SUBMISSION TO THE ACCC INQUIRY INTO THE AUSTRALIAN DAIRY INDUSTRY

This submission informs the ACCC enquiry based on the workings of the dairy industry in Western Australia, specifically from the viewpoint of Brownes Foods Operations Pty Ltd (Brownes).

Introduction

Following decades of market milk regulation, since 2000 the dairy industry in WA has suffered a number of setbacks due to, by and large, its failure to adjust to a post deregulation world. At the time of deregulation WA had 400 dairy farms producing 412 million litres of milk from 65,000 cows. A significant number of farms failed to rapidly adapt and restructure their operation to remain viable in an open unregulated market. As a consequence, WA today has around 160 dairy farms, milking approximately 55,000 cows and producing approximately 390 million litres at the end of 30 June 2016.

While consolidation occurred and average production per farm increased, the industry continued to remain focused on producing fresh drinking milk for WA as it had for decades before deregulation. This meant that investment in processing equipment for storable milk (cheese, butter, powder) was negligible pre and post deregulation resulting in sub-scale, nationally and internationally uncompetitive plants and infrastructure, that are no longer in operation, presenting the state with unique challenges in times of significant surpluses as currently is the case.

The dairy supply chain in WA is broadly similar to that in other states, however, supply chain costs are significantly higher. This is due to farms being spread over a wide area in the South West with relatively much smaller production scale. It is estimated that the cost of moving milk from farm to processing plant and then to local customers or port for export to be approximately three times that of larger producing states like Victoria. Also despite its geographic proximity to Asia, the cost of moving milk from WA in refrigerated containers from Freemantle is up to 20% more expensive than East Coast ports.

WA milk production is highly seasonal with frequent imbalances between supply and demand. Shortages are typical over the summer months while surplus production is typically available from late autumn and into winter. The average peak to trough ratio is approximately 1.5. At the same time, monthly milk consumption is typically flat, averaging 24 million litres per month in 2016. There has been minimal growth in consumption of fresh milk in recent years.

The excess supply over demand in 2016 after allowing for exported milk was approximately 70 million litres with no home for it. This explosive increase was driven by a record growing season, high farmgate price and favorable contractual conditions, all of which will be expanded on later in this document.

Despite numerous studies carried out by government and non-government bodies since deregulation, it appears that few of the recommendations, if any were taken up by the WA dairy industry as evidenced by the number of crises that have beset it.

The domestic milk market in WA cannot and will not underpin sustainable growth for the industry or individual dairy farms, as a result of the aggressive discounting of branded milk in supermarkets. This not only has eliminated brand premiums, but has effectively put a lid on market share growth as well as effectively acting as price setter for the market. According to the most recent Aztec scan data reports, private label milk market share in WA sits at 34.5%.

Sustainability will only come about by being a competitive player nationally and internationally, specifically in Asia. Long term profitability in the export market is more likely to come from the development of high value products and improved cost competitiveness of the supply chain.

Competition for milk

Milk Supply Dynamics in WA

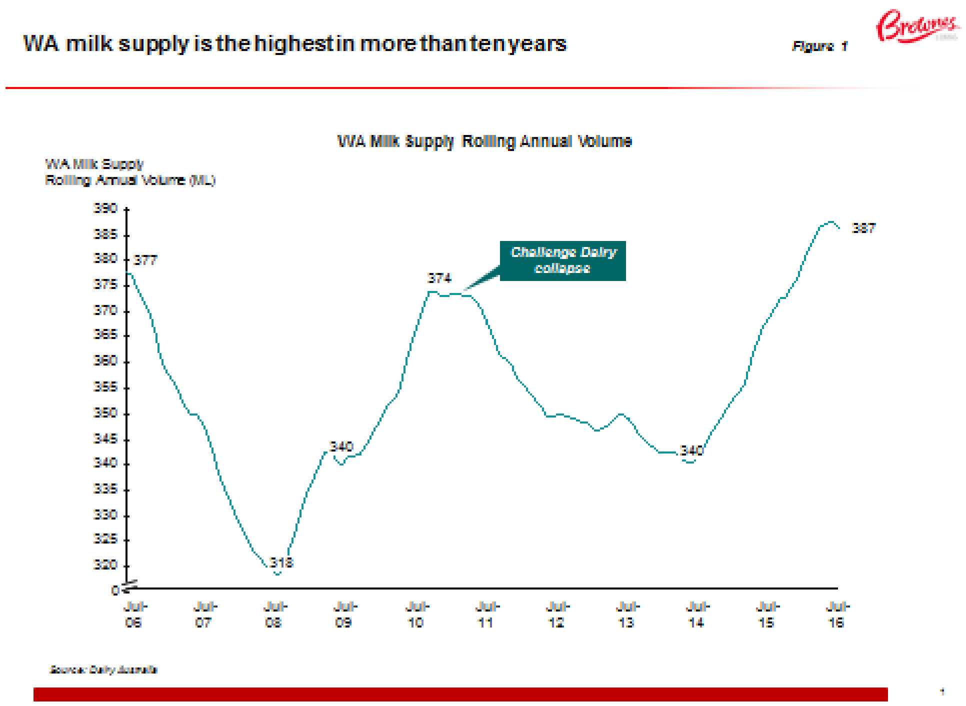
The State's production predominantly caters to local demand. Export volumes are relatively small due to the significantly underdeveloped nature of export business compared to the East Coast.

