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31 January 2018

Mr Rod Simms
Chairman
Australian Competition and Consumer Commission
GPO Box 3131
CANBERRA ACT 2601

By email: dairyinquiry@accc.gov.au

Dear Mr Simms,

Re: Australian Competition and Consumer Commission's Interim Report into the Dairy Industry

By way of background, Dairy Connect is an industry body representing the value chains of the Australian dairy industry, including but not limited to dairy farmers, processors, vendors and other industry stakeholders. We also work cooperatively and collaboratively with other agricultural and dairy bodies to ensure that the best outcome is obtained for the dairy industry in Australia.

For the sake of clarity, this response has been broken down into the eight points noted under 'Interim recommendations' in the Australian Competition and Consumer Commission (ACCC) Interim Report released for public comment in November 2017.

Recommendation 1 & 2 - Milk supply contracts should be both easy to comprehend and condensed into a single document, enabling farmers to fully understand the terms of the agreement which they are signing.

Dairy Connect agrees that the first step in creating fair contracting practices is ensuring that all parties are made fully aware of the terms stipulated in such agreements.

The ACCC finding at page 169 of the ACCC Interim Report stating that Milk Supply Agreements are often extensive, difficult to understand and spread over many documents, is in line with the experiences of our producer members. Their response has been very positive toward creating a simplified, compiled document which clearly states the key terms of a contract, such as supply, timings, delivery method, milk quality testing, etc.

It is submitted that this would create contracts that are easy to understand and can be easily referred to by both parties in the event of dispute. The current system utilising multiple documents including Supplier Handbooks and Milk Supply Agreements causes confusion, particularly when it comes to calculating / forecasting receivable farmgate milk prices.

Dairy Connect also supports the need for a confirmation signature, thus indicating agreement, from both parties in the event that changes to any documents relating to milk supply should be made, prior to any changes coming into effect. This means that any documented modifications to the expected practices involved in milk supply will be made known to farmers, to ensure they are in agreement with the proposed changes, which can then be implemented.

Given the inequity in the power relationships between the parties and the high cost to obtain independent legal advice on such contracts, it is suggested that a program be implemented to allow producers to obtain such advice from their industry bodies or an independent single body established by, or funded by, the Government.

For your assistance, Dairy Connect has previously raised the issue of 'milk labelling' and the 'quality of milk testing' with the Senate and a copy of that letter is attached. We would request that you consider its contents for your final report.

Recommendation 3 - Contracts should not restrict farmers from switching processors

The Interim Report acknowledges that the bargaining power processors have over farmers is related to problems that arise with milk supply contracts, in particular those that shift the risk of milk supply onto farmers and impose clauses which act as barriers for farmers to switch between processors (pages 21-24)*. Dairy Connect supports these findings and agrees that supply clauses which restrict the ability of farmers to transact with third parties via exclusivity measures should be removed from milk supply contracts**. It is our opinion that these changes should be immediately implemented via the revised changes to the voluntary code of conduct and through an introduced mandatory code for milk supply contract negotiations as recommended by the ACCC (See Recommendations 7&8).

Should this recommendation be followed and a non-exclusive supply model be implemented, there would be issues such as farmer notification times, logistics management and risk distribution that would all need to be recognised and implemented through a better regimented code of conduct. Dairy Connect recognises the magnitude of this task however feels that ridding the industry of supply exclusivity issues would be a great step toward long-term milk supply

resolutions.

Attached to the submission is a 'dual supply model' that has been endorsed by the Farmers Group of Dairy Connect and which provides a mechanism for consideration by the ACCC as a way forward.

**Dairy Connect would like to query however, that on page 112 of the interim report the ACCC noted that "past or existing clauses are unlikely to have substantially lessened competition among processors". It is our opinion that this view may leave the door open for processors to be able to circumvent ACCC recommendations by leaving the potential for explicit exclusive supply clauses to remain in supply agreements. Most farmers lack the bargaining power to negotiate non-exclusive supply agreements with processors, and should the final report not recognise this there is a threat that the industry may remain as 'status quo'. Farmers would still bear all the risk of processor decisions, would have no bargaining power to gain access to price risk management tools, and would not be able to generate competition for their milk for the majority of the year.*

***Further, as per page 112 of the Interim Report, it is stated that many processors submitted that exclusivity clauses provide benefit to farmers, including certainty that milk will be collected, be properly tested for quality assurance, and that collection and sampling processes are performed efficiently. We would submit that the above benefits can be delivered through other mechanisms, and that they don't need to be tied to the sale of the milk. For example, in theory a farmer could have a logistics provider that ensures pick up/ sampling / testing, but with that milk still being able to be sold to a number of buyers.*

Recommendation 4 - Independent body(ies) should be able to mediate contractual disputes

The role for an independent body to act as a mediator and a binding arbitrator in relation to farmer-processor contractual disputes is a further positive initiative proposed in the Interim report and is supported by Dairy Connect. At bare minimum, Dairy Connect would agree that detailed dispute resolution clauses should be included as part of all contracts as highlighted under Recommendation 4.

In regards to feedback as to the most appropriate body to establish a dispute resolution framework, Dairy Connect would be pleased to be involved in further discussions to find an appropriate model. For instance, we could consider the current method of dispute resolution in the horticultural code of conduct, linked here (https://www.accc.gov.au/business/industry-codes/horticulture-code-of-conduct/dispute-resolution-under-the-horticulture-code).

It is our understanding of the Horticultural Code that the establishment of 'Horticultural Mediation Advisors' has been a useful, independent party to intervene in dispute resolutions should the initial dispute resolution process fail to settle the issue. By establishing an external independent body fair negotiations of price and quality can be ensured, and this would pose an alternative of lesser financial cost to producers as opposed to taking legal action.

Recommendation 5 - Farmers should fully consider the implication of contracts with processors

Dairy Connect firmly supports the statement made in the Interim Report that farmers should fully consider the contracts that they enter into.

