





# Submission on the ACCC Dairy Inquiry Interim Report

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## About NSW Farmers

### *A profitable and sustainable New South Wales farming sector*

The NSW Farmers' Association is Australia's largest state farming organisation representing the interests of its farmer members.

Farmers across New South Wales produce more than \$15 billion worth of food and fibre every year, representing around one quarter of Australia's total agricultural output. Our state's unique geography means a wide variety of crops and livestock can be cultivated and nurtured. NSW Farmers is Australia's only state-based farming organisation that represents the interests of farmers of all agricultural commodities – from avocados and tomatoes, apples, bananas and berries, through grains, pulses and lentils to oysters, cattle, dairy, goats, sheep, pigs, and chickens.

Our focus is not just on issues affecting particular crops or animals – it extends to the environment, biosecurity, water, economics, trade, and rural and regional affairs. We also have an eye on the future of agriculture; we are advocates for innovation in agriculture, striving to give our members access to the latest and greatest innovations in research, development, and extension opportunities. Our industrial relations section provides highly specialised advice on labour and workplace matters.

Our regional branch network ensures local voices guide and shape our positions on issues which affect real people in real communities. Members are the final arbiters of the policies of the Association – through our Annual Conference and elected forums such as Executive Council, members can lobby for the issues which matter to them and their community to become Association policy. Our issue- and commodity-specific Advisory Committees are elected by members to provide specialist, practical advice to decision makers on issues affecting the sector. We are proudly apolitical – we put our members' needs first.

In addition, NSW Farmers has partnerships and alliances with like-minded organisations, universities, government agencies, and commercial businesses across Australia. We are a proud founding member of the National Farmers' Federation.

## Executive summary

The NSW Farmers Association welcomes the opportunity to comment on the ACCC's Dairy Inquiry Interim Report.

The Association is disappointed with the Interim Report, its findings, recommendations and lack of analytical rigour. This inquiry into the Australian dairy industry is a once in quarter of a century opportunity to resolve competition issues within the supply chain. The ACCC was vested with wide ranging authority to provide an accurate understanding of the bargaining power between industry players. These powers have not resulted in the rigorous and compelling report that was expected, as the analysis and recommendations have failed to identify crucial competition issues throughout the whole of supply chain.

Specifically, the Association is disappointed at:

- the lack of rigour in analysing the various markets for dairy, including poor market definition especially in relation to the fresh white milk market;
- ACCC's tendency to excuse or justify retailer behaviour as being consistent with beneficial competition and consumer outcomes, even where there is a lack of analysis or evidence to make such claims; and
- the fact that ACCC's draft recommendations do not substantially address the power imbalance in the dairy supply chain. Further recommendations are required to improve competitive outcomes within the dairy industry.

To ensure that this inquiry delivers meaningful change to the industry, the whole dairy supply chain needs to be examined by analysing the relationships that exist within it. The supply chain has three distinct relationships:

- Dairy farmer – Processor
- Processor – Retailers
- Retailer – Consumer

Our comments on the ACCC's Dairy Inquiry Interim Report have been organised around these relationships; highlighting areas that require further analysis, suggesting additional mechanisms to address competition issues within these relationships, and providing a response to the ACCC's Interim Report recommendations.

## Recommendations

NSW Farmers recommends that:

1. The ACCC undertake a close and detailed analysis of the impact of retailer behaviour throughout the dairy supply chain.
2. A mandatory code of conduct within the *Competition and Consumer Act 2010* be introduced for the dairy industry.
3. A Standing Market Offer regulatory framework be implemented for the dairy industry, to require processors to make one standing offer to the market.
4. The Voluntary Dairy Code is strengthened and it continues operation in the short-medium term, depending on the implementation timeframe for the mandatory code.

## Whole of Supply Chain

### *Failure to account for downstream impacts of retailer behaviour*

The key weakness of the Interim Report is its failure to effectively analyse all of the vital relationships within the dairy supply chain. The Association acknowledges that the markets between farmer and processor are ones for raw milk, which are geographically restricted by the ability to viably transport milk for processing. However, the Interim Report analysis neglects to examine whole of supply chain issues, particularly in analysing retailer behaviour and its downstream impacts on the relationship between processors and farmers. This failure is concerning, as it is clearly an area of investigation within the inquiry's terms of reference. The analysis is fundamental to accurately comprehend the competition issues within the dairy industry, as the strength of the retailers' market power has had serious impacts throughout the industry.

