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Dairy inquiry team
Agricultural Unit
ACCC
Email: dairyinquiry@accc.gov.au

12th December 2016

Dear Sir/Madam,

Re: ACCC inquiry into the Australian dairy industry

The Queensland Dairyfarmers' Organisation Ltd (QDO) is grateful for the opportunity to make this submission to the ACCC inquiry into the Australian dairy industry. The QDO is the peak industry organisation representing the interests of dairy farmers in Queensland. The QDO is a member of the Australian Dairy Farmers (ADF) and the Queensland Farmers' Federation (QFF). The most pressing issue for QDO in this inquiry relates to retail pricing for milk and we have expressed our concerns in detail below. We have addressed all 6 issues raised by the ACCC issues paper below.

Issue 1 – Competition for milk

The level of competition between processors in Queensland is low at present. Most processors are looking to maintain or decrease their milk supply so are not looking to expand and compete for new suppliers. The only company currently looking to expand supply is Maleny Dairies but they are only looking to pick up one additional farmer. A hand full of farmers are likely to switch from Parmalat to Lion early in 2017 due to a potential reduction in price by Parmalat, location, high components being more suited to Lion payment system and availability of brewers grain. However the level of competition between processors is currently very low and the price paid to farmers by the varying processors typically do not vary a great deal for an average farm.

The industry manages undersupply of milk during low production months, typically from February to April, by trucking up milk from NSW and Victoria. This has become much more pronounced since 2011 with the introduction of $1/L mil. This has caused a significant reduction in production in Queensland by reducing the retail value of milk and thus limiting farm gate prices.

Production in 2009/10 in Queensland was 530ML while in 2015/16 it was only 405ML. Drinking milk sales in Queensland in 2009/10 were 499ML while in 2015/16 they were 583ML. Queensland has moved from a surplus milk supply of 31ML in 2009/10 to a deficit of 178ML in 2015/16 which is a stark change in such a short period of time.

Processors have also responded to undersupply of milk in Queensland by moving production of products such as yogurt and flavoured milks to NSW. This trend is continuing for the major processors who now largely see Queensland production as meeting fresh white milk sales only.

One of the issues restricting competition between processors is that some processors have their contracts on a calendar year basis while others operate on a financial year. This limits the ability of farmers to switch between processors when their contracts are up since processors have been unwilling at times to offer contracts with a different start date. Also it limits the ability of farmers to negotiate the best supply arrangements for them with multiple processors.

Exclusive supply arrangements have been a feature of contracts in Queensland to the advantage of processors and to the detriment of farmers. This has been a long standing issue for farmers and is an issue that has limited competition and should be addressed. A code of practice being developed by ADF with most major processors is seeking to address this issue.

Issue 2 – Contracting practices

Contracts are typically 1 to 5 years in length with various incentives to sign longer contracts. The majority of processors in Queensland are companies rather than cooperatives so prices are fixed for a year typically with no ability for either step ups or step downs. Norco is a cooperative who has at times had step ups including this year. However step downs are not something that Norco supports or has done historically.

Risks in the supply chain are shared between farmers and processors but very little risk is faced by retailers. Farmers face very significant risk based on weather, disease and fluctuations in input costs. Processors face risks including generally providing a relatively flat price year on year. Retailers typically lock into long term contracts at low prices and with either fixed prices or minimal volatility in prices.

So typically in the supply chain farmers take the highest risks but the returns/profits do not match the risk they take. Processors typically would take moderate risk and obtain a moderate return/profit. Whereas retailers typically take a low risk and obtain a high return relative to other members of the supply chain.

Anecdotal evidence suggests that returns from dairy products for retailers are as high as a 40% margin which would appear to be extremely high relative to the low risk they take. It is also hard to understand how retailers are able to vary the margins they add to products to make it more attractive for consumers to buy their products versus branded products. It would appear hard to argue that this is allowing for equal competition amongst brands.

