Queensland Dairyfarmers' Organisation

Submission to the Commonwealth Government

Competition Policy Review - 2014

Introduction

The Queensland Dairyfarmers Organisation (QDO) welcomes the Governments 'root and branch' review of the Competition and Consumer Act in Australia as there have been significant changes in the competition policy environment for dairy farmers in Queensland and Australia over the past 30 years which are in need of addressing.

We strongly advocate the need for the C&C Act to be strengthened, particularly in areas to outlaw predatory conduct that has negative effects on competition, value chain suppliers and ultimately consumers.

We also fully appreciate that to do this review properly will take a reasonable amount of time and there will be further time needed for the Government to consider the recommendations, draft any changes to the Act and the passage of those amendments through the Parliament prior to entering into force. However, this is time Queensland dairy farmers do not have in the current market environment.

As such we believe the Australian Government should firstly, as a matter of urgency, implement amendments to section 46 of the C&C Act to outlaw predatory conduct and then, again as a matter of urgency, implement a Mandatory Code of Conduct to address the immediate problems, while work is carried out on reviewing and implementing improvements to the C&C Act. The QDO will pursue this issue during the course of the Review.

The Review will be receiving submissions from the National Farmers Federation and Australian Dairy Farmers Limited. The QDO supports the submissions from these two organisations. This submission provides additional commentary and Queensland dairy farming specific issues which should be seen as additional detail to the NFF and ADF submissions.

Context

The globalisation of the Australian economy since the floating of the Australian dollar in 1983, and the entry of many large multinational food manufacturing and processing companies has meant the competitive environment for dairy farmers has changed significantly.

From a Queensland industry in the 1980's which was characterised by the majority of milk produced by dairy farmers being processed and marketed through a large number of cooperatively owned dairy companies to today when there are two significant multinational milk processors (Parmalat and Lion) and one NSW cooperative processing Queensland milk.

Clearly, on a macro scale, the globalisation of the Australian economy has delivered significant benefits and productivity growth in many sectors of the economy, but this has also led to a significant reduction in the choice for small businesses, including farmers, of where they can purchase their inputs from and sell their outputs to. For many farmers there is no choice for either inputs or outputs.

<u>Impacts of the Supermarket Milk Price War</u>

The Queensland dairy industry has been particularly hard hit in the past four years by the supermarket milk price wars leading to significant impacts on farm prices. In particularly, Queensland dairy farmers are required by the companies operating in the market for raw milk supply in the State to produce high quality milk every day if the year, something that is not required by dairy companies for a majority of dairy farmers in Southern Australia.

Production of milk all year round has substantial additional production costs and risks compared to seasonal milk production as production of pasture out of optimum seasonal growth months requires significantly greater supplementation of purchased inputs such as grains, silage and hay.

As virtually all of Queensland milk produced is used as drinking milk, it makes Queensland farmers highly susceptible to impacts from manipulation of the price of drinking milk by major supermarkets through the ongoing supermarket 'milk price war'.

With the requirement to supply milk all year round it makes for a difficult operational environment for dairy farmers with limited or no alternative supply and production system options.

When the milk price war started on Australia Day 2011, fresh milk was discounted to the unsustainable level of $1 per litre, which was started by Coles and then followed by the other major supermarket chains.

This marketing gimmick has sacrificed the value of fresh milk right across the nation and this has had major knock on effects for the domestic fresh milk industry and the dairy farming families that supply fresh milk for Australian consumers.

The impacts of discounting supermarket branded fresh milk by up to 33 percent to $1 per litre have been wide spread, including;

- devaluing fresh milk at retail level nationally by an estimated $220 million per annum;
- forcing a large price difference between supermarket store brands and processor proprietary brands to an average differential of 91 cents per litre;

