SA Dairyfarmers' Association Inc
ABN 70 250 523 225
Unit 5 Emerson Centre
780-802 South Road
Glandore SA 5037

Telephone (08) 8293 2399
Facsimile (08) 8293 8886
Email sada@sada.asn.au

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06 February 2018

Commissioner Rod Simms
Australian Competition and Consumer Commission
GPO Box 922
Adelaide SA 5001

For Attention of the ACCC Dairy Inquiry

RE: - SADA Response to the ACCC Interim Report into the Dairy Industry in Australia

Dear Commissioner Simms,

The South Australian Dairyfarmers' Association (SADA) acknowledges the efforts made in enquiring into the dairy industry by the ACCC after having the industry referred to it by the Federal Treasurer. SADA welcomes the report and generally agrees with the ACCC's findings, particularly giving regard to the disparity between the processors and producers.

SADA now responds to the Interim Report and the proposed (interim) recommendations.

At the outset SADA maintains its position, as expressed in its initial submission to the ACCC, that the Commission can adopt a more proactive approach to the day to day business of overseeing the industry. SADA maintains the position that the ACCC could take a more pre-emptive role in the industry rather than responding after the fact to complaints which have happened.

We firmly believe that the ACCC does have the power and should have the inclination "to inspect a building for its integrity rather than merely examining the rubble".

SADA expresses its concern that no such commitment has been demonstrated in the ACCC's interim report. We have considered the interim report and provide the attached submission.

At the completion of this inquiry SADA looks forward to a fairer contracting environment for all its members, both processors and producers. We also look forward to a more assertive ACCC engaging in its policing role to prevent rather than investigate breaches of the ACCC's laws.

Yours sincerely

John Hunt
President

SA Dairyfarmers' Association Inc
ABN 70 250 523 225
Unit 5 Emerson Centre
780-802 South Road
Glandore SA 5037

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Facsimile (08) 8293 8886
Email sada@sada.asn.au

ACCC Recommendations

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

Agreed.

However as far as a recommendation goes it reflects the current status quo. It is what is in the contract and the transparency of the information surrounding the contract that is of greatest importance.[1]

SADA is of the opinion that while contracts for milk supply can be something other than written, giving consideration to the identified disparity between the contracting parties, the notion of a written contract provides some limited protection to the farmer. Nevertheless, considering the nature of such contracts and the remedies available to parties in a contractual dispute, the expectation of a timely response means that whatever dispute that may arise between producer and processor it is unlikely that the courts will be available to address the issue before the farmer, in particular, suffers negative impacts as a result of that dispute.

It is also the position of SADA that each contract should contain a clearly understandable and reliable liquidated damages clause. During the period after Murray Goulburn found itself in difficulties a number of MG suppliers, who had also become shareholders, found themselves in an environment where they could have gone to other processors and saved themselves from more financial hardship by exercising the liquidated damages clause in the contract and moving away from MG to a new processor. Several farmers spoke to MG about exercising that option and the response from MG was to threaten legal action beyond what was described in the liquidated damages clause in an effort to force MG suppliers to stay. We believe MG relied on the inherent ambiguity of the liquidated damages clause to make their threats. This approach caused deep anger amongst those farmers whose hands were forced by the approach of MG.

It is the position of SADA that a standardised liquidated damages clause forms part of the contract between the parties or alternatively consideration be given to a standardised liquidated damages clause forming part of the mandatory code of conduct.

SADA also agrees that an identified mediation (and perhaps arbitration) body as discussed in a later recommendation be identified to deal with contractual disputes in a timely manner.

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.

Agreed.

But simplicity does not prevent duplicity. It is important that there should be much greater transparency, particularly surrounding pricing information that the processor possesses. As the interim report points out, part of the disparity between the contracting parties is caused by the much greater access that the processor has to market information. It is not unusual for that information to be withheld by the processor in the contracting process.

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[1] Page 73 Interim Report

99% of milk supply contracts with farmers are not negotiated. They are imposed on a take it or leave it basis.[2]

By way of an example paragraph 6 of the standard Parmalat contract effectively says, 'we will let you know what the price is when we're ready'. It also refers the farmer to the Parmalat Handbook (attached) and incorporates the Handbook as terms of the contract. There is no price in the Handbook.

The Handbook merely says in para 2.1,

> *"The Supplier will be paid for milk supplied in accordance with the prices and methods set out in the most recent Parmalat pricing letter."*

The rest of the Handbook is a declaration of the duties of the producer as to the quality and standards that are to be supplied.