There is a clear imbalance of bargaining power within the supply chain. Major retailers have significant market power given their dominance in the retail sector. The effect of this down the supply chain is extreme for those states including Queensland who are almost exclusively domestic market oriented. Major retailers are able to set a low price for their own brand and processors have to comply with these terms in order to gain shelf space and sales. It would also appear that major retailers are able to force down the price of branded dairy products while at the same time driving up their margins on these goods. It would be a game processor not to comply with demands of major retailers given the potential to lose shelf space. Clearly retailers have the bargaining power in this relationship.

When farmers are negotiating with processors, the bargaining power largely lies within the processing sector. One of the reasons is that once a processor has been squeezed by major retailers they have little choice commercially but to pass this cost squeeze onto their suppliers being the dairy farmers. This realistically leaves little room for negotiation by dairy farmers.

In addition laws to limit collective bargaining limit the bargaining power of dairy farmers. It seems that the laws limit bargaining power of farmers when it is the retailers and processors who have greater bargaining power and resources. It is perplexing as to why the laws are protecting major companies like retailers and processors from small businesses like dairy farmers when clearly the opposite should be occurring. If this imbalance in bargaining power were properly addressed the dairy industry in Queensland and other parts of Australia would not be held at ransom by major retailers and be in the state that it currently is.

Issue 3 – Transparency and price signals

The main concern of dairy farmers in Queensland re transparency and price signals relates to the ability of farmers to compare prices and conditions offered by processors. When making a decision on whether to sign a new contract with their existing processor or switch to a different processor, if there is a demand for the farmer to do so, it can be very difficult to compare contracts and contractual terms.

Typically payment systems vary between processors including headline price, payments for components, quality issues, penalties, bonuses for longer contracts and many other conditions. In addition, farmers profiles vary considerably so there is no one size fits all best contract. Without a detailed understanding of the contracts, all the contract terms and the profile of their farm going forward it is often very difficult for farmers to accurately know which contract will deliver them the best price and overall outcome. Some processors may attempt to assist farmers to accurately understand the true picture. However others processors have an incentive to use the ambiguity over contractual terms to their commercial advantage and appear to deliberately make it complicated to avoid comparison by farmers.

Issue 4 – Domestic retail markets

Issue 4 in the ACCC issues paper relating to domestic retail markets is the area of greatest concern and interest to QDO and its members. The Queensland dairy industry is almost entirely domestic focussed and thus actions of major retailers are the major driver of the returns, or lack thereof, on Queensland dairy farms. The impact of $1 per litre milk on the dairy industry in Queensland has been extreme in the negative sense. It is hard to fathom what the positive impacts of private label product supply contracts for the dairy industry in Queensland are when retailers are selling milk for $1/L. The impacts of $6/kg cheese will end up having similar if not worse effect in other states especially since 10L of milk are required to produce 1kg of cheese so the retail milk value is only 60c/L.

The single national milk pricing policy of major retailers – whatever its purpose or intent – directly causes unfair and unreasonable business conditions for dairy farmers in Queensland. The Queensland dairy industry is completely dependent on the domestic market. In 2015/16, 407ML of milk was produced in Queensland while around 585ML was consumed as milk (fresh white, UHT and flavoured). All milk produced in Queensland is consumed in Queensland and around 178ML (30%) of milk consumed is trucked in from southern states (Victoria and NSW). In addition, around 55% of white milk sold is retail brands, which average $1.01/L according to Dairy Australia figures, while 45% is branded fresh white milk.

UHT production has moved to other states as has the majority of the high margin flavoured milk. Lion has recently moved 15ML of flavoured milk production from Queensland to Sydney. This means that the Queensland dairy industry is completely dependent on the domestic market and that retail fresh white milk pricing, including $1/L sales, determine the price paid to farmers.

