



Australian Government

Department of Agriculture, Fisheries and Forestry

Mr John Hawkins
The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Mr Hawkins

Thank you for the letters you sent on 16 February 2011 to DAFF and ABARES inviting a submission to the Economics References Committee inquiry into the impact of the recent decision by certain supermarkets to heavily discount the price of dairy products (especially milk) on the Australian dairy industry.

The terms of reference of the inquiry require the Committee to examine a number of issues including farm gate, wholesale and retail milk prices, the decrease in Australian milk production and the suitability of the framework contained in the Horticulture Code of Conduct to the Australian dairy industry. I enclose for the Committee's information the following attachments which the Committee may find useful in its deliberations.

Attachment 1 Deregulation of the Australian dairy industry.

Attachment 2 Dairy industry statistics - comparison before and after deregulation.

Attachment 3 Horticulture Code of Conduct and Produce and Grocery Industry Code of Conduct.

Attachment 4 Supermarket price discounting for home brand milk – Excerpt from ABARES *Australian Commodities* March Quarter 2011.

Officials of the Department will be appearing before the Committee on 10 March 2011 to respond to any further queries the Committee may have.

Yours sincerely

Allen Grant
Executive Manager – Agricultural Productivity Division

8 March 2011

DEREGULATION OF THE AUSTRALIAN DAIRY INDUSTRY

Prior to 2000, milk pricing and supply in Australia were regulated by a combination of state and Australian Government policies. In most states, dairy authorities controlled the sourcing, distribution and pricing of milk. This regulated environment was targeted at ensuring year round supply of fresh drinking milk and in effect created separate regional markets for drinking milk. While the arrangements varied slightly between each state, a commonality was the use of production quotas or milk pooling arrangements to source drinking milk.

In the early 1990s, the then Australian Government announced the establishment of an independent inquiry into competition policy in Australia. A key recommendation of the inquiry was for the immediate review of state and Australian Government laws which restricted competition. The ensuing review of the public benefit of Victorian state based drinking milk regulations (conducted in the late 1990s) found that the regulations caused a negative net public benefit. Accordingly, under the national competition policy agreement the Victorian government was required to remove its milk pricing regulations.

Victorian dairy farmer and manufacturing representative bodies supported removal of the regulations. Other milk producing states recognised their own arrangements were unsustainable if Victoria proceeded with deregulation – largely because of the constitutional right to free interstate trade. Accordingly, all states agreed to an orderly and managed reform process, provided the Australian Government could devise a restructure package.

Dairy Industry Adjustment Program

On 28 September 1999, following consultation with industry, the Australian Government announced its intention to implement the \$1.74 billion Dairy Industry Adjustment Program. This figure increased to \$1.92 billion with the announcement of the Supplementary Dairy Assistance Scheme 2001 in May 2001. The Adjustment Program remains the largest package provided to an Australian agricultural industry to assist with structural adjustment pressures.

The Dairy Adjustment Authority (DAA) was established in 2000 by the *Dairy Produce Act 1986* and closed on 31 December 2008. The DAA was responsible for administering applications and making eligibility determinations for the two largest DIAP elements – the Dairy Structural Adjustment Program and the Supplementary Dairy Assistance Scheme. These programs offered farmers 32 quarterly payments made over eight years from 2000 – 2008. The last scheduled payment to farmers was made in mid-April 2008.

It was decided that a consumer levy was the fairest way to fund the Adjustment Program, given that consumers were considered the main beneficiaries of deregulation through lower retail prices and greater product choice. Funding for the Program was therefore provided through the Dairy Adjustment Levy, an 11 cent per litre levy imposed on the retail sale of drinking milk. This levy commenced on 8 July 2000 and was removed on 22 February 2009 when sufficient monies had been collected to repay loans and borrowings associated with the Program.