In continuation from Recommendation 3, it is vitally important that unfair bargaining power cannot be leveraged during discussions between farmers and other parties; thus ensuring open and transparent negotiations of each contractual agreement. In addition, the adoption of Recommendations 1 and 2 would mean that simpler, 'plain english', compiled agreements are established to enable the thorough consideration of supply agreements by farmers.

Given the Interim Report's findings that farmers do not, in general, seek professional legal advice in making contract decisions, independent industry organisations are in a positive position to act as a general advice body to these producers. This would signify, for instance, Dairy Connect adding an additional branch to our current member services, and similarly to the services offered by our fellow industry bodies. Given the importance of this recommendation there would be merit to allocating additional industry or government funding to help facilitate this process.

Recommendation 6 - Processors should better publish pricing information

Dairy Connect is in strong agreement with the need for greater transparency in the ways in which processors determine farmgate milk prices. This has been a recurring issue raised by members and dairy farmers with our Farmers' Group, with many highlighting the processing and calculations required to determine even a singular price estimate takes too much time and effort. This no doubt results in many producers bypassing or 'skimming' over such important functions to determine the profitability of their farming enterprise.

A further issue with the current methods of pricing is that the contract pricing terms are presented very differently between the various processors. This means that comparison between processors is difficult for farmers, and can be viewed as a hindrance to basic market transparency and hence anti-competitive.

The bare minimum revision to the way in which processors present their milk pricing terms should be to create an industry-standard format, to at least provide farmers the ability to compare and evaluate their offers with a sense of clarity. "We need to be able to compare apples with apples" one Dairy Connect member has commented.

The Interim Report's idea of the use of an interactive online price modelling system is an interesting one and Dairy Connect encourages the viability of such a system to be explored further. A few comments regarding this proposal would be the need to make sure the site is as user-friendly and easy to navigate as possible, as well as the importance of strenuous road-testing of the pricing models to make sure they will not be giving producers misguided forecasts.

Recommendation 7 & 8 - The Voluntary Code should be strengthened, whilst a mandatory code be seriously considered.

Dairy Connect and our members agree that it is absolutely necessary for the voluntary code to be strengthened. After its release in 2017, Dairy Connect had concerns regarding its structure, and as we said upon its release, time will tell whether or not a voluntary code is sufficient to address the core industry issues.

Almost a year on and it is our opinion, as well as the findings of the Interim Report, that the voluntary code as it stands is not sufficient. The two proposed additional obligations and one 'other change' are agreed with by Dairy Connect, as we have highlighted earlier through our responses to Recommendations 1, 3, 4 and 6.

It is our hope that by making these positive amendments processors may be more willing to adopt the voluntary code, but it is our concern that without a form of market or consumer pressure, the voluntary code by nature will continue to allow processors to bypass its recommendations and continue to hold the unfair and unconscionable negotiating power.

In which case, intervention in the form of a proposed mandatory code of conduct for the dairy industry would be supported by Dairy Connect. It is our belief that the return to a form of 'regulated dairy industry' may be one mechanism to provide a sustainable way forward, should there not be appropriate response by processors (and retailers) to the voluntary code of conduct. A mandatory code of conduct, as highlighted by the Interim Report on page 26, could permanently remove the negative contracting practices which currently result in terms that impede competition and distribute greater levels of risk to farmers.

In the event that a mandatory code be considered as the correct direction in the long term for the dairy industry, Dairy Connect would urge the importance of collaboration in establishing such a code. We would be willing to be involved in any industry wide

discussion of the contents of a mandatory Code for the dairy industry.

Concluding Remarks

Might we also indicate our support for the development of a commodity milk price index (Index), which had begun its development but was then terminated by mutual consent between the parties. Might we strongly indicate that mechanisms that may assist the producer make informed decisions regarding farm gate price should be encouraged by industry and the Government. The concept of the Index was firstly raised by the then Minister for Agriculture, the Hon Barnaby Joyce MP and then subsequently endorsed for development by the Office of the recently commissioned Minister for Agriculture, the Hon David Littleproud MP. We are indicating our continued willingness to participate in the development of the Index.

In conclusion, the dairy industry has been under sustained pressure over the past years and it is evident that systemic and fundamental change is required to ensure the continued viability and sustainability of the dairy industry into the future. It is submitted that the dairy industry may be seen to be at 'crossroads' with a 'once in a generation' opportunity for positive collective change to occur.

Over the years there have been many reviews into the dairy industry but the comprehensive review by the ACCC and its interim recommendations, which we state should become part of its final Report, are a mechanism to provide guidance and direction for the industry as a whole and for industry bodies to embrace and support their implementation.

Failure to do so may result in the decline of the dairy industry's importance to the economic vitality within Australia and elsewhere throughout the world where Australian dairy produce provides sustenance to growing nations.

Dairy Connect compliments the ACCC on its Interim Report and Recommendations. Dairy Connect is willing to augment its comments, if required.

Yours Faithfully,

Shaughn Morgan
Chief Executive Officer

Attachments:
- 'Dairy Directions' Paper
- Milk labelling letter, dated 3 February 2017

3 February 2017

Mr Mark Fitt
Committee Secretary
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Mr Fitt,

RE: SENATE INQUIRY INTO THE AUSTRALIAN DAIRY INDUSTRY

I am writing this further correspondence to you regarding Dairy Connect's initial submission to the Senate Inquiry into the Australian Dairy Industry (the 'Committee'). In addendum to our initial submission, I wish to raise two additional topics.

The first point that I would encourage to be included for consideration by the Members of the Committee is that of milk labelling, or more specifically the definition of 'milk' and how it may be not clear to the consumer of dairy products, particularly with the expansion of plant-based 'milk-alternative' brands.

