Australian
Competition &
Consumer
Commission

Determination

Application for authorisation

lodged by

Dairy Farmers Milk Co-operative Limited (DFMC) and Australian Co-operative Foods Limited (ACF)

in respect of

Milk Supply Arrangements between the parties following the sale of ACF

Date: **22 October 2008**

Authorisation no.: A91089

Public Register no.: C2008/851

Commissioners: Samuel
Schaper
King
Martin

Summary

The ACCC grants authorisation for the inclusion of the back to back milk purchasing policies and back to back pricing arrangements contained in clauses 4.4, 4.6.2 and 5.6 of the amended Milk Supply Agreement (which will come into effect following the completion of the sale of ACF) (amended MSA) to apply to various contracts between ACF, DFMC and dairy farmers. Authorisation is granted for a period of five years.

The authorisation process

The Australian Competition and Consumer Commission (ACCC) can grant protection from the application of the competition provisions of the *Trade Practices Act 1974* (the Act) if it is satisfied that the benefit to the public from the conduct outweighs any public detriment. The ACCC conducts a public consultation process to assist it to determine whether a proposed arrangement results in a net public benefit.

The application for authorisation

Dairy Farmers Milk Co-operative Limited (DFMC) and Australian Co-operative Foods Limited (ACF) (the applicants) are related parties. On 25 August 2008, ACF, DFMC and National Foods entered into a Tripartite Deed in the context of an agreement for the sale of ACF to National Foods Limited (National Foods). Following the sale of ACF, DFMC and ACF will cease to be related bodies corporate and may be regarded as potential competitors for the acquisition of raw milk from DFMC farmers.

Broadly, the applicants have sought authorisation for the inclusion of the back to back milk purchasing policies and back to back pricing arrangements contained in clauses 4.4, 4.6.2 and 5.6 of the amended Milk Supply Agreement which will take effect as and from the Scheme Implementation Date (amended MSA). The back to back pricing and back to back purchasing policies are to apply to several agreements between ACF, DFMC and farmer members.

The key effect of the clauses are:

- DFMC must adopt the same milk purchasing policy (including price structure) in relation to its acquisition of milk from its members, as ACF applies to its purchase of milk from DFMC (clause 4.4)

- DFMC must adopt the same milk price in relation to the purchase by DFMC from its farmer suppliers of milk, as DFMC received from ACF for the milk it sells to ACF (clause 5.6) and

- DFMC will sell to ACF milk it acquires from farmer members on the same terms and conditions relating to payment, pricing, collection and quality as contained in its farmer contracts (clause 4.6.2).

The applicants submit that following the sale of ACF, the continuation of the milk pricing and purchasing policies may amount to conduct, including price fixing, in breach of the Act.

The applicants seek authorisation of the pricing and purchasing policies to apply in existing supply contracts and Revised Farmer Supply Contracts until their expiry, and to apply to future supply contracts for a period of five years.

Public detriment

The ACCC considers that authorisation of the back to back pricing and back to back milk purchasing policies will not enable the parties to set prices at a level that is too high or too low relative to the market price. Prices will continue to be negotiated in an environment where world prices have a significant impact on domestic prices for raw milk.

Further, the non-exclusive nature of the amended MSA enables ACF to acquire milk from parties in addition to DFMC. The ACCC also notes that farmers are free to choose whether to enter into a supply contract with DFMC, and following the expiry of any contractual obligations, DFMC members can negotiate to supply raw milk to ACF, or other processors directly.

The ACCC considers that any barrier for processors who wish to enter or expand into particular regions are not increased by the proposed arrangements for which authorisation is sought.

Public benefit

The ACCC is satisfied that the continuation of the back to back pricing and back to back milk purchasing policies are likely to result in the following public benefits:

- certainty of supply in the short to medium term through the continuation of existing supply arrangements and

- transaction cost savings and efficiency gains for DFMC farmers and ACF.

Balance of public benefit and detriment

Overall, the ACCC considers that in all the circumstances the public benefits will outweigh the public detriment.

Length of authorisation

The ACCC generally considers it appropriate to grant authorisation for a limited period of time, so as to allow an authorisation to be reviewed in light of any changed circumstances.

The applicants sought authorisation with respect to the making and giving effect to the agreement in respect of the prices to be offered to dairy farmers, the offering of and inclusion of such prices, as well as the payment of such prices in Revised Farmer Supply Contracts, for a period of five years.

The ACCC grants authorisation for the back to back pricing and back to back purchasing policies as outlined in clauses 4.4, 4.6.2 and 5.6 of the amended MSA for a period of five years.

Interim authorisation

At the time of amending the application for authorisation, the applicants also requested interim authorisation for the offering of, and entering into, Revised Farmer Supply Contracts and any future supply contracts which include agreed prices. The applicants note that interim authorisation is not being sought to <u>pay</u> the prices set out in the Revised Farmer Supply Contracts, because such payment will not occur unless authorisation for implementation of back to back pricing is granted by the ACCC.

The ACCC considered the request for interim authorisation at the time of the draft determination, and granted interim authorisation to allow the applicants to offer, and enter into, Revised Farmer Supply Contracts which include agreed prices consistent with the back to back pricing policies.

Interim authorisation will remain in place until the date this final determination comes into effect or until the ACCC decides to revoke interim authorisation.

Contents

List of abbreviations

ACCC	Australian Competition and Consumer Commission
ACF	Australian Co-operative Foods Limited. Where relevant it also refers to the entity after it has been acquired by National Foods
amended MSA	Amended Milk Supply Agreement to take effect as and from the Scheme Implementation Date
Anticipated Full Demand	is a concept implemented to ensure that the long range planning of both DFMC and the farmer members for milk supply align with ACF's anticipated value-added operational demand for milk
current MSA	Milk Supply Agreement dated 1 July 2004 which is currently in force between ACF and DFMC. Following the completion of the sale of ACF it will be replaced by the Amended MSA
DFMC	Dairy Farmers Milk Co-operative Limited
Existing supply contracts	Supply contracts which are currently in existence, and will continue to exist after the completion of the sale of ACF, but which are not Revised Farmer Supply Contracts
Fleurieu	Fleurieu dairy farmers collective bargaining group
Fonterra	Fonterra Co-operative Group Ltd
Future supply contracts	Supply contracts to be entered into after the completion of the sale of ACF, including any renewals of any existing supply contracts and Revised Farmer Supply Contracts
Minimum Volume	a concept whereby DFMC agrees to use its reasonable endeavours to supply ACF with a 'Minimum Volume' for each region during each quarter of the term of the agreement
Murray Goulburn	Murray Goulburn Co-operative Limited
National Foods	National Foods Limited
Norco	Norco Co-operative Limited
Parmalat	Parmalat Australia Ltd
QDO	Queensland Dairyfarmers' Organisation
Revised Farmer Supply Contracts	Amended supply contracts with DFMC to take effect upon the completion of the sale
Supplement	Supplement to the current MSA dated September 2005
the Act	*Trade Practices Act 1974* (Cth)

Undertakings	Section 87B undertakings offered by National Foods and accepted by the ACCC on 24 July 2008
Warrnambool	Warrnambool Cheese & Butter Factory Company Holdings Ltd

1. Introduction

Authorisation

1.1 The Australian Competition and Consumer Commission (the ACCC) is the independent Australian Government agency responsible for administering the *Trade Practices Act 1974* (the Act). A key objective of the Act is to prevent anti-competitive conduct, thereby encouraging competition and efficiency in business, resulting in a greater choice for consumers in price, quality and service.

1.2 The Act, however, allows the ACCC to grant protection from legal action in certain circumstances for conduct that might otherwise raise concerns under the competition provisions of the Act. One way in which parties may obtain protection is to apply to the ACCC for what is known as an 'authorisation'.

1.3 The ACCC may 'authorise' businesses to engage in anti-competitive conduct where it is satisfied that the public benefit from the conduct outweighs any public detriment.

1.4 The ACCC conducts a public consultation process when it receives an application for authorisation. The ACCC invites interested parties to lodge submissions outlining whether they support the application or not, and their reasons for this.

1.5 After considering submissions, the ACCC issues a draft determination proposing to either grant the application or deny the application.

1.6 Once a draft determination is released, the applicant or any interested party may request that the ACCC hold a conference. A conference provides all parties with the opportunity to put oral submissions to the ACCC in response to the draft determination. The ACCC will also invite the applicant and interested parties to lodge written submissions commenting on the draft.

1.7 The ACCC then reconsiders the application taking into account the comments made at the conference (if one is requested) and any further submissions received and issues a final determination. Should the public benefit outweigh the public detriment, the ACCC may grant authorisation. If not, authorisation may be denied. However, in some cases it may still be possible to grant authorisation where conditions can be imposed which sufficiently increase the benefit to the public or reduce the public detriment.

The application for authorisation

1.8 On 22 May 2008, Dairy Farmers Milk Co-operative Limited (DFMC) and Australian Co-operative Foods Limited (ACF) (the applicants) lodged application for authorisation A91089 with the ACCC. On 29 August, the applicants amended their application for authorisation to account for amendments arising from agreements being entered into for the sale of ACF to National Foods Limited (National Foods).

1.9 Broadly, the applicants have sought authorisation for the inclusion of the back to back milk purchasing policies and back to back pricing arrangements contained in clauses 4.4, 4.6.2 and 5.6 of the amended Milk Supply Agreement which will take effect as and from the Scheme Implementation Date[1] (amended MSA). The back to back pricing and back to back purchasing policies are to apply to several agreements between ACF, DFMC and farmer members.

1.10 Authorisation is sought for the back to back pricing and back to back purchasing policies to apply to existing and future supply contracts, as well as Revised Farmer Supply Contracts. The applicants have requested that authorisation be granted for the inclusion and giving effect to the pricing and purchasing policies for a period of five years.

Interim authorisation

1.11 At the time of lodging the original application, the applicants also requested interim authorisation to allow the parties to continue the back to back pricing and purchasing policies in contracts between ACF, DFMC and farmer members while the substantive application for authorisation is being considered by the ACCC.

1.12 On 18 June 2008, the ACCC considered the request for interim authorisation and noted that the legal protection provided by interim authorisation was not needed until DFMC and ACF cease to be related bodies corporate. At that time the sale process was likely to be ongoing for some months.

1.13 The ACCC decided not to grant interim authorisation at that time on the basis that DFMC and ACF are able to continue with the current pricing and purchasing arrangements without the need for the legal protection provided by interim authorisation.

1.14 At the time of amending the application for authorisation, the applicants also requested interim authorisation for the offering of, and entering into, Revised Farmer Supply Contracts and any future supply contracts which include agreed prices. The applicants note that interim authorisation is not being sought to <u>pay</u> the prices set out in the Revised Farmer Supply Contracts, because such payment will not occur unless final authorisation for implementation of back to back pricing is granted by the ACCC.

1.15 The ACCC considered this request for interim authorisation at the time of the draft determination and decided to grant interim authorisation to allow the applicants to offer, and enter into, Revised Farmer Supply Contracts which include agreed prices consistent with the back to back pricing policies.

1.16 Interim authorisation will remain in place until either the date that the ACCC's final determination takes effect, or until revoked by the ACCC.

Draft Determination

1.17 On 25 September 2008, the ACCC issued a draft determination proposing to grant authorisation for the inclusion of the back to back milk purchasing policies and back to back pricing arrangements contained in clauses 4.4, 4.6.2 and 5.6 of the amended MSA to apply to various contracts between ACF, DFMC and dairy farmers. The ACCC proposed to grant authorisation for a period of five years.

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[1] The Scheme Implementation Date refers to the date in which the agreement for the acquisition of ACF by National Foods comes into effect.

Chronology

1.18 Table 1.1 provides a chronology of significant dates in the consideration of the application.

Table 1.1: Chronology of application for authorisation A91089

DATE	ACTION
22 May 2008	Application for authorisation lodged with the ACCC, including an application for interim authorisation.
9 June 2008	Closing date for submissions from interested parties in relation to the request for interim authorisation.
18 June 2008	The ACCC decided not to grant interim authorisation at this time.
27 June 2008	Closing date for submissions from interested parties in relation to the substantive application for authorisation.
7 July 2008	Submission received from DFMC and ACF in response to interested party submissions.
13 August 2008	The applicants requested the ACCC delay releasing a draft determination pending possible amendments to the application.
27 August 2008	Meeting with the applicants to discuss amendments to its application for authorisation.
29 August 2008	Applicants lodge amended application for authorisation and request for interim authorisation.
2 September 2008	Applicants provide public submission supporting amended application and request for interim authorisation.
3 September 2008	Public consultation on amended application and request for interim authorisation begins.
9 September 2008	Closing date for submissions from interested parties.
25 September 2008	Draft Determination issued and interim authorisation granted.
22 October 2008	Final Determination issued.