The Association contends that the Interim Report has not recognised that the power of the retailers has created a concentration in dairy processing and this has reduced competition for farmers' raw milk. The Interim Report highlights that geographic markets in Victoria and southern NSW have higher levels of processor competition for raw milk, with dairy farmers having up to eight processors competing for their supply.<sup>1</sup> In contrast, farmers in the central milk pool, encompassing most of NSW and Queensland, typically have less competition for their milk.<sup>2</sup> Generally, these farmers have less than three processors to choose from, and often only have one default processor. The report further states that these geographic markets are highly concentrated, with 85 per cent of raw milk in most regions purchased by the three largest processors.<sup>3</sup>

However, the Interim Report fails to undertake a comprehensive analysis of the reasons that concentration exists in these markets, only noting the need for scale and high barriers to entry within the processing sector. This is a poor explanation for this market concentration, given that these barriers and scale issues have not constrained the establishment of multiple processors of varying scale in markets found in Victoria and southern NSW.

A closer examination of these markets clearly reveals a strong link between the lack of competition in the processing sectors and the end market of these products being to retailers. This correlation demonstrates the power and the ability of retailers to squeeze margins from the rest of the supply

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<sup>1</sup> Australian Consumer & Competition Commission, *Dairy Inquiry- Interim Report*, November 2017, 101-102.

<sup>2</sup> Ibid 102.

<sup>3</sup> Ibid 103.

chain, particularly in establishing one-dollar a litre milk. This power imbalance necessitates that in these markets dairy processing is undertaken at scale to be viable and these market dynamics have in turn reduced competition for farmers' raw milk. In geographical markets where final consumption occurs in export markets, there is significantly more processor competition in the raw milk market.

The retailer sector has also undertaken unreasonable discounting of milk and this has had negative impacts on the dairy industry that were not examined in the Interim Report. A common rebuttal to examining the impact of the retailers discounting actions, is that such unreasonable prices would change suppliers' behaviour and subsequently put upward pressure on milk prices. This is flawed logic, and based on assumptions that have little understanding of dairy production. The supply of milk is inelastic, in the short term there are only marginal changes that can be achieved through the management of herd size. Most costs associated with dairy production are sunk costs, including the establishment of a dairy shed, cold store chains, and requisite electricity and water connection. To recover sunk costs farmers will continue to produce, even when the marginal cost outweighs the milk price, to ensure that they have production capacity when milk prices recover. The only alternative is to exit from dairy farming altogether. The changes in dairy supply capacity occur over years and decades, and do not respond to retailers' short-term marketing strategies.

The Association considers that current retailer practices have the potential to seriously damage the industry in the long term, through continuing to force dairy farmers out and thereby damaging the sustainability of the industry. The supply of raw milk is highly inflexible and increases cannot occur quickly given the lack of appropriate dairy farming land, urban encroachment, and stringent planning requirements to establish new dairies. There is the potential that in the future Australian consumers may not be able to afford fresh drinking milk on a routine basis.

## Farmer – Processor

In the Interim Report, the ACCC recognised the clear imbalance in bargaining power between dairy farmers and processors. This imbalance has been well-known by farmers and it is pleasing to see it formally acknowledged. However, the narrow focus of the recommendations is disappointing, as a suite of measures are needed to effectively address the competition issues between farmers and processors.

We welcome the recommendation to introduce a mandatory code. A mandatory code would provide transparency on the minimum content of milk supply contracts, monitor industry participants' compliance and address breaches. However, other mechanisms are needed to complement the mandatory code and the introduction of a Standing Market Offer would redress the disproportionate allocation of risk on farmers. There is also a need to reduce contractual complexity and enhance transparency for milk pricing so farmers can make informed decisions appropriate to their business.

### *Inappropriate Allocation of Risk on Farmers*

The Association seeks substantial action on the inappropriate allocation of risk on dairy farmers. The Interim Report found that there are clear differences in bargaining power, enabling parties to shift risk to others within the supply chain.<sup>4</sup> Currently processors pass their commercial risks back onto farmers and consequently farmers operate with a high degree of uncertainty.<sup>5</sup>

NSW Farmers requests that the ACCC explore market contract mechanisms to address the inappropriate apportionment of risk to dairy farmers. The Interim Report recognised that such mechanisms have been adopted in other markets and it is essential that similar mechanisms are implemented to address the inappropriate allocation of risk to dairy farmers. Specifically, the Association supports the imposition of a standing offer regulatory framework for raw milk supply contracts.

