

“RESTRICTION OF PUBLICATION OF PART CLAIMED”

- First paragraph and dot points listed under the heading “Herd Information” on Page 10
- Names of certain referenced documents p 31 – 32.

ATTACHMENT TO APPLICATION FOR AUTHORISATION BY DAIRY WESTERN AUSTRALIA LIMITED

1. EXECUTIVE SUMMARY

Since deregulation of the Western Australian dairy industry, prices received by dairy farmers for their raw milk has fallen to such an extent that significant numbers of dairy farmers are leaving the industry.

Raw milk production in WA has started to decrease since December 2004, despite increasing demand. Dairy WA is concerned that this decrease will result in a higher retail price for consumers in the long term due to the shortages of supply and the high cost of import replacement from the Eastern States.

Falling prices have been a result of the uneven bargaining power between the processors and WA dairy farmers. The WA dairy farmers have been unable to realise benefits from collective negotiating under the current authorisation applied for by the Australian Dairy Farmers' Federation, which is to expire in June 2005.

A significant problem is that dairy farmers are to a large extent locked into a single processor and processors' contracts are on a “take it or leave it” basis.

Therefore, Dairy WA or a body established by Dairy WA (“Dairy WA”) seeks authorisation to negotiate on behalf of WA dairy farmers who authorise Dairy WA to do so with dairy processors and to engage, if necessary, in collective boycott activity with regard to those dairy processors, supermarkets or others, if there are no current contracts in place or the processor seeks to unilaterally change a pre-existing contract with dairy farmers.

The authorisation application also seeks approval for contracts between Dairy WA and its contracting dairy farmers to require the consent of both parties for the dairy farmer to negotiate and contract directly with any processor.

2. APPLICATIONS FOR AUTHORISATION

2.1 Form B - Agreements Affecting Competition

Dairy WA or a body established by Dairy WA seeks authorisation under Section 88(1) of the Trade Practices Act 1974 (Cth) to make a contract or agreement or arrive at an understanding, a provision of which would have the purpose, or would have or might have the effect, of substantially lessening competition within the meaning of Section 45 of the Act.

Authorisation is sought for the purposes of engaging in the following proposed conduct:

- (a) An arrangement whereby Dairy WA negotiates raw or packaged milk supply contracts with:
 - 1. National Foods Milk Limited (“National Foods”);
 - 2. Peters and Brownes Foods Limited (“PB Foods”);
 - 3. Challenge Dairy Co-operative Limited (“Challenge”);
 - 4. Challenge Australian Dairies Pty Ltd (“QAF/Challenge JA”)
 - 5. Harvey Fresh Pty Ltd (“Harvey Fresh”);
 - 6. Other Australian and international dairy processors; and
 - 7. Retail suppliers of milk in Australia;

in relation to the price, terms and conditions of supply contracts, as an intermediary for WA dairy farmers who appoint Dairy WA to act on their behalf.

- (b) An arrangement by Dairy WA on behalf of members and non-members (both present and future) who appoint Dairy WA to negotiate on their behalf to give effect to any contracts entered into by Dairy WA with dairy processors or retailers.

Further, Dairy WA seeks interim authorisation for the same purposes.

Interim authorisation is sought on the grounds that National Foods have announced their intention to issue contracts with the aim of the contracts being finalised before the anticipated completion of the authorisation process proper; suppliers have been instructed provide feedback on new contracts by the end of March^{a1}.

2.2 Form A - Exclusionary Provisions

If the application pursuant to Form B is granted, Dairy WA requests the ACCC separately consider their application pursuant to Form A. Dairy WA is not seeking authorisation for collective bargaining being conditional on authorisation for collective boycott. WA dairy farmers are in a weak bargaining position and at the present time there is little opportunity to find alternative buyers without the necessary structural support to transfer milk to other States. At the present time we anticipate that a power of collective boycott may be necessary to facilitate collective bargaining occurring

Dairy WA or a body established by Dairy WA seeks authorisation under Section 88(1) of the Trade Practices Act 1974 (Cth) to make a contract or agreement or arrive at an understanding, where a provision of the proposed contract, arrangement or understanding would be, or might be, an exclusionary provision within the meaning of Section 45 of the Act.

Authorisation is sought for the purposes of engaging in the following proposed conduct:

An understanding between WA dairy farmers, undertaken through voluntary individual agency contracts between WA dairy farmers and

^a Please see list of documents at the end of the Appendices.

Dairy WA, whereby Dairy WA reserves the right to include a provision in its agency contracts with WA dairy farmers which states that:

- (a) WA dairy farmers who have appointed Dairy WA as the agent for the sale of their milk may enter into contracts directly with processors or retailers only with the consent of Dairy WA;
- (b) WA dairy farmers who have appointed Dairy WA as their agent may collectively boycott any processor or retailer which attempts to contract without consent, with a WA dairy farmer contracted to Dairy WA; and
- (c) WA dairy farmers who have appointed Dairy WA as their agent may refuse to supply processors where no current contract is in place or where there is are changes to the terms and conditions and price offered by a processor that has not been agreed with Dairy WA and the processor seeks to enforce the contract with the dairy farmer.

It should be noted that raw milk is highly perishable and that a collection boycott could only be undertaken at significant personal cost to dairy farmers. It is therefore anticipated that collective boycott would only be used as an ultimate last resort.

2.3 Interim Authorisation

Dairy WA seeks interim authorisation for both Forms A & B applications the basis of which is outlined in Item 11.

3. BACKGROUND – DAIRY INDUSTRY IN WESTERN AUSTRALIA

The Western Australian dairy industry was deregulated in full on 1 July 2000 in relation to both market milk and manufacturing milk. The price of market milk to dairy farmers had been supported by Farmgate Pricing and Supply Management Regulations. There were also additional domestic support provisions for manufacturing milk prior to that date.

