ACCC inquiry into the Australian dairy industry

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NSW Farmers' Association Background
The NSW Farmers' Association (the Association) is Australia's largest State farmer organisation representing the interests of its farmer members – ranging from broad acre, sheepmeat, cattle, wool and grain producers, to more specialised producers in the horticulture, dairy, egg, poultry, pork, oyster and goat industries.

Executive Summary

The NSW Farmers' Association (the Association) is Australia's largest State farmer organisation representing the interests of its farmer members. We appreciate the opportunity to comment on the Issues Paper, and highlight the concerns of dairy farmers in NSW.

Within Australia, dairy producers face a number of challenges that threaten the sustainability of their businesses and the industry as a whole. A lack of competition between processors has meant that dairy farmers are price takers, receiving less than the cost of production for their product. The key issues identified within this submission are a lack of competition between processors, unfair contract terms, impact of $1 per litre milk on the industry and lack of transparency and communication from processors as significant concerns.

The structure of the dairy industry is unique, having undergone a shift from a regulated to deregulated market. Producers, processors and retailers have had to adapt to meet these market conditions. The majority of dairy processors are now internationally owned and export product out of Australia into the global market, tying the domestic milk price to a volatile market currently characterised by low prices and oversupply.

Despite this, there continues to be a high demand for locally produced fresh drinking milk and dairy products in Australia. The Association welcomes the ACCC review as a first step in ensuring the future sustainability of the dairy industry.

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Introduction

The dairy industry in New South Wales

The dairy industry in NSW is characterised by a number of medium sized enterprises typically producing milk for the domestic milk drinking market. In 2014/15 there were 215,000 dairy cows across 704 registered dairy farms each producing more than 1 billion litres of milk annually. The estimated gross value of milk production for 2015/16 is $584 million.[1]

The NSW dairy industry is largely domestically focused with the value of exports being only 2 per cent the value of production in 2015-16. Of the milk that is not exported, around 62 per cent is sold to the domestic milk drinking market, 27 per cent is used in manufacturing dairy products that are consumed within Australia, and the remaining 11 per cent is used to produce dairy products that are exported.

Dairy production in NSW faces a number of geographic and climatic challenges which result in differing production systems. Dairy farms located in the south of the state are typically characterised with their milk being part of the southern milk pool, whereas those located further north (both inland and coastal) commonly use a year round production system. Dairy farmers throughout the state are reliant on having continual water access, through irrigation licenses as well as access to feed from out of season and off-farm sources.

The major processors in NSW are Norco (13per cent market share), Parmalat (16per cent), Lion (7per cent), Fonterra (6per cent), Bega Cheese (16per cent), DFMC (18per cent) and Murray Goulburn (22per cent).[2]

[1] Dairy Australia 2016, *Australian Dairy Industry in Focus 2016,* p. 3-10
[2] Freshagenda 2014, *Growing the NSW Dairy Industry – Report to NSW Government*, p 14

Issue 1 – Competition for milk

1. The level of competition between processors for the acquisition of milk, across regions

Competition between processors varies across the regions of NSW. Some areas are limited to one or two processors, such as the far north coast and central west of the state. Other regions have the option to supply to numerous processors.

Milk swaps confuse the issue of competition, particularly in areas where competition between processors is limited or non-existent. Swapping milk is a commercial decision made by the processors, yet this limits the producers' ability to participate in the market themselves. This is most relevant to areas where milk is swapped to processors who are not willing to pick up from these locations under a regular contract.

Exclusive supply clauses are commonplace in dairy supply contracts. They have effectively limited the ability for a producer to innovate their business, either through vertical integration of their own small processing business or securing separate income streams through dual supply. Dual supply clauses can currently be negotiated in particular circumstances but only with some processors. To improve competition within the industry, exclusive supply clauses should be removed and replaced with a minimum supply amount, allowing farmers to make their own business decisions regarding their milk and production capacity.

Lack of competition contributes to the position of producers as price takers within the industry, without an option to move to another processor with better prices or contract terms.