2. Background

The Australian dairy industry[2]

Dairy farming

2.1 In 2006-07 the Australian dairy industry produced approximately 9.5 billion litres of milk with a farm gate value of $3.2 billion.[3] Taking into account reduced national dairy herd size and higher feed costs, the industry expects that milk production for 2007-08 will fall by approximately 5% to 9.1 billion litres.[4]

2.2 Dairy farming occurs in all Australian states, however it is mainly concentrated in those areas which have high average rainfall or have reliable irrigation systems. Essentially, milk production is concentrated in the south-east corner of Australia, with Victoria, Tasmania and South Australia accounting for 79% of national output.[5] Production in these regions is highly seasonal with a peak during October to November, tapering off in the cooler months of May to June. The production of long shelf-life manufactured products in the south-east region has enabled maximum milk utilisation within the seasonal cycle. However, production in Queensland, New South Wales and Western Australia is less seasonal with the focus on year round supply of local fresh drinking milk products. Farmers in these regions manage calving and feed systems to ensure more even year round production.

2.3 The total number of individual Australian dairy farms has been steadily declining for a number of decades. For example, in 1980 there were 22 000 dairy farms whereas in 2006-07 there were approximately 8000.[6] While farm numbers have been decreasing, milk output has generally grown due to increasing cow numbers and improved cow yields. In particular total milk production has increased from 5432 million litres (in 1980) to 9582 million litres (in 2007)[7] and the average herd size increased from 85 cows in 1980, to 225 in 2006-07.[8]

Dairy manufacturing and processing

2.4 Processors purchase raw milk from farmers (for example through farmer co-operatives, collective bargaining groups or individual farmers) and process it into various dairy products for sale domestically or export.

2.5 Australia's dairy manufacturing sector is diverse and includes farmer owned co-operatives and public, private and multi-national companies. Co-operatives no longer dominate the industry, but still account for approximately 55% of the milk output.

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[2] Information outlined in this chapter was largely obtained from the applicants supporting submission, Dairy Farmers Milk Co-operative Limited and Australian Co-operative Foods Limited, *Submission accompanying application for authorisation of milk supply arrangements*, 22 May 2008.
[3] Dairy Australia, *Australian Dairy Industry In Focus 2007*, p. 9.
[4] Dairy Australia, *Dairy 2008 Situation and Outlook*, June 2008, p. 6.
[5] Dairy Australia, *Australian Dairy Industry In Focus 2007*, p. 18.
[6] Ibid, p. 11.
[7] Ibid, p. 9.
[8] Ibid, p. 12.

2.6 The major dairy processors in Australia are National Foods Limited (National Foods), Fonterra Co-operative Group Ltd (Fonterra), Parmalat Australia Ltd (Parmalat), Dairy Farmers Co-operative, Murray Goulburn Co-operative (Murray Goulburn), Warrnambool Cheese and Butter Factory Company Holdings Limited (Warrnambool) and Norco Co-operative Limited (Norco). Each of these is active in the acquisition of raw milk, and to varying degrees, in the production of dairy products.

2.7 Milk is processed into either drinking or manufacturing milk. Approximately 23% of total milk production is used as drinking milk with the remaining 77% used in the manufacturing of dairy products such as cheese, ice cream, skim milk power, yoghurt, butter and cream.[9]

2.8 Around 68% of manufactured product overall is exported with the remaining 32% sold on the Australian market. This contrasts with drinking milk, where some 96% is consumed in the domestic market.[10]

The export market

2.9 Australian dairy farmers operate in a deregulated and open market. Consequently, international prices are a major factor determining the price received by farmers for their milk.[11] In particular, farm gate prices paid to farmers in the south-east of Australia are heavily influenced by world dairy commodity prices.

2.10 Australia exports around 50% of domestic raw milk production (after processing - particularly in the form of milk powders and cheese).[12] Therefore, processors of dairy products to satisfy domestic demand compete directly for raw milk to go into production aimed at export markets. Accordingly, processors of product for domestic markets are required to match world dairy prices to ensure supply.

2.11 The Australian domestic dairy market is also influenced by trade from New Zealand especially in cheese products where New Zealand sourced cheese products accounts for about 15% of the national market. Butter and blended table spreads are also influenced by smaller volumes of trade from New Zealand. There are no barriers to this trade with New Zealand.

The applicants

Dairy Farmers Milk Co-operative Limited

2.12 DFMC is a trading Co-operative limited by shares. It was established on 2 April 2004 and commenced trading following a restructuring of ACF on 29 June 2004.

2.13 DFMC's principal activity is the acquisition of milk from members (pursuant to supply contracts with its members) and the sale of all such milk to ACF (pursuant to the MSA). DFMC is the owner of the milk it sells to ACF. It does not have any infrastructure for milk collection and storage and is dependant on ACF for the

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[9] Dairy Australia, *Australian Dairy Industry In Focus 2007*, p. 18, Dairy Australia, *Dairy 2008 Situation and Outlook*, June 2008, p. 12.
[10] Dairy Australia, *Australian Dairy Industry In Focus 2007*, p. 21.
[11] Ibid, p. 10
[12] Ibid, p. 22.

collection and storage of the milk which DFMC acquires from its members and on sells to ACF.

2.14 Currently, there are 797 dairy farmer members of DFMC located in Queensland, New South Wales, Victoria and South Australia. Table 2.1 shows the location and number of DFMC farmer members by region.

Table 2.1: DFMC farmer members by region

Region	Number of farmer members
Far Northern (North Queensland)	78
Northern (South-East Queensland and Northern New South Wales)	193
Central (New South Wales excluding Northern New South Wales and Riverina)	329
Riverina / Northern Victoria (and Gippsland)	70
Western Victoria / South Australia	127
Total	797

2.15 Membership is voluntary and members join and leave regularly. Active membership in DFMC requires satisfaction of the criteria set out in DFMC's registered Rules.[13] This includes the supply of at least 200 litres of milk to DFMC in any relevant seven day period.

Australian Co-operative Foods Limited (ACF)

2.16 ACF is a Co-operative limited by shares and a trading Co-operative. ACF operates under the trading name Dairy Farmers and is one of Australia's largest dairy manufacturers, supplying fresh and processed products to both local and export markets.

2.17 ACF's principal activities are the collection, processing, packaging, distribution and marketing of milk and other dairy or related food products. ACF manufactures a range of dairy products including fresh and UHT milk, flavoured UHT milk, cheese, butter, spreads, yogurts, creams and dairy desserts.

2.18 ACF acquires almost all of its raw milk from DFMC and supplies its products nationally. Its key brands include Dairy Farmers, Oak, Coon, Cracker Barrel, Dare, Moove, Shape and Ski.

2.19 Currently, DFMC and ACF are related parties within the meaning of section 4A(5) of the Act. Under a restructure in June 2004, ACF was established as a separate cooperative from DFMC. The relationship between the parties is:

[13] Rules of Dairy Farmers Milk Co-operative Limited, Rules 13.2.

- DFMC is wholly owned by its members who are almost all also members of ACF
- DFMC owns 20% of ACF[14]
- DFMC members own the remaining 80% of ACF and
- a new rule 50A was included in ACF's registered Rules which gives DFMC the power to remove from office a majority of directors of ACF.

2.20 The location of ACF's facilities and the products manufactured at each facility are outlined in Table 2.2.

Table 2.2: Location of ACF's facilities

State	Location of facility	Products manufactured
NSW	Lidcombe	Fresh white and flavoured milk and fresh cream
	Wetherill Park	Dairy foods, sour cream, bottle and carton UHT
	Hexham	Fresh white milk, condensed milk and deserts, cottage cheese
	Baulkham Hills	Fresh white milk and fresh cream
Queensland	Malanda	Fresh white and flavoured milk, fresh cream and cheese
	Booval	Fresh white and flavoured milk, fresh cream, powders
South Australia	Clarence Gardens	Fresh white and flavoured milk
	Jervois	Cheese and powders
Victoria	Simpson	Cheese
	Allansford	Cheese (cut and wrap only)
	Shepparton	Fresh white and flavoured milk
ACT	Canberra	Fresh white and fresh cream

Sale of ACF

2.21 In February 2008 ACF announced that it was considering bids for the acquisition of its business. Informal merger clearance was sought from the ACCC by a number of potential bidders:

[14] There is currently a dispute before the Courts between ACF and DFMC regarding the percentage shareholding of DFMC.

- on 24 July 2008, after accepting court enforceable undertakings from National Foods, the ACCC announced that it would not oppose the proposed acquisition of ACF by National Foods

- on 24 July 2008, the ACCC released a Statement of Issues outlining preliminary concerns with the bid by Parmalat Australia Ltd (Parmalat) and Murray Goulburn Co-operative Limited (Murray Goulburn). On 8 August 2008 the application by these firms for ACCC clearance was withdrawn.

- On 30 June 2008, a request for informal clearance by Fonterra Co-operative Group Ltd (Fonterra) was withdrawn.

- on 26 August 2008, the ACCC announced it would not oppose the proposed acquisition of assets and shares of ACF by Murray Goulburn.

2.22 On 25 August 2008, it was announced that National Foods had entered into an agreement to acquire ACF, with Warrnambool and National Foods to form a 50:50 joint venture to acquire and operate the existing cheese business of ACF. The proposed acquisition is subject to a number of conditions, including a shareholder vote and court approvals.

Undertakings[15]

2.23 The undertakings offered by National Foods, pursuant to section 87B of the Act, and accepted by the ACCC, provide that if the bid by National Foods and Warrnambool is successful, National Foods will divest the following assets to a purchaser(s) approved by the ACCC:

- the ACF processing facilities in Clarence Gardens (South Australia) and Lidcombe (New South Wales)

- licences of certain white milk brands - on a perpetual basis in South Australia and on a time-limited basis in New South Wales

- licences of certain flavoured milk brands - on a perpetual basis in South Australia and New South Wales and

- certain depots and milk distribution agreements in South Australia and New South Wales.

2.24 National Foods will also supply a quantity of raw milk to the approved purchaser(s) over the 12 months following the divestment date.

2.25 Further information about the proposed transaction can be obtained in the Public Competition Assessment for National Foods Limited – proposed acquisition of Australian Cooperative Foods Limited dated 19 September 2008 found on the ACCC's website (www.accc.gov.au).

[15] A copy of the undertakings can be found on the ACCC's website www.accc.gov.au.

National Foods

2.26 National Foods is a wholly owned subsidiary of Kirin Holdings Company Limited. It supplies dairy products in every state of Australia. Its principal activities are the processing, manufacturing, packaging, distribution and marketing of milk, fresh dairy foods, juice and cheese.

2.27 National Foods produces:

- a range of full cream, flavoured and modified fresh and UHT milks with brands such as Pura, Pura Light Start, Masters, Farmers Union, Big M and Pura Classic
- fresh dairy foods including a range of yoghurts, fromage frais, dairy desserts and cream under brands including Yoplait, Fruche, YoGo and Divine Classic and
- a range of specialty cheeses under brands such as King Island, South Cape, Tasmanian Heritage, Mersey Valley, Tilba, Timboon and Heidi Farm.

2.28 National Foods has production facilities across every Australian state. The location of National Foods' facilities and the products manufactured at each facility are outlined in Table 2.3.