The Dairy Industry Adjustment Program was designed to be cost neutral to the Commonwealth. The consumer levy funded all administrative costs, payments to

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farmers and grants to dairy dependent communities under the Program. The surplus levy was credited to the Commonwealth. The levy collected about \$20 million per month and the Government recognised that there was likely to be an over-collection of the levy when it introduced the legislation to terminate it (*Dairy Adjustment Levy Termination Bill 2008* Explanatory Memorandum). The termination of the levy was conducted in such a way as to minimise the surplus levy. That is, the levy termination day was amended to be the 7th day after the Ministerial declaration was registered on the Federal Register of Legislative Instruments, not as previously specified in the Act the 28th day thereafter.

DAIRY INDUSTRY STATISTICS – COMPARISON BEFORE AND AFTER DEREGULATION

Farm numbers

- The number of dairy farms has fallen by two-thirds over the last three decades from approximately 22 000 in 1980 to 7500 in mid 2010.
- The number of registered dairy farms fell by 4328 between 2000-01 and 2009-10 – a result of deregulation and drought.
- Owner-operated farms still dominate the Australian dairy industry with corporate farms making up 2 per cent of the total.

	1979-80	1989-90	1999-00	2009-10
Farm Numbers	21 994	15 396	12 896	7511
Milk Production (billion litres)	5.4	6.2	10.8	9.0

Source: Dairy Australia

Herd size and annual yield

- Cow numbers fell by approximately 576 000 head to around 1.6 million head between 2000-01 and 2009-10, largely a result of drought.
- The decline in farm numbers and cow numbers reflects a period of consolidation within the industry.
- While milk production in Australia reached a high of 11.2 billion litres in 2001-02, it has gradually reduced to 9 billion litres in 2009-10.
- Average annual milk production per cow in 2009-10 was 5445 litres, up by 2597 litres on 1979-80 production. This has meant that the percentage decline in milk production has been less than the decline in cow numbers.
- Strong productivity gains are attributable to improvements in herd genetics, pasture management practices, calving patterns and supplementary feeding regimes.

	1979-80	1989-90	1999-00	2009-10
Cow Numbers (million)	1.8	1.6	2.1	1.6
Yield (litres/head)	2848	3781	4996	5445