Western Australian dairy farmers have subsequently been required to negotiate supply and pricing agreements with the dairy processor they supply. It had not previously been necessary for dairy farmers to individually or collectively negotiate prices with their local dairy processor.

In general, the dairy processors have a monopsony as there is only one local dairy processor to which a farmer can supply raw milk and major processors do not compete with one another for the supply of raw milk at the farmgate, sourcing additional milk requirements from Challenge. WA dairy farmers have reported that some processors also seek to enforce sole supply arrangements, only adding to this monopsonistic pressure².

Attached is an outline of the impact of the last 12 months on dairy farmers in WA, from a WA agricultural consultant.³

Milk Prices

As a result of these changes, Western Australian dairy farmers now receive significantly lower prices for their raw milk.

The farmgate price for raw milk prior to deregulation was (1999/00):

Market Milk:	45.5 cents/litre
Manufacturing Milk:	24.6 cents/litre
Average Price Received:	34.3 cents/litre

The average farmgate price for raw milk for 2003/04 as at June 2004:
 National Foods/PB Foods: 26 – 27 cents/litre
 Challenge: 24 – 25 cents/litre

In other areas, the figures are as follows:

State	Yr 2000 (cents/litre)			Yr 2004	
	Mkt	Mfg	Av	Processor	cents/litre
Qld	54.9	21.9	36.7	Nth Dairy Farmers	29-31
				Central Parmalat	38-41
				SE Parmalat / National Foods	33-36
				SE Dairy Farmers	29-31
				SE Norco	32-33
NSW	47.7	21.8	32.6	National Foods	29-31
				Dairy Farmers	29-31
				Bega	32-34
Vic	42.7	20.7	22.2	Major Co-operatives	26-27
Tas	44.3	18.9	20.9	Bonlac SC	25-27
SA	44.6	22.2	28.0	National Foods / Dairy Farmers	28-30
				Major Co-operatives	26-27

(Document 4 - See Page 22⁴)

The current average price paid for raw milk in WA has resulted in a significant number of dairy farmers exiting the industry.

Farm Numbers

In the financial year 1999/2000, there were 437 dairy farmers in Western Australia. That number has been reduced to less than 300 dairy farmers at the

present time. It is anticipated that an additional 40-60 dairy farmers will leave the industry during this financial year.⁵

At the time of deregulation it was estimated that based on milk production there was approximately 70,000 dairy cattle in Western Australia.

Initially volumes of raw milk produced did not decrease, as remaining dairy farmers purchased the herds of farmers exiting the industry. This changed in the current financial year, herds are now being exported and/or slaughtered and the volume of raw milk produced started to decline in March 2004. Grower reports indicate that twelve (12) months ago 100% of dairy stock sold in the market place were actively purchased by dairy farmers, currently this has been reduced to approximately 50%, with the remaining stock sold for export or slaughter.

It is anticipated that there will be a further reduction in March 2005 when it is anticipated further dairy farmers will exit the industry.

Escalating reduction in raw milk volumes

The volume of raw milk produced prior to deregulation (1999/00) was:

Milk Production: 412 million litres

The volume of packaged market milk sold prior to deregulation (1999/00) was:

Market Milk: 190 million litres

The volume of raw milk produced to the end of 2003/04:

Milk Production: 403 million litres

The volume of packaged market milk sold during 2003/04:

Market Milk: 204 million litres

(Dairy Australia: Industry Statistics⁶)

Rolling yearly raw milk production to the end of January 2005:

Milk Production: 392.3 million litres

December 2004 production was down 8.2% on December 2003. It should be noted that whilst volumes produced have started to drop, consumer demand for market milk in Western Australia has increased.

Estimated raw milk production for the 2005 year is 392 million litres as at 28 February 2005, down from the estimated raw milk production for the 2004 year of 405 million litres^b. This is relatively consistent with estimates to date for the 2004/05 year of 395 million litres, but most recent reports received by growers indicate that there may be a more rapid decline in raw milk production experienced in the later half of the 2004/05 year (See herd figures below).

Cost of Production

The cost of production for many farmers now exceeds the average farmgate price. Costs of production can readily be determined by processors accessing information that has been prepared by the WA dairy industry, on the behalf of WA dairy farmers or the Australian dairy industry on behalf of all Australian dairy farmers. Recent examples of this are 'Dairy 2004: Situation and Outlook' prepared by S Spencer and funded by Dairy Australia, 'The Sustainable Milk Price Report' prepared by Dr G Hough and funded by the WA Dairyfarmers Collective Bargaining Group and previously the Dairy Farm Performance data, collected and prepared by the Department of Agriculture.

WA Dairy farmers' estimated cost of production for the 2003/04 year:

Cost of Production: 22 – 30 cents/litre

Estimated Cost of Production is the total annual operating costs per litre of raw milk production, excluding costs of finance that would apply to the majority of farms, for the 2003/04 year^c.

^b See Document 4 – Page 55.

^c See Document 4 – Page 60.

This is consistent with the estimated cost of production for the 2001/02 year:

Cost of Production: 25 – 31 cents/litre

Estimate excludes costs of finance and debt reduction (Document 7 - Page 9⁷).

The reduction in estimated cost of production from the 2001/02 year to 2003/04 year may indicate the efficiency gains made by the production sector over this time period.

Costs of on-farm production have been affected by a number of factors. In particular, debt levels have increased as dairy farmers attempt to become more “efficient” by increasing herd sizes and investing in infrastructure at a time of significantly reduced prices. Debt loadings faced by WA dairy farmers continue to increase as well as the cost to finance these debts.