Table 2.3: Location of National Foods' facilities

State	Location of facility	Products manufactured
NSW	Penrith	Fresh milk
	Leeton	Juice
	Smithfield	Juice
Queensland	Crestmead	Fresh milk
	Lytton	Juice
Victoria	Wodonga	Soy beverages
	Campbellfield	Cheese packaging
	Chelsea Heights	Fresh milk and cream
	Timboon	Specialty cheese
	Morwell	Fresh dairy foods
	Cobden	UHT flavoured milk
Tasmania	King Island	Specialty cheese and cream
	Burnie and Heidi farm	Specialty cheese
	Lenah Valley	Fresh milk
South Australia	Salisbury	Fresh milk
	Regency Park	Juice
	Murray Bridge	Dairy snacks, cream and cheese
	Berri	Juice
Western Australia	Bentley	Fresh milk, UHT milk and juice

Milk Supply Arrangements between DFMC and ACF

2.29 At the time of lodging the original application for authorisation in May 2008, the competitive tender process being carried out for the sale of ACF had not reached a stage where it was possible to identify any purchaser. This situation has now been clarified upon the entry into agreements for the sale of ACF to National Foods on 25 August 2008.

2.30 The acquisition is to be effected by a Scheme of Arrangement and, subject to satisfaction of certain conditions, including a shareholder vote, is expected to be completed in or about November 2008. On 25 August 2008, ACF, DFMC and National Foods also entered into a Tripartite Deed in the context of the agreement for the sale of ACF. The agreement includes an amended Milk Supply Agreement (amended MSA) and amended supply contracts with DFMC to be entered into with farmers prior to the completion of the sale (Revised Farmer Supply Contracts).

The amended Milk Supply Agreement

2.31 The amended MSA will come into effect following the completion of the sale of ACF and will expire on 30 June 2017. The amended MSA will replace the current milk supply agreement between DFMC and ACF dated 4 July 2004 (current MSA) and the Supplement to that agreement dated September 2005 (Supplement).

2.32 The amended MSA sets out the terms on which ACF will acquire milk from DFMC following the sale of ACF. To date, ACF has been acquiring milk from DFMC according to the terms set out in the current MSA.

2.33 A summary of the key terms of the <u>amended</u> MSA are:

- ACF must use its reasonable endeavours to pursue commercial opportunities which will sustain and grow the current regional supply of milk to ACF (clause 3.1(a))

- ACF must assist DFMC to provide its farmer members, on a regional basis, with a consistent and orderly opportunity to grow on-farm production (clause 3.1(b))

- DFMC must purchase all of the qualifying farmer members' milk which is offered for sale to it, and supply it to ACF (clause 3.2.1)

- ACF must, subject to certain limited exceptions, purchase from DFMC all of the qualifying farmer members' milk which DFMC has purchased (clause 3.3(a))

- DFMC agrees to use its reasonable endeavours to supply ACF with a 'Minimum Volume' for each region (see table 2.1) during each quarter of the term of the amended MSA (clause 3.4).

- The amended MSA incorporates a concept referred to as 'Anticipated Full Demand', which seeks to ensure that the long range planning for milk supply of both DFMC and farmer members align with ACF's anticipated value-added operational demand for milk (clause 3.4).

- the milk supply arrangements between ACF and DFMC are non-exclusive and ACF is not restricted from purchasing milk or products similar to milk from any third party (clause 3.8).

- DFMC must adopt the same milk purchasing policy (including price structure) in relation to its acquisition of milk from its members, as ACF applies to its purchase of milk from DFMC (clause 4.4) **(back to back milk purchasing policy)**

- DFMC will sell to ACF milk it acquires from farmer members on the same terms and conditions relating to payment, pricing, collection and quality as contained in its farmer contracts (clause 4.6.2) **(back to back pricing)**

- ACF is obliged to pay DFMC a commercial price for milk, being the market value or price of milk on a GST exclusive basis. However, in respect of the period after 30 June 2010 and for milk which exceeds the Anticipated Full Demand level for a region, ACF is only obliged to pay DFMC a commercially reasonable price having regard to the best end use (subject to logistical and administrative costs to which that milk is likely to be put (clause 5.1.1).

- if the parties are unable to agree on a 'commercial price', the issue may be resolved by mediation and then expert determination (clause 5.4.3 and 14)

- the parties must agree on a pricing structure for the acquisition of milk by ACF which has regard, among other matters, to quality, quantity, geographic, transportation and handling factors (clause 5.1.3)

- an obligation on DFMC to adopt the same milk price in relation to the purchase by DFMC from its farmer suppliers of milk, as DFMC received from ACF for the milk it sells to ACF (clause 5.6) **(back to back pricing)**

- DFMC must direct ACF to make, on its behalf, payment to DFMC's farmer members for milk supplied by them to DFMC which is on sold by DFMC to ACF (clause 7.2)

2.34 The restraint in the current MSA on ACF from acquiring milk directly from a DFMC member or from any other supplier of milk other than DFMC (the restraint clause) is not part of the amended MSA.[16]

DFMC's supply contracts with farmers

2.35 By virtue of clause 4.4 of the amended MSA, the milk purchasing policy agreed between DFMC and ACF for the supply of milk is reflected in the contracts and arrangements that DFMC enters into for the acquisition of milk from its members.

2.36 DFMC acquires milk from its members through the following supply contracts:

- Defined Volume Fixed Term Contracts
- Revised Farmer Supply Contracts (which only come into effect following the sale of ACF) and
- Volume Incentive Contracts.

2.37 Farmer members are free to choose whether or not they enter into a supply contract and which contract they enter into. Farmer members are free to choose not to enter into a supply contract and still supply milk to DFMC, in which case they are paid a base price

[16] Clause 20 of the <u>current</u> MSA provides that the following provisions <u>cease</u> to apply in the event that ACF and DFMC cease to be related parties: back to back pricing (clause 5.6); back to back milk purchasing policies (clause 4.4); and the restraint on ACF (clause 9).

for milk price. DFMC members are required to supply a minimum amount of raw milk to DFMC in order to be considered as an active member of the co-operative.

2.38 The applicants note that the overwhelming majority (over 95%) of DFMC farmer members choose to enter into a contract in order to access additional benefits such as higher prices and certainty of milk off-take for the duration of the contract.[17]

2.39 The applicants advise that contracts are frequently reviewed and at any one time there are a number of supply contracts being renewed or new agreements being negotiated and entered into by DFMC. At present there are 776 supply contracts between DFMC and farmer members.

Defined Volume Fixed Term Contracts

2.40 Defined Volume Fixed Term Contracts are generally two to three year agreements under which a farmer agrees to supply DFMC with a defined volume of raw milk. The volume is to be supplied by that farmer member on a six monthly basis during the term of the contract. The ACCC understands that the defined volume ensures a minimum volume is supplied by the farmer but that in addition they are required to supply all their milk to DFMC.

2.41 Under these contracts the farmer receives a contracted base price for milk supplied each month during the contract period. The contracted base price is an amount announced by DFMC from time to time for a reference litre of milk.[18] The farmer member also receives payments for supplying the defined volume referred to in their contract and are entitled to a volume incentive payment for supply of raw milk above the defined volume.

2.42 Neither the farmer member nor DFMC can terminate the contract without giving 180 days notice, except in limited circumstances. Even with notice the contract can only cease at the completion of the contract term.

Revised Farmer Supply Contracts

2.43 The Revised Farmer Supply Contracts are amended Defined Volume Fixed Term Contracts. To satisfy the condition precedent of the sale of ACF, DFMC must use reasonable endeavours to secure the entry by DFMC farmer members into Revised Farmer Supply Contracts prior to the completion of the sale of ACF.

2.44 The applicants advise that the purpose of these contracts is to secure a specified volume of milk, per region, which is equivalent to a proportion of the milk supplied by ACF to DFMC during the 2007-08 financial year.

2.45 Farmers who decide to enter into a Revised Farmer Supply Contract, contract to supply a defined volume of milk, supplying at least a minimum volume of milk over a 6 month period. However, in order to maintain security of milk, farmers are required to supply all their milk to DFMC[19] even where this amount falls above the defined volume.

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[17] Addisons, *Authorisation Application lodged by Dairy Farmers Milk Co-operative Limited and Australian Cooperative Foods Limited*, 7 July 2008, p. 2.

[18] A reference litre of milk is defined as 3.95% fat and 3.15% protein.

[19] Clause 2 of the Revised Farmer Supply Contract.

2.46 The main changes which have been incorporated in the Revised Farmer Supply Contracts, which differ from the existing Defined Volume Fixed Terms Contracts are:

- farmer members may terminate the contracts giving not less than 90 days written notice, at the completion of the contract period, subject to obtaining prior written consent of DFMC. DFMC can only withhold its consent if termination of the supply contract will be reasonably likely to result in the estimated milk supply to DFMC under Revised Farmer Supply Contracts in the relevant region for 3 quarters following the termination, to fall below the minimum regional contract level for those 3 quarters in that region. The minimum regional contract level is defined to be a volume which is 10% above the minimum volume DFMC is required to supply to ACF for that region under the amended MSA.

- farmers can terminate their supply contract during the contract period on 90 days' notice if they decide to sell their farm or cease operating a dairy business. However, before doing so, they must ensure that the farm or the farmers' dairy herd is sold to a person who agrees to continue to supply the minimum volume specified in the Revised Farmer Supply Contract to DFMC during the term of the contract period. This differs from the current Defined Volume Fixed Term Contract in that under the current contract farmers can terminate their contract during the contract period on 14 days' notice with DFMC's consent, if they decide to permanently leave the dairy industry.

- liquidated damages are payable if a farmer fails to supply the minimum volume during any six monthly period. This differs from the current Defined Volume Fixed Term Contract in that under the current contract liquidated damages are payable if a farmer fails to meet the minimum volume specified in their contract for 2 or more consecutive six monthly periods.

Volume Incentive Contracts

2.47 Volume Incentive Contracts are generally one year agreements where a farmer member agrees to supply DFMC with all of the raw milk produced at their farm.

2.48 Farmer members who are a party to a Volume Incentive Contract receive a contracted base price for their raw milk each month during the term of the agreement as fixed by DFMC and a Volume Incentive Payment.

2.49 The farmer members can terminate the contract with DFMC at any time during the term on 120 days notice or with 28 days notice after the agreement expires. Although the earliest the contract can expire is at the end of the contract term.

Pricing arrangements

2.50 The applicants advise that the prices paid by ACF to DFMC, and that DFMC pays to its farmer members, for raw milk depends on a number of factors related to the quality of milk and the geographic location from which the raw milk is sourced.

2.51 The applicants advise that prices negotiated by DFMC and ACF may differ across regions (see Table 2.1), however the same price is offered to all of DFMC's members within a region. Factors which may influence the price in a region include localised weather impacts, the nature of competition within each region, the economics of dealing with shortfalls by transporting milk from other regions or the requirement to fill specific contracts.

2.52 As noted, ACF and DFMC agree from time to time on the price which ACF will pay to DFMC for milk. The prices are determined through commercial negotiations between DFMC and ACF. The amended MSA requires ACF and DFMC to:

- agree to the milk purchasing policy no later than six months before the commencement of each relevant financial year (clause 4.1.1)
- agree upon a pricing structure for milk (clause 5.2)
- agree pricing periods for each financial year of between one and twelve months duration (clause 5.3) and
- no later than one month prior to each pricing period, to negotiate and agree in writing the commercial price for milk for the next pricing period (clause 5.4).

2.53 The back to back pricing arrangements (under clause 5.6) provides that the prices agreed between ACF and DFMC form part of the supply contracts offered to farmer members by DFMC.

2.54 The applicants advise that DFMC and ACF hold a series of meetings and negotiations to determine the price of milk, standard contract terms and the Milk Policy Guide[20]. Further meetings are held during the year to monitor and review:

- the competitive price of milk
- ACF's milk needs and
- the supply patterns from farmer members

in order to indicate to ACF whether the supply pool is at risk from matters such as competition or difficult seasonal or farm gate cost conditions. Following these meetings and reviews, there may be subsequent price changes. The applicants advise that for the financial year of 2007-08 there were at least five price changes.

[20] The applicants advise that the Milk Policy Guide is not a pricing document, although it includes a number of matters which are relevant to price including: description of the different types of supply agreements between farmers and DFMC; a definition of 'new milk'; details of 'gates charges' (ie freight and cartage costs); and an explanation of the Quality Payment Systems. Other matters included in the Milk Policy Guide include issues such as sampling of milk, animal feedstuffs, animal health and minimum volumes and pick up arrangements.

