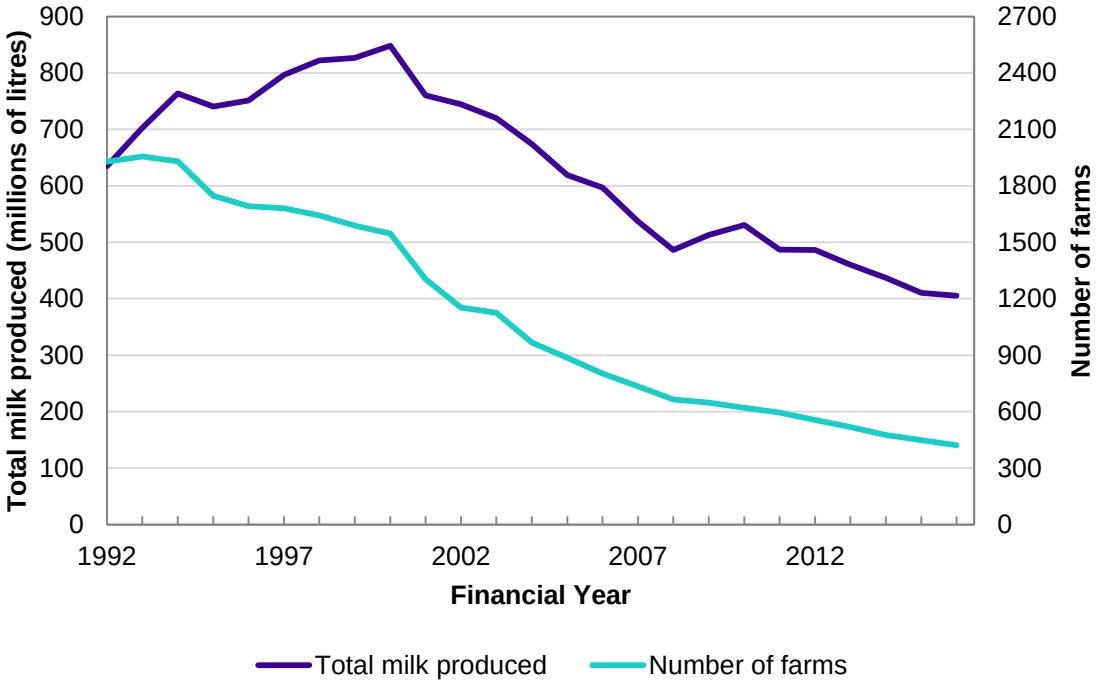
Appendix 4 – Additional chart analysis

Chart 1: Total milk production and farm numbers, New South Wales



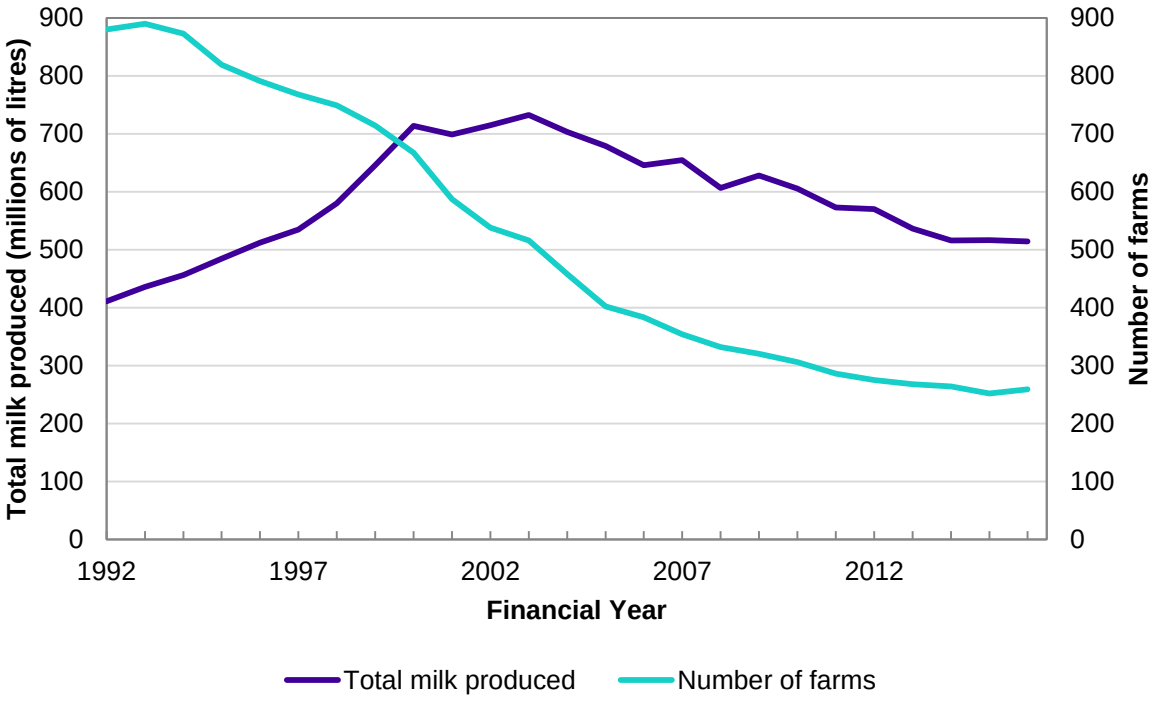
Source: Dairy Australia data, and ACCC analysis

Chart 2: Total milk production and farm numbers, Queensland



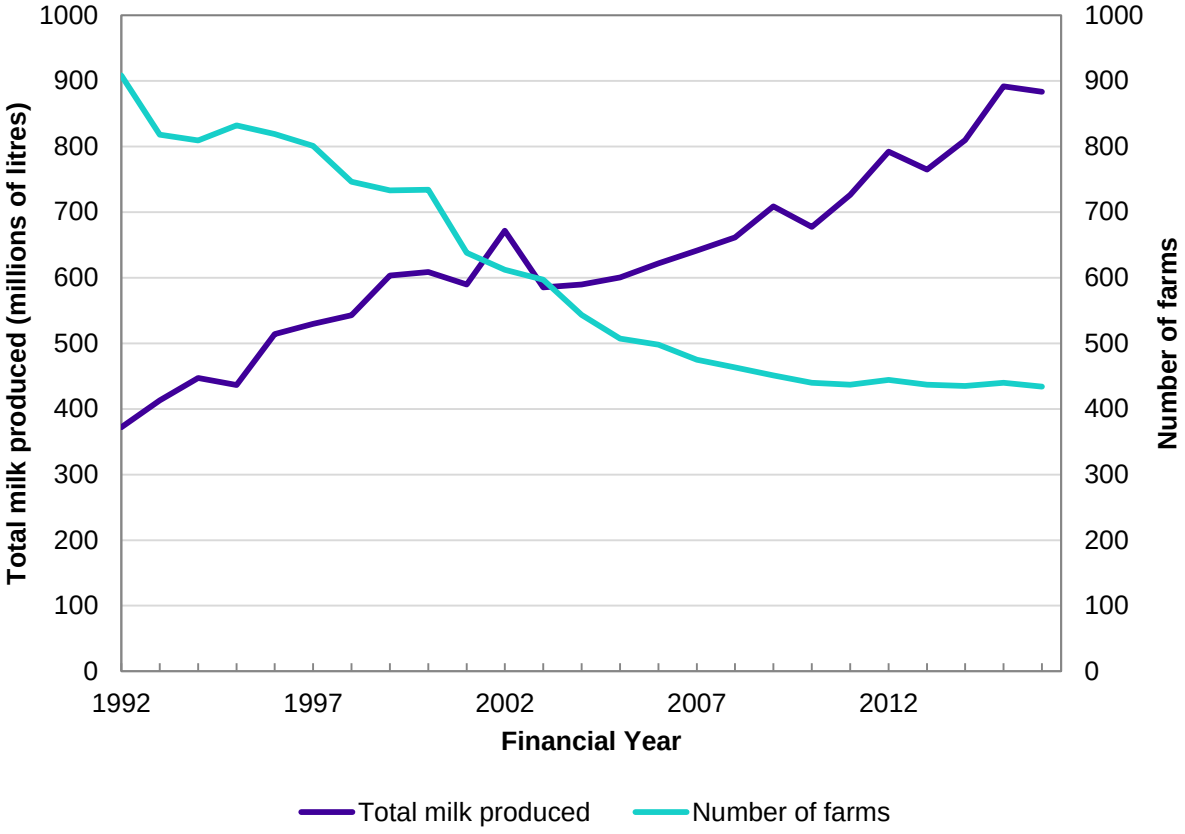
Source: Dairy Australia data, and ACCC analysis

Chart 3: Total milk production and farm numbers, South Australia



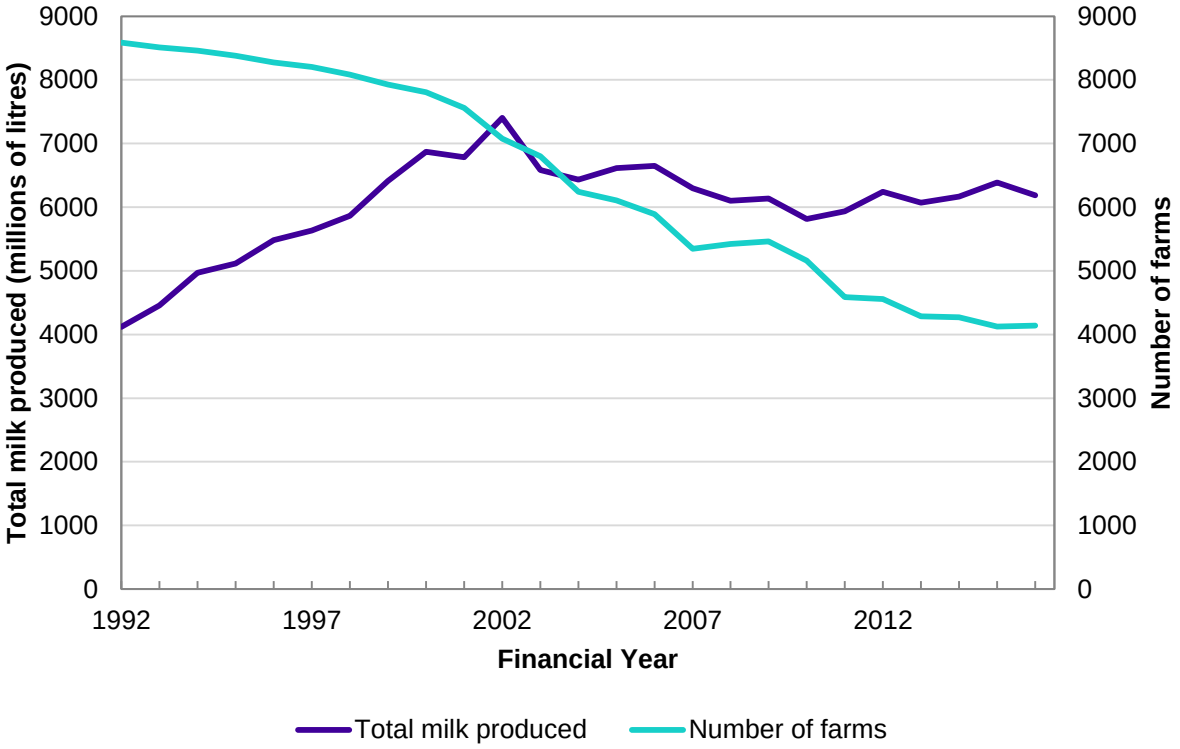
Source: Dairy Australia data, and ACCC analysis

Chart 4: Total milk production and farm numbers, Tasmania



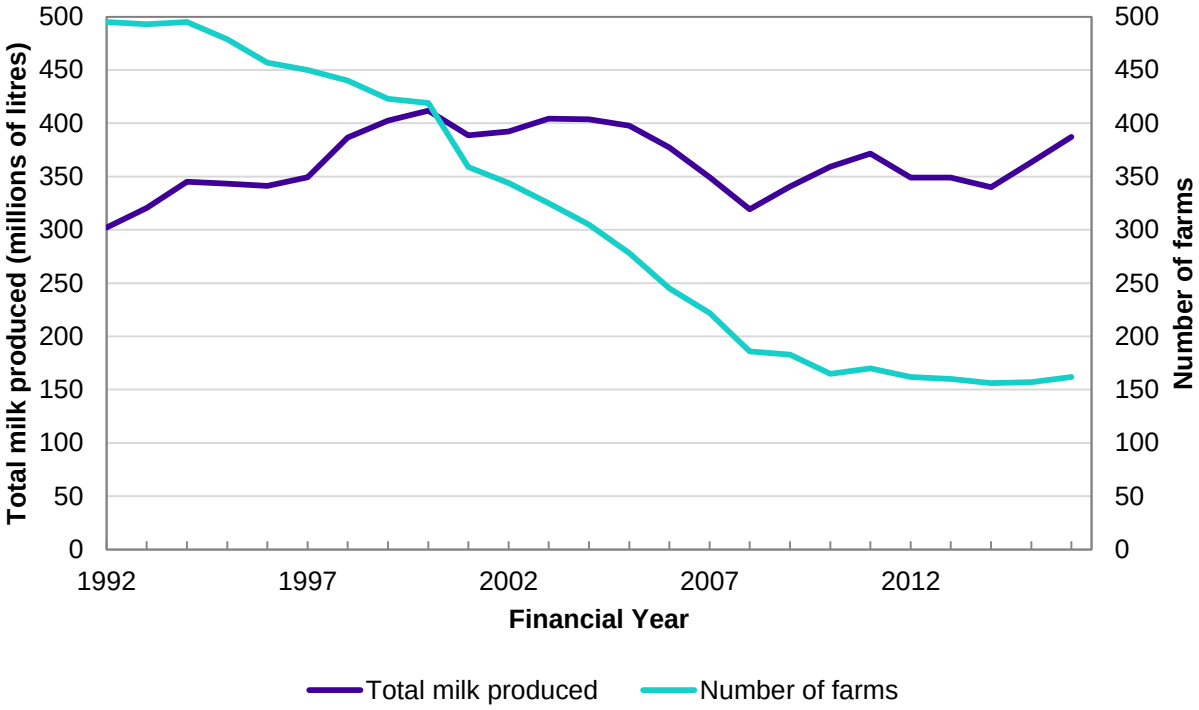
Source: Dairy Australia data, and ACCC analysis