2. The ability of producers to switch between processors or other buyers

The Australian dairy industry is an example of as a 'thin market', with a low number of buyers and sellers and therefore high price volatility. Competition between processors changes depending on the region, and in NSW some producers are not able to switch to a different processor. Producers in these regions have a lack of bargaining power and are at a serious disadvantage when it comes to negotiating contract terms or price. Our members have noted particular instances where there was competition between two processors in a region, however one processor withdrew and left them no choice but to supply the other processor (who had no obligation to take them on) or leave the dairy industry. Processors are also often reluctant to take on new suppliers, limiting the producer's choice in the matter.

Switching processors is also difficult when the majority of processors in Australia sign their contracts to the financial year, but one processor works to the calendar year, meaning that if a producer wants to switch to or away they face six months without a supply agreement. With a perishable product such as milk, producers are not able to store their product until they find a new processor, instead needing milk supply certainty at all times.

In areas where it is possible to switch processors, this is most often an emotive switch away from a particular processor, rather than a switch towards a processor because of their superior terms or price. In many cases, this is due to frustration regarding contract terms, lack of honest negotiation, and lack of communication from the processors.

Issue 2 – Contracting practices

3. The different types of supply contracts used across the supply chain and in certain regions

Supply contracts or agreements define the relationship between producers and processors. In accordance with the basic principles of contract law, contracts should be developed as an agreement between two parties but in the case of the dairy industry the process of contract negotiation is affected by an imbalance of bargaining power. This is particularly evident in areas where there is no or little competition, so the farmer must take the price and contract terms that they have been offered.

In recognition of the inequitable bargaining position of dairy farmers, in 2002 the ACCC authorised Australian Dairy Farmers to collectively bargain with milk processors.[3] Producers can form collective bargaining groups under ADF's authorisation, or seek authorisation from the ACCC separately. However, under the ACCC's conditions, because collective bargaining is a voluntary undertaking, processors are not required to accept a request to negotiate with the approved collective bargaining group.[4]

Contracts offered to producers are typically standard form contracts, with the result that producers feel like they must "take it or leave it", due to the lack of information and communication from the processors. The law relating to unfair contract terms has recently been updated to give small businesses some protection from unfair contract terms in standard form contracts.[5] The outcome of strengthening this law will be evident as small dairy businesses sign or update their contracts.

The duration of milk supply contracts varies between processors, with some offering annual renewals, and others locking suppliers in for up to three years. Longer contracts provide business certainty for the processor but limit the opportunity to revisit contract terms and keep the producer locked in without knowing what price will be offered for subsequent years. This puts the producer at a serious disadvantage.

Supply contracts do not cover all essential elements of the producer-processor relationship. The conditions around milk quality are not located within the contract, meaning they can be changed by the processor at any stage. These conditions are what is used to determine payments, bonuses or penalties, yet are not locked in for the duration of the contract.

The majority of contracts no longer include a minimum price. Minimum price is considered by producers to be a positive inclusion in all contracts. This provides certainty for producers, who benefit from the knowledge that they are guaranteed a minimum income for the duration of their contract, and can make their own strategic business decisions based on this amount. This measure would increase industry confidence, investment and growth.

Due to the privacy restrictions on contracts, ACCC should use their powers to investigate the discrepancies between processor contracts.

[3] Competition and Consumer Act 2010 (Cth), s88
[4] Dairy Australia 2014, *Collective bargaining for dairy farmers*, p. 5
[5] Competition and Consumer Act 2010 (Cth), Schedule 2, Part 2.3

4. Concerns about anti-competitive conduct or unfair trading practices, including unfair contract terms

Producers are not able to accurately compare contracts offered by different processors due to privacy clauses and the threat of collusion unless they are part of an ACCC-sanctioned collective bargaining group. However, there are particular contract terms that are generally known. Producers perceive these to amount to anti-competitive conduct, unfair trading practices or unfair contract terms.

