



**Application of the Australian
Government's Industry Codes of Conduct
Policy Framework to the dairy industry
Discussion Paper**

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Introduction

Over the past two plus years there has been considerable debate about whether the dairy industry requires a code of practice and if so, in what form. This is largely due to a series of unfortunate incidents in April and May 2016 where Australia's two largest dairy processors, Murray Goulburn Cooperative and Fonterra Australia, reduced the farm gate price paid to its dairy suppliers retrospectively for the 2015-16 season. Affected dairy farmers were forced to accept a price reduction of more than 10 per cent in their milk prices for the year. Higher cost farmers incurred debt, either to the processor or privately, driving some to exit the industry. It could be argued that if a code of practice was in place during this period, such events may never have happened.

Codes of practice have been used by many industries, governments and social organisations for decades. Their intent is to make our workplaces safe and ensure businesses are transacting with suppliers and consumers openly, fairly and honestly. Put simply, codes of practice are statements of principle and practical advice for how a business or industry should operate.

In response to the price step down the Australian dairy industry, under the auspices of its peak advocacy body, the Australian Dairy Industry Council Inc. (ADIC) introduced a voluntary code of practice on 30 June 2017. All of Australia's state dairy farming organisations (SDFOs) and most of the big dairy processors, including Murray Goulburn Cooperative and Fonterra Australia, were signatures. This means that all SDFO members (farmers) and signature processors are required to adhere to a minimum standard of practice in contract management.

Most requirements in the dairy code are for processors to action. They include providing clear and transparent price signalling, methodology and negotiation arrangements; offering notification periods of 30 days for contract variations and 90 days for termination unless mutually agreed; never issuing retrospective changes; honouring loyalty payments over contract terms; allowing farmers to supply additional milk to other processors; and providing a dispute resolution process in the event of a contract disagreement. When the code was released a Senate Economics Reference Committee (ERC) was conducting an inquiry into the legality and impact of the retrospective price step down and the Australian Competition and Consumer Commission (ACCC) was investigating similar matters under the *Competition and Consumer Act 2010* (CCA). Recognising these initiatives, the ADIC included a clause in the code that it will be reviewed after 12 months of operation. This positioned the review to consider the findings and recommendations of the ERC and ACCC (reports released in August 2017 and April 2018 respectively) alongside:

1. a comparison of the different types of codes available and their effectiveness.
2. independent external legal advice on the existing code. This was a recommendation made by ERC in its report and the United Dairyfarmers of Victoria in its submission to the ACCC inquiry.
3. stakeholder, member and farmer feedback on their experiences and proposed changes to the code.

Over the coming month or so the Australian dairy industry must decide on the type of code it really wants. Ideally this will be a consensus decision from farmers and processors based on this weight of evidence as opposed to a previously stated position. The purpose of this paper is to help industry arrive at its decision by raising the issues and applying the evidence in the context of the Australian Government's *Industry Codes of Conduct Policy Framework* (November 2017).

Types of industry codes available

There are three types of industry codes. A non-prescribed voluntary code is what the dairy industry has currently. It is written and enforced by industry. The ACCC may provide advice consistent with its *Guidelines for developing effective voluntary industry codes of conduct* (July 2011) if the industry requires. There are also prescribed voluntary codes and mandatory codes. These are legislated documents under the auspices of the CCA. Terms and conditions are developed by the relevant federal department with policy carriage (in the case of dairy the Department of Agriculture and Water Resources) working with the Office of Parliamentary Counsel. An exposure draft legislation is released for public consultation before it is tabled in Parliament for approval to become law. The ACCC regulates prescribed voluntary and mandatory codes by conducting compliance checks and taking enforcement action where appropriate. This can involve resolving breaches administratively, issuing infringement notices or for more serious offences, applying court enforceable undertakings under section 87B of the CCA. Penalty amounts for breaches of certain provisions are up to \$63,000. Infringement notices are set at \$10,500 for a body corporate and \$2,100 for an individual and other entity. The key difference between a prescribed voluntary code and a mandatory code is application. A prescribed voluntary code, like the dairy industry's current non-prescribed code, allows a company or individual to decide if they want to participate. Alternatively, a mandatory code applies to all participants irrespective of motive.