3. The application for authorisation

3.1 The applicants seek authorisation for the inclusion of the back to back milk purchasing policies and back to back pricing clauses as set out in clauses 4.4, 4.6.2 and 5.6 of the amended Milk Supply Agreement between DFMC and ACF. The back to back pricing and back to back milk purchasing policies are to apply to several agreements between ACF, DFMC and dairy farmers. The MSA is confidential and has been excluded from the public register.

3.2 The effect of the clauses are:

- DFMC must adopt the same milk purchasing policy (including price structure) in relation to its acquisition of milk from its members, as ACF applies to its purchase of milk from DFMC (clause 4.4)
- DFMC must adopt the same milk price in relation to the purchase by DFMC from its farmer suppliers of milk, as DFMC received from ACF for the milk it sells to ACF (clause 5.6) and
- DFMC will sell to ACF milk it acquires from farmer members on the same terms and conditions relating to payment, pricing, collection and quality as contained in its farmer contracts (clause 4.6.2).

3.3 More specifically, authorisation is sought for:

1. the inclusion in the amended MSA of amended clauses 4.4 and 5.6 which provide for the continuation of the agreement in respect of back to back milk purchasing policies and back to back pricing arrangements upon completion of the sale of ACF
2. the inclusion in the amended MSA of new clause 4.6.2 which provides, among other things, that DFMC will sell to ACF milk it acquires from farmer members on the same terms and conditions relating to payment, pricing, collection and quality as contained in its farmer contracts.
3. the implementation of the back to back pricing and back to back milk purchasing policies by DFMC in its dealings with farmers for the supply of milk to ACF, following completion of the sale of ACF to National Foods
4. the making and giving effect to the agreement in respect of the policies and prices which are to be the subject of back to back pricing in DFMC's Revised Farmer Supply Contracts following completion of the sale and
5. the making and giving effect to the agreement in respect of the prices ACF will pay farmers whose Revised Farmer Supply Contracts are assigned to ACF, or which contracts ACF obtains the benefit of, in accordance with the transaction agreements.

3.4 The arrangements potentially raise concerns under the anti-competitive conduct provisions of the Act. Consequently, the applicants have lodged application for authorisation A91089 under section 88(1) of the Act to make and give effect to a contract or arrangement, 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. Further, by agreeing new prices ACF and DFMC would be deemed to be making and/or giving effect to a price fixing agreement in contravention of section 45 of the Act.

3.5 Under section 88(6) of the Act, any authorisation granted by the ACCC is automatically extended to cover any person named in the authorisation as being a party or proposed party to the conduct.

3.6 The applicants seek authorisation for a period of five years.

3.7 Specifically the applicants advise that:

- in respect of existing supply contracts, which are those currently in existence and which will continue in existence after completion of the sale of ACF, until the contracts and arrangements expire
- in respect of Revised Farmer Supply Contracts, which are the amended supply contracts between DFMC and farmer members entered into prior to the completion of the sale, to take effect upon completion of the sale. Authorisation is sought for these contracts until the contracts expire and
- in respect of future supply contracts, which are those supply contracts entered into after completion of the sale of ACF, including any renewals of any existing supply contacts and Revised Farmer Supply Contracts, for five years.

3.8 The applicants also seek authorisation, for a period of five years, with respect to the offering of, and entering into, Revised Farmer Supply Contracts which include prices to be paid following the grant of final authorisation. If such contracts are assigned to ACF or ACF otherwise obtains the benefit of them, authorisation is sought for the payment of the agreed prices in any such contracts for the period from completion of the sale of ACF to National Foods until 30 June 2011.

4. Submissions received by the ACCC

Submissions from DFMC and ACF

4.1 The applicants submit that the conduct would not result in an anti-competitive detriment because:

- milk prices agreed between DFMC and ACF have been, and will continue to be, in line with prevailing market prices
- membership of DFMC is voluntary and members enter into and renew supply contracts on a regular basis
- ACF will be free to acquire from other suppliers and DFMC's farmer members will be free to supply to other processors including ACF directly
- regional factors ensure that there will be no industry wide pricing and
- grocery retailers exert considerable countervailing power on retail pricing in the dairy industry.

4.2 The applicants submit that the conduct will result in the following public benefits:

- certainty for farmers, processors and consumers by ensuring that existing supply contracts will be enforceable
- certainty of future milk supply arrangements, providing farmers with the security necessary to plan and grow production (which is particularly important in a period of extended drought and high input costs)
- continuation of access for farmers (particularly small to mid sized farmers) to DFMC's information and expertise on market trends which in turn lowers transaction costs and
- facilitation of the growth of exports through security of the existing milk pool and the potential for growth of the pool.

4.3 The applicants also provided a supporting submission with their amended application for authorisation. The applicants submit that the conduct to which the amended authorisation application applies does not change the assessment of the likely anti-competitive detriment and public benefits because:

- the amendments to the MSA and to the Revised Farmer Supply Contracts are the product of an arms' length negotiation between National Foods and DFMC. The applicants submit that the amendments seek to balance the interests of ACF, as a processor of milk, and the interests of DFMC's farmer members. In particular:
    - o the amendments to the MSA dealing with the supply of a Minimum Volume by DFMC to ACF provide ACF with security of milk supply following the sale. This is particularly important during the period immediately following the sale where National Foods must ensure that it will have sufficient milk supply to meet ACF's operational needs and

- the amended MSA does not oblige ACF to acquire milk from new farmer members where that milk exceeds ACF's Anticipated Full Demand levels. In addition, ACF is only obliged to pay DFMC 'a commercially reasonable price having regard to the best end use (subject to logistical and administrative costs) to which that milk is likely to be put', for any milk which exceeds ACF's Anticipated Full Demand levels. Those provisions of the amended MSA provide ACF with leverage in its negotiations with DFMC.

- the conduct affects only a relatively small number of farmers. Relevantly, the Minimum Volume for the 2008-09 and 2009-10 financial years is specified in the amended MSA and is a proportion only of the total milk supplied by DFMC to ACF during the 2007-08 financial year

- membership of DFMC will remain voluntary and farmers are free to enter into Revised Farmer Supply Contracts with DFMC if they wish to do so. In addition, subject to the terms of their individual agreements with DFMC, farmers will remain free to supply other processors as and when their supply contracts expire

- farmers will continue to compete among themselves including on quality and volume

- the amended MSA will continue to oblige ACF to pay a commercial price for milk which will continue to be determined by factors such as world market prices. The applicants submit this will continue to constrain the prices received by dairy farmers and paid by processors. In addition, regional factors will continue to ensure that the conduct does not give rise to industry wide pricing. The agreement in respect of the policies and prices to be the subject of back to back pricing in DFMC's Revised Farmer Supply Contracts was necessary because of the need to offer farmers Revised Farmer Supply Contracts before completion of the transaction and further, to provide farmers with a level of certainty regarding the prices to be payable by ACF following the transaction and

- supermarkets will continue to exert considerable countervailing power.

Submissions from interested parties prior to the amended application

4.4 The ACCC also sought submissions from 49 interested parties potentially affected by the application, including various processors, dairy farmer collective bargaining groups, government departments and the potential bidders for the purchase of ACF.

4.5 The ACCC received public submissions prior to the amended application from:

- National Foods and
- Fleurieu Dairy Farmers Collective Bargaining Group

National Foods

4.6 National Foods supports the grant of (both interim and final) authorisation and noted that following a sale of ACF, the proposed authorisation would allow for the continuation of existing milk supply arrangements thereby providing greater certainty and reduced commercial disruption for all relevant parties.

Fleurieu dairy farmers collective bargaining group

4.7 Fleurieu dairy farmers collective bargaining group (Fleurieu) submits that DFMC does not provide competitive benefits for farmers as they have little or no bargaining power because they can only negotiate to sell milk purchased from members to ACF and cannot bargain with other processors.

4.8 However, Fleurieu submits that DFMC and ACF do pay the commercial price for milk that applies in the region. Fleurieu recognises that ACF, to receive the required volume of milk, must pay a price to farmers that is competitive.

4.9 Fleurieu notes that the supply contracts which DFMC has with its farmer members do not provide flexibility, and act as a barrier to the movement of supply from DFMC to another processor. Fleurieu notes that the defined volume fixed term contracts require 180 days notice to terminate the contract.

4.10 Fleurieu submits that when DFMC offers contracts at the beginning of the year, the prices are indicative only and may be varied throughout the contract. Fleurieu submits that farmers are under pressure to sign a contract with DFMC in order to obtain additional pricing benefits, such as being paid the defined volume contract premium and the volume incentive payment. If a farmer does not sign they will not receive these benefits.

DFMC/ACF's response to Fleurieu submission

4.11 In response to the issues raised by Fleurieu, the applicants note that farmers are free to supply milk to DFMC for on-sale to ACF without the need to enter into any contract. The applicants note, however, that the overwhelming majority (over 95%) of DFMC farmer members choose to enter into a supply contract. The applicants note that farmers are free to supply other processors once their supply contract is terminated.

4.12 The applicants submit that the reason a majority of farmers elect to enter into a supply contract with DFMC is that such contracts provide benefits to farmers in the form of higher prices and certainty of milk off-take for the duration of the contract. The applicants note that farmers value certainty of milk off-take which has been illustrated by the fact that approximately 35% of farmers enter into a 3 year supply contract as opposed to a 1 or 2 year contract. The applicants also note that farmers who are party to a defined volume fixed term contract are guaranteed minimum prices for the duration of the contract.

4.13 The applicants also submit that supply contracts with farmers expire on a rolling basis. DFMC offers contracts to farmers whose contracts are coming to an end as well as to new farmers throughout the year, not just in June. The applicants submit that although supply contracts specify a contract period, the contract does not automatically expire at the end of that contract period. For a contract to end, a farmer must provide notice terminating the conduct. The notice required to terminate a defined volume fixed term contract is 180 days, and for a one year supply agreement 120 days notice is required.

4.14 The applicants also note that a farmer who enters into an agreement does so knowing it is for a minimum period. Should a farmer wish the contract to come to an end at expiry of that term, the farmer may give the appropriate notice and does not need to wait until expiry of the contract before giving notice.

Submissions from interested parties following the amended application

4.15 The ACCC consulted interested parties on 3 September 2008 on the amended application for authorisation and the request for interim authorisation.

4.16 The ACCC received public submissions following the amended application from:

- National Foods
- Queensland Dairyfarmers' Organisation
- Fleurieu Dairy Farmers Collective Bargaining Group

National Foods

4.17 National Foods supports the amended application for authorisation and submits that it will facilitate the continuation of the existing back to back milk supply arrangements offering greater certainty and reduced commercial disruption for dairy farmers, ACF/National Foods and DFMC.

4.18 National Foods also supports the grant of interim authorisation. National Foods notes that prior to the completion of the sale of ACF, it is commercially essential that ACF and DFMC offer their farmer members the Revised Farmer Supply Contracts. National Foods submits that interim will allow:

- affected farmers to make an informed decision on the proposed ACF transaction. These dairy farmers will need to understand the contract terms and conditions that are intended to apply after the acquisition occurs and
- National Foods will obtain comfort regarding milk supply security, which is a critical element of the ACF business that it wishes to acquire.

Queensland Dairyfarmers' Organisation

4.19 The Queensland Dairyfarmers' Organisation (QDO) supports the continuation of the pricing and purchasing policies.

4.20 QDO submits that authorisation is necessary to ensure a smooth transition and sale process. QDO also submits that authorisation will allow minimal disruption to producers' confidence to continue with milk supply, and at the same time have no impact on the consuming public.

Fleurieu

4.21 Fleurieu asked a number of questions regarding the Revised Farmer Supply Contracts in order to determine that they will be fair and not pose barriers to trade. Fleurieu submits that DFMC's desire to secure milk supply is understandable and it could be in the best interests of milk suppliers to have a secure market for farm milk, but some of the contractual conditions of supply may be detrimental to the suppliers of raw milk.

DFMC/ACF's response to Fleurieu submission

4.22 In response to the Fleurieu's submission, the applicants submit that the Revised Farmer Supply Contracts do not pose any barriers to trade and are not detrimental to the suppliers of raw milk.

4.23 The applicants note that:

- when a Revised Farmer Supply Contract is offered to a farmer, the farmer will be provided with details of the pricing which, subject to authorisation, will be paid pursuant to the contract
- the Revised Farmer Supply Contracts will be for defined volumes of milk. The volumes of milk which will be the subject of individual farmer contracts will be a matter between DFMC and each farmer and
- participation in any capital distribution by DFMC from the sale of ACF will be governed by DFMC's rules.

