Code of Practice for Contractual Arrangements

Between Dairy Farmers and Processors in Australia

Introduction

This Code of Good Practice for Contractual Agreements between farmers and processors has been drawn up by the Australian Dairy Industry Council (ADIC) as an agreed position between Australian Dairy Farmers Limited (ADF), Australian Dairy Products Federation (ADPF) and the dairy processors who are signatories to the Code.

The Code sets out good practice for contracts between farmers and processors. This Code has been agreed to address a number of issues with dairy contracts that may be contested under the new Unfair Contract Terms* Law which will operate from the 12th November 2016.

The aim of this Code is to address these issues in a way that works for both farmers and processors.

The code will apply to standard form contracts between processors and farmers. The code does not preclude a farmer negotiating an individual contract with a processor.

Whilst adherence to this Code is voluntary, it is designed to set out minimum good practice in terms of dairy contracts. Parties adopting this Code should do so in full.

For purposes of definition a contract is any written or verbal agreement between a farmer and a processor whether it is termed a contract or a supply agreement.

Farmers and processors are encouraged to engage in discussion on all elements of the standard form contract prior to signing.

The Code has been developed by the ADIC for the benefit of the dairy industry and will be lodged as a voluntary code with the Australian Competition and Consumer Commission (ACCC).

The following 11 elements represent the code of practice with further details to be found in the Addendum:

1. Transparency

Clauses in the contract should clearly and simply state the mutual obligations of both farmer and processor.

2. Pricing

Contracts between farmers and processors must set out either a clear price, and/or a clear pricing mechanism (such as a formula) or a price notification process (the process by which the processor notifies the producer of the price), such that at any given point in time, a producer can be certain of the base milk price that will be paid for the milk produced.

Processors should negotiate contracts which;

A. have a price or pricing mechanism that is negotiated and agreed between the farmer and the processor; and/or

B. have a price, pricing mechanism or price notification process that is at the processors discretion.

Whether the processor offers contracts under either of these options, the contracts should, at all times, comply with the requirements of this Code for each of these options.

3. Pricing Mechanisms

Where the contract provides for a pricing mechanism (as opposed to a fixed price or a price notification process), such as a pricing formula, the contract should specify:

a. the exact pricing mechanism/formula to be used; and
b. how any variations to the pricing mechanism/formula are to be dealt with.

4. Contractual Variations e.g. Step-Ups and Step-Downs

The actual price paid to the farmer may be subject to adjustments, provided that such adjustments are compliant with the Code.

In all cases, a description of how any contract adjustments, including pricing (or adjustment calculations) desired by either party must be set out clearly in the contract at the outset.

Any downward changes to such adjustments (or adjustment calculations) cannot be made unless the dairy farmer has been given at least 30 days' written notice of any proposed downward changes and for the avoidance of doubt, no changes should ever be made retrospectively*. Companies recognise that downward price movements are undesirable.

The contract must allow the dairy farmers to terminate their contract with the processor without penalty on a maximum of 30 days written notice from the date of notification (or shorter period where the contract is due to expire in less than 30 days) to the farmer of any change made by the processor to the price adjustment(s). Such notice may be served by the dairy farmer at any time within 30 days of receipt of notice from the processor of any price change.

5. Loyalty Payments

A farmer is entitled to all loyalty and other payments where they have supplied to the end of a contract and/or term irrespective of whether they remain a supplier post a contract.

6. Volume/Exclusivity Clauses

If a farmer produces more milk than required or contracted to their primary processor, then they have the right to negotiate other supply options for the additional milk produced.

This clause will also apply if the primary processor is prepared to take milk in addition to the contracted volume at a lower price.

7. Contract Duration

Supply agreements may be for fixed terms or may be rolling arrangements.

8. Termination/Notice to Terminate

For fixed term contracts notice of termination needs to be a minimum 90 days, and/or by mutual consent, but farmers must supply to at least the end of the contract period.

9. Termination on Fundamental Breach

The contract must allow either party to terminate the contract with immediate effect if the other party fundamentally breaches the terms of the contract.

The contract should specify what would constitute a fundamental breach by either party.

10. Dispute Resolution

A contract must include a clause which describes the process on how disputes between the parties to the contract will be managed.

11. Review

It is proposed that the completed best Practice Code on Contractual Arrangements as agreed by industry be reviewed after one year and then subject to a review every three years or whenever a need arises. A review could be requested by one or more parties to the Code. ADIC will take responsibility for initiating any review.

