

2 September 2008

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) dated 22 May 2008 (Authorisation Application)

We refer to our meeting with you and representatives of the Commission on 27 August 2008. The purpose of this letter is to:

- 1 describe the circumstances leading to, and the reasons for, the amendment of the Authorisation Application;
- 2 summarise the amendments made by DFMC and ACF to the Authorisation Application (see Attachment A which describes briefly the amendments made to the various agreements the subject of the Authorisation Application dated 22 May 2008);
- 3 explain why the amendments to the authorisation application will not result in any anti-competitive detriment and will result in significant public benefits;
- 4 describe the conduct for which interim authorisation is sought; and
- 5 explain why a grant of interim authorisation in the terms sought will not result in any anti-competitive detriment.

DFMC and ACF consent to this letter being placed on the public register.

A Circumstances leading to, and reasons for, the amendment of the Authorisation Application

At the time at which the Authorisation Application was lodged in May 2008, the competitive tender process by which ACF sought to identify a possible purchaser had not reached a stage where it was possible to identify any such purchaser. An inevitable consequence of that situation was that neither DFMC nor ACF could predict whether any purchaser would require changes to the Milk Supply Agreement between DFMC and ACF dated 1 July 2004 (MSA) or other conditions which may impact on the terms of the authorisation sought. That

situation has now been clarified upon the entry into agreements for the sale of ACF to National Foods Limited (**National Foods**) on 25 August 2008. The acquisition is to be effected by a Scheme of Arrangement (**Scheme**) 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 to National Foods. Briefly, the terms of the acquisition of ACF by National Foods include an agreement between ACF, DFMC and National Foods:

- 1 to amend the MSA in certain respects, with such amended MSA to take effect as and from the Scheme Implementation Date (**Amended MSA**);
- 2 to use reasonable endeavours to secure the entry by DFMC farmer members into new, amended supply contracts with DFMC (**Revised Farmer Supply Contracts**) prior to completion of the sale, with such contracts only to take effect upon completion of the sale. 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 only of the milk supplied by ACF to DFMC during the 2007/08 financial year. The requisite proportion is confidential to National Foods, DFMC and ACF. It is a condition of the sale that the specified volume of milk is secured by the relevant date up until at least 30 June 2010;
- 3 subject to authorisation by the ACCC, for the payment by ACF upon its sale to National Foods, of prices to DFMC under the amended MSA for the acquisition of milk, which prices are to be the subject of back to back pricing in DFMC's Revised Farmer Supply Contracts if the sale is completed; and
- 4 subject to authorisation by the ACCC, for the payment by ACF upon its sale to National Foods, of prices to farmers whose Revised Farmer Supply Contracts are assigned to ACF, or which contracts ACF obtains the benefit of, in accordance with the transaction agreements.

Attachment A describes briefly the amendments that have been made to the MSA and supply contracts provided to the Commission together with the authorisation application on 22 May 2008.

B Amendments to the Authorisation Application

As a result of the agreement with National Foods described above, DFMC and ACF have amended the Authorisation Application to seek authorisation for the following conduct:

- 1 the inclusion in the Amended MSA of:
 - a) amended clauses 4.4 and 5.6 which provide, respectively, 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 to DFMC; and
 - b) 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 ;

- 2 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;
- 3 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
- 4 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.

In respect of the conduct referred to in paragraph 2 above, authorisation is sought for such conduct in respect of the following contracts and arrangements between DFMC and its farmer members, namely:

- a) **Existing supply contracts**, which are those contracts which are currently in existence, and which will continue in existence after completion of the sale of ACF (including arrangements with farmer members for the acquisition of milk for on sale to ACF which exist without the parties having entered into a written contract), but which are not Revised Farmer Supply Contracts (**existing supply contracts**) – for which conduct, authorisation is sought until the contracts and arrangements expire;
- b) **Revised Farmer Supply Contracts** – for which conduct, authorisation is sought until the contracts expire; and
- c) **Future supply contracts**, which are those supply contracts to be entered into after completion of the sale of ACF, including any renewals of any existing supply contracts and Revised Farmer Supply Contracts (and any arrangements with farmer members for the acquisition of milk for on sale to ACF which occur without the parties entering into a written contract) (**future supply contracts**) – for which conduct, authorisation is sought for a period of up to five years from the date of the authorisation.

In respect of the conduct referred to in paragraph 3 above, authorisation is sought for:

- a) the making of the agreement in respect of the prices to be offered to farmers;
- b) the offering of and inclusion of such prices in Revised Farmer Supply Contracts and any future supply contracts (**Pre-completion Conduct**); and
- c) payment of such prices to farmers under Revised Farmer Supply Contracts and any future supply contracts (**Post-completion Conduct**)

for which conduct, authorisation is sought for a period of five years. 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.

C Effect of conduct to which the amended authorisation application applies

DFMC and ACF 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 referred to in sections 11 and 12 of the submission lodged by DFMC with the ACCC on 22 May 2008. This is 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. To that end, the amendments seek to balance the interests of National Foods/ACF, as a processor of milk, and the interests of DFMC's farmer members. In particular:
 - the amendments to the MSA dealing with the supply of a Minimum Volume by DFMC to ACF provide National Foods/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;
 - 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 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, which 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;
- supermarkets will continue to exert considerable countervailing power.

D Interim Authorisation

Although the agreement as to the prices to be paid by ACF to DFMC under the amended MSA only applies from the date the sale of ACF to National Foods is completed, DFMC and ACF must offer Revised Farmer Supply Contracts to members well before the Second Court hearing date in order to satisfy the condition precedent. ACF and DFMC propose to include in those Revised Farmer Supply Contracts the agreed prices. However, those prices will only be payable to farmers if the following conditions are satisfied:

1. the sale of ACF to National Foods is completed; and
2. the Commission grants final authorisation for the implementation of the agreed pricing.