4.24 The views of the applicants and interested parties are also discussed in the ACCC's evaluation of the arrangements in Chapter 6 of this determination. Copies of public submissions are available from the ACCC website (www.accc.gov.au) by following the 'Public Registers' and 'Authorisations Public Registers' links.

Submissions following the draft determination

4.25 On 25 September 2008 the ACCC issued a draft determination proposing to grant authorisation for the inclusion of the back to back milk purchasing policies and back to back pricing arrangements contained in clauses 4.4, 4.6.2 and 5.6 of the amended MSA to apply to various contracts between ACF, DFMC and dairy farmers. The ACCC proposed to grant authorisation for a period of five years.

4.26 A conference was not requested in relation to the draft determination. The ACCC received no submissions following the release of the draft determination.

5. The net public benefit test

5.1 The ACCC may only grant authorisation where the relevant test in section 90 of the Act is satisfied.

Application A91089

5.2 The applicants lodged application for authorisation A91089 under section 88(1) of the Act to make and give effect to a contract or arrangement, 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. The relevant tests for this application are found in sections 90(6) and 90(7) of the Act.

5.3 In respect of the making of and giving effect to the arrangements, sections 90(6) and 90(7) of the Act state that the ACCC shall not authorise a provision of a proposed contract, arrangement or understanding, other than an exclusionary provision, unless it is satisfied in all the circumstances that:

- the provision of the proposed contract, arrangement or understanding would result, or be likely to result, in a benefit to the public and
- this benefit would outweigh the detriment to the public constituted by any lessening of competition that would result, or be likely to result, if the proposed contract or arrangement was made and the provision concerned was given effect to.

5.4 The applicants seek authorisation for inclusion in the amended MSA prior to the completion of any sale of ACF, and to make and give effect to the amended MSA in order for ACF and DFMC to continue with the back to back pricing and back to back purchasing policies under clauses 4.4, 4.6.2 and 5.6 of the amended MSA.

5.5 The applicants also seek authorisation to make and give effect to the agreement of prices (which are to be subject of back to back pricing) in DFMC's Revised Farmer Supply Contracts. Similarly, authorisation is sought to make and give effect to the agreement of prices which ACF will pay farmers under Revised Farmer Supply Contracts which ACF obtains the benefit of.

Application of the tests

5.6 The Australian Competition Tribunal (Tribunal) has stated that the test under section 90(6) is limited to a consideration of those detriments arising from a lessening of competition.[21]

5.7 However, the Tribunal has previously stated that regarding the test under section 90(6):

> [the] fact that the only public detriment to be taken into account is lessening of competition does not mean that other detriments are not to be weighed in the balance when a judgment is being made. Something relied upon as a benefit may have a beneficial, and also a detrimental, effect on society.

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[21] *Australian Association of Pathology Practices Incorporated* [2004] ACompT 4; 7 April 2004. This view was supported in *VFF Chicken Meat Growers' Boycott Authorisation* [2006] AcompT9 at paragraph 67.

Such detrimental effect as it has must be considered in order to determine the extent of its beneficial effect.[22]

5.8 Consequently, given the similarity of wording between section 90(6) and (90(7), when applying these tests the ACCC can take most, if not all, detriments likely to result from the relevant conduct into account either by looking at the detriment side of the equation or when assessing the extent of the benefits.

Definition of public benefit and public detriment

5.9 Public benefit is not defined in the Act. However, the Tribunal has stated that the term should be given its widest possible meaning. In particular, it includes:

> ...anything of value to the community generally, any contribution to the aims pursued by society including as one of its principle elements ... the achievement of the economic goals of efficiency and progress.[23]

5.10 Public detriment is also not defined in the Act but the Tribunal has given the concept a wide ambit, including:

> ...any impairment to the community generally, any harm or damage to the aims pursued by the society including as one of its principal elements the achievement of the goal of economic efficiency.[24]

Future with-and-without test

5.11 The ACCC applies the 'future with-and-without test' established by the Tribunal to identify and weigh the public benefit and public detriment generated by arrangements for which authorisation has been sought.[25]

5.12 Under this test, the ACCC compares the public benefit and anti-competitive detriment generated by arrangements in the future if the authorisation is granted with those generated if the authorisation is not granted. This requires the ACCC to predict how the relevant markets will react if authorisation is not granted. This prediction is referred to as the 'counterfactual'.

Length of authorisation

5.13 The ACCC can grant authorisation for a limited period of time.[26]

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22 Re Association of Consulting Engineers, Australia (1981) ATPR 40-2-2 at 42788. See also: *Media Council case* (1978) ATPR 40-058 at 17606; and *Application of Southern Cross Beverages Pty. Ltd., Cadbury Schweppes Pty Ltd and Amatil Ltd for review* (1981) ATPR 40-200 at 42,763, 42766.

23 Re 7-Eleven Stores (1994) ATPR 41-357 at 42,677. See also Queensland Co-operative Milling Association Ltd (1976) ATPR 40-012 at 17,242.

24 Re 7-Eleven Stores (1994) ATPR 41-357 at 42,683.

25 Australian Performing Rights Association (1999) ATPR 41-701 at 42,936. See also for example: Australian Association of Pathology Practices Incorporated (2004) ATPR 41-985 at 48,556; Re Media Council of Australia (No.2) (1987) ATPR 40-774 at 48,419.

26 Section 91(1).

Conditions

5.14 The Act also allows the ACCC to grant authorisation subject to conditions.[27]

Future and other parties

5.15 Application to make or give effect to contracts, arrangements or understandings that might substantially lessen competition or constitute exclusionary provisions may be expressed to extend to:

- persons who become party to the contract, arrangement or understanding at some time in the future[28]
- persons named in the authorisation as being a party or a proposed party to the contract, arrangement or understanding.[29]

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[27] Section 91(3).
[28] Section 88(10).
[29] Section 88(6).

6. ACCC evaluation

6.1 The ACCC's evaluation of the agreement to make and give effect to the back to back pricing and back to back purchasing policies is in accordance with the net public benefit test outlined in Chapter 5 of this determination. As required by the test, it is necessary for the ACCC to assess the likely public benefits and detriments flowing from the inclusion of the back to back pricing and back to back purchasing policies in certain agreements between ACF, DFMC and farmers.

The market

6.2 The first step in assessing the effect of the conduct for which authorisation is sought is to consider the relevant market(s) affected by that conduct.

6.3 Defining the markets affected by arrangements proposed for authorisation assists in assessing the public detriment from any lessening of competition from the arrangements. However, depending on the circumstances, the ACCC may not need to comprehensively define the relevant markets, as it may be apparent that a net public benefit will or will not arise regardless of this definition.

6.4 The applicants submit that the relevant markets for this application for authorisation are the regional markets for the acquisition of raw milk in far north Queensland; Eastern Australia (south east Queensland, New South Wales and some parts of Victoria); and Southern Australia (Victoria and South Australia).

6.5 The applicants also submit that downstream markets may be affected by competition in the regional markets for the acquisition of raw milk. The applicants submit these are the:

- New South Wales, Queensland, South Australia and Victorian markets for the manufacture and wholesale supply of fresh milk
- New South Wales, Queensland, South Australia and Victorian markets for the manufacture and wholesale supply of flavoured milk
- national market for the manufacture and wholesale supply of cheese
- national market for the manufacture and wholesale supply of cream and
- national market for the manufacture and wholesale supply of dairy foods, yoghurts and dairy desserts.

6.6 The ACCC accepts that there are regional markets for the acquisition of raw milk. In this regard the ACCC notes that DFMC members are located in the following regions (see also Table 2.1):

- Far Northern (North Queensland)
- Northern (South East Queensland and Northern NSW)
- Central (NSW excluding Northern NSW and Riverina)
- Riverina/Northern Victoria (and Gippsland)

- Western Victoria/South Australia.

6.7 The ACCC notes that each DFMC member within a specified region is paid the same amount for the supply of raw milk, subject to quality bonuses and penalties.

6.8 For the purpose of assessing this application for authorisation the ACCC considers that the relevant areas of competition are the regional markets for the acquisition of raw milk according to the regions identified in paragraph 6.6.

6.9 The ACCC also considers that there may be some competition effects in downstream markets such as those submitted by the applicants and outlined at paragraph 6.5.

Dairy industry participants

6.10 The applicants submit that ACF has major competitors for the acquisition of raw milk in every regional market except the Far Northern region.

Fonterra

6.11 Fonterra is a co-operative owned by approximately 11 000 New Zealand dairy farmers. In Australia, Fonterra operates through several subsidiaries including Fonterra Brands (Australia) Pty Ltd and Fonterra Australia Pty Ltd.

6.12 Fonterra is involved in the manufacture and distribution in Australia of butter, cheese, cream, ice cream, milk, yoghurt and dairy desserts.

6.13 Fonterra's brand names include Bega, Anlene, Brownes, Mainland, Perfect Italiano, Connoisseur and Western Star.

Parmalat

6.14 Parmalat is a wholly owned subsidiary of the Italian based global dairy company Parmalat SpA. The company entered the Australian dairy industry as a result of an on-market takeover of Pauls Limited in 1998. Parmalat supplies dairy products in Queensland, New South Wales, the Northern Territory, South Australia and Victoria.

6.15 Parmalat produces:

- a range of dairy products including yoghurt, custards and creams under brands such as Vaalia Yoghurt, Paul's Custard and Parmalat children's products
- a range of full cream, skim and organic white milks under brands such as Rev, Slim Milk and PhysiCAL, and soy milk under the brand Soy Life and
- a range of other beverages including flavoured milk and iced coffee under brands such as Rush, Breaka Flavoured Milk and Ice Break.

Murray Goulburn

6.16 Murray Goulburn was formed in 1950 and supplies products in all supermarket chains within Australia.

6.17 Murray Goulburn provides products under the brand Devondale and is involved in the manufacture and distribution of butter, milk (UHT and reduced fat UHT) and cheese (tasty, mild and reduced fat) to domestic and export markets.

Warrnambool Cheese & Butter

6.18 Warrnambool was established in 1888 and listed on the Australian Securities Exchange in May 2004. The company focuses on producing bulk dairy products for corporate customers.

6.19 Its brands include Sungold and Great Ocean Road, and it produces cheese, milk powders, whey protein concentrate, fresh milk, butter and cream which are largely sold to export markets.

Norco

6.20 Norco is a diversified agricultural co-operative based in northern New South Wales. NORCO Foods, a division of Norco, produces dairy goods including fresh milk, flavoured milk, creams, custards, cheese and ice cream.

The counterfactual

6.21 As noted in Chapter 5 of this determination, in order to identify and measure the public benefit and public detriment generated by conduct, the ACCC applies the 'future with-and-without test'.

6.22 The applicants submit that the counterfactual (the future without authorisation) involves a future in which the current MSA will continue to be in place between ACF and DFMC until 2017 however ACF and DFMC will not be able to enforce the back to back pricing and the back to back milk purchasing policies in the current MSA.

6.23 The applicants submit that in the counterfactual, under the current MSA:

- DFMC is obliged to supply all of the milk it acquires from its farmer members. This includes milk acquired by DFMC from farmer members who have not entered into a supply contract. The applicants note that farmer members are only obliged to supply a minimum amount of milk in order to maintain their membership of DFMC
- ACF is obliged to acquire all the milk DFMC has acquired from its members and
- ACF is free to acquire milk directly from DFMC's members or any other person.

6.24 The applicants submit that in the counterfactual DFMC will be required to unilaterally determine the price at which it will acquire milk from its farmers. While the current MSA requires that ACF continues to pay DFMC a commercial market price for milk, ACF will not be obliged to pay DFMC the amount that DFMC decides to pay to farmers as the contracted base price and volume incentive.

6.25 The applicants also submit that the counterfactual will:

- expose DFMC to significant commercial risk as the prices it has agreed and will agree to pay its farmer members for milk may exceed the price it is able to negotiate with ACF for such milk while it is nonetheless obliged to sell all of such milk to ACF and

- create uncertainty as to the enforceability of the existing supply contracts with farmer members.