Addendum

A description of rationale for each of the elements of the code for Explanatory Purposes only

1. Transparency

The Australian dairy industry operates in a global market place and farmers and processors work to adapt their practices, prices and strategies to accommodate its volatility.

This Code reflects the need by both parties to provide certainty for their businesses. Farmers need as much certainty as they can get – particularly in relation to price and payment issues. Similarly, processors need a security of supply.

Clauses in a contract should clearly and simply state the mutual obligations of both farmer and processor.

Processors should ensure that any forecasts for forward pricing and volumes are sufficiently transparent so-as-to allow farmers to make their own assessment as to their veracity.

To further aid in transparency it is important that contracts are fair, simple, realistic and easily understood by both parties.

Many standard form contracts have confidentiality clauses over the whole contract which clearly does not aid transparency.

It is acknowledged that some elements may need to be confidential but there should be greater transparency to aid comparison by dairy farmers. Processors should remove these clauses from applying over the whole contract and also, for the purpose of comparison, to put all versions (excluding any confidential clauses) of their standard form contracts on their websites.

2. Pricing

Contracts between farmers and processors must set out either a clear price, and/or a clear pricing mechanism (such as a formula) or a price notification process (the process by which the processor notifies the producer of the price), such that at any given point in time, a producer can be certain of the base milk price that will be paid for the milk produced.

Processors should negotiate contracts which have a price or a pricing mechanism that:

A. is negotiated and agreed between the farmer and the processor; or
B. price notification process that is at the processors discretion.

Whether the processor offers contracts under (A) or (B) above, the contracts should at all times comply with the requirements of this Code for each of these options, set out below.

Processors are encouraged to offer farmers two or more different pricing options to enable discussion with farmers on the pricing model which best suits their farming system, the market for their milk and their preference for risk or security.

In all circumstances, the contract must provide that producers will be given at least 30 days written notice of any downward change to the price, or pricing mechanism or price notification process, and for the avoidance of doubt, the contract should not permit any downward changes to the price, changes to the pricing mechanism, or change to the price notification process to be made retrospectively. For avoidance of doubt, this does not apply to step-ups or price increases.

Option A – Negotiated Milk Price

Under this option, the milk price, or the pricing mechanism, is negotiated and agreed between the farmer and the processor in advance. The contract must set out:

a. what has been agreed by negotiation at the outset, whether that be a fixed price for a period of time, or a pricing mechanism (such as a formula); and
b. how variations to the price or pricing mechanism are to be negotiated and agreed (including any dispute resolution process).

A price notification process is incompatible with this option A.

Processors may negotiate and agree pricing with individual producers. Processors using this option must be able to demonstrate that the pricing was individually negotiated, and agreed, with each producer (for example, by maintaining a written record of the negotiation).

Processors are also encouraged to negotiate and agree pricing with recognised farmer Collective Bargaining Groups (CBG) where the farmers have given the CBG representatives authority to negotiate and agree pricing on their behalf.

Option B – Pricing at Processors Discretion

Under this option, the milk price, or the pricing mechanism, or the price notification process is at the discretion of the processor (i.e. the processor has the ability to set the price, price mechanism, or price notification process.).

Contracts under this option must set out clearly at the outset:

a. the price, pricing mechanism or price notification process that the purchaser has opted for; and
b. how variations to the price, pricing mechanism or price notification process will be dealt with.

In all cases where the contract is made under this option B, the contract must expressly:

a. state that no downward variation to the price or to the pricing mechanism or price notification process will be made by the processor unless the processor has given the farmer at least 30 days' written notice of any such changes (and for the avoidance of doubt, no contract should allow the processor to make retrospective downward changes to pricing in any circumstances);

b. allow the farmer to terminate their contract with the processor without penalty on a minimum of 30 days' written notice following notification (or shorter period where the contract is due to expire in less than 30 days) to the farmer of any reduction made by the processor to the price, pricing mechanism or price notification process. Notice by the famer must be submitted within 30 days of receipt of the written notification of any downward change to the price, pricing mechanism, or price notification process; and

c. state that the processor undertakes to put in place a mechanism to engage in dialogue with the farmer or the farmer's authorised Collective Bargaining Group (where such a mechanism has been agreed by the processor with the farmers CBG), or a mechanism to formally consult with the farmer or the farmer's CBG (where such mechanism has been agreed by the processor with those farmers CBG) in advance of any variations to pricing.

In respect of 'b' above, farmers and processors may agree a longer notice period, beyond the 30 days' notice period, provided that such longer notice period is agreed through a process of negotiation with the farmer or a farmer's CBG.