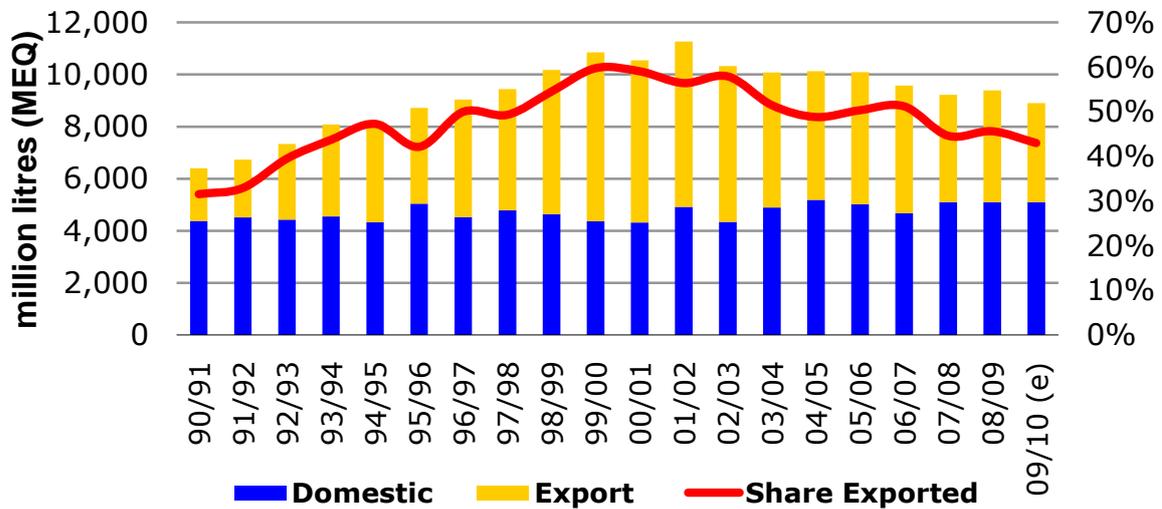
Source: Dairy Australia

Australian industry market mix

- Australia’s milk production supplies the domestic drinking milk market as well as a large processed milk product export market.
- The volumes of milk going into the drinking milk sector have show steady growth in recent years and in 2009-10 accounted for 25 per cent of total milk production. This compares with 17 per cent in 2001-02.
- Of the remaining 75 per cent of milk produced, 30 per cent is used in the domestic processing industry and 45 per cent exported.
- Our major export markets in 2009-10 include: Japan, China, Singapore, Indonesia and Malaysia.

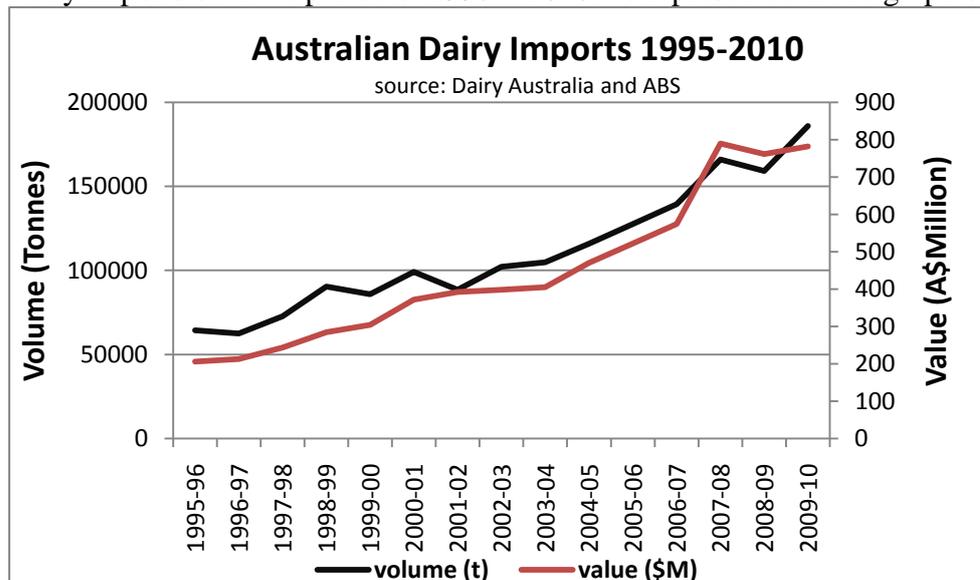
Australian industry market mix

Source: Dairy Australia



Dairy Imports

Dairy imports over the period of 1995 – 2010 are represented in the graph below.



HORTICULTURE CODE OF CONDUCT **PRODUCE AND GROCERY INDUSTRY CODE OF CONDUCT**

Horticulture Code of Conduct

The Horticulture Code of Conduct is one of three codes prescribed by the *Trade Practices Act 1974* (now the *Competition and Consumer Act 2010*). The code regulates trade between growers and wholesalers of fresh fruit and vegetables. It was introduced on 14 May 2007.

The aim of the code is to improve the transparency and clarity of transactions between growers and wholesalers and to provide a fair and equitable dispute resolution procedure. It is intended to:

1. increase transparency of prices, margins and charges that are determined by wholesalers and returned to growers; and
2. provide clarity so that both growers and wholesalers understand the terms and conditions under which business will be conducted and so growers can compare what terms, conditions and opportunities are on offer from various wholesalers and marketers.

It benefits growers and wholesalers by improving business practices in the fruit and vegetable wholesale sector. The code also seeks to benefit growers by ensuring they have better access to information about how wholesalers buy and sell their produce. The intention of the code was not to increase the price paid to growers, but to provide them with the same terms of trade conditions that other industries possess.

