Australian Food and Grocery Council

SUBMISSION

4 MARCH 2011

TO:
SENATE, ECONOMICS COMMITTEE

IN RESPONSE TO:
THE IMPACTS OF SUPERMARKET PRICE DECISIONS ON THE DAIRY INDUSTRY INQUIRY

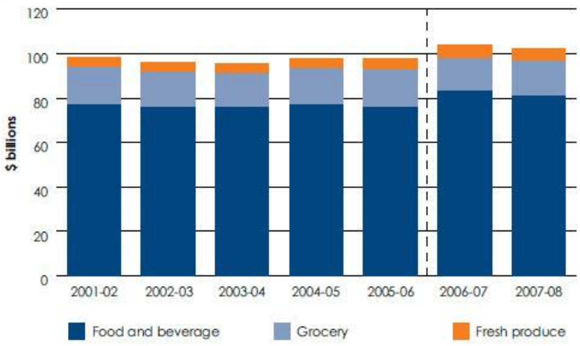
The Australian Food and Grocery Council (AFGC) is the leading national organisation representing Australia's food, drink and grocery manufacturing industry.

Membership of AFGC comprises more than 150 companies, subsidiaries and associates which constitutes in the order of 80 per cent of the gross dollar value of the processed food, beverage and grocery products sectors. (A full list of members is included as Appendix A.)

AFGC's aim is for the Australian food, beverage and grocery manufacturing industry to be world-class, sustainable, socially-responsible and competing profitably domestically and overseas.

With an annual turnover of $102 billion (see chart), Australia's food and grocery manufacturing industry makes a substantial contribution to the Australian economy and is vital to the nation's future prosperity.

Figure 1. Industries turnover (2007-8)



Source: ABS, catalogue number 8221.0 and 8159.0

Manufacturing of food, beverages and groceries in the fast moving consumer goods sector[1] is Australia's largest and most important manufacturing industry, four times larger than the automotive parts sector – the food and grocery manufacturing industry is a vital contributor to the wealth and health of our nation. Representing 28 per cent of total manufacturing turnover, the sector is comparable in size to the Australian mining sector.

The industry's products are in more than 24 million meals, consumed by 22 million Australians every day, every week and every year. The food and grocery manufacturing sector employs more than 288,000 people representing about 3 per cent of all employed people in Australia paying around $13 billion a year in salaries and wages.

The growing and sustainable industry is made up of 38,000 businesses and accounts for $44 billion of the nation's international trade. The industry's total sales and service income in 2007-08 was $102 billion and value-added increased to nearly $27 billion[2]. The industry spends about $3.8 billion a year on capital investment and over $500 million a year on research and development.

Many food manufacturing plants are located outside the metropolitan regions. The industry makes a large contribution to rural and regional Australia economies, with almost half of the total persons employed being in rural and regional Australia[3].

It is essential for the economic and social development of Australia, and particularly rural and regional Australia, that the magnitude, significance and contribution of this industry is recognised and factored into the Government's economic, industrial and trade policies.

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[1] Fast moving consumer goods includes all products bought almost daily by Australians through retail outlets including food, beverages, toiletries, cosmetics, household cleaning items etc..

[2] AFGC and KMPG. *State of the Industry 2010*. Essential information: facts and figures. Australian Food and Grocery Council. Oct 2010.

[3] About Australia: www.dfat.gov.au

1. RECOMMENDATIONS

The AFGC requests the Senate Economics Committee:

- Consider the negative impacts the supermarket price decisions are having on the wider food and grocery manufacturing sector.
- Consider the establishment of a Supermarket Ombudsman to independently adjudicate concerns relating to retailer behaviour, trading terms, use of market power, including those related to unsustainable price discounting.
- Seek a government response to the recommendations included in the 2010 Economics Committee report *Milking it for all its worth – competition and pricing in the Australian dairy industry.*
- Request the Productivity Commission investigate the impact of the pricing and policy decisions of major supermarkets on the productivity and sustainability of food producers and manufacturers in Australia and the possible flow on effects to food security.
- Request a review of the effectiveness of the Competition and Consumer Act 2010 (Cth) (the CCA) (formerly the Trade Practices Act 1974) to establish and respond to anti competitive pricing behaviour.