General concerns have been raised regarding the amount of time producers are given to consider contracts at the point of renewal, the timing of pricing announcements and contract terms that seem to be inherently unfair. Some processors have clauses within their contracts that equate continued supply to producers being “deemed to have signed” contracts. This restricts the ability of the producer to change processor, amplified by the perishable nature of milk.

Dairy farms in NSW typically calve and produce milk all year round, which means on-going certainty about milk supply is crucial. This narrows the window of opportunity to question supply contract terms as the milk will still need to be picked up tomorrow. This in itself weakens the negotiation power of producers. Further, some processors only give two weeks for producers to consider the new contract. This limits the opportunity for independent legal advice, querying any changes and negotiating terms.

The price paid for milk supplied needs to be communicated to farmers appropriately. Producers are unhappy with the current approach to pricing announcements, with some processors making announcements six months before the season, and other processors announcing the price two weeks after the season has commenced. This restricts producer’s ability to compare prices and conditions offered by processors.

Changes to contracts, supply terms or price need to be communicated to producers clearly and ahead of time. Producers need time to transition their on-farm management to meet the new standard of supply which can take time and additional steps such as changes in nutrition or genetics.

Contract terms such as the use of step-downs can be unfairly applied to mitigate business risk encountered by the processors. This year has seen a number of processors readjust their prices retrospectively mid-season. This practice effectively penalises producers for the business forecasting and price setting decisions of the processor. It is especially questionable when processors that took this measure in 2016 recorded significant profits. “Step downs” and “claw backs” are detrimental elements of any contract, perceived as penalising the farmer for the commercial risk of the processor.

Some terms are not included in the contract, meaning they can be changed without the consent of or consultation with the producer. Minimum quality standards, targets and pricing are contained within supplementary documentation such as supplier handbooks. These are elements that producers are required to meet, however can be altered by the processor as they see fit. These terms need to be included in supply contracts and agreements, or processors need develop a formal process for communication of any changes to their suppliers.

Issue 3 – Transparency and price signals

5. How farmgate milk prices are set and communicated to producers

Transparency around milk price is crucial to the future of the dairy industry. Producers need to understand how prices are set to firstly know that they are getting a fair price for their product, and secondly manage their own on-farm costs and forecasting.

The process of setting farmgate milk price is not clearly understood by producers. The mechanisms used to determine price are different in each processor and not well explained. Even when producers attempt to understand and apply the pricing formula or matrix used to their own production figures, they can get different results. There is no convenient way to compare milk prices paid by different processors in real time.

Producers are often assured that a processing company sets a "competitive price", with no explanation of how this competitive price is ascertained. When the dual Murray Goulburn and Fonterra step down occurred in May 2016, some companies saw this as an opportunity to readjust their price while others held firm.

Communication and transparency around milk price needs to improve, and the ACCC might wish to consider examples from other countries as part of its inquiry. The Irish dairy industry does an annual review of the prices paid by each dairy processor, allowing farmers to consider and question the price they received, and make an informed decision about the coming year.[6] This retrospective price comparison would allow producers to see if the price they are receiving really is "competitive", and be used to verify other market information.

There needs to be improved communication about how the price is set at the start of the season, but also throughout the duration of the contract. Producers have reported instances of poor communication when prices are set, when prices are changed, and when producers ask direct questions regarding prices and contract terms. There have also been instances where the price is communicated after the season has already started, putting producers at a disadvantage in running their own businesses.

Producers are concerned that there is a growing disconnect between the people who are setting the price and the realities of running a dairy farm. There is no consideration of the actual cost of production, which has resulted in farmers getting paid below what it actually takes to produce the milk. With farms operating below cost, there is little left to plan for the future of the individual business and the wider dairy industry.

Even though price is tied to global market, the domestic industry needs to be sustainable to ensure the future supply of fresh and local dairy produce in Australia.

6. The availability and use of meaningful global market information and price signals across the industry, including by dairy farmers

Producers in NSW continue to have questions about the effect of the global market milk price on the daily fresh milk market in NSW and other states. There is a constant demand

[6] http://www.farmersjournal.ie/irish-farmers-journals-2014-milk-price-review-184781#.V9i7CIEGEVE.email

for Australian dairy products in the domestic market, which should translate to a consistent price for milk.