The Australian Government Minister for Agriculture, Fisheries and Forestry has Ministerial responsibility for the code, while the Australian Competition and Consumer Commission (ACCC) has responsibility for informing traders and growers of their rights and obligations and enforcing the code, if necessary.

Key Provisions of the Code

The code covers transactions between a person who grows horticulture produce and someone who:

- buys that produce for resale; or
- sells that produce on behalf of a grower for a commission or fee.

The code does not cover transactions between a grower and those who buy the produce for processing, retailing or exporting.

The code requires that:

- wholesalers make publicly available their 'terms of trade' documents outlining their preferred trading conditions;

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- growers and wholesalers use written agreements (known as Horticulture Produce Agreements);
- wholesale transactions are either on an agent or a merchant basis;
- wholesalers provide written transaction information to growers; and
- growers and wholesalers must participate in both independent assessment of transactions and mediation where there is a dispute under the code.

Horticulture Produce Agreements can be flexible to cater for long term multiple transaction supply arrangements through to single spot market transactions.

An agent transaction occurs when a wholesaler sells produce on a grower's behalf for commission or fee. A merchant transaction occurs when a wholesaler buys a grower's produce for resale.

The code prohibits a trader from acting as both an agent and a merchant under the one agreement. In requiring that wholesaler trade is carried out on an agent or merchant basis the code effectively prohibits the previous practice whereby growers were advised of the price after ownership of the produce had transferred to the trader. Grower representative organisations were opposed to this practice as they believed that it allowed a trader to manipulate prices and minimise risk. The previous practice also did not provide growers with clarity as to what happened to their produce nor did it provide the market signals they required to make informed business decisions.

Horticulture Produce Assessors

The code specifies that growers and wholesalers must participate in an independent assessment where there is a dispute. Under the code the independent assessment of produce and transactions is undertaken by Horticulture Produce Assessors.

An assessor may be appointed at any time by either party to a Horticulture Produce Agreement to investigate and report on any matters of disagreement under that agreement, regardless of whether or not a mediator has been appointed. An independent assessor can assist parties to resolve issues and concerns without the need for mediation or expensive legal action. The code requires that growers and wholesalers comply with a reasonable request made by an assessor in investigating a matter.

Dispute Resolution and Mediation

The code also specifies that growers and wholesalers must participate in mediation where there is a dispute. The mediator acts to help the parties reach their own agreement which then becomes a contract subject to the normal requirements of contract law.

The Australian Government provides funds for mediation to ensure the service is available to all parties. The party applying for mediation is required to pay a \$50 application fee and both parties are required to pay any expenses accrued in attending mediation sessions.

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In the case of a dispute arising between a grower and a wholesaler, the code specifies that the parties can use any type of dispute resolution procedure they choose. However, if either party wishes to use the code's dispute resolution process the other trading party must comply.

The code requires that disputing parties follow the steps laid out below:

Step 1: One of the disputing parties is required to notify the other in writing that they are initiating a dispute under the code.

Step 2: The parties must then attempt to resolve the dispute themselves.

Step 3: If, after three weeks, the dispute has not been resolved, then either party may refer the matter to the Horticulture Mediation Adviser.

Step 4: The adviser will work with both parties to help resolve a dispute and, if asked, appoint a mediator.

Office of the Horticulture Mediation Adviser

The code established the Office of the Horticulture Mediation Adviser whose role is to conduct an initial assessment of a reported dispute arising under the code's requirements and appoint a mediator at the request of a grower or wholesaler. The adviser maintains a panel of appropriately skilled mediators familiar with horticulture issues across Australia.

Reasons for the Exclusion of Retailers, Processors and Exporters from the Horticulture Code of Conduct

The code does not apply to retailers, processors or exporters because they are not wholesale intermediaries and because it was considered that transparency and clarity, the issues which the code addresses, were not issues of concern as they generally trade with clear and written terms.

The Produce and Grocery Industry Code of Conduct

The Produce and Grocery Industry Code of Conduct (the voluntary code) is a voluntary code managed by the industry-funded Produce and Grocery Industry Code Administration Committee (PGICAC).