Where a farmer has given 30 days written notice (or other agreed notice period) of terminating their contract, there will be a~~A~~ cooling off period of 21 days~~ applies~~ to rescind the notice to terminate for the farmer from date of notification by the processor of a change.

All of the above specifically applies to price changes (with the exception of opening price declarations) or other supply arrangement changes during the contract term.

3. Pricing Mechanisms

Where the contract provides for a pricing mechanism (as opposed to a fixed price or a price notification process), such as a pricing formula, the contract should specify:

a. the exact pricing mechanism / formula to be used; and
b. how any variations to the pricing mechanism / formula are to be dealt with.

4. Contractual Variations – e.g. Step-ups and Step-downs

The actual price paid to the farmer may be subject to adjustments, provided that such adjustments are compliant with the Code.

In all cases, any potential adjustments, including pricing (or adjustment calculations) desired by either party must be set out clearly in the contract at the outset.

Any downward changes to such adjustments (or adjustment calculations) cannot be made unless the dairy farmer has been given at least 30 days' written notice of any proposed downward changes and for the avoidance of doubt, no changes should ever be made retrospectively*.

(*Dairy farmers and processors may agree a longer notice period, beyond the 30 days' notice period, provided that such longer notice period is agreed through a process of negotiation.)*

The contract may provide for the following examples of adjustments, provided that any calculations pertaining to such adjustments are specified in the contract and are clear at the outset:

a. cents per percentage of any measurable constituent content (e.g. percentage of butterfat content);
b. seasonality adjustments designed to incentivise a certain profile of production (e.g. cents per litre deductions/additions by month);
c. transport payments (e.g. deductions/additions for volume loaded into a tanker at collection);

d. milk quality payments (e.g. deductions/additions for somatic cell counts), in which case the testing methods for such quality assessments, and appropriate appeal mechanisms, should be clearly specified in the contract. With exception of law changes in quality issues;
e. production methods (e.g. conforming to specified animal welfare requirements); and/or; and
f. bonuses for continuity of supply.

The contract must allow the dairy farmers to terminate their contract with the processor without penalty on a maximum of 30 days* written notice from the date of notification to the farmer of any change made by the processor to the price adjustment(s). Such notice may be served by the dairy farmer at any time within 30 days of receipt of notice from the processor of any price change.

Step-Ups and Step-Downs

Farmers understand that if they are going to accept step-ups then, on rare occasions, due to global market conditions or other mitigating factors, there may be a need for step-downs.

Farmers and processors need to work together on a process for the timing of future step-downs and also to ensure there is more transparency and reporting on the financial and business reasons for a step-down from processors with detailed explanations provided to farmers and the industry generally.

~~The industry~~Processors ~~needs to ensure~~should make every effort to minimise~~ that~~ the possibility of step-downs late in the season~~ do not happen~~. A step-down in the second half of the year means that many farmers cannot plan, budget and adapt for the new pricing. Dairy farmers and processors need to work together on the timing of any future step-down in price.

Processors should give a commitment in the contract that where a step down in price is required, they will make every endeavour to ~~ensure any step-down will occur~~ give notice in the first half of a season.

5. Loyalty Payments

If a farmer has supplied milk to a processor for an entire season and then wants to move to another processor, then it is appropriate they receive all payments that accrue over the period of the contract or supply agreement with the processor.

These payments should not be contingent on the farmer being a supplier when, for example the June payment is made in mid-July, as currently applies in a number of processor arrangements.

Processors recognise the sensitivity of this issue and will ensure, through their contracts with farmers, that all payments, including bonuses and step-ups, are treated equitably to all their suppliers within a contract term.

If a farmer supplies to the end of a contract then all payments accrued in that year will be paid irrespective of whether they remain a supplier post a contract or not.

6. Volume/Exclusivity Clauses

If a farmer produces more milk than required or contracted to their primary processor, then they have the right to negotiate other supply options for the additional milk produced.

This clause will also apply if the primary processor is prepared to take milk in addition to the contracted volume at a lower price.

The code does not preclude a processor of a farmer negotiating exclusivity in their contract.

Where a farmer has a contract with a processor and wishes to expand their production and a processor does not want to purchase the additional milk under the same contractual terms and conditions, the contract between the farmer and processor must allow the dairy farmer to supply the additional milk to other processors.

Most dairy farmer/processor contracts have previously required exclusivity clauses that preclude the farmer supplying more than one processor.

An example would be an exclusivity clause in a contract that prohibits a farmer from selling the milk deemed surplus to its processor's requirements to another processor; or forces a farmer to take a lower price for milk supplied above a specified contracted volume, which impedes the farmer's choice about the way they choose to farm and may lead to the farmer being forced to reduce their milk production.

