AUSTRALIAN FOOD & GROCERY COUNCIL

Sustaining Australia

FOOD AND GROCERY MANUFACTURING 2030

ABOUT THE AFGC

The Australian Food and Grocery Council (AFGC) is the leading national organisation representing Australia's food and grocery manufacturing sector. The membership of AFGC comprises more than 180 companies, subsidiaries and associates.

Established in 1995, the AFGC promotes the role the sector plays in sustaining Australia's economic, community and environmental health, advocates on issues of concern and interest to the sector, and acts as a forum to discuss and pursue those issues.

The food and grocery manufacturing sector provides the products Australian's use every and enjoy every day or is exported around the world. It is a sector that takes the fresh produce from Australian farmers and turns it into the iconic products we know and trust.

This $127 billion sector significantly contributes to the Australian economy and directly employs over 276,000 people with 108,000 of these jobs in rural and regional Australia.

ABOUT EQ ECONOMICS

EQ Economics is a micro advisory and economic research firm based in Sydney, Australia and was founded in 2016 by its Managing Director, Warren Hogan. EQ Economics undertakes analysis, research and forecasting of the Australian economy, industry and financial markets. EQ Economics creates strategies, reports, briefings and forecasts for organisations from across a wide range of businesses and government organisations.

Warren Hogan is Lead Economist and Managing Director of EQ Economics. Warren has been a professional economist working in banking, government and academia for 25 years. Warren was Chief Economist of ANZ Bank from 2009 to 2016 having previously worked as Chief Economist of Credit Suisse in Australia. More recently, he worked in the Federal Treasury as a Principal Advisor and was an Industry Professor at the University of Technology Sydney.

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EXECUTIVE SUMMARY

Food and grocery manufacturing is a critically important part of the Australian economy. It is the largest component of Australia's manufacturing sector and is a significant employer, providing almost 276,000 jobs around the nation, including more than 108,000 in regional areas.

The sector plays a vital role in supplying high-quality food and grocery products to Australians taking fresh produce from Australian farmers and turns it into the iconic products we know and trust. The food and grocery manufacturing sector's success at keeping supermarket shelves stocked during the early months of the 2020 COVID-19 pandemic demonstrated the importance of a vibrant Australian sector for Australia and robust supply chains.

Food and grocery manufacturing is also an important contributor to Australia's international trade: exports account for $36.7 billion in 2018/19 and are quickly growing to be the biggest opportunity for this sector.

As a provider of high-quality, trusted food and grocery products, the Australian sector is positioned to capitalise on the contemporary global opportunities – rising populations, rising incomes, and growing numbers of middle-class consumers – many of them on our doorstep.

Australia's food and grocery manufacturing sector is facing a defining moment: the strengths that made the sector a resilient and reliable force during the COVID-19 lockdowns of 2020 and in the decades before then, are not enough to ensure a robust and growing sector well into the 21st century.

Without innovation and new investment, this vital sector could stagnate or even decline. However, with a clear vision supported by policy and investment, Australia's food and grocery sector could become a $250 billion powerhouse by 2030 – double its current size.

Sustaining Australia: Food and Grocery Manufacturing 2030 examines the potential of the sector ready to be unleashed, the opportunities the sector has and what needs to be done to realise them.

It also confronts the challenges both domestically and globally, that if not addressed could see the sector stagnate or decline.

Our sector's place in the world

Australia's well-deserved 'clean and green' reputation will not be enough to ensure our sector remains competitive in either the domestic or export markets. In a fast-moving environment shaped by digital technology and social media, consumers are opting for innovative and premium products that are convenient and in harmony with a growing focus on healthy and sustainable living. Meeting these market trends requires investment – in new products, innovative packaging and digital technologies that provide consumers with rich experiences and assure them of authenticity and provenance.

Australia's food and grocery sector has been under pressure as profitability has declined and capital investment stagnated over the past decade. The unavoidable result has been being a stifling of innovation; spending on research and development in the sector has fallen in recent years to 2009/10 levels.

If these trends are reversed and the sector is supported to invest, the potential rewards are immense.

Through measures such as the Modern Manufacturing Strategy[1], the Australian Government is funding programs that will spark new thinking about the future of Australian manufacturing. Further investment in this program is needed to give Australian food and grocery manufacturing the strength to maintain its traditions of excellence and the competitiveness to supply domestic markets while growing new ones abroad.

The ambition of achieving high sector growth is now more urgent, given the need to ensure resilience in Australia's domestic manufacturing capability, as well as to ensure sustained economic growth following the effects of the COVID-19 pandemic and associated restrictions on business and consumer activity.