Decision making criteria for prescribing a mandatory code

The Australian Government's criteria in its *Industry Codes of Conduct Policy Framework* (November 2017) is broadly consistent with most role of government tests applied by policy makers. For example, the principal criteria to be satisfied before imposing a levy to fund agriculture research and development, marketing or biosecurity programs include demonstration of market failure, achievement of net industry benefit (that is, industry benefits must exceed the costs of raising and funding the levy) and that the application of the levy is practical. In the context of the *Industry Codes of Conduct Policy Framework* (November 2017) five questions need to be answered 'yes' for the Australian Government to impose a mandatory code on an industry.

Is there an identifiable problem (existence of a market failure) in the industry?

In 2000 the Australian dairy industry was deregulated. This shifted the industry from state and federal governments regulating the sourcing and pricing of milk to private businesses serving global markets of which international prices are the key determinant of the price received by farmers for their milk. Since this period markets have generally operated efficiently with private agents making decisions about investment, production, distribution, risk management and many other aspects of their economic performance. Successful investment has returned the relevant agent or firm greater profits, and consumers have received higher-quality and/or lower-priced products. In these cases, there has been little or no need for government intervention.

In some cases, however, markets can fail to function in an efficient way. This is where prices, in this case milk, do not accurately reflect its true value. In this situation either the buyer or seller makes excess returns at the expense of the other who carries a disproportionate level of risk. If the cause of market failure was removed such advantages and disadvantages would disappear as market prices move to reflect the asset's true value.

Markets fail for various reasons. Generally, it is the result of a public good, externality, market power, risk or asymmetric information. In the case of dairy, the ACCC found it has been operating with asymmetric information to the detriment of farmers. Efficient markets require participants (processors and farmers in this instance) to have equal, accurate and relevant information. When this doesn't occur demand or supply can be inappropriate and prices and volumes in the market fail to be at a social optimum. For example, there are labelling requirements for chemicals and fertilisers used on farms because consumers are not reasonably able to test produce for residues. To address the issue maximum residue limits are prescribed and regulated by biosecurity divisions in government departments. Addressing the information gap protects participants and helps the market operate efficiently. In the situation of dairy, it is farmers who do not have the same information as processors. They are provided with overly complex milk supply contracts and are not privy to milk pricing and payment methodologies. Consequently, they have limited bargaining power and carry a disproportionate level of risk than their processor counterparts.

Can the problem be addressed using existing laws or regulations?

Dairy farmers are protected from unfair contract terms under Australian competition law. Unfair contract terms include terms that enable one party (but not another) to avoid or limit their obligations under the contract; terms that enable one party (but not another) to terminate the contract; terms that penalise one party (but not another) for breaching or terminating the contract; or terms that enable one party (but not another) to vary the terms of the contract. An issue for dairy farmers is the terms that set out the price and supply of milk is exempt from these laws. Consequently, farmers are exposed to unnecessary risk which only further government and/or industry intervention can address.

Has industry self-regulation been attempted?

The dairy industry's voluntary code was the industry's response to removing risk and addressing market failure. It has been recognised by the ACCC that 'significant efforts (were) made by industry in developing the voluntary code'. In terms of effectiveness the ACCC noted that 'improvements to current-year contracts have been achieved'. These are important developments when considering the Australian Government's statement that 'the path to prescribing an industry code is usually a progressive one. Industry codes will generally not be prescribed unless there is evidence that existing measures, including any self-regulation that has been attempted within an industry, have failed to address the identified problem.'

Yet irrespective of the gains made farmers are still exposed to risk. Not all processors are signature to the code and there are no binding penalties for code breaches. In some dairy regions farmers can switch processors if they are not a code signature or if contract terms are unreasonable. However, in other dairy regions farmers only supply to one monopoly processor in their region or market. There is no issue if contract terms are fair and reasonable but if circumstances change, as they did with Murray Goulburn Cooperative and Fonterra Australia back in 2016, affected farmers would be forced into undue hardship once again. This is the primary reason why the ACCC and some of Australia's SDFOs recommend a mandatory code be imposed on industry. It is argued that eliminating the risk provides farmers with an enhanced level of protection, paving the way for increased on farm investment and processor competition in the industry.

The *Independent Review of the Food and Grocery Code of Conduct Draft Report* (June 2018) recommends an alternate option to managing the risk at less cost to industry. Like the dairy code, the food and grocery code is voluntary participation. This enables participants like major wholesaler Metcash to not be signatures; creating similar supplier risk in the industry. Despite this the review found 'the broad feedback from stakeholders is that the grocery code has contributed to a significant improvement in retailer-supplier relations' and 'the ACCC has not taken any enforcement'. Furthermore, the review found some retailers signature to the code have implemented programs above the code's core requirements. For example, Coles created a Nurture Fund to support the growth of innovative small suppliers and introduced an independent adjudicator to resolve complaints. For similar reasons to dairy the ACCC argued for the food and grocery code to become mandatory. The review disagreed with this recommendation on the grounds a 'voluntary code has the advantage of fostering industry buy-in and ownership by the signatories, which is vital to supporting robust and sustainable changes in business culture. It also provides greater scope for the retailers and wholesalers to establish innovative solutions that best suit the industry to resolve its own problems.'