The lack of the ability to have dual supply where there are contractual limitations on volume restricts a farmer's ability to invest, grow and innovate.

Contracts which deny a farmer a right to sell their product to more than one entity where one entity does not wish to take all the farmers milk under the same contract terms and conditions are arguably anti-competitive and could be a breach of the Trade Practices Act.

This inability to supply a third party puts a cap on the future growth of dairy farming businesses that may affect the future viability and scale of their business.

Farmers acknowledge that it would be a reasonable expectation for a processor to require separation of their contracted milk from milk supplied to another processor to ensure their milk supply and quality terms have been met. However, farmers' also note it is possible for a farmer to have a second vat installed to store milk and facilitate the supply of milk to another processor, which should satisfy the requirements of the contract with the original processor.

Farmers acknowledge a contract which provides for non-exclusivity of supply should contain clauses which provide for assurance of supply terms and conditions required by a processor to be met and these conditions should be negotiated between the farmer and processor.

Changing Contracts between Processors

If the farmer and processor agree to terminate their supply contract it is to the benefit of both parties that the transition arrangements are negotiated and agreed to minimise the risks to both parties.

It is acknowledged that competition for supply would be to the benefit of both farmer and processor to mutually agree to facilitate transition arrangements from one processor to another to minimise the risk to a farmer from being out of contract where contract periods do not align.

7. <u>Contract Duration</u>

Supply agreements may be for fixed terms or may be rolling arrangements.

8. <u>Termination/Notice to Terminate</u>

For fixed term contracts notice needs to be minimum 90 days but must the farmer must supply to at least the end of the contract.

Termination notice periods should be negotiated and agreed between farmer and processor and defined in the supply agreement or contract, including any penalties to be applied (subject to the other provisions of this Code):

The contract should specify how notice is to be served by either party.

Farmers are of the view that there are termination periods in the industry that are excessive. There are contracts between farmers and processors that have termination notice periods of up to six or twelve months. In some cases, notice cannot be given until the contract term has concluded.

For example, a processor commences its contracts in January, and requires six-months' notice for a termination of supply from farmers. This means that a three-year contract can last almost four years, if a contract is signed late in one year and notice is provided at the end of the period of the contract.

Another processor includes a 12-month termination clause, requiring no greater <u>and</u> no less than 12-months' notice of termination of supply, leaving farmers with a very small window in which they are able to advise that they wish to terminate supply.

In most cases, it appears no such clause exists for the processor.

Contracts between farmers and processors should provide for a reasonable notice of termination period which is negotiated between the farmer and the processor and should apply to both parties.

9. <u>Termination on Fundamental Breach</u>

The contract must allow either party to terminate the contract with immediate effect if the other party fundamentally breaches the terms of the contract.

The contract should specify what would constitute a fundamental breach by either party.

10. <u>Dispute Resolution</u>

A contract must include a clause which describes the process on how disputes between the parties to the contract will be managed.

Other Terms to be Specified in the Contract

The contract should also specify, for example:

a. parties to the contract: the legal identity of the parties to the contract and their addresses for service;
b. volume measurement: the method to be used to measure the volume of milk collected;
c. timing of payment: either monthly or four weekly and the date in the month on which the payment should be made;
d. sampling process: the method used to take samples from the milk;
e. legal obligations: compliance with any applicable state and national regulations;
f. processor obligations: compliance by the farmer with processor requirements in respect of any applicable schemes or assurance standards;
g. force majeure: the contract should specify what events constitute events of force majeure, and how such events will be dealt with;
h. property and risk: point of transfer of ownership of the milk and risk in the milk;
i. assignment (assignation): the circumstances under which the contract can and cannot be assigned by either party must be specified but in any event neither party should be entitled to assign their rights and obligations under the contract without the other party's written consent;
j. provision of insurance: any obligations on either party to insure should be specified;
k. confidentiality: whether any confidentiality obligations apply; and
l. governing law and jurisdiction: these should be specified in the contract.

11. Review

It is proposed that the completed best Practice Code on Contractual Arrangements as agreed by industry be reviewed after one year and then subject to a review every three years or whenever a need arises. A review could be requested by one or more parties to the Code. ADIC ~~be~~ will take responsible for initiating ~~the~~ any review

The review process would assess the Code's effectiveness and compliance and examine any issues raised with the operation of the Code.

Notwithstanding the review, the parties may raise concerns regarding the adoption, use or interpretation of the code at any time.