Escalating Farm Debt

Low prices paid for raw milk by processors has resulted in a lack of income available for interest or debt reduction, taxation, succession planning or the ability to handle adverse seasonal conditions. Banks are now reluctant to fund WA dairy farm businesses without additional security. This has resulted in ongoing debts moving from banks to unpaid bills owed to local rural service providers⁸ such as veterinarians.⁹ Current outstanding debts for stockfeed moved from an average arrears of 32 days in December 2002 to 228 days in December 2003 and then to 260 days in December 2004.¹⁰

Dairy farmers have typically survived to-date on restructuring their debt loadings by long-term finance restructuring. These options are no longer available to them and many dairy farmers are now selling assets, in particular heifers to survive.¹¹

Traditionally farmers with little or no debt (often on smaller farms) are able to remain in the industry for longer periods during a downturn.

Whilst on-farm production costs are public information and provided by the WA Government, similar information about processor costs of production is considered to be commercially sensitive information and held in strict confidence, at the insistence of the processors. This includes information on the retail market returns received by the WA dairy industry. Such information is critical to dairy farmers in order for them to gauge the overall health of their industry.

Herd Information

“RESTRICTION OF PUBLICATION OF PART CLAIMED”

CONFIDENTIALITY
GRANTED

If the current and projected dairy herds for sale are not taken up by the WA dairy industry this will impact heavily on the short term milk production, The Western Australian Farmers Federation (“WA Farmers”) estimates that the milk production

of these herds are 12.7 million litres. The sale of export heifers will have a longer reaching impact over the next 1-2 years.¹²

4. FUTURE PROJECTIONS

Consequences of Change

- **Swiss Cheese Effect**

The exit of farmers from any agricultural industry never occurs in an orderly fashion. Typically, individual farmers exit creating what could be termed a “Swiss Cheese Effect”; that is individual pockets of the dairy production region over time fall below critical mass resulting in the closure of processing plants and the loss of affected areas to that type of agricultural production. This is expected to occur in Western Australia due to the low number of dairy farmers in certain specific areas. These areas will become the growing hole of the Swiss Cheese and be totally removed from the industry.

The occurrence of the Swiss Cheese effect has a very real but inequitable public cost with respect to the localised effect on rural communities, as the brunt of a declining WA dairy industry is not being borne evenly throughout the WA community. In addition the remaining dairy farmers are experiencing reduced services or increased costs attributed to those services due to the Swiss Cheese Effect.

The decision of individual farmers to exit is driven by many factors including prices below the cost of production and growing debt. The affected areas will become uneconomic; if sufficient farmers exit, the remaining farmers may have been able to withstand low prices and may be very efficient but will lose their livelihood as, in the short-term critical services such as milk collection become more expensive or stop. An example of this is Great Southern^d area where dairy farm numbers dropped from 25 to 14 in the last five years.^e Milk haulage costs have risen to up to 9 cents per litre and there is concern by the remaining dairy

^d The Great Southern consists of the following shires: Denmark, Plantagenet and Albany.

^e From statistics provided by WA Farmers, see Document 5.

farmers that haulage arrangements will cease and contracts will not be renewed. In the long-term, processing plants may be forced to close.

The Swiss Cheese Effect was highlighted by the Western Australian Legislative Assembly Economics and Industry Standing Committee's report. The Report compared dairy farm numbers by Shire in July 2000 and 2003, for Shires with greater than 10 farmers in July 2000. The Murray Shire had the highest rate of farm exits to June 2003 with an exit rate of 50%. The Harvey and Capel Shires had the lowest exit rate, with an exit rate of 22% (Document 15 - Page 35¹³). However, figures provided by WA Farmers suggest accelerating decline in some shires.^f

Consequences of reduced production

- **Increased Operating Costs**

As raw milk production declines, dairy farmers will face increased operating costs as services begin to decline or become more expensive. Such costs will be felt throughout the supply chain. Already, there has been a gradual decline in the skills base available to the dairy industry, which has led to increased labour costs¹⁴. Increased operating costs and low milk prices are additional barriers for new entrants to the WA dairy production sector.

- **Loss of processors**

The reduction in raw milk produced is predicted to continue as further farmers exit. Owing to the lower prices paid by Challenge⁹ compared to that paid by PB Foods, Harvey Fresh and National Foods, it is anticipated that Challenge will bear the brunt of reduced raw milk supplies as their suppliers exit the industry or where possible attempt to transfer to the other three processors. This is currently occurring, and inevitably this will severely impact the volume of raw milk supplied to Challenge.

^f See Document 5.

⁹ Challenge currently pays suppliers between 23-28 cents per litre. See Document 25.

Currently manufactured dairy products sold by dairy processors nationally are being sold in WA at discounted prices, such that the returns received in WA are significantly less than those received in the Eastern States. PB Foods in its Information Fact Pack^h in late 2004 to suppliers acknowledged that retail prices for dairy products in WA are 15-22% lower than those in other States. It is assumed that the primary driver behind this is the gaining of market share against manufactured dairy products processed in WA. As milk production falls due to reduction in the WA dairy herd, processing facilities such as PB Foods Balcatta plant will become uneconomic to operate at significantly reduced volumes.

Import of Milk From Interstate & Price to Consumers

ⁱIt is anticipated that based on current milk prices, milk production will decline in WA resulting in:

- The importation of manufactured products at a minimum price of South Australian retail plus freight. It is predicted that when imported manufactured dairy products have total market share with the removal of manufactured dairy products processed in WA, their prices will rise substantially.
- The importation of packaged liquid market milk during seasonal shortfalls at a minimum price of South Australian retail plus freight.