Chart 5: Total milk production and farm numbers, Victoria



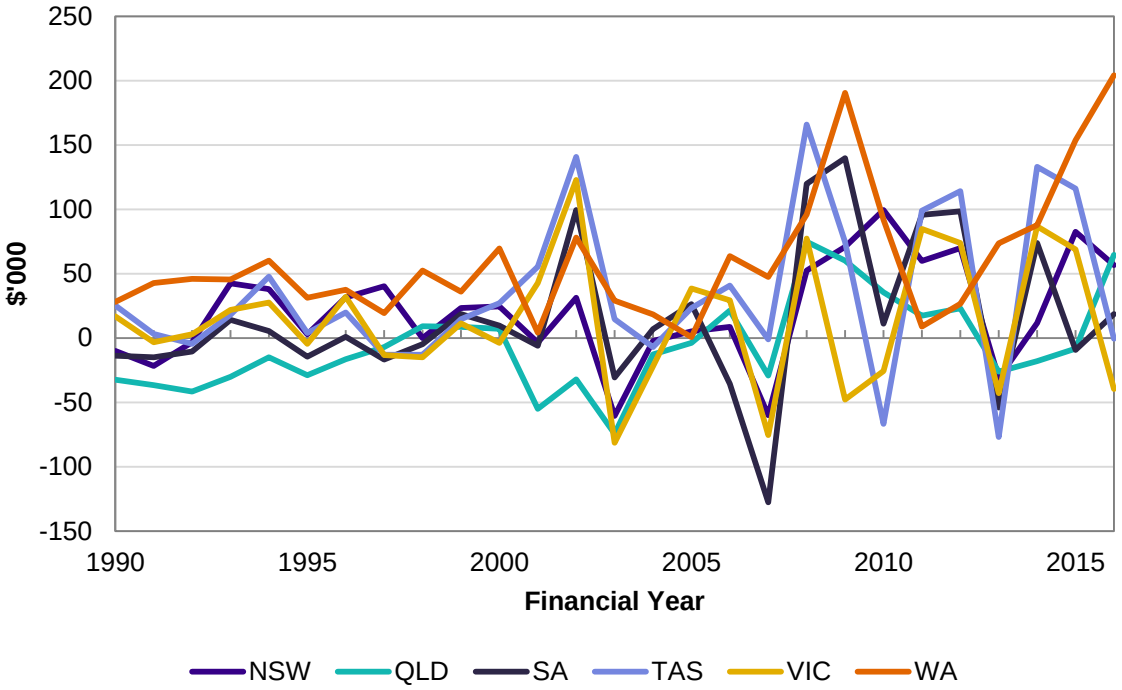
Source: Dairy Australia data, and ACCC analysis

Chart 6: Total milk production and farm numbers, Western Australia



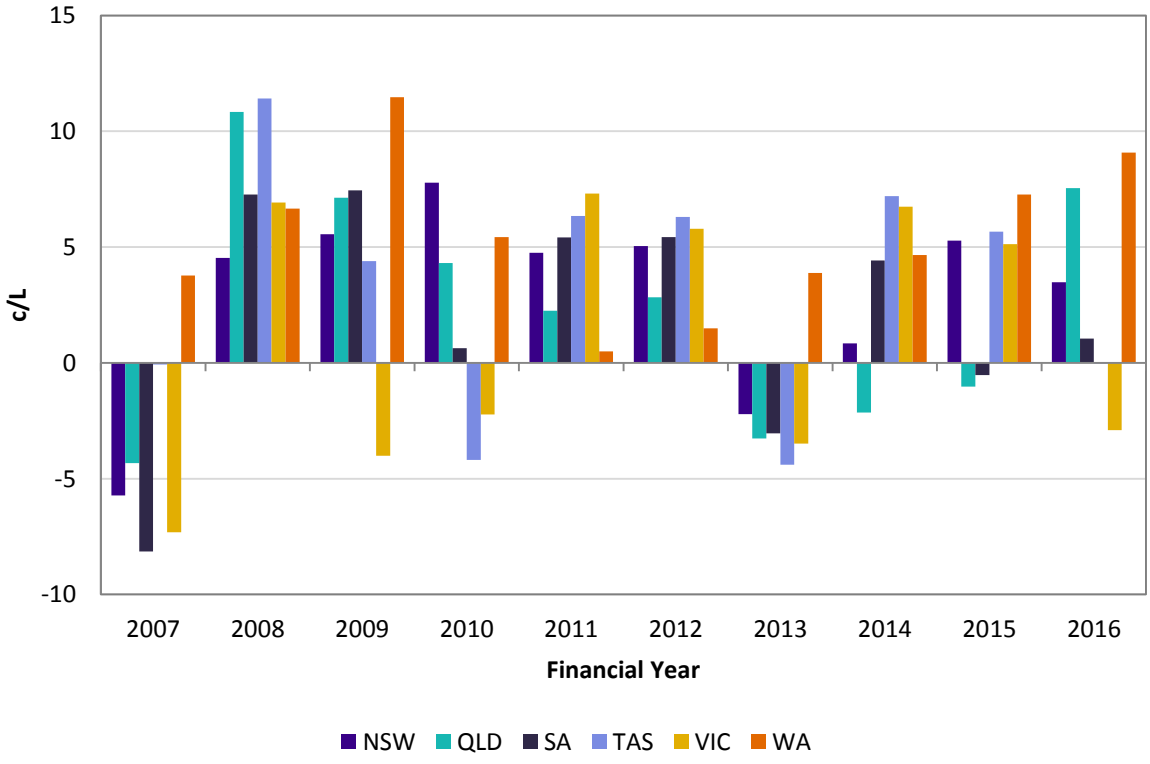
Source: Dairy Australia data, and ACCC analysis

Chart 7: Farm business profit, by state, real terms (2017 dollars)



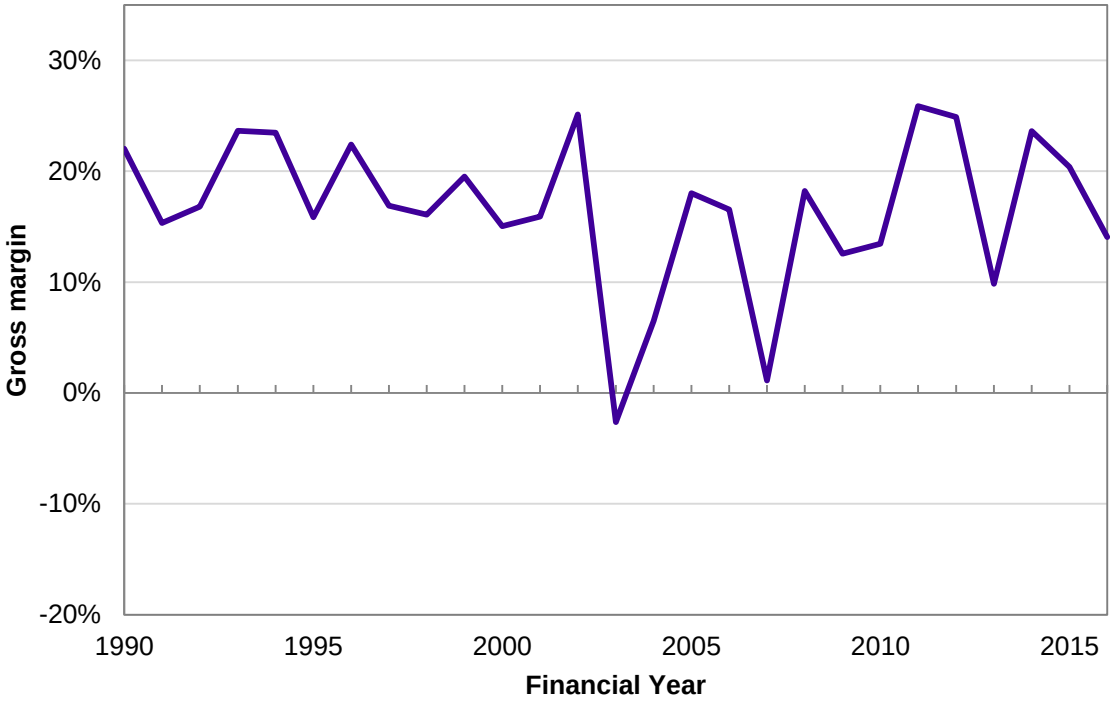
Source: ABARES, ACCC analysis

Chart 8: Farm business profit, by state, real terms (2017 dollars)



