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Response to Comments by Challenge Dairy Co-operative Ltd

(Prepared for Jenni Mattila & Co in the context of an investigation by the Australian Competition and Consumer Commission into pricing arrangements for the dairy industry of Western Australia – February 2006)

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These notes concern remarks made by Challenge Dairy Co-operative Limited in its letter to the ACCC of January 20, 2006 following from some of my earlier comments in the brief paper entitled 'Milk Pricing in Western Australia'. That paper was attached to the submission made by Jenni Mattila & Co in the context of the Dairy WA Draft Determination now being considered by the ACCC.

The intended rationale for Challenge in the WA market place, when it was established with substantial support from the Government of Western Australia, was to mimic the role in price setting for fluid milk that is played by dairy co-operatives in eastern Australia, and other countries. This is more or less stated in the letter from Challenge to the ACCC.

But there is a vast difference between Challenge and the large co-operatives operating in eastern Australia in both scale and product mix.

It is most unlikely that Challenge will succeed in putting a floor under the farm gate price of milk in Western Australia. Challenge continues to put its faith in specialty dairy products ('value adding') whereas the business of the large co-operatives in eastern Australia is based on production of bulk cheese, milk powders and butter for which there is a large international market. Pooling the returns from these markets, less processing costs, yields the prices on which dairy farmers in eastern Australia plan their operations. Furthermore, premiums on these prices can then be readily negotiated for the fluid milk market.

Fundamentally, Challenge fail to recognise that adding value is also adding costs. Speciality products involve higher production, and especially marketing costs, given the need to establish brands in the competitive retail food industry. Brand management is a risky business that is almost by definition unsuited to a co-operative business structure, where many members are not in a position to take financial risks,

The financial statements for Challenge also appended to the earlier submission suggest that joint venture strategies with Asian business partners have not been successful. Challenge is relying on building a brand name for cheese – a difficult prospect as argued above – and strengthening the relationship with Singapore-based QAF who currently only purchases a small amount of milk. Given the current situation and the losses incurred to date, the future of Challenge may even be in doubt.

The upshot is that Challenge is most unlikely to play a major role in price formation at least in the way that was intended, leaving the present situation unchanged whereby two

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processors can dominate the WA market for fluid milk. The terms and conditions offered by these two processors are more or less identical.

Challenge underestimates the significance of transport costs in segmenting the market for dairy products in Western Australia. My earlier remark 'distinct catchment zones' was possibly misinterpreted if it were taken to mean no competition for supplies by processors and no switching between processors by farmers.

Rather the intention was to point out that the cost of transport sets severe limits on the extent of competition in the WA dairy industry. In my view, the characterisation of local monopsony in accessing milk is still defensible. Regional monopsonies/oligopsonies for milk exist elsewhere in eastern Australia and is recognised in ACCC determinations allowing collective bargaining by groups of farmers. But the farm gate consequences are different in Western Australia because there is only a fledgling co-operative and its returns and prices are not linked to the world market in any meaningful sense. Instead, price formation is effectively dependent on two firms only.

It is not my understanding that the proposed Milk Negotiating Agency was intended to be involved in 'milk balancing' as implied on page 4 of the Challenge letter. Challenge are correct in saying that they are providing a balancing supply for other processors but this is to weaken the bargaining position of other farmers. This was the intended meaning of my earlier description of Challenge as 'supplier of last resort.'

With some fall in milk supply already, other processors are now relying on Challenge for additional supplies – what Challenge call milk balancing. If supplies fall further, other processors will sign up farmers directly weakening the existing position of Challenge and making a mockery of any suggestion of milk balancing.

Business failure by Challenge would fall disproportionately on some farmers, as would for that matter changing economic circumstances or business strategies of any of the other milk processors in Western Australia. There is therefore a potentially useful role for the proposed Milk Negotiating Agency in managing the risks of the evolving situation in the WA dairy industry.

Challenge concede the case for collective bargaining in their recent submission but fail to acknowledge important differences in bargaining strength between dairy farmers in Western Australia and eastern Australia

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