Queensland Dairyfarmers' Organisation

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Australian Competition and Consumer Commission
23 Marcus Clarke Street
CANBERRA ACT 2601

QDO RESPONSE TO
ACCC INTERIM REPORT INTO DAIRY INDUSTRY

1. Summary

The QDO strongly support the key ACCC findings that

- the dairy market does not work and must be fixed – it is a failed market
- Industry structures, and price structures are inevitably different and higher in Queensland than other markets and this is not principally or significantly caused by inefficient farmers, industry structure or systems
- the voluntary code of conduct insufficiently remedies market inefficiencies/failings and must be strengthened
- a voluntary code insufficiently remedies market inefficiencies/failings and must be made mandatory.

However, we feel that even a strengthened and mandatory code is a weak and insufficient response to the current problems in Queensland, will not establish a functioning and efficient market, and more must be done.

The Dairy Inquiry Interim Report (the Interim Report) of the Australian Competition & Consumer Commission (ACCC) vindicates and supports what dairy farmers and Queensland Dairyfarmers' Organisation (QDO) has said about the dairy market in Queensland:

- The market doesn't work – it is a failed market and must be fixed
- Farmers have no negotiating power and prices and terms are dictated to them by processors – we say this is their easy and weak response to retailer pressure
- Processor returns have been and continue to be massively reduced from $1/lire milk
- Farmgate milk prices are inadequate and unsustainable
- Merely increasing retail prices won't fix the problem as increased profits to retailers and/or processors won't be passed on to farmers, because the market is broken
- Voluntary codes and other solutions have not worked and need to be strengthened and made mandatory.

There are several gaps in the Interim Report, and factual errors leading to wrong conclusions, but they don't impair the key finding of market failure. While the Interim Report powerfully and in detail makes the case that the dairy market is a failed market, and highlights many of the problems

in the industry previously identified in many other reports, it identifies insufficient solutions to solve the problem. The final report must have sufficiently broad recommendations that dairy farmers can be confident the failed market will be fixed – anything less guarantees future farm failures and guarantees continued campaigning for re-regulation.

Deregulation of the dairy industry has failed – the shallowness of the ACCC proposals in response are of enormous concern. Those who advocate deregulation and the freeing of market forces (i.e. the Australian Government and its agencies, in this instance) have an unambiguous obligation to have a proper, effective, and thorough policy toolkit available to use to fix the problem, when deregulation fails. The limited responses from ACCC – which will not resolve the problems of the dairy industry nor fix the market – expose an enormous gap in the readiness of Governments to fix their policy mistakes. Sadly, that failure is killing the dairy farming sector in Queensland, but an appropriately strengthened final report from ACCC has the capacity to do much more.

2. Imbalance of bargaining power, risk and collective bargaining

As ACCC states, the dominant picture that has emerged is one of clear imbalances in bargaining power at each level of the dairy supply chain. This begins with the relationships between retailers and dairy processors, and progresses down to the relationship between processors and farmers. Unlike others in the supply chain, most dairy farmers have no bargaining power and limited scope to reposition their businesses to mitigate this.

There needs to be a strengthening of collective bargaining including the capacity of dairy farmers to involve their representative organisations in collective bargaining negotiations, including as their representatives. However this alone will do nothing to address the imbalance of power between retailers and farmers.

The ACCC correctly states that farmers face most of the risk and retailers have none. Also, ACCC acknowledge that farmers take prices and retailers set them. Surely this is a fundamental problem that the ACCC must address - so that farmers have reduced risk and receive higher prices and retailers accept appropriate levels of risk.

