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Submission to the Australian Competition and Consumer Commission

Inquiry into the Australian dairy industry

30 November 2016

By e-mail: dairyinquiry@accc.gov.au

Norco Co-operative

Norco Co-operative Limited is an Australian, farmer owned dairy co-operative governed by a Board of elected farmer directors that has been in business since 1895. Norco is based in Lismore (NSW) and currently has 334 active members on 218 supplying dairy farms across Northern New South Wales and South East Queensland. Total business revenue was $541 million last financial year. Operating business divisions Norco Foods and Norco Rural Retail / Agribusiness, Norco is a quality manufacturer, wholesaler and retailer of a range of dairy products including milk, cheese and ice cream, a retailer of a diverse range of agricultural products across NSW and Queensland and a manufacturer of stockfeeds and pet foods in both NSW and Queensland. Our dairy farms are spread from Kenilworth QLD in the north, west to Toowoomba QLD and down along the coastal fringe to Taree and Gloucester NSW in the south.

Issue 1 – Competition for milk

Norco believes that processor competition for milk supply is strong and that Members / Milk Suppliers ("suppliers") to the co-operative have the option to fully explore their options when their Milk Supply Agreement (MSA) renewal occurs. Norco offers its suppliers the opportunity to enter into MSA terms of either five (5) years, three (3) years or one (1) year or, as a member of the co-operative, a supplier has a right to supply and can elect to continue supply without a MSA, so flexibility exists in Norco's system for suppliers to choose the type of MSA or supply arrangement that best suits their needs. The 3 and 5 year MSA both have the option to extend automatically for another term of the same duration so for example, at the end of the first 5 years, the supplier can automatically roll the MSA for a second 5 year term. The Norco MSA also allows the supplier to give Norco 180 days notice prior to the end of the roll date to let Norco know that they will possibly leave the Co-operative and transition to another processor or by giving notice that they do not want their MSA to automatically renew they can defer the renewal up until the end date to allow for more time to assess their options before electing to renew a MSA or transfer supply to another processor. This gives the supplier the flexibility to review the market to determine if there is a better deal out there for them and several suppliers take this option, although it should be stated that in the current financial year, all suppliers have remained with the Co-operative.

Norco of course wants the supplier to stay with the Co-operative so we work hard to ensure that we are paying the best price we can afford. Our suppliers, as members of the co-operative, also have the added benefit of receiving a dividend on their shares, a rebate on their rural stores purchases and interest free terms on purchases made from our rural stores. The Norco Board discusses milk pricing regularly at monthly Board meetings to ensure our price is competitive and paying a competitive price is always at the forefront of the Board's strategy. Norco believes that the price it pays needs to be competitive in the market prior to the other supplier benefits on offer. Given the declining milk volumes in our region over the last few years and also the ability of suppliers to transition to a new processor at the end of their MSA, Norco is very aware that the milk price paid has to be competitive and sustainable to ensure that we maintain the milk supply needed to, in turn, meet the co-operative's contracted volume requirements to customers.

Norco believes that the main driver for a supplier to move processors is due to the price on offer and the stability of that price and as a result of that, Norco continually reviews its pricing strategy to ensure we remain competitive and to provide the highest possible returns to the co-operative's suppliers.

Regarding the over and under supply of milk question, Norco uses a lot of its spring flush milk in its ice cream factory. We also purchase externally small volumes of milk during autumn to meet our processing requirements. Norco uses milk swaps for logistics purposes only and this only accounts for approximately 2% of our total milk volume.

Issue 2 – Contracting practices

Norco offers its suppliers the opportunity to enter into Milk Supply Agreement (MSA) terms of either five (5) years, three (3) years or one (1) year or a supplier can continue to supply without a Milk Supply Agreement , so flexibility exists in Norco's system for suppliers to choose the type of supply arrangement that best suits their needs. Other processors in the region also work off Milk Supply Agreements or contracts with similar terms and the reason for that is, as a business, we have to ensure that we can meet our contractual obligations to our customers. Milk Supply Agreements also provide our suppliers with stability in their business so that they can apply for finance, invest in technology to improve productivity and make other business commitments that may improve their farming enterprise.

Norco is aware of the recent changes to the law to protect small businesses from unfair terms in standard form contracts and we have reviewed our Milk Supply Agreements to ensure that they comply.

Norco's pricing operates on a 12 month basis and is released in May or June of each year as part of our annual budgeting process. Our pricing is separate to the Milk Supply Agreements because we cannot provide a price for 3 or 5 years with 100% confidence as we may lose a customer contract or have other market conditions impact the business. Norco's pricing system consists of:

- Base price – we have different pricing tables for our Northern Region volume versus our Southern Region volume. Norco's Southern Region is an area in NSW defined as "any point south of the Telegraph Point Bridge, inclusive of Wilson River catchment west of bridge" and essentially covers Norco's suppliers in the Taree/Hunter region of NSW and milk north of that point is the Northern region;
- Add ons or deductions for milk quality and milk components;
- A collection efficiency bonus, which is essentially a volume bonus;
- A Milk Supply Agreement length bonus; and
- A Retrospective Step Up (RSU) Bonus.