2. INTRODUCTION

AFGC welcomes the opportunity to make this submission to the Senate Economics Committee Inquiry into the Impacts of Supermarket Price Decisions on the Dairy Industry.

This submission is presented in two main parts:

- general comments on the impact of the aggressive discounting practices of supermarket retailers ; and
- specific comments relating to the Terms of Reference of the Inquiry.

Australia needs profitable and resilient food and grocery production and manufacturing industries to

1. provide a wide range of safe, nutritious and affordable products for consumers against an uncertain future of food production being able to keep up with demand globally;
2. value-add to food and fibre crops and livestock, create wealth regionally and across the whole economy, and provide 288,000 jobs in the sector and more in primary production;
3. to give the necessary levels of certainty to food and grocery manufacturers in Australia required for financial investment in new products, new processes and expanding manufacturing; and
4. ensure consumers continue to have choice in supermarkets and access to the brands they trust.

Price promotion and discounting is a normal part of retailing, encouraging consumers to frequent stores and purchase products. However, recent substantial reductions in price levels for a range of products including milk threaten the viability of agri-food processors which will inevitably have a flow on effect to farmers.

Retailers are advertising unsustainable low prices on private label staple products such as milk that they claim are “here to stay”. If maintained for any length of time, brand owners will be forced to reduce their prices to defend market share and ultimately they will be forced to seek lower prices from producers. If these low prices are at a level that does not allow for a fair return then Australia risks the loss of both food processors and producers in the longer term.

Specifically in relation to drinking milk, based on member advice, AFGC is informed that the margins achievable for milk production in Australia are between 1-3 per cent. With all major retailers adopting the same discounting practice simultaneously a new baseline – or floor – price is established . This has significant flow on impacts beyond the major supermarkets and is most noticeable in the effect it has on small to medium retailers that rely on sales of staples products to maintain viability. They are unable to match the pricing structure and hence bear the costs of reduced turnover and trade. In the fresh milk sector, there are hundreds of small vendors that rely on the sale of milk to underpin their business. It is critical that the infrastructure and systems underpinning the delivery of this fundamental product are not compromised as a result of the current pricing policy of large supermarket chains.

Food manufacturing margins are slim in many mainstream categories. Aggressive, sustained discounting erodes reasonable margins and undermines the capacity for manufacturers to continue producing in Australia. Without fair returns on investment companies cannot justify capital expenditure to improve plant, product and processes to remain competitive against imports. This will encourage companies to cease manufacturing in Australia taking production to countries where overall costs are lower with products then imported back into Australia.

If the current “price war” continues, the profitability of Australian food manufacturing sector (including farmers) will be eroded and the result will be further increases in the level of imported food. This alarming scenario brings a range of associated concerns relating to food safety, ethical sourcing arrangements and importantly, food security issues which are increasingly topical in light of recent natural disasters. Also, if the Australian food (and grocery) manufacturing base is eroded, so too is the capacity of companies to invest and innovate in such areas as new, healthier and more sustainably-produced goods.

The costs of producing safe, high quality, clean and environmentally-sound food and grocery products has been increasing for some time without a corresponding increase in return for producers. Input costs, such as wages, packaging, energy, water and transport continue to rise, in most cases ahead of inflation. In addition to these steadily increasing costs, the government has recently announced that there will be a further and significant impost on business resulting from a tax on carbon emissions. Companies based in Australia will be forced to incur this additional cost on production when competitors from countries such as China and SE Asia will not be subject to the tax.

Margin squeeze by a dominant retail sector is exacerbating this issue and will have a tangible impact on the capacity for Australian consumer to purchase locally made food and grocery products.

Australian manufacturers simply cannot keep incurring cost increases and decreasing margins and maintain a manufacturing presence in Australia. Critically, approximately half of the almost 288,000 people employed in the industry are based in rural and regional centres like Bathurst, Ballarat and Bundaberg. The impact of the closure of these iconic production sites – which are part of the economic and social fabric of the towns – would be significant.

