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Our Ref: KXE:DA1695/22  
Your Ref: C2008/850

Dr R Chadwick  
General Manager  
Adjudication Branch  
Australian Competition and Consumer Commission  
GPO Box 3131  
Canberra ACT 2601

Dear Dr Chadwick

**Authorisation Application lodged by Dairy Farmers Milk Co-operative Limited (DFMC) and Australian Cooperative Foods Limited (ACF)**

This letter responds on behalf of DFMC and ACF to comments made in the submission by The Fleurieu Dairyfarmers Collective Bargaining Group (**Group**) dated 6 June 2008 (**Fleurieu Submission**).

Defined terms used in this letter have the same meaning as used in the submission accompanying the application for authorisation, unless otherwise stated.

**General comments**

DFMC and ACF make the following general comments regarding the Fleurieu Submission:

- of the 27 members of the Group, 4 members currently supply DFMC and 14 have previously supplied DFMC and now supply other processors. This demonstrates the ability of farmers to move between processors, which DFMC and ACF submit will remain unaffected by the conduct for which authorisation is sought;
- without commenting on the accuracy of the Fleurieu Submission regarding the circumstances surrounding the formation of the Group in 2005, DFMC agrees that "DFMC/ACF has over the years, paid the commercial price for milk that applies in the region" and further agrees that for "ACF to receive the required volume of milk [it] must pay a price to farmers that is competitive". Clause 5.1.1 of the Milk Supply Agreement between DFMC and ACF requires ACF to pay a commercial price for the milk it acquires from DFMC. That commercial price is affected by a number of factors including processor demand for milk in a particular region and the presence of alternate, competing processors with requirements for milk in the same region.
- the Group also states that their experience in 2005 was that "the regional price was being suppressed by the lack of vigorous competition". ACF and DFMC understand that only 2 of the Group's members chose to terminate their agreements with DFMC at that time. In any event, the fact that price increases were announced after Warrnambool Cheese and Butter Cheese Company (**WCB**) entered the region

illustrates the vigorous competition ACF and DFMC face in that region for the acquisition of raw milk. This is also borne out by the fact that in two of the past three years other processors have paid higher prices for raw milk in that region than has been paid by WCB, and members of the Group (and other raw milk suppliers) have switched processors as a result;

- the Commission considered submissions of the Group in 2005 in relation to the Commission's determination of the application for authorisation by Australian Dairy Farmers Limited.<sup>1</sup> The Group stated that it would be feasible for a new non-South Australian based processor to enter the region, and this is what in fact occurred at that time. The Commission accepted their arguments and considered that Fleurieu's experience indicated that the traditional regional boundaries of the market may now be much broader.<sup>2</sup>
- the Fleurieu Submission makes a number of inaccurate statements regarding DFMC's alleged "*conflict of interest*" and "*operational impotence*", which are irrelevant to the Commission's consideration of the application for authorisation. DFMC notes, however, that it is required to, and does, operate in accordance with co-operative principles. At all times, DFMC acts in the best interests of its farmer members which includes, as a priority, their interests in obtaining security of milk off-take from their farms at a competitive price. It conducts arms length negotiations with ACF in respect of the price for acquisition of raw milk. These negotiations involve consideration of factors including publicly available information regarding the commercial price of milk paid by other processors in the region, and the strategic value of milk to ACF at the time.

#### **The contractual arrangements between DFMC and its farmer members**

The terms of DFMC's supply contracts with farmer members are explained in detail in section 4.2 of the submission accompanying the application for authorisation. In response to the matters raised in the Fleurieu Submission, DFMC and ACF submit that such contracts do not "*act as a barrier to the movement of supply from DFMC to another processor*". Farmers are free to supply milk to DFMC for on-sale to ACF without the need to enter into any contract at all. However the overwhelming majority (over 95%) of DFMC farmer members choose to enter into a contract, being either a Defined Volume Fixed Term Contract (which can be either a 2 year or 3 year contract) or a Volume Incentive Contract (which is a 12 month contract) (also referred to as a Supply Agreement). Farmers are also free to supply other processors once their supply contract is terminated. Supply contracts of a specified duration are in both ACF's and farmers' interests.

- The reason a majority of farmers elect to enter into either a Defined Volume Fixed Term Contract or a Volume Incentive Contract with DFMC is that such contracts provide benefits to farmers. The benefits include a higher price and certainty of milk off-take for the duration of the contract. The fact farmers value certainty of milk off-take is best illustrated by considering the proportion of farmers that elect to enter into 3 year rather than 2 year contracts, even though the price does not differ. DFMC and ACF calculate that, of those farmers electing to enter into Defined Volume Fixed Term Contracts, approximately 35% elect to enter into a 3 year contract. In addition, farmers value the certainty provided by the guaranteed minimum prices in the Defined Volume Fixed Term Contracts. Farmers are guaranteed to receive at least those minimum prices for the duration of the contract, although the base price paid to

<sup>1</sup> The Australian Competition and Consumer Commission 'Application for revocation of authorisation A90782 and its substitution by authorisation A90966' 26 April 2006 at 12-13

<sup>2</sup> The Australian Competition and Consumer Commission 'Application for revocation of authorisation A90782 and its substitution by authorisation A90966' 26 April 2006 at 23

farmers in the past has always exceeded the minimum price. These minimum base prices allow farmers to better manage risk by evening out the 'ups and downs' of the market. Put simply, those contracts allow farmers the choice of certainty of milk prices for a defined period.