In addition, the ACCC needs to also ensure unfair contract laws are extended to all dairy farmers by lifting the contract threshold to $1m/contract or determine all dairy farmers are covered regardless of contract value

3. Code

The ACCC recommends introduction of a mandatory code between farmers and processors should be considered, noting the ineffectiveness of voluntary codes. QDO broadly supports the amendments to the code proposed by the ACCC. However, the QDO believes that the first step should be to try and strengthen the voluntary code by:

- Strengthening provisions in the code in a range of areas including prohibiting milk swaps (where it is demonstrated to impact on competition for milk supply), banning exclusive supply obligations and facilitating collective boycott capacity
- Ensuring that all processors sign up to the code
- Have a clear process for handing complaints and disputes, which is balanced, mandatory, very quick and very cheap, otherwise we must regard any dispute resolution process as being phony.

At this stage the rhetoric from processors is how bad a mandatory code would be and retaliation they would take if one was introduced which is not constructive to moving forward. A better approach would be for processors to genuinely agree to work proactively with ADF to strengthen the existing code. However if processors are unwilling to do so in a genuine way then the only remaining option is legislation via a mandatory code.

Regardless which approach is taken, there should be a process, panel and suitably qualified person to deal with disputes via mediation or arbitration. There needs to be access to speedy, cheap mediation and arbitration. This would available during contract negotiation and contract dispute settlement at the dairy farmer/processor and processor/supermarket interface.

In addition, there needs to be a mandatory code between retailers and processors to address the market imbalances that occur. This would include issues not only between processors and retailers but also what ends up at farmgate.

4. Retail pricing

The ACCC states that the farmers' lack of bargaining power means that they are unlikely to benefit from an increase in the retail or wholesale prices of private label milk or other dairy products. Also, that any increases in margins flowing from an increase in the retail price will simply be captured by the major supermarkets, or at best shared between the supermarkets and processors.

If this statement is correct, and QDO believes this to be the case, then this does not indicate that nothing should be done. The obvious conclusion is that something needs to be and should be done by government to fix this problem given the market is unable to do so in the ACCC's view – and history has proved the market, and processors, and retailers, will not fix the problem.

The ACCC also states that the price paid to farmers does not vary between private label and branded milk. In Queensland contracts between farmers and processors used to show prices to farmers from a variety of products including branded and store brand milk and these were higher for branded milk. However, processors no longer disclose prices to farmers based on where milk goes after backlash from retailers. But some processors including Norco have stated publicly that buying Norco milk returns more money to farmers' pockets. And in a cooperative like Norco this is very likely to be the case, however greater transparency would still be an essential means to improve the trust between farmers and processors.

The ACCC states that private label drinking milk is at times sold at a gross loss by supermarkets in Tasmania and Queensland (once distribution costs are taken into account). And that negative margins in regions are subsidised by higher margins achieved in other regions. And that Cross-subsidisation within diverse businesses such as supermarkets is relatively common.

Currently Norco reportedly sells $1/litre milk to Coles for around 99c/litre in Queensland for white milk delivered to retailer depots. But this is the price before each retailer incurs the costs, capital and labour, of getting the milk onto their stores' shelves. Coles stated in July 2016 that it costs them around 20c/L to transport milk to their stores. When these costs are added it is estimated the true cost to get milk to stores is around $1.19 in Queensland. At $1/litre they are selling at a loss in Queensland and other retailers and brands are unable to compete.

The economics are even worse in the Darwin regional market, where the landed price of milk is around $1.25/litre. Retailers selling for $1/litre are losing money on the acquired cost of milk even before their own costs are added.

It is extremely confusing as to why anti-competitive behaviour such as cross subsidisation with retailers is permitted under competition law. This prohibits competition from smaller suppliers in high cost markets because of this cross subsidisation. Clearly a review of the completion law needs to occur to ensure that there is a level playing field between small and big retailers and processors which clearly does not exist today.

There needs to be a regional assessment of costs backed up by retail prices and payments to processors/farmers to reflect this. This would reflect supply and demand in different regions which would reflect the price in other regions plus transport if supply does not meet demand.