A gap identified by the ACCC in dairy is a lack of effective dispute resolution process for contract and code non-compliance. Many milk supply agreements reviewed by the ACCC over several seasons did not contain a process. However, 'following the commencement of the voluntary code, the ACCC observed that more milk supply agreements commonly include dispute resolution.' This is evidence of the dairy code being effective. The ACCC suggested that some processes may not be beneficial given the continued presence of imbalance of bargaining power. This is another reason why the ACCC recommended the introduction of a mandatory code. An alternate option is for industry to introduce an independent dispute resolution process in a revised version of the code. This would be activated when a potential contract or code breach is not resolved via the processor's dispute resolution process.

An effective dispute resolution process is one of several gaps in the dairy code when benchmarked against the ACCC's *Guidelines for developing effective voluntary industry codes of conduct* (July 2011). For the dairy code to become best practice it also needs to have binding sanctions for non-compliance and independent management oversight, including reporting and review, of code conditions. A logical next step for industry is to update its code to satisfy these requirements.

Is an industry code the most suitable mechanism for resolving the problem?

The *Industry Codes of Conduct Policy Framework* (November 2017) applies mandatory codes as a last resort. It states that 'the government is keenly aware that any intervention can have unintended or unforeseen consequences which distort the market and create further problems for market participants. It can impose an unnecessary administrative burden on businesses that are required to comply with regulation. Regulation can also create significant barriers to entry for new firms and can stifle innovation and choice. Once regulation becomes established, it may be difficult to alter and can become out of date when market conditions change. The government will only prescribe mandatory or voluntary codes in very limited circumstances - when it is necessary for supporting the efficient operation of markets or the welfare of consumers. This high threshold is reflected in the limited number of codes that have been prescribed over the years.'

Government intervention in the dairy industry includes regulation, research and development, innovation in extension delivery, knowledge innovation systems, facilitating investment, improving market access and enabling resilience in farms and rural communities. The ACCC make eight recommendations in its report, most of which focus on regulating contract management including the introduction of a mandatory code. If the industry expands these recommendations to include relevant ERC recommendations and several ACCC findings converted to tangible actions, the need for a mandatory code reduces. For example, introducing a standard contract template for use by all processors and released at the same time across industry will make it easy for farmers to understand and compare processor terms. It will also increase capacity for farmers to switch processors to improve their terms and conditions. This addresses some of the information asymmetry, strengthens farmer bargaining power and stimulates competition between processors. The ADIC structure provides an opportunity for processors and farmers to work collaboratively to deliver these actions and outcomes.

Is there likely to be a net public benefit?

Critical to an assessment of whether government should intervene is the notion of net benefit. This is the sum of private benefit, private cost, public benefit, public cost and unquantifiable effects which are all attributable to an intervention to offset the effects of market failure. The availability of positive net benefit indicates that government intervention is appropriate and the distribution of net benefit between private and public actors in the economy informs the way that government might intervene. It should be noted that in some cases government intervention can unintentionally compound, rather than correct, a market failure. A strategic approach to investment will help ensure such negative outcomes are avoided.

The dairy industry will bear greater cost for administering a mandatory code (as compared to its existing voluntary code which currently has no administration cost, fees or penalties). Under the Australian Government's *Cost Recovery Guidelines* (July 2014) 'non-government recipients of specific government activities should be charged some or all of the costs of those activities.' The ACCC will therefore be imposing cost recovery fees (fees charged when a good, service or regulation is provided directly to a specific individual or organisation) and/or cost recovery levies (charges imposed when a good, service or regulation is provided to a group of individuals or organisations e.g. an industry sector rather than to a specific individual or organisation). There are also penalties for non-compliance, which can be issued to processors and farmers.

At this stage it is not clear what the costs would be for a mandatory dairy code. This will be outlined in a *Regulatory Impact Statement* (RIS), to be drafted by the Department of Agriculture and Water Resources should the Minister for Agriculture, in consultation with the Treasurer, approve the ACCC's recommendation.