The Western Australian Department of Agriculture have estimated the cost of transport of milk from South Australia to Perth is 18.6 cents per litre by tanker and 56.4 cents per litre for packaged milk.

This would result in a higher than national average price to WA consumers. It is, we believe, unrealistic to assume that the retail prices of imported dairy products will simply be at levels of South Australian retail price plus freight over the medium to long term as South Australia is already exporting raw liquid milk into

^h See Document 27.

ⁱ Department of Agriculture Western Australia, Economic Evaluation of two possible milk pricing systems in Western Australia – Pages 18 – 19.

Victoria. Whilst we believe the WA Department of Agriculture estimates of transport costs are possibly too high in relation to packaged milk, the continued contraction of the WA dairy industry will have long-term ramifications for the retail price of dairy products in Western Australia, with increases in retail prices being the inevitable consequence. Continuity of supply may also be affected.

We are concerned that the eventual outcome will be that the WA industry will, in the future, only provide sufficient milk for the local white milk market and possibly only to major supermarket chains such as Woolworths and Coles. We fear a shortage of supply would result in independent retailers being forced to source milk at a higher price from interstate.

5. TRANSPORTATION ARRANGEMENTS

At the present time, each of the four major processors requires its dairy farmer suppliers to use that processors' nominated transport system.

Dairy farmer suppliers are charged transport costs by the processors for the transport service. Whilst some processors such as Harvey Fresh and Challenge use their own trucks, National Foods and PB Foods have contracted out their transport services.

The transport system is extremely inefficient. In some areas four different trucks operated by different processors pick up raw milk on the same road. Examples of these roads are:

- Government Road, Harvey
- South Western Highway, Harvey – Boyanup
- Railway Road, Boyanup – Capel.

It would also appear that in the Great Southern contracted transport services are used as an additional profit centre by processors with dairy farmers charged 9c per litre transport costs.

Dairy farmer suppliers, through the WA Farmers, have requested that processors permit them to contract other trucking companies to deliver raw milk, subject to the same standards as those currently in place. Processors have refused to allow the use of other trucking companies, regardless of whether they meet the required standards.

Allowing dairy farmers a choice of trucking companies may significantly reduce costs to dairy farmer suppliers, thereby making the industry more competitive and efficient, reducing overall costs. This would be one of the aims that Dairy WA would seek to achieve on a negotiated basis with processors.

WA Farmers estimated the potential savings that could occur with a rationalised transport system when benchmarked against a rationalised raw milk transport system operated in South Australia. An estimated annual saving of \$4 – 8 million or, on current production levels, 1 –2 cents/litre was predicted if a similar system was adopted as operated by South Australian Milk Haulage (Document 17 - Page 5.¹⁵ See also Document 18¹⁶).

6. MARKET CONCENTRATION

The WA market is segmented amongst processors as follows^l:

Processor	Approximate % WA Milk processed
PB Foods	50%
National Foods	26%
Challenge	19%
Harvey Fresh	5%

There are also a few small boutique processors which produce dairy products for niche markets^k which are not included in the figures above.

^j Figures extrapolated from information in Document 15 - Pages 11 and 13.

^k See Document 15 - Page 13.

7. IMPACT OF DEREGULATION ON PROCESSORS & SUPERMARKETS ON AN AUSTRALIA-WIDE BASIS

Processors and supermarkets have increased or maintained their gross profit margin from dairy products. Nationally, there has been an increase in returns on manufactured milk of \$300m. This appears to have largely come about by the reduction in national farmgate income of \$321m that had been offset in part by DSAP payments (Document 19 - page 24¹⁷).

Whilst the NCC Report to the Productivity Commission blames reductions in raw milk volumes on drought, this has not been the case in Western Australia. In WA the reduction in raw milk volumes which started to occur in March 2004 is largely attributable to low farmgate raw milk prices and rising farm debts. In addition to this a small number of dairy farmers have retired or exited the industry due to ill health. It is anticipated that the WA dairy industry could experience a rapid decline in raw milk production over the next 6 - 12 months of potentially a further 30 – 40 million litres.

The analysis in the Report to the Productivity Commission does not state that the fall in prices to consumers is the direct result of reduction in farmgate prices, although it notes there has been little or no impact on gross margins of supermarkets and processors. The fall in gross profit margin is clearly almost solely attributable to loss of on-farm profits.

A report published by the Department of Agriculture, Fisheries and Forestry shows that with respect to 2 litre whole milk sales through supermarkets, dairy farmers' share of margin has dropped significantly. This is a shrinking proportion of an already-reduced price (Document 20 - Page 24).¹⁸

Processors and supermarkets have sufficient strength to negotiate effectively. The processors' imperative is to pay the lowest price possible to dairy farmer suppliers. Dairy farmers have little or no bargaining power as individuals or through a processor specific collective bargaining group.¹⁹ They must either

accept the price and conditions offered or exit the industry. PB Foods Negotiating Group has had no success in negotiating a higher price for raw milk and has a role that to date has been limited to sending newsletters drafted in part at least by a staff member of PB Foods.

There is no or little incentive for processors to improve efficiency when reduction in prices paid by retailers can be passed directly on to dairy farm suppliers without a reduction in the processors' profit margin. As the Report notes, there has been no rationalisation of processors^l. The weak bargaining power of dairy farmers has meant there has been little or no pressure on processors, unlike dairy farmers, to become more efficient. The monopsony position held by processors also means that to-date it has not been possible for dairy farmers to collaborate in such a way to allow them to seek out higher prices for raw milk from interstate processors^m. Alternate markets are only available if it is possible to co-ordinate raw milk supply in such a way as to spread the risk of such arrangements over a number of dairy farmers.