Coles introduced $1/L milk in 2011 while in 2010 store brand milk was selling for on average $1.17/L. When taking into account inflation between 2016 and 2011, $1 in 2016 is equivalent to 87c in 2011. If we go forward to 2024, when the existing 10 year contract between Murray Goulburn and Coles ends, $1 will likely be around 72c in 2011 dollars when you take account of inflation of around 2.5% per year. When we compare the $1.17 that was received in 2010 to the 72c in 2024 this would be almost a 40% reduction in 13 years.

It is unclear how any business in Australia could cope with such a massive cut to their price. However as price takers, completely exposed to the domestic market and the desires of the price setting retailers, dairy farmers in Queensland are expected to put up and shut up in the interests of retailer's profits and consumers getting milk at a price which is below sustainable levels.

It is clear that the current use of milk as a close to or below cost 'advertising agent' by major supermarkets is having a direct cumulative and detrimental impact of the domestic fresh milk dairy industry. It is progressively undermining the viability and sustainability of the domestic dairy industry.

Anecdotal evidence suggests that major retailers are linking retail agreements to shelf space. There is anecdotal evidence that one major processor gained substantially increased shelf space and shelf space in more stores of a major retailer after contracting to supply the retail brand product. This occurred especially after the consumer outcry to retail brand milk in mid 2016. This practice by retailers in well known in dairy industry and clearly major retailers are holding processors at ransom.

It has often been claimed by retailers that dropping the retail price of milk will cause the consumption of milk to increase. However studies by Dairy Australia clearly show that this is not the case. Despite initial rises, the per capita consumption of white milk is no higher in 2016 than in 2011 when the discount retailer brand milk was introduced. In effect by retailers reducing the retail price of milk margins have been wiped from the value chain but there has not been any volume response from consumers. This is a lose lose situation for dairy farmers. And given that farm gate prices have been stagnant, and fallen considerably in real terms, it is hard to credibly argue that retailers have worn the cost of the reduction in margins when clearly farmers have borne the brunt of the reductions.

With this evidence it is clear that the current practices of supermarkets needs to be addressed to ensure the future viability and sustainability of the domestic fresh milk dairy industry, which is in the interests of all in the industry supply chain, including the major supermarkets, all levels of Government and most importantly Australian consumers.

It is short sighted to believe that forcing retail milk prices down is in the interests of consumers. In the short term, consumers do benefit from lower milk prices. In the longer term though, as retailers wipe out other retailers and milk brands, consumers will pay for the lack of competition. Retailers will gain greater control of the retail market, as has occurred for the majority of the last 5 years, and consumers will eventually pay more due to this lack of competition. And at the same time dairy farmers will not be making a reasonable profit and substantial damage will occur to the dairy industry as has occurred over the last 5 years.

The introduction of regional cost reflection pricing is critical to the future of the dairy industry but also to fair competition by retailers and milk processors. Postage stamp pricing prohibits competition by allowing retailers to cross subsidise between different regions and stop other retailers and processors from competing in higher cost markets including Queensland.

While some retailers sell their branded product on the shelf for $1/L throughout the country the cost of delivering that product to their stores appears to vary considerably. Anecdotal evidence suggests that in some regions the cost to get milk to stores is around 73c/L if not lower, some like

Queensland are very close to $1/L while other markets are reportedly $1.25/L. These costs of supply do not include a reasonable apportionment of retailer costs or a profit margin for retailers. If this anecdotal evidence is proven to be correct then clearly retailers are using milk as a loss leader.

Is it anti-competitive to allow retailers to sell milk for a $1/L if the cost of acquiring this milk is more than that? Clearly it is impossible for other retailers and processors to compete for retail market share if their main competitor is willing to sell at a loss by cross subsidising between regions to acquire market share. Smaller retailers are unable to compete in this distorted market place and have no choice to lose market share. It is also impossible for processors to compete into these high costs markets unless they are willing to lose money to do so. Processors are only selling dairy products, mostly milk, and are not able to cross subsidise profits from one product to make up for losses on others as the major retailers do.