Norco does not have step downs or claw back provisions as part of its pricing system and if a price reduction had to occur, it would be done by changing the base price at budget time and communicated in advance of supply by our members. Norco's RSU bonus is reviewed by the Board each quarter and if the financial circumstances allow it, an amount per litre is paid to suppliers on the prior quarter's volume. Our most recent RSU bonus was for the September 2016 quarter where we paid an additional 0.5 cents per litre on the first quarter's milk volume.

Issue 3 – Transparency and price signals

As Norco's business is predominantly bottled milk for domestic sales, commodity pricing does not have a significant impact on our business or its price to suppliers. Norco is impacted by commodity pricing in its ice cream business, however, and our contracts with customers allow for the rise and fall of these prices.

Norco's pricing is communicated to suppliers, after the annual budgeting process, in May or June of each year. During the budgeting process we review our expected sales volumes and sales pricing for the upcoming year, we review our forecast expenses across the business and also the suppliers' milk price compared to the market. Norco's review of the milk pay system starts in approximately January of each year and finishes when the budget is signed off by the Board which usually occurs in May so it is given significant review time which also includes a competitor review to ensure Norco remains competitive with the market and we can offer the best price possible to our members.

Norco holds twice yearly suppliers' meetings in March and then again in September and milk pricing is often discussed at these meetings. These meetings result in our suppliers having regular and open dialogue with the business on many items, including competitive pricing. If Norco envisaged that a potential price cut was required, it would be discussed at a round of suppliers' meetings and would not be "sprung" on the suppliers in May with the pricing change taking effect from July. In fact, we often discuss global trends at these meetings to give members a sense of the global market and how this may impact the Norco business. Norco also provides six months notice to suppliers if there are going to be any structural changes to the milk pay system such as introducing or eliminating part of the milk pay system described at item 2.

Norco tries to be as transparent with its suppliers as it possibly can and provide no surprises. We aim to pay the highest price the business can afford without jeopardising the sustainability of the business. We also write a monthly newsletter to our suppliers which highlights industry and business items each month.

<u>Issue 4 – Domestic retail markets</u>

In 2015/16 Norco sold 168 million litres of processed and packaged fresh milk to the Australian domestic market. Of this, 94 million litres, or 56%, was for retailer contracts and the remainder was of branded sales. Norco has a strong relationship with Coles and currently has a 5 year contract in place with Coles and when that contract began in July 2014, Norco passed on a 3 cent per litre price increase to its suppliers. Given the magnitude of the retailer volume market share within both Norco's business and the market in general, the volume will not go away and someone has to make it. Norco's branded volume has increased significantly since the social media campaign started in May however it is still under 50% of our total sales volume.

The benefit of the relationship that Norco has with Coles is twofold in that the contract underpins a substantial volume, which allows the factories to run more efficiently, and having the relationship has the added benefit of being able to increase Norco branded sales because Coles knows what a reliable supplier Norco is.

The retailer $1 per litre milk campaign has been in place for 6 years now and any increase in the retail price would most likely flow onto the total market in general. Farm Gate Price increases to milk suppliers in the meantime will only come from increased profitability predominantly in branded sales, efficiency improvements through the supply chain and/or well-negotiated contracts with customers.

Norco believes it is imperative to have an understanding of all aspects of the supply chain right through ultimately to the consumer market demand.

Issue 5 – Global markets

In 2015/16 Norco sold a small volume of milk, 389,000 litres, to China and we sold 1.2 million litres of ice cream to Japan and America. Exporting is not a large part of Norco's business, however it is growing and we would like to see it grow further. Due to the type of products that we are exporting, we don't see a lot of volatility in the prices of these products.

Norco follows a letter of credit process for all new export customers.

Issue 6 – Production costs and profitability

Although each of our suppliers will have their own business circumstances, in general terms, the key factors influencing farm profitability will be the price they receive for their milk, commodity prices regarding their inputs, weather and their level of debt.

The price farmers receive for their milk is a key profit driver and the stability of that price, that is, when the price is not volatile, is a key driver of farmer confidence and for investment on farm. Suppliers need both a sustainable price to ensure ongoing profitability and that price needs to be consistent to give the supplier the ability to invest on farm in order to take costs out and improve profitability.

Commodity prices such as grains, fuel and electricity all have a big impact on farm profitability and these have all been low for approximately two seasons now which assists with farm profit. The weather impacts farm profitability because a dry season or other natural disasters such as cyclones and floods adds costs regarding feed inputs and irrigation however we are having a second strong season in our region in this regard.

Lastly, a farmer's debt level and the interest being paid can have a big impact on the farmer's bottom line and high debt levels add financial pressure. Norco tries to assist its suppliers in this regard by having interest free terms with our rural stores.

Yours sincerely

NORCO CO-OPERATIVE LIMITED

G.T. McNamara

GREG McNAMARA

Chairman