- causing the loss of market share of processor proprietary brand milk sales to discounted $1 per litre supermarket store brands and with that the loss of processor profitability;
- forcing processors to discount their own proprietary brands to try and slow the loss of market share, with a further loss in processor profitability;
- these market pressures on processors have been passed back to dairy farmers through the reduction and ongoing suppression of farm gate prices, along with the reduction in contract periods and tightening of contract conditions, quality penalties and addition of freight charges. This has been happening while farm operational costs, like the up to 17.5% increase in electricity charges (one of the larger input costs to dairy farmers due to milk cooling and irrigation) announced by the Queensland Competition Authority on 30 May 2014, have continued to go up, forcing farmers out of the industry.
- preventing the recovery of milk production following the severe flooding in Queensland in 2011 and 2013 and driving milk production lower, when Queensland has seen a major shortage of milk to meet its own needs since the start of 2011.
- small independent retailers and processors have been placed at a huge disadvantage on price, particularly in regional areas, where major supermarkets use national cost averaging and sell milk at a loss at $1 per litre in regional towns, including very isolated large and small centres like Mount Isa or Charleville. In fact processor representatives are telling the QDO they are losing money servicing some regional centres. If the processors withdrew from supplying loss-making centres then the consumers in those centres would only have a choice of supermarket own brand milk and that is only in those regional centres where the major supermarkets trade. This also impacts on independent retailers, corner stores and other outlets which normally supply milk to consumers in those centres. This implication was forewarned by the processing sector during the Senate Inquiry in 2011.

In 2007, Queensland milk supply was close to the regional market demand line, caused by many years of severe drought impacts combined with low farm gate prices. The processors responded to this tightening supply, by increasing the prices of their products in the market place, enabling them to then afford to pay farmers a much higher farm gate price as well as providing longer five year term contracts. This initiative allowed milk production to stabilise and recover. In the current market environment, if processors acted to increase prices they would lose further market share to the supermarket discounted $1 per litre store brand milk.

In 2011 and 2013 with severe flooding impacting many Queensland primary production areas, unlike the other industries such as the fruit and vegetable industry when the supply to the market was impacted the price, based on supply and demand, rose. The flooding also adversely impacted Queensland fresh milk supply, but prices did not rise. In fact the farm gate price for milk fell during this period due to the market power interference by the Coles led supermarket milk price war, which has not allowed normal market supply and demand pressures to function properly in the Queensland market.

In Queensland alone, we have now lost more than 100 dairy farmers since Coles started the milk price war in 2011, and we arguably should not have lost any, as we have been short of milk in Queensland to meet the needs of Queensland consumers since the start of 2011.

This is not just a loss of generational expertise in dairy farming and upcoming young farmers, but equates to a loss of some $300 to $340 million investment in milk production in Queensland and some 340 on-farm jobs, let alone the jobs lost from cut backs by the processors and job losses from regional Queensland as service work to the dairy industry is lost. This is a clear case of regional market failure.

At the same time farmers are leaving the dairy industry we are short of fresh milk to meet the daily needs of consumers.

This year we are forecast to be more than 20 percent or more than 120 million litres short. This figure will get worse unless the current market failure is addressed.

At the same time milk processors are freighting milk longer distances from NSW and Victoria, at a much higher landed cost, than they are paying Queensland dairy farmers, to fill this supply gap.

Sourcing milk from the southern Australian regions to fill the domestic market gap is effectively diverting milk away from being manufactured into dairy products for the export market and transferring income from the dairy industry to the transport sector. This is a net loss to the Australian economy as a whole and will have long-term ramifications.

The QDO and Australian Dairy Farmers (ADF) foresaw and presented these possible implications to the Senate Inquiry in 2011, however the growing impacts and their causes are still being ignored.

The forecast population growth in Queensland over the next ten years translates to the need for another 110 million litres of fresh milk to meet the needs of Queensland consumers. To achieve that goal, let alone take advantage of the opportunities in the growing Asian market, farmers and investment need to be attracted to our industry not driven out of it.

This year's opening prices for southern dairy farmers supplying the export market was up 25 to 30 percent. New Zealand dairy farmers were being paid 15 percent more (in equivalent AUD terms) this year, for low cost seasonally produced milk, than that being paid to Queensland dairy farmers.

All of these are factors which should be having a positive influence on the Queensland farm gate milk price, but are not. If a truly free market operated, then farm gate prices should increase.

Over the last twelve months many of the dairying regions in Queensland have experienced the worst rainfall deficit on record, unfortunately for many, this directly followed a record flood. The extra costs from drought have burnt into farm margins, particularly with very high feed prices and increased electricity consumption with irrigation.

