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Australian Competition and Consumer  
Commission  
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Dear Sir/Madam

### **Inquiry into the Australian Dairy Industry – Submission in response to the Interim Report**

Fonterra welcomes the opportunity to provide this submission in response to the Interim Report released on 30 November 2017 as part of the ACCC's inquiry into the competitiveness, trading practices, and transparency of the Australian dairy industry.

As stated in our submission in response to the Issues Paper, Fonterra sees the Inquiry as an important measure to help instil confidence in the industry and position it to achieve a bright future.

With significant involvement in the dairy industry both in Australia and internationally, Fonterra considers it is well placed to comment on the matters raised in the Interim Report.

Fonterra Co-operative is a global dairy business and the world's largest dairy exporter, operating in over 140 countries. The Co-operative is owned by approximately 10,500 farmer-shareholders, who currently have more than AU\$1 billion of equity invested in Australia.

Locally, Fonterra Australia works with some 1,300 farmer suppliers in Victoria and Tasmania and employs around 1,650 people. Last season we collected and processed roughly 20 per cent of Australia's milk at our seven factories located throughout regional Victoria and Tasmania.

We were actively involved in the development of the *Code of Practice for Contractual Arrangements between Dairy Farmers and Processors in Australia (Code)*, and were one of the first companies to sign up to the new Code. As a signatory, we are committed to taking steps in our business to improve pricing signals so that farmers can have more certainty and plan ahead with confidence.

Fonterra has also extensively participated in, and cooperated with the ACCC, in relation to the Dairy Inquiry.

This submission provides comments on the eight interim recommendations and some additional matters raised by the Interim Report. To the extent that we have not commented on an issue in the Interim Report, that does not mean we agree with the ACCC's position.

### **SUMMARY**

Fonterra strongly supports the voluntary Code that has been developed by the dairy industry, with the support and encouragement of Government. We believe it is important that the Code is given an opportunity to work before other changes are considered.

We consider there is merit in exploring an industry body to handle disputes relating to compliance with the Code. It is important that processors comply with the Code, as there will be an unfair playing field if only some processors do so.

Given the strong support within the dairy industry for the Code, we think that an effective industry-led dispute resolution process is not dependent on having a mandatory code. We do not support the introduction of a mandatory industry code, particularly given that the key areas it is intended to cover are already addressed under the current Code. In our view, it would be preferable to focus efforts on providing greater transparency and education for farmers about how the milk price they receive is impacted by global market forces.

Further, over-simplifying complex topics such as raw milk pricing can reduce transparency in relation to information that is critical for farmers to make informed decisions and manage risk effectively. Trying to impose a “one-size-fits-all” solution to the inherent price uncertainty of global markets, runs the risk of stifling the very innovation that can provide farmers with greater control to manage decisions about their milk supply.

## **INTERIM RECOMMENDATIONS**

### Interim Recommendation 1

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

We do not support this recommendation.

We ask our farmers to sign an application form when they first begin to supply to Fonterra. However, our Milk Supply Handbook (**Handbook**), which sets out terms and conditions for the supply of raw milk to Fonterra, is updated and provided annually to all our suppliers.

Obtaining signatures on an annual basis from our around 1300 suppliers would impose an excessive and unnecessary administrative burden upon all parties.

Also, we would be concerned that farmers would be worse off in that, under the proposed requirement, they might lose collection of their raw milk (which is perishable) due to a failure to complete the paperwork.

In our view, there are better ways to help make sure farmers understand their contractual arrangements. They include:

- Our 10-day formal induction program for all new suppliers.
- Regular communications between us and our suppliers, including weekly email updates from the GM of Milk Supply, our Monthly Global Update as well as our specialised website for suppliers.
- Consultation with the Bonlac Supply Company (which represents Fonterra’s suppliers) about the terms and conditions of the Handbook.
- On-the-ground support services which help provide our farmers with advice on a range of matters including questions they may have about their terms of supply.

### Interim Recommendation 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.*

We agree with the objective of simplifying contracts where possible, however this must be balanced against the need to provide farmers with information that is transparent, accurate and provides sufficient detail to help them in running their businesses.