WA milk production experienced explosive growth since the middle of 2014 culminating in the highest production in 10 years (*Refer Figure 1 below*). This was driven by:

- High farmgate milk prices, including additional growth incentives offered by Harvey Fresh (Parmalat) and Lion. Brownes does not offer growth incentives.
- Attractive longer term contracts with uncapped supply
- Outstanding seasonal growing conditions in 2015 not experienced in 15 years, continuing into 2016

The above factors resulted in total production of approximately 390ML for 12 months ending June 2016 vs total market demand of 285ML (284ML in 2015).

Surplus milk has traditionally been processed for bulk export or into UHT packs by Parmalat, bulk cheddar cheese by Brownes, and/or transported interstate by Lion Nathan and Harvey Fresh at a loss. Both Lion Nathan and Harvey Fresh have processing plants in other states, whereas Brownes operates only in WA. Despite the advantages of geographic proximity to Asian markets, demand for export of fresh milk from WA for Asian markets collapsed in 2015/2016 due to over-supply of significantly cheaper milk from Victoria, Europe, and the USA. This also coincided with slower demand growth in Asia.

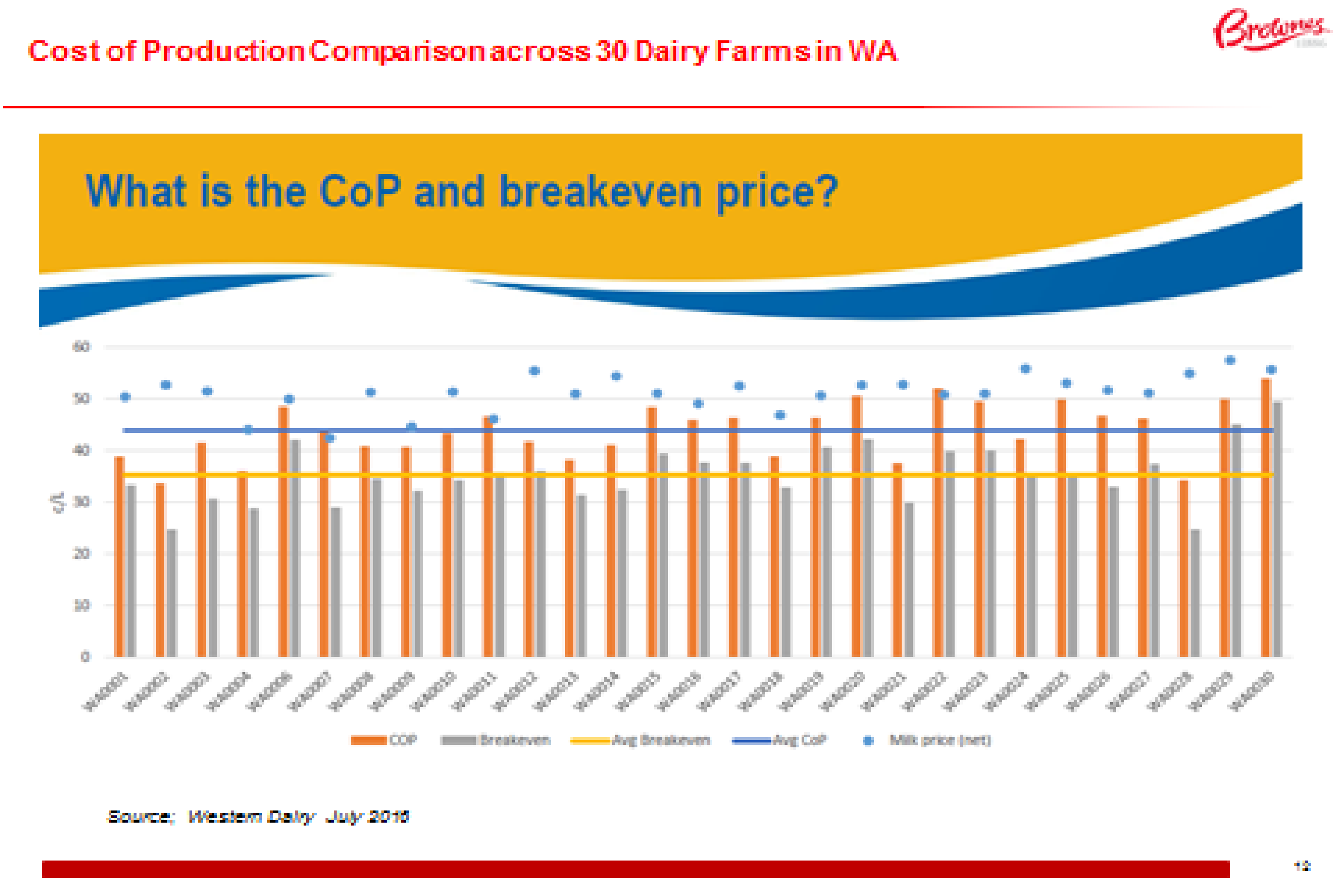


The deregulation of the dairy industry in 2000 created a whole new set of dynamics in the domestic milk supply chain. Dairy farmers and processors rapidly found themselves in a position of significantly weaker market power compared with the giant national retail chains.

To compound this problem, the rapid market growth of generic milk put processors in an extremely difficult position whereby supermarkets were no longer their most important wholesale customer, but also their most powerful retail competitor with significant leverage.

Since the introduction of nationwide milk tendering by Woolworths in 2000 and $1/L pricing by Coles on Australia Day in 2011, the consumer and supermarket chains have been the big winners. Whilst consumers and retailers have gained substantial benefits from deregulation, the continued downward pressure on milk prices has seen a 60% decline in the number of dairy farmers in WA due to lack of competitiveness.

There remains a wide range in the cost of milk production between Western Australian dairy farms. It appears that some dairy farms have not made the necessary changes required to remain profitable in a highly competitive marketplace. A recent study by Western Dairy illustrates this in the figure below;



The study also found that despite farmers regularly complaining about price, price variation alone has an impact of only 33% on profitability, whereas variable and overhead cost variations have an impact of 89% and 203% respectively. This clearly supports the contention that many dairy farms have not restructured

their operation to cope in a highly competitive market, or are simply oblivious to market dynamics and continue to adopt a cost plus mentality.