The impacts of the drought and market failure can be clearly seen in the results of a survey of Queensland dairy farmers carried out in January this year which achieved a response rate of 46%. The survey confirmed that farm confidence remains extremely low and fragile due to negative farmgate returns and low milk prices, which is now being exacerbated by rising input costs such as electricity.

The survey responses presented that;

- the majority of Queensland dairy farmers are not confident about or were uncertain of the future of their dairy farming business and the whole northern dairy industry,
- 50% of the State's dairy farmers said they could not confidently expect to be dairy farming any longer than 12 months and only 23% presented that they expect to still be dairy farming in 5 years' time,
- 90% of those people with an expectation of possibly leaving the industry listed "lack of profitability" as the major reason for considering leaving the industry,
- 71% of farmers could not pay all of their monthly bills with their monthly milk cheque, and that a similar percentage has had to increase their level of loan or overdraft debt over the past year and had been forced to postpone vital repairs.

These low levels of confidence amongst Queensland dairy farmers have been reinforced by the recently released Dairy Australia Situation and Outlook report where surveyed Queensland dairy farmers reported the lowest levels of a positive outlook, lowest levels of expected profit this year, and lowest levels of intended investment in the next 12 months.

What has happened in the United Kingdom (UK) over the last decade and half can be used as a forecast of what is in store for the Australian domestic market if the current supermarket tactics continue.

During this time in the UK, the supermarket brands have largely taken over the market place, supermarkets have taken control of the supply chain and from the data provided from the UK group DairyCo, from 1997 to 2009, or 12 years, the retail milk gross margins for;

- farmers increased by only some 4 percent,
- processors increased by some 20 percent, however
- retailers increased by over 600 percent.

At the same time, choice for consumers in the UK has declined and they are now paying a higher price. As this has unfolded more and more UK farmers have left their industry and now the UK imports dairy products from the Europe to meet its consumer's needs. Now in the UK the major supermarkets have started another 'milk price war'. The UK farmers are also seeking stronger Government intervention to bring about fairness in their market.

<u>Unconscionable Conduct</u>

The QDO has welcomed the ACCC's decision in May 2014 to take action against Coles in the Federal Court where it has been alleged Coles engaged in unconscionable conduct with regard to certain dealings with suppliers.

The QDO has made a range of representations to the ACCC with regard to the dealings of the major supermarkets since the commencement of the milk price war in 2011. We do not know if the ACCC action involves any dairy specific issues at this time.

The QDO has a concern with this process of investigation and ultimate action. We believe the Act needs to be strengthened in this and other areas as it can often take many years to collect the evidence and develop a case before the action in initiated. The case itself can often take many months, if not years, to complete and there is the option of an appeal for any aggrieved party.

During such time, not only can the conduct continue but it can cause such damage that a supplier may go out of business while the regulatory process is proceeding.

There needs to be a more timely approach to the issue so that damage to a supplier stops.

Misuse of Market Power

The discussion under the Supermarket Price Wars discussed above and in the section below on mandatory codes of conduct outlines a range of issues where the QDO contends a misuse of market power has been operating at the retailer level.

Unfair Contract Terms

The QDO has serious concern with the way a processor can effectively demand contract terms that are unfair to the dairy farmer. For example, the major processors require all their contracts with Queensland dairy farmers to include a clause which requires the farmer to not only supply to the contracted volumes stated in the contract but that the farmer not supply any milk above the contracted volumes to any other processor, ie all milk produced must be consigned to the one processor.

The QDO has discussed this issue with the ACCC and at this stage it is not entirely clear if the ACCC is still considering the matter.

Dairy farmers can have more than one vat in which their milk production can be stored. The QDO acknowledges that there is some justification for a processor to require all the milk in a single vat to be consigned as that eliminates possible contamination issues if more than one tanker was connecting to a vat.

However, the QDO believes it is anti-competitive to require all milk from a single farm to be supplied to the one processor if the farmer decides to have a second vat to allow supply to another processor/manufacturer. If a farmer could supply milk to more than one company via a second vat, there is the possibility for a competitor company to set up a small dairy manufacturing business such as a specialty cheese business.