For example, Fonterra’s Handbook covers a broad range of topics including:

- pricing and payments;
- milk quality and testing;
- food safety;
- requirements for milk collection;
- milk storage and refrigeration;
- animal health, welfare and biosecurity;
- social responsibility and environmental sustainability;
- benefits; and
- administration.

The Handbook is written in plain language so its contents are clearly communicated to our suppliers. We consult with Bonlac Supply Company (as representatives of our suppliers) about the contents of the Handbook.

In 2014, Fonterra introduced a simplified milk pricing structure which includes:

- a simplified base price;
- the removal of Seasonal Ratio Payment incentives (which a farmer could miss out on if they had a bad final month of the season);
- reinvestment into off-peak pricing to reduce risk for farmers and maintain a price signal for the value of off-peak milk to our customers; and
- reinvestment of a growth incentive back into base price, and supporting growth outside the pricing system to make it more attractive and material for farmers in an expansion phase.

However, over-simplifying complex topics runs the risk of stifling innovation. It may also reduce transparency in relation to information that is critical for farmers to make informed decisions and manage risk effectively. An example of this is the findings of the National Competition Council in relation to milk pricing, as referred to on page 79 of the Interim Report:

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

### Interim Recommendation 3

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

As acknowledged in the Interim Report (page 24), this issue is addressed by the recent Code, which Fonterra and other major processors are signatories to.

Clause 5 of the Code provides:

*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.*

Guidance on this clause is set out in section 5 of the Addendum to the Code:

*If a farmer has supplied milk to a processor for an entire season and then wants to move to another processor, it is appropriate they receive all payments that accrue over the period of the contract or supply agreement that they supplied to the processor. Such payments should not be contingent on the farmer being a supplier when, for example the June payment is made in mid-July.*

Section 5 of the Addendum further explains:

*Processors recognise the sensitivity of this issue and will ensure, through their contracts with farmers, that all payments, including bonuses and step-ups, are treated equitably to all their suppliers within a contract term. If a farmer supplies to the end of a contract then all payments accrued in that year will be paid irrespective of whether they remain a supplier post a contract or not.*

#### Interim Recommendation 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.*

Fonterra supports the development of an industry-led independent body to enforce and handle disputes about compliance with the Code in a consistent way.

In our view, it is critical that such a body should be developed and managed by the dairy industry, rather than a body external to that industry. We consider the dispute resolution service facilitated by Grain Trade Australia is a good model in this regard.

We do not think the industry body should consider disputes not related to the Code. Such disputes will often turn on the particular terms and conditions of the milk supply agreement between the relevant processor and the relevant supplier.

We agree processors should have their own internal dispute resolution processes to handle, at least in the first instance, disputes with suppliers.

#### Interim Recommendation 5

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

We agree with this recommendation, which recognises the significant value of milk supply contracts.

We also think it is important that farmers understand the global market in which they operate and the impact it has on pricing. This issue is discussed further below.

#### Interim Recommendation 6

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

Fonterra is committed to working towards providing farmers with greater certainty around pricing and pricing outcomes.

In February this year, Fonterra will launch a suite of tools and resources under the brand Farm Source – it will include a digital income estimator which enables farmers to see the impact of changes to production volume and solids composition, milk price revisions and the opening price for the next season. Within the tool, suppliers can view income estimates for the current season and can also test for different scenarios, for example by changing the milk price or adjusting the composition of production. The tool has been roadtested by a group of our suppliers and we are confident that it will

provide another avenue for our suppliers to obtain up-to-the-minute information about price and pricing outcomes.

Even with this online tool, we expect field representatives who sit down and prepare income estimates for farmers will continue to play a vital role. However, in doing so, it is important that a field representative of a processor explains clearly to the farmer underlying assumptions that the field representative is making – for example, regarding expected price step ups – and what impact those assumptions have on the milk price that the farmers will receive.

#### Interim Recommendation 7

*The voluntary dairy Code should be strengthened.*

We agree with this recommendation in part.

