



Australian
Competition &
Consumer
Commission

ACCC Inquiry into the Australian dairy industry

Issues Paper

8 November 2016

The Dairy Inquiry

On 27 October 2016 the Treasurer, the Hon Scott Morrison MP, issued a notice requiring the Australian Competition and Consumer Commission (ACCC) to hold an Inquiry into the competitiveness of prices, trading practices and the supply chain in the Australian dairy industry. The Inquiry commenced on 1 November 2016.

The ACCC's Inquiry will cover all geographical and major product markets within the Australian dairy industry. Through the inquiry, the ACCC will analyse the industry to identify structural and behavioural issues that affect its performance.

The Inquiry will involve broad consultation, including seeking feedback in response to this Issues Paper, requesting information from businesses, and holding forums in producing regions.

The ACCC must submit its report following the Inquiry to the Treasurer before 1 November 2017. The report will then be publicly released.

Terms of Reference

The Terms of Reference for the Inquiry, as set by the Treasurer, state that matters to be taken into consideration in the Inquiry must include, but not be restricted to:

- i. the nature of competition between processors for both the acquisition of raw milk and the supply of processed milk and dairy products
- ii. the nature of retail pricing arrangements for milk and dairy products, and their impact up the supply chain
- iii. the effect (direct or indirect) of domestic retail and export prices, and level of domestic and overseas demand, for Australian processed milk and dairy products on dairy producers and processors
- iv. the nature of the commercial relationships between dairy producers and acquirers of raw milk and the impact of corporate structures adopted (including cooperative structures) upon those relationships
- v. the mechanisms used by acquirers of raw milk to determine prices paid when acquiring raw milk and the transparency of those mechanisms
- vi. the availability, transparency and accessibility of market price information, and its effectiveness for forecasting movements in farm gate milk prices
- vii. the terms on which raw milk is acquired from dairy producers and the means by which such terms are agreed
- viii. the allocation of commercial risk across the dairy supply chain
- ix. the role of collective bargaining in the dairy industry and its effectiveness
- x. the existence of, or potential for, anti-competitive conduct and the possible impacts of any such conduct on businesses within the dairy supply chain
- xi. any other factors affecting farm profitability.

Potential outcomes

The Inquiry may lead to a range of outcomes, such as:

- opportunities for the ACCC to make recommendations and / or to work collaboratively with governments and industry to develop solutions to any competition or other trading problems
- ACCC action to address any behaviour in the industry that raises concerns under the *Competition and Consumer Act 2010*
- improved transparency about competition and trading practices in the supply chain.

Timetable

The dates below are indicative. As the Inquiry progresses, the ACCC will publish further information with confirmed dates on its website.

1 November 2016	Commencement date
8 November 2016	Release of Issues Paper
December 2016	Initial information requests to be issued
12 December 2016	Due date for feedback in response to the Issues Paper
March - May 2017	Public forums and hearings - locations and dates to be confirmed
November 2017	Final report to be released

Inquiry background

This Inquiry has arisen due to a number of issues. In April and May 2016 Murray Goulburn Co-operative Co Limited (Murray Goulburn) and Fonterra Australia Pty Ltd (Fonterra Australia) announced significant cuts to the farmgate milk price paid to dairy farmers. In the case of Murray Goulburn, these cuts involved both a step down in the price and the partial 'claw back' of payments made throughout the season. Separate to the Inquiry, the ACCC is investigating this conduct to examine whether Murray Goulburn and Fonterra Australia have engaged in false, misleading or unconscionable conduct in breach of the *Competition and Consumer Act 2010*. An investigation involves a specific assessment of whether a breach of law has occurred, while this Inquiry will focus on the broader operation of the industry. The Murray Goulburn and Fonterra Australia investigations remain on foot, at the time of release of this Issues Paper.

The price cuts were the catalyst for the broader consideration of issues affecting the profitability of dairy farms and the operation of the dairy industry. On 25 August 2016 a national meeting of key dairy industry stakeholders was held in Melbourne and was chaired by the Deputy Prime Minister and Minister for Agriculture and Water Resources, the Hon Barnaby Joyce MP. The Deputy Prime Minister announced the ACCC Inquiry at the conclusion of the meeting.

The ACCC's Inquiry is broader than the price cuts issue and we will not focus solely on a particular trader. The ACCC will examine how the whole industry operates.