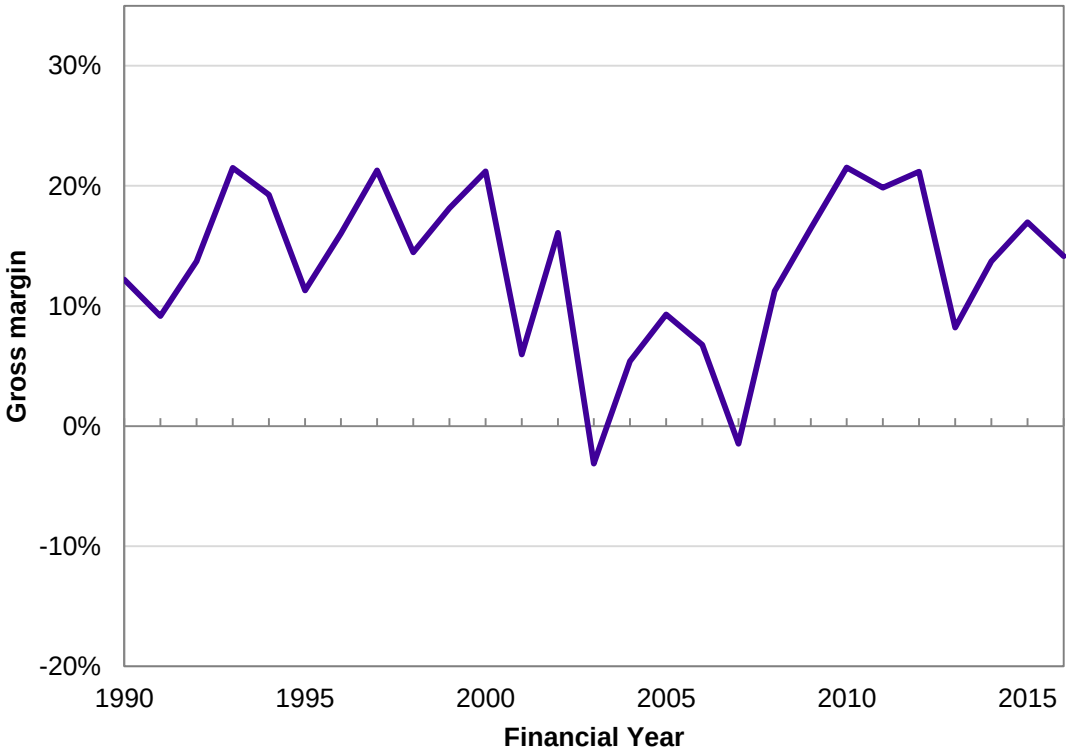
Source: ABARES, ACCC analysis

Chart 9: Gross margin, Australia



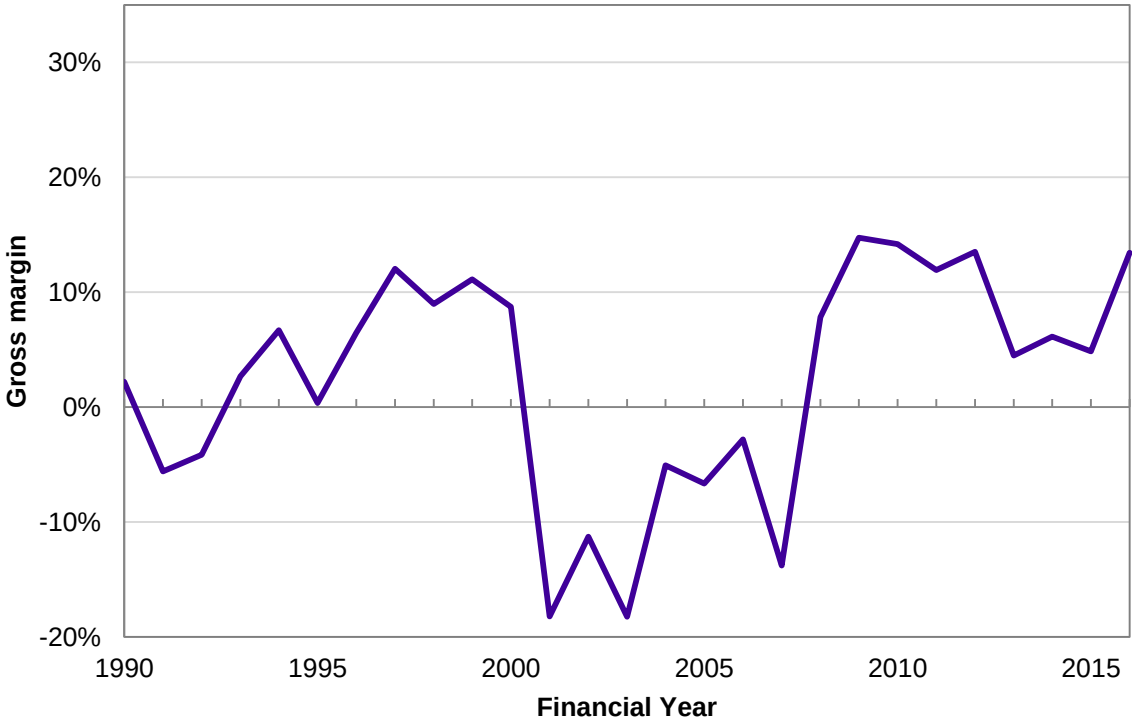
Source: ABARES, ACCC analysis

Chart 10: Gross margin, New South Wales



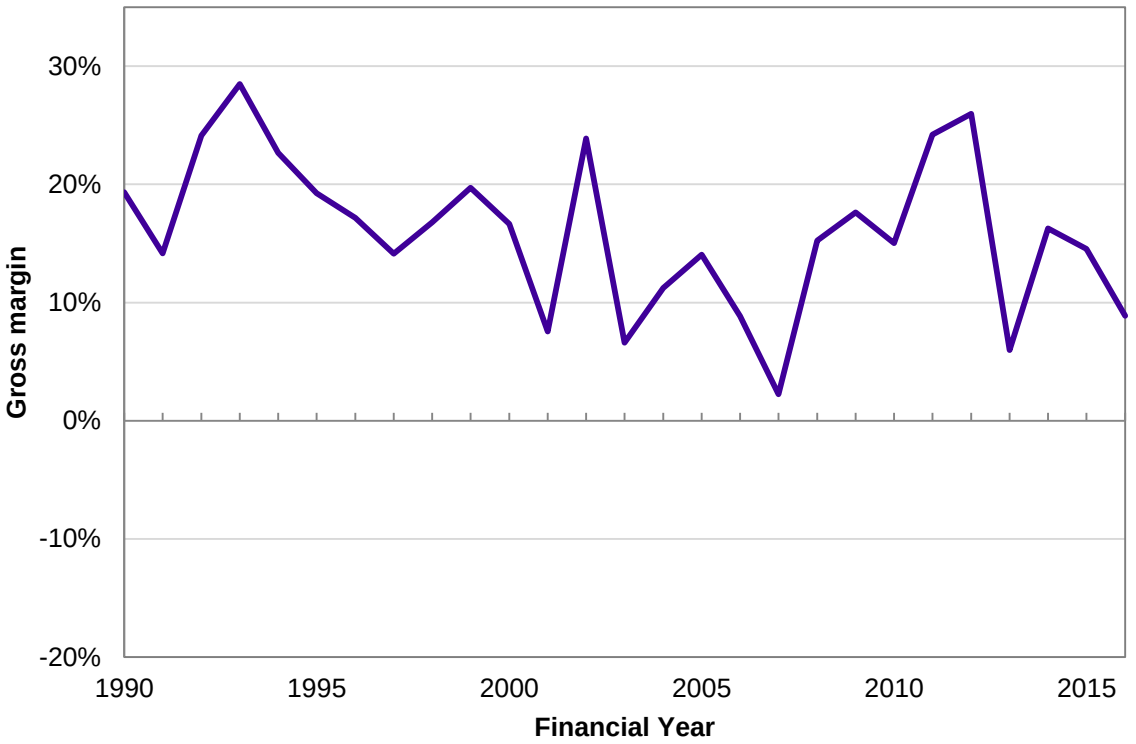
Source: ABARES, ACCC analysis

Chart 11: Gross margin, Queensland



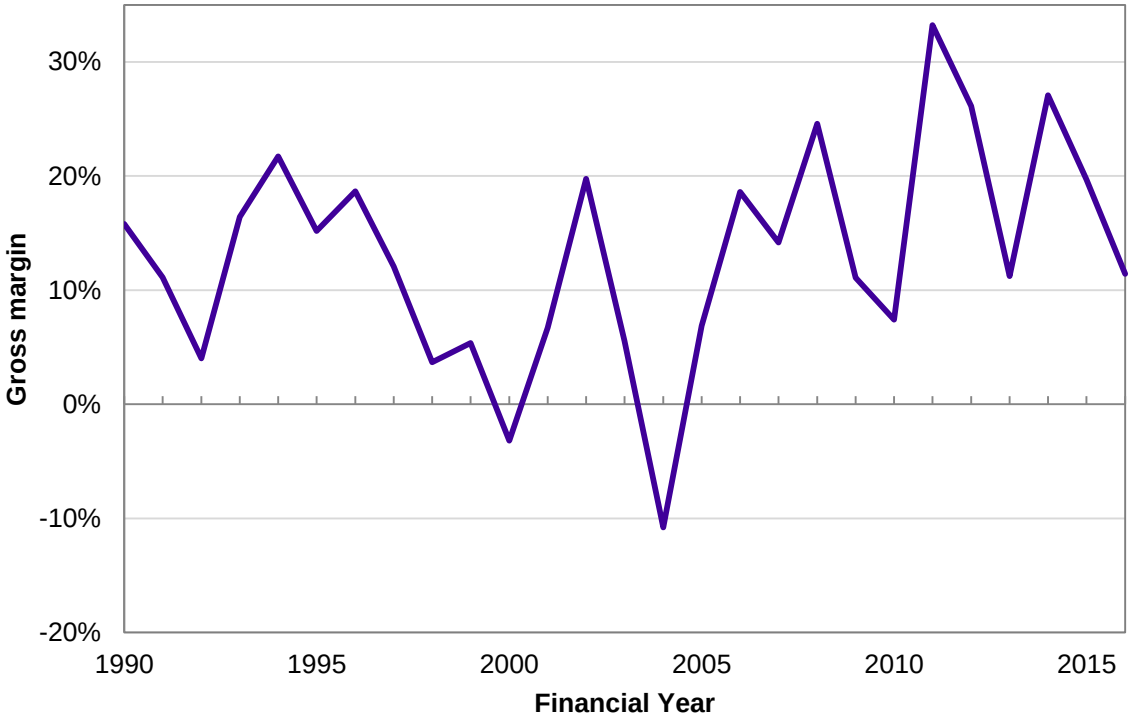
Source: ABARES, ACCC analysis

Chart 12: Gross margin, South Australia



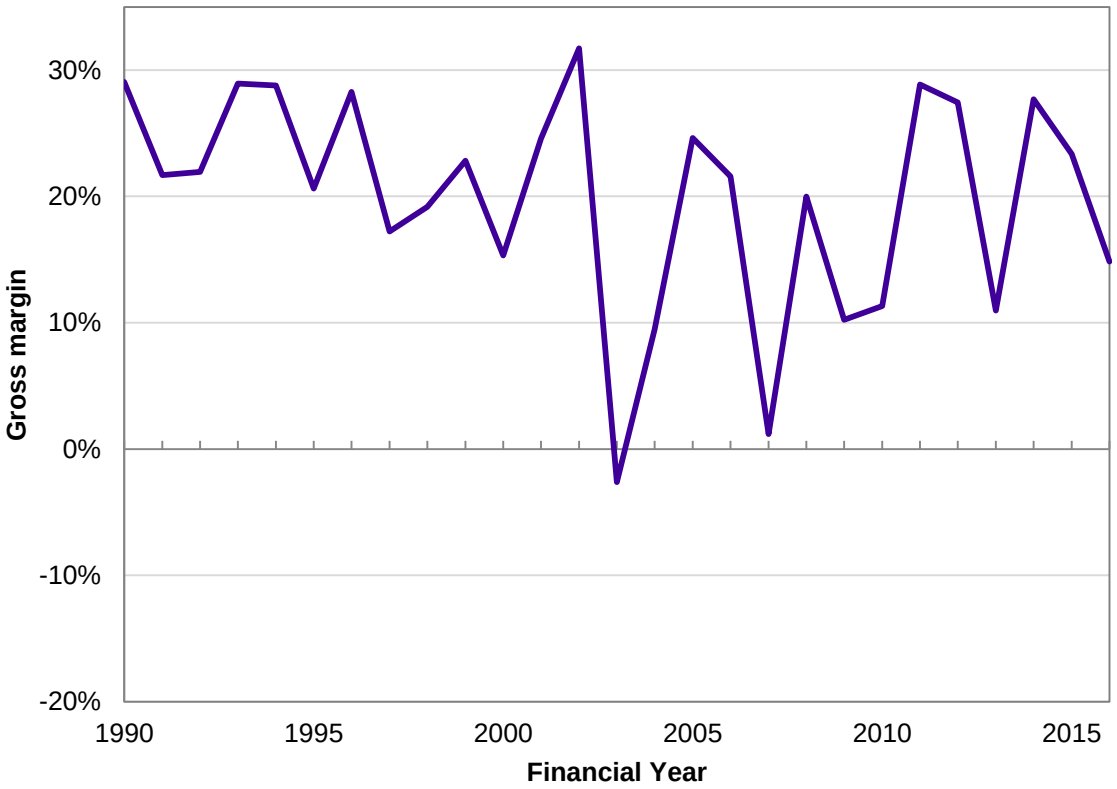
Source: ABARES, ACCC analysis

Chart 13: Gross margin, Tasmania 3: Gross margin, Tasmania



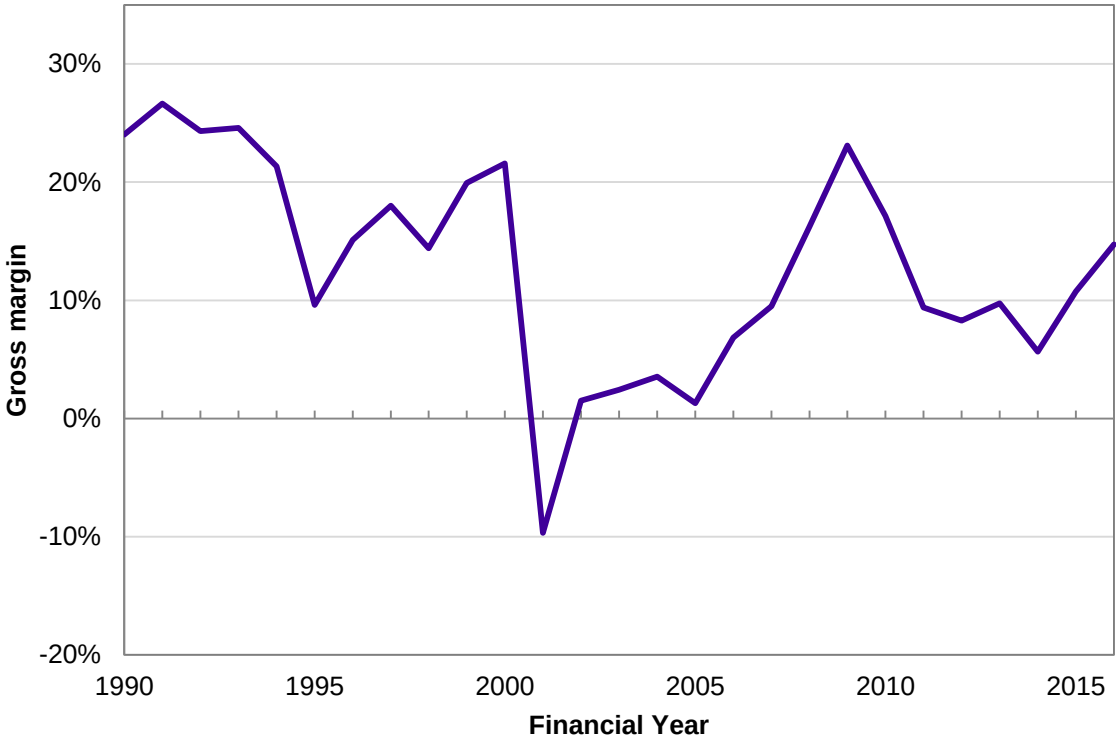
Source: ABARES, ACCC analysis

Chart 14: Gross margin, Victoria



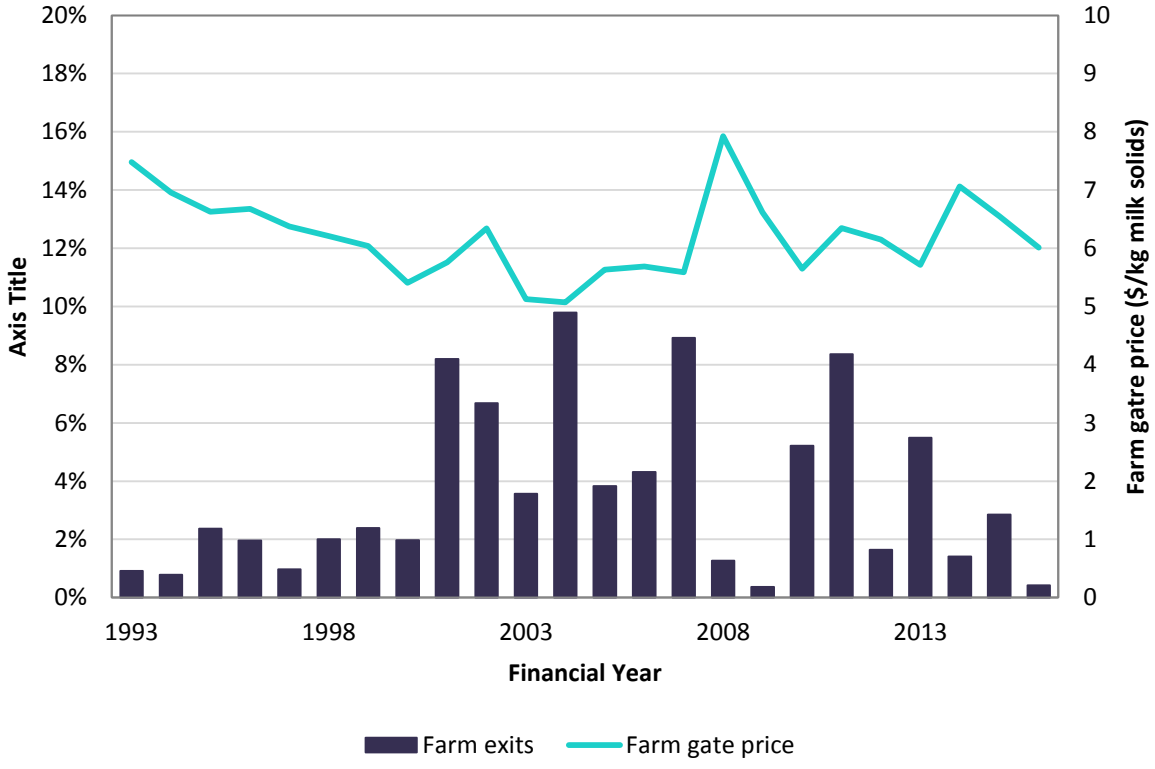
Source: ABARES, ACCC analysis

Chart 15: Gross margin, Western Australia



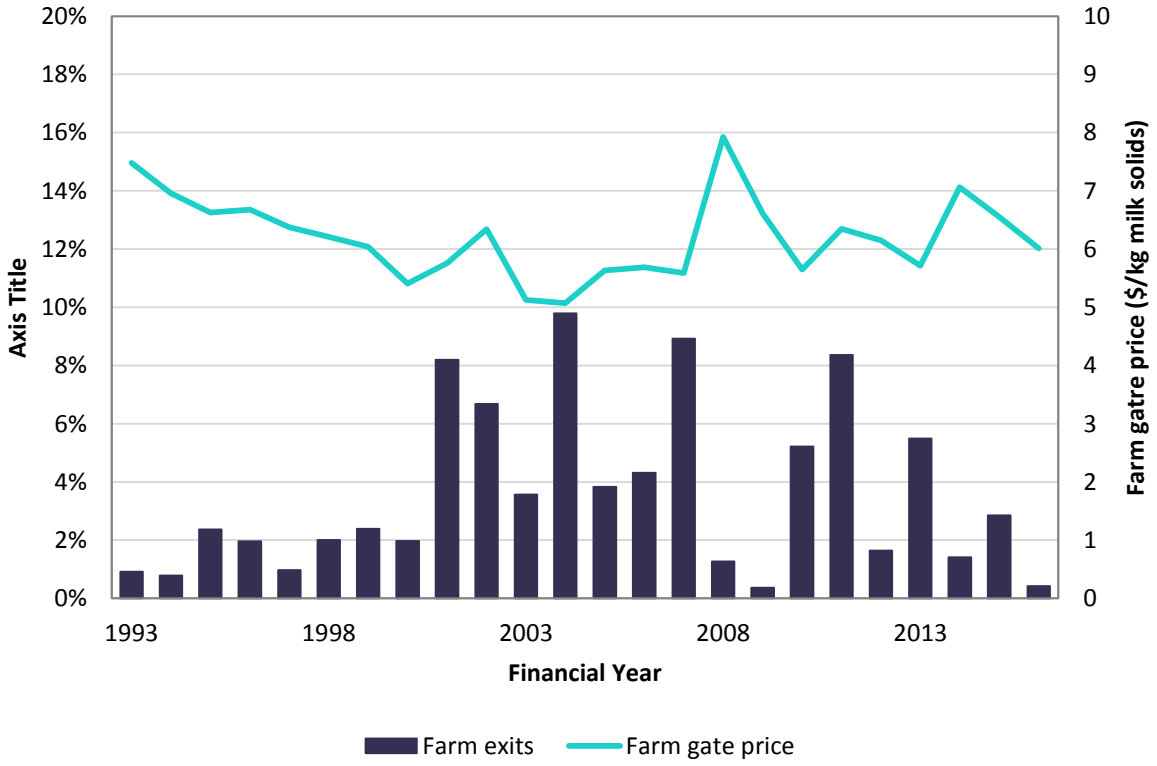
Source: ABARES, ACCC analysis

Chart 16: Farm exits and farm gate price, Australia, real terms (2016 dollars)



