AUSTRALIAN COMPETITION & CONSUMER COMMISSION

Performance of Australia's dairy industry and the profitability of Australian dairy farmers since deregulation in 2000

ACCC Submission to the Senate Dairy Inquiry

29 November 2019

Overview

The Australian Competition and Consumer Commission (ACCC) welcomes the opportunity to make a submission to the Rural and Regional Affairs and Transport References Committee inquiry into the Performance of Australia's dairy industry and the profitability of Australian dairy farmers since deregulation in 2000.

The ACCC is an independent Commonwealth statutory authority responsible for enforcing the Competition and Consumer Act 2010 (the CCA). In doing so we promote competition, consumer protection and fair-trading, and regulate national infrastructure for the benefit of all Australians.

The ACCC has undertaken extensive analysis of the Australian dairy industry at various times over the last two decades, in particular:

- In 2001, a study of prices, costs and profits following farmgate price deregulation.[1]
- In 2018, an inquiry into the competitiveness of prices, trading practices and the supply chain in the Australian dairy industry.[2]

Additionally, the ACCC has analysed the dairy industry in the course of investigating proposed mergers and collective bargaining arrangements, and other alleged breaches of the competition and consumer protection laws. In particular, in recent years the ACCC has investigated several alleged unfair contract terms in milk supply agreements. As a result, the ACCC has developed a substantial understanding of the Australian dairy industry, which informs this submission.

ACCC Dairy Inquiry

On 27 October 2016 the Treasurer, the Hon Scott Morrison MP issued a notice requiring the ACCC to hold an inquiry into the competitiveness of prices, trading practices and the supply chain in the Australian dairy industry (ACCC Dairy Inquiry).

The ACCC Dairy Inquiry followed late-season retrospective changes to the farmgate prices paid by Australia’s two largest dairy processors in April 2016 which caused substantial detriment to dairy farm businesses in the southern regions of the Australian dairy industry. These ‘step-downs’ caused severe and unforeseen reductions in the incomes of more than 2000 dairy farmers and significantly impacted the productivity of the industry. Farmers exited the industry and the volume of milk produced fell substantially in the following season.

Farm profitability

The terms of reference for the Dairy Inquiry, among other things, directed the ACCC to examine factors affecting farm profitability.

The ACCC examined movements in farmgate prices, farming costs, raw milk production volumes and revenue generated by farmers over time. We also looked at the most likely influences on these movements, including the deregulation of the industry, climate events, the geographic source of raw milk, and changes in the retail and processing sectors of the supply chain.

Overall, dairy farm profitability in Australia is volatile, and is most directly affected by significant movements in either:

- farming costs, the main driver of which is the cost of fodder, and more recently the cost of water, and/or

[1] ACCC, Impact of farmgate deregulation on the Australian milk industry: study of prices, costs and profits, April 2001 available at https://www.accc.gov.au/publications/impact-of-farmgate-deregulation-on-the-australian-milk-industry.

[2] ACCC, Dairy Inquiry Final Report, April 2018, available at https://www.accc.gov.au/publications/dairy-inquiry-final-report.

- farmgate prices, which are determined by competition between processors for milk and the ability to fulfil domestic and global demand for products.

Movements in both costs and farmgate prices vary across states, due to differing climatic conditions and the degree to which dairy products in that particular state are sold into export markets versus the domestic market.

Deregulation led to a substantial reduction in the retail prices of dairy products, particularly drinking milk. This in turn led to reduced wholesale prices and margins for processors, with many private label drinking milk contracts operating at close to average cost for processors. Farmers and farmer representative groups expressed their concern that Australian farmers would be more profitable but for this retail price behaviour and the reduced margins of processors.

The ACCC understands and respects the concerns of many farmers that retail prices of private label drinking milk products have negatively impacted farmgate milk prices. Recognising these concerns, the ACCC Dairy Inquiry included an in-depth examination of the effects of retail pricing along the dairy supply chain. This included the use of compulsory information gathering powers to obtain data and documents from supermarkets and processors from 2010 to 2016, and summonsing all relevant processing and retailing businesses to give evidence under oath in private hearings. We analysed the correlation between movements in retail prices, farm gate milk prices, reduced production volumes and a subsequent increase in farm exits in response to lower profitability.

The ACCC concluded that the introduction of $1 per litre milk or reductions in other dairy retail prices did not have an observable direct impact on farm numbers, output or profitability. Rather, we found that movements in farmgate prices can be attributed to changing demand conditions within the export or domestic market, and that almost all contracts for the supply of private label milk allow processors to pass-through movements in farm gate prices to supermarkets. This means that processors do not have an incentive to reduce farmgate prices as a result of the lower wholesale prices they receive for private label milk, as the farmgate prices are passed through to the supermarkets. Furthermore, evidence within documents compulsorily obtained from processors did not indicate that farmgate price movements were directly influenced by prevailing retail or domestic wholesale prices.