It is apparent that there has been a rapid growth of health-based functional products, with one of the most prominent items being the various forms of alternative 'milks' (such as those made from extracts of, for example, soy, almond, rice and coconut). We submit that these products have positioned themselves as competitors against traditional dairy products, despite having, we believe, lower nutritional values. We feel this has been done in a way that may be misleading to consumers. Hence, this is a matter of education of the community and the consumer who wishes to purchase dairy products as defined by the Federal agencies.

The Australia New Zealand Food Standards Code (the 'Code'), at Section 2.5.1, defines milk as "the mammary secretion of milking animals, obtained from one or more milking's for consumption as liquid milk or for further processing". In addition, the Code also specifically states in Section 2.5.1-3 that "a food sold as 'milk' must be milk".

Dairy Connect believes that this may be a highly important standpoint for the Australian dairy industry to adopt in order to remain competitive in the changing domestic marketplace. Further, this may also be an opportunity for the Federal Government to provide the consumer with information regarding the products that they purchase and to also ensure that the term 'milk' is sold as the definition provides. However, this is a matter for open

discussion with the consumer and the industry generally. Dairy Connect looks forward to that public and industry discussion. Indeed, we encourage it to occur.

Secondly, the events of the past year have led to a significant proportion of NSW dairy farmers having to change or modify their processors. Some of our members have advised Dairy Connect that they have changed their choice of processor for the first time during the operation of their farming enterprise.

During this transition, a recurring issue has been the need to adapt to variances in:

- protocols for sampling;
- volume measurement;
- testing results; and
- quality reporting procedures.

This is particularly so with the practices and reporting structure that may be different from one processor to the next. This has created undue and ongoing uncertainty amongst dairy producers. We understand that there have been a number of reported incidences of processor compensation to farmers who have received wide variances in volume calibration as milk is measured into new tankers.

Furthermore, the reports of quality testing are typically owned by the processors and are not made directly available to the farmers. We would submit that this should be changed and the producers provided with such information.

We feel that this confusion and lack of transparency in farmer/processor relations regarding milk quality and volume measurement may be detrimental to the ability of Australian dairy to remain a premium producer in the world market.

Dairy Connect would like to put forward the recommendation that the use of a nationally standardised system for the measuring and reporting of Australian milk, as an additional component of our previously mentioned voluntary code of conduct.

May I express the appreciation of Dairy Connect for the opportunity to put forward these points to the Members of the Committee.

Yours faithfully,

Shaughn Morgan
Chief Executive Officer

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Milk Choices

A new model for Australian milk pricing

Contact: milkchoices@outlook.com

1 Introduction

In the wake of the dairy crisis, a different approach to buying and selling milk at the farmgate is worth considering.

The decisions made by just a handful of people shattered the livelihoods of many farming families and trust along with it.

The time is right for change, too. The show of support from ordinary Australians during the crisis has won the attention of the regulators and politicians. All are looking to our industry for solutions.

It's not easy to find sensible ideas that will work in the real world. Few people outside the dairy industry understand its quirks. At the same time, while Australian dairy farmers are known for being innovative, few of us have the time or knowledge of the processing sector to flesh something like this out.

With all this in mind, a handful of farmers came together to build a concept that we could hand over to the broader industry to consider, refine and make its own. We invited a few trusted industry people with specialist expertise to join the group, too. We wanted whatever we proposed to be something worthwhile, something that would stand up to scrutiny and that could really work for the entire supply chain.

We ended up with a group of about 10 volunteers. None of them was paid a cent, none work for processors and none are in a position to make their fortunes with the implementation of the concept outlined in this paper.

All are simply sick and tired of seeing our industry in crisis and want to see it move forward.

But who *are* we, you ask? We decided to remain largely anonymous because:

- This is not <u>our</u> idea. It's yours to use. We hope you'll look at the concept and judge it purely on its merits.
- All of us have our own livelihoods on the line. Change isn't always popular. We're frankly not keen on being burnt at the stake or refused collection by a processor.
- The industry will need to take ownership of this idea. If you're unhappy with the status quo, it's time to demand something different.

Of course, no concept – and this is purely a concept for industry development rather than a commercial offering – could ever be the entire solution or suit everybody. But whatever your own circumstances, it's worth looking at more closely. Why? Because farmers should have the right to choose.

Milk Choices explores the possibilities, starting with one simple thought: what if dairy farmers could sell our milk to more than one customer, just like any other business does?

2 Rationale

To return Australia's dairy industry to stability and growth, the value of milk must be maximised at all times by:

- Flowing to the highest stream return (i.e. revenue return)
- Reaching the most efficient processors
- Accounting for risk and reward all the way along the supply chain
- Correctly pricing the cost of capacity at different times, including off peak

These outcomes are not delivered, however, because a lack of continuous competition in the milk market means the industry fails to optimise milk supply and capacity.

The current farm-gate milk marketing and pricing structure forces each farm to deliver all its milk to a single processor. This limits the free transfer of milk between buyers and sellers throughout the season.

The solution is to allow farmers to accept bids for their milk from a variety of buyers rather than leaving that marketing decision in the hands of a single processor.

The proposals outlined here are more relevant to the export-focussed markets, where issues such as risk management, price transparency and volatile stream returns are more typically found than in domestically-focused markets.

The Milk Choices concept is not designed to replace current arrangements but to provide an alternative that farmers can opt into if it suits their businesses.

3 How the proposed system works

There are two core contractual structures in the proposed system:

3.1 Foundation Processor Agreement

A farmer signs an agreement with one Foundation Processor.

The Foundation Processor is responsible for collection, quality testing and delivery of all milk from the specified farm to one of its factories, based on an agreed table of fees and charges.

The Foundation Processor is also the buyer of any Standard Milk Price volumes produced by the farmer. Standard Milk Price volumes are those collected by the Foundation Processor from the farmer in excess of any Fixed Volume Contracts for that farmer, as outlined below. This means the Standard Milk Price remains a floating volume, floating price milk marketing mechanism, as it is today.