The primary objective of the voluntary code is to promote fair and equitable trading practices among industry participants. This is achieved through the encouragement of fair play and open communication between industry participants as a means of avoiding disputes. For unavoidable disputes, the voluntary code provides a dispute resolution mechanism. The voluntary code is intended to cover all industry participants (except consumers) in the Australian produce and grocery industry. These participants include primary producers, processors, wholesalers, distributors and retailers.

There are four key principles of the voluntary code:

1. *Produce standards and specifications.* Both suppliers and retailers respect each others right to have produce fairly evaluated, and to purchase the best produce at the best price.
2. *Contracts.* All industry participants accept the right of suppliers and retailers to freely negotiate the terms and conditions of any supply contract. The voluntary code provides a checklist of Terms of Trade that may be included in contracts.
3. *Labelling, packaging and preparation.* All industry participants accept retailers' rights to outline labelling, packaging and preparation requirements, and retailers agree to communicate to suppliers any changes to these requirements in clear, meaningful and accurate terms at the time of ordering.
4. *Dispute resolution scheme and procedures.* All industry participants support a two-stage dispute resolution scheme that encourages industry participants to resolve disputes under internal procedures and with any unresolved disputes referred to the Produce and Grocery Industry Ombudsmen.

The voluntary code supported in the produce and grocery industry with the following organisations and businesses committed to promoting it and their own internal dispute resolution mechanisms:

- Aldi Stores
- Australian Chamber of Fruit and Vegetable Industries Limited
- Australian Chicken Growers Council
- Australian Egg Corporation Limited
- Australian Retailers Association
- Coles Group Limited
- Murray Valley Winegrape Growers
- National Association of Retail Grocers of Australia
- National Farmers' Federation
- National Retail Association
- Queensland Retail Traders and Shopkeepers Association
- Woolworths Limited

On 8 March 2007, the voluntary code was amended to include a Terms of Trade Checklist. The checklist provides industry with a practical list of those areas that should be included in any supply chain contract to avoid misunderstandings. The checklist includes items such as supplier obligations, price determination, variation and notification, and procedures to manage compliance.

On 29 January 2009 the Australian Dairy Farmers resigned their membership of the Code Administration Committee saying that relationships in the dairy industry had moved onto such an extent that membership was no longer necessary.

Dispute Resolution Service

The Produce and Grocery Industry (PGI) Ombudsman and dispute resolution process is confidential and funded by the Australian Government. It is a two-stage dispute system, designed to do the following:

1. *Encourage applicants to raise disputes with the respondent.* The voluntary code encourages both parties to resolve the matter in good faith, without prejudice and in keeping with any internal procedures one of the parties may have in place.
2. *Encourage unresolved disputes to be raised with the Produce and Grocery Industry Ombudsman.* Parties may apply to the PGI Ombudsman for assistance in resolving any dispute that cannot be resolved internally.

An application fee of \$50 is payable, although this may be waived if serious financial hardship, determined by the Ombudsman, will result.

Disputes may be referred to the PGI Ombudsman by either the applicant or the respondent where:

- the respondent has failed to respond to the matter in dispute within a reasonable period or within that period stipulated in the internal procedures;
- the applicant and respondent are unable to resolve the matter under the internal procedures;
- the applicant or respondent is dissatisfied with the outcome of the internal procedures; or
- the applicant is dissatisfied with the respondent's internal processes or procedures; or
- the applicant is dissatisfied with the respondent's internal processes or procedures in considering the matter or in reaching its decision.

Since its introduction in 2001 the mediation service has received 587 enquiries and 240 applications for mediation which have resulted in 151 signed agreements. The majority of enquiries have concerned the horticulture sector and relationships between growers and wholesalers.

