Dairy Farmers Milk Co-op's Response to the Interim Report into the Australian Dairy Industry

Dairy Farmers milk co-operative

Introduction

DFMC thanks the ACCC for the opportunity to provide comment on the Interim Report of its Dairy Inquiry.

We have taken the approach of commenting briefly on the Interim Recommendations and then addressing some of the issues in the report in more detail.

Interim Recommendations

1. **Written Contracts** – We agree with the ACCC's position, but not sure it will achieve much**.**
2. **Simplified Documentation** – We agree.
3. **Switching Processors** – We agree.
4. **Dispute Resolution system** – We agree, but processors could simply avoid farmers who are in their view troublesome or dump them at the first opportunity.
5. **Farmers & contracts** – We agree although while the average value of a contract may be $700,000, the opportunity cost of selecting one contract over another will be much less. Having said that, it still could be the difference between profit & loss.
6. **Processors should indicate their assumptions in pricing announcements** – We agree. Currently an 'average' is quoted without the actual background to the calculation being made. Is it influenced by some large suppliers receiving higher payments? Is the price quoted at maximum quality? Perhaps the industry bodies should define a number of typical example farms that processors would need to use when quoting their prices – something like the 'comparison rate' used in financial products.
7. **Voluntary Code** – While we agree with the proposed changes, we feel that while the code remains voluntary, it does not do enough to overcome the issues for all farmers.
8. **Mandatory Code** – We agree that a mandatory code is required and in particular that dispute resolution process must be included. One issue remains the financing of any such process. The processor will usually have much greater resources and finance than any aggrieved farmer or groups of farmers.

Dollar Milk

On Page 19, the Interim Report states "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 of farmgate prices". DFMC cannot agree with the conclusions drawn on this issue in some regions (specifically Queensland and Western Australia, and probably New South Wales and South Australia), in the longer term. While we understand that the contracts require that farmers supplying milk for the retailer brands to be paid at the regionally competitive rate, to say that retailer branded milk has no impact ignores the long term prospects for milk price.

In the southern states, the milk price is fairly discernible on an annual basis.

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However, take for example south east Queensland and northern New South Wales. There are effectively three processors supplying the vast majority of the market – Norco, Parmalat and Lion. The first two have contracts with the two largest retailers. Lion has only minor contracts and relies mainly on branded sales (including flavoured milk). We believe Lion loses money in Queensland as the route trade business is shrinking and the margins are lower (see our response to P148 at the end of this document) – small drops to small stores are not a great way to make money, even at branded milk prices. The ACCC has focused on margin, but that is only one side of the business equation. Volume must also be taken into account.

We believe that Lion is therefore not be inclined to lift milk price and lose more money. Does the ACCC really believe that Norco or Parmalat will lift their prices to counter the falling supply of milk in that region and incur the displeasure of their two major customers? In fact, Parmalat recently reduced its price to its farmers despite falling milk supplies (See your Fig 15). So how does the price of milk ever rise while the processors struggle to be profitable? The 'competitive price' will not shift. Farmers therefore face declining prices in real terms while the ever increasing uncertainty of favourable weather causes them significant cost pressures.

A short term answer is to bring milk from further south to make up the shortfall. At the moment, southern milk prices make that feasible but as sure as night follows day, the price in Victoria will be 50 cents per litre within a year or two. It is entirely possible that Lion will exit the south east Queensland market – and that will certainly 'soften competition'.

An assertion is made that if the retailers were to increase their prices, it is unlikely that the processors would pass it on. Given the power that the retailers hold over the processors, they could undoubtedly insist that any shelf price increase be passed to the farmers in an attempt to gain some PR advantage. Their issue in doing this is that southern farmers might expect something similar (despite the milk used only being a small part of the milk pool).

Balance of Power

Whether Collective Bargaining is used or a mandatory code is introduced, unless there are elements that:

- require the processor to be involved;
- has a mediation or 'independent expert' process with enforceable outcomes; and
- has resources to enable the farmers to compete on equal terms,

then nothing will change.

While processors have the ability to pick and choose their involvement and the option to not offer contracts in the future to those who challenge them, the balance of power will remain firmly in the hands of the processor. This has happened before.

Under the heading 'contracting practices' on Page 21, the ACCC suggests that the industry should develop a dispute resolution process, etc. We agree with this proposition but re-iterate our points above.

Collective Bargaining

DFMC is disappointed that the ACCC has been somewhat dismissive of Collective Bargaining. DFMC and Lion have shown how Collective Bargaining can work, given the right structure and imperatives. We urge the ACCC to revisit this option as a viable approach, including our proposed code (given similar support to their proposed mandatory code).