Information on the global dairy price is available, but the correlation between this price and the farmgate price paid to farmers is not well understood. There needs to be evidence of greater market analysis by the processors through transparent communication with producers.

Issue 4 – Domestic retail markets

7. The major supply channels for the domestic market, including major supermarkets and other retailers

The retail environment in Australia is perceived to have limited options for supply, with major supermarkets seeming to hold the power with regards to the sale and in-store promotion of both private label and branded dairy products.

The details of the supply contracts between processors and retailors are protected by confidentiality agreements, and the majority of the terms of these agreements are not known. One feature that is known is the supply for dairy products to a particular retailer can be for terms of 1 – 10 years. If the price is contractually set for 10 years, this could continue to hold the price artificially down, restricting natural inflation. It also fails to explain the price uncertainty experienced by producers.

The shelf position of branded dairy products is significantly limited compared to $1 per litre milk or private label products including cheese. It would be interesting to note whether this is the result of contract arrangements between the processors and retailers, and whether the retailers offer reasonable conditions to processors for in-store shelf location and promotion of branded milk products.

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.

The overwhelming feedback regarding $1 per litre milk is that it has had a negative impact on the dairy industry as a whole. $1 per litre milk was introduced by Coles in 2011 as a point of differentiation in an on-going retailer price war, but it has become a permanent feature of all major supermarket chains. Milk is a premium fresh product with significant nutritional benefits, however is sold for less than the price of bottled water.

Dairy Australia found that despite some claims, $1 per litre milk did not permanently increase milk consumption.[7] Dairy Australia also conducted consumer research which indicated that consumers think the price of milk is too low, and are concerned for the farmers involved. Consumers also showed a willingness to buy branded milk after the price step down by some processors was brought to light through traditional and social media in April 2016[8]. It is therefore clear that the retailers' decision to continue to sell $1 per litre milk is not a result of consumer demand.

In order to measure the economic effect of $1 per litre milk, more information is needed about the costs and margins along the entire supply chain. Producers are not privy to the contracts between the processor and the retailer, but are concerned how this affects the overall farmgate milk price and would like to see this closely scrutinised by the ACCC. This lack of clarity around supply chain cost and margins also applies to branded milk lines, with producers unable to see where the extra value created ends up in the supply chain.

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[7] Dairy Australia 2016, *Dairy Situation and Outlook - October 2016, p 14-15*
[8] *ibid*.

Producers in NSW are also concerned about the flow on effects for industry which appear to be growing uncertainty about the future, signified by a lack of on-farm investment. Producers have been forced to reduce on-farm costs through efficiency measures, however when these steps have been taken and the price doesn't improve, there is an issue somewhere else in the supply chain. It also means that as farmers try to reduce their on-farm costs, activities considered non-essential to the day-to-day milk supply are cut back, such as herd recording. This is a short term cost saving measure that will have a long term effect on the industry and the ability of farmers to manage their investment in their herd.

There are also effects that cannot be quantified, but that clearly exist. The psychological impact of $1 per litre is that if you tell consumers they should only pay a certain amount for a product, they will believe it. The issue arises when this price is less than the cost of production, and supply becomes unsustainable. This message also trickles down to the producer, who sees the price they are receiving for their hard earned product and feels at the very least disheartened, if not overwhelmed and unable to continue.

The issue of $1 per litre milk is now expanding to other dairy products, particularly cheese. Australians consume 13.5 kg of cheese (135 litres of milk) per person per year with around. 5 per cent of cheese consumption being cheddar types and the remaining 45 per cent is spread across the wide range of non-cheddar cheese varieties.

It is estimated that nearly 45 per cent of domestic sales of Australian cheese is through the major supermarket chains and is more focused on the cheddar types. As a result, a significant proportion, of predominantly specialty cheeses, are sold through smaller independent retail traders including delicatessens and specialty food stores, who are more readily able to adjust their pricing according to demand and supply signals.