A standing offer regime would require processors to provide one market offer that has standard terms and conditions, and clear and transparent pricing. This offer would essentially be a base price for the raw milk supplied, plus differentials. These differentials would highlight the factors that are

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<sup>4</sup> Ibid 56-7.

<sup>5</sup> Ibid 63-4.



important to processors in their pricing structures. Each processor could be obliged to provide one standing offer to the market; however, the price for that contract would be determined by the individual processor. Furthermore, processors would remain free to provide alternative offers with prices differing above the standing offer.

There are significant benefits to a standard market offer within the dairy industry. It would provide clarity and comparability for farmers, enhancing the transparency around pricing and enabling farmers to access the best returns. More importantly, it provides the market with information as to the value of risk. As an example, prices can be compared between a processor's standing offer and an alternate market offer, where risk has been apportioned differently. The difference in this price is effectively the value of carrying the above mentioned risks. Over time this process, would provide farmers with better knowledge, and overcome some of the information asymmetries that provide processors with unreasonable market power.

Finally, the operation of a standing offer would enable farmers' to contract according to their risk appetite. The operation of different offers would enable farmers to choose between clarity on price and the opportunity for greater revenue, with additional risks.

### **Industry Codes**

#### **Mandatory Code**

NSW Farmers is supportive of implementing a mandatory code of conduct within the *Competition and Consumer Act 2010* (Cth) for the dairy industry, as per Recommendation 8. Industry has always intended for the Voluntary Dairy Code to become mandatory, and this recommendation is simply actioning this natural progression.

A mandatory code would moderate the imbalance in bargaining power between farmers and processors, through providing minimum standards for contractual terms and enforcing non-compliances. Farmers are at a substantial disadvantage in negotiating milk contracts, as they are small business entering into contracts with processors, whom are generally large companies. The mandatory code would redress this power imbalance by providing minimum requirements for contractual terms. The setting of a clear standard would enhance transparency around milk contracts and highlight those arrangements that cannot be entered into.

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The mandatory code offers farmers a vital level of legal protection. Mandatory codes are legal instruments. Any contractual terms in breach are automatically invalid ensuring that the parties are not bound. Compliance activities under the mandatory code are undertaken by the ACCC and actions can be taken for breaches. The ACCC's oversight is critical as it ensures that non-compliances are identified and that breaches have consequences, such as financial penalties and infringement notices.

The precise content of the mandatory code would be developed through a process involving the farming and processing sectors. This process would be to address concerns within the industry and develop actions that deliver improvements. The starting point for the mandatory code's content should be the relevant ACCC recommendations and the Voluntary Dairy Code.

The Interim Report highlighted that a key area for inclusion in the mandatory code is that contractual terms should not unreasonably restrict farmers from switching processors. Currently there are elements in contracts, both terms and structure, which hinder farmers' ability to change processors.<sup>6</sup> Certain contractual terms are the prime mechanism used to hinder farmers switching supply to an alternate processor. The Interim Report identified that the key barriers are lengthy termination notice period, loyalty bonuses and retrospective step-ups.<sup>7</sup> These barriers are not acceptable and farmers must be able to switch their supply arrangement to receive the best price for their product. The mandatory code must clarify the contractual terms that unacceptably reduce farmers' ability to move processors.

The ability of farmers to switch processors is also hindered by the structure of certain contracts, namely the different expiry dates for contracts. Supply agreements are generally offered on a financial year arrangement but Parmalat offers agreements on a calendar year in certain areas. This misalignment creates a risk for any farmer considering moving processor, as there is a period without guaranteed milk collection.<sup>8</sup> The consultation process for the development of the mandatory code needs to address this timing misalignment.

Finally, it is important to highlight that mandatory codes are already operating within other agriculture sectors and successfully addressing issues similar to the dairy experience. The Horticulture Code, for instance, provides a positive example of a mandatory code in action and the

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<sup>6</sup> Ibid 108-9.

<sup>7</sup> Ibid 109-110.

<sup>8</sup> Ibid 109.

benefits it can provide farmers. There are lessons to be learnt from the horticulture example, to ensure that the drafting of the dairy industry's mandatory code produces the intended outcome. Clarity on terminology and definitions of key terms are vital, as a mandatory code is a legal instrument and all parties must understand their obligations. The examples set by other industries provides the dairy industry with the means to identify potential issues and draft a code that delivers real outcomes.