3.2 Fixed Volume Contracts

The farmer has the right to sell milk under Fixed Volume Contracts to both the Foundation Processor and other buyers.

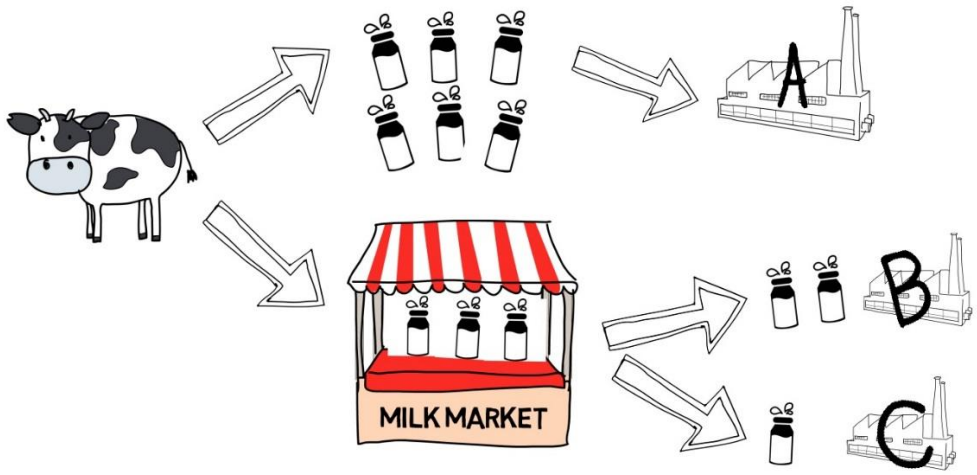
Under these Fixed Volume contracts, the Foundation Processor is obliged to deliver milk to other buyers whenever the farmer contracts with them (earning a fee in the process).

The farmer is only able to commit a certain percentage of forecast volumes per month to Fixed Volume Contracts to manage production risk (i.e. not having enough milk to cover their Fixed Volume Contract obligations). Deliveries made by the farmer to their Foundation Processor in excess of Fixed Volume Contracts are the Standard Milk Price volumes outlined above.

3.3 Practical example

At the start of the season, Farmer Brown enters a Foundation Processor Agreement with Processor A. She later decides to spread her risk by putting 50,000kgs of milk solids on the open market.

Under Fixed Volume Contracts, Processor B buys 40,000kgs for February delivery on an index linked price, and Processor C buys the remaining 10,000kgs for April at a fixed price. This means Farmer Brown's milk is split between processors A, B and C at different times of the year under different pricing mechanisms.



This makes sense because every processor has a unique production mix.

Processor A would have been forced to turn Farmer Brown's last 50,000kgs into low value product because it doesn't have enough capacity at its high-value plant.

On the other hand, Processor B doesn't have quite enough milk to fill its own, so can pay $5.60 for the same milk, while Processor C is prepared to pay quite a premium to top up milk flows at $5.80.

All other milk that the farmer delivers to Processor A will be priced as Standard Milk Price volumes, as it is now – a floating volume, floating price mechanism.

Processors B and C now have the right to receive milk from Processor A on the terms agreed in their Fixed Volume Contracts, with delivery obligations for Processor A enshrined in the Foundation Processor Agreement with the farmer.

This sort of trade is already occurring between processors under milk swap agreements. These could be extended and standardised further to make the proposed trading more efficient, including terms and conditions governing scheduling, notification periods and credit.

Farmers do not typically participate in this trading among processors because:

- Retrospective bonus payments (including step ups) which are linked to continuous supply up until the payment date of the bonus
- Explicit and implicit exclusivity clauses

3.4 Contractual considerations

The proposed industry code of conduct contains many important elements that go some way, especially if mandated and enforced, to engendering the processor behaviour necessary for this proposal's implementation.

It is, however, based on the contracts that apply in traditional milk supply arrangements. For this reason, specialised contracts between farmers and foundation processors as well as other buyers deserve consideration.

3.4.1 Foundation Processor contract

The Foundation Processor contract would need to be signed for a fixed time period, with suitable notice periods to ensure certainty of collection and having a buyer for Standard Milk Price volumes.

It would also contain clauses like those in sugar/grains agreements with rights and responsibilities for deliveries, testing, default and so on.

The Foundation Processor contract would include the charges and necessary process for delivery of Fixed Volume contracts to Other Buyers.

Pricing of the Standard Milk Price volumes would need to be defined in relation to marketing objectives, how prices are updated and the like. While the pricing structure of these volumes could be similar to the current annual blended return, more formal information in relation to price updates and how the milk will be sold could be included, similar to Harvest Pools in sugar.

3.4.2 Fixed Volume Contracts

Fixed Volume contracts could involve any time period and/or pricing structures, including fixed price, index linked, guaranteed minimum, range pricing and various others.

To enter into a Fixed Volume contract, the farmer may be required to have a Foundation Processor agreement in place for that time period.

The Fixed Volume contracts could be standardised across the industry to allow for on-sale and also netting, as is seen in grains track markets.

4 Benefits for the Australian dairy industry

By creating more continuous competition for milk, this proposal would benefit the Australian dairy industry with:

- Increased competition for milk throughout the season
  Allowing a freer market can direct milk to better uses throughout the year.

- Greater price innovation
  Processors will be able to introduce various risk management pricing structures that better match the risks that customers are also looking to hedge, such as fixed pricing, guaranteed minimum pricing, collar pricing and the like.

- Better price signals which allow better decision making
  The proposal introduces a true spot and forward market price that farmers can use to manage their business.

- Farmers in control of their own risk management
  The move to more fixed and forward contracting will shift processors away from taking risk management decisions on behalf of farmers. Instead, they will be able to work with farmers who are looking to lock in some milk price and customers who want to lock in their buy prices.

- More manageable milk flow for processors
  Gives processors more control over decision making, such as whether to buy more milk for additional production and at what price.