Therefore, interim authorisation is sought for the 'Pre-completion Conduct', namely, the **offering** to farmers, and **entering into**, of Revised Farmer Supply Contracts which include the agreed prices. 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 Commission.

E Reasons why interim authorisation should be granted

DFMC and ACF submit that the following factors support the application for the grant of interim authorisation in this case:

- 1 ***The grant of Interim authorisation is necessary to ensure security of sufficient milk supply for National Foods in the event that its acquisition of ACF proceeds***

DFMC and ACF understand that National Foods wishes to ensure that it has the minimum volumes of raw milk necessary to honour its obligations and meet its own processing requirements before it completes its acquisition of ACF. The grant of interim authorisation will allow the parties to secure such milk supply by offering and entering into Revised Farmer Supply Contracts which reflect the back to back pricing to be paid upon completion.

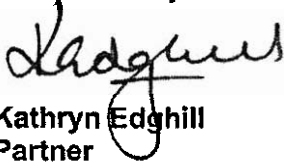
The application for interim authorisation is urgent. DFMC and ACF must secure the entry by DFMC farmer members into Revised Farmer Supply Contracts by 8 am on the Second Court hearing date in relation to the Scheme. It is currently expected that the Second Court hearing date will take place sometime between 8 to 10 weeks from the date of this letter. However, by reason of the numbers of farmers involved and their geographical spread, it is necessary to start the process of offering and entering into the Revised Farmer Supply Contracts as soon as possible. The condition precedent to the Transaction requires DFMC and ACF to have secured a specified volume of milk in a number of regional areas, extending from far North Queensland, Central New South Wales to Southern Victoria. DFMC had in excess of 800 farmer suppliers during the 2007/08 financial year.

- 2 ***The conduct for which Interim authorisation is sought arises because of timing issues and can be unwound should final authorisation for the implementation of back to back pricing not be granted***

The Pre-Completion Conduct is simply a timing issue insofar as it brings forward to the pre-completion phase, the offer of back to back pricing. The actual implementation of the back to back pricing will not take effect unless and until completion occurs and such conduct is authorised by the ACCC. In other words, the prices only come into effect if the Commission is satisfied that the agreement:

- a) does not give rise to any anti-competitive detriment; or
- b) that the public benefits outweigh any anti-competitive detriment.

Yours faithfully



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Attachment A
Summary of the amendments made to
the MSA and Revised Farmer Supply Contracts

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.

1. **The Minimum Volume for the 2008/09 and 2009/10 financial years is specified in Part 1 of Schedule 1 to the amended MSA.** The specified volumes represent a proportion only of the total volumes supplied by DFMC to ACF during the 2007/08 financial year.
2. The Minimum Volume for each quarter of the following financial years commencing in 2010/11, is to be determined in accordance with the provisions of the amended MSA. Briefly, ACF and DFMC are required to negotiate with a view to agreeing the Minimum Volumes for the forthcoming financial year. If the parties cannot agree, the dispute resolution clause in the amended MSA applies. The dispute may ultimately be resolved by expert determination. Pending the resolution, the Minimum Volume in the previous financial year applies.

The amended MSA incorporates a concept referred to as 'Anticipated Full Demand', the object of which is to seek 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. The concept is relevant in 2 respects:

1. ACF will continue to be obliged to pay DFMC a commercial price for milk, being the market value or price. 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".
2. ACF can still refuse to acquire milk from new farmer members provided that the milk to be supplied is excess to ACF's Anticipated Full Demand.

Although the amended MSA will continue to oblige ACF to pay DFMC a commercial price for milk, National Foods, DFMC and ACF have agreed more specific pricing parameters to apply under the amended MSA for the 2008/09, 2009/10 and 2010/11 financial years. The agreed pricing parameters are confidential to ACF, DFMC and National Foods. However, the following information can be made publicly available:

1. subject to authorisation, for the 2008/09 financial year farmers will receive no less than the fixed and minimum farm gate milk prices offered by ACF and DFMC to farmers in about June 2008 (that is, the prices which were offered before the relevant transaction agreements were entered into with National Foods); and
2. subject to authorisation, for the 2010/11 financial year, farmers will receive no less than the minimum farm gate milk prices offered by ACF and DFMC to farmers in about June 2008 for the 2010/11 financial year (that is, the prices which were offered

before the relevant transaction agreements were entered into with National Foods). In addition, National Foods has agreed to procure that ACF pays competitive prices for each region.

National Foods, ACF and DFMC have also agreed to amend the supply contracts which DFMC enters into with farmers. In satisfying the condition precedent, DFMC must use the Revised Farmer Supply Contracts. The Revised Farmer Supply Contracts offered to farmers will be conditional on the sale. The main differences between the supply contracts provided to the Commission on 22 May 2008 and the Revised Farmer Supply Contracts are:

1. Under the current supply contracts, farmers cannot terminate their contract before the contract period specified in the agreement. Further, in order for the supply contract to come to an end, including at the end of the contract period, a farmer must provide 180 days' notice. Relevantly, the following changes have been made to the Revised Farmer Supply Contracts:
 - (a) 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
 - (b) 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.
2. 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.
3. Under the current supply contracts, 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. Under the Revised Farmer Supply Contract, liquidated damages are payable if a farmer fails to supply the minimum volume during any six monthly period.