Supermarkets are aware that the pricing agreements with processors are damaging the dairy industry. Anecdotal evidence indicates that supermarkets have included a clause in their agreements with processors that processors must pay their dairy farmers a sustainable price. If this is in fact true, the supermarkets have not seen fit to enforce the clause and it would appear to be a futile gesture.

8. COLLECTIVE BARGAINING IN W.A.

The Australian Dairy Farmers Federation Limited applied to the Australian Competition and Consumer Commission in February 2001 to obtain an authorisation under **section 45** of the **Trade Practices Act**. National Foods Limited appealed against the authorisation. The decision of the Australian Competition Tribunal of 16 August 2002 provides that dairy farmers may form a collective bargaining group. The collective bargaining group must:

^l See Document 19 - Page 7.

^m See Document 19 - Page 7.

- have a shared community interest; and
- have similar supply patterns (seasonal supply or all-year-round supply); and
- be located at a distance where their product can be economically delivered to the processor's plant; or
- the dairy farmers must supply a specialty raw milk product.

The authorisation provides that these collective bargaining groups must not be open to all the dairy farmers that operate in Western Australia.

This limitation imposed by the Australian Competition Tribunal creates particular difficulties in Western Australia as a result of the small number of dairy farmers involved and their geographical limitation to the South-West. This number is at a stage where significant declines in farm numbers are expected in the immediate future. There are also concerns that the direct relationships that exist between producers and processors under the collective bargaining process authorised by the Australian Competition Tribunal result in significant pressure being placed upon dairy farmers not to enter into effective negotiations. There has been pressure on dairy farmers by processors not to enter into functional collective bargaining arrangements. It is important to note that the authorisation granted by the Australian Competition Tribunal expires in June 2005.

The objective of this proposal is to stabilise the WA dairy industry to allow dairy farmers to negotiate with dairy processors on something that remotely resembles an equal footing. The actual total numbers of dairy farmers involved in WA would be significantly smaller than a single potential collective bargaining group in the Eastern States.

9. COLLECTIVE BARGAINING UNDER CURRENT AUTHORISATION

The collective bargaining process under the current authorisation has not been as successful as one would have hoped. A number of problems have arisen that indicate that the collective bargaining process is, in its current form, flawed:

1. The Western Australian Department of Agriculture ran a benchmarking programme on dairy farm performance from the early 1990s to 2000/2001. Dairy farmers were invited to participate annually. Dairy farmers filled in their data, with the income data being supplied in a very usable format by the processors. They sent it direct to the Department, who run it through their model. Processors offered their assistance to dairy farmers to prepare the information to send to the Department. The dairy farmers then received information back on where they sit against their peers.

It appears that this information, which was available publicly, clearly outlines the cost of production that individual dairy farmers' face. It has therefore possible for processors to be able to calculate which of their dairy farmers will have to leave the industry as costs rise and milk prices either fall or remain static. It also provided processors with valuable information when fixing prices.

2. National Foods

It would appear National Foods did not approach the collective bargaining process with any degree of trust or mutual respect. National Foods cut contracted volumes by 40% without any notice to the Collective Bargaining Group Negotiation Committee, nor to their suppliers, in mid 2003.²⁰

A collective bargaining group had been formed to negotiate with National Foods Limited. A small number of dairy farmers (ten, as far as can be ascertained) remained outside the collective bargaining process, because they were uncertain whether they would remain in the industry or were not opposed to the process but had not responded to the Group's letters. The collective bargaining group was unable to successfully negotiate a price improvement on the previous year's price and the members of the collective bargaining group had their volumes of milk unilaterally reduced for the upcoming year. The ten dairy farmers who remained outside the collective bargaining process were unaffected by this massive reduction in volume.ⁿ These dairy farmers did not seek to negotiate a separate deal with National Foods. Understandably, the WA dairy farmers are reluctant

ⁿ See Document 15 – Page 26

to become part of an effective processor specific collective bargaining group in the future.^{o 21}

3. PB Foods

In contrast the collective bargaining process with PB Foods has been approached by both sides in a climate of mutual trust and knowledge building. However the Collective Bargaining Group Negotiation Committee has only been able to negotiate small concessions on terms and conditions in supply agreements, they have not been able to negotiate for a higher or sustainable farmgate price for their members. The Negotiation Committee's main role is the dissemination of information from PB Foods.²²

4. Challenge Dairy Co-operative Ltd

Challenge does not directly supply the retail domestic market, its market to-date is purely export or the on-sale of raw milk to WA domestic processors. Challenge acquires the surplus raw milk and consequently pays the lowest price of 23-28 cents²³, its members have not to-date been paid any dividends.

Challenge has entered a joint venture arrangement with the Singaporean company QAF. As part of the agreement, the Challenge processing facilities were transferred to the joint venture company, Challenge Australia Dairies, of which QAF has a 51% shareholding.

Demand for Additional Milk

5. If a processor requires additional raw milk, the processors buy and sell amongst themselves (usually buying from Challenge at a price significantly in excess of the price paid to all WA dairy farmer suppliers) – they do not acquire additional raw milk from their existing suppliers. At present Challenge pays its suppliers 23-28 cents per litre^p and on-sells part of its supply for between 32-42 cents per litre.²⁴

^o See Document 21.

^p See Document 25.

