

January 20, 2006

The General Manager
Adjudication Branch
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2602

**RE : Challenge Dairy Co-operative Ltd., response to the ACCC Pre-Determination
Conference with regard to Applications for authorization A90961 and A90962 made by
Dairy WA Ltd**

Dear Mr Gregson

Thank you for the opportunity to respond to the draft determination as proposed by the ACCC. In our opinion, this determination reflects a clear analysis of the WA dairy industry situation, and the effect of a MNA on the stakeholders within that industry.

Challenge continue to have significant concerns in relation to authorisation being sought by Dairy WA to establish a Milk Negotiating Agency (MNA). We believe ACCC support to set up what would constitute a monopoly situation controlling the WA raw milk supply, will not provide net public benefits.

We acknowledge the applicant has agreed to withdraw the application for boycott powers. We further acknowledge the recent proposed draft determination (including new conditions) Authorisation No.A90966 (the ADF Draft Determination).

With respect to Challenge Dairy Co-operative Ltd (Challenge) and its role in the WA Dairy Industry, it is regretful that many of the statements made by Dairy WA are incorrect. Further, it is unfortunate that DWA have not sought to confirm or clarify information they have presented with respect to Challenge. We will address this directly with Dairy WA in the future.

Dairy WA has proposed the formation of a West Australian Milk Negotiating Agency to provide a public benefit based on:

1. Improved bargaining power for small producers
2. Significant cost saving, particularly in the area of transport costs and providing better economies scaled to process
3. The re-distribution of monopsony profit
4. Easing the transition to industry de-regulation
5. Improving the viability of small dairy farming businesses
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 for small producers

- It is the efficiency of producers rather than size which determines the ongoing viability of dairy business in a deregulated market.
 - Price signals (determined by markets in which processors operate) will determine direction for farmers – seasonality, quality, quantity etc Individual farmers will make the choice as to where their business operates.
- 2. Significant cost saving, particularly in the area of transport costs and providing better economies scaled to process**
- Challenge believes there are opportunities to be captured by rationalization of transport
 - The State Government Senate enquiry in the WA recommended that a feasibility study of transport arrangements be done – this opportunity has not yet been investigated.
 - It is the belief of Challenge that an MNA is not required in order to drive transport efficiencies.
 - Dairy WA have further indicated that costs may be saved by providing better economies scaled to process, however it has not been demonstrated to Challenge where these cost savings will be made.
- 3. The re-distribution of monopsony profits**
- CDC believes that large Australian co-operative structures set the floor price in Australia, as they are determined to maximise returns to farmers through the farmgate price.
 - CDC believes that in Western Australia that is the role of Challenge. Our changed focus to value added products will add value to milk outside the domestic market.
 - Milk balancing – is an integral and part of the CDC business. The reason NFL & HF use CDC is that they cannot balance through their current product range. This balancing service generates significant savings for processors and thus justifies higher prices charged. Only CDC has the will to return these margins to farmers through the milk price. Prior to de-regulation, the major processors balanced their own supply and milk “outside” of the domestic market regularly returned between 13 and 18 cents/litre. Milk balancing by Challenge contributes to rationalization of stainless steel and transport, and again farmers can be assured of receiving any benefits gained by CDC via the farmgate price.
- 4. Easing the transition to industry de-regulation**
- Dairy WA have not fully explained how the MNA will ease the transition to deregulation, which has already been in operation for nearly 6 years nor (in the event) how an MNA would prepare dairy businesses for the resumption of normal market forces.
 - DSAP gave farmers many opportunities to make choices. Many chose to direct DSAP funding into adjusting post-deregulation.
 - Other factors have contributed to difficulties in dairy industry in recent times, drought (high feed prices), strong AUD, record low commodity prices.
 - Dairy Australia’s “Situation & Outlook 2005” & “In Focus” report confirms many businesses continue to adjust.
 - Total milk production for WA for 2004/2005 is 396 million Litres – marginally down on the six year average of 399 million litres. This is despite a sharp decrease (25% +) in the number of farmers in the industry
 - Average herd size is 260 cows – an increase of 15% over 2004 figures

- Average production per cow was 6,250 Litres – the highest in Australia
- Average debt per cow was 7% lower than 2004 figures
- Cows numbers projected to fall by 4% but a further gain of 8% in productivity is expected
- More than 65% of farmers expect to be in the industry in 3 years time
- 33% of farmers are positive – they produce over 64% of supply
- Those who do not expect to be in the industry in 3 years time account for less than 10% of current production
- There remains significant scope for profitable production in WA – the industry has settled into distinct groups, featuring progressive “growers” and a larger number of smaller producers in a “holding pattern”

5. Improve viability of small dairy farm businesses:

- It is the efficiency of producers rather than size which determines the ongoing viability of dairy business in a deregulated market.

