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Australian Competition & Consumer Commission

via email: dairyinquiry@accc.gov.au

FEEDBACK TO ACCC INQUIRY INTO THE AUSTRALIAN DAIRY INDUSTRY (Issues Paper dated 8 November 2016)

Company Overview

Warrnambool Cheese and Butter Factory Company Holdings Limited (**WCB**) is Australia's oldest dairy processor and has been producing high quality dairy products for over 125 years. The Company is located at Allansford in south west Victoria, one of the best dairy regions in Australia.

Its products include cheese, butter and butter blends, milk, cream and dairy ingredients which are sold in Australia and to various customers around the world under well-known brand names including *Sungold, Coon, Cracker Barrel*[i] *and Mil Lel*. Sales are well-balanced between domestic and export markets.

Manufacturing operations occur at a factory site in Allansford, near Warrnambool, in south-west Victoria. The site comprises separate manufacturing facilities for cheese and other dairy products, and a cheese cut and wrap operation. WCB also operates a specialty cheese plant in Mil Lel, just north of Mt Gambier, in South Australia.

WCB employs over 650 people. WCB has been listed on the ASX since 2004, and in 2014, Canadian dairy company Saputo Inc. acquired 87.9% of WCB shares.

This response does not contain confidential information and WCB does not object to its publication.

Feedback

Issue 1 – Competition for milk

1. The level of competition between processors for the acquisition of raw milk, across regions.

WCB consider there to be a high level of competition between processors in the regions it acquires milk being predominantly South West Victoria and South Australia. The table below outlines in a general way the major processors which procure milk in the regions shown; however, the crosses in the table should be read as indicative only, as WCB understands that each processor has a degree of flexibility in relation to the regions in which it can procure milk.

	South West Vic	South East SA*	Central SA
WCB	**x**	**x**	**x**
Murray Goulburn	**x**	**x**	**x**
Fonterra	**x**		
Bega	**x**		
Lion		**x**	**x**
Parmalat			**x**
Australian Dairy Farmers Co-op (ADFC)	**x**		
Australian Consolidated Milk (ACM)	**x**		

*South East SA can be considered as part of the South West Vic region with the majority of milk produced in this region processed in South West Victoria.

2. The ability of producers to switch between processors or other buyers.

WCB considers that producers in our regions that supply milk to WCB do so under standard form arrangements and are able to readily switch between WCB and other processors. A number have switched to and from WCB over past 2 - 3 years and we expect movement of supply between processors to be an ongoing industry trait.

All producers who supply milk to WCB do so under transparent standard terms and conditions as detailed in the WCB Milk Supply Handbook. Under these standard terms and conditions there are no term supply requirements, or exclusivity requirements, and as such producers are able to cease supply to WCB on very short notice.

Some suppliers who supply milk to WCB under the standard terms and conditions have also chosen to do so under fixed term supply agreements. The length of WCB's fixed term agreements varies from 3 to 5 years and agreements includes: -

- WCB Farm Investment Partnership - a program that was offered to all suppliers that provided financial incentives to support expansion and investment on farm,
- WCB Milk Cooling Rebate - a program offered to all suppliers that provides a rebate on milk cooling and storage investment on farm, and
- New Suppliers - for suppliers recently joining, exclusivity in favour of WCB to provide certainty to WCB of continued supply to support WCB’s investment in additional processing capacity.

Each of the fixed term supply agreements contain a clause to recover benefits received by the supplier and a clause to enforce exclusivity of supply to WCB throughout the term.

Issue 2 – Contracting practices

3. The different types of supply contracts used across the supply chain and in certain regions.

As outlined in feedback on question 2 above, all producers who supply milk to WCB do so under transparent standard terms and conditions. Some producers are also under term supply agreements.

Under WCB's standard terms and conditions: -

- there is the use of step-ups. Only producers that are a current supplier at the date of any step up announcement are entitled to participate in any step up unless they have retired or exited the industry.
- there are no specific terms that allow for step downs or a retrospective component to be passed on to suppliers in the unlikely event of a step down occurring
- there is no notice period required by the producer to cease supply

4. Concerns about anti-competitive conduct or unfair trading practices, including unfair contract terms

WCB offers full transparency of supply terms to its producers in relation to its standard terms and conditions, and maintains regular consultation with its producers throughout the year. WCB is of the view that its standard terms do not contain any provisions that could be considered as anti-competitive or unfair trading.

Issue 3 – Transparency and price signals

5. How farmgate milk prices are set and communicated to producers

WCB sets a farmgate milk price each season being the period from 1 July to 30 June each year. WCB operates a milk pricing system that has been common practice for processors in our region for many years being the announcement of an opening milk price (at the commencement of the season) with periodic reviews of the milk price throughout the year. Price increases are generally made during the year and back dated step ups paid if/when market and trading conditions become more certain.