The Association recognises the significant volumes of cheese that are produced and sold as private label products and also that there is significant demand for such products. It is therefore not the existence of these products in themselves that is an issue – it is the fact that they are used as a loss leading item which has devalued consumers' perception of the commodity that causes considerable industry concern and rightly, leads to concerns about long term viability of the industry.

The dairy industry in the United Kingdom has had similar experiences with major supermarkets introducing private label milk at discounted prices. Farmers there faced the situation of prices received (on average across the UK 23.66 pence per litre) being below the cost of production (on average between 30 and 32 pence per litre) which compounded their belief that their product had been devalued in the eyes of consumers both in today's terms as well as having no regard for the long term viability of the industry.

Issue 5 – Global markets

9. Options for supply into export markets, including products and destinations

The Association has supported and contributed to the advocacy work of the National Farmers Federation and Australian Dairy Farmers on international free trade agreements to ensure the Australian dairy industry has access to a variety of export options.

There have been some examples of successful export from NSW such as those from the a2 milk company. Norco has also been involved in sending fresh milk supplies directly to China.

10. Any barriers to selling into export markets

For a producer to enter into an export market, they would need to either vertically integrate their business or enter into a co-operative arrangement with other producers. Initial barriers to entry include capital expenditure to establish processing and storage facilities, brand design, identifying the relevant market, promotion and marketing and make the appropriate sales contacts overseas. Producers are also limited through contract terms such as exclusive supply clauses, risking their regular income if they investigate an alternative supply option.

While these barriers are typical to new businesses looking to export, they have proven to be a sufficient deterrent for the majority of dairy farms in NSW who do not have the spare capital to invest in new ventures due to the instability and uncertainty of the farmgate milk price.

Issue 6 – Production costs and profitability

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

The profitability of dairy farms is affected by input costs and the margin from the farmgate milk price. Feed is a significant cost for producers who grow or purchase quality stock feed that often incurs additional costs through on-farm management or freight. Electricity and water costs vary across the different regions, and cost reduction methods such as solar are not always available or appropriate for the working hours of the dairy sheds. Increasing the scale of a dairy farm is often thought to be the answer reducing input costs and becoming more profitable, however this incurs further costs with regards to property and infrastructure investment, and additional staffing. Investment into the future is also difficult for producers to plan when there is lack of certainty about income.

Additional income from selling cows into the beef market has been particularly beneficial over the past twelve months. Beef cattle prices in NSW rose due to the end of the drought and subsequent need to restock. Due to the volatility of the beef market, this is a source of income open to dairy farmers, however is not a sustainable or reliable alternative income source.

The Australian dairy industry operates in a high cost environment of a first world country where there are high and justified expectations of quality of product, environmental employment and animal welfare standards. Unfortunately, there is little price premium for such expectations - it would also appear that there is a double standard when dairy products arrive in the supermarket - the Australian consumer wants all these standards upheld yet seek to pay the lowest price, effectively a heavily discounted price. Producers are then not receiving a fair price for milk, and this affects the overall profitability of dairy farms.

Conclusion

The Australian dairy industry is not operating effectively, and is facing an uncertain future. The lack of competition for the milk supply has reduced producers to price takers, often forced to accept a price below the cost of production due to no other alternative options to supply. Producers instead try to stay viable through extensive on-farm cost reduction measures and a halt on investment. The price itself is volatile, tied to a global market through pricing mechanisms that are not understood due to a lack of communication and transparency from the processors. Processors are at the mercy of the major retailers, who have devalued a fresh and nutritious food source by artificially holding the price at $1 per litre as a means to compete with each other.

The ACCC inquiry into the dairy industry will hopefully shed light on the intricacies of the supply chain and bring transparency to the industry, creating a sustainable future for producers, processors, retailers and consumers. The Association looks forward to continuing to engage with the ACCC throughout this inquiry on behalf of our members.