In our view, it is important that processors do comply with the Code, otherwise there will be an issue of unfairness between processors who comply and those who do not (in addition to the consequences for farmers of the non-compliance). If such a situation arises, it would become difficult for processors to continue to comply with the Code, if their competitors are not doing so.

In our view, the best way for the Code to be enforceable would be through an industry body, as referred to above in our response to Interim Recommendation 4.

The issue of timely price disclosure is difficult to address because the price that a processor is able to offer is affected by global dairy commodity prices, which are constantly changing and can be volatile. Farmers' desire for a milk price to be announced as early as possible must be balanced against their desire for the announced milk price to be as accurate as possible. If the announced milk price or estimated price is too high or too low, it can result in the farmer not making the best choice of processor.

It should also be noted that most of Fonterra's suppliers, who supply pursuant to the Handbook, are entitled to cease supplying Fonterra at any time and switch to another processor. That appears to be different to the situation described in the Interim Report, where a farmer may not have price information before having to make a decision, at a particular point in time, about whether to renew a milk supply agreement with a processor.

#### Interim Recommendation 8

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

We do not agree with the introduction of a mandatory code of conduct under the *Competition and Consumer Act 2010* (Cth).

The current Code has been negotiated recently by industry participants, with assistance from Government, and it should be given a chance to work. All major Australian processors have agreed to become signatories to the Code.

As explained above, we consider it is critical that the body that handles disputes regarding compliance with the Code is developed and managed by the dairy industry, rather than a body external to that industry. We consider the dispute resolution service facilitated by Grain Trade Australia, which does not rely on a mandatory industry code, is a good model in this regard.

Finally, we do not believe a mandatory industry code would address the fundamental issues that led to the establishment of the Dairy Inquiry. As discussed further below, we consider it would be preferable to focus efforts on providing greater transparency and education for farmers about how the milk price they receive is impacted by global market forces.

## **OTHER ISSUES RAISED BY THE INTERIM REPORT**

### The 2015-16 season

As a general comment, we would caution the ACCC not to base its analysis too heavily on the 2015-16 season. There is no doubt that that season was extremely difficult for many farmers. However, the fall in milk prices was ultimately caused by global factors, which severely affected dairy farmers around the world.

In Fonterra's view, looking across a number of recent seasons, Australian dairy farmers have received a milk price comparable with that of other major commodity milk pools, such as Europe and New Zealand (see Appendix 1 to this submission). The Australian milk price has been underpinned by the high level of competition between dairy processors (discussed further below), as well as export opportunities. This suggests that there is not a fundamental market failure in relation to raw milk prices.

In our view, what made the 2015-16 season particularly bad in Australia was that, despite global prices falling sharply early in that season, the impact of those global price movements on Australian milk prices was not communicated clearly and promptly to farmers by all processors. This meant some farmers were not prepared for that impact, and may have made different decisions about their production levels and financial planning had they been better informed.

In our view, there is no "one-size-fits-all" solution to the issues raised by the 2015-16 season. Rather, what is needed is a suite of measures that include different pricing options for farmers to manage their risks (see further below) but also, critically, giving farmers transparency and education about what those risks are.

### Risk allocation

The Interim Report states that processors pass on a disproportionate share of risk to farmers and should be able to manage risk exposure without needing to shift the risk to farmers.<sup>1</sup> It suggests that processors have significant discretion when deciding whether to vary farmgate prices. It further states 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.<sup>2</sup>

We disagree with the analysis in the Interim Report.

The reality is that the international dairy market is volatile and all parties in the dairy chain are impacted by this. Processors do not simply pass on their risk to farmers. Processors also face significant losses if global prices fall. As well as reduced demand and lower prices for their products, processors face losses from reduced utilisation of processing plants, and reduced recovery of the high fixed costs that those processing plants represent.

In fact, processors do shield farmers from the global price risk to a degree by giving opening prices and forecasts, and trying to stick to those. This means farmers have an expectation about their likely income for a season, despite global markets moving constantly. However, it should not be expected that processors will shield farmers from significant market movements beyond processors' control.