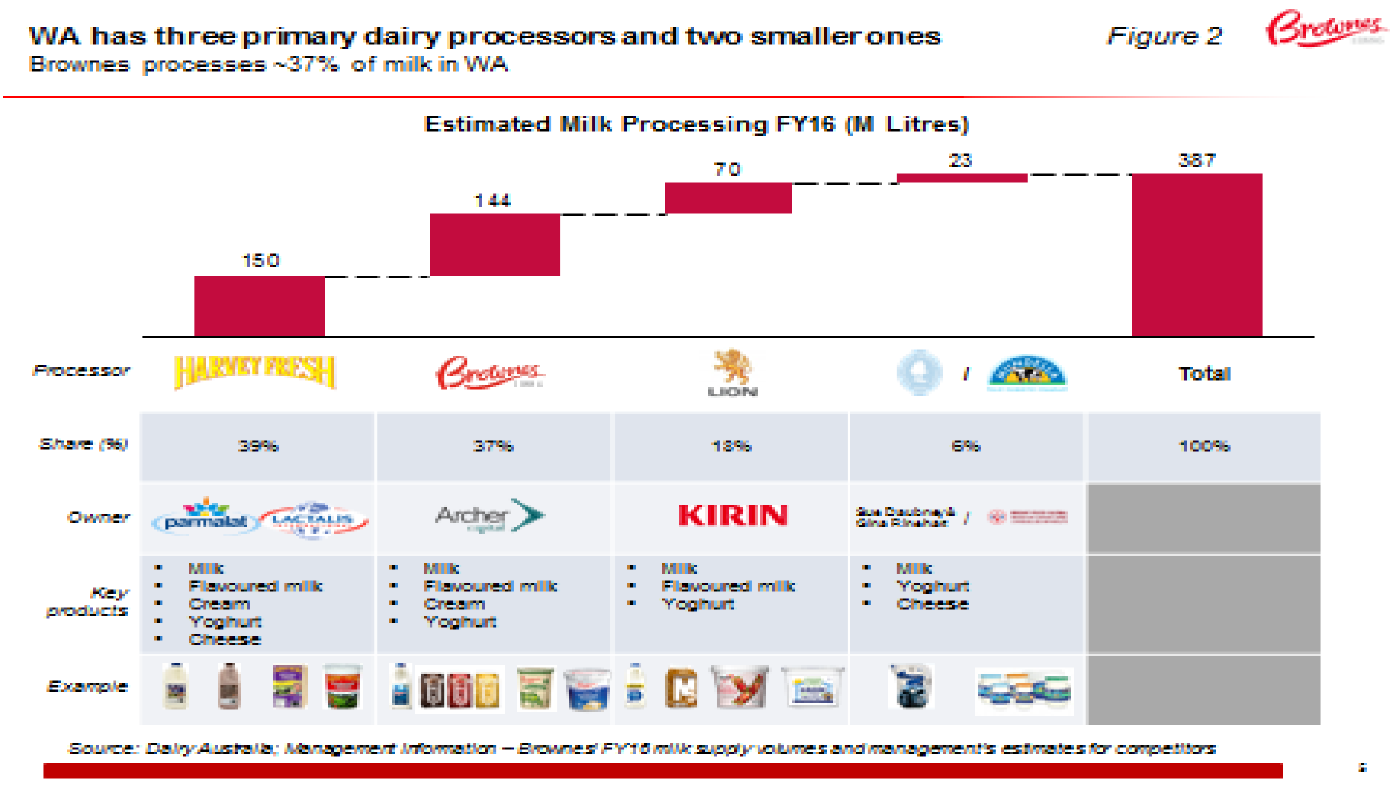
In 1999 in its inquiry into deregulation, the Senate Rural and Regional Affairs and Transport References Committee warned of the need to avoid "a commercially driven crash" in the dairy industry. In WA this crash occurred in 2000 following deregulation, again in 2010 following the collapse of the Challenge Dairy Cooperative, and again in 2016 following a 35% excess supply to demand.

The erosion of processor margins have been of such scale that capital investment in research and development as well as upgrading plant and equipment, beyond maintenance capital, have become unviable.

Competitive participation in the domestic and international markets is critical if the Western Australian dairy industry is to be sustainable. Dairy farmers must provide a competitively priced product to Western Australian processors for domestic consumption and export. Efficient farm practices together with contemporary business structures are critical to Western Australian dairy's competitiveness.

Competition and Contracting Practices for Milk in WA

There are three main processors in WA that compete for milk supply. These are Brownes, Harvey Fresh (acquired by Parmalat in 2012) and Lion Nathan. Together they account for 94% of raw milk purchased from dairy farms (*Refer Figure 2 below*).



WA does not produce a large enough amount of milk, to enable any of the three large processors to operate at scale. Industry analysis recently carried out by Coriolis (a consultancy) suggests that the average processing capacity is circa 120ML per plant. This compares with 750ML per plant in NZ.