Other issues that have been raised with the ACCC included the oversupply of milk in Western Australia, concerns about practices affecting the renewal of milk supply agreements and continued concern about retail drinking milk prices, particularly from dairy farmers in New South Wales and Queensland.

Additionally, on 14 September 2016 the Senate referred issues regarding the Australian dairy industry to the Senate Economics References Committee for inquiry and report. The Committee is due to report by 24 February 2017. The Senate Inquiry will consider:

- the legality of retrospective elements of milk contracts
- the behaviour of Murray Goulburn
- any other related matters.

Process

The ACCC invites your views by way of written feedback, telephone conversations and comments at public hearings. The ACCC will also directly contact some market participants to request specific information. Through the Inquiry, the ACCC has the legal power to compel certain information from industry participants where required.

Feedback

This Issues Paper seeks feedback on a number of issues. However, you do not need to comment on all the points in your feedback. Also, the issues discussed in this paper are a guide and are not exhaustive. The ACCC encourages you to raise other relevant issues.

You should provide feedback by 12 December 2016. Responses should be emailed to dairyinquiry@acc.gov.au. If you would like to provide information over the phone or if you have any questions, please contact:

Amy Bellhouse
Amy.Bellhouse@acc.gov.au
03 9290 1997

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Mark.Laybutt@acc.gov.au
02 6243 1280

Public hearings

The ACCC will hold producer forums in a number of locations across Australia. The timing and location of these forums will be made available on the ACCC's website.

The ACCC will also hold formal hearings where invited parties provide sworn evidence to the ACCC. These hearings can be public or private.

Treatment of information

Broadly speaking, the Inquiry is a public process and written feedback will be posted on the ACCC website.

The *Competition and Consumer Act 2010* contemplates that interested parties providing written feedback to the Inquiry are entitled to make claims for confidentiality in certain circumstances.

The ACCC can accept a claim of confidentiality from the party if the disclosure of information would damage their competitive position. If the ACCC is satisfied that the confidentiality claim is justified, it must keep that information confidential unless it considers that disclosure of the information is necessary in the public interest.

If the ACCC considers that the confidentiality claim cannot be upheld, the ACCC will provide the parties with an opportunity to withdraw part or all of their feedback. If this information is withdrawn then the ACCC will not take it into account. If a party elects not to withdraw the information then the ACCC may disclose the information publicly. If the ACCC subsequently considers that disclosure of information that has initially been treated as confidential may be

necessary in the public interest, the ACCC will consult with the party providing the information before any such disclosure is made.

The ACCC invites interested parties, where appropriate, to discuss confidentiality issues further with the ACCC in advance of providing written feedback.

Any information for which parties would like to claim confidentiality should be provided in a separate document (e.g. as an Annexure to a public feedback) and should be clearly marked as “confidential” on every page. Reasons must be provided in support of the claim for confidentiality, so that the ACCC can properly consider whether the claim is justified.

The Issues Paper

The Australian dairy industry

Industry overview

Dairy is Australia’s third largest agricultural commodity in terms of farmgate value, and fourth in terms of export value.¹ In 2015-16, 9.54 billion litres of milk was produced nationally², which according to Dairy Australia was processed into cheese (30 per cent), skim milk powder and butter (29 per cent), drinking milk (fresh and long-life UHT) (26 per cent), whole milk powder (6 per cent) and a range of other products (9 per cent) such as yoghurts, custards, dairy desserts, whey proteins and nutraceuticals. Production exceeds domestic consumption, so access to export markets is critical: around 34 per cent of total Australian dairy production was exported in 2014/15³, including 65 per cent of manufactured dairy products (compared to around 6 per cent of drinking milk).⁴

Approximately 66 per cent of Australian milk production is sold domestically in the form of liquid milk and manufactured products. Historically, this number has varied from around 40-60 per cent⁵: declining production and population growth (rather than significant increases in per capita consumption) have resulted in an increasing proportion of production being sold on the domestic market. Long term trends for per capita consumption of drinking milk and butter/butter blends are fairly stable, while consumption of cheese and yoghurt has gradually increased. Around 94 per cent of drinking milk is consumed on the domestic market. A range of dairy products are also imported.