However, high growth won't happen organically. Indeed, if left without intervention and a strategic approach, there is a real risk that the current trend of offshoring manufacturing and importing increasing levels of high value-added food and grocery products could continue to the point where consumers will struggle to find high value-added products that are made in Australia.

[1] The Modern Manufacturing Strategy is a whole-of-government strategy. www.industry.gov.au/data-and-publications

The task at hand

The cost of manufacturing food in Australia has been rising at a higher rate than selling prices over the past decade. Profits in food manufacturing have been falling despite a broader trend of rising profitability across the Australian economy.

Over the past ten years, Australian food manufacturers' input prices have increased by 49 per cent from 2010 to 2020, whereas output (wholesale selling) prices have only increased by 24 per cent in the same period. Compare this to the broader manufacturing sector where output prices have closely tracked input prices, and the challenge is obvious.

Food and grocery manufacturers have little opportunity to pass on higher input costs due to the highly concentrated nature of Australia's retail marketplace. In a market already dominated by two major supermarket retailers, the arrival of overseas-based competitors has driven a focus among the majors on cutting purchasing costs. The result has been a limited ability for manufacturers to pass through cost increases, a progressive decline in operating margins, and stagnation in the new investment required to stimulate innovation and productivity.

Around the world, investment in innovation in food and beverage manufacturing is increasing and will continue to do so. If Australian businesses cannot attract some of that vital new investment, manufacturing will go elsewhere, in particular to markets where the investment case is enhanced by government support.

The choice before us: high growth, declining or muddling through

This report presents three different projected scenarios for Australia's food and grocery sector. Developed by EQ Economics for the Australian Food and Grocery Council, the scenarios outline the different potential futures that could become reality depending on the investment and policy decisions made now.

To support strong post-COVID economic and jobs growth, the sector needs to be on a high growth path, aiming for a turnover of $250 billion by 2030. The High Growth scenario shows that investing in innovation and new products will grow local manufacturing's share of domestic markets, stem the trend towards increasing import penetration and position Australian food and grocery manufacturers to take advantage of the abundant export opportunities resulting from a rapidly growing global middle class, particularly in Asia.

In the High Growth scenario, domestic population growth, product innovation, a lift in food and grocery wholesale price inflation and strong export growth will potentially double the size of the Australian food and grocery sector to $250 billion in 2030 – a 6.8 per cent annual growth rate in the 2020s.

Without the right policy settings and sector confidence to invest and innovate, sector might muddle through or face decline. The central Muddle Through scenario describes what happens if the sector trends of the past decade are continued over to the next. That scenario is essentially an ongoing underperformance by the food and grocery sector compared to the broader Australian economy – with real growth in turnover of less than one per cent a year, an employment growth rate that is half that of the national average, and a continuing rise in the penetration of imported goods into domestic markets.

A worst-case Declining Sector scenario examines the result of leaving sector settings unchanged and global market conditions becoming increasingly unfavourable to Australian manufacturers. A domino effect of falling investment and innovation could see domestic production barely grow over the decade to 2030 and a diminished international presence for Australian-made food and groceries. Increased offshoring would coincide with nearly 16,000 jobs lost across the sector.

To set the food and grocery manufacturing sector on a high growth path, action is needed to accelerate sector innovation and investment to develop new, high value-add products and a modern and competitive sector.

Policy recommendations

A prosperous future for Australia's food and grocery sector requires new investment – in smart manufacturing technology and in skills to increase productivity, resource efficiency and sustainability. The sector needs the agility to respond to changing consumer demands and boost competitiveness to mitigate the realities of operating in a high-cost economy with limited pass-through of input costs.

Specifically, the AFGC recommends:

1. Strategic industry policy

1.1 The AFGC recommends that non-food grocery manufacturing be added to the food and beverage priority manufacturing sector within the Modern Manufacturing Strategy.

1.2 The AFGC recommends that the Minister for Industry, Science, Energy and Resources, in consultation with other portfolios, develops an annual set of policy and regulatory reforms that move the sector towards its growth ambition of $250 billion by 2030; and ensures any new government policy or regulatory proposal explicitly considers the impact on the sector's ability to achieve this goal.

1.3 The AFGC recommends that the Australian Government task the government-industry taskforce established to develop the Food and Beverage roadmap with providing ongoing advice in relation to achieving the high growth ambition of $250 billion by 2030.

2. Investment incentives

2.1 The AFGC recommends that the Australian Government allocate additional funds to a dedicated co-investment grant program within the Modern Manufacturing Initiative, specifically for food and grocery manufacturers, to adopt to adopt modern manufacturing and digital technologies that enhance competitiveness in domestic an export markets, resilience, sustainability and agility.