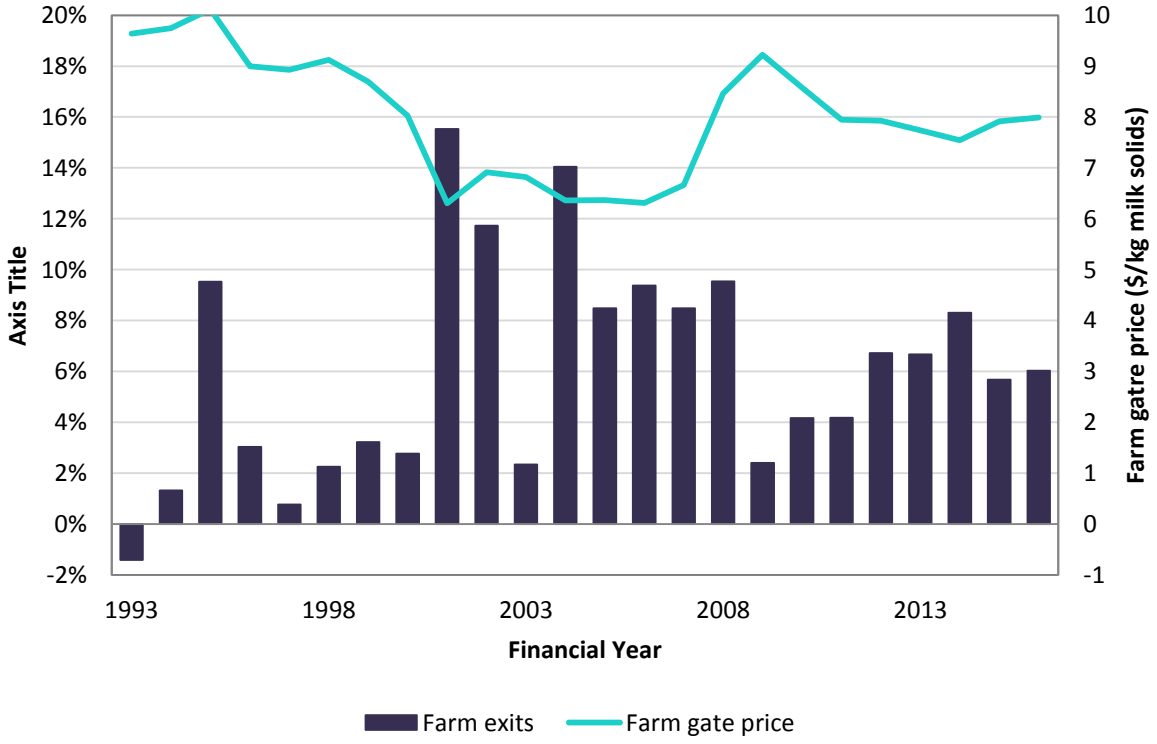
Source: Dairy Australia data, and ACCC analysis

Chart 17: Farm exits and farm gate price, New South Wales, real terms (2016 dollars)



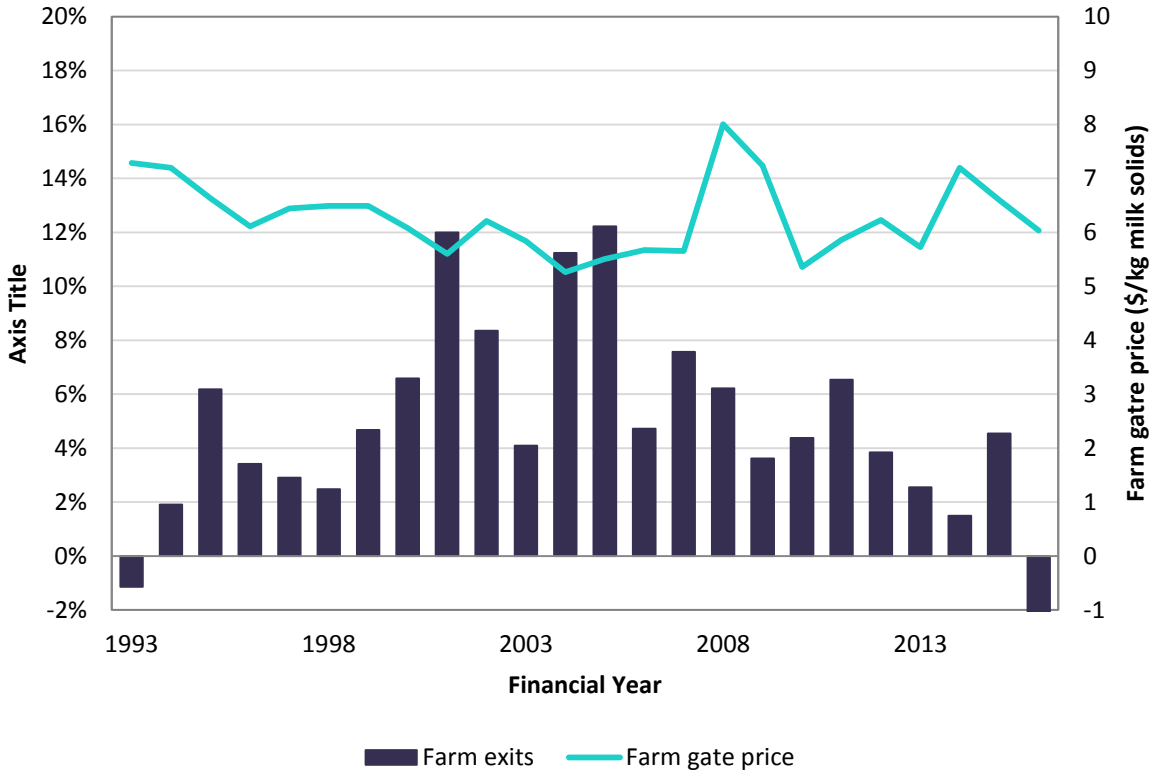
Source: Dairy Australia data, and ACCC analysis

Chart 18: Farm exits and farm gate price, Queensland, real terms (2016 dollars)



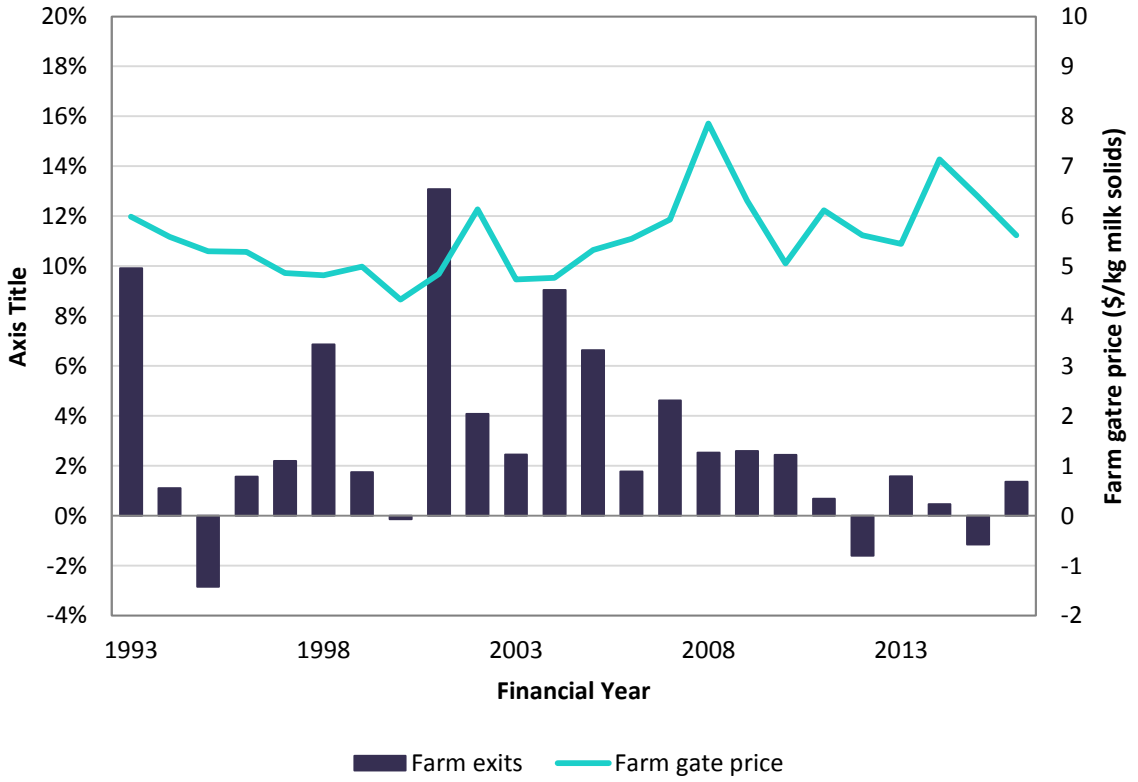
Source: Dairy Australia, ACCC analysis

Chart 19: Farm exits and farm gate price, South Australia, real terms (2016 dollars)



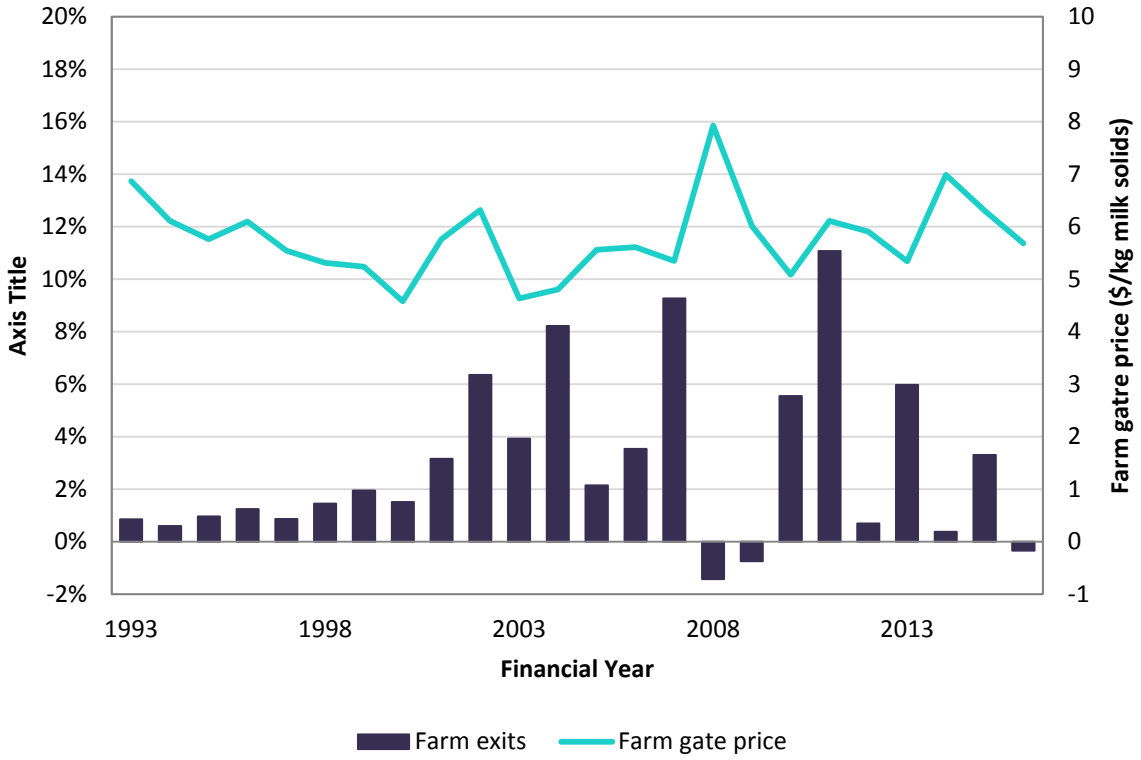
Source: Dairy Australia, ACCC analysis

Chart 20: Farm exits and farm gate price, Tasmania, real terms (2016 dollars)



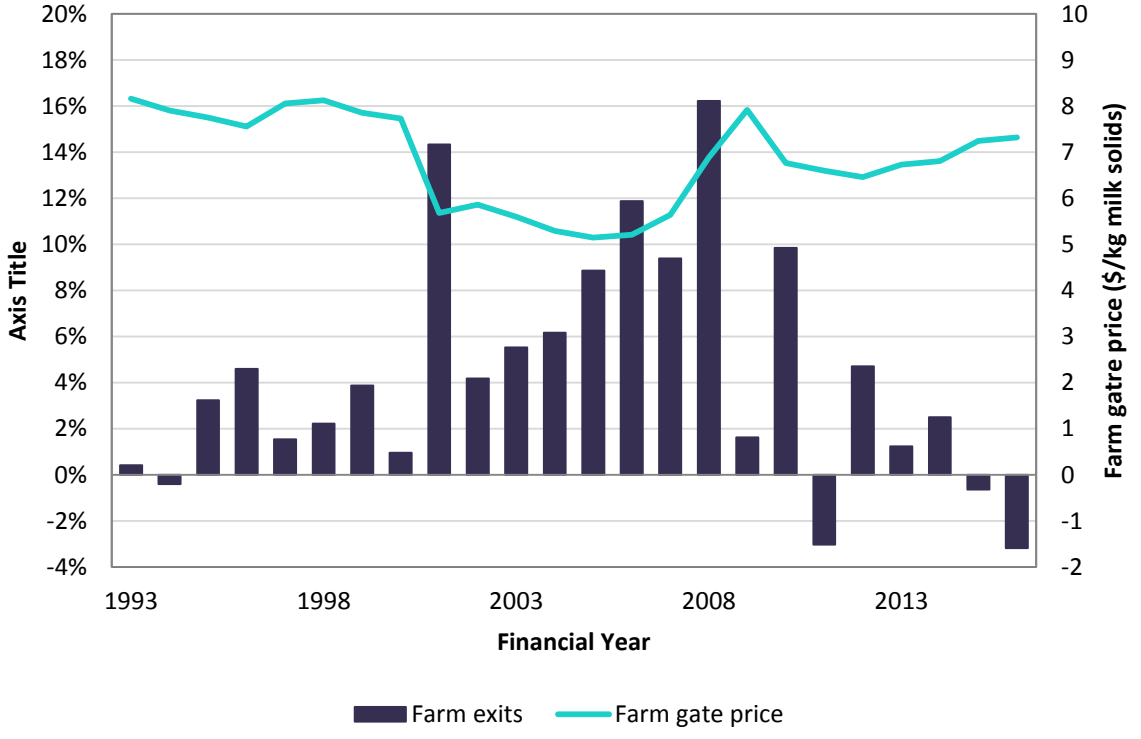
Source: Dairy Australia data, and ACCC analysis