5. Impact of $1/litre milk on farm gate price in Queensland

The claim reducing retail prices don't impact farm gate prices, and increasing retail price won't increase farm price, is wrong in Queensland especially with the presence of a cooperative. Currently there is very little manufactured dairy products (such as cheese, yogurts and UHT milk) produced in Queensland. Virtually all of the milk produced is sold as fresh milk locally in Queensland. As a result, changes to the retail price of fresh white milk dictate the price that farmers receive for their product. Also, if 2 of the 3 major processors in Queensland supply home brand milk, this is large proportion of total milk produced in Queensland and processor profits down how can this not affect farm gate price?

A cap on the retail value of milk at $1/L has put a cap on the value that processors receive. Reportedly Norco receives around 99c/L with its contract with Coles for private label milk. If the retail price went up that would lift the cap and would give Coles scope to increase the price paid to Norco. Being a cooperative which aims to return profits back to farmers, Norco is ideally placed in passing on this increased margin to their farmer members – as they have done in the past for branded product price increases.

Even if the ACCC is correct in judging changing retail prices don't have a linear or direct impact on the prices paid to farmers in every market at every time, there is clear and unequivocal evidence that the reduction to $1/L by major retailers and the holding of the price at that level has had a major impact on prices up and down the supply chain in Queensland, such that farmgate prices do not reflect farmer costs.

As the ACCC states, Co-operatives are often seen by farmers as playing an important role in the market, as by returning all profits not reinvested (via the farm gate price or dividends), they will provide a price that reflects market returns, which corporate processors will need to match in order to compete for supply.(p71)

Norco is a cooperative and a large portion of their milk is Coles brand milk so how can farmers' price not be affected? Norco paid farmers the lowest for milk 57.2c/litre in 2016. Clearly if Coles paid more to Norco this would lead to higher, more sustainable returns to farmers.

Also the price paid to Parmalat and Lion farmers is benchmarked against the 2 other major processors. So if Norco's price is low then this affects other farmers. Consequently the price received by both Parmalat and Lion farmers has been reduced in the past year to reflect the price paid by Norco which is largely dictated by the price received by its contract with Coles.

Also the ACCC states that processors earn higher gross margins on branded products than private label products. Branded product margins are a key driver of processors' overall profitability. So if the introduction of $1/L milk clearly reduced the retail price of branded milk would this not have reduced the price and profits to processors? In Queensland with a cooperative being one of the 3 processors, would this not have reduced profits being returned to farmers? In addition, wouldn't this reduced price be matched by other processors? Also, Norco makes more money on branded milk and sells more of it, wouldn't it lead to their farmers being paid more and Parmalat and Lion matching their price? It is hard to see how $1/L milk has not impacted farmer price in Queensland. The ACCC needs to use economic principles and logic to examine impacts not just an examination of historical data.

It is often claimed by supermarkets that the reduction in profits with the introduction of $1/litre milk was borne by the supermarkets. This is not correct and flies in the face of the evidence. In Queensland they shared the costs by forcing down the price they paid to processors, who then imposed a price cut on farmers. The farm gate price paid for milk in 2011 is actually still higher than what Norco is paying their farmers now without taking into account farmers diminishing terms of trade per year of about 1.2cpl.

When $1/litre was introduced by Coles in January 2011, Woolworths matched the price. As a result of this Woolworths forced down the price with their milk supplier Parmalat. Parmalat then forced a

price reduction of 3c/litre on their dairy farmers as a result of their revised contract with Woolworths. Lion also dropped their price by 3cpl as a result of the contract with Coles.

If around 40% of Parmalat total milk take was used for store brand milk in 2011, then the farm gate value of the milk farmers supplied for store brand milk reduced by 7.5c/litre as a direct result of $1/litre milk. That is, a 3c/litre overall price drop occurred for farmers from the introduction of $1/litre milk which was around 40% of the total milk sales. So in effect, the price drop to farmers on $1/litre milk is 3c divided by 0.4 (the proportion of milk which caused a price drop) which is a 7.5c/litre fall in the price received by farmers for the milk they supply for store brand milk.