So clearly it is anti-competitive for major retailers to sell milk below the cost of delivering that milk and thus must be prohibited by government. Retail prices of fresh white milk should reflect the cost of selling the milk in each region that it is sold to allow dairy farmers, all retailers and all milk brands to compete on a level playing field.

In addition retailers apply different cost allocations methodologies and margins for different products they sell. For their own milk brands they sell, the allocation of retail costs and margins is often low or negative to make these products attractive to consumers, gain market share and act as a loss leader. For processor branded milk, there are usually a higher allocation of retail costs and significant retail margins, reported to be between 24 and 40%, which makes the price of branded milk higher and less attractive to the consumer. This predatory pricing practice is anti-competitive and should be prohibited by government.

QDO's has ongoing concerns with the deficiencies within the provisions of the competition laws. Australia is one of only two countries that doesn't have an 'effects test' in their respective competition laws. The 'Effects Test' looks at what the 'effect' of the action is on competition to determine if it reduced competition. The proposed amendment, introduced into the House on 1 December 2016, would mean corporations with large market power could not carry out actions that have the intent, effect or likely effect of reducing competition.

It is clear to all rational people that an 'Effects Test' would be a positive for competition and deliver better market function. In an Australia without an 'Effects Test' large powerful companies can unfairly damage suppliers and small competitors and our ACCC cannot prove anti-competitive intent or 'purpose' even though the 'effect' is clear. After all, the objective of the Competition and Consumer Act is the promotion of competition, fair trading and consumer protection. It would be advantageous for it to do what it was intended to do.

There have been a long list of breaches of the current competition law by major supermarkets over recent years and the list would have been much shorter with laws that actually worked to support farmers. Competition law reform remains essential for all of our futures in small business, farming and as consumers. The fact that Britain, which was the training ground for most of the architects of milk discounting in Australia, has had to strengthen their competition laws to control the excesses of retailers should not be ignored.

A commitment by the federal government to introduce of an 'effects test' into the Competition and Consumer Act must be delivered upon. This was a change called for by the Harper review of Competition and Consumer Law. The 'effects test' would address anti-competitive practices of some big corporates, not only for dairy but for all Australian businesses. It is vital for all Australian dairy farmers and all small businesses that the changes to section 46 of the Competition and Consumer Act proposed are implemented.

Issue 5 – Global markets

Currently around 67% of milk produced in Australia is sold domestically while 33% is sold onto global market. Australian production is down 10.3% so far in 2016/17 and domestic demand is up slightly due to population growth. As a result around 75% of Australia's production could be consumed domestically this year and only 25% exported. This year, the domestic drinking milk market will be as large as total exports. In 2015/16 3.4bL of milk was exported while 2.5bL was consumed in Australia as drinking milk. If the production drops to 8.9bL, the total export and domestic drinking milk volumes should be similar at around 2.5bL. This would indicate that the dominant factor in determining domestic farm gate prices in Australia is the domestic retail price not the world milk price.

In Queensland almost all of the milk produced is consumed in Queensland. As a result the global market has little direct impact on farm gate prices. However retailers expect to pay bulk international prices for highly packaged domestic milk. The true additional costs of packaging and year round production are not reflected in domestic prices. For example a large portion of what is sold onto export markets is excess milk produced at peak low cost times around the world. However to supply a domestic fresh milk market stable year round production is required which adds significantly to costs of production. This is discussed further under issue 6 below.

With the farm gate prices being supressed by retailers opportunities for high valued exports are being pursued including a potential new plant at the Toowoomba airport site. If successful, this would see farm gate prices increased to match high priced international markets in preference to meeting the low priced needs of domestic retail markets including $1/L milk.

Issue 6 – Production costs and profitability

The key factors influencing the profitability of Queensland dairy farms are the retail price of milk in Queensland, bought in feed costs, heat / humidity and maintaining a relatively flat supply of milk throughout the year.