The contract then binds the producer to Parmalat exclusively at paragraph 3 which provides:

> *"The producer must supply all cow's milk produced on the Property during the Term of this Milk Supply Agreement or any Subsequent Term to Parmalat, the only exception to this being for milk used in the rearing of calves or personal use on the property."*

Expressed simply, Parmalat, as a massive multi-national corporation worth billions, will demand exclusive contractual terms from the small farmer, to a price that is not yet indicated and that Parmalat can change at any time they please. To be fair to processors it is hard to guess a price on any commodity so that flexibility isn't too unreasonable. However, the paragraphs below indicate potential abuse of the pricing mechanisms.

Historically processors have waited and observed the prices that other processors are offering just before the start of the contract and then posted a similar price.

The prices (with the notable exception of Beston Global Foods in early 2017) are always similar to each other and just enough to keep farms marginal. Once the milk disappears into the oubliette of the processor there is little to see how the processor generates profit and how much is made. Annual reports of publicly listed companies do open a window. However, by the time the report is produced the dislocation between the farmer and how the processor makes money from their milk is declared, the trail is masked to beyond opaque.

At the end of the financial year processors will then offer a "step up" or much more rarely a "step down". This is a calculated variation on the price originally offered which is an acknowledgement that money was made on the milk and additional few cents per litre will be back paid. That price is at the complete discretion of the processor. If a step down is imposed then the processor will demand money back from the farmer, as was the case when Murray Goulburn and Fonterra sent bills out for up to $250,000 to their producers in 2016. SADA does acknowledge that step downs are rare as processors tend to be conservative in their forward estimates to avoid the sort of pain that they can generate.

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[2] *Ibid* page 59

It is notable that smaller boutique processors do have a much healthier relationship with producers. These smaller processors, e.g. small cheese manufacturers, tend to pay better and the relationship has a more symbiotic quality than the relationship with the bigger end of town.

With regard to parity issues, Parmalat posted a 2016 net profit of €64 million ($97.3 million AUD) in its annual report (page 147). It is a multinational with €4.59 Billion ($6.98 billion AUD) in assets globally. (2016 annual report page 144).

The average farmer in the supply contract has about 300 cows on his/her property with a nominal asset value of $3.5 million AUD.

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

Agreed.

Processors are seen to time reward payments and loyalty payments not as a reward but rather as a hobble. The exclusive nature of the supply to a processor who in most contracts can exercise a first right of refusal on a price that the processor sets means that there is no capacity for the farmer to seek to sell excess milk elsewhere and pursue a better price.

There should be a mechanism by which excess milk can be identified and an avenue be available to the producer to find another market if they so desire. The exclusive nature of the contract means that in times of low prices there is no capacity for the farmer to change their risk profile extraneous to the boundaries of the contract. This places increased risk on the farmer in an environment where increased risk shifting by processors has been clearly identified as an approach that needs to be redressed by the ACCC. (There are a number of farmers across the nation that have been arguing for an ability to create a "spot market", for excess milk.[3] These suggestions accommodate the notion that a farmer can be contracted to supply to a point and then be free to sell milk on the open market outside of the boundaries of the contract.)

Contracts such as the MG contract as described in preceding paragraphs referring to the liquidated damages clauses have been aggressively, and in the opinion of SADA, unreasonably asserted to simply bully contracted farmers into remaining with Murray Goulburn. This caused deep resentment amongst those farmers impacted because MG misrepresented the terms of the clause in such a fashion as to render the farmer as living in a state of effective debt bondage. Once again because of the disparity between the contracting parties there was generally little stomach for any producer to take the matter to court, not because the farmers are necessarily worried about losing the case but rather because of the stress and the financial commitment of taking such a case on.

In the MG case, the net result was that farmers simply caved in to pressure from MG in spite of the truth that they could have exercised the terms of the liquidated damages clause to their advantage.

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[3] https://www.dropbox.com/s/7un96z7mhp9lppa/Let%20the%20milk%20flowPresentation.mov?dl=0
Please note that SADA has not endorsed this approach but rather it is the opinion of some dairy farmers in several states. The reason it is mentioned in this submission is that it does suggest similarities between the ACCC's observations and some farmer's ambitions for supply chain management.

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.

Agreed.

The court system is too slow and too cumbersome to be able to offer an effective remedy system for a contractual dispute. SADA suggests that where such a dispute does occur and is taken before a body as suggested, that the body be able to hear the matter and determine the outcome with all reasonable expediency.

It is noted that the civil appeals tribunals in some jurisdictions have power within the small claims division. In the Northern Territory, a small claim is any figure up to $100,000 and can hear all contractual disputes except those which engender the principles of equity, which are reasonably rare in contractual disputes.