- Greater efficiency
  Processors will be better able to fill their capacity at non-peak times.

More detail can be found in Section 7.

4.1 Manageable for Australian dairy farmers

The current farm gate milk price system has been all that generations of Australian dairy farmers have known in the export oriented areas. Even so, change will be manageable.

First, selling milk to other buyers would be an “opt in” decision. Farmers who don’t want to participate are free to maintain the status quo.

Second, farmers can choose to take “baby steps” towards participation, selling as much or as little of their milk to other buyers as they like.

Third, this is about the farmer having more marketing control – the ability to choose when and how to sell their milk. It is just another business decision but one that puts farmers in control over the revenue side of their businesses.

Finally, Australian farmers in industries as diverse as grains, sugar, cotton, wool and beef are well schooled in this type of marketing. There are a range of other industry participants entering the market to help them with those decisions, which do not need to be made alone.

5 What's needed to make the system function

The proposed system requires some level of regulation because:

- Under the current price model, most market price risk is being managed by processors but the effects are borne by farmers. Processors have little incentive to change and every reason to maintain the status quo.
- It is unlikely that a third party will be able to disintermediate this part of the industry for the reasons outlined in Section 6.
- Perishability and the existing exclusive (explicit and implicit) nature of milk price contracts makes it difficult for farmers to market their milk to more than one party.

5.1 Regulation of contracts to allow competition

To create an environment where competition is possible despite the above impediments, we suggest the following to be enacted and enforced by the ACCC:

- Removal of explicit and implicit exclusivity clauses within agreements between farmers and processors. This will, by definition, allow Fixed Volume contracting to occur. Specifically:
    - Any contracts between processors and farmers must have a fixed time period with cancellation only possible based on mutual agreement or default (both Foundation Processor Agreements and Fixed Volume Contracts)
    - The removal of all clauses which exclude payment of retrospective amounts due to farmers who have ceased supplying their Foundation Processor and/or who have supplied milk to buyers outside the Foundation Processor (including step ups and any bonuses accrued)
    - The removal of all exclusive dealing clauses that require all of a farm's milk to be delivered to a single buyer.
- Creation of contractual framework that allows a farmer to on-sell their milk to any buyer via the Foundation Processor
    - The ability for farmers to sell volumes to Other Buyers up to a certain volume threshold to manage production risk
    - The obligation of Foundation Processors to on-deliver milk to Other Buyers to satisfy Fixed Volume contracts entered into by the farmer
    - Clear guidelines on costs, processes, required notification and the like for the Foundation Processor and their role in Fixed Volume contracts between farmers and Other Buyers

5.2 Mechanisms to govern interactions between processors

We also propose that, to deal with the credit risk and delivery risk inherent in the above on- sale of farmer milk production to Other Buyers via their Foundation Processor, a centralised market for such transactions is developed, which includes:

- Mechanisms for managing counterparty credit risk between Foundation Processors and Other Buyers, including the potential for posting of security margins or credit guarantees like those in place in sugar and electricity.
  - The Dairy Farmers Support Package may be useful in guaranteeing processor obligations in this market
- Regulation and monitoring of the terms, conditions and charges upon which transfers between Foundation Processors and Other Buyers occur, to ensure anti-competitive behaviour in these areas doesn't limit the successful operation of a continuously competitive market.
- Regulation and monitoring to ensure that new styles of contracts such as fixed price, index price and the like are not stymied by the processing community.
- Potential for standardisation of terms, as in other global commodity markets.

While limited regulation is called for, it is to allow free competition in a traditionally anti-competitive market rather than to replace it with protectionism.

5.3 Regulatory parallels in other Australian industries

Markets with similar perishability issues (sugar and electricity) have either regulation in place (electricity) or arose from a regulated environment (sugar).

Likewise, it is interesting to note that approximately $7.7b of electricity was traded in the NEM in 2014-15, while the farm-gate value of sugar cane is estimated around $2.0b based on current sugar prices.

According to Dairy Australia, the farm gate value of dairy in recent years has been around $4.0b, making the dairy industry of a comparable size to other industries where regulation is present.

More information on how these industries ensure continuous competition despite the perishable nature of the commodities, please refer to Section 6.

6 About the group behind this submission

The group's aim and this submission are focussed on proposing a solution to many of the issues with milk pricing that we all recognise, rather than rehash the same complaints.

The nine individuals composing this group have diverse backgrounds, both inside and outside of the dairy industry, with expertise in:

- Farming
- Processing
- Consulting
- Risk management
- Trading
- Global commodities
- Australian and global milk pricing
- Financing
- Communication

Ironically, the imbalances of power endemic throughout the Australian dairy sector means that the group members would prefer not to be publicly associated with this submission.

7 Appendix A: Dealing with perishability in sugar and electricity

The perishable nature of off-farm milk is a key barrier to continuous competition, around which this proposal has been designed.

Milk must be pasteurised and processed soon after milking to make it shelf stable. This puts farmers in a naturally disadvantaged position in relation to making choices for their milk, as they are most worried about not having a buyer for their milk and therefore losing 100% of its value.

While dairy farmers could theoretically invest in a factory and then store end product, a much higher level of investment is required than storing other commodities such as wheat, making it unviable.

Perishability also makes attempts to disintermediate the industry by a third party difficult. For example, a pooling agent or milk broker style business is at a natural disadvantage to processors with manufacturing assets.

Successful milk brokers without processing facilities typically operate on a very clear back to back basis (i.e. all the farm's milk going basically to one buyer, which is more a milk co-operative than anything else).

In other cases, where the intermediary has attempted to sell the supply to a truly diverse range of customers, there has been very mixed success, including either failure to launch or farmers not being paid.

Many milk broking operations that currently exist actually have access to some processing assets which enable their broking activity.

7.1 Comparable industries with perishable commodities

Raw milk is not the only commodity market in Australia which involves a perishable product.