In 2010 before $1/L milk was introduced there were 621 dairy farmers in Queensland while today there are 429. Milk production in Queensland fell steadily after deregulation from 848ML in 1999/2000 to 537ML in 2006/7. Between 2006/7 and 2009/10 milk production was very stable and Queensland production roughly met Queensland consumption. In 2010 milk production was 530ML. However since the introduction of $1/L in early 2011 milk production in Queensland started falling again. In 2015/16 Queensland milk production had fallen to 407ML.

According to Dairy Australia, farm gate prices in Queensland were 57.2c/L in 2008/9. This fell to 53.1c/L in 2010/11 when $1/L milk was introduced. The price has recovered to 57.4c/L in 2014/15 and the price would have been similar in 2015/16. So in reality the price has stayed the same since 2008/9 due to the imposition of $1/L milk. This is despite 7 years of inflation which amounts to a 19% inflationary impact during this time. So in reality farm gate prices have fallen by 19% in real terms since 2008.

Many dairy farms in Queensland do not have access to sufficient quantities of low cost high quality pastures to feed their cows. As a result the majority of farmers rely on buying in feed whether that be for quality or alternately quanity which may include grain, silage, hay protein meal or other products. This has a major impact on their costs and profit relative to farmers in other states. In addition the high heat and especially humidity in Queensland are a real challenge when dairy farming. This adds to costs compared to farming in cooler and low humidity areas.

Maintaining a relatively flat supply of milk throughout the year which is required by Queensland processors is a major challenge in Queensland as we try to meet the needs of the domestic fresh milk market. Unfortunately maintaining a flat supply curve adds significantly to costs but this is often not reflected in returns to farmers. It is a major challenge and cost to attempt to get cows pregnant during the hot and humid summer months to try and maintain a flat milk supply. In addition, feeding cows during autumn when feed is low causes farmers to buy in a significant amount of feed at high cost. Unfortunately the substantial extra costs of maintaining year round milk production, which could be 20c/L more during low production months, are not reflected in returns to farmers.

The Queensland government undertakes yearly surveys of the profitability of Queensland dairy farms. The QDAS report for 2015-16 has been released on-line and can be found at:
http://dairyinfo.biz/technical-information/farm-business-management/qdas/

In 2016 56 dairy farmers were surveyed from the 429 dairy farmers in Queensland which is around 13% of farms. To participate in the scheme is voluntary and typically the better and bigger farms participate in the program. This is highlighted by the fact that the Queensland average farm produced 0.95ML in 2016 which the average QDAS farm produced 1.6ML. The average profit reported in the QDAS report was 5.6c/L. However this result is skewed as mentioned above and also this does not include a depreciation cost. Consequently it is likely that the average Queensland dairy farmer is losing money at present. Clearly the $1/L retail brand pricing is limited revenue for Queensland dairy farmers and causing low or negative profits for many dairy farmers.

In addition regulation has had a marked increase in costs in Queensland. Electricity prices continue to escalate and electricity is a major cost item for dairy farms both with the dependence on irrigation, usually high pressure systems, as well as for running dairy sheds. Another major regulatory impact has come from the mandating of ethanol which has increased the price of feed grain for dairy farmers. These government policies make it very different to compete when many competitors do not face the same cost impositions.

Unlike dairy farmers in other parts of Australia, Queensland dairy farmers typically have not sold or exported large numbers of dairy cows. They do sell cows to meat works but this income is relatively small compared to dairy farmers selling dairy cows for export and older cows to the meat works.

I have attached a letter from a dairy farmer in Queensland and the three QDO submissions from the previous senate dairy enquiry in 2011 for your information. The QDO stands ready to provide any further information, where possible, the ACCC may require and would welcome the opportunity to discuss any of the information presented.

Yours Sincerely,

Brian Tessmann
President
Queensland Dairyfarmers' Organisation Ltd