This is not just about dairy products. Coles has indicated that they are increasing supplier requirements to include a range of animal welfare and social issues (for example hormone free beef and “cage-free” eggs). In most cases, the retailer has claimed that the consumer will not pay more. Moving to hormone free beef means Australia will need more cattle, eating more food, on more land, over more time to produce the same amount of beef. Obviously the cost of this beef will be higher. The outstanding question is if the retailers are not going to incur the cost of these requirements then "who will pay?” Given the market power of the major retailers in Australia and the limited choice food manufacturers and farmers have, it is highly likely the costs will be forced onto either farmers or manufacturers of products.

The net result is that a key part of Australia's economy is weakened, consumers short term gains are threatened by a drop in the resilience of supply of some food products and the wealth creating capacity of an important part of the economy is eroded.

3. RETAIL MARKET IN AUSTRALIA

The domination of Coles and Woolworths in the Australian market is reflected by their sales data, which indicate that they are not only large in Australia, but they are also large by global standards (Table 1.) That two Australian retailers occupy positions in the top 30 retailers globally by turnover given the population of Australia, demonstrates their significant capacity and their dominant position in the domestic market.

The aggressive discounting by one major retailer forces the other to rapidly follow simply because of their size. If they do not, substantial shifts in market share can occur. If it is major category and/or a driver of “foot traffic” (such as fresh milk) this could result in substantial losses.

Table 1. Australian retailers are some of the largest globally.[4]

Company	Country of Origin	Rank	2008 Retail Sales (US$mil)
Wal-Mart	US	1	401,244
Carrefour	France	2	127,957
Metro	Germany	3	99,004
Tesco	UK	4	96,210
Schwarz Unternehmens Treuhand	Germany	5	79,924
The Kroger Co.	US	6	76,000
The Home Depot, Inc.	US	7	71,288
Costco Wholesale Corporation	US	8	70,977
Aldi GmbH & Co.	Germany	9	66,063
Target Corp.	US	10	62,884
Woolworths	Australia	26	36,002
Wesfarmers (Coles)	Australia	28	32,716

3.1. The Discounting of Fresh Milk

AFGC is not privy to specific details of margin levels in different parts of the supply chain for dairy products as these are confidential commercial arrangements between suppliers and customers. Notwithstanding this, given the nature of the fast moving consumer goods sector, the understanding is that the margins achievable are extremely slim, ranging from 1-3 per cent with manufacturers relying on high turnover of product to maintain any level of profitability.

AFGC is unable to comment specifically on how Coles, Woolworths and other retailers are accommodating the price reductions within their business models. While publicly they have stated that they will absorb the price increases, it is unclear how this will translate across the sector and the impact on other categories.

It is agreed, however from industry advice that:

1) the price levels (for milk) are significantly lower than those prices that have been consistently offered in the market place for some time;
2) the price levels are unsustainable;
3) there will be shift in market share from branded milk products to private label; and
4) retailers will eventually seek to recoup lost margins by pressuring food processing companies (including milk processors) to reduce their prices/margins and this will flow through to the producers.

[4] Global Powers of Retailing 2010, Deloitte

3.2. FURTHER DISCOUNTING OF FOOD AND GROCERY PRODUCTS

AFGC recognises the importance of products being price competitive in the market place and strongly supports consumers rights to source affordable and safe goods. In recent years the range of products available to the consumer in particular categories has decreased. The major retailers have developed their own private label brands that have replaced a number of branded products in various categories. This is particularly the case in the dairy sector where the number of branded products has reduced to the point where there is only a leading brand and the retailer brand on offer.

In the long run, however, consumers may be disadvantaged if the ongoing margin squeeze on manufacturers by retailers leads to less choice in the market through branded products being unable to compete with private label. Retailers can afford to discount their own private label products if they squeeze the margins of their suppliers of both the private label and branded food products. Furthermore, because of the retail concentration, manufacturers are often not in a position to resist margin squeeze by choosing not to supply.

3.3. DEVALUATION OF PRODUCT WORTH

Consistent discounting of product eventually results in a “resetting” of the worth of the product in the mind of consumers. Consumers equate the discounted price with the real value of the product and will only buy the product when the price is discounted. If the discounted price is below production price the situation is clearly unsustainable unless significant changes can be made in cost structures within the business.