Chart 21: Farm exits and farm gate price, Victoria, real terms (2016 dollars



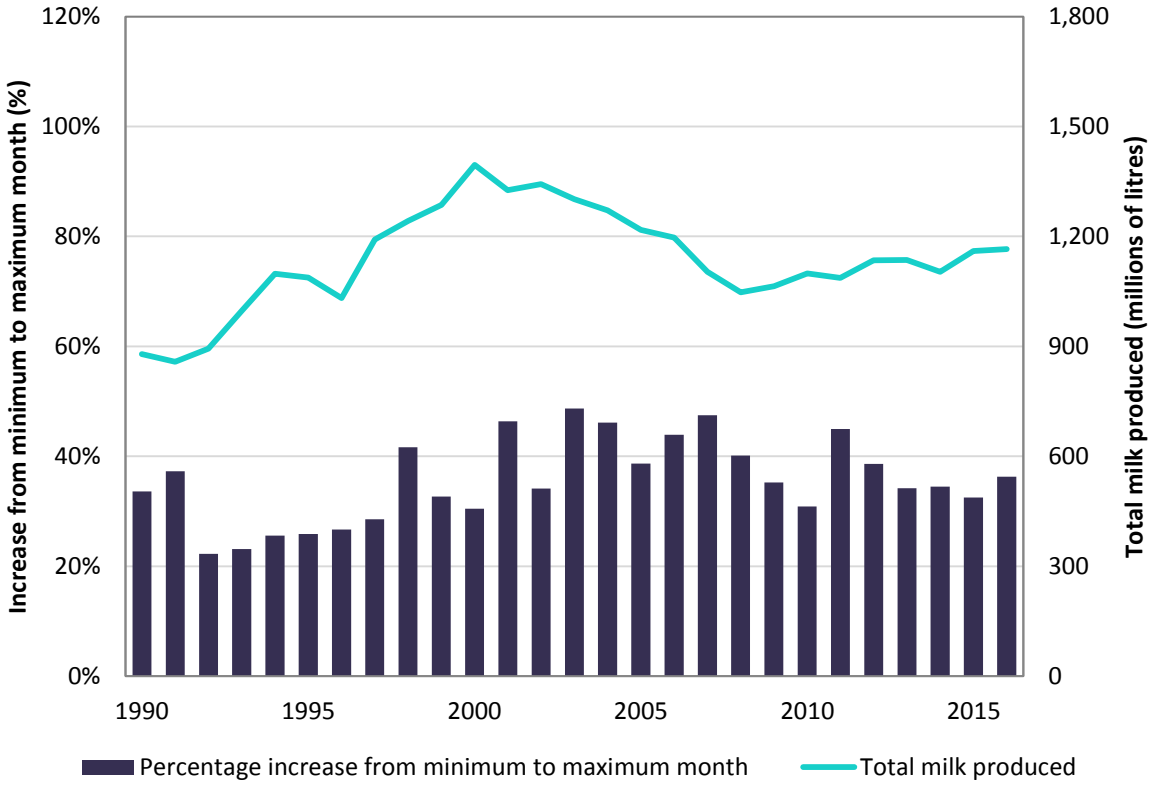
Source: Dairy Australia data, and ACCC analysis

Chart 22: Farm exits and farm gate price, Western Australia, real terms (2016 dollars)



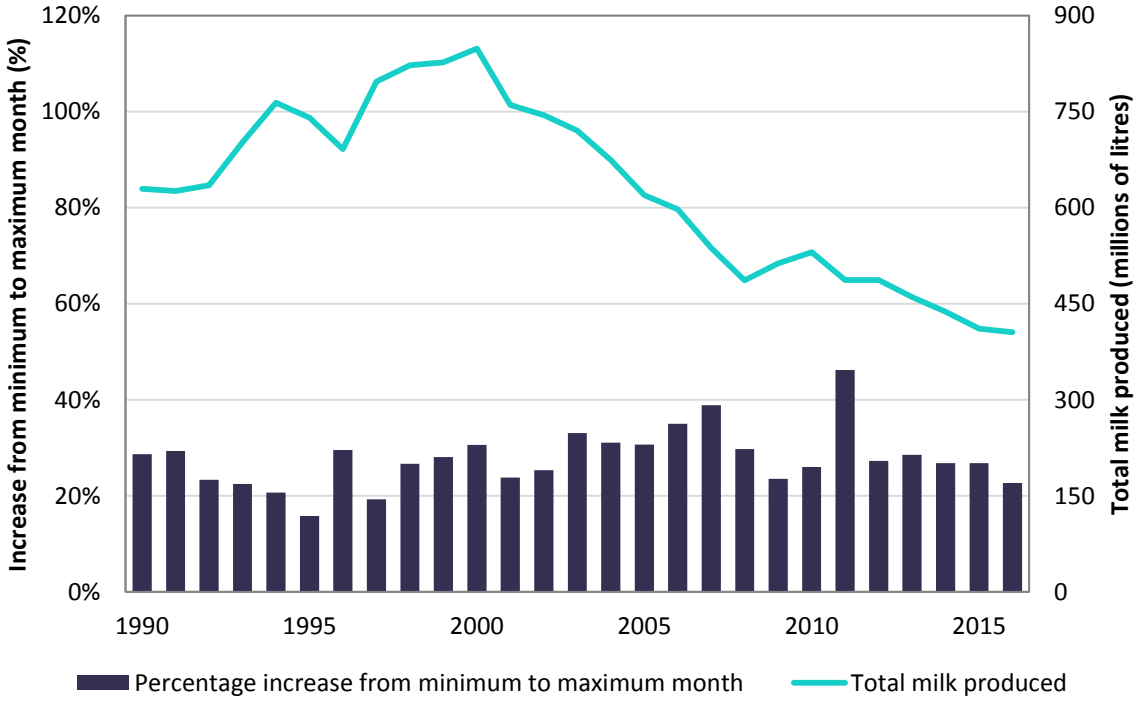
Source: Dairy Australia data, and ACCC analysis

Chart 23: Seasonality of milk production, New South Wales



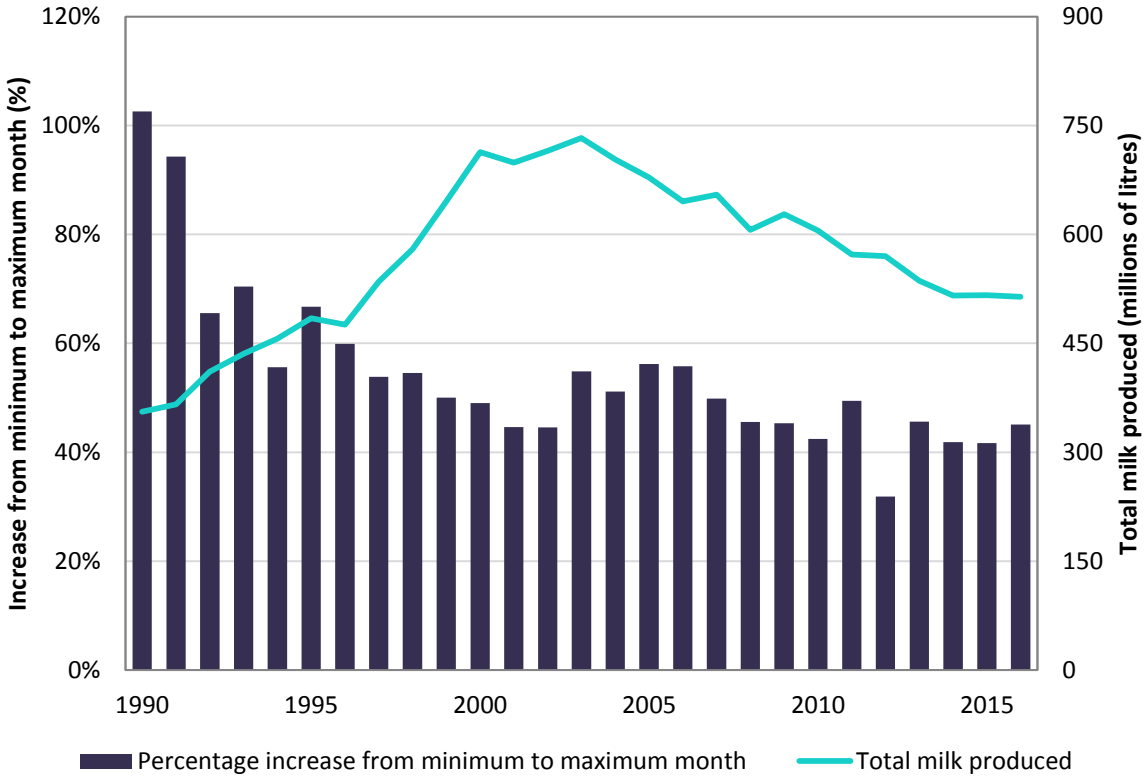
Source: Dairy Australia data, and ACCC analysis

Chart 24: Seasonality of milk production, Queensland



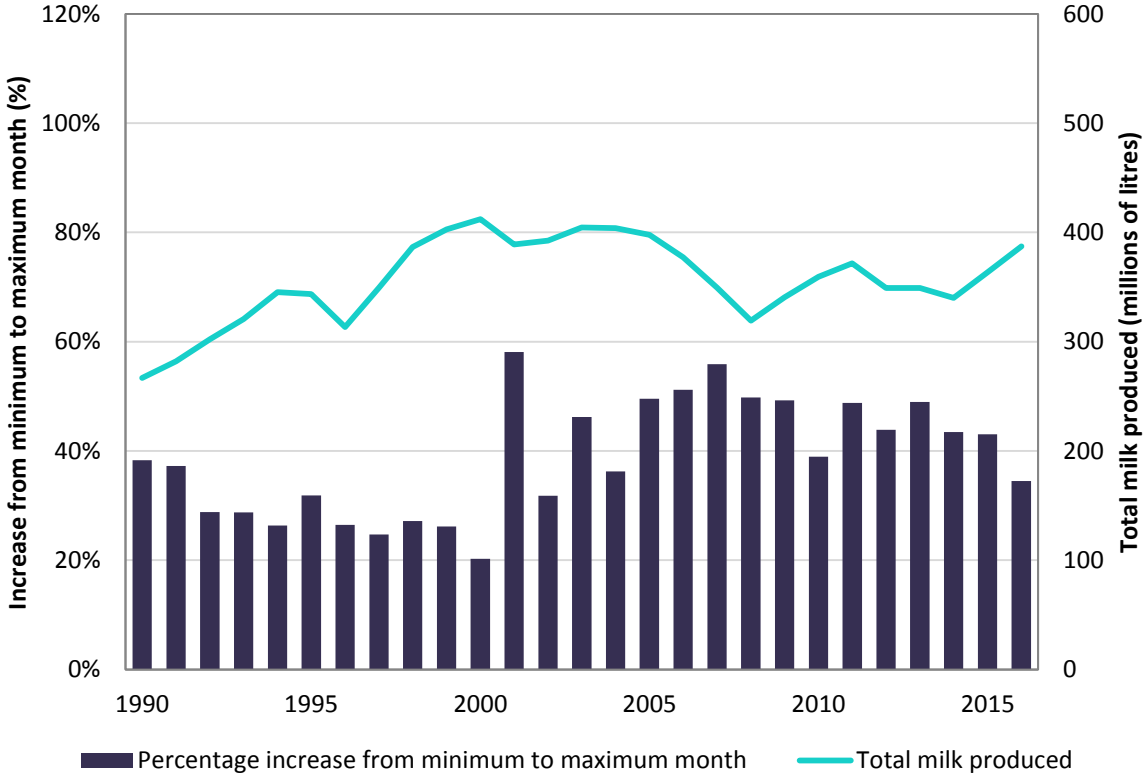
Source: Dairy Australia data, and ACCC analysis

Chart 25: Seasonality of milk production, South Australia



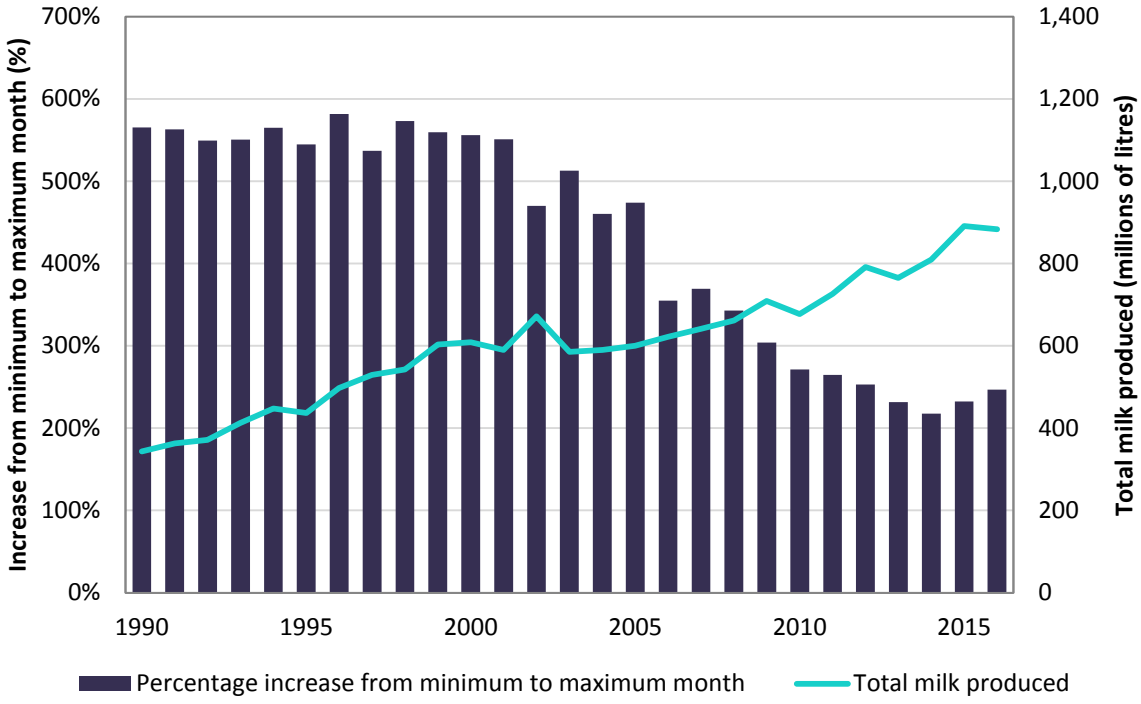
Source: Dairy Australia data, and ACCC analysis

Chart 26: Seasonality of milk production, Western Australia



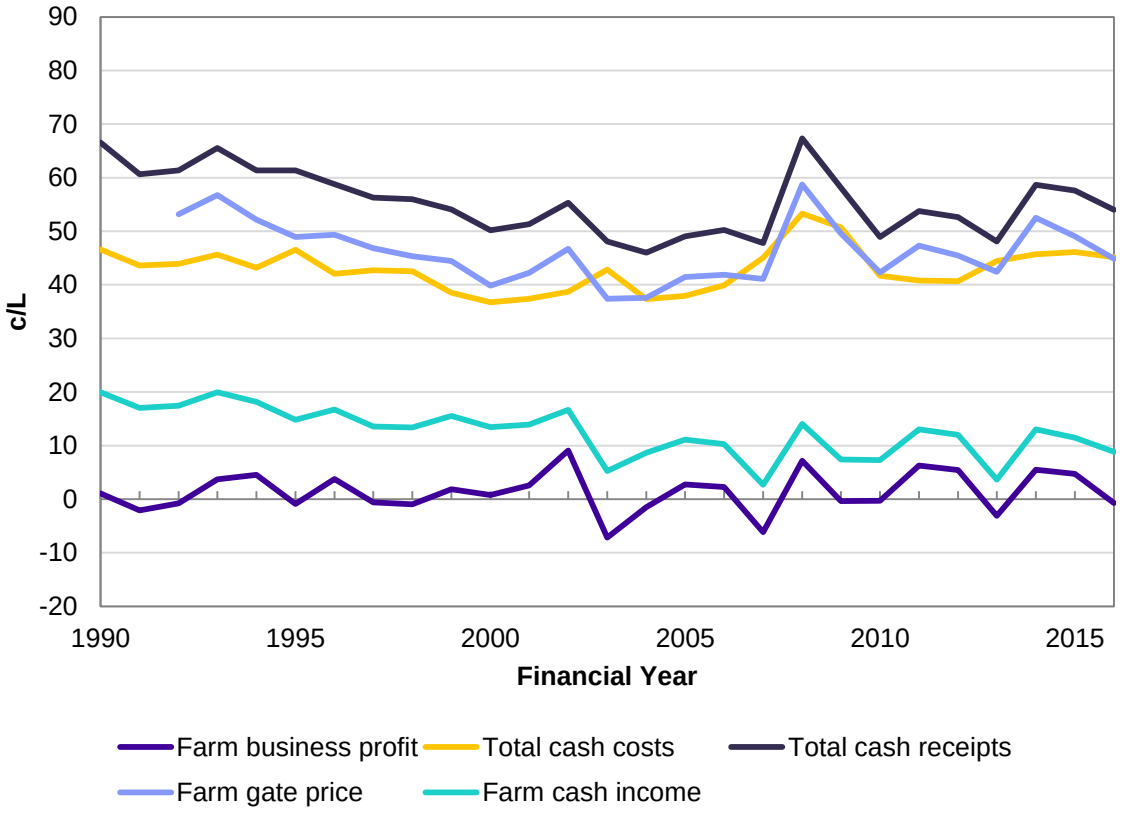
Source: Dairy Australia data, and ACCC analysis