WCB operates in both the domestic and export markets as discussed in feedback to questions 7 to 10 below. Farmgate milk prices are set having regard to the expected market returns for our range of products including assessments of relevant external market factors such as world commodity prices and exchange rates.

During the course of the year, WCB regularly communicates details relating to farm gate milk prices to producers as follows:

- the opening milk price at the commencement of the season typically in June each year for the following season commencing from 1 July.
- formal price reviews throughout the year in accordance with a quarterly review process (October, January, April, June).
- at other times if market circumstances change significantly.

WCB also regularly communicates to producers via monthly newsletters and supplier meetings.

WCB provides producers with "income estimates" that detail the predicted milk income for each individual farm based on that farm's milk flows.

6. The availability and use of meaningful global market information and price signals across the industry, including by dairy farmers

There is a significant amount of global market information available that is relatively easy to access, free of charge or via subscription. WCB accesses numerous publications and reports information including: -

- Dairy Australia Situation and Outlook Report
- Rabobank
- NZ Agrifax analysis
- Dairy Globe
- Global Dairy Trade
- Dairy Week

We understand that the Australian Government has set aside $2 million dollars to build a dairy commodity price index in response to the market conditions that have been experienced during last season. It is our position that there is already a plethora of tools available to the processors and farmers in the form of commodity price indices, futures markets and general market information. We do not believe there is a need to create an additional platform. Dairy Australia has built a great platform for this through their Situation and Outlook Report information. They were publicly advising the downturn of global prices throughout the latter half of 2015 in a timely and accurate manner. Any perceived market failure here is, in WCB's view, not the quality of the information but its dissemination to and understanding within the broader farmer community.

Issue 4 – Domestic retail markets

7. The major supply channels for the domestic market, including major supermarkets and other retailers.

The Australian domestic market, at both the retail and foodservice level is, on a general basis, a relatively concentrated one and this does have an impact on the levels of competitiveness along the supply chain. Despite this dynamic, the underlining market structure is open and unregulated and it would be difficult to say the supply of the domestic market as being subject to restrictive arrangements or practices on competitive grounds. Australian dairy processors have various options to market and sell their products in a range of domestic channels, or have the relative freedom to sell to and build markets outside of Australia.

Competition in the retail and foodservice sectors in Australia is forever evolving and we believe that the free and open market that exists will continue to create opportunities for the dairy industry. It must also be considered that the Australian domestic market is mature and overall growth could be described as flat. Within this maturity though, there does exist a level of stability which is in contrast to the volatility of the global market. Due to this stability the Australian market has been relatively attractive over the past 12-18 months against a global dairy commodity market that experienced a downward spiral in prices. We have therefore seen an increase of imported product, especially from New Zealand. New Zealand has had an obvious cost competitive advantage through the last half of 2015 and the first half of 2016 due to their farm gate milk prices being significantly below that of Australia's.

A correction in dairy farm gate prices in Australia from 1 July 2016 has returned Australian farm gate prices to a position that is more closely aligned to the global market place.

8. The impact of $1 per litre milk on the industry. This includes information about the positive and negative impacts of private label product supply contracts.

In respect to the retailers pricing of their own branded 1 litre packaged milk at $1, this has been as a result of an open, free and competitive market, and therefore cannot be held up as failure of the competition environment or, on its own, as a success or failure of the Australian dairy industry.

In our own experience however the margin that can be gained through the retailers' private label business are very tight and in general WCB has not participated in this market for that reason. Our understanding is one of the dynamics that has allowed for tight margins is in relation to the private label agreements with the retailers by new entrants in the sector who have invested heavily to build new capacity in retail packaged products where there was already surplus capacity, and where market demand is generally flat.

Issue 5 – Global markets

9. Options for supply into export markets, including products and destinations

The global export market provides a plethora of opportunity for Australian dairy processors. WCB has been exporting dairy products from Australia since the late 1800's and it continues to provide very attractive commercial opportunities for our company. The volatility that exists in the export market is nothing new and records show that it existed in the early days of WCB's export exploits. As a matter of history we have seen volatility caused by such factors as war, oil crisis, one of Australia's largest dairy export markets, the United Kingdom joining the European Union (and now voting to leave the EU), the crash of the global stock market, recessions, success and failures of market access negotiations, food quality issues, the Global Financial crisis, changes in and the abolition of dairy production quotas and closures of complete markets due to political reasons. These factors have always, and will continue to pervade the global dairy market.

Volatility provides both opportunities and risk and the key is to gain experience and expertise in traversing this environment, but most importantly is to recognize that volatility exists and cannot be controlled. The factors that lead to the downturn in market prices experienced during 2015 were well known and the levels and depths of this were in complete contrast to the momentum of farm gate milk prices during the 2015/16 season.