6.26 The ACCC considers that given the applicants have sought authorisation for conduct that would otherwise breach the Act – arrangements that may substantially lessen competition including price fixing agreements – the ACCC considers the applicants would be unlikely to give effect to the pricing and purchasing policies in the absence of authorisation.

6.27 Ultimately, the ACCC accepts the future without the authorisation would be a situation as submitted by the applicants whereby DFMC will set a price for the acquisition of milk from its farmer members independently from the price it negotiates with ACF for the on-sale of milk. The ACCC notes that the completion of the sale of ACF to National Foods is dependant on a number of conditions, including a shareholder vote. The sale may be affected if any one of the conditions not be satisfied.

6.28 The ACCC considers that an alternate counterfactual may be that dairy farmers may choose to collectively bargain with ACF under the terms of authorisation A90966 granted to the Australian Dairy Farmers Limited in April 2006. However, conditions of this authorisation require that collective bargaining groups can only be formed by dairy farmers who have a 'shared community interest'. This is where farmers in the group each have a reasonable expectation of supplying the same plant of a dairy processor and are within the economic delivery zone of that plant. To be part of the same bargaining group farmers must demonstrate that they have similar supply patterns or supply a specialty raw milk product.

Public detriment

6.29 There are two broad outcomes following the sale of ACF and the removal of the restraint clause in the current MSA (on ACF from purchasing raw milk directly from DFMC farmers or from parties other than DFMC), namely:

- ACF will be free to purchase milk directly from farmer members of DFMC and others. ACF and DFMC can therefore be regarded as potential competitors in the purchase of raw milk from farmer members of DFMC and

- DFMC and each of its farmer members can be regarded as potential competitors for the supply of raw milk to ACF.

6.30 The applicants have sought authorisation to include the back to back pricing and back to back milk purchasing policies (including price structure) as outlined in clauses 4.4, 4.6.2 and 5.6 of the amended MSA. Essentially, this requires both DFMC and ACF to adopt the same milk price in relation to the purchase of raw milk by DFMC from its farmer members, which is on-sold to ACF. The applicants have sought authorisation to agree to, and implement, this price at both stages.

6.31 The ACCC's assessment of the public detriments likely to result from the arrangements follows.

Price effect

Submissions

6.32 The applicants submit that the existence of the back to back pricing is merely the mechanism for applying prices which have been achieved through commercial negotiations. The applicants submit that the prices paid by DFMC to its farmer members have historically been in line with prevailing market prices.

6.33 The applicants note that clause 5.1.1 of the amended MSA specifically obliges ACF to pay a commercial price for milk. However, in respect of the period after 30 June 2010 and for milk which exceeds the Anticipated Full Demand level for a region, ACF is only obliged to pay DFMC 'a commercially reasonable price having regard to the best end use (subject to logistical and administrative costs) to which that milk is likely to be put'.[30]

6.34 The applicants submit that when determining the commercial price of milk, the parties have regard to the following factors to ensure that the price of milk reflects market prices:

- quality
- quantity
- geographic variations
- transportation and
- handling costs.

6.35 The applicants submit that world market prices and the price which New Zealand commodity products can be imported into Australia constrain the prices which Australian dairy farmers and processors can achieve.

6.36 The applicants submit that prices differ by reason of the differing value of milk to ACF in each of the regional milk pools. The value of milk as reflected in the prices ACF is willing to pay are determined by the product mix for each individual ACF processing facility and ACF's strategic imperatives. For example, the applicants submit that in 2007 ACF asked DFMC to supply greater volumes of milk from the Southern Victorian region and indicated it was prepared to pay in excess of prevailing market prices for such milk. ACF had assessed a need for further milk to meet its business plans and it was concerned about a decline in milk supply in various areas due to the drought. DFMC subsequently entered into supply contracts with approximately 100 dairy farmers from the region.

6.37 The applicants also submit that individual farmers are weak sellers and have limited capacity to influence prices received for their milk especially given the fixed nature of production systems. The applicants submit that dairy farmers have limited capacity to vary milk supply in response to short term changes in price.

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[30] Addisons, *Authorisation Application lodged by Dairy Farmers Milk Co-operative Limited (DFMC) and Australian Cooperative Foods Limited (ACF) dated 22 May 2008 (Authorisation Application): Attachment A – Summary of amendments made to the MSA and Revised Farmer Supply Contracts*, 2 September 2008, p. 7.

6.38 The Fleurieu dairy farmers collective bargaining group (Fleurieu) notes that DFMC and ACF have, over the years, paid the commercial price for milk that applies in the region. However, Fleurieu submits that DFMC has little or no bargaining power because they can only negotiate to sell milk purchased from members to ACF and can not negotiate with other processors to get a better deal.

ACCC's view

6.39 As noted, following the sale of ACF, National Foods and DFMC may be regarded as potential competitors for the acquisition of raw milk from DFMC members, and as a result of the non-exclusive nature of the amended MSA, ACF has the opportunity to acquire milk from any other third party which means that DFMC members may be potential competitors with DFMC for the supply of raw milk to ACF. As such the proposal to continue to give effect to the back to back pricing policy may amount to a price agreement between competitors.

6.40 Agreements between competitors which influence the pricing decisions of market participants have the potential to result in allocative inefficiencies. That is, they can move prices away from levels that would be set in a competitive market. Public detriment may arise from such a price agreement if the price negotiated between ACF and DFMC was artificially higher or lower than would otherwise be in the absence of the price agreement.

6.41 Under the terms of the amended MSA, the price for the supply of raw milk by DFMC to ACF, including the price which DFMC pays to its farmer members, is commercially negotiated. In determining the price regard is had to such factors as quality, quantity, geographic variations, and transportation and handling costs.

6.42 Confidential pricing information provided by the applicants and supported by the submission by Fleurieu suggests that this price has been consistent with prevailing market prices.

6.43 The ACCC does not consider that authorisation of the arrangements would remove the commercial incentives that currently apply in price negotiations between the parties. In particular the ACCC notes that there are a number of features which are likely to limit the ability of the parties to set the price for raw milk too high or too low relative to the counterfactual of no authorisation, namely:

- the prices which DFMC can achieve are constrained by world market prices
- prices are set according to regional variations and authorisation is not likely to result in an industry wide price for milk
- the amended MSA provides for a commercial price for milk between the parties
- membership of DFMC is voluntary and, following the expiry of any supply contracts, farmer members can supply ACF and other processors directly. Supply contracts are generally for two or three years.
- ACF is able to acquire from other suppliers and
- the countervailing power on the part of the major supermarket chains.

World market prices

6.44 As Australia exports around 50% of its annual milk production (after processing), international prices for manufactured dairy products influence the domestic price for raw milk. With the growing importance of the exporting of dairy products such as cheese, milk powders and butters, processors have an incentive to purchase greater amounts of raw milk from farmers. In times of high demand, processors (who export) tend to negotiate up the price of raw milk to ensure they have the necessary supply to service export markets, subsequently increasing the price of raw milk. The price effect is regardless of the intended use of the raw milk but is strongest in the southeast of Australia. Prices in other regions are influenced primarily by local supply and demand conditions. Although the ACCC notes that even in Queensland, Victorian farm gate prices plus freight costs tend to set a maximum price above which it would not be economical to source raw milk locally.

6.45 Further, domestic prices for manufactured products, for example cheese from New Zealand, are influenced by imports. There are no barriers to trade with New Zealand and the applicants submit that cheese imported from New Zealand constitutes about 15% of the national market.

6.46 As such the ACCC understands that world prices operate as a significant influence in the pricing of raw milk in Australia. ACF and DFMC will continue to negotiate prices for the acquisition of raw milk in this context with or without authorisation.

Regional price variations

6.47 The ACCC notes the claim by the applicants that the value of milk to dairy processing companies varies according to different regions and the best use it can make from the milk it collects. These regional variations will continue to apply and the ACCC does not consider that authorisation will result in a standard price being paid to all DFMC farmers across regions.

MSA requires a commercial price to be paid for raw milk

6.48 Under the amended MSA the price agreed between ACF and DFMC is set commercially according to relevant factors including the effective competitive price for milk paid to farmers in a region by other similar processors in that region and the cost of transporting and handling the milk.

6.49 The amended MSA obliges ACF to pay DFMC a commercial price for milk, being the market value or price. In respect of the period after 30 June 2010 and for milk which exceeds the Anticipated Full Demand level for a region, ACF is obliged to pay DFMC 'a commercially reasonable price having regard to the best end use (subject to logistical and administrative costs) to which that milk is likely to be put'. ACF will consider the next best use for the milk and pay a price according to that use, taking into account any additional costs.

6.50 The ACCC notes there are parameters in the amended MSA to ensure that for a period after the sale, farmers will not receive less than the fixed and minimum farm gate milk prices as agreed between ACF and DFMC. This ensures that contracts and planning decisions made by farmers before the sale of ACF can still apply.

6.51 If ACF and DFMC are unable to agree on a commercial price the amended MSA provides that the issue may be resolved by mediation and then expert determination. Access to a dispute resolution process may help to ensure that prices for raw milk as agreed between the parties reflect the market price for milk in each region.

Membership of DFMC is voluntary and, subject to any supply contracts, DFMC members can negotiate with other processors including ACF directly

6.52 The applicants advise that DFMC membership is voluntary and members regularly leave and join. DFMC members are free to choose whether to enter into a supply contract, or supply DFMC without a contract, however membership to DFMC relies on members supplying a certain minimum amount of milk to DFMC.

6.53 Farmers who do not enter into contracts, or whose contracts expire, remain free to seek to negotiate directly with ACF for the acquisition of their milk (in competition with DFMC) or other processors.

6.54 The ACCC notes, however, that the majority of farmer members do enter into a supply contract in order obtain the benefits of higher milk prices and certainty of supply. Farmers on a contract with DFMC are not able to supply alternate processors.

6.55 The ACCC also notes that ACF and DFMC must use reasonable endeavours to secure the entry by DFMC farmer members into Revised Farmer Supply Contracts prior to the completion of the sale. The ACCC understands ACF and DFMC are obliged to enter into Revised Farmer Supply Contracts for a specified volume of raw milk which is equivalent to a certain proportion of the milk supply by ACF to DFMC during the 2007-08 financial year.

6.56 Further, under the amended MSA, DFMC agrees to use its reasonable endeavours to supply ACF with a 'Minimum Volume' for each region during each quarter of the term of the agreement. Initially, the Minimum Volume is a proportion of the total volumes supplied by DFMC to ACF previously during the 2007-08 financial years, and commencing in 2010-11 will be determined in accordance with the provision of the amended MSA

6.57 The ACCC notes that the terms of supply contracts are for 1, 2 or 3 years, and at any one time a material proportion of farmer members' contracts are due to expire (see paragraphs 2.35 – 2.49 for the types of supply contracts DFMC has with its farmers and paragraphs 6.78 – 6.83 for further discussion). The applicants submit that this will ensure that the price for raw milk will not become artificially low following the sale of ACF.

ACF is able to acquire raw milk from other suppliers

6.58 The ACCC considers that the non-exclusive nature of the amended MSA further increases the likelihood that the prices negotiated between the parties will reflect market prices. The ACCC notes that while the amended MSA places an obligation on ACF to purchase all qualifying milk supplied by DFMC members (clause 3.3(a)), it will be free to acquire additional milk directly from persons other than DFMC, including DFMC's members who are not subject to a supply contract.

6.59 Clause 3.3 in the amended MSA requires ACF to acquire 'all of the qualifying farmer member's milk' purchased by DFMC from its members. The definition of qualifying farmer member's milk is contained in clause 1.1 of the MSA as:

- milk which is produced by a member of DFMC at a farm from which ACF collected milk at any time in the 8 weeks prior to the completion date of the amended MSA or
- milk which is deemed to be qualifying farmer member's milk pursuant to clause 3.7(b) of the MSA.[31]

6.60 Clause 3.7 deals with new farmer members. ACF is not obliged to purchase milk from DFMC if the milk was produced at a farm from which ACF did not collect milk at any time in the 8 weeks prior to the completion date of the amended MSA. ACF can also refuse to acquire milk from new farmer members provided that the milk to be supplied is excess to ACF's Anticipated Full Demand.[32] If ACF decides not to acquire the new farmers milk DFMC is free to sell that milk to another processor (clause 3.7(c)).