Chart 27: Seasonality of milk production, Tasmania



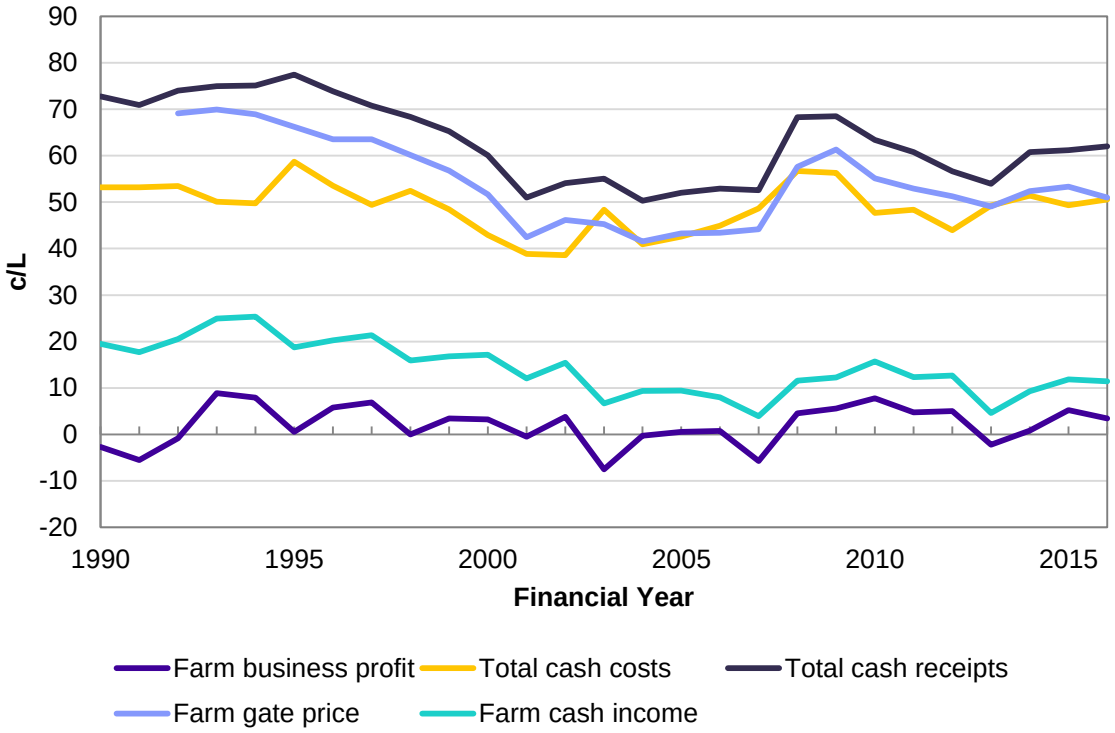
Source: Dairy Australia data, and ACCC analysis

Chart 28: Farm profitability, Australia, real terms (2017 dollars)



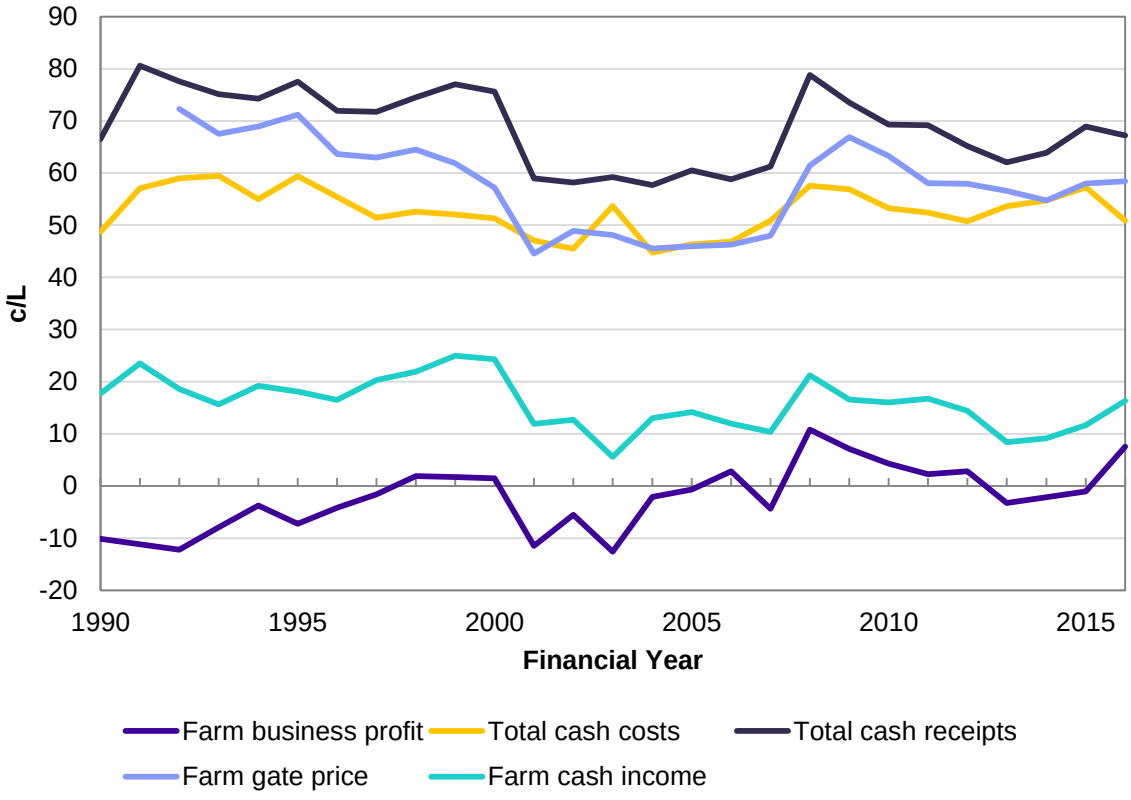
Source: ABARES data, Dairy Australia data, and ACCC analysis

Chart 29: Farm profitability, New South Wales, real terms (2017 dollars)



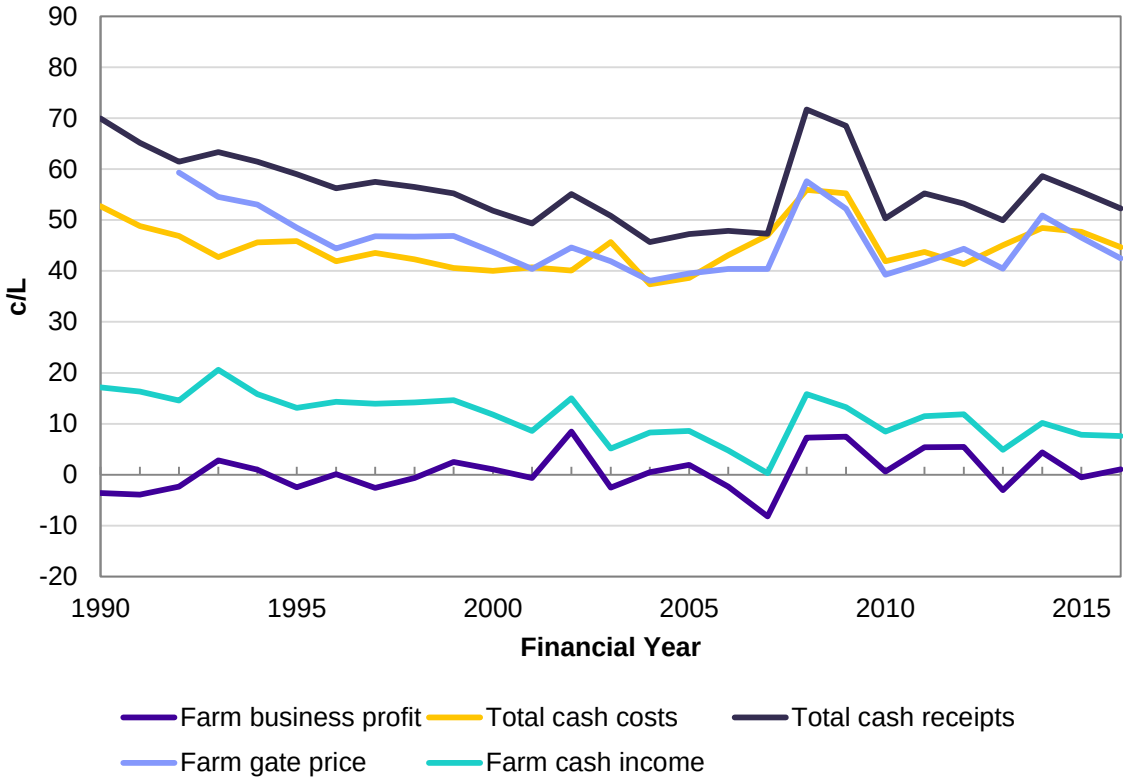
Source: ABARES data, Dairy Australia data, and ACCC analysis

Chart 30: Farm profitability, Queensland, real terms (2017 dollars)



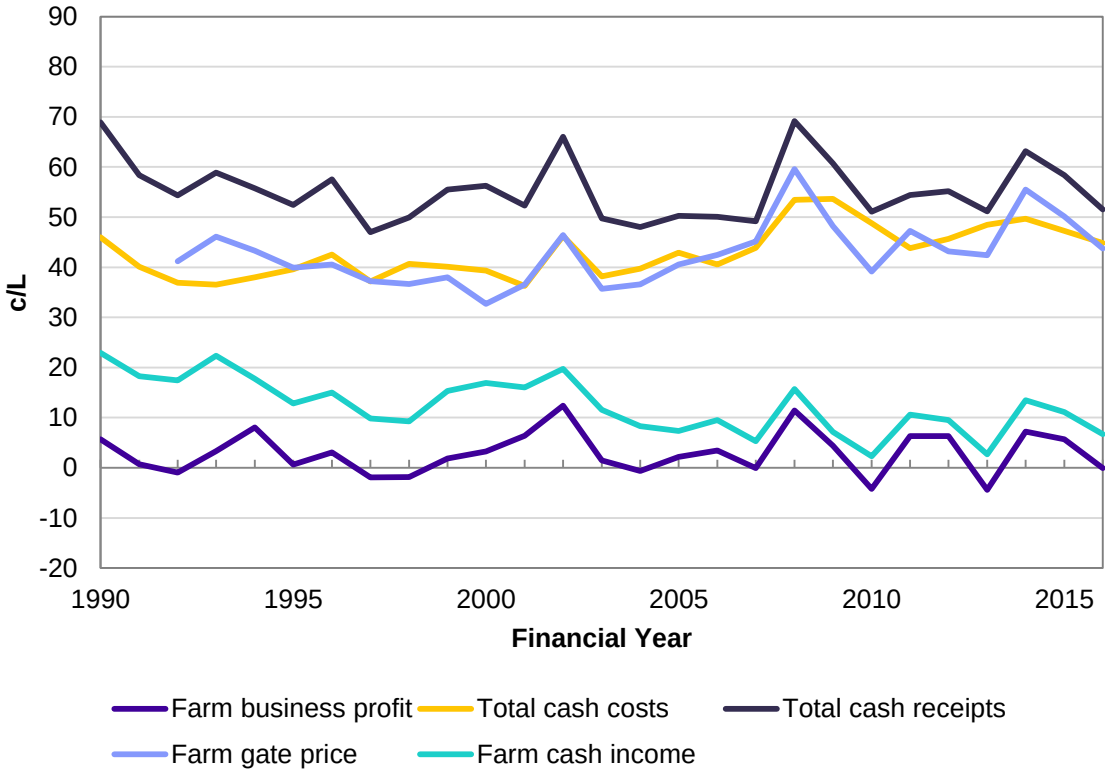
Source: ABARES data, Dairy Australia data, and ACCC analysis

Chart 31: Farm profitability, South Australia, real terms (2017 dollars)



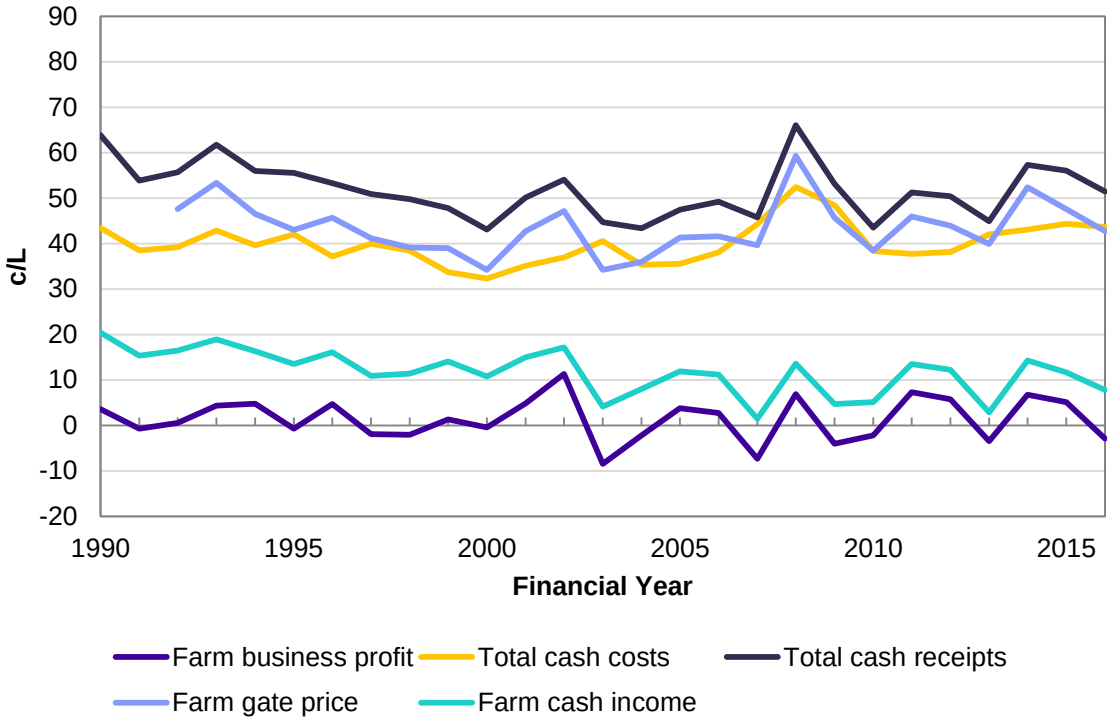
Source: ABARES data, Dairy Australia data, and ACCC analysis

Chart 32: Farm profitability, Tasmania, real terms (2017 dollars)