Sugar has the same issue of a quick decline in value immediately after harvest: sugar cane quickly loses sucrose content after harvest and cannot be stored or transported long distances. This means nearly all cane goes to the nearest sugar mill, meaning cane farmers are faced with the same 1:1 relationship as dairy farmers.

Electricity is also a perishable commodity, as once it has been made it must be absorbed by an end user; while battery storage is beginning to change this the market structure of electricity has been developed in order to deal with its perishable nature.

7.1.1 What we can learn from the sugar industry

The sugar industry has developed a very strong intercompany trading system to deal with perishability. While recent developments in the industry are changing the way the cane payment system works, we can still learn much from its operation up until now, with many of these elements expected to continue despite industry changes.

Once cane is transferred to the mill, cane growers retain an economic interest in the sugar made from that cane, called the Grower Economic Interest (GEI). The GEI is based on the farmer's specific sugar quality and yield, and is adjusted for a toll cane crushing fee and other costs.

The GEI does not mean the farmer owns sugar made from their cane – it is a right they receive from the mill that crushed their cane. This right (the GEI) then allows them to determine how, when and by who the sugar that was made from their cane gets sold.

The farmer is then able to nominate their GEI into a wide number of sugar marketing options, which may be offered by the mill that crushed their sugar or another entity.

Where growers nominate GEI to a marketing group that isn't their local mill, the nominated marketing group then has the right to receive physical sugar from the farmer's local mill. The GEI creates a transfer right or obligation.

The GEI system is underpinned by a very strong and detailed set of contractual rights and responsibilities between farmers and their crushing mills and marketing groups, as well as between the various mills and the marketing groups to allow for the transfer of GEI. There is a high degree of standardisation in these contracts.

In addition, industry-wide integrated reporting and logistics systems allows the various GEI transfers to occur at a low transaction cost. Credit and delivery risk are also managed by a system of bank and cross guarantees.

Similar contracting practices and integration of reporting/logistics systems occurs in grain storage, where farmer rights over grain in store can be transferred to multiple buying parties.

By creating continuous competition, the GEI system delivers a number of benefits to the Australian sugar industry:

- Farmers can ring marketing agents (including their own mill) at any time and allocate a fixed quantity of their production into a variety of risk management products on time lines up to three years forward, including but not exclusive to:
  - Fixed price contracting, including the ability to leave target desired selling levels for the marketing agent to manage
  - Guaranteed minimum price contracting, with the price being compared to a world sugar price indicator
  - Range price contracting i.e. a guaranteed minimum and maximum price, with the price being compared to a world sugar price indicator
  - Daily average style pricing, based on world sugar markets
- Any sugar cane not allocated to the above risk management products automatically goes to a floating volume / floating price "pool"
  - The sugar model basically makes the blended, annual return pool the buyer of the "last" delivered cane rather than all the farmer's production, as it is in dairy
  - Production risk is managed by only allowing a maximum of typically 65% of forecast production to price risk management products, meaning a minimum of at least 35% must be left to the floating volume / floating price pool
    - This covers production risk: farmer production would need to undershoot forecast by 35%, a big miss, before it put at risk any of the fixed volume commitments made to price risk management products. Penalties and remedies exist for the situation where not enough production is delivered to cover the fixed volumes contracted to price risk management contracts.
    - Farmers don't have to allocate 65% to price risk management products. They may leave all production to the floating volume / floating price pool

- Farmers receive detailed reporting and analysis of their marketing done until now versus forecast production, as well as market updates to assist them with decision making. In addition, there are a wide variety of consultants to act as independent advisors.
- By fixing in sales, farmers are then able to use this as security against Advance Payment financing options offered by their Marketing Agents. For example, banks will lend say 50-70% against forward contracted sales, based on the financial strength of the marketing agent buying the farmer's sugar.

7.1.2 What we can learn from the electricity market

The electricity market is regulated to deal with perishability.

Most electricity in Australia is traded and distributed through the National Electricity Market (NEM), which is regulated and managed by the Australian Energy Market Operator (AEMO).

In simple terms, the AEMO receives signals from end buyers about how much electricity they want and when. These signals are then given to electricity producers, who run their production assets accordingly.

Forecast signals are given over a variety of forward timeframes to allow for planning, with final signals then given on a very short-term basis. Essentially, all production is pooled and then distributed to the highest-priced buyers at any time.

Trading in the market is underpinned by a very strong scheduling and supply/demand matching system, which is basically the logistics network of the industry.

In addition, market participants are required to provide a variety of credit and delivery guarantees to manage risk of participants that trade with them.

8 Appendix B: Link between more continuous competition and milk price index

A significant focus has been placed on how a milk price index could be helpful in assisting dairy farmers to better understand their milk price and deliver more transparency.

Both of these ends are crucial in returning the industry to a stable footing and future growth. However, a milk price index cannot assist in ensuring that the industry maximises the value of its milk at all times by ensuring the free flow of milk between all parties.

In addition, while an index can provide some explanatory value to milk prices seen in the market, it is always based on some level of assumptions including production mix, prices achieved, capacity utilisation, processing costs and correct returns for processors, among others.

These assumptions can drastically alter the explanatory value of the index. For example, if the index modelling assumes that a factory's fixed costs should be "paid for" by a factory that is only 60% utilised post the Spring peak, the processor will justify lower milk prices than a model which assumes that processors should be competing for milk to fill their factories over this time with some factories at high utilisation and others at zero (some plants should only be open for balancing purposes over Spring peak period).

Ultimately, an index can only justify pricing based on the assumptions made to the model, rather than provide a tool which helps to actually change industry behaviours. For this, we need a more competitive market for milk, year-round.

This continuous market can then provide the transparency desired, as ultimately nothing is more transparent than a traded price.

Index-based pricing attracts attention because it is used in the US system and delivers both transparency and a tradeable price. What needs to be recognised is that this is made possible by a regulated pooling system, whereby each factory pays a milk price based on the specific product it produces (so a cheese factory pays a milk price based on cheese returns), with farmers then paid a blended price based on all of the factories in their region.