Australian dairy production is concentrated in the south-eastern corner of the country and in coastal areas. Information provided by Dairy Australia shows that around 66 per cent of production occurs in Victoria, 12 per cent in New South Wales, 9 per cent in Tasmania, 6 per cent in South Australia, 5 per cent in Queensland and 4 per cent in Western Australia. The concentration of farms in regions with a climate suited to pasture-based production reflects the fact that the Australian dairy industry has traditionally maintained a low cost base, enabling production beyond domestic demand for sale into global markets.

Australian dairy farms are generally owner-operated small and medium size enterprises, and have operated in a fully deregulated market since 2000 (although the government continues to be involved in the administration of food standards and food safety assurance systems).

¹ ABARES 2013/14 from Dairy Australia *Australian Dairy Industry In Focus 2015*, p. 5

² <http://www.dairyaustralia.com.au/Markets-and-statistics/Production-and-sales/Latest-statistics.aspx>

³ Dairy Australia *Australian Dairy Industry In Focus 2015*, p. inside front cover

⁴ *ibid.*, p. 18

⁵ *ibid.*, p.19

Consistent with trends in other agricultural industries, there has been a shift to fewer, larger and more efficient dairy farms. In the period from 1999/2000 to 2014/15, milk production declined by 10 per cent, the number of cows in the national herd by 20 per cent (to 1.74 million), and dairy farm numbers by more than 50 per cent (to 6,128). There was also increased average production per-cow during this time.⁶

The decline in farm numbers has not occurred evenly across Australia, with the south-east of Australia being the least affected. These states are less reliant on supplying the drinking milk markets, with the manufacturing of long shelf-life products allowing greater access to export markets. The predominantly pasture-based nature of the industry in this region generates a production peak in October (reflecting a majority of producers calving in spring), tapering off through summer and into winter. Relatively low-cost rainfed pasture enables product from these regions to compete in export markets, although recent droughts and processor demand for flatter production have seen costs increase as producers have increased purchases of feed inputs such as grain and concentrates.

Production regions that are particularly focused on domestic drinking milk have experienced more significant declines in farm numbers. These regions are in Queensland, Western Australia and parts of New South Wales and tend to be characterised by relatively stable production across the year, achieved through management of calving patterns and feed production systems. As a result, they tend to have a higher average cost of production, and also attract a higher average farmgate price.

Since deregulation in 2000 there has been no legislative control over prices, which are now set by market forces. Five major dairy processors accounted for 79 per cent of volume nationally in 2015-16, with a large number of smaller processors making up the remainder of the industry. The five largest processors (by volume) were Murray Goulburn, Fonterra Australia, Parmalat Australia Ltd, Warrnambool Cheese & Butter, and Lion Dairy & Drinks.

Milk supply contracts contain relatively complex farmgate prices and payment systems with the price quoted by a buyer or processor generally being the 'effective price' for their 'average supplier', quoted as an effective price per unit (\$/kg milk solids or c/L). The effective price is calculated based on payments for:

- fat content
- protein content
- a range of incentives or deductions for things such as:
 - flat supply (to encourage steady supply throughout the year)
 - scale or growth
 - quality
 - loyalty.

Issue 1 – Competition for milk

This section of the Issues Paper focuses on the level of competition between purchasers of milk at the farmgate. Milk is primarily purchased by processors at the farmgate level, although some contract processing arrangements do exist for producer to retailer direct supply relationships.

Competition between processors is critical to the functioning of the dairy industry to ensure that producers have options when selling their milk, and retailers and other buyers have options when purchasing dairy products.

⁶ *In Focus 2015*, p. 6-14

In order to assess the level of competition that exists between buyers, the ACCC seeks further information about the specific sales options available to producers in their local region.

The ACCC would appreciate feedback on:

1. The level of competition between processors for the acquisition of milk, across regions
2. The ability of producers to switch between processors or other buyers.

When providing feedback, you may wish to comment on:

- The features of dairy regions. This includes the range of potential buyers, and access to and reliance on domestic or export sales.
- Why producers choose to supply certain buyers
 - How the corporate structure of potential purchasers affects this
- How the industry manages under or over supply of milk.
- The use of exclusive supply terms in contracts
- The use of loyalty and other bonuses
- Whether milk supply agreements operate on different 12-month cycles (i.e. calendar year and financial year) and the impact of this on options for switching between processors
- Processor margins. This includes information on costs of production for processors.
- The capacity of processing facilities and the factors affecting their operations
- The regularity with which processors trade milk ('milk swaps')
- The impact of any consolidation or vertical integration in the industry.