### **Voluntary Dairy Industry Code**

NSW Farmers is supportive of the recommendation to strengthen certain areas of the Voluntary Code. Industry's intention was to review the Voluntary Code after 12 months of operation, to identify areas of improvement. This strengthening process should be started immediately and the areas identified by the ACCC must be incorporated.

The proposal to remove the incumbent processor's right of refusal regarding a farmer's supply of milk to an alternative processor is particularly important. It is vital that farmers are able to make their own supply choices and are empowered to develop flexibility and divergence in their business to enable better risk management. Mechanisms need to be developed for farmers to identify excess milk and to exercise their right to find another market.

The Voluntary Code should continue operating in the short term. This would enable industry time to develop the content of the Mandatory Code, whilst still providing farmers with a degree of direction on contractual practices.

## ***Contracting Practices***

### **Contract Complexity**

The Association welcomes the Interim Report's finding that there is undue complexity and opaqueness in milk contracts. As highlighted above, there is a stark imbalance in bargaining power with milk contracts. Owing to this clear disparity, it is vital that the contracts are simplified and transparent so that farmers have a clear understanding of their agreement. We are supportive of the ACCC recommendation that all processors should simplify their contracts where possible, including by minimising the numbers of documents. Simplification would improve the ability of farmers to make an informed decision on the most appropriate supply agreement for their business and potentially facilitate comparing offers between processors.

## **ACCC Dairy Inquiry – Interim Report**

It is important to highlight that milk contracts do not cover all the essential elements of the farmer–processor relationship. Conditions around milk quality that determine payments, bonuses, or penalties are not located within contracts, and they can be unilaterally changed by the processor. Industry needs to address this issue to ensure that farmers have sufficient certainty.

### **Independent Body – Mediation, Arbitration and Expert Advice**

NSW Farmers are supportive of the recommendation that 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. It is vital that industry provides a clear mechanism for farmers to access in the event of a contractual dispute. The traditional court system is not effective for farmers, as it is inaccessible due to costs, the time of proceedings, and power imbalance between parties.

The independent body also needs to have the power to bind parties to the outcome of the process. Contracts between farmers and processors must include an obligation that any dispute is referred for binding resolution; this can potentially be included within the Mandatory Code. A single body dealing with all industry disputes would, over time, provide industry with clarity about the types of behaviours that are appropriate and those that are concerning. This would give farmers a better understanding about acceptable practices, and help to develop best practice guidance for industry.

The location of the independent dispute body has not been determined, however there are a range of options for industry to consider. The Horticultural Code operates under a mediation structure and industry should investigate whether a similar option would be appropriate for dairy. The grains industry has a well-developed dispute resolution mechanism to ensure that commercial transactions occur in a fair manner.<sup>9</sup> The dairy industry is able to draw on these examples to develop a determination process that is appropriate to the industry.

### **Legal & Financial Implications**

NSW Farmers’ recognises the importance of farmers seeking advice so that they understand the legal and financial implications of contracts with processors. However, it is important to highlight that farmer representative groups are not well placed to provide advice to farmers owing to a lack of indemnity insurance to cover the cost of any litigation arising from this advice. Additionally, as has

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<sup>9</sup> Ibid 175.

been highlighted throughout the submission the uncertainty and complexity of contracts with pricing would make it difficult to provide meaningful advice.

### *Farmgate Milk Prices*

Farmers need greater transparency around farmgate milk prices to facilitating effective competition. Currently processors do not disclose sufficient pricing information, and this results in farmers entering contractual arrangements without a clear understanding of the pricing structure. For farmers to be able to make informed contracting decisions greater transparency around milk pricing is required.

NSW Farmers supports the recommendation that processors should make public information identifying how their pricing offers apply to individual farm production characteristics to enable better farm income forecasts. However, further actions are required and the proposed Standing Market Offer should be extended to these farm income estimates. This information would give farmers a greater understanding on the base milk price, and the various differentials that processors apply. These disclosure mechanisms would allow farmers to make better comparisons of processors milk supply terms and enhance competition.

The timeliness of pricing information is another area that must be addressed to enable farmers to make informed decisions. Often milk prices are declared without sufficient time for farmers to be able to analyse the content of the offer or compare with other processors. This is an area that needs improvement to ensure that farmers have sufficient time to consider contracts.