2.2 The AFGC recommends that the Australian Government implement a co-investment grants program that supports and fast tracks food and grocery manufacturers' research, development and testing of new sustainable packaging formats, and changes to packaging equipment to facilitate a circular economy.

2.3 The AFGC recommends that the Australian Government alter the eligibility threshold for the temporary full expensing (instant asset write-off) measure to include companies with significant manufacturing capital stock in Australia that do not meet the alternative eligibility test.

3. Skills

3.1 The AFGC recommends that the Australian Government provide funding for:

- A skills audit to understand the gap between the sector's current skills capabilities and the needs of a more automated and digitalised food and grocery manufacturing sector,
- a sector-wide, advanced food and grocery manufacturing training centre with access to virtual and augmented reality technology to help train local workers to operate advanced manufacturing equipment and digital technologies, and
- a grant process that supports food and grocery manufacturers to offer on the job training or integrated learning programs that connect the sector with education/training providers.

4. Regulatory reform

4.1 The AFGC recommends that the primary responsibility for setting and enforcing food standards (including composition and labelling of foods) should be centralised to a national agency, with states and territories responsible for food safety enforcement.

4.2 The AFGC recommends that Food Standards Australia New Zealand (FSANZ) assessments should be allowed to reference international assessments and international standards, with appropriate stakeholder consultation, on a case by case basis.

4.3 The AFGC recommends that greater emphasis should be given to sector self-substantiation in assessments of amendments to the Food Standards Code, and greater use of sector codes of practice within an appropriate risk assessment and management framework.

5. Digital labelling

5.1 The AFGC recommends an industry-government taskforce be established to develop an agreement for meeting regulatory compliance through digital labelling.

5.2 The AFGC encourages manufacturers and retailers to adopt the electronic Product Information Form as a first step towards digital labelling.

6. Retail-supplier relationships

6.1 The AFGC recommends that the Australian Government monitors the effect of supermarket buyer power on manufacturers' profitability and investment levels; and the effectiveness of the Food and Grocery Code of Conduct.

7. Export growth

7.1 The AFGC recommends that all governments and sector develop an export growth strategy that aims to deliver food and grocery export growth of ten per cent per annum to 2030.

7.2 The AFGC recommends that the Australian Government adopt the recommendations from the AFGC's report *Non-Tariff Measures Impacting Australian Processed Food Industry Exports*.

In summary

Australian food and grocery manufacturing is already a strong, dynamic and critically important sector, but there are important decisions that need to be made now about what the sector can be in the future.

There are challenges that must be addressed but more important are the opportunities that must not be neglected. These are the opportunities to strengthen and modernise Australian food and grocery manufacturing to create an enduring, resilient and vigorous sector that not only provides for Australians at home but offers our best to the world and secures our place in it.

CHAPTER ONE

AUSTRALIA'S FOOD AND GROCERY MANUFACTURING SECTOR

- Food and grocery is the largest manufacturing sector in Australia, with output of $127 billion, which is 32 per cent of total manufacturing output.
- The sector employed 276,000 people in 2019 with over 40 per cent of these jobs in regional Australia.
- There are complex forces shaping the sector, resulting in an intensification of the trend to offshore production, particularly evident over the past decade.
- The COVID-19 pandemic has highlighted that food and grocery manufacturing is an essential sector to Australia.

SECTION ONE

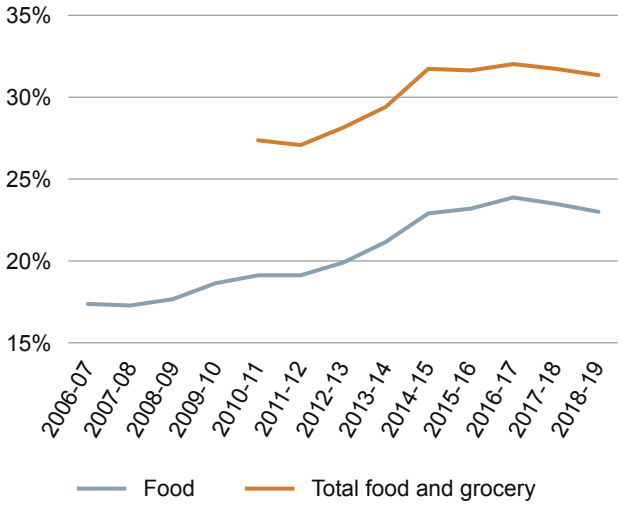
CONTRIBUTION OF FOOD AND GROCERY MANUFACTURING TO THE AUSTRALIAN ECONOMY

Food and grocery manufacturing (the sector) has a long and proud history in Australia. It is the main producer of food, beverage and grocery products sold through retail outlets, such as supermarkets, and to the food service sector.