Issue 2 – Contracting practices

Dairy is a volatile commodity and the ACCC understands that flexibility is built into many contracts in the industry to ensure that price changes can be accommodated. Contracts generally allow for:

- 'step ups' (price increases with a retrospective component)
- price increases (for the rest of the year – not retrospective), or
- 'step downs' (price decreases which may have a retrospective component).

Some processors also offer fixed-price contracts, although these are less common.

From 12 November 2016 a new law will protect small businesses from unfair terms in standard form contracts.⁷ Many farmers are likely to be small businesses and a milk supply agreement is likely to be a standard form contract. The law aims to address some of the power imbalances existing in business-to-business transactions. Further information on these laws can be found on the ACCC's [website](#).

Collective bargaining authorisations from the ACCC can enable producers to collectively negotiate with buyers, in circumstances where it may otherwise raise concerns under competition laws. Collective bargaining is an arrangement where two or more competitors come together to negotiate with a customer over terms, conditions and prices. This may reduce imbalances in bargaining power in commercial negotiations. Collective bargaining arrangements require the voluntary involvement of both buyers and sellers in order to be effective. Collective boycotts can also be authorised in some circumstances. Further information about collective bargaining and collective boycotts can be found in the ACCC's recently released [publication](#).

⁷ A standard form contract is one that has been prepared by one party to the contract and where the other party has little or no opportunity to negotiate the terms – that is, it is offered on a 'take it or leave it' basis.

The ACCC would appreciate feedback on:

3. The different types of supply contracts used across the supply chain and in certain regions
4. Concerns about anti-competitive conduct or unfair trading practices, including unfair contract terms.

When providing feedback, you may wish to comment on:

- The use of step-ups and step-downs in processor contracts, and the use of terms that allow for retrospective payments by producers where a step-down occurs
- The allocation of risk in contracts across the supply chain
- Imbalances in bargaining power, including the level of contract negotiation
- The operation of direct arrangements between producers and retailers
- The effectiveness of existing collective bargaining arrangements and the level of awareness of and industry support for collective bargaining
- Practices surrounding the renewal of contracts, including notice periods, timing and the nature of negotiations
- Payment practices, including the timing of payments.

Issue 3 – Transparency and price signals

Transparency means that key market information is available to industry participants. Improved transparency would enable those in the dairy industry to make decisions based on more accurate and reliable information.

The ACCC understand that processors have access to and use price indicators including Global Dairy Trade (GDT), New Zealand, European and US futures markets, and various data analysis and reporting services. These information sources provide price reference points for the price of various dairy products. The ACCC also understands that some producers may use these tools.

The ACCC seeks information about the accessibility, accuracy and value of price and other market information that is currently available. This includes information about the extent to which this information is used by producers and processors.

The ACCC would also like to further understand how processors set farmgate milk prices and whether this process is transparent.

The ACCC would appreciate feedback on:

5. How farmgate milk prices are set and communicated to producers
6. The availability and use of meaningful global market information and price signals across the industry, including by dairy farmers.

When providing feedback, you may wish to comment on:

- The timing and nature of processor announcements about farmgate milk prices
- The ability of farmers to compare prices and conditions offered by processors
- Other sources of pricing information that are used to assist with farm business decisions and forward planning.

Issue 4 – Domestic retail markets

This section of the Issues Paper is focused on understanding the impact that the practices of domestic retailers have on the dairy industry.

The impact of \$1 per litre private label milk has been a key point of discussion and the ACCC will examine this issue closely through the Inquiry. A very high proportion (94%) of

drinking milk (including fresh and UHT long-life) is sold into the domestic market.⁸ Supermarkets account for approximately 53-54% of domestic sales of drinking milk.⁹ In 2014/15, private label ('home brand') drinking milk accounted for 64% of fresh regular full cream and 51% of fresh reduced and no-fat milk sales in Australian supermarkets.¹⁰

However, the ACCC's assessment of domestic retail issues will not be confined to private label or supermarket sales. The ACCC wants to understand the range of domestic supply channels that are available to processors and other sellers of dairy products.

The ACCC would appreciate feedback on:

7. The major supply channels for the domestic market, including major supermarkets and other retailers
8. The impact of \$1 per litre milk on the industry. This includes information about the positive and negative impacts of private label product supply contracts.