These findings are further supported by the fact that Norco, a major supplier of Coles private label milk, recently exercised the clause in its contract to increase the price paid directly to its farmers by 6.5 cents a litre in March 2019, even though Coles initially continued to sell $1 per litre milk.[3]

Accordingly, the ACCC remains of the view that dairy farmers lack bargaining power, and are unlikely to benefit from an increase in the retail (or wholesale) prices of private label milk or other dairy products. Even if processors were to receive higher wholesale prices from sales to supermarkets, this does not mean the processors will pay farmers any more than they have to in order to secure milk.

The need for a mandatory code of conduct

The key recommendation of the ACCC Dairy Inquiry was that the government should introduce a mandatory code of conduct for the industry. As mentioned above, dairy farmers typically have very limited bargaining power when negotiating with processors, and limited scope to reposition their businesses or switch to a different farm enterprise. Processors also have access to better information about prices and general market conditions than farmers. Imbalances in bargaining power, information asymmetries and the historical use of cooperative contracting models in the industry have resulted in contracts and practices that favour processors and/or reduce farmers' ability to switch, such as:

- processors' ability to vary farmgate milk prices throughout a season or within a contract period
- processors' ability to unilaterally vary terms in contracts

[3] See e.g. ABC News, 'Dairy co-op Norco lifts direct milk price to farmers 6.5 cents a litre but Coles still refuses to budge on $1 milk' (7 March 2019) https://www.abc.net.au/news/rural/2019-03-07/dairy-co-op-norco-lifts-milk-price/10878346.

- farmers having limited time and information with which to make critical decisions about which processor to supply
- farmers being subject to unnecessary switching barriers in contracts, such as conditional loyalty bonuses and extended notice periods, and
- the absence of effective dispute resolution processes.

These practices lead to inappropriate risk allocation between farmers and processors, a weakening of competition between processors for raw milk supply, and potentially inefficient investment decisions by farmers. The ACCC determined that a mandatory code was the best way to address these systemic issues over the long term.

The ACCC therefore welcomes the government’s commitment to introduce a dairy code and its recent progression. In order to fulfil its policy objectives it is important that the code adequately addresses the issues identified by the Inquiry, such as imbalanced bargaining power in the farmer-processor relationship. To this end, the ACCC has provided comprehensive feedback to the code development process.

Terms of Reference

Introduction of a mandatory industry code of practice

As outlined above, in its Inquiry Report the ACCC recommended that a mandatory code of conduct be prescribed for the dairy industry to mitigate problems arising from the significant imbalance in bargaining power and information between processors and farmers. These lead to inappropriate allocation of risk, inefficiencies in investment decision making by farmers and less effective competition between processors. The ACCC continues to recommend that a mandatory code of conduct be prescribed.

While, ultimately, it is the Government’s decision whether to implement a mandatory code, and to determine what should be included in such a code, the ACCC recommended that the code should be designed to improve transparency and certainty in contracts, set minimum standards of conduct and provide for dispute resolution processes. Specifically, the ACCC recommended that the code should include requirements:

- obliging processors to give timely and transparent information to farmers about the terms on which they propose to acquire milk from farmers
- requiring processors not to include contract terms which unreasonably restrict farmers’ ability to switch processors
- addressing processors’ ability to change key trading terms through multi-year contracts, step-downs and unilateral variation of contracts
- that contracts contain an effective independent dispute resolution process
- that processors and farmers act in good faith during negotiations, performance of the contract, dispute resolution and the ending of an agreement.

The ACCC will administer the code once implemented. This will involve industry education, and monitoring compliance by assessing reported breaches of the code and conducting compliance checks. Sections 51ADD–51ADG of the CCA give the ACCC an audit power to make a compulsory request for information or documents that businesses are required to keep, generate or publish under an applicable industry code.

Regulating the price of milk

The ACCC's inquiries and other investigations have informed our view that introducing regulation of farmgate milk prices in Australia would raise several region-specific and complex economic, social and legal issues. These include:

- Regulation of the farmgate milk price may pose a significant risk to processors' export competitiveness and their overall demand for milk.
- A single price that applies nationally would disproportionately favour farmers with lower production costs, such as those in south-eastern Australia.
- Milk can be and is transported between regions and states.

The remainder of this submission provides a summary of these issues. They are analysed and reported in detail in the above-mentioned reports.[4] We also make some comments on the likely regulatory costs associated with determining a minimum farmgate milk price for the purpose of regulation.

Regulation could reduce demand for farmgate milk

While 27 per cent of milk produced on Australian farms is used for drinking milk (both fresh and long life),[5] exports of processed milk products account for a significantly higher proportion of milk produced by Australian dairy farmers.[6] Australian processors do not control sufficient share of global markets or offer sufficiently differentiated products to influence global prices to achieve higher margins for processors or farmers.[7]

Processors set their farmgate milk prices with regard to the mix of products they produce, the fat and protein levels (milk solids) required to produce these products,[8] and the price they can achieve for the finished product. Processors are unable to pass on to global markets a higher farmgate milk price.

Processors also require flexibility in how they structure their pricing so they can acquire milk of the specifications they require at the time of year which best matches their intended output. For example, a processor with a focus on supplying fresh drinking milk to the domestic market will have different requirements to a processor which exports milk powder and cheese.