**SUPERMARKET PRICE DISCOUNTING FOR HOME BRAND MILK – EXCERPT
FROM ABARES AUSTRALIAN COMMODITIES MARCH QUARTER 2011 REPORT**

Around one-quarter of Australia's total milk production is consumed as market milk (drinking milk), with just over half of the volume being sold through major supermarkets. Other milk outlets include independent grocers, fast food outlets, corner stores and service stations.

Market milk processors are contracted by supermarkets to supply their generic branded milk (also known as 'home brand' milk), and contracts usually run for two to three years. Contracted processors' own branded products ('branded milk') are also sold by supermarkets. Home brand milk and branded milk are not identical—with branded milk having a wider range of products that are differentiated on fat, protein and calcium content—but there is likely to be a high degree of substitution.

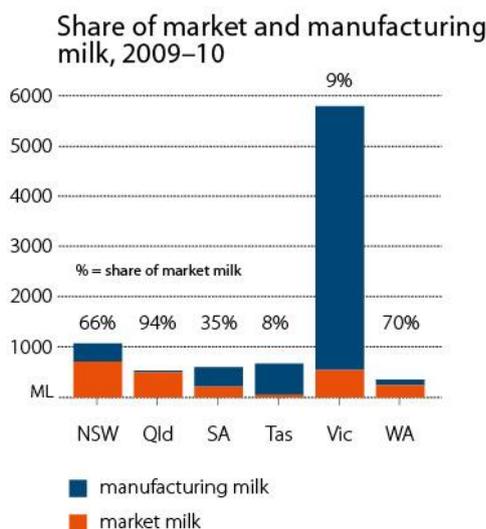
Sales of home brand milk have been increasing in recent years. In 2009–10, home brand milk accounted for around half of the supermarket milk sales and around 7 per cent of overall milk produced. Home brand milk is normally sold at a discount compared with branded milk but some consumers continue to purchase branded milk, which suggests that they recognise some level of difference for which they are willing to pay a premium.

Since late January 2011, the major supermarket chains have reduced the retail price for their home brand fresh milk to \$1 a litre, well below prices for branded milk. For example, Coles Brand 2 litre milk (full cream) was reduced from \$2.47 a container to \$2. In comparison, the price of a particular branded milk (full cream) at a major supermarket is currently \$3.89 for a 2 litre container. Despite the reduced price of the home brand milk, the major supermarkets have pledged not to reduce the contract price to the processors for this milk.

While it is too early to conclude the effect of this price discounting on consumption of milk, it is reasonable to expect that consumption of home brand milk will increase because of an increase in the quantity demanded for milk overall (due to the lower price) and substitution away from branded milk and toward home brand milk. Given that the consumer demand for milk is relatively price insensitive, it is unlikely that total milk consumption will increase significantly in response to the decline in the price of home brand milk, especially in the short term. However, it would be expected that consumers will substitute, at least to some extent, home brand milk for branded milk, and that consumption of branded milk would consequently decline. The degree of substitution will depend on the level of differentiation consumers perceive between the products and the additional price they are willing to pay for the attributes of branded milk.

In response to increased competition caused by the lowering of prices of home brand milk, there is a possibility that processors could reduce branded milk prices in supermarkets and other retail outlets in order to protect their market share. Whether this will occur will depend on the difference in processors' profit margins on home brand milk and branded milk (under the assumption that the supermarkets will not reduce the contract price of home brand milk). There are three possibilities.

1. If the processors' profit margins are similar for these two categories of milk, the processors will simply increase the supplies of home brand milk and reduce branded milk supplies as long as the contract price for home brand milk is not reduced. Under this scenario, the prices for branded milk are unlikely to change, and little of the impact is expected to spill over to the price of milk at the farm gate.
2. If the processors' profit margins for branded milk are higher than for home brand milk, the reduction in sales of branded milk will lead to a decline in the processors' overall profits. In response, the processors could maintain market share by lowering retail prices and seek to pass this on by reducing the milk price offered to farmers. This could also apply to processors not supplying home brand milk.
3. If the processors' profit margins for branded milk are lower than for home brand milk, the prices for branded milk are unlikely to change, profits may increase because of higher sales of branded milk (and assuming that supermarkets maintain contract prices to processors) and some of this increased profit may be passed back to farmers in higher prices. However, it is unlikely that processor profit margins are higher for home brand milk.