The loss of Australian manufacturing base for tinned fish (tuna, salmon) in recent years is an example of the destructive effect of aggressive discounting. Tinned fish can be stored for extended periods by consumers meaning that they can afford to wait for each discounting period and then stock up. With little purchasing of product with no discounts, retailers adopted the practice of almost constant discounting. This contributed to the demise of the Australian manufacturing of tinned fish first at Eden, NSW and more recently at Port Lincoln. Now Australian supermarkets only stock imported tinned fish, as none is manufactured locally.

With a loss of the manufacturing base in Australia, consumers face a future of choice being restricted essentially to imported products.

4. INQUIRY TERMS OF REFERENCE

The Inquiry arose following widespread community concern regarding the potential impacts current supermarket pricing of milk practices on the long term wellbeing of the dairy industry in Australia, and particularly the impact on dairy farmers. The Terms of Reference for the Inquiry reflect those concerns. AFGC has demonstrated above that the impacts of sustained aggressive discounting extend beyond the dairy industry with potentially severe ramifications for the whole of food and grocery manufacturing sector, and its viability in Australia.

Recommendation

That the Senate Economics Committee consider the negative impacts some supermarket price decisions are having on the wider food and grocery manufacturing sector.

AFGC will address each of the Terms of Reference below.

4.1. Farm gate, Wholesale and Retail Milk Prices

The continued, secure supply of food products to the consumers relies on all parties along the supply chain making reasonable and fair returns on their investment. It relies also on consumers perceiving they are receiving value for money so they continue to make repeat purchases. By the same token, products bought by the consumer must meet their specific needs in terms of price, quality, convenience etc.

There is no evidence that businesses involved in the supply chain in Australia are making disproportionate profits. In fact contrary to some claims there is robust evidence to suggest that drinking milk margins are extremely low (from 1-3 percent) and arguably unsustainable at current levels.

Similarly there is no evidence that prices in Australia are set systematically higher than prices overseas. Prices in Australia may vary from the prices of similar products overseas reflecting differences in input costs of production, manufacturing and distribution.

The corollary, therefore, is that any substantial depression in retail price of grocery products, must ultimately flow up across the whole supply chain with each sector contributing lost margin. The balance of which sector suffers the most margin loss is normally a function of market power.

4.2. Australian Production of Milk

AFGC has no information regarding the causes behind the drop in milk production in Australia.

4.3. Whether Such a Price Reduction is Anti-competitive

Price points set at or close to the cost of production and supply are *prima facia* anti-competitive. Particularly so if the action is carried out by a company that has significant or dominant capacity in the market.

The characteristics of the Australian retail market are such that if there is a significant initiative taken by one player in the market place (particularly in relation to price) it is highly likely that the move will be matched if the lower price is intended to be for the long term.

In the case of milk pricing and the question of whether the price reductions are anti-competitive, smaller retailers of fresh milk are undoubtedly impacted by the recent aggressive price discounting by major retailers. It is unlikely they will be able to match the pricing arrangements offered by large retailers for a number of reasons. If the discounting is continued for an extended period it is inevitable pressure upstream on suppliers may result in smaller suppliers of fresh milk (producers and manufacturers) being driven out of business as returns shrink to unsustainable levels. This in turn will leave the industry with fewer, larger players, which again may leave the market less competitive.

4.4. Horticultural Code of Conduct

The Horticultural Code of Conduct provides guidance to industry on fair trading terms within the Horticultural Sector. It aims to address the potential imbalance in the market place which exists between large wholesale markets for fruits and vegetables and small regional producers.

AFGC considers the Horticultural Code of Conduct ill suited to the current Australian Dairy Industry due to intent of the Horticulture Code to review and provide clarity on arrangements between wholesalers and agents. The dairy sector has different sourcing and supply arrangements compared to the horticultural sector. Specifically, producers or farmers sell milk to milk processors, which then supply the supermarkets. This is not analogous to the situation in the horticultural sector where there are a range of different market mechanisms and environments that result in a level of ambiguity in trading terms and conditions.

Notwithstanding that, AFGC considers there may be a role for a Food and Grocery Ombudsman to investigate issues of food and grocery retail pricing behaviour. The role of the Ombudsman would be to independently adjudicate concerns relating to predatory pricing and anti competitive behaviour, including those related to significant and dramatic price discounting.

Recommendation

That the Senate Economics Committee Consider the establishment of a Supermarket Ombudsman to independently adjudicate concerns relating to retailer behaviour, trading terms, use of market power, including those related to unsustainable price discounting.