Larger and more modern scale plants have the advantages of higher labour and equipment productivity, thereby lowering the overall unit cost of production.

The significant deterioration of processor margins since deregulation and the introduction of $1/L milk mean little beyond maintenance capital is ploughed back into plant upgrades or research and development.

Contracting Practices

All processors purchase their milk via exclusive bilateral supply contracts. The majority of these range in duration from 3 to 5 years, and the remainder are either shorter or longer in duration. Contracts predominantly operate on financial year cycles although this may possibly change with the acquisition of Harvey Fresh by Parmalat, a December balancing company.

Most terms and conditions are fairly generic and pertinent to the supply of raw milk, however, it is understood that both Lion and Harvey Fresh offer growth premiums as well as penalties for under supply. Brownes does not offer growth premiums nor does it penalise farmers for under supply.

Subject to serving termination notices in contracts (usually 12 months), farmers are free to move between processors when their contracts expire. Loyalty bonuses are not a feature of supply in WA, and farmers are generally loyal to processors and very few tend to switch processors at the expiration of their contracts.

Those that do, do so for higher prices on offer and corporate structure does not appear to play a role in farmer decision to move. For example, in 2015 four farms chose to move from Brownes to Lion due to higher prices offered ahead of Lion securing additional volume to supply the Coles private label contract under negotiation at that time. The Coles contract was previously supplied by Harvey Fresh since 2011.