9 Appendix C: Barriers to continuous competition at the farmgate and its consequences

Typically, there is not continuous competition for milk in Victoria and Tasmania:

- High switching costs imposed by milk pricing plans and contracts force almost all competition for milk to be concentrated between July (the beginning of a milk payment season) and September/October (the beginning of the spring peak milk production for most farmers).
- A lack of wholesale trade between processors due to strategic reasons limits industry-wide optimisation of the milk price and subsequent flow through of profit to both milk prices and the industry profit pool.
- While farmers are theoretically free to switch processors at any time, the high switching costs make this practically and economically highly unlikely.

9.1.1 Switching costs and their impact on continuous competition

As laid out in Table A below, two main forms of switching costs are imposed on farmers:

A) Retrospective payments such as step ups, and various incentives/bonuses paid on all milk delivered up until the point of time in the year if the farmer is still supplying a given processor
B) Terms within the supply agreements, even those with no fixed term, which either make the farmer an exclusive supplier to a given processor or allow the processor to stop picking up the farmer's milk with minimal notice.

Table A

A) Impact of retrospective payments

- Most milk in commodity producing regions is bought on an opening price/step up model. An opening price is paid from the start of the milk year (July), with the potential of step ups (increases to this price) throughout the year. These step ups are typically paid on all milk delivered in a given milk year up until the step-up date – for example, if a step up is announced for March 2017, all milk delivered from July 2016 to March 2017 is paid a retrospective bonus, with milk delivered post the date of this step up receiving automatically the higher, stepped up rate. A key condition of being paid this retrospective step up is that the farmer must still be delivering milk to the same processor at the step-up date (i.e. if they were to have switched processor before then, they would not be eligible).

- The retrospective nature of these step ups means that their absolute dollar value increases as more and more milk is delivered in any given year. For example, a step up paid in September 2016 would only see a retrospective bonus paid on July 2016-September 2016 deliveries (3 months of milk); however a step up in March 2017 would be paid retrospectively on 9 months' worth of milk. In addition, the seasonality of milk supply, which sees largest producing months around spring, amplifies the above example.

- Essentially, the step ups act as a significant switching cost for the farmer to factor in to any decision about changing processors, in particular post the peak production in spring. More correctly, it is the *prospect* of coming step ups which act as the switching costs – if a farmer switches processors before step ups that *may* be coming, they will lose the potential to receive that retrospective payment.

- In a similar fashion, many milk pricing plans contain a range of incentives and bonuses that have a similar retrospective nature i.e. they are paid on a certain date for all milk delivered up until that date, subject to the farmer still supplying at the nominated incentive judgment day. These contingent incentives and bonuses add to the switching costs involved in a farmer deciding to switch processor.

B) Implicit or explicit limits on external negotiation

- Most milk supply agreements contain one or both of the following clauses:
    - The farmer must provide all milk from that farm to their processor: this means any decision to move processor or supply some portion of milk to another processor will be a breach of contract
    - The processor can cease to pick up milk from the farm with some minimal notice period: this implicitly limits the farmer's ability to sell some portion of their milk outside that processor, as it is essentially a threat that behaviour as such could see them lose a customer for the remainder of their milk

- Both of these types of clause act as barriers to a farmer marketing their milk outside the incumbent processor and therefore as a barrier to continuous competition for milk

9.1.2 Lack of wholesale trade

In theory, wholesale milk trade could deliver a more continuously competitive market for milk. Commodity product processors maximise profits by selling their liquid milk to other processors rather than make product with it, based on these other processors paying a sufficiently high price due to higher returning revenue streams.

The processing sector in Victoria and Tasmania is concentrated, and the sale of Murray Goulburn Co-operative will leave even more farmers with few supply choices.

The desire to participate in mutually beneficial trade can be limited by the fear that another party is gaining more supply, which could increase its capacity to compete in future.

This leaves most commodity processors either unwilling to sell to other commodity processors or demanding a premium price such that it makes the deal unprofitable for the buyer.

Many of the processor submissions made the comment that considerable volumes of milk transfer on milk swaps, as evidence of a wholesale milk trade existing.

While commendable, the key focus of these swaps is to generate transport cost savings and/or mitigate supply risk by diversifying across regions outside the typical economic milk capture footprint and, typically, they are structured to remove the potential for any profit beyond savings generated.

9.1.3 Summary

- In summary, the switching costs typically embedded in the current milk pricing structure (step ups, bonuses and incentive payments) and a lack of wholesale trade hinder continuous competition in the market for milk into commodity processing plants.

- In addition, these switching costs hugely qualify processor comments that farmers are free to switch processors at any time – while this is true in theory, in practice the loss of retrospective payments when switching acts as a barrier to free movement.

9.2 Impacts of this lack of continuous competition

The lack of continuous competition for milk has three key impacts:

1. It limits industry-wide optimisation of milk and thereby decreases both the industry profit pool and milk prices
2. It hinders the delivery of correct pricing signals to industry participants as the only price signal given is an annual blended pool return
3. It stifles pricing innovation including price risk management

9.2.1 Limited industry-wide milk optimisation

There is significant underutilised capacity in the industry for a substantial portion of the year.

The industry does take some steps to manage this excess capacity, including performing maintenance during this period and in some cases running lower staff hours, where possible.

However, it is our experience that, outside the peak milk production period in spring, nearly any processor would look to buy and process additional milk: in a high fixed cost industry such as commodity dairy product processing, the value of more milk (marginal milk) through a factory is typically gross margin positive.

So, outside of spring peak, a liquid milk market should see high levels of trade and arbitrage to maximise the value of the milk at an industry level.

For example, even when cheese is a much better performing stream return than WMP; Processor A may schedule to make WMP with some of its milk and that Processor B is scheduled to have underutilised cheese making capacity at that time.