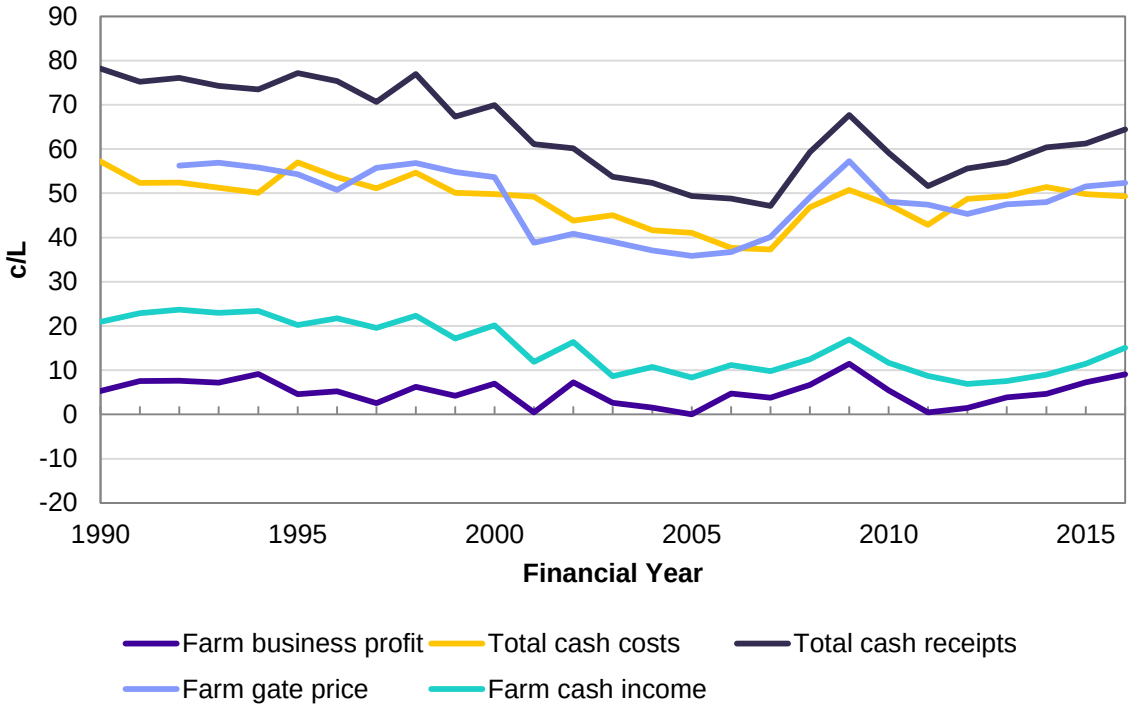
Source: ABARES data, Dairy Australia data, and ACCC analysis

Chart 33: Farm profitability, Victoria, real terms (2017 dollars)



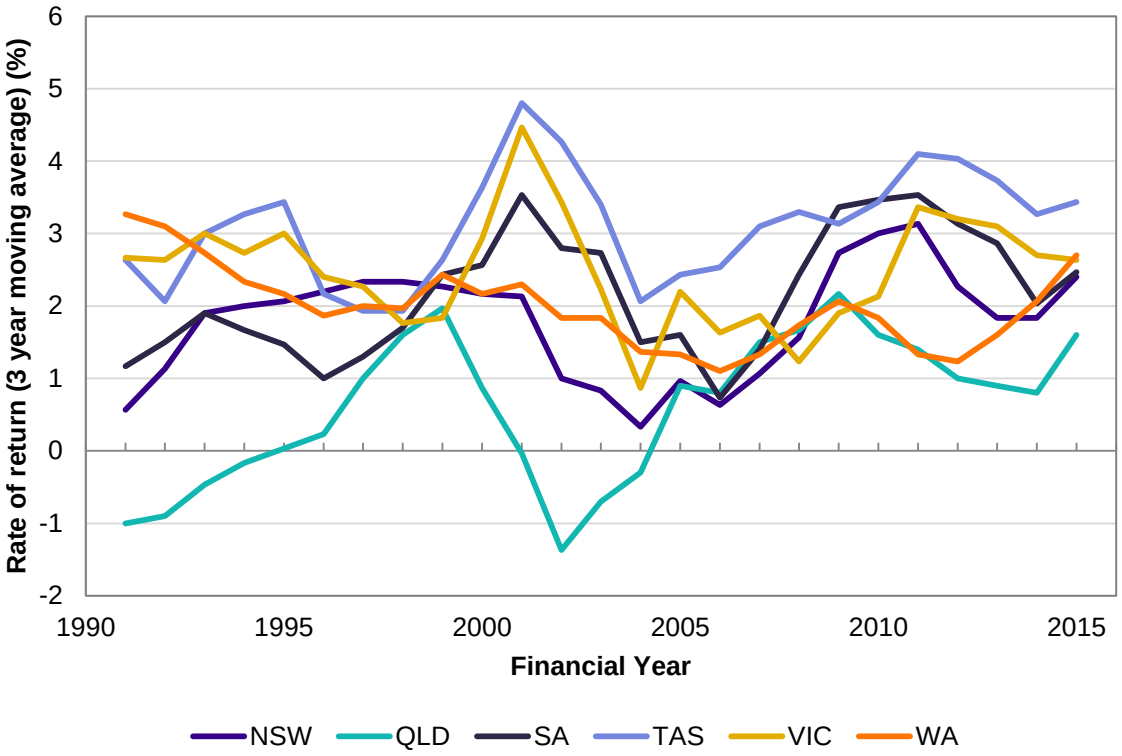
Source: ABARES data, Dairy Australia data, and ACCC analysis

Chart 34: Farm profitability, Western Australia, real terms (2017 dollars)



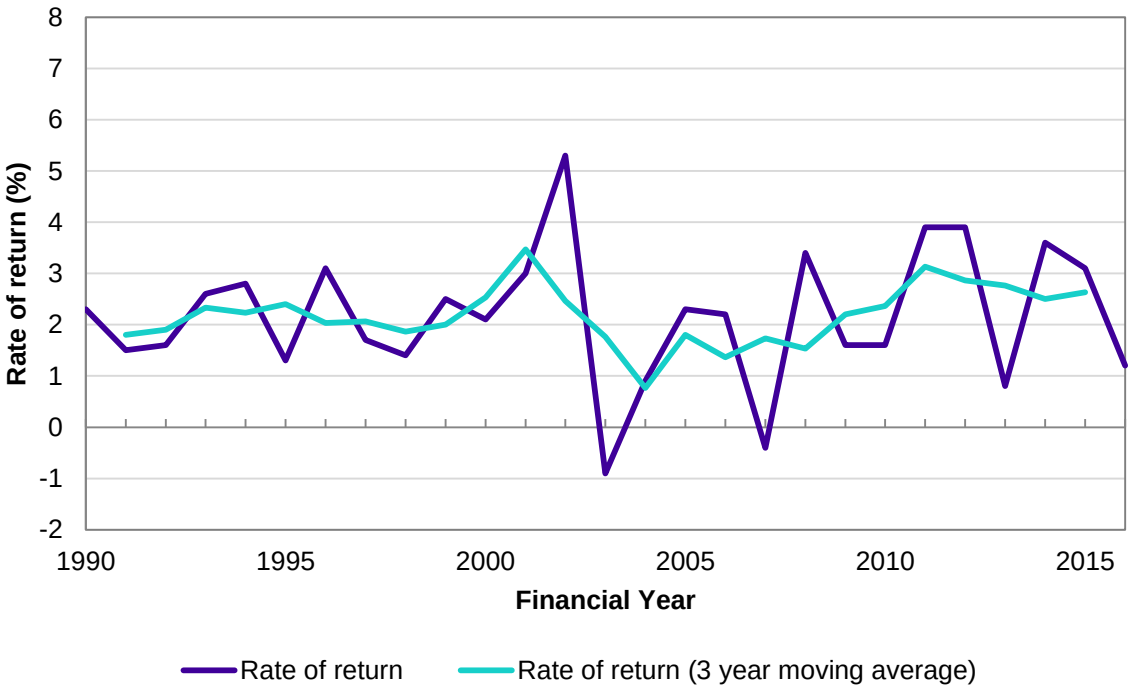
Source: ABARES data, Dairy Australia data, and ACCC analysis