Uncertainty in the current situation also exists in terms of how long supermarkets will maintain the lower prices for home brand milk and, if they are maintained over a long period, whether the major supermarkets will maintain their commitment to the contract price for home brand milk. If the contract price falls, it can be expected that the processors will seek to pass on the lower price to dairy farmers.

Should the processors seek to offer a lower price to farmers for market milk, the extent of the price reduction could vary between regions. In south-eastern Australia (especially Victoria,

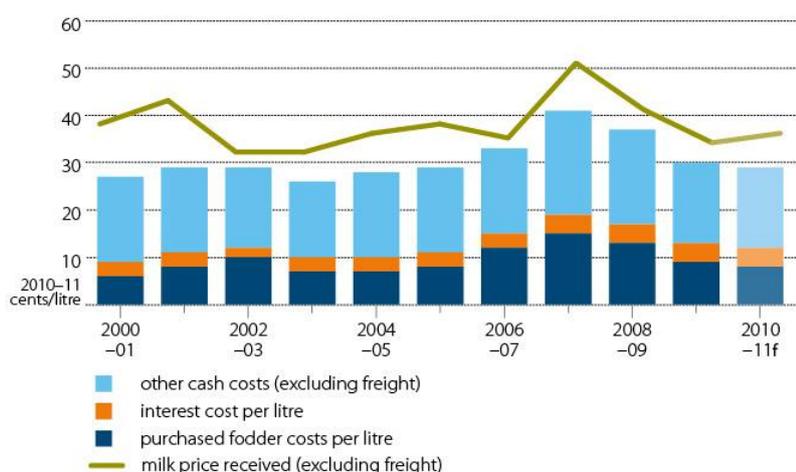
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southern New South Wales, Tasmania and South Australia), the milk price paid by manufacturers for the export of dairy products sets a floor to the extent to which market milk price at the farm gate can fall.

In Victoria and Tasmania, where around 90 per cent of milk is used in manufacturing dairy products, the price paid to farmers for market milk will be closely linked to the price received by farmers for selling milk to dairy product manufacturers. Market milk processors will not be able to pay dairy farmers less than the price being offered by major dairy product manufacturers. Around 60 per cent of manufactured milk is exported in the form of processed products and so the price is determined largely by developments in the world market, rather than domestically.

According to ABARES farm surveys, the farmgate milk price in Victoria is expected to average around 36 cents a litre in 2010–11.

Average milk prices and farm cash costs per farm, Victoria



In northern New South Wales and Queensland, a very high proportion of milk production is used in the market milk sector. The average farmgate milk price in these regions is generally higher than that received by dairy farmers in the regions of south-eastern Australia (estimated at around 46 cents a litre in 2010–11). To a large extent, the farmgate milk price differentials reflect different farm costs for milk production and the cost of transporting milk between regions. In particular, the highest differential payable would reflect the transport costs of buying lower priced milk from the south plus any premium that may be required to secure a contract with dairy farmers in those regions.

Should the processors attempt to lower milk prices to farmers in northern New South Wales and Queensland as a result of supermarket discounting, the lowest that the price could be reduced to, while still maintaining farmer viability in the short run, would be the cash costs of production—currently estimated to average around 40c a litre per farm in this region. Maintenance of farm production in the region in the long run would also need to cover farmers’ depreciation costs, family labour cost and profit margin. Adding the first two costs would increase the estimated average cost of production to around 50c a litre, leaving no margin for price reductions without affecting average farm viability in the long term.

In Western Australia, a high proportion of sales of milk to the domestic market (around 70 per cent in 2009–10) and higher farmgate milk prices compared with south eastern Australia would suggest a similar situation as that for northern New South Wales and Queensland.