Regular milk trading or swaps between processors is not a feature of the WA dairy industry.

Pricing

In the case of Brownes, pricing is usually reviewed annually and set for the ensuing 12 months period commencing 1 July. Price adjustments are prospective and never retrospective. It is likely that the two other processors adopt similar methodology. As contracts are commercial in confidence, pricing is not generally disclosed in the public domain and there is no advertised base price as is the case in the East.

Pricing is based on a number of factors such as;

- Components in the milk in terms of $/Kg of fat and protein, translated into cents per litre.
- Quality grade based on somatic cell count, total plate count and temperature
- Grade 2 is regarded as the norm, with Grade 1 attracting a premium and Grade 3 and 4 attracting penalties. Grade 5 milk is not regarded as fit for human consumption and is not accepted. Also milk containing antibiotic or contaminated is usually rejected

Pricing is determined relative to market competitive pressures, and milk supply and demand. In recent months and since prices have significantly reduced in Victoria, national tenders have become more prevalent, and Brownes consequently lost a number of long standing customers as it either could not match the national price offered or simply dropped as a local supplier without a national footprint. Brownes operates in WA only whereas its two main competitors operate nationally.

Step-ups and Step-downs are not used in processor contracts in WA.

In recent years farmgate prices in WA have been on the increase despite falling prices and margins at the supermarket shelf and export markets. Processors have borne the brunt of market pressure, effectively divorcing the farmgate price and suppliers from the aggressive competitive environment in the local and export markets. The combination of favourable farmgate prices and long term uncapped contracts have no doubt contributed to unsustainable levels of supply the WA dairy industry finds itself in today.

Domestic Retail Market

The major supply channels in the WA retail market are very similar to others in Australia where Coles and Woolworths by and large dominate the market. Other players include Metcash IGA and since June 2016, Aldi, with 15 stores opened and on track to open a further 2 by 2017. Spud Shed is the third tier player and heavy discounter with 7 established stores and growing. Petrol & Convenience chains together with the above wrap up the majority of the retail space.

There is no doubt that the introduction of $1/L pricing has had a significant negative impact on predominantly processors. Further, processors suddenly found their biggest wholesale customers have turned also into their formidable competitors, with considerable leverage over other dairy products supplied by processors, not just milk. This has led to price drops across all retail customers as processors were now competing with Coles and Woolworths.

In an attempt to gain share and shift surplus milk, it was not uncommon during 2015 and 2016 in the Perth market to see price fighter brands discounting milk to $1.60 for a 2L bottle of regular milk at outlets such as Spud Shed and IGA despite the cost to shelf being the same as for major brands. This price is below the cost of production. The market risk hitherto has been absorbed by processors not farmers.

All major retailers operate under their own Terms & Conditions of Purchase (TCP) as opposed to formal contracts of supply, with the exception of tolling agreements for private label supply.

TCPs contain "Trading Terms", effectively the price required for a processor to getting their branded products on the shelf. For branded white and flavoured milk products Woolworth charge 14.08% while Coles charge 13.2% of the retail price. In the case of other dairy products and juice, Coles charges 15.65%.

In addition to the above, all promotions are fully funded by the processor, in other words the retailer's margin is always protected. This can be very detrimental to a processor if there are multiple and frequent promotions between competitors, effectively all competing for a smaller share of shelf. For example during 2016, flavoured milk promotional activity in Coles increased by 40%, significantly eroding processor margins through effectively reduced volume share on crowded shelves.

Failure to perform on shelf as a result of the above will result in potential deletion of some stock keeping units at periodic supply review times.

Brownes Profile

Brownes is Australia's and WA's oldest dairy, celebrating 130 years in 2016. The company is wholly Australian owned, and is the only major independent dairy processor in WA.

Brownes locally purchases & processes approximately 144ML of raw milk, equivalent to 37% of the state's production, from a contracted supply base of 53 farms.

Brownes operates from its main processing plant at Balcatta, a northern suburb of Perth located approximately 15 kilometres from the CBD, employing 255 employees. The plant manufactures white milk, flavoured milk, yogurt, cream and other dairy products.

Browns also operate a small plant located in the South West at Brunswick Junction. This plant used to, among other things, produce commercial quantities of cheddar cheese, however, since December 2015 its sole function is the staging of milk delivery from farm to Balcatta.

End..