Chart 35: Rate of return excluding capital appreciation, 3 year moving average



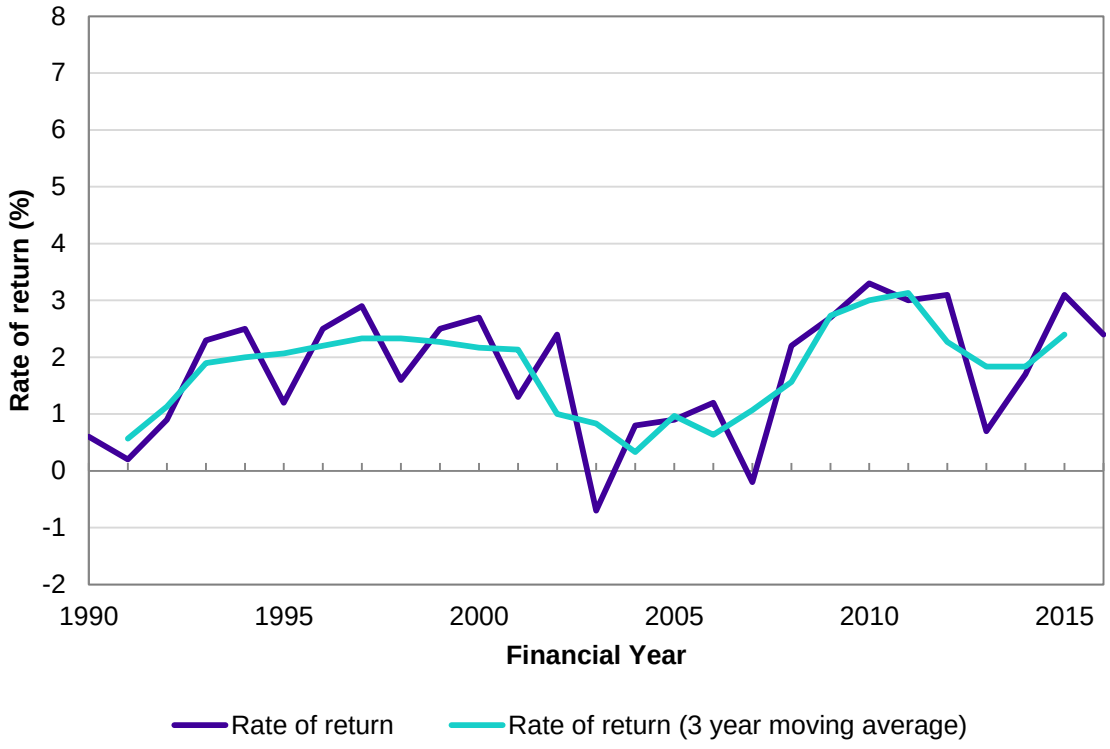
Source: ABARES data, and ACCC analysis

Chart 36: Rate of return excluding capital appreciation, Australia



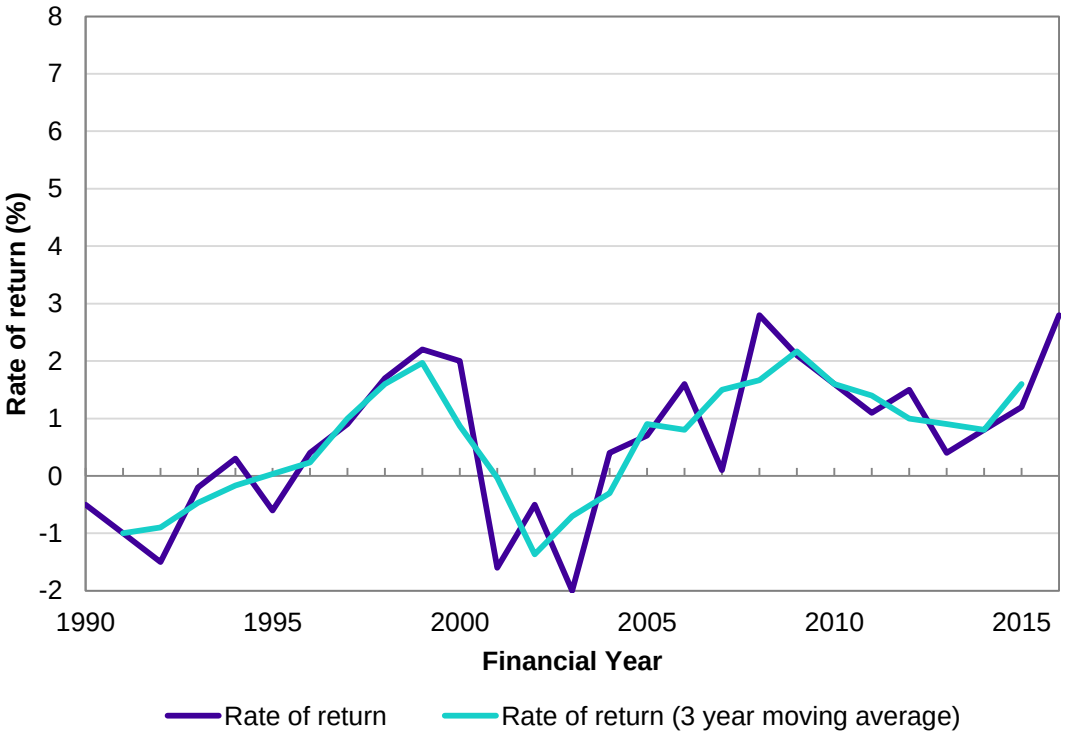
Source: ABARES data, and ACCC analysis

Chart 37: Rate of return excluding capital appreciation, New South Wales



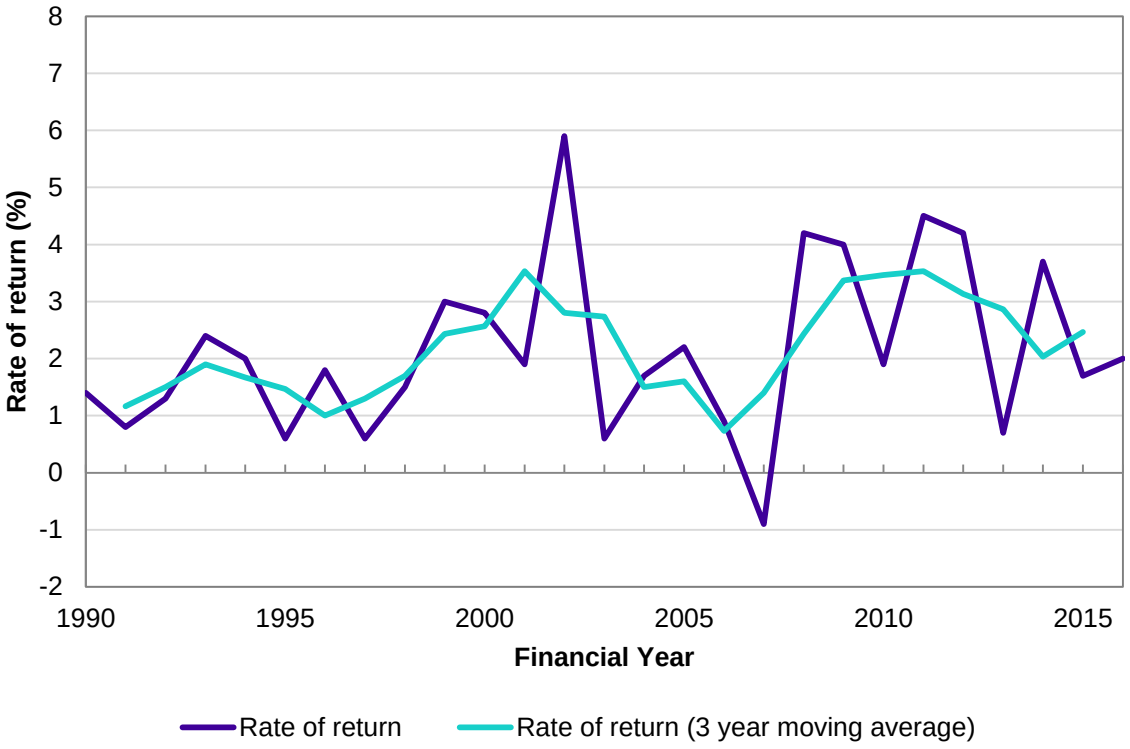
Source: ABARES data, and ACCC analysis

Chart 38: Rate of return excluding capital appreciation, Queensland



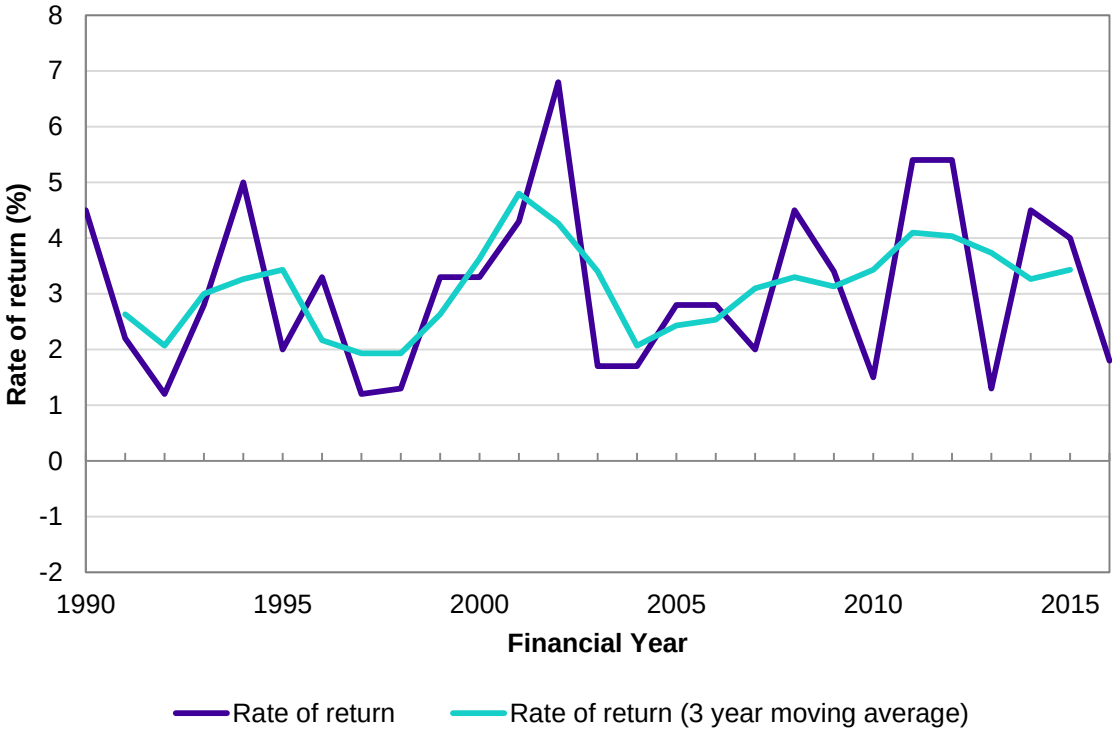
Source: ABARES data, and ACCC analysis

Chart 39: Rate of return excluding capital appreciation, South Australia



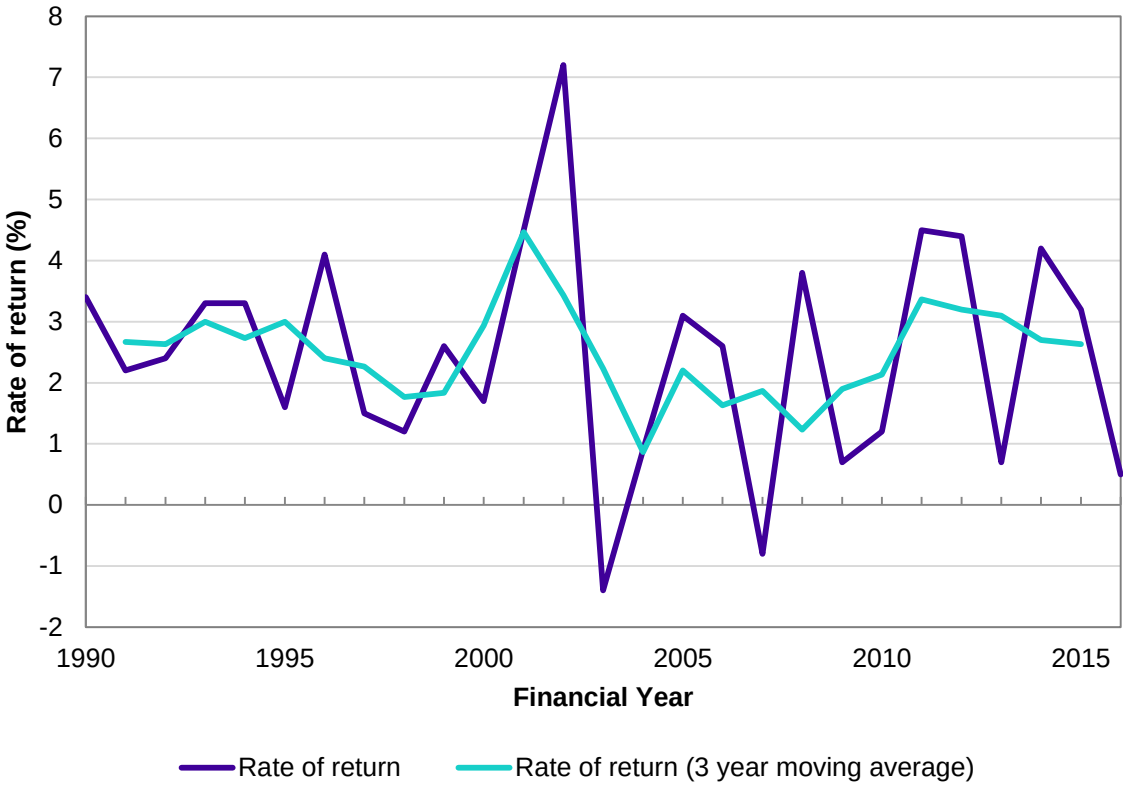
Source: ABARES data, and ACCC analysis

Chart 40: Rate of return excluding capital appreciation, Tasmania



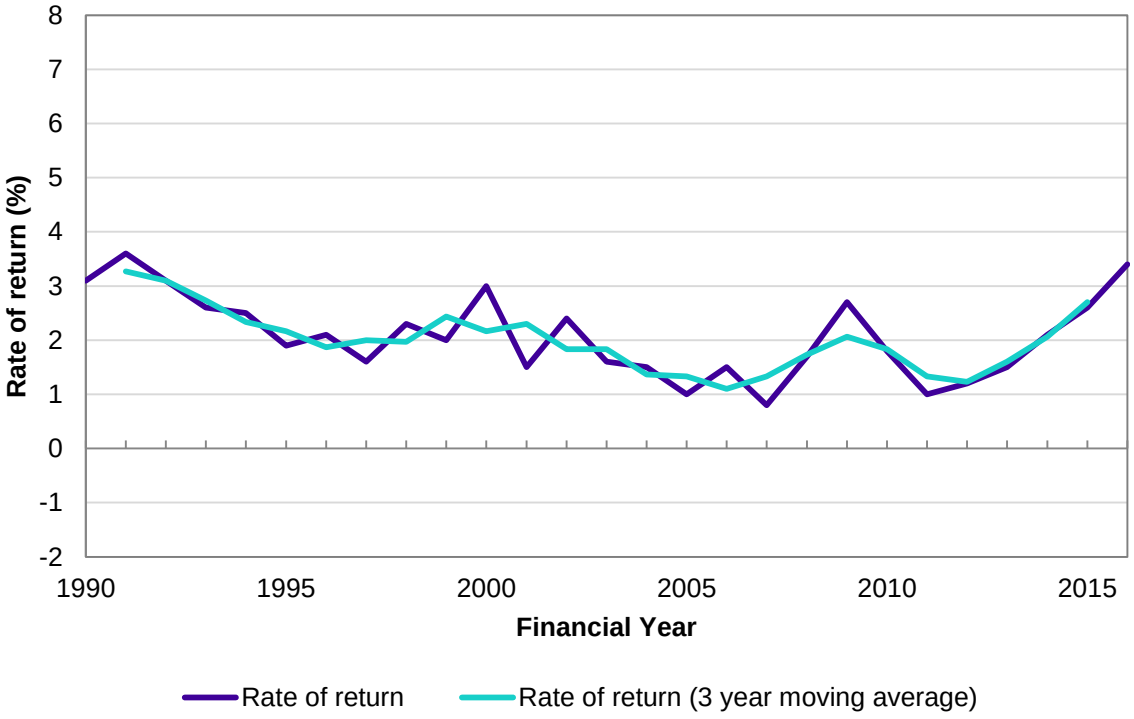
Source: ABARES data, and ACCC analysis

Chart 41: Rate of return excluding capital appreciation, Victoria



Source: ABARES data, and ACCC analysis

Chart 42: Rate of return excluding capital appreciation, Western Australia



Source: ABARES data, and 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.[300] DFMC's members account for approximately 50 per cent of Lion's milk pool in the regions it operates in.[301] 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.[302] Lion considers that the arrangement can provide time savings through the ability to negotiate consistent contracts for a group.[303]

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.[304] Members of DFMC have individual milk supply contracts with DFMC, and not with Lion.[305] 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 milk[306]
- 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 contracts[307]
- DFMC charge Lion the same price for milk that it pays to its members.[308]

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.[309] 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.[310] It is unlikely that DFMC's members would have voted to approve the sale without the milk supply agreement.

The agreement requires Lion to pay DFMC an 'aggregation fee' to cover the costs of aggregating the farmers milk.[311] The back-to-back pricing/milk policy**,** which is part of their milk supply agreement with Lion**,** is authorised by the ACCC.[312]

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[300] Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 2.

[301] Note: far north Queensland, south east Queensland, central NSW, northern Victoria and central SA.

[302] Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 32.

[303] Lion Dairy and Drinks, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 12.

[304] Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 2.

[305] Lion Dairy and Drinks, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 12.

[306] Ibid, 12-13.

[307] Ibid.

[308] Ibid.

[309] Note: 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, 2..

[310] Ibid.

[311] Ibid.

[312] Ibid, 2-3.

From DFMC's perspective, the key benefit that the agreement provides to DFMC members is the ability to negotiate and ensure a competitive farmgate milk price and other terms and conditions.[313] The agreement also requires Lion to negotiate with DFMC each year, and allows for an independent expert to determine disputes when they arise.[314] 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.[315]

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 for milk was strong. However, since that time changes in processor ownership and a surplus of milk supply in WA has reduced the incentive of processors to negotiate with CBGs.

The majority of farmers in WA currently operate on standard form contracts. The 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. This may leave the farmer with no alternative supply options. Farmers concerns have some basis, as a number of farmers in WA had their supply arrangements terminated by a processor in 2016.[316]

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.[317] It is authorised to collectively bargain by the ACCC 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.[318] Under the agreement, Parmalat agrees to purchase Premium's members' milk. The agreement governs the negotiations between Parmalat and Premium and includes a dispute resolution mechanism.[319] If a dispute cannot be resolved, an independent expert can determine the matter.[320]

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[313] Lion Dairy and Drinks, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 12.

[314] Dairy Farmers Milk Co-operative Limited, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 1.

[315] Ibid.

[316] Belinda Varischetti, *WA dairy farmers reeling after processors Brownes confirms it will not be renewing four farmer contracts,* ABC Rural, 19 May 2016, accessed 11/9/2017, http://www.abc.net.au/news/rural/2016-05-19/wa-dairy-processor-brownes-terminates-milk-contracts/7429998.

[317] Note: 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.

[318] Australian Competition and Consumer Commission, *Premium Milk Ltd - Revocation and Substitution - A91236,* 22 June 2010, 1.

[319] Ibid, 2.

[320] Ibid.

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.[321] It initially had 360 members, which represented a substantial volume of available Queensland milk.[322]

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) considered 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.[323] The MMC meets as required, at least one month before the commencement of a new supply year, and negotiates supply volumes, delivery requirements, quality standards and prices.[324]

As discussed in *Chapter 7*, Premium and Parmalat sought the assistance of an independent expert to resolve a price dispute for the 2017 season.[325] The ACCC understands this was the first time Parmalat and Premium were unable to negotiate a price.[326]

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.[327] Manning Valley has seven farmer members located in NSW.[328]

Following the introduction of $1per 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, quality milk in Woolworths' stores.[329] Negotiations resulted in Woolworths establishing the "Farmers Own" brand, the milk for which is now supplied by farmers in Queensland, Victoria, WA and SA.[330] The suppliers in SA are also a CBG.[331]

Manning Valley lodged a notification to collectively negotiate with Woolworths and separately with Milk2Market.[332] Milk2Market is a milk supply management business that assists Woolworths with the logistics of acquiring raw milk.[333]

Negotiations with Woolworths took two years to complete.[334] The parties established a three year rolling agreement, which is renewed every three years subject to any concerns. The latest agreement commenced in 2016.[335]

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[321] Australian Competition and Consumer Commission, *Premium Milk Supply Pty Ltd - Authorisation - A90745*, 12 December 2001, 1..

[322] Note: However, membership was offered to 580 farmers; Ibid..

[323] Port Curtis Milk Suppliers Co-operative Association Limited, *Submission to the ACCC Inquiry into the Australian Dairy Industry*, 12 December 2016, 5.

[324] Australian Competition and Consumer Commission, *Premium Milk Ltd - Revocation and Substitution - A91236,* 22 June 2010.

[325] 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.

[326] Ibid.

[327] Australian Dairy Farmers, *Collective Bargaining for Dairy Farmers*, July 2014, 10.

[328] Ibid.

[329] Ibid.

[330] Woolworths, *Our Background,* accessed 4/8/2017, https://www.woolworths.com.au/shop/discover/our-brands/farmers-own-milk.

[331] Australian Competition and Consumer Commission, *NSW MidCoast & SA Barossa Mid North Co-operative Dairymen Limited Collective Bargaining Groups - Collective Bargaining Notification - CB00287,* 3 Februrary 2015.

[332] Australian Dairy Farmers, *Collective Bargaining for Dairy Farmers*, July 2014, 10.

[333] Ibid.

[334] Ibid.

Manning Valley engaged a competition lawyer to assist with the negotiation process, which the group believes was an invaluable investment. Although the cost of the lawyer was $60 000, 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 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.

The arrangement between Woolworths and Manning Valley creates mutual benefits for both parties. The farmers have secured favourable contract terms and a favourable price for their milk, while Woolworths have available a differentiated, local product with a provenance story that appeals to consumers.

[335] Australian Competition and Consumer Commission, *Manning Valley Dairy Farmers - Collective Bargaining Notifications - CB00326 & CB0032,* 16 March 2016.