If $1/L milk has no impact on farmgate price, then if all milk sold in Queensland was sold at $1/L, would that mean that the farm gate price would not go down? I would be surprised if any processor in Queensland would suggest this would be the case. Putting aside the small processors, I would be surprised if Norco would hold its farmgate price if it only sold $1/L milk and the profits from branded milk were not returned to farms. Given the competitive pricing provisions from Parmalat and Lion, that would lead to a fall in price from those 2 processors as well. It is hard to fathom in Queensland how farmgate prices would not be affected by increased or decreased sales of $1/L milk.

These price change data are all established facts demonstrating the clearest linkage between $1/L milk and farmgate prices in Queensland.

6. Queensland Processor competition for milk supply

The ACCC states that there are multiple processors competing in all Queensland areas except central and far north Queensland. This may be the case in theory in south east Queensland (SEQ) where there are 3 major processors. However in reality there is little to no competition for milk supply between the 3 major processors currently in SEQ. All 3 major processors have the milk supply they require and are not actively seeking additional milk. None of the 3 major processors have sought additional supply or attracted more than a handful of new suppliers in recent years.

Underpinning some of the analysis of competitive pressure by ACCC is a proposition that if a farmer is a certain distance from a processor, that processor is a competitor for their milk. This is simply not reflective of reality and leads ACCC to faulty conclusions such as their map on page 100 and the discussion around that page suggesting South-East Queensland farmers have multiple processors seeking their milk. This is wrong. QDO members in that area are clear that they mostly have one processor seeking their milk, sometimes two, and there are many custom-and-practice arrangements at the local level which guarantee there is little or no competition at the farmgate. That map is dangerously wrong.

The ACCC also found that milk swaps and trades have not had an adverse impact on competition. Instead the ACCC found that it is the capacity for processors to engage in milk swaps and trades which inhibits farmers switching processors, not whether they actually engage in swaps and trades.

It is hard to understand how milk swaps and trades would not have an impact in Queensland. If they were deemed illegal and processors had to cease all current arrangements, it would force them to compete for milk supply. It would then be extremely likely that those farmers, who are well placed to service multiple processors, would attract more competition for their milk supply than those who only have one choice of processor. So some farmers could be better off and some may be worse off. This would appear to impact competition.

7. Queensland farm exits

The ACCC claims that farm exit, farm numbers and output trends in the higher cost regions have not changed in response to the introduction of one dollar per litre milk This is not correct in Queensland. Below is a table of the number of dairy farms, milk production and fresh milk sales in Queensland. The farm numbers are from QDAS reports while milk production and sales are from Dairy Australia.

	Farms (QDAS)	% change	Milk production	% change
1999/2000	1545		848	
2000/01	1305	-15.5	760	-10.4
2001/02	1185	-9.2	744	-2.1
2002/03	1125	-5.1	720	-3.2
2003/04	970	-13.8	674	-6.4
2004/05	880*	-9.3	619	-8.2
2005/06	802	-8.9	597	-3.6
2006/07	734	-8.5	537	-10.1
2007/08	630	-14.2	486	-9.5
2008/09	**610**	**-3.2**	**513**	**5.6**
2009/10	**595**	**-2.5**	**530**	**3.3**
2010/11	**566**	**-4.9**	**487**	**-8.1**
2011/12	**548**	**-3.2**	**491**	**0.8**
2012/13	510	-6.9	465	-5.3
2013/14	485	-4.9	444	-4.5
2014/15	443	-8.7	418	-5.9
2015/16	429	-3.2	414	-1.0
2016/17	405#	-5.6	418	1.0

*no data found so interpolated, # QDO estimate

Deregulation occurred in 2000 and this caused a substantial decline for 8 years following deregulation. The average yearly decline in farm numbers was 10.5% between 1999/2000 and 2007/08 while milk production fell on average by 6.7%. The large fall in farms numbers and milk production over this period was due to a range of factors including deregulation, drought and the resultant closure of processing facilities.