## Processor – Retailer

### *Market Definition*

The definition and boundaries for the markets facilitating transactions between processors and retailers are not clearly defined within the Interim Report. The Interim Report analysis suggests that there is only one market for all dairy products. The Association disagrees with this definition.

A common test for defining the boundaries of a market for competition purposes is the degree of substitutability in supply and demand. The Association concedes that there is significant substitutability in dairy supply, where processors can switch between different categories of dairy products, such as cheese and milk, given changing market conditions. This substitutability does not exist on the demand side, retailers do not change their demand for fresh milk for another dairy product, such as cheese or yoghurt. There is no justification provided for the Interim Report treating these markets as exhibiting the same dynamics and characteristics.

At a minimum, there are two distinct markets within the dairy industry; one for fresh milk and another for value add dairy products. Had these markets been defined properly by the Interim Report, the analysis and findings around competition issues and the existence and abuse of market power could have been significantly different. These two markets need to be clearly defined and analysed in the Final Report to ensure that all competition issues are adequately considered.

### *Impact of one dollar a litre milk on farmers*

The Association is extremely disappointed by the Interim Report's finding that the removal of one dollar a litre milk would not have a discernible impact on farmgate milk prices, or margins achieved by farmers. We consider that the analysis is factually inaccurate, and would request that a more detailed and longer-term analysis is conducted.

The ACCC rationalises their position by demonstrating that revenues from dollar a litre milk predominantly impact the margins achieved by the processor and the supermarket, and thus its removal would only improve their margins.<sup>10</sup> The report states that all contracts for the supply of private label milk have clauses that allow processors to pass-through movement in farmgate prices to supermarkets, and conclude that changes in farmgate milk prices are not influenced as processors

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<sup>10</sup> Ibid 153.

profits are not impacted.<sup>11</sup> This logic does not reflect the experience the industry. Processor gross margins on private label milk have fallen, yet it is not acknowledged that this has impacted on returns to farmers.<sup>12</sup> Our farmer members have reported processors dropping their farmgate price due to downward pressure from private label milk.

Additionally, it is important to acknowledge that the Interim Report found that processors exhibit significant power over farmers. We suggest that improvements to more competitive market conditions would alter this power dynamic and it is logical to assume that if retailers made more of the economic surplus available to processors, some of that surplus would find its way to farmers.

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<sup>11</sup> Ibid 153.

<sup>12</sup> Ibid 156.

## Retailer – Consumer

### *Market Definition*

The Interim Report did not clearly define the consumer market. Implicitly, the Interim Report suggests that there is one market for all dairy products, though the report seems to suggest that there are distinct markets for convenience dairy products and supermarket dairy products. That appears to imply that dairy products bought from full line supermarkets, are not competing with dairy products bought from speciality stores, such as corner stores. These implications do not reflect known consumer behaviour and to ensure that the whole dairy supply chain is accurately analysed it is vital that the consumer market is clearly defined.

### *Dollar a litre a milk not good for consumers*

In examining dollar a litre milk, the Interim Report finds that the lions-share of the surplus goes to consumers, and hence is a positive from a competition and consumer perspective. It further states that accounts of retailers selling milk at a loss can be explained by cross-subsidisation across geographic regions, where transport and logistics costs may differ. The ACCC appears to be comfortable with this behaviour as it provides consumers with lower prices.

The Association doubts the validity that dollar a litre milk is in the long-term interest of consumers. Currently the retailer strategy is to use milk as a loss leader to attract shoppers into the store to buy more profitable grocery items. Any losses incurred by the retailer or surplus to the consumer on fresh milk are recovered by increased margins on other grocery products. The consumer is thus left no better off as a result of this discount, unless the consumer only purchases fresh milk. However, it is known that very few consumers walk into a supermarket only to purchase fresh milk.



## Conclusion

NSW Farmers is disappointed with the Interim Report, including its analysis and recommendations. The key weakness of the report is that it did not encompass an analysis of the whole dairy supply chain. This inquiry into the Australian dairy industry is a once in a quarter of a century opportunity to resolve competition issues within the supply chain. We consider that for this opportunity to be realised, the impact of retailers on the industry must be recognised, accounted for, and effectively managed. The Interim Report has focused on the processor–farmer relationship. We support the introduction of a mandatory code but consider that further mechanisms to increase transparency are needed to complement the code.