Towards the end of 2015 most dairy companies in Australia were publicly declaring the imbalance between product prices and the farm gate milk price. On 5 November 2015 WCB announced their half year results which included a net operating loss and advised the reason as being "*the decrease in profit is mainly due to declines in global international commodity prices and a high raw milk cost relative to market conditions*".

10. Any barriers to selling into export markets.

The greatest challenge in selling into export markets today is the continual management and protection of the Australian dairy industry's strong reputation as a supplier of quality, sustainable and ethical dairy products.

Significant investments have been made by the industry as a whole in being able to gain this position in the global market place. That level of management and vigilance must continue. The current biggest threat Australia's dairy industry faces to this hard fought status is the introduction of rBst growth hormones into the Australian dairy supply chain. The Australian Pesticides and Veterinary Medicines Authority (APVMA) is currently considering an application by Elanco for the introduction of Posilac, a growth hormone. If this were to be approved in Australia, it would create a major impediment to Australia’s dairy trade position because in some export markets, Australian milk continues to drive a premium margin as a result of being free of added hormones.

Another barrier to selling into export markets are any barriers to entry importing countries could impose.

Issue 6 – Production costs and profitability

11. The key factors influencing the profitability of dairy farms, including costs of production

The wide and varied nature of Australia’s dairy farming businesses means there are a multitude of factors that affect farm profitability. Among those that have the greatest impact are the seasonal conditions experienced in our major dairy and fodder growing regions. Adverse conditions in these areas pose a double edged impact on farm cost of production by reducing pasture growth and home grown fodder, and often increasing the cost of purchased feeds such as grain and hay.

Milk price volatility has a sapping effect on industry confidence and subsequent investment in growth. The international market for dairy continues to be volatile and farmers have found it difficult to overcome these extremities.

Maintaining downward pressure on the cost of production continues to be one of the industry’s key challenges, though it should be noted that dairy is not alone in this regard. Our ability to compete globally on a cost of production basis is a key element in the long term success of the industry. Efficient, cost effective production of home grown feed is a proven driver of farm profitability. Understanding key marginal decisions with regard to inputs and maintaining a high degree of cost control are critical skills for the farm business manager. It is important that industry continues its focus on driving improvement in these areas at the farm level.

Commentary on alternative income streams

In recent years dairy businesses have supplemented their income through the sale of heifers, primarily to export markets. Whilst this has been an effective strategy to manage cashflow shortfalls in any given year, some adverse effects have arisen from the ongoing use of this strategy on some farms, including; increased herd age and issues maintaining milk quality and cow fertility. More recently the propensity for some farms to rely on this source of income has put their businesses at risk when spot demand is reduced or orders cancelled.

Due to the relatively high cost of land and infrastructure involved in dairy farming, opportunities to successfully diversify into mixed farming businesses are limited. Whilst the dairy 'chopper' market has been at historical highs, dual purpose dairy breeds still make up a very small percentage of the national herd, indicating that normal domestic demand for these animals in the meat industry is limited.

Issues concerning the supply of inputs
A sustainable, affordable and consistent supply of both water and power is required for the industry to maintain the current level of production. Recent government policy in regard to these resources has significantly increased the cost of power and added a level of volatility to the water market which intensified the cost-price squeeze on farm businesses. Clear, balanced and consistent policy is required in this area for the industry to prosper and to foster an environment that will permit growth.

As farm businesses grow and become more complicated, more employees and greater skillsets are needed to profitably manage them. Australian farms are faced with a relatively high cost of labour when compared to our global competitors. The supply of quality skilled and unskilled labour remains a critical issue for the industry. A rural exodus, combined with the fractured and ad hoc nature of industry training and career pathways continues to pose challenges in attracting people into the industry.

Finally, the ability to attract and engage capital investment is developing into a key constraint of the Australian dairy industry. As the average age of farm owners continues to increase, new business models and capital investment pathways are needed to ensure dairy business assets can be effectively and efficiently transitioned without burdening investors or new entrants with risk. Much of the industry consists of small owner-operator farm businesses which have found it difficult to attract outside investment in order to grow, invest in farm improvements and efficiencies or transition to retirement. The ability to provide investors with scalable, liquid opportunities to invest capital remains limited whilst the level of assets required can also be a barrier to those progressing from share farming to farm ownership.

Further to the above regarding on-farm costs, due to government policy restricting gas exploration it is expected that the WCB's cost of gas for its production facility in Victoria will increase by 50% from 2018. This will in turn negatively impact the milk price paid to suppliers.

To discuss the above or for further information, please contact:

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[i] Trademark used under licence