Post the impact of deregulation there was a 4 year period of relative stability. There was a relatively modest fall in farm numbers (3.4% per year on average) and milk production (0.4% average fall) between 2008/09 and 2011/12. The impact of deregulation was now passed and there was a concerted campaign to push prices up in 2007/08 with supply demand reaching parity. Also Norco started signing suppliers up for about 4-5 cents higher than existing prices. This resulted in a price lifted across the board with 3-5 year contracts which increased Qld production and gave that stability.

$1/litre milk was introduced in 2011. The following year in 2012/13 the period of stability in farm numbers ceased and the number of farms fell on average 5.9% per year, and milk production by 3.1%, between 2012/13 and 2016/17.

8. Collective bargaining and competition for farmers milk in Queensland

More than a decade ago the ACCC sought to limit the power of a range of collective bargaining groups throughout Australia including dairy farmers. It would appear that there was a fear that collective bargaining groups would be too powerful and dictate terms to other entities including milk processors. Unfortunately the ACCC's actions have limited the power of small players and allowed big players to distort milk markets without recourse to remedies for these abuses of market power.

Currently only 3 collective bargaining groups operate in Australia which include Premium, which negotiates with Parmalat only in Queensland, and DFMC which negotiates with Lion throughout Australia. However the Premium agreement with Parmalat runs out in 2018 and the DFMC agreement ends in 2019 and it is unclear whether the 2 agreements will continue and if so in what form. It is likely that DFMC will have a revised Milk Supply Agreement with Lion, but there are a few sticking points.

There are 16 collective bargaining groups in the dairy industry which no longer operate. Processors have chosen not to negotiate with these collective bargaining groups and instead sets terms themselves and require farmers to either accept all terms and sign or do not sign and potentially be left with no alternative.

This non-collective system may be viable in markets such as south eastern Australia where there is healthy competition between processors. This means that processors tend to sharpen contract terms to maintain milk supply and attract new farmers. In addition, processors in south eastern Australia service both the domestic and export market. The market that is able to obtain the highest price by processors is able to pay more for farmers' milk and thus attract milk supply.

However in markets such as Queensland where competition between processors is small to non-existent, this system does not deliver a level playing field. Farmers in almost the whole of Queensland have no choice but to be price takers – they cannot store their perishable product and wait for the processor to improve their offer, and there is no other processor to whom to sell.

In south east Queensland there is some competition between the 3 major processors who are present in this market (Parmalat, Lion and Norco) for milk supply. However at present there is no appetite or market pressure for any of these processors to actively compete for milk in the marketplace. In Central Queensland there is only 1 major processor in Parmalat so there is no competition at all. The same is the case for north Queensland where the only major processor is Lion.

In addition to a lack of competition between milk processors in Queensland, processors actively undertake milk swaps with other processors to balance out milk supply requirements. As a result, if a processor is short of milk they can acquire additional milk from other processors. This uncompetitive relationship between processors virtually eliminates any need to compete for farmers milk, and the threat of it entirely eliminates the bargaining capacity of an individual farmer. Lion has ceased this practice because of fear of ACCC claims of collusion.

In addition processors often work together when picking up milk and often the same transport company is used to pick up milk for multiple processors.

From a farmer perspective, activities between processors that increase efficiency leading to better outcomes for farmers and processors are supported. However if activities between processors have a negative impact on competition for milk supply, and farmers are worse off as a result, then this is not supported.