6. To date Western Australian domestic processors have a policy of not taking on new suppliers, other than Harvey Fresh, which has taken on 2-3 additional suppliers to replace their previous suppliers who have left the market. PB Foods, for example, initially said that they will not take on other suppliers^{25,26}. We understand that they may have to re-consider their position given the reduction in milk volumes as suppliers exit the industry and their herds slaughtered. Anecdotal information indicates that PB Foods is sourcing supply from Challenge but we have been unable to verify this information. Processors have indicated they will enforce current contract obligations²⁷ and are calling for an early commitment to upcoming contracts. Challenge members have Delivery Rights Units (DRUs) that are enforceable over the long term. Challenge has indicated it will enforce these obligations. PB Foods contracts were executed immediately after deregulation and any changes other than volume estimates are made unilaterally by PB Foods. In addition to this, not all areas are serviced by all processors, further limiting options of dairy farmers.
7. Processors are monopsony purchasers in a number of specific geographic regions, partly due to transport arrangements. Therefore, in most cases, there is no competition for the purchase of an individual dairy farmer's milk.

10. PUBLIC BENEFIT TEST

Summary of What We Believe is the Current State Of the WA Dairy Industry

The WA dairy industry is in a state of accelerated decline due to lower than national average milk prices paid to WA dairy farmers, accelerating farm debt due to milk prices being insufficient to cover costs of production, interest, tax and debt repayments, reduction in the State herd size as a result of dairy cattle being slaughtered rather than onsold and heifers being sold in significant number to overseas markets.

Milk volumes produced in WA dropped by 8% in February 2005 compared to that of February 2004. The figures are not yet available but current information indicates a sharper decline in the March 2005 figures based on the sale of herds.

If there is no significant change it is anticipated that service providers and financiers will increase the foreclosure on mortgages, commence debt recovery action and call in bills of sale over cattle. It is reasonable to assume that those dairy farmers with the highest levels of outstanding unpaid debt will exit the industry first. The possible slaughter of a number of large herds may result in a greater than anticipated reduction in milk volumes in the immediate future.

Processors in the month of March are in some cases faced with a shortfall in supply. Milk is being sourced from Challenge in the short term. Some processors have attempted to attract suppliers from other processors however as one would expect existing contracts are being enforced.^q Dairy farmers must either complete their existing contracts or exit the industry. Contracts are being offered (without success on current information) to dairy farmers within the processor's geographic area - not necessarily to low cost producers.

Theoretically milk production could drop to a level where only the local whole milk market was supplied to major supermarkets and packaged milk for independent retailers and for manufactured milk products were imported from interstate. The price increases to consumers would be significant based on transport costs from SA.

If the WA dairy industry collapsed or contracted significantly, it is unlikely that higher milk prices would result in significant new entrants into the industry because of the high startup-up costs and insufficient returns to justify investment, difficulty in obtaining skilled workers^r and dairy farming families seeking other employment opportunities. In the south west of Western Australia, dairying is not an industry that lends itself to the introduction of factory farms because of the local workforce having access to higher paid jobs in the local mining and manufacturing industries and the low return on assets^s.

The Benefit of the Milk Negotiating Agency

We believe the introduction of a milk negotiating agency would have considerable public benefits including:

^q See Document 29.

^r See Document 16.

^s See Document 7 - Page 11.

1. Improved bargaining power for small producers;
2. Significant transaction cost saving, particularly in the area of transport costs and providing better economies scaled to processes;
3. The re-distribution of current monopsony profits;
4. Easing the transition to industry deregulation;
5. Improving the viability of small dairy farming businesses; and
6. Opening up new marketing opportunities by co-ordinating the supply of dairy farmers' milk, who are members of the milk negotiating agency.

1. Improved Bargaining Power

Individual dairy farmers, as well as processor specific bargaining groups have very little bargaining power when attempting to negotiate with processors. The experience of the National Foods Collective Bargaining Group points to the ineffective nature of a single processor approach. The PB Foods Negotiating Group's inability to negotiate in a practical sense merely re-enforces weakness of the dairy farmers' position in Western Australia. In the present circumstances it is not possible for dairy farmers to effectively negotiate with processors as they are locked in any many cases by their geographic position and arrangements between processors for the supply of additional milk. It is intended to remove this direct link between dairy farmers and processors and to allow Dairy WA to supply processors in the most cost effective and efficient manner possible regardless of historic contracts with individual dairy farmers. It is intended that both dairy farmers and processors would benefit from the reliability of supply and improved efficiencies.

Processors provide dairy farmers with standard form contracts on a 'take it or leave it' basis. PB Foods merely provides dairy farmers with updated information and requires them to estimate volumes of milk for sale. Dairy farmers would prefer to have the freedom to agree to commercially viable contractual terms, for example being allowed to increase their supply on mutually agreeable terms and not on the terms of the processors.²⁸

For practical purposes there is comparatively little price differential between the current contracts, other than the price offered by Challenge to its dairy farmer members for milk that was priced to be used as manufactured milk only. Processors have held prices at levels significantly below interstate prices and at a level below the cost of production when interest, tax, debt repayment and return on capital are included. The impact of this has been significant increases in farm debt and increasing numbers of farmers exiting the industry with their cows subsequently being slaughtered.

It would appear that the processors and the supermarkets are siphoning off all surplus profit and using their competitive power to negotiate agreements, while a significant number of dairy farmers operate at a continuing loss.

It is reasonable to assume that if the dairy farmers had an adequate competitive bargaining position they would not enter into contracts that are demonstrably lower than their cost of production. It has been argued that the processors would act altruistically and not force significant numbers of their dairy farmers out of business. It is possible that the impact of falling milk volumes is being masked in the short term by processors accessing milk on the spot market from Challenge together with some comparatively unsuccessful attempts to poach other processor dairy farmer suppliers. It appears that the processors understanding of the broader industry impact is either negligible or possibly willful blindness. Processors seem to be unaware or unconcerned by rapidly rising debt levels, farms foreclosure and aged receivables amongst suppliers reaching 260 days.¹

It is intended that by allowing dairy farmers to effectively negotiate as a group across the South West and with different processors, the result will be an improved bargaining position through managing and supplying significant volumes of milk at a price and on conditions that will hopefully improve the likelihood of the WA industry surviving.