4.5. 2010 Economic Reference Committee

AFGC supports a number of the recommendations included in the 2010 Economics Committee report *Milking it for all its worth* – competition and pricing in the Australian dairy industry.

AFGC notes there has not been a government response to the report and seeks an update on the key issues of concern that were identified as part of the report.

Specifically, Recommendation 4 requesting the ACCC to undertake monitoring of the pricing practices within the dairy chain with a view to establishing whether predatory pricing or misuse of market power is occurring.

The AFGC supports the recommendation that the ACCC or Productivity Commission conducts further study into the implications of increasing shares of the grocery market being taken by the generic products of the major supermarket chains. AFGC is of the view that specific attention be focussed on not just the current and future impact on prices paid by consumers, but also the needs of Australia in terms of food security and economic and environmental sustainability, as well as the economic viability of farmers and processors.

Recommendation 5 – relating to the review and evaluation of the effectiveness of the national competition policy based on evidence provided to the 2010 inquiry, suggesting that while it is hard to find precise data, it is evident that the retailers are making far more profit from the sale of drinking milk than are the farmers.

The AFGC supports and seeks advice on the issue of domination by the two major supermarket chains of Woolworths and Coles, including a reference to evidence suggesting that the supermarkets' increasing share of the milk market through the sale of generics is putting pressure on processors who are increasingly in the position of having to compete with their own branded goods.

The AFGC supports the finding that this issue should be of concern to all Australians. The evidence suggests that section 46 of the Consumer and Competition Act (CCA, former Trade Practices Act) is not operating effectively possibly allowing larger players to unfairly dictate terms to the weaker parties in the chain.

The AFCG supports the recommendation that changes be made to enhance the effectiveness of the CCA, particularly those provisions relating to misuse of market power, predatory pricing, mergers and creeping acquisitions and the need for anti-price discrimination provisions.

Recommendation

That the Senate Economics Committee:

Request the government response to the recommendations included in the 2010 Economics Committee report *Milking it for all its worth – competition and pricing in the Australian dairy industry* be tabled as soon as possible .

Request the Productivity Commission investigate the impact of the pricing decisions and policies of major supermarkets on the productivity and sustainability of food producers and manufacturers in Australia and the flow on effects on food security.

4.6. Legislative Amendment

As noted above, the AFGC is of the view that there is a need to review the effectiveness of the legislation relating to market power and anti-competitive behaviour in Australian retail market.

As far back as 1976, a number of government reviews into the Trade Practices Act 1974 (TPA) have recommended that section 49 be repealed on the proposition that section 46 (misuse of market power) could be used to prosecute cases of anti-competitive price discrimination. A recommendation from a review in 1993 was accepted by the Keating government, which repealed the section in 1995.

The former section 49 of the Trade Practices Act made it an offence for suppliers of products and services to apply dissimilar conditions to equivalent transactions with other trading partners, thereby placing them at a competitive disadvantage.

The AFGC is of the view that there is an essential difference between section 49 and section 46. Section 49 provided for an "effects" test – i.e. did the conduct have the effect of bringing about a substantial lessening of competition? Section 46 was based on a "purpose" test - i.e. that the conduct had the purpose of substantially lessening competition. A purpose test is notoriously difficult to prove: it needs a whistleblower or "smoking gun" documents to substantiate it and even these may not be decisive.

The AFGC is of the view that the switch from the s49 "effects" test to the s46 "purpose" test was a significant weakening of the provision against anti-competitive price discrimination.

There is and has been for some time concern relating to the use of the clear market power of large retailers in Australia and the associated negative impact on smaller retailers and food and grocery manufacturers.

Recommendation

The AFGC seeks a review of the effectiveness of the Competition and Consumer Act 2010 (Cth) (the CCA) (formerly the Trade Practices Act 1974) to establish and respond to anti competitive pricing behaviour.

Australian Food and Grocery Council

AFGC MEMBERS FEBRUARY 2011

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Level 2, Salvation Army House
2–4 Brisbane Avenue
Barton ACT 2600
Locked Bag 1
Kingston ACT 2604

T: (02) 6273 1466
F: (02) 6273 1477
afgc@afgc.org.au
www.afgc.org.au