The evidence is clear that the premise that collective bargaining groups would become too powerful is not the case. It is also clear from the evidence that retailers exclusively hold the bargaining power especially in market milk driven states like Queensland. Retailers impose their

bargaining power on processors and processors in turn impose on famers is a system which is unfair, anti-competitive and not in the interests of long term industry sustainability. There needs to be a review of collective bargaining arrangement to ensure that the weakest bargaining group is not taken advantage of - which is the current system. Such a review needs to make it much easier for farmers to negotiate collectively, and reduce or eliminate the capacity of processors to refuse to deal with them.

9. What is a competitive milk price in Queensland

The competitive milk price in Queensland is driven by 2 factors. What other processors in Queensland are paying and what farmers in Victoria are being paid.

Contracts between Lion and DFMC and between Premium and Parmalat state that farmers need to be paid a competitive milk price compared to other farmers in Queensland. If farmers are being paid less than other farmers then the price goes up. If they are paid more the price falls as has occurred recently for both Lion and Parmalat.

However processors are also able to truck milk up from Northern Victoria to meet any shortfall in Queensland/Northern NSW market. Given there is a shortfall in Queensland production to meet local needs there is a requirement to truck milk from southern states to meet needs.

The cost of transport from Victoria is around 17c/litre according to the ACCC. As a result, a competitive price in Queensland is also the cost of milk in northern Victoria plus 17c/litre.

Assuming the sale of Murray Goulbourn to Saputo goes through, the lowest price in Victoria will be lifted to $5.60kg which is equivalent to around 41.5c/litre. When the 17c/litre transport cost is added this gives a Queensland landed price of 58.5c/litre. This is almost around 1c/L more than dairy farmers in Queensland are being paid by Norco, Lion and Parmalat on average.

However the ACCC noted that the price is 10-16c higher but sometimes only 3c. Why? Is this competitive? Is there a lack of competition in the Qld dairy market to allow processors to usually pay less for locally procured milk which is fresher, has lower spoilage rates, less logistical challenges and less environmental impact from fuel emissions?

In addition, in autumn in some years we have seen prices offered in some parts of southern Australia higher than the Queensland price with milk from that area then being transported up to Queensland. It clearly demonstrates that processors are willing to pay a lot more for a small percentage of their milk (brought in from southern Australia) than pay a bit extra to make a sustainable price for the vast majority of milk (sourced in Queensland). This also is distorting the market.

10. Conclusion

Deregulation of the dairy industry has failed – the shallowness of the ACCC proposals in response, as set out in the interim report, are of enormous concern.

Those who advocate deregulation and the freeing of market forces (i.e. the Australian Government and its agencies, in this instance) have an unambiguous obligation to have a proper, effective, and thorough policy toolkit available to use to fix the problem, when deregulation fails.

The limited responses from ACCC – which will not resolve the problems of the dairy industry nor fix the market – expose an enormous gap in the readiness of Governments to fix their own policy mistakes.

Sadly, that failure is killing the dairy farming sector in Queensland, but an appropriately strengthened final report from ACCC has the capacity to do much better.

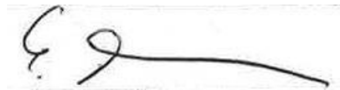
That is, Government has a much stronger obligation to find ways to resolve the failed market, than the interim ACCC report demonstrates.

It is the QDO's strong view that the ACCC's final report must contain recommendations to solve the major problems in the dairy industry relating to retail pricing that have been clearly demonstrated and outlined by dairy farmer representative bodies. As outlined previously, a mandatory code, with major changes, will not, in and of itself, resolve the current market failure in the dairy industry.

Additional concrete legislative solutions need to be developed which is not included in the interim report. Potential solutions to retail pricing problems are:

- Re regulate the industry to set processor and farm gate prices
- Re regulate the industry to set farm gate prices only
- Strengthen the effects test to unambiguously solve the problem
- Introduce new legislation to outlaw anticompetitive behaviour of retailers with increased penalties
- Introduce a mandatory code of conduct for retailers with clear anti-competitive provisions and farm gate pricing provisions.

Sincerely



Eric Danzi

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