Mandatory Code

For the reasons outlined in previous comments, DFMC is supportive of the introduction of a Mandatory Code, especially in relation to the dispute resolution process. From our experience, such an arrangement provides both a remedy in the case of disputes but, more importantly, lessens the chance of such disputes as all parties know that only genuine grievances will produce a potentially desirable outcome. *We are uncertain as to the process for the development of such a code*.

Milk Swaps

DFMC believes that milk swaps have been detrimental in the central South Australian region. While it is true that central South Australia once had a substantial manufacturing base more than 10 years ago, the only such manufacturing facility (now owned by Bestons Foods) has struggled for milk supply and has changed hands several times over the past 10 years. While the current owners have big plans, they are yet to materialise. There has been investment in the south east of South Australia (Mt Gambier) in recent times but this is more likely to support the argument that central South Australia is more appropriately a domestic market.

While the situation is improving, the presence of Warrnambool Cheese & Butter and Murray Goulburn in the central South Australian region only makes sense if the milk they buy can be swapped with local processors such as Parmalat and Lion – otherwise they have to transport milk over long distances which makes little sense in their product mix. Over the last five years, declining milk supplies should have meant increased prices but this has not been the case as the processors have maintained the mantra that central South Australia is a manufacturing region and should be priced accordingly, despite being some 5 hour drive from the next milk pool and even further to the processing plants of Warrnambool & MG. Central SA processors have resisted paying as much as 0.5 cpl extra and only recently agreed to paying 1 cpl extra.

Our belief is that the statement in the interim report is too broad and greater acknowledgement of potential for the use of milk swaps in an anti-competitive manner should be highlighted in the final report.

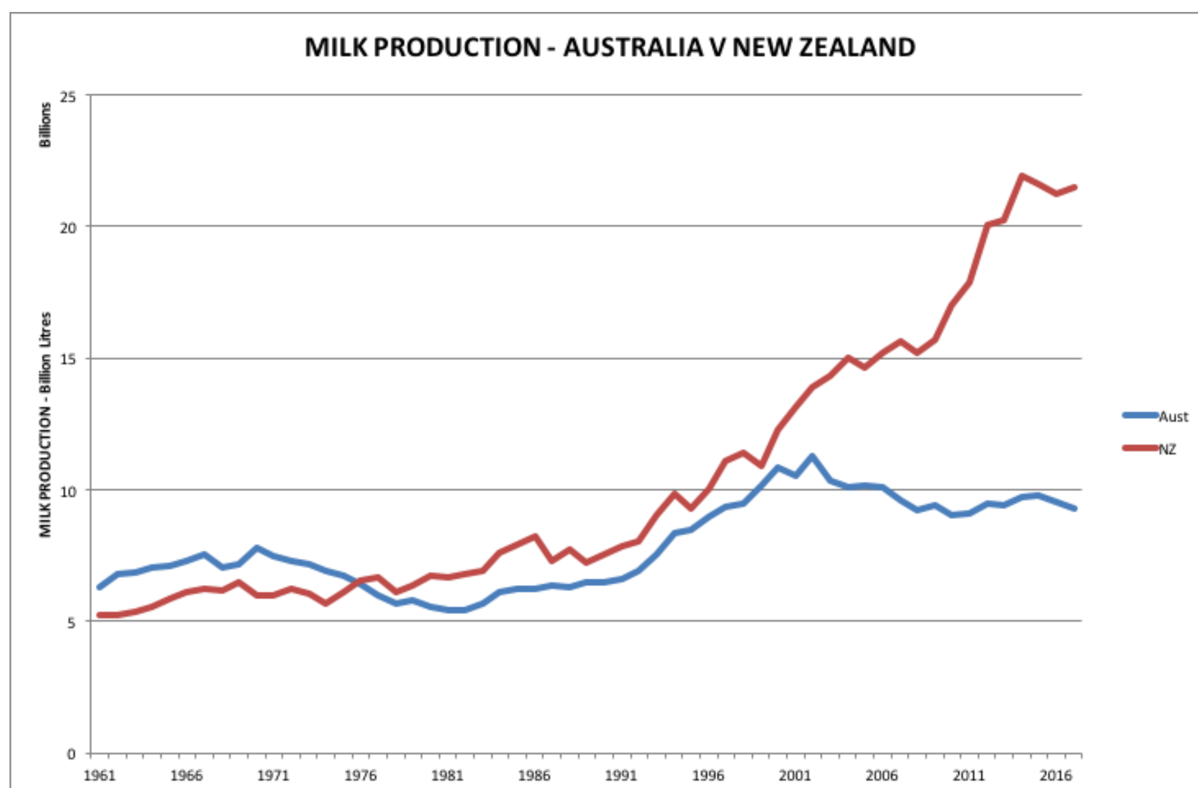
The Impact of Pricing Strategies on Australia's milk supply situation

In Chapter 2, the report canvasses a range of pricing and related risk issues. One area that has had a significant effect on the southern dairy industry has been the decision of processors to encourage farmers to flatten their milk supply by seasonally pricing milk and providing other

incentives aimed at flattening the supply. Larger farmers are also incentivised. This concept originally started in the mid-90s in a bid to counter poor milk quality / composition at the end of the season (late Autumn) which resulted in outcomes like poor cheese quality but processors soon realised the asset utilisation benefits that ensued.