Some processors and many dairy farmers are exposed to movements in international markets. This is particularly the case in regions that supply large volumes of milk for exportable products, such as cheese, butter and milk powders. The impacts of fluctuations in this market also flow into domestic-focused areas.

If a regulated minimum price for milk reduces processors' ability to compete in export markets, or processing efficiency is reduced because processors can no longer flexibly adjust their pricing to best match their production requirements, this may reduce demand for raw milk at the farmgate. At the same time, as the domestic market has a flat level of demand, processors supporting the domestic market will have limited opportunities to expand their businesses.

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[4] ACCC, Impact of farmgate deregulation on the Australian milk industry: study of prices, costs and profits, April 2001, available at https://www.accc.gov.au/publications/impact-of-farmgate-deregulation-on-the-australian-milk-industry and ACCC, Dairy Inquiry Final Report, April 2018, available at https://www.accc.gov.au/publications/dairy-inquiry-final-report.

[5] Dairy Australia, *Australian Dairy Industry In Focus 2018*, 2018, p 17.

[6] In 2017-18, exports accounted for approximately 36 per cent of total milk production, generating $3.36 billion in export revenue (Dairy Australia, *Australian Dairy Industry In Focus 2018*, 2018, p. 3.

[7] Australia accounts for only around 6 per cent of world dairy product exports (Dairy Australia, *Australian Dairy Industry In Focus 2018*, 2018, p 19).

[8] Australian Competition and Consumer Commission, *Dairy Inquiry Final Report*, ACCC, 2018, p. 43.

If this occurs, while some farmers may be better off with a higher farmgate milk price, others may be unable to find a buyer for their milk at all. Consequently, to minimise the impact of regulation on export competitiveness it would likely be necessary to create a domestic / export market milk distinction when determining a minimum farmgate milk price.

In any event, consumer prices would likely increase with the reintroduction of regulation as processors of fresh milk products would pass their higher production costs through to retailers.

Prior to the deregulation of the dairy industry in 2000, both state and federal governments had in place legislation regulating the production volumes, price and uses of milk, as well as equalising dairy farmer returns. Deregulation led to a substantial reduction in the retail price of milk as well as other dairy products. In 2001, the ACCC estimated that savings from sales of supermarket milk to Australian consumers were likely to be around $118 million on a full year basis as a result of these price reductions.[9]

Production costs vary and milk can be transported long distances

Any farmgate milk price regulation would have to be responsive to the complexities of milk production costs that vary between farmers, across and between states, and throughout the year.

A consequence of differing climatic conditions, demand, and the resulting production systems is that the cost of milk production varies from farm to farm, across and between states, and throughout the year. Input costs (for example feed, water, fuel and fertiliser) can also be highly volatile. The cost of production is significantly higher in Western Australia, Queensland and Northern NSW compared to south-eastern Australia.[10] For example, Queensland and Northern NSW have had an average cost of production of around $8/kg of milk solids over the last five years, while this was just over $5/kg of milk solids in Tasmania and Victoria (Gippsland region).[11] Reflecting this, the indicative factory prices paid in 2019 were 61 cents per litre (cpl) in Queensland, compared to 47.2 cpl in South Australia and 48.2 cpl in Victoria.[12]

Consequently, a single price that applies nationally would disproportionately favour farmers with lower production costs, for example those in south-eastern Australia, encouraging them to increase production. This would necessitate some kind of managed quota system.

Additionally, a minimum farmgate price is likely to make products that would normally be exported less competitive internationally. The ACCC Dairy Inquiry found that while the majority of milk is processed within the region where it is produced, raw milk is transported between regions on the east coast when there is an economic incentive to do so.[13] As raw milk can be transported from one region to another, (the Inquiry found that average transport costs for milk trucked from southern production regions to Queensland was approximately 17c/L) a minimum farmgate price could lead processors in those regions with a focus on exported products to divert milk supply to the domestic market, especially if the farmgate price differential between those regions exceeded 15-17c/L. This would potentially exacerbate existing concerns, with more milk being shipped interstate and further disadvantaging milk suppliers in high-cost regions. If it were determined that a region-by-region regulated farmgate milk price were more appropriate, this would likely require prohibiting or limiting the movement of milk interstate. This may raise issues under the Australian Constitution.[14]

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[9] ACCC, Impact of farmgate deregulation on the Australian milk industry: study of prices, costs and profits, April 2001 available at https://www.accc.gov.au/publications/impact-of-farmgate-deregulation-on-the-australian-milk-industry.

[10] Australian Competition and Consumer Commission, *Dairy Inquiry Final Report*, ACCC, 2018, pp. 135-9.

[11] Dairy Australia, *Australian Dairy Situation Analysis Report May 2019*, 2019, p. 42.

[12] Dairy Australia, In Focus 2019, the Australian Dairy Industry, 2019, p.10.

[13] Australian Competition and Consumer Commission, *Dairy Inquiry Final Report*, ACCC, 2018, pp. 68-70.

[14] Commonwealth of Australia 2010, ***Australia's Constitution***, *pocket edition with overview and notes by the Australian Government Solicitor.*