To do this now the small company either has to buy the milk from a major company at much higher rates than the farm gate price, potentially making it competitively unviable as a start-up, or buy all the milk from a single dairy farmer every day.

The small company, in its formative stages of development, may not have either a market or the manufacturing capacity to take such large volumes. However, if the business was given the opportunity to source milk at a competitive price from a farmer, it may be able to develop and grow a longer term production and marketing capability and over time provide an additional source of milk supply for many dairy farmers.

Under current required contractual arrangements this alternative supply source has no chance of developing leading to an entrenched competitive advantage for the major company. While this is an anti-competitive issue, it is also an issue for consideration under misuse of market power, unfair contract terms, statutory duty of good faith, and it could be considered an unconscionable conduct to force a farmer to make the choice between supplying all their milk to the one company or not supplying the company at all. This is particularly relevant in Queensland where the opportunity to move from one company to another is limited particularly through geography.

An example of dairy farmers attracting a new competitor into their region was through a collective bargaining group operating under the ADF authorization which was formed in South Australia more than a decade ago.

The SA dairy farm gate supply market was characterized by two major companies whose farm gate prices were not reflective of the market prices being paid to dairy farmers in Victoria. The collective bargaining group was able to attract sufficient daily volumes of milk to make it viable for a Victorian company to negotiate a supply and milk collection agreement which saw higher farm gate prices for the farmers in the group. This, in turn, led the other two processors at the time in SA to increase their farm gate prices to match the Victorian company. This pro-competitive outcome is indicative of what can be achieved when there are the opportunities to balance market power between small business dairy farmers and large dairy processing companies.

The QDO has welcomed the Minister for Small Business, Mr Billson, announcement that the Federal Government has moved to extend unfair contract term protections from consumers to small businesses. While this will also take some time to be fully operational, it is not clear if it will solve the particular problem dairy farmers in Queensland encounter like the issue described above. The ACCC, who administer the Act, has generally taken a view that if a group of small business farmers sign a contract with a specific clause included, it is not an unfair clause because it has been accepted by at least several small businesses. The QDO believes that the C & C Act should be amended to give specific guidance on these types of issues so that there can be more legislative direction on what constitutes unfair clause(s) in contracts offered to small business, particularly where choice of processor is limited or non existent.

Collective Bargaining

Following the deregulation of the domestic milk price in Australia in 2000, the Australian Dairy Farmers Ltd. was authorized by the ACCC to allow for collective groups of farmers to negotiate with milk processors over milk price and supply conditions.

This measure was about seeking to help moderate the imbalance in market power and to help farmers derive a fairer outcome and reduce individual farmer transaction costs in a deregulated market, as well as providing an opportunity for dairy farmers to attract a new competitor to contract milk supply in their region. The arrangements over the past decade have delivered varying outcomes for the collective bargaining groups which have formed.

Because of the current tactics of the major supermarkets the provision of collective bargaining for groups of dairy farmers, particularly in Queensland, has now been rendered ineffective for the purposes of supplying milk for drinking milk purposes – the supermarkets have applied their market power to force processors to supply milk at a lower average price to the store and the processors have simply forced the lower retail prices onto their farmer suppliers.

The QDO believes a key to collective bargaining becoming more effective is to further balance the excessive market power of the major retailers by providing for farmers to collectively boycott. While dairy farmers need to have their milk collected and processed every day, it is the threat of a group of farmers boycotting supply to one particular entity, due to that entity exercising its market power, and supplying to alternative entity, would help to rebalance a little the considerable power currently available to both the large processing companies and the major retailers.

<u>Mandatory Code of Conduct</u>

With the initiation of the 'milk price war' by Coles, the QDO and ADF have raised a number of issues with the Federal Government and the ACCC. We believe the tactics being employed by supermarkets are potentially in breach of the C & C Act, including;

- predatory conduct providing their store brands with an anti-competitive advantage over processor proprietary brands and small independent retailers,
- instances of false and misleading advertising, which has been the subject of a recent action by the ACCC finding against Coles and an undertaking given by Coles,
- failure of the collective bargaining provisions against the power of retailers,
- medium to longer term implications for the primary producers, the supply chain and consumer choice and price.