6.61 The ACCC considers that if ACF can acquire raw milk more cheaply from sources other than from DFMC, this will influence the price ACF will negotiate with DFMC which will help to ensure the price for raw milk will not become artificially high following the completion of the sale of ACF.

Countervailing power of grocery retailers

6.62 The applicants submit that the countervailing power of the major supermarket chains imposes a significant constraint on retail pricing of dairy products.

6.63 The ACCC has previously considered the countervailing power of the major supermarket chains in the context of assessing applications for authorisation of collective bargaining arrangements by dairy farmers. In particular, the ACCC considered that even where dairy farmers are able to negotiate increases in prices paid to them as a result of bargaining collectively, the competitive nature of the downstream market and the size and relative bargaining power of the major supermarket chains would mean that such increases are unlikely to be significant and the extent to which such increases are passed on to consumers is likely to be limited.

6.64 This has recently been confirmed by the ACCC in its report into the competitiveness of retail prices for standard groceries. The ACCC found that the bargaining power of the major supermarket chains in negotiating terms of supply for private label products is being reflected in retail prices. The ACCC noted that raw milk and processor costs of production have increased significantly and are subsequently reflected in wholesale prices for branded milk. However, processors contractual obligations and the bargaining power of supermarkets, has meant these increases in production costs are

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[31] Addisons, *Authorisation Application lodged by Dairy Farmers Milk Co-operative Limited (DFMC) and Australian Cooperative Foods Limited (ACF),* 14 July 2008, p. 2.

[32] Addisons, *Authorisation Application lodged by Dairy Farmers Milk Co-operative Limited (DFMC) and Australian Cooperative Foods limited (ACF) dated 22 May 2008 (Authorisation Application): Attachment A – Summary of amendments made to the MSA and Revised Farmer Supply Contracts,* 2 September 2008, p. 7.

not being fully reflected to the same extent in wholesale or retail prices for private label milk.[33]

ACCC conclusion on pricing arrangements

6.65 The ACCC notes the applicants' submission that negotiations are carried out in a competitive environment and that to date the prices negotiated between ACF and DFMC have reflected the market price for milk. The ACCC notes that commercial negotiations take into account world prices, global demand, and regional and seasonal factors. The ACCC does not have any evidence before it which suggests that this will not continue following the sale of ACF.

6.66 The ACCC considers it unlikely that the pricing arrangements would result in any inflation or deflation of the price of raw milk. In particular the ACCC notes the requirement in the amended MSA for ACF to pay a commercial price for milk, being the market price or value (by virtue of clause 5.1.1) and this is supported by a dispute resolution procedure if the parties fail to reach agreement.

6.67 The ACCC also considers that the fact that prices are negotiated and set for DFMC members across particular regions as opposed to all DFMC members reduces any anti-competitive effect the arrangements may have and more accurately reflects the commercial prices for milk from each region.

6.68 The ACCC notes that upon the expiry of any supply contracts, there is an opportunity for individual farmers to negotiate directly with ACF, or to negotiate with other processors in order to receive the best commercial price for their milk. While many farmers will be subject to a supply contract and be required to supply all their milk to DFMC, upon expiry of their contract farmers are able to choose whether to enter or renew a supply contract, or to negotiate directly with an alternate processor.

6.69 The ACCC considers that while the current market has strong demand for milk the bargaining positions of farmers is stronger and the incentive for processors (including ACF) to pay a commercial price for milk is increased. This exists with or without the authorisation.

Supply effect

Submissions

6.70 The applicants submit that the non-exclusive nature of the amended MSA reduces any anti-competitive detriment the authorisation may have because ACF will be free to acquire milk from sources other than DFMC. Further, subject to the terms of membership of DFMC and any supply contracts they may be party to, farmer members of DFMC will be free to supply ACF directly, or supply other processors.

6.71 Fleurieu submits that the supply contracts between farmers and DFMC act as a barrier to the movement of supply of raw milk from DFMC to another processor. Fleurieu

[33] Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries, July 2008, p. 296.

submits that farmers feel pressured to sign supply contracts with DFMC in order to receive financial benefits, even though the prices announced by DFMC at the beginning of the year are indicative only, and may be varied during the term of the contract.

6.72 Fleurieu is concerned that the requirement to provide 180 days notice in order to terminate a supply contract is unreasonably long. Fleurieu claims that even at the end of the term of the contract, the farmer is still required to give 180 days notice to terminate.

6.73 The Revised Farmer Supply Contracts may be terminated in the following circumstances:

- farmers will only be required to provide 90 days' notice in order to bring their supply contract to an end at the completion of the contract period and
- farmers may terminate the Revised Farmer Supply Contracts during the contract period provided that they provide DFMC with 90 days' written notice and obtain DFMC's prior written consent. DFMC can only withhold its consent if termination of the supply contract will be reasonably likely to result in the estimated milk supply to DFMC under Revised Farmer Supply Contracts in the relevant region for 3 quarters following the termination, to fall below the minimum regional contract level for those 3 quarters in that region. The minimum regional contract level is defined to be a volume which is 10% above the Minimum Volume DFMC is required to supply to ACF for that region under the amended MSA.

6.74 Further, the applicants advise that under the current supply contracts, farmers can terminate their contract during the contract period on 14 days' notice, with DFMC's consent, if they decide to permanently leave the dairy industry. In addition, farmers can terminate their contract on 30 days' notice if they sell their farm. Under the Revised Farmer Supply Contracts, farmers can still terminate their supply contract during the contract period on 90 days' notice, if they decide to sell their farm or cease operating a dairy business. However, before doing so, they must ensure that the farm or the farmers' dairy herd is sold to a person who agrees to continue to supply the Minimum Volume specified in the revised farmer supply contract to DFMC during the term of the contract period.

ACCC's views

6.75 The ACCC notes that public detriment may arise if the effect of the arrangements was to lock up a significant section of the farmer base thereby raising barriers to entry or expansion for other processors.

6.76 The ACCC notes that in general, access to a reliable supply of raw milk is essential for processors to be able to meet current demand and plan for future growth. This is particularly so in times where demand exceeds supply as in the current environment. If all dairy farmers in a region are tied to long term contracts with a particular processor barriers to entry and expansion for new milk processors seeking to enter that market are high.

6.77 Security of milk off-take is also important to farmers which means that committing to a supply contract may be attractive to many farmers. Under the DFMC arrangements farmers may choose to enter into supply contracts with DFMC in order to supply ACF with raw milk (see paragraphs 2.35 to 2.49). Farmer members have a choice of two contracts to enter into, each with varying financial incentives, or may choose to supply milk without a supply contract.

6.78 The ACCC notes that over 95% of DFMC farmer members are currently contracted to supply milk to DFMC with terms of either 12 months, 2 years or 3 years depending on the type of contract. The applicants advise that farmers value the certainty provided by guaranteed minium prices for the duration of fixed term contracts and of the farmers that enter the Defined Volume Fixed Term Contract, 35% elect to enter into a 3 year contract. The ACCC notes that by virtue of the Tripartite Deed between ACF, National Foods and DFMC, DFMC must use all reasonable endeavours to secure a proportion of milk supply in each region by entering into Revised Farmer Supply Contracts with farmer members.

6.79 Should DFMC members wish to cease to supply DFMC in order to deal directly with another processor or with ACF directly they would need to give notice terminating the contract. The ACCC notes that termination of the Revised Farmer Supply Contract requires 90 days notice prior to the end of the contract period, existing Defined Volume Fixed Term Contracts requires 180 days notice, and the Volume Incentive Contracts require 120 days notice.

6.80 Fleurieu submits that this length of time is excessive and acts as a barrier to farmers who wish to change processors, particularly as farmers must give the appropriate notice at the end of the current contract term.

6.81 In response the applicants have clarified that farmers on an existing two or three year Defined Fixed Term Contract may give notice to terminate the contract at any time, including before the end of the contract period. Although the contract does not expire until the end of the contract term. For farmers on a 12 month Supply Agreement 120 days notice period applies unless the farmer wishes to terminate the contract after the 12 month contract period has expired. In this case the farmer only has to give 28 days notice and does not need to wait until expiry of the contract term before giving notice.

6.82 The ACCC also notes that at any one time there are a number of supply contracts being renewed or negotiated. For example the applicants advise that of the 736 existing Defined Value contracts, 14% are due to expire by the end of 2008.

6.83 Further, farmers are not required to enter into a contract with DFMC to supply milk to DFMC and DFMC members appear to join and leave regularly.

6.84 It is also relevant to note that the issue of whether there would be a substantial lessening of competition in the acquisition of raw milk was considered by the ACCC as part of its informal clearance process.

6.85 The ACCC considered that the divestitures required as part of the undertaking offered by National Foods will create a viable fresh milk processor in competition with ACF in New South Wales and South Australia where the ACCC identified competition concerns. It was considered that the presence of an alternative fresh milk processor or processors who would act as a significant acquirer of raw milk in central New South Wales and South Australia will act as a constraint on ACF pricing decisions. As part of the undertakings, National Foods will supply the purchaser with a specified amount of raw milk over the 12 months following the divestiture date.

6.86 Overall, while the locking in of raw milk supplies through long term supply contracts may create barriers for processors who wish to enter or expand into particular regions the ACCC is satisfied that the arrangements do not increase any barriers that otherwise exist with or without the authorisation.

6.87 In general the ACCC notes that the capacity for dairy farmers to switch between processors does exist, even though the incidence of switching actually occurring may not be high.

ACCC conclusion on supply arrangements

6.88 The ACCC considers there will be limited anti-competitive detriment generated by the supply arrangements resulting from authorisation. In particular the ACCC notes that:

- the term of supply contracts are for a maximum of 3 years and are entered into at the discretion of the farmer. Further, there is no penalty for giving notice to terminate a supply contract once the minimum contract term has been carried out and the relevant notice to terminate a contract can be given prior to the expiry of the contract

- where a farmer is not subject to a supply contract or a farmer's supply contract has expired, that farmer is able to supply other processors or seek to supply ACF directly should they wish and

- while ACF is obliged to acquire all of DFMC's qualifying milk, ACF will be able to acquire additional milk directly from persons other than DFMC including DFMC's members.

ACCC conclusion on public detriments

6.89 The ACCC considers authorisation of the back to back pricing and back to back milk purchasing policies will not enable the parties to set prices at a level that is too high or too low relative to the market price. Prices will continue to be negotiated in an environment where world prices have a significant impact on domestic prices for raw milk.

6.90 Further the non-exclusive nature of the amended MSA enables ACF to acquire milk from parties in addition to DFMC. Similarly, following the expiry of any contractual obligations, DFMC members can negotiate to supply raw milk to other processors or to ACF directly.

6.91 The ACCC considers that any barriers for processors who wish to enter or expand into particular regions are not increased by the proposed arrangements for which authorisation are sought.

Public benefit

6.92 The applicants submit the proposed conduct will deliver significant public benefits through, broadly:

- providing certainty for existing and future supply contracts thereby providing security of milk supply

- encouraging farmers to remain in or enter the industry and
- facilitating the growth of exports by ACF.

6.93 The ACCC's assessment of the public benefits likely to result from the conduct follows.

Certainty of supply through continuation of existing milk supply arrangements or entering Revised Farmer Supply Contracts

Submissions

6.94 The applicants submit that authorisation will ensure that the terms of existing supply contracts and Revised Farmer Supply Contracts will be enforceable, therefore providing certainty to farmers and DFMC who are party to the contracts. Authorisation will ensure the ongoing ability for farmers to plan for matters affecting future production and growth.

6.95 With respect to Revised Farmer Supply Contracts, authorisation is sought for the offering of, and inclusion of, prices prior to the completion of the sale of ACF, and post sale the payment of such prices to farmers.

6.96 The applicants submit that authorisation of the pricing and purchasing policies to be included in such contracts ensures that DFMC, ACF and farmers can continue to rely on and enforce the prices already agreed upon and inserted into the supply contracts for the duration of those existing contracts, and for the period of authorisation for future supply contracts, following the completion of the sale of ACF.

6.97 The effect is that farmers will be able to continue to plan their production including growing their herds to meet current high demand, especially given the demand for exports. The applicants submit that this is particularly important during a period of extended drought and high feed, fertilizer, fuel and other input costs, to provide the necessary basis for farmers to invest in growing their milk production capacity.