A limitation of the RIS is failure to articulate opportunity cost. This is the calculation of industry production and sales forgone from diverting resources to compliance activities. These are compounded if the ACCC, the code's regulator, is inefficient or ineffective. The concern for dairy is business leaders reporting in the *ACCC business stakeholder survey report* (2016 and 2017) and the ERC have described the ACCC's administration practices as cumbersome and lacking transparency. The *Independent Review of the Food and Grocery Code of Conduct Draft Report* (June 2018) said 'it does not believe that the ACCC's current approach to annual compliance checks is leading to the best outcomes for the industry.' In response, the review recommended the ACCC streamline its operations and adopt a more targeted approach to enforcement. To the ACCC's credit, its 2017 performance results for its enforcement division in the stakeholder survey are significantly better than 2016. However, with negative responses still ranging from 19 to 23 per cent across its six key performance indicators, more continuous improvement is required to obtain industry confidence.

An important consideration for dairy is whether net benefit has been achieved in other industries subject to a mandatory code. Currently, these industries include franchising, horticulture, wheat, oil and sugar.

The *Franchising Code of Conduct* was established in 1998 and has been reviewed four times. In its submission to the last review the Franchise Council of Australia (peak industry body representing franchisors, franchisees, service providers and suppliers involved in franchising) supported the code as an effective part of the regulatory framework. It argued for legal advice to be obtained before contract signing and for mediation to remain as the best and most cost-effective method for resolving franchising disputes. It did not support the creation of any ombudsman or providing dispute jurisdiction to any new court or tribunal. While it advocated for code simplification and efficient operation the overall summary was it strikes a fair balance between protection for franchisees and compliance cost for franchisors.

The *Horticulture Code of Conduct* was established in 2007 and was updated in 2017 following release of the *Independent Review of the Horticulture Code of Conduct final report* (November 2015). A key finding from the review was broad industry consensus that the code was ineffective. Growers and grower bodies said the code's lack of effectiveness was due to its inability to bring about increased transparency, whereas traders believe that the code failed because it was inflexible and did not reflect the way the industry operates. Industry also said most horticulture produce transactions did not occur under the code, the dispute resolution mechanism was irrelevant, and enforcement inadequate. In response the review recommended that pre-code contracts be included in an amended code and the ACCC be provided increased enforcement powers. These were supported by growers and grower bodies but not central markets and their related industry bodies.

The *Wheat Port Code* commenced in 2014 to establish an access arrangement to ensure that exporters of bulk wheat have fair and transparent access to port terminal services. It was the most recent step in the gradual deregulation of Australia's wheat marketing arrangements, which commenced in 2008 with the removal of the 'single desk'. The code is currently under review with a final report scheduled for release in August 2018. A key finding arising from the *Wheat Port Code Review interim report* (April 2018) was validation of the need for a mandatory code but with amendments to improve effectiveness. These include increasing flexibility to exempt port terminals where there is a history of providing access on fair and reasonable terms to third-party exporters, improving the code's general operation, and clarifying and streamlining reporting obligations and enforcement.

The *Oil Code* was introduced in 2007 to regulate the conduct of wholesalers and fuel resellers who are involved in the sale, supply or purchase of declared petroleum products, such as unleaded petrol and diesel. It aims to help industry participants make more informed business decisions, improve transparency in wholesale pricing and provide access to declared petroleum products at a published terminal gate price. The Department of Environment reviewed the code in 2016 but the final report is unavailable for analysis.

The *Sugar Code of Conduct* was introduced in 2017 to regulate the conduct of growers, mill owners and marketers in relation to contracts or agreements for the supply of cane or the on supply of sugar. A review of the code is currently underway with a final report scheduled for release in December 2018. No analysis can be undertaken as the review has just commenced.

Conclusion

The ERC and ACCC reports found that farmers are disadvantaged in contract management. They have inadequate information in relation to pricing and payments, limited bargaining power in contract development and find it difficult to switch processors to improve their terms and conditions. This is evidence of market failure, which Australian competition law and other regulations are unable to address. The industry has successfully attempted self-regulation via a voluntary code of practice, but farmers are still exposed to risk and continue to experience an imbalance of power. Responding to the findings and recommendations of the ERC and ACCC would address these issues. In relation to the type of code to be adopted industry needs to determine whether it wants to eliminate farmer risk at moderate to high industry administration cost with low industry regulatory control or does it want to accept some farmer risk at lower industry cost with complete industry regulatory control. Selecting the first option is a commitment to adopt a mandatory code. Selecting the second option is a commitment to upgrading the voluntary code to be consistent with best practice.