¹ See Document 10.

As a matter of basic principle a single buyer (processor) will negotiate a price with multiple sellers (or a weak seller with no alternate buyer readily available) at a price that effectively allocates the surplus to that buyer. To date the actions of processors have largely resulted in downward pressure on the price of milk to dairy farmers since deregulation. This has been reinforced by Challenge operating as a sump by paying lower than average prices to its dairy farmer members then on selling part of its milk on the spot market to other processors effectively holding the total price paid to dairy farmers down.

The aim of Dairy WA is to break this cycle and be able to negotiate for the sale of its milk at a price that more equitably allocates surplus profits and on reasonable conditions for its dairy farmers.

The benefit of improved dairy farmer bargaining power is to reduce the likelihood of industry failure and to limit the need for higher priced import replacements to consumers.

2. Transaction Cost Savings

A major aim of the Milk Negotiating Agency is to arrange on behalf of its members a more efficient transport service. A significant aspect of this transport arrangement is to reduce the inefficiency in the transport system where multiple trucks operate to collect partial loads and sometimes transport milk over long distances. The proposed arrangements would be voluntarily agreed as part of the contracts with processors and dairy farmers (who usually pay transport costs). In particular we anticipate that in the Great Southern there will be a significant reduction in transport costs from the current 9 cents per litre in some areas.

3. Redistribution of Monopsony Profits

Transaction cost savings resulting from transport improvements would improve the viability of the industry, particularly in the Great Southern area where dairy farm numbers have dropped significantly and costs of transport are unsustainable.

In recent times anecdotal evidence indicates the monopsony profits earned by dairy processors in Western Australia may to some extent been reduced as a result of the competitive process, having been competed away in the form of lower prices to supermarkets and subsequently consumers. Current information available to us does not support this contention, however it is not an unreasonable assumption. Furthermore, the dairy processors still earn a similar proportion of the retail sales value to that which it earned previously.^u

The current situation if left unchecked, will result in a dramatically falling supply of milk and possibly a switch from manufactured milk to whole milk by utilizing agreements with Challenge. The additional cost of transporting dairy products from interstate to make up any necessary shortfall in the whole milk market as well as manufactured milk products would result in increasing prices to Western Australian consumers or alternatively potential shortfall in supply.

At the present time milk that would have been previously been used for manufacturing is now being diverted to the whole milk market. It should be noted that the diversion of manufactured milk to other suppliers by Challenge does not result in a higher price paid to dairy farmers. It is therefore not anticipated that during the current duration of processor-dairy farmer contracts that there would be any significant likelihood of an increase in prices to dairy farmers.

4. Easing the Transition to Industry De-Regulation

Approximately five years has passed since the dairy industry was deregulated. The transition has not been as successful as would have been hoped.

It is acknowledged there was an oversupply of raw milk in WA possibly because of the use in some instances of a single pricing policy by some processors.

De-regulation resulted in aggressive price cuts to dairy farmers who were unable to easily access other buyers for their milk either in WA or interstate.

The collective bargaining committees have also been unsuccessful in raising prices to dairy farmers because of the dairy farmers inability to access

^u See Document 20 – Page 24.

processors willing to offer a higher price. Processors have to date dictated prices and terms for milk. Challenge supplies additional milk when shortfalls occurred. Processors have had access historically to cost of production by dairy farmers, however the costs of production excluded interest debt repayments return on capital and tax. Collective bargaining groups and individual growers have had little or no information regarding processors costs. Members of the National Foods Collective Bargaining Group had more disadvantageous terms and conditions imposed upon them on a take it or leave it basis than the small group who remained outside the collective bargaining process. PB Foods have not renewed their contracts since de-regulation commenced and negotiation in any form has not for practical purpose been attempted with changes being unilaterally imposed.

It would appear reasonable to assume that even with additional negotiating experience the dairy farmers would have little ability to effectively negotiate the processors using a single processor collective bargaining group. The Milk Negotiating Agency would have the brief to obtain the best possible prices and terms and conditions from any purchaser, in that regard the Milk Negotiating Agency undertakes a role similar to many other organizations in Australian society in particular producer co-operatives. In a number of cases ownership in the producers' goods do not pass and it effectively operates as a marketing organization.

The aim is for the milk negotiation agency to enter into contracts with dairy farmers to voluntarily engage their services to seek out and obtain better prices for their milk and improved terms and conditions. Dairy farmers may of course choose whether to engage the Milk Negotiating Agency to act this on their behalf or not. However once the Milk Negotiating Agency has been appointed the contract would be enforceable subject to the terms and conditions agreed with the dairy farmer.

5. Improving the Viability of Small Dairy Farms

The aim is to provide for a more cohesive and efficient industry and may result in improved stability in the industry in the future. We are gravely concerned about existing debt levels and as a result about the continued viability of small dairy farm businesses. There is an accelerating decline of the number of dairy cattle in Western Australia as a result of herds being slaughtered as well as the export of heifers. There is an accelerating decline in milk volumes since December 2004.

6. Opening Up New Market

The brief to the Milk Negotiating Agency includes a requirement for them to seek out new markets locally, interstate and possibly overseas.