6.98 Further, the applicants submit that ACF and consumers will benefit as ACF will have security of milk supply across regions which means it will be able to competitively tender for the supply of milk products to major grocery retailers and potentially grow the export market.

6.99 National Foods supports authorisation claiming it will allow for the continuation of existing milk supply arrangements which will provide greater certainty and reduced commercial disruption for all relevant parties.

ACCC's views

6.100 The ACCC accepts that the inclusion of the pricing and purchasing policies in the amended MSA and Revised Farmer Supply Contracts will provide certainty for existing supply contracts arrangements. This is particularly beneficial for farmer members of DFMC, where in light of the sale of ACF, it will help ensure there will not be a disruption in the supply of their milk for the agreed price. National Foods has committed to specific prices for raw milk not less than those already offered by ACF to DFMC.[34]

6.101 The ACCC also accepts that continuation of the purchasing and pricing policies as set out in the amended MSA will provide National Foods with some certainty and enable them to plan and meet the demands for supply of fresh milk and other dairy products at least in the short to medium term.

6.102 Whether the arrangements allow for longer term certainty largely depend on future price and contract negotiations as existing contracts expire and market conditions change. It is difficult therefore to determine to what extent the arrangements for which authorisation is sought will assist National Foods in tendering to major supermarket chains or increasing the value of exports as claimed.

6.103 Further, the ACCC notes that while farmers on supply contracts are obliged to supply all their milk to DFMC, following the expiration of these contracts they will have the option to negotiate with processors or ACF directly. The non-exclusive nature of the amended MSA means that ACF is no longer restricted from only acquiring raw milk from DFMC and may acquire additional milk from other suppliers, subject to ACF meeting its obligation under the amended MSA to acquire all qualifying farmers' milk. As a result some degree of change in the way raw milk is supplied in the future by DFMC members is possible and may be beneficial to both farmers and ACF.

6.104 The ACCC accepts there is some public benefit in the short to medium term from ensuring certainty of milk off-take and providing the opportunity for farmers and the future buyer of ACF to plan for future production.

Transaction cost savings and input into contracts

Submissions

6.105 The applicants submit that the arrangements significantly reduce transaction costs to farmers who do not have to have price negotiations with DFMC or ACF. As a result of the back to back pricing, negotiations will only take place between DFMC and ACF. The applicants submit, however, that farmers have input into the terms of the contracts through their membership of DFMC.

6.106 The applicants note that prior to entering negotiations with ACF, DFMC engages consultants to advise on world market prices, trends and other factors influencing export prices for Australian manufactured product, Australian and regional factors which may influence market price, and publicly available information regarding competitor pricing and other activities. DFMC also gathers information from its farmer members which may be relevant to the market price.

6.107 The applicants submit that this avoids information asymmetries arising from the disparity in bargaining positions and resources of the parties. The applicants submit that this will be particularly important for small to mid sized and individual farmers who do

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[34] Addisons, *Authorisation Application lodged by Dairy Farmers Milk Co-operative Limited (DFMC) and Australian Cooperative Foods Limited (ACF) dated 22 may 2008 (Authorisation Application): Attachment A – Summary of amendments made to the MSA and Revised Farmer Supply Contracts*, 2 September 2008, p. 7.

not have the time or expertise to gather such information or it would be expensive to for them to do so individually.

6.108 The applicants also submit that dairy farmers will continue to have direct access to ACF through the provision of field advisory services which ACF is obliged to provide under the amended MSA (clause 8). These services are directed at ensuring that farmers are both efficient and competitive by assisting them to produce high quality milk and high volumes. Through the provision of these services farmers are directly made aware of ACF's strategic issues and imperatives and can work towards them.

ACCC's views

6.109 The ACCC accepts there may be cost savings and efficiency gains experienced by individual farmers from the continuation of the pricing and purchasing policies by relying on DFMC to gather information and negotiate on their behalf with ACF for the commercial price of milk. The ACCC notes that DFMC performs a series of roles on behalf of its farmer members, by gathering information, consulting with experts on market prices, and negotiating with ACF for the supply of raw milk. In this way negotiations regarding pricing, production costs and other specific regional concerns can continue to be given appropriate weight and communicated to ACF when the price for raw milk is determined.

6.110 To the extent that DFMC members continue to supply DFMC with milk, ACF will also experience cost savings by negotiating with one party as opposed to numerous individual farmers. That being said, the ACCC notes there can also be benefits resulting from the flow and exchange of information where individual negotiations do take place.

ACCC conclusion on public benefits

6.111 The ACCC accepts that the continuation of the back to back pricing and back to back milk purchasing policies are likely to result in the following public benefits:

- certainty of supply in the short to medium term through the continuation of existing supply arrangements and
- transaction cost savings and efficiency gains for farmers and ACF.

Balance of public benefit and detriment

6.112 The ACCC may only grant authorisation if it is satisfied that, in all the circumstances, that the back to back pricing and back to back milk purchasing policies, are likely to result in a public benefit that will outweigh any public detriment.

6.113 In the context of applying the net public benefit test at section 90(8)[35] of the Act, the Tribunal commented that:

> … something more than a negligible benefit is required before the power to grant authorisation can be exercised.[36]

[35] The test at 90(8) of the Act is in essence that conduct is likely to result in such a benefit to the public that it should be allowed to take place.

6.114 The ACCC considers it unlikely that the pricing arrangements would result in any inflation or deflation of the price of raw milk. The ACCC considers that supply negotiations, including for price, are carried out in an environment that necessarily reflects world prices, global demand and regional and seasonal factors. The ACCC does not have any evidence before it which suggests that this will not continue following the sale of ACF.

6.115 Further, the non-exclusive nature of the amended MSA enables ACF to acquire milk from parties in addition to DFMC subject to the requirement that ACF acquire all qualifying farmer's milk.

6.116 Similarly, at the expiry of any supply contracts, DFMC members are able to negotiate to supply raw milk to other processors or to ACF directly. The ACCC notes, however, that farmers subject to a supply contract are required to supply all their milk to DFMC who in turn supplies all the milk it acquires to ACF. The ACCC considers this may result in some anti-competitive detriment by locking in supply of raw milk, however notes that supply contracts are for relatively short periods of time and farmer members may terminate their contracts subject to certain conditions.

6.117 The ACCC considers that any barriers for processors who wish to enter or expand into particular regions are not increased by the arrangements.

6.118 The ACCC considers public benefits, particularly in the short to medium term, are likely to result. In particular there is benefit from ensuring certainty of supply following the sale of ACF. There are also likely to be some transaction cost savings and benefits from ensuring effective input into contracts.

6.119 On balance, the ACCC considers the public benefits will outweigh the public detriment.

Length of authorisation

6.120 The ACCC generally considers it appropriate to grant authorisation for a limited period of time, so as to allow an authorisation to be reviewed in the light of any changed circumstances.

6.121 Authorisation is sought with respect to the making and giving effect to the agreement in respect of the prices to be offered to farmers, the offering of and inclusion of such prices, as well as the payment of such prices in Revised Farmer Supply Contracts, for a period of five years.

6.122 The applicants submit that authorisation for a period of five years would not bring about any substantial lessening of competition because the price negotiated by DFMC and ACF reflects the commercial price for raw milk.

6.123 As such, the ACCC grants authorisation to the back to back pricing and back to back purchasing policies as outlined in clause 4.4, 4.6.2 and 5.6 of the amended MSA to be

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[36] Re Application by Michael Jools, President of the NSW Taxi Drivers Association [2006] ACompT 5 at paragraph 22.

reflected in existing supply contracts, Revised Farmer Supply Contracts and future supply contracts for a period of five years.

7. Determination

The application

7.1 On 22 May 2008 Dairy Farmers Milk Co-operative Limited (DFMC) and Australian Co-operative Foods Limited (ACF) (together 'the applicants') lodged application for authorisation A91089 with the Australian Competition and Consumer Commission (the ACCC). On 29 August 2008, the applicants amended their application for authorisation to account for amendments arising from agreements being entered into for the sale of ACF to National Foods Limited.

7.2 Application A91089 was made under subsection 88(1) of the *Trade Practices Act 1974* (Cth) to make and give effect to a contract or arrangement, 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.

7.3 Broadly, the applicants have sought authorisation for the inclusion of the back to back milk purchasing policies and back to back pricing arrangements contained in clauses 4.4, 4.6.2 and 5.6 of the amended Milk Supply Agreement which will take effect as and from the Scheme Implementation Date (amended MSA). The back to back pricing and back to back purchasing policies are to apply to several agreements between ACF, DFMC and farmer members.

7.4 Authorisation is sought for the back to back pricing and back to back purchasing policies to apply to existing and future supply contracts, as well as Revised Farmer Supply Contracts. The applicants have requested that authorisation be granted for the inclusion and giving effect to the pricing and purchasing policies for a period of five years.

7.5 The key effect of these clauses is as follows:

- DFMC must adopt the same milk purchasing policy (including price structure) in relation to its acquisition of milk from its members, as ACF applies to its purchase of milk from DFMC (clause 4.4)
- DFMC must adopt the same milk price in relation to the purchase by DFMC from its farmer suppliers of milk, as DFMC received from ACF for the milk it sells to ACF (clause 5.6) and
- DFMC will sell to ACF milk it acquires from farmer members on the same terms and conditions relating to payment, pricing, collection and quality as contained in its farmer contracts (clause 4.6.2).

The net public benefit test

7.6 For the reasons outlined in Chapter 6 of this determination the ACCC considers that in all the circumstances the arrangements for which authorisation is sought are likely to result in a public benefit that would outweigh the detriment to the public constituted by any lessening of competition arising from the arrangements.

7.7 The ACCC therefore **grants** authorisation to application A91089 for a period of five years.

Conduct for which the ACCC grants authorisation

7.8 The ACCC grants authorisation for:

1. the inclusion in the amended MSA of amended clauses 4.4 and 5.6 which provide for the continuation of the agreement in respect of back to back milk purchasing policies and back to back pricing arrangements upon completion of the sale of ACF
2. the inclusion in the amended MSA of new clause 4.6.2 which provides, among other things, that DFMC will sell to ACF milk it acquires from farmer members on the same terms and conditions relating to payment, pricing, collection and quality as contained in its farmer contracts.
3. the implementation of the back to back pricing and back to back milk purchasing policies by DFMC in its dealings with farmers for the supply of milk to ACF, following completion of the sale of ACF to National Foods
4. the making and giving effect to the agreement in respect of the policies and prices which are to be the subject of back to back pricing in DFMC's Revised Farmer Supply Contracts following completion of the sale and
5. the making and giving effect to the agreement in respect of the prices ACF will pay farmers whose Revised Farmer Supply Contracts are assigned to ACF, or which contracts ACF obtains the benefit of, in accordance with the transaction agreements.

7.9 This determination is made on 22 October 2008.

Conduct not authorised

7.10 Authorisation was not sought for, and does not extend to, any other provisions of the amended MSA.

Interim authorisation

7.11 At the time of lodging the application, DFMC and ACF requested interim authorisation to continue to engage in the conduct while the authorisation application is considered by the ACCC should the ACCC not have made a final determination by the time any sale of ACF is completed. The ACCC considered the initial request for interim authorisation on 18 July 2008 and decided that the protection afforded by interim authorisation was not required until DFMC and ACF cease to be related bodies.

7.12 At the time of amending the application for authorisation, the applicants also requested interim authorisation for the offering of, and entering into, Revised Farmer Supply Contracts and any future supply contracts which include agreed prices. The applicants note that interim authorisation is not being sought to pay the prices set out in the Revised Farmer Supply Contracts, because such payment will not occur unless authorisation for implementation of back to back pricing is granted by the ACCC.

7.13 The ACCC considered the request for interim authorisation at the time of the draft determination and decided to grant interim authorisation to allow the applicants to offer, and enter into, Revised Farmer Supply Contracts which include agreed prices consistent with the back to back pricing policies.

7.14 Interim authorisation will remain in place until the date that this final determination comes into effect or until the ACCC decides to revoke interim authorisation.

Date authorisation comes into effect

7.15 This determination is made on 22 October 2008. If no application for review of the determination is made to the Australian Competition Tribunal, it will come into force on 13 November 2008.