6. Opening up new markets by coordinating supply of milk

- This is indeed the current role of Challenge as it moves from low value commodity processing into value added, dairy ingredient markets, capturing supply from an increased portion of the industry.
- It would appear that the MNA would provide an unnecessary duplication of what is already in operation.
- It is ironic that post drought, with national supply recovering and processors looking to source milk to fill factories, that there has not been an easy market for WA's supply. We believe this is testament to the difficulty in transport and logistics moving raw milk to the eastern seaboard. New market opportunities are available in new product ranges etc in Asia but will require close relationships between processors and customers to ensure product integrity, quality, and rapid response to customer needs etc. Third party intervention via an MNA may not facilitate this process.

There were issues raised at the pre-determination conference and the final document submitted by the MNA, however that require further comment.

1. Milk Pricing

Milk pricing is determined by the capacity of the processor to extract value from that milk. National Foods and Harvey Fresh pay a similar milk price – largely concentrated on fresh milk products on local markets. Peter Brownes pay a slightly lower price, as they have some exposure to lower priced export commodity prices. Challenge, have paid a lower price again a result of a greater exposure to commodity markets.

The base argument from the MNA is that this pricing differential precludes WA dairy farmers changing between processors – and there is no competition for farmers / milk supply. However, Challenge have clearly and demonstrably changed their focus to value added products. A major capital project has been commissioned at Capel to value adding cheese for the retail and food services sector. Further, significant capital has been approved to value add milk fat at our Boyanup plant, where high value frozen cream, cream cheese, frozen milk concentrates and liquid whey will be produced.

We are also increasing our role as a milk trader – again returning a positive contribution, if the MNA were to be established, the removal of sales revenue from milk trading will negatively impact on our milk price to the detriment of the WA dairy industry.

Challenge have increased prices for 2006 by 13%, and budget forecasts show further increases will be achievable.

It is a falsehood to suggest the status quo with milk prices within the WA dairy industry are expected to remain constant.

Challenge are clearly positioning themselves, to pay a competitive oceanic milk price. The existing milk price argument and the notion of “parallel pricing” between processors, used to justify the establishment of the MNA, is invalid.

Even prior to our clear directional change, we have attracted two large NFL suppliers to provide their total supply to Challenge, there have been several NFL/Challenge and Peter Brownes suppliers who have changed to Harvey Fresh, and a new supplier has recently commenced with Challenge.

It is expected that increased competition will result as the Challenge price increases – in line with commercial market forces of supply and demand. In fact, with the latest summer milk prices released by Challenge, there will be suppliers from the two proprietary company processors who will be achieving the same or even lower prices than a 100% Challenge member. NFL and PB suppliers in regions farthest from processing centres are charged additional transport costs. This is in contrast to Challenge suppliers, where a constant milk price is paid regardless of location.

The milk prices throughout Australia are set through the larger co-operatives, where milk and trading revenue are directly returned to the shareholders – the farmer members. Proprietary companies are forced to pay a competitive price to achieve supply. The same principle will apply in Western Australia – it is imperative that Challenge continues to grow and add value to the dairy industry.

2. Milk Balancing

Milk balancing or trading represents significant revenue on our balance sheet. The MNA proposes to take over this facet of our business – with no processing facility. The very reason that NFL and HF balance their supply through Challenge – at a significantly higher price than is paid to their own suppliers – is that they CANNOT balance their milk supply within their existing product range. PB can balance supply using their bulk cheese processing capacity through Brunswick. However, the MNA cannot balance milk without processing facilities. Further, the removal of this part of our business would negatively impact on our current milk price, affecting the direct viability of between 45% and 50% of the state’s dairy farmers.

Challenge maximises the returns from milk balancing – contrary to the view expressed by advocates of the MNA at the conference. Other processors are charged a higher farmgate price for using Challenge processing capabilities for their milk balancing. Their savings

are probably greater than the increased farmgate price – through factory and logistical efficiencies in areas such as transport. Challenge channels these savings directly back into the farm sector and is therefore contributing through the balancing process to transport rationalisation in the WA dairy industry – ironically a key issue raised by the MNA to be addressed.