Processors also generally take on the risk of accepting the entire volume of milk supplied by a farmer, which may exceed the farmer's expected volume. That is a risk over which the farmer has the greatest control. If farmers are prepared to commit to a set supply volume, it makes it easier for the processor to offer greater certainty regarding pricing. As discussed below, Fonterra does not have the capacity to offer fixed prices for most of its raw milk intake due to our exposure to international markets.

### Fixed milk prices

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<sup>1</sup> Interim Report, Chapter 2

<sup>2</sup> Interim Report, p 70

The Interim Report suggests 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*”.<sup>3</sup>

Fonterra already runs a Fixed Base Milk Price (**FBMP**) program which allows suppliers to lock in up to 70% of their anticipated milk volumes at a set price, similar to locking in part of a loan at a fixed interest rate.

We introduced the FBMP program to assist farmers in managing risk, to provide them with greater price certainty and to help them plan ahead with confidence. However, in our experience, the take up of such arrangements has been low. This may be due to the fact that step downs are rare, as well as farmers’ fears of missing out on step ups and reluctance to commit to particular supply volumes.

In some cases, farmers may also have decided not to accept fixed milk prices because other industry players were talking up milk prices. The take-up rate for our FBMP program was particularly low in the 2015-16 season, when the most recent step down occurred.

It is also not the case that all processors can offer fixed base pricing for the majority of their raw milk intake. The more a processor is exposed to the export market, the less certain the value of its revenue stream and the less they are able to offer competitive fixed milk prices. Fonterra relies on fixed price sales at the start of a milk season to hedge its fixed price milk offer, but only a small percentage of its annual raw milk intake is used to meet Fonterra’s commitments under those fixed price sales.

#### Transparency and education

In our view, all industry players – including farmers – need a strong understanding and awareness of milk pricing and the impact that the global market has on this.

Fonterra is committed to providing its suppliers with greater price transparency and has undertaken a number of measures to equip farmers with tools to enhance their understanding of pricing and the assumptions behind it. These include:

- providing farmers with monthly Australian global dairy updates, which include information on market conditions, commodity prices, currency and input costs – the factors that influence the cost of production and farmgate milk price;
- weekly communications through our web-based communications system that provides suppliers with important business information including pricing updates, and also a weekly email titled *Watt Matters*;
- cluster meetings with suppliers within and across regions at different stages through the season; and
- our new online farm income estimator to be launched in February (as discussed above).

#### Milk Price Index

Fonterra also supports the introduction by Government of a Milk Price Index for dairy farmers. This will provide farmers with a further independent and trusted source of information about what is happening in global dairy markets.

The proposed index also has the potential to support the development of price risk management tools such as dairy futures and options, which are currently available to New Zealand suppliers through the New Zealand Exchange. Such tools can provide farmers with greater control over their milk price and greater ownership of their decisions.

However, for the reasons discussed above, we consider that farmers will not get the full benefit of the Milk Price Index unless they have a sufficient understanding about what the index means for the raw

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<sup>3</sup> Interim Report, p 85

milk price they receive. This reinforces the importance of educating the entire industry about the impact of global markets.

#### Price setting and announcements

Fonterra agrees with the ACCC's comment that the assumptions and risks behind income estimates should be communicated clearly to each individual farmer and that the implications of not meeting all assumptions are also made clear.<sup>4</sup> It is also critical that the assumptions and risks are reviewed and updated on a regular basis to ensure accuracy in the output of data.

#### Competition between processors

The Southern Australian milk pool, in which Fonterra operates, is highly competitive with processors competing for supply to fill the processing capacity of their factories.

We do not agree with the suggestion that similar pricing between processors indicates a lack of competition.<sup>5</sup> In order to obtain supply, companies are compelled to set their milk price at a level similar to that of their competitors.

As the proposed sale of Murray Goulburn shows, the failure to pay farmers a competitive milk price leads to a loss of milk supply which can be catastrophic for a processor given its high fixed costs.