Alternatively, SADA recommends a standardised arbitration clause be inserted into all dairy contracts or that an arbitrator be nominated in a mandatory code of conduct. The *Competition and Consumer (Industry Codes—Horticulture) Regulations* (Cth) 2017, creates a mediation structure that could be used as a basis for a similar structure for dairy, however, SADA feels that such a regulatory structure could extend to the functions of an arbiter.

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

Partially agreed.

SADA always recommends to its members that they engage in due diligence when engaging in the contractual process. However, it is difficult to consider financial implications of contracts that do not contain fixed prices. SADA accepts the difficulties in trying to fix prices to commodities and understands the formulas being applied by processors to their step up and step down processes.

For this recommendation to be achieved SADA would support a mandatory disclosure system by which processors make available their costs and risk assessments with regard to the term of the contract. It is extremely difficult for the farmer to have properly considered the financial implications of a contract with a processor when the information to the producer is essentially obscured.

SADA notes the ACCC's observations regarding $1 milk:

> *"The introduction of $1 per litre private label milk in 2011 initially reduced supermarket margins and transferred the benefit of these savings to consumers. It had no initial effect on processor margins, or on farmgate milk prices. However, both supermarkets and some processors incurred significant reductions in profit as a result of substitution by consumers from branded to private label milk."*[4]

and

> *"The ACCC examined the question of the removal of value from the industry. The margin analysis in this chapter confirms there has been a reduction of some value from the industry*

[4] Interim report page 20

since the reduction in private label milk prices in 2011, and that this value has mainly been passed on to consumers in the form of reduced retail prices.

This removal of value has reduced the profits of some processors. However, the ACCC has concluded that it is unlikely to have had a strong impact on farmgate milk prices. While processors have experienced reductions in profits, most processors remain profitable overall and are still able to compete to acquire the raw milk they need to satisfy demand for their dairy products. It is this degree of competition faced by processors and the demand for raw milk, rather than the absolute profitability of processors, that determines farmgate prices."[5]

The ACCC has been unable to make the specific documentation available to the reader that it relies on to make these conclusions because of commercial sensitivities of the information provided.[6]

SADA struggles to accept that there is no downward pressure on the price at the farm gate. Where a processor provides milk to a supermarket that sells $1 milk then the size of such orders mean that the processor will be under pressure to lower their price. This is acknowledged by the ACCC which suggests that the price impact has been felt by the supermarkets and the processors. Processors who have been granted extended supply contracts to supermarkets[7] have been granted greater leverage over their suppliers because of the certainty they have to supply the supermarkets.

If the ACCC is correct in their assertion that the farmgate price is unaffected by $1 milk it is because the processors have a history of screwing down prices at the farmgate that predates $1 milk, it demonstrates that the disparity that exists today has been an industry standard ever since deregulation and only serves to demonstrate that the ascendency of the processor is a norm that has been allowed to operate for far too long.

However, it has not been the experience of SADA to hear the voices of bitter complaint regarding the pressure on farmgate prices since deregulation. Those angry voices have become pronounced since the introduction of $1 milk.

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

Agreed.

However, SADA's position is that this recommendation needs to go further. Processors disclose almost no information about their pricing structure at the time of contracting. This serves as leverage against the farmer and past conduct has had the flavour of collusive behaviour. In the case of milk price contracts there is unlikely to be evidence of actual collusion. There doesn't need to be, historically the price has been set by a price leader such as MG and then other processors have followed suit. An example of where this formula was not followed was in early 2017 where Beston nominated a price that was more than a dollar above the rest of the pack. SADA notes that Beston, while still in the market for an increased share, has been less forthcoming this year.

It is the position of SADA that the withholding of critical pricing information should be a cause for the termination of a contract by a farmer.

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[5] *Ibid* page *154*
[6] *Ibid* page 142
[7] *Ibid* page 151

The Voluntary Dairy Code should be strengthened.

Agreed.

But such strengthening should include mechanisms that can be made binding upon the signatories to the code. Currently, from an evidentiary point of view the existing code can offer no more than probative value in an adjudicated contest in a court.

Significant rigour will need to be introduced into a code for it to have any capacity to have an impact. SADA notes that other jurisdictions may suggest a "prescribed" rather than a "mandatory" code.

> The value of such a code is its enforceability. Enforceability is driven by two important features from SADA's perspective. Firstly, the code needs to have substance. It is the position of SADA that substance means the force of law. If a "prescribed" code has some strength behind it, it is because it has a regulatory basis. In this case SADA struggles to see any significant difference between "prescribed" and "mandatory". If it does not have the force of law then beyond evidence of intention in a dispute before a court, there is little use for such a code beyond probative value in evidence in a disputed matter before a court. SADA notes that in the Interim Report[8] the ACCC dismisses the merit of a prescribed code as being insufficient to surmount the disparity that exists between the contracting parties.
>
> Secondly strengthening should include timeliness. Any enforceability structure needs to be timely. In an industry which is as fluid as dairy there is a need for timely resolution processes to put in place. SADA believes that where there is a regulated mediation process then the pathway to settlement will be clearer and fairer to all concerned.