3. Consumer Benefit

The provision of a public benefit and potential public detriments as a result of granting authorisation is obviously of key concern to the ACCC. We are of the opinion that milk prices, and prices of milk based products to consumers will increase should the authorisation be granted. From a Challenge perspective, all retained earnings are re-distributed back to the members in the form of farmgate milk price. Any higher pricing sought through the MNA will need to be derived through product pricing – increased prices for the consumer.

4. Economics report prepared for Dairy WA Ltd by Dr Alistair Watson

We are pleased that Dr Watson in his report has confirmed, in his words, the *“value of co-operatives in strengthening the market power of dairy farmers throughout the world”*. We wholly agree that *“co-operative processing and manufacturing facilities have emerged around Australia to guarantee farmers a market for their output”*.

Dr Watson confirms and Challenge agrees *“with deregulation, the price paid for manufacturing milk in Victoria based on world prices for manufactured products effectively set a floor from which all year production of fluid milk could be priced in eastern Australia”*. Challenge believes that it is only a large influential Australian co-operative structure, determined to return as much as possible through the farm gate price, which sets this floor. We believe (in the absence of scale manufacturing processing in other parts of Australia), this “floor” effectively is transferred to manufacturing milk in other states.

In WA this is particularly relevant, where over supply to the small and static domestic market has traditionally resulted in such milk being processed into low value commodity products. Challenge agrees with Dr Watson *“that the scale of operations in WA is insufficient in manufacturing to allow competitive products of manufactured dairy products”*. Dr Watson’s paper has confirmed that the ongoing Challenge initiatives, to move away from such inefficient and low value commodity processing will continue to add value to farmers output and drive the price for any milk processed for the domestic market.

Further, Dr Watson states that processors have *“distinct catchment zones and thus do not have to compete with one another for suppliers of raw milk at the farmgate”*. In this regard we believe that Dr Watson has not been fully informed. It is our clear understanding that there are no zones to restrict processors from sourcing milk anywhere in WA. In fact, if market forces dictate and milk can be sourced profitably, there is no reason whatsoever that processors cannot source milk from wherever they choose. Similarly, farmers are free to source alternative processors within the limits of contractual arrangements.

It should be noted that Dr Watson's comments regarding "*the small local co-operative.....a supplier of last resort*" are puzzling. We have detailed the important role Challenge plays in WA in providing a "balancing supply" for other processors. Given Dr Watson's comments it seems likely that he has not been fully informed of this role.

Challenge believes Dr Watson to be correct in his statement that "*there are no technical differences between fluid milk and milk for manufacturing at the farm level*"; in fact differentiation occurs at the processing level. This is indeed one of the core tenets for the implementation of market milk deregulation and has been recognized by Dr Watson.

He also concludes as do many in the dairy industry and government sectors that changes following deregulation are "*irreversible*" and that "*potential remedies are with respect to strengthening farmer negotiating positions, formally by action by the Australian Competition and Consumer Commission or informally through agreement between participants in the supply chain.*"

It is for this reason that Challenge continues to support the ADFP in its moves for collective bargaining. Challenge supports the draft determination proposed by the ACCC Authorisation No. A90966

It was disappointing to find the DWA final submission contains so much inaccurate information, relating both to the WA Dairy Industry and to the workings and operation of Challenge Dairy Co-operative. We are further disappointed that the submission was extremely antagonistic toward processors. We feel that the success of any single desk structure operating within an industry would need the full support of the key stakeholders within that industry. It is quite apparent that the MNA has failed to develop a relationship with the processing sector.

Challenge has always indicated it will be supportive of a structure or scheme that will benefit the dairy farmers within the state. To this point in time, we have seen no evidence of such a scheme. We have seen no detail with regard the operation of the proposed MNA – there has been no progression beyond the conceptual stage. Until implementation details for incorporation into the WA Dairy industry can be revealed for balanced and constructive comment, Challenge cannot support the proposal. We do not feel that the interest of both dairy farmers and the public is being served by the creation of the MNA. It is our intent to progress under commercial market forces in our joint venture relationship, implement the value adding strategies outlined above, and return the highest milk price possible to our members.

From a Challenge perspective, apart from the removal of the collective boycott provision, there was no additional clarity with regard the operation of the proposed MNA, resulting from the pre-decision conference held on 28th November 2005. All our previous concerns remain and we are of the opinion that the denial of the interim authorisation should be extended to the final determination.

Yours sincerely

Peter Giddy

Larry Brennen

Chief Executive Officer
Challenge Australian Dairy Pty Ltd

Executive Chairman
Challenge Dairy Co-operative Ltd