- As a processor, ACF requires certainty of milk supply in order to meet the demands for supply of fresh milk and other dairy products. It achieves this by contracting with DFMC for the supply of milk based on back to back terms with its farmer members.

In further answer to the matters raised in respect of DFMC's contractual arrangements in the Fleurieu Submission, DFMC and ACF say:

- farmers have the benefit of explanation of the effect of the contracts offered by DFMC. This occurs, and has occurred, at meetings of farmers at which DFMC and ACF are present and is part of the service offered by ACF's Farm Services staff, acting as DFMC's agents when dealing with DFMC farmer members;
- as set out in the application for authorisation, ACF and DFMC meet in about May of each year to agree on the supply arrangements for the following financial year. ACF and DFMC generally announce to farmers the 'agreed base prices' in about June. Those 'agreed base prices' are fixed for the period July to December of the forthcoming financial year. Although the amount paid by DFMC to a farmer for that period can be higher, the price can never be lower than the agreed announced base prices. For example, the prices for July to December 2008 were announced on 8 June 2008. At this time, ACF and DFMC also announce 'indicative prices' for the period January to June of the forthcoming financial year. These indicative prices are not fixed, although farmers on Defined Volume Fixed Term Contracts will receive at least the minimum base price. ACF and DFMC negotiate the base prices for the period January to June, sometime between July and September. The base prices for the period January to June are announced to farmers as soon as they are agreed between ACF and DFMC.
- 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. All farmers are able to enter into and terminate contracts at times when pricing is not merely "indicative". This includes farmers whose contract period expires at a time when base prices will not have been announced (which is by far the minority). This is because, 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 contract. The contracts contain the following notice periods:
  - for farmers on a two or three year Defined Volume Fixed Term Contract, 180 days' notice must be given. Although farmers can give notice at any time, including before the end of the contract period, the contract cannot expire before that time; and
  - for farmers on a one year Supply Agreement, 120 days' notice must be given, unless the farmer wishes to terminate after the 12 month contract period has expired. In that case, the farmer only has to give 28 days' notice. Again, farmers do not need to wait until expiry of the contract term before giving notice.

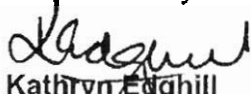
This means that farmers on supply contracts which expire at a time when base prices will not be announced can choose to provide notice such that their contract can expire at a time when base prices will be announced. This is subject to the 90 day grace period dealt with below. In practice, farmers can renew their agreements with DFMC after the contract period, whether or not they have given the appropriate notice. There is, therefore, no "*pricing pressure*", as DFMC and ACF understand that

term to be used in the Fleurieu Submission, on farmers to sign any contract with DFMC. In any event, farmers on Defined Volume Fixed Term Contracts have the protection of a minimum base price which is specified in the contract at the time they enter into the agreement. The minimum base price applies for the duration of the contract;

- provision is made in the contracts for payment of liquidated damages in the event that a farmer ceases to supply under a contract before its expiration. This simply represents an acknowledgment of the need for a processor to have certainty of raw milk supply for business planning purposes. In any event, liquidated damages are only payable if a farmer fails to supply the minimum volume for 2 or more consecutive six monthly periods;
- there is no penalty involved in termination of a contract. A farmer who enters into an agreement does so knowing that it is for a minimum period (which period is either 1, 2 or 3 years at his or her election). If a farmer wishes the contract to come to an end at expiry of that term the farmer must give notice in accordance with the timeframe specified in the contract. Farmers do not need to wait until expiry of the contract before giving notice; and
- Farmers on a Defined Volume Fixed Term Contract are paid an additional amount for agreeing to supply a minimum volume. This allowance is referred to as the Contract Consideration payment. Farmers are given a 90 day grace period, that is, they continue to receive the Contract Consideration payment for 90 days after the contract period expires so long as they are still supplying milk. The 90 day grace period applies whether or not a farmer has given notice terminating the contract. At any time during this period (or after) he or she may renegotiate a new contract. In practice, farmers can renew their agreements with DFMC after the contract period, whether or not they have given the appropriate notice. If after this 90 day grace period a farmer has not entered into a new agreement with DFMC and is still supplying milk, the farmer continues to be paid the Base Milk Price but is not "out of contact"

DFMC and ACF would be happy to elaborate on any of the matters raised in this letter should the Commission wish.

Yours faithfully

  
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