Western Australian dairy farmers have a lower cost of production than dairy farmers interstate making it feasible for them, subject to transport costs, to supply Eastern State markets. Sharp increases in interstate milk prices in the past twelve months have increased the likelihood of this being a serious possibility.

A co-ordinated approach would also permit additional boutique operations to open up to suppliers of the gourmet dairy market in WA.

The current situation where Challenge on-sells its members' milk to the other processors at a significant mark-up in the spot milk market indicates that there is a sporadic shortage of milk in Western Australia. The current price for milk paid to dairy farmers is unlikely to improve in the short term, National Foods contracts expire in June however dairy farmers are effectively locked in for an additional 3 months. PB Foods have a requirement that exiting dairy farmers give 3 months' notice. Challenge suppliers are locked in by enforceable Delivery Rights Units for the supply of specified quantities of milk.

The aim is to open up new markets for the supply of milk in the short term to allow dairy farmers to remain in the market until existing contracts are able to be re-negotiated or revised. In the longer term the aim is to allow WA dairy farmers to participate in a national market for milk.

11.AUTHORISATION

Authorisation is therefore sought for an initial period of 5 years to allow Dairy WA to negotiate with processors or retailers on a processor-by-processor and retailer-by-retailer basis with regard to contract prices and terms and conditions relating to the supply of WA raw or packaged milk. Dairy WA will separately negotiate contracts for the supply of raw milk from WA dairy farmers who have entered into an agency arrangement for the sale of their milk.

An initial period of 5 years would enable Dairy WA to negotiate longer term contracts, where appropriate, with both suppliers and processors to provide greater certainty for both parties.

If the authorisation sought above is granted, authorisation is also sought for an initial period of 5 years for Dairy WA to reserve the right to include a provision in its retainer contracts with WA dairy farmers to stipulate dairy farmers may enter into contracts directly with processors or retailers only with the consent of Dairy WA.

Authorisation is also sought to permit Dairy WA or dairy farmers who have authorised Dairy WA to act on their behalf to refuse to supply processors where no current contract is in place.

Dairy WA is not seeking that the authorisation for collective bargaining be conditional on authorisation for collective boycott. However previous behaviour of some processors when dealing with dairy farmers on an individual basis indicates that such an authorisation may be necessary.

Interim authorisation is sought on the following grounds:

- A proposal for new draft National Foods contracts has recently been announced and the processors have indicated that these contracts must be executed "immediately". We assume the processors' intention is for the contracts to be finalised before the anticipated completion of the Authorisation process.
- The current authorisation is due to expire in June 2005.

- A new and potentially significant problem is that it appears that there is a significant and substantial decline in milk production since December 2004 to February 2005 compared to the same period last year. It is anticipated that there will be a further decline in milk volumes for the month of March 2005.
- It is anticipated, based on current information from financiers and industry service providers regarding difficulties farmers are facing servicing existing debt, that this may be the beginning of an accelerated decline in the industry. We understand that if it is possible to show there is a potential improvement in milk prices in the short term together with improved ongoing dairy farmer bargaining power, financiers and service providers may give individual dairy farmers the opportunity to trade out of their existing debt problems.

12. DOCUMENTS

CONFIDENTIALITY
GRANTED

No	Author	Document	Date
1	<i>Restriction of Publication Claimed</i>		
2	<i>Restriction of Publication Claimed</i>		
3	Steve Hossen Rural Consulting Pty Ltd	Outline of impact of past 12 months for Dairy clients	9 March 2005
4	Steve Spencer, Ridge Partners	Dairy 2004 : Situation and Outlook – Report to the Australian Dairy Industry	June 2004
5	WA Farmers	Dairy Farm Numbers per Shire in Western Australia	March 2005
6	Dairy Australia	Industry Statistics from website	
7	Dr Glenys Hough	The Sustainable Milk Price in Western Australia	2003
8	Paul Jarvis	WA Dairy Providers Face Crunch Time Countryman	3 February 2005
9	<i>Restriction of Publication Claimed</i>		
10	<i>Restriction of Publication Claimed</i>		
11	<i>Restriction of Publication Claimed</i>		
12	<i>Restriction of Publication Claimed</i>		
13	<i>Restriction of Publication Claimed</i>		
14	<i>Restriction of Publication Claimed</i>		
15	Economics and Industry Standing Committee	The Sustainability of the Dairy Industry in Western Australia:	December 2003
16	John Giumelli, Dairy Traineeship Co-ordinator, TafeWA	Letter re shortage of dairy industry trainees	2 March 2005

CONFIDENTIAL
EXCLUDED

No	Author	Document	Date
17	WA Farmers	Submission to Economics and Industry Standing Committee - Inquiry into the Sustainability of the Dairy Industry in Western Australia	August 2003
18	<i>Restriction of Publication Claimed</i>		
19	National Competition Council	NCC Report to Productivity Commission: NCC Occasional Series - Dairy Now and Then: The Australian Dairy Industry Since Deregulation	November 2004
20	Department of Agriculture, Fisheries and Forestry	Price Determination in the Australian Food Industry	2004
21	<i>Restriction of Publication Claimed</i>		
22	<i>Restriction of Publication Claimed</i>		
23	National Foods	Farmgate Milk Supply Agreement	23 June 2004
24	<i>Restriction of Publication Claimed</i>		
25	Challenge	Letter to Members re prices	29 November 2004
26	<i>Restriction of Publication Claimed</i> <i>Restriction of Publication Claimed</i>		
27	PB Foods	"Information Fact Pack"	2004
28	PB Foods	Letter to producers re no new suppliers	28 May 2003
29	<i>Restriction of Publication Claimed</i>		
30	<i>Restriction of Publication Claimed</i>		
31	<i>Restriction of Publication Claimed</i>		