In an efficient market, we should see a price at which:

- Farmers shift some of their milk supply away from Processor A towards Processor B, and/or
- Processor A is willing to sell the milk to Processor B, in some mutually beneficial trade.

In Victoria, in particular, transport costs are generally not significant impediment to this sort of trade. If this type of trade was transparent and encouraged at industry wide level:

    - As the example shows, one key reason for more milk trade is the ability to capture stream return differentials (i.e. the differences in revenue between making various different products and sub-products from milk)
    - Likewise, more efficient processors should be able to pay a higher price and gain more milk for their factories
    - Processors that better risk manage their milk intake to end-product customer
    - Ultimately, an efficient milk market may lead to companies and the industry as a whole more efficiently shaping capacity, with certain plants basically becoming peak plants only.

However, the lack of a continuously competitive free market for milk doesn't allow this to happen at the industry level at present, despite each processor aiming to maximise profit and milk price based on their own milk supply and capacity footprint.

As a side note, it is important to differentiate the above from current industry attempts at growing shoulder milk, which involve milk pricing plans that reward shoulder milk production over peak milk production.

These attempts, given they are fixed premiums for off-peak milk, are really just re-allocations of milk payments from the same milk price pool (i.e. they don't necessarily reflect the market value of the milk outside peak).

We do not advocate more efforts to incentivise shoulder milk production; rather that a liquid milk market will ensure it optimises the milk it does have on the shoulder.

9.2.2 Poor pricing signals

The current milk price structure is an annual blended pool return. Revenue from all the various products the processor is expected to make are pooled together.

Costs including processing, administration and the like are subtracted, as are a required profit or return on capital.

The milk pool is established and turned into the monthly milk prices farmers are paid, adjusted for the various fixed incentives in the pricing plans, such as seasonal (price premiums for different months) and size-based bonuses.

Some processors may also need to adjust milk prices to ensure they are competitive with other buyers of milk rather than lose milk supply and associated capacity utilisation.

This all means the price paid for milk late in the season becomes a function of what the milk was worth early in the season rather than what it is worth at any specific point in time.

For example:

- If commodity prices are very high during the peak (Sep-Jan), then the milk price should be strong as the peak milk (a large % of overall annual production) will have been turned into higher priced product
- However, say in Feb/Mar commodity prices tumble and the milk becomes less valuable, this won't be reflected immediately in the milk price for Feb-Jun, because that year's blended pool return has already "baked in" the high commodity prices earned over peak
- In addition, the seasonal premiums for off-peak milk that exist in most milk pricing plans will further increase the discrepancy between the actual value of the milk and the price being paid for it under the pricing plan at that time.

This sends a very poor price signal to the industry and hurts it as a result. Extending the above example:

- The farmer, responding to this high price signal, will look to maximise production (via additional inputs such as feed) as it is likely well over marginal cost of production
- The processor will be losing money on the additional milk being received, weakening industry equity and, potentially, the subsequent year's milk price
- If commodity prices stay low and the subsequent year's milk price stays low, the farmers will have been increasing production into what could next year be a loss-making milk price
- This process works in reverse as well, whereby spot milk prices should be much higher but are held back by having "baked in" low commodity prices early in a season – meaning farmers and the industry aren't able to respond to a profitable opportunity.

If a liquid and transferrable market existed outside the current pooled milk price, it would be priced based on the economics of the milk at that point in time, rather than being a blended pool return.

This more efficient spot/forward market would then be giving a more accurate price signal to farmers about current market supply and demand conditions, and provide an avenue to manage their businesses accordingly by fixing prices for various forward time periods.

9.2.3 Stifling of price innovation including price risk management

In any industry, price risk management decisions involve assessing the relative risk and reward of locking in a price now or leaving that price un-fixed and seeing what is available at some future date.

For example, a wheat farmer will do a risk/reward analysis of locking in price on 10% of the wheat crop today versus some future date.

As we have described, dairy farmers typically must send all their milk to a single processor and there are high switching costs for farmers trying to sell their milk elsewhere at a future date.

This means the price risk management tools some industry members offer revolve around locking in some portion of the annual blended pool price (e.g. lock in say 30% of your 2016/17 season milk price and leave the rest under the typical step-up model).

While these programs are a step in the right direction, they are somewhat limited by their nature of being annual price risk management tools:

- Locking in an annual price means farmers and processors (or their end customers, if the processor on-sells the milk in the form of 12 months of product supply) are being asked to make a risk/reward decision on what will happen to the milk market over a full year period, including all the various drivers of that such as commodity prices, currencies, processor margins and the like
- While locking in is the only option available to some farmers for selling their milk (for the reasons outlined above), both processors and end customers have a wider variety of options in locking in their relative prices:
    - Processors can sell their end product made from the milk at any time for any forward time period; they are also able to make decisions on milk price, such as the level of step ups/downs, at a future time period
    - Customers can decide to lock in their buy prices at any future time period for any number of lengths of contract e.g. next 3 months, 6 months or the like.

As such, for both processors and end customers there must be a strong incentive to lock in their buy prices for a 12-month period. This of course acts as a disincentive for the farmer to lock in, meaning underutilisation of price risk management programs.

If there was more continuous competition for milk, industry participants could choose to fix in whatever portion of milk they want for whatever term they want (i.e. rather than having to match all three participants on an annual basis, some participants could lock in months 3-6, others 6-12, others 0-6).

By better matching their own business needs, the risk margin demanded by the participants would decrease.

This would all be very beneficial to the processing sector. Rather than being asked to make risk decisions on behalf of the farmers, the processors would become risk matchers and margin managers. They could take a customer bid price and calculate it discretely into a farmer sell price, making their processing margin. This is how it works in most other commodity markets around the world.

These types of risk management offerings from processors to customers are becoming a “ticket to play” with large high value customers globally, who are now beginning to receive such solutions from other global exporters where more suitable price mechanisms assist their delivery.