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

Strongly Agreed.

SADA's position is that a mandatory code should be adopted. Such a code should establish the bare minimum standards of what should be in a contract and the mediation/arbitration steps taken should there be a breach. Such a code should cover:

- Minimum disclosure levels by the processor including a right of termination by farmer for incomplete disclosure,
- Minimum supply amounts by the farmer,
- A retained right by a farmer to on sell milk produced in excess of minimum supplied amounts,
- A clause for minimum standard of supply by the farmer,
- Include a requirement for good faith,
- A standard mediation/arbitration mechanism.

[8] Pages 189-191

SADA expects that contracts that breach such a code should be unenforceable on the grounds of illegality.[9]

Minimum disclosure by the processors reflects disparity between the parties in the contracting processes. If the intent of the Australian Consumer and Competition Law is to level the playing field between businesses that are so profoundly disparate then such a disclosure system would be the best available tool to deal with the disparity. A producer should have the protected right to enter into a contract being reasonably informed. SADA members have attempted to seek information across the supply chain in the past only to be, albeit politely, prevented from finding such information out. SADA members are not seeking to position themselves to create an unfair arrangement with the processors, however, SADA members have become exhausted by living on the very margins of viability without having any contracting strength at their fingertips.

In terms of minimum supply clauses, SADA acknowledges that processors require certainty of supply. However, this desire for certainty becomes manifest in clauses that demand that all milk produced on a dairy is subject to a first right of refusal at the set price of the processor. Anecdotally, such refusal is never granted. This effectively robs the producer of the capacity to on sell surplus milk into the market place and leaves the farmer with limited control over their own enterprise.

Should a producer be able to find a better spot price of their excess milk they should be able to retain the right to sell that milk into the market place for that price. Contractual clauses that prevent excess amounts from being traded by the farmer, how that farmer sees fit, are in the opinion of SADA unfair clauses.

Minimum standard clauses already exist in farm contracts. Farmers understand that they have to produce their product at particular standards and farmers accept that this is an obligation that they owe to the processors.

SADA maintains that there needs to be a requirement for good faith negotiations in any dispute resolution process and moreover, that such a clause should include protection from adverse conduct by processors when a farmer enters into a dispute with a processor. The capacity for a processor to engage in adverse conduct with farmers is substantial and fear of such conduct has historically caused some farmers to become reluctant to assert rights that they held in the commercial relationship.

A standard mediation/arbitration mechanism should be part of a mandatory code of conduct. SADA believes that as part of a dispute resolution process there could be a standardised clause that forms a standard minimum that binds all parties to a dispute resolution process. As stated such a process should describe a quick and reliable dispute resolution process.

In Conclusion.

SADA expresses its gratitude to the ACCC for its diligent work in the interim report. It is clear that the major finding by the ACCC with regard to the ocean that separates contracting parties is recognised and that the gulf is so wide that the normal tools that are potentially available, such as boycotts and collective bargaining, are so impotent as to be dismissed as next to useless by the ACCC itself.

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[9] *St John Shipping Corp v Joseph Rank Ltd* [1957] 1 QB 267, Devlin J observed noted that a court would not as a general principle, *"enforce a contract which is expressly or impliedly prohibited by statute."*

The disparity has led to many years of inability by farmers to protect their interests and this has had a deleterious impact on an industry with a long and proud history reducing it to an industry that has an increasing reputation as being one that offers little for those who seek to enter the farming business.

SADA is not so naïve as to argue for the re-regulation of a deregulated industry. Nevertheless, the chasm that separates the processors from the producers in terms of parity is so wide that there are sound reasons to cover the field with some form of protection for the weaker party. The ACCC since 2016 has had powers to deal with unfair contract terms regarding the use of standard form contracts in the small business domain.

SADA recognises that that law has yet to settle regarding what the boundaries of such legislation is but would nevertheless argue that it is there to primarily protect the interests of small businesses. The thresholds for such considerations are between $300,000 and $1,000,000 (with less than 20 employees) contracts and many if not most milk supply contracts fall within those parameters.

These laws should enable the ACCC to take a more assertive role in the dairy industry and to make their presence known.

At the completion of this inquiry SADA looks forward to a fairer contracting environment for all its members, both processors and producers. We also look forward to a more assertive ACCC engaging in its policing role to prevent rather than investigate breaches of the ACCC's laws.