By contrast, New Zealand farms supplying Fonterra have historically been paid a flat price all year (although the 'year end' expected price can fluctuate due to market realities) and all farmers have effectively the same price opportunities that vary only with composition and quality.

The following chart clearly shows the impacts that pricing strategies can have on a region's milk production. Both countries de-regulated at the same time although the impact in NZ was much less. Also, to be fair, the NZ dairy industry has been historically more concentrated geographically (allowing the management of 'end of season' milk to be easier to deal with). The conversion of sheep farms on the South Island has also had an impact but once again, the pricing policy in NZ has allowed this to happen.



Source: USDA

Some things that appear not quite right….

Page 76: It is too simplistic to believe (as some farmers do) that because one product group rises (i.e. butter) that the price of butterfat should rise. Most southern processors have complex product mixes that have varying amounts of the various components in them – protein, butterfat, lactose, etc. For example, just because butter rises 20% doesn't mean that

there will be a relative increase in the wholemilk powder price. Processors try to judge where the compositional return will be maximised over the long term and try to encourage farmers to head in a similar direction. Rises in product groups such as butter are often driven by unusual circumstances that can change quite rapidly – for example, a lot of butter is used in baking and manufacturers may suddenly change their recipes to include things like tallow or vegetable shortening when butter is too expensive.

Page 77: While farmers have the option not to flatten their milk profile, they would suffer significantly in financial terms as, for even those on the current 'traditional' payment profile, the spring price has been discounted to pay higher prices in Autumn and Winter. As outlined in the previous section, the New Zealand farmers do not have this issue.

Page 88: Fig 3.6 We question the accuracy of this Table in relation to Lion and DFMC. Generally speaking the prices paid by both are similar – the differences are likely to be caused by the pricing schedules used – for example fixed v variable pricing. The dates are probably correct as in some years (2012 for example), we were in dispute but the opening prices usually ended up very similar. Perhaps the prices should be left out as there is not information presented as to what they actually represent.

Page 101: To our knowledge, Murray Goulburn does not buy milk in SE Queensland and northern NSW. This issue sometimes arises due to the incorrect coding of a Shire on processor records.

Page 101: To our mind, this map is quite misleading in the case of central NSW and further north. Large areas on the map are coloured where they may be only one or two farms present (and in some cases, we wonder what farms are there anyway). This is probably due to the previously mentioned issue. Also, there may be one farm in a large Shire which results in a significant area of the map being coloured.

Page 109: Our recollection is that Pauls operated on a calendar year basis prior to its purchase by Parmalat.

Page 148: Branded milk sales have apparently maintained a reasonable share according to Fig 6.6. However, irrespective of whether the product deserves its success or not, there has been significant growth in A2 milk within the category and at this stage, the retailers do not have an equivalent product. With this product removed, the story is quite different in terms of branded sales - in supermarkets at least. A visit to a supermarket and the facings maintained by various products will quickly reveal the real position. Another example of the volume of branded milk sales that have been lost is the use of private label milk by coffee shops in shopping centres – these were previously serviced by the major processors but now it is not uncommon to see café staff pushing shopping trolleys full of milk.

Page 150: The cost of logistics and refrigeration cannot be ignored when assessing product margins. This will bring the margin of private label milk much closer to zero. In any event, the margin on that product is largely irrelevant to the retailers – as a 'loss leader' the margins on other products in other non-dairy categories are where the impact should really be measured.

Page 162: Fig 15 seems to have an incorrect title. It looks more like Queensland. That being the case, it can be seen that production responded to milk price increases in the 2007 / 2008 period by flattening out. In more recent times, the price has declined and the milk intake has returned to its downward trend.

Page 166: It is difficult to understand how the statement in 6.4.1 can be made as Fig 15 clearly demonstrates that milk production in Queensland as well below demand. We have previously addressed how any price increase could be passed to farmers.

Page 176: In our experience, processors don't like mediation – the proposed result is often 'the middle ground' which means a shift in position when the processor may feel that no ground should be given.

Page 181. The report states that 'the ACCC understands the situation is similar in South Australia'. This may be true for south east South Australia (Mt Gambier) but certainly not for central South Australia (some 5 hours drive away at a cost of at least 4 – 5 cpl).

Collective Bargaining Groups have only existed in SE Queensland because Parmalat chose to let Premium be formed to simplify their pricing arrangements and Lion had no choice due to the sale of Dairy Farmers and the subsequent agreement. To be fair, they are in the process of negotiating an extension to the current arrangement.