When providing feedback, you may wish to comment on:

- Any emerging supply options and the importance of production differentiation for domestic markets
- The nature and form of processor supply agreements with retailers and direct producer supply agreements with retailers
- Any links between retail agreements and shelf space or product position
- The impact of other private label dairy products (for example, private label cheese)
- Retail margins and whether retailers use milk or other dairy products as a loss leader
- Any fluctuations in prices paid by retailers to suppliers of dairy products.

Issue 5 – Global markets

While the high proportion of dairy production sold on the domestic market helps to provide a measure of stability to farmgate prices, dairy is a globally traded commodity. The Australian industry is heavily influenced by the operation of international markets, which are a major factor determining what farmers receive for their milk.

Australia is responsible for around 2 per cent of world milk production, but accounts for approximately 6 per cent of world dairy trade, ranking fourth behind New Zealand, the European Union and the United States.¹¹ Major export markets for Australia are south east Asia, Japan, greater China, and the Middle East, with small quantities of product going into other parts of Asia, the Americas, Africa and Europe. A range of dairy products are also imported, further exposing the industry to global markets.

Only around 7 per cent of global dairy production is traded¹², and according to data from Dairy Australia, the four major exporters produce 89 per cent of this. Thinly traded markets of this kind (ones with a limited number of interested buyers and sellers) are highly sensitive to relatively small changes in global supply or demand, as demonstrated by the recent, prolonged downturn in international prices. Despite Australia being less exposed to global markets than some other major exporters, the resulting volatility (exacerbated by foreign currency movements) impacts on the returns of manufacturers and farmers.

⁸ *In Focus 2015*, p. 2

⁹ <http://www.dairyaustralia.com.au/Markets-and-statistics/Production-and-sales/Domestic-Sales-Summary.aspx>

¹⁰ *In Focus 2015*, p. 23

¹¹ *In Focus 2015*, p. 19

¹² Food and Agriculture Organisation, *Status and Prospects for Smallholder Milk Production*, 2010

The ACCC would appreciate feedback on:

9. Options for supply into export markets, including products and destinations
10. Any barriers to selling into export markets.

When providing feedback, you may wish to comment on:

- The level of volatility of global market prices and the ability for exporters to manage this. This can include information about any broader impacts of oversupply in international markets.
- The use of hedging or any other risk management practices by processors
- The role of non-processor exporters in the industry (for example, brokers or companies that utilise contract packing services from processors)
- The importance of product differentiation
- The level of competition that imported products introduce to domestic markets.

Issue 6 – Production costs and profitability

Ultimately, a strong dairy industry is reliant on the continued and profitable operation of producers. The ACCC understands that a range of factors influence the profitability of dairy farmers including farmgate milk prices, seasonal conditions and input costs such as water, feed and fertiliser.

Following a long-term downward trend in inflation adjusted farmgate milk prices, the last decade has seen a more volatile pricing environment, with the two seasons preceding 2015/16 being relative peaks. Volatile markets, combined with the erratic Australian climate and its impact on production costs, results in dairy farm cash incomes fluctuating significantly from year to year.¹³ Profitability also varies between regions and farms depending on localised income, climatic and cost factors.

The ACCC also understands that many Australian dairy farms have also derived significant portions of their income from livestock sales in recent years, either of heifers for live export, or through sales of older ('chopper') cows into beef markets.

The ACCC would appreciate feedback on:

11. The key factors influencing the profitability of dairy farms, including costs of production.

When providing feedback, you may wish to comment on:

- Alternative income streams, including income from the sale of livestock. This includes information about:
 - the ability to switch between income earned from dairy and other sources
 - any barriers to supply channels for the sale of livestock.
- Any significant issues concerning the supply of inputs
- The level of competition between producers, including the factors that influence processor decisions regarding which farms they acquire milk from.

¹³ At the national level, the average farm cash income of dairy farms declined from around \$156 000 in 2014–15 to an estimated \$101 000 in 2015–16 as a result of lower farmgate milk prices and a slight reduction in milk production per farm. The projected farm cash income of dairy farms in 2015–16 is around 13 per cent below the 10-year average to 2014–15. http://data.daff.gov.au/data/warehouse/9aas/2016/adfpfd9aas20160802/AustDairyFinPerf_2013-14_2015-16_v.1.0.0.pdf