The Interim Report also suggests that the raw milk markets are limited to local geographic regions, such as the northern, eastern and western districts of Victoria. We disagree. Raw milk can be and is transported across such regions if there is an economic incentive to do so. The cost of transport is a key consideration but is not prohibitive should returns from products vary significantly. Dairy products must often be transferred a number of times for primary and/or secondary processing, as well as distribution and sale.

Further, if there was a significant price differential for raw milk between local geographic regions, it could be exploited by a milk broker or trader, or through milk swap arrangements.

Typically, however, there is little economic incentive to transport raw milk further afield for processing provided there is adequate processing capacity in the local area.

The Interim Report recognises that investment into upgrades and greater capacity are an indicator of competition. Fonterra's ongoing investment in its assets and operations over the last few years includes:

- The recent completion of our \$140 million rebuild of our Stanhope cheese plant which was destroyed by fire in late 2014.
- Expanding our capacity at our Wynyard and Cobden sites.
- Consolidating our distribution network and six warehouses under one facility in Melbourne with a 10-year Warehouse Services Agreement with NewCold Advanced Logistics.

On 24 January 2018, Fonterra announced that we are investing a further \$165 million in capital expenditure at all of our seven factories in regional Victoria and Tasmania.

The new expansion includes:

- \$125 million expansion at Stanhope, which will double the size of the cheese plant.
- \$12 million investment in Tasmania, which includes expansion of our Wynyard cheese plant and an increase in lactose processing capacity at Spreyton.

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<sup>4</sup> Interim Report, p 82

<sup>5</sup> Interim Report, p 87



- \$7 million expansion at the Darnum nutritionals plant in Gippsland, as well as the installation of two robotic palletisers in Bayswater.
- \$13.5 million for projects at Cobden and another \$8.6 million at Dennington.

Unused processing capacity is also a key driver of competition between processors. It means processors must compete, by offering higher raw milk prices to farmers, to fill that unused capacity.

We do not agree with the Interim Report's suggestion that capital requirements are a barrier to entry/expansion for significant international players.<sup>6</sup> In Fonterra's view, the Australian milk pool is extremely attractive from a global perspective and there are no barriers to entry that cannot be overcome by large scale international players. This can be demonstrated by Saputo's entry into the Australian market and recent reports of a number of international bidders for Murray Goulburn.

### Step downs

The Interim Report states that 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.<sup>7</sup>

We recognise that a price decrease can cause significant difficulty to farming businesses and we seek to avoid any decrease wherever possible. Under our Handbook, we now provide our suppliers with a minimum of 30 days' prior notice of a mid-season price decrease should this occur. Most of our suppliers are also entitled to terminate their supply of milk to Fonterra at any time, and they may choose to do so if there is a step down.<sup>8</sup>

We agree with the Interim Report that a ban on step downs could lead to more conservative opening prices.<sup>9</sup> In our view, it would also inevitably lead to more conservative step ups and would have an adverse effect on farmers' cash flow throughout the season.

Price increases, or step ups, are common in the dairy industry, while Fonterra has only had step downs in two of the last 10 seasons (in the 2009-10 season, following the global financial crisis, and in the 2015-16 season).

### Butter

The Interim Report states that the ACCC is considering the current supply situation in relation to butter, which has recently increased in price, and the potential reasons for that.<sup>10</sup>

The global demand for butter has increased significantly in recent years with consumers shifting to more natural products like butter. It is therefore necessary for butter prices to increase in order to encourage dairy processors to manufacture additional butter.

However, it is not as simple as building more factories to produce more butter. This is because, we do not have the milk volumes to fill more factories. While the demand for butter has increased, global milk production has declined, which restricts butter production.

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

### Fonterra's processing facilities

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<sup>6</sup> Interim Report, p 126

<sup>7</sup> Interim Report, p 84

<sup>8</sup> Fonterra Australia Milk Supply Handbook, section 3.11, p 12

<sup>9</sup> Interim Report, p 85

<sup>10</sup> Interim Report, p 158

The Interim Report states that Fonterra has processing facilities in Central and Northern New South Wales.<sup>11</sup> This is not correct. Fonterra's seven processing facilities are located in Victoria and Tasmania. Fonterra previously owned processing facilities in New South Wales.