One of the core issues is the fact that supermarkets effectively set the retail price of both processor proprietary and store brands on the supermarket shelf, which is in affect the market place of choice for consumers standing in front of the supermarket fridge. The supermarket has then discounted their store brand, by as much as 33 percent, to an unsustainable level of $1 per litre, in affect using fresh milk as a sacrificial discount marketing agent, to attract shoppers to grow overall grocery sales, but also to increase the supermarket's store brand market share and power.

By implementing this discounting the supermarket has created a huge difference in price between the two brand categories, which now equates to 91 cents per litre on average, which obviously provides the supermarket store brand with an unfair advantage on price in the eyes of consumers.

In addition to this, the use of ‘national cost averaging’ by major supermarkets places an even greater price difference between the two brand categories in regional areas. In many regions the price of $1 per litre at retail would be well below the costs of goods sold at the point of retail purchase by consumers.

And then there are a wide range of other tactics used by supermarkets to give their store brands advantages over processor proprietary brands including, but not limited to;

- manipulation of shelf space facing to give store brands much more exposure than that given to proprietary brands;
- selective replenishment of shelves to give the impression “processor branded” products have sold out;
- brand mimicking where the supermarket store brand label is specifically designed to look very similar to the main stream processor owned proprietary brand labels;
- negotiating outside preset tender specifications.

The QDO believes these tactics are all predatory to varying degrees and need to be addressed by the Federal Government.

To date we have received less than detailed or comprehensive responses to the issues raised with the ACCC, with some key issues not being responded to at all. As such we eagerly await the release of the report on the results of their most recent investigations.

The major supermarkets are no longer just retailers of groceries, they are brand owners as well and as such the test of the C & C Act should equally be applied to products on the supermarket shelf as it is to one major supermarket competing against another.

The QDO and ADF and other industry groups have been collectively working on proposed resolutions to the current problem. The QDO, ADF and the National Farmers Federation (NFF) have a firm policy position to have the Federal Government implement a Mandatory Code of Conduct.

The QDO and ADF have gone to considerable time and expense in drafting a Mandatory Code of Conduct in legislation and regulation to cover the whole supply chain from farm to the retail checkout. The Code is targeted at creating a fairer and more transparent trading environment and is to be headed by an ombudsman with the power to act and address unfair and unconscionable conduct.

This Code has been presented to the Federal Government. To date the Federal Government has publically stated that it is considering the Voluntary Code of Conduct proposed by the two major supermarkets.

The dairy industry is still awaiting the release of the draft for Voluntary Code of Conduct by the Federal Government for public comment as promised late last year.

The QDO is extremely concerned that the major supermarkets are seeking to delay progress on the issue so that they can continue their current tactics which are deriving larger profit and market share and power gains for them largely at the expense of others.

Our frustration is that as time passes more Queensland farmers are being unnecessarily forced out of our industry and others are under undue severe financial pressure.

From the little we understand about the proposed Voluntary Code, we believe it has some major fundamental flaws including;

- there is no independent Adjudicator or Ombudsman with the power to obtain information, documents and evidence. This is referenced in more detail in the NFF Submission under discussion of a Perishable Goods Commissioner,
- there are no financial or other penalties,
- it does not stop the ability for supermarkets to take advantage of their market power for predatory behavior that negatively affects suppliers, competition and consumer choice,
- does not stop supermarkets from undertaking unsubstantiated below the cost of goods sold at discriminatory pricing between store and proprietary brands that advantage store brands and conversely disadvantage proprietary brands,
- does not effectively cover the whole supply chain or provide for third party complaints on behalf of others to avoid the risk of retribution on suppliers.

All of these issues are specifically addressed in the Mandatory Code of Conduct we have drafted.

As such we have urged and will continue to urge the Australian Government, as a matter of urgency:

- implement a Mandatory Code of Conduct; and
- implement amendments to section 46 of the C&C Act to outlaw predatory conduct.

The QDO believes it is essential to implement these measures to address the immediate problems, while work is carried out on reviewing and implementing improvements to the C & C Act which will arise out of this Review process. We cannot wait another couple of years to have the problems outlined in this submission and in the submissions of NFF and Australian Dairy Farmers to be resolved.