We trust that the information in this submission is of assistance in preparing the Final Report of the Dairy Inquiry.

Please do not hesitate to contact us if you have any queries.

Yours sincerely

A handwritten signature in black ink, appearing to read 'René Dedoncker', with a stylized flourish at the end.

René Dedoncker  
Managing Director  
Fonterra Australia

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<sup>11</sup> Interim Report, p 44 and 100-2

## Appendix 1

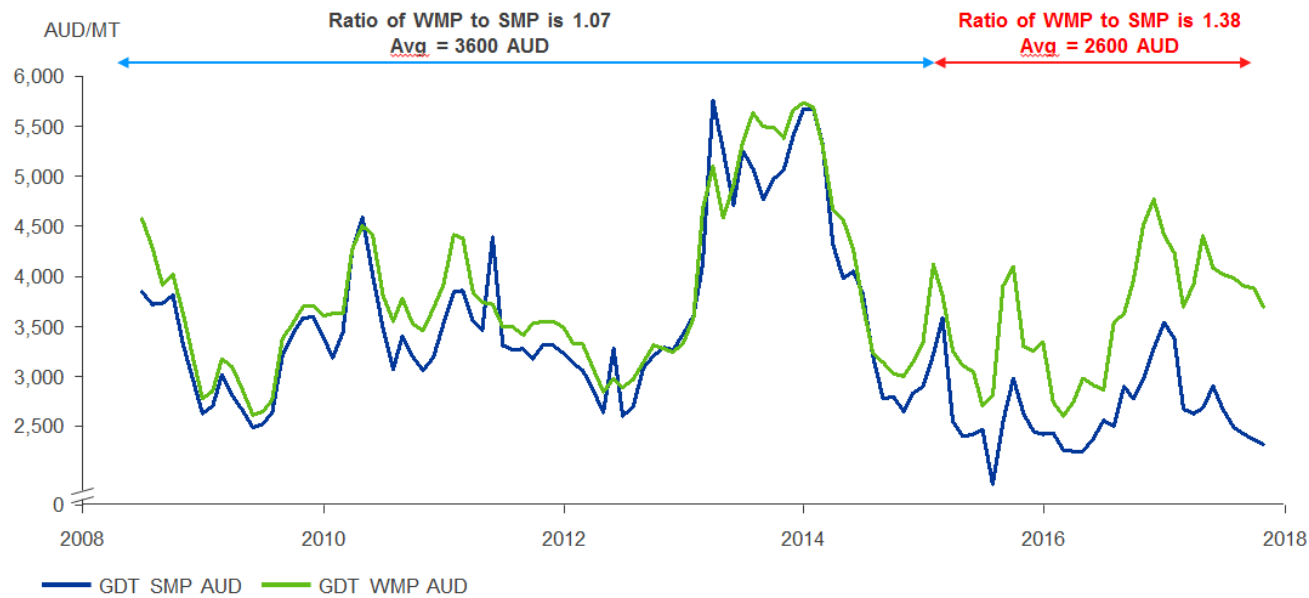
Comparison of Fonterra's milk prices in Australia and New Zealand

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18E
Aust. Milk Price A\$kgms	\$ 4.50	\$ 5.70	\$ 5.45	\$ 4.97	\$ 6.95	\$ 6.00	\$ 5.13	\$ 5.20	\$ 6.02
Fonterra Milk Price NZ\$kgms	\$ 6.10	\$ 7.60	\$ 6.05	\$ 5.80	\$ 8.40	\$ 4.40	\$ 3.90	\$ 6.12	\$ 6.40

Note: As at January 2018. Prices for the FY18 season (FY18E) may be subject to revision. The Australian Milk Price for FY18 includes the additional 40c incentive being offered by Fonterra for that season.

## Appendix 2

## Devaluation of Skim Milk Powder (SMP) (relative to Whole Milk Powder (WMP))



Note: SMP powders have traditionally supported butter prices. Despite strong butter prices, milk is still being diverted to cheese and WMP due to superior returns driving global shortages of fat.