Food and grocery is the largest manufacturing sector in Australia, accounting for 32 per cent of output in 2018/19, up from 27 per cent a decade ago[2] (Chart 1). The next biggest sector within Australia's manufacturing base is primary metal manufacturing, which has an annual turnover less than half that of the food and grocery sector.

Chart 1: Food and grocery is the largest component of Australian manufacturing

Food and grocery share of manufacturing in Australia

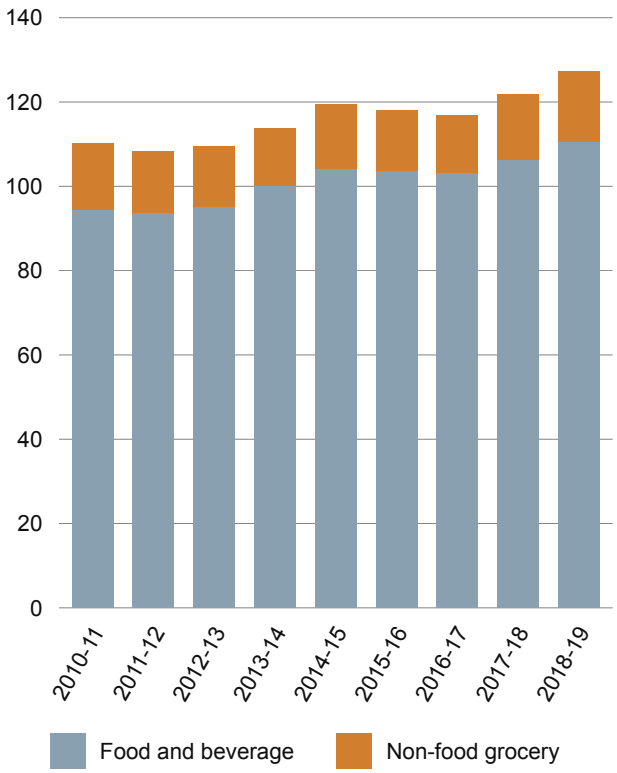


Source: ABS, EQ Economics

Total manufacturing output in Australia in 2018/19 was $404 billion[3], which was below the record high level of $410 billion in 2008/09. In contrast, food and grocery output has grown at an average annual rate of 2.4 per cent over the past decade with output at $127 billion in 2018/19 or 6.5 per cent of GDP (Chart 2).

Chart 2: Food and grocery manufacturing production

$bn



Source: ABS, EQ Economics

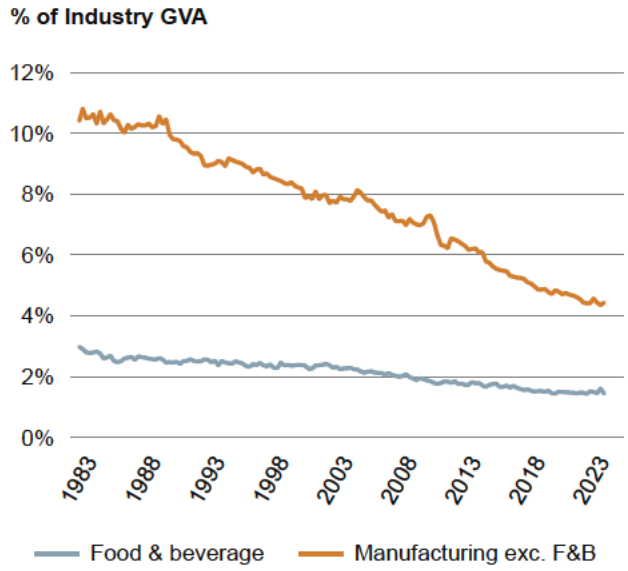
Australia's manufacturing base has been under pressure for decades. Manufacturing output as a share of GDP has declined from around 15 per cent in the 1970s to just above 5 per cent in 2020. When measured in terms of total sector gross value-added (GVA), the manufacturing share when excluding food and beverage manufacturing has fallen from 11 per cent in the early 1980s to under 5 per cent in 2020, a 60 per cent decline. At the same time the food and beverage share of total sector gross value-added has declined by 40 per cent from 2.4 per cent to 1.4 per cent (Chart 3).

[2] The primary dataset used in this report is the Australian Bureau of Statistics (ABS) Annual Business Survey. The latest available data are from 2018/19.

[3] All variables are in nominal (current) dollars unless o herwise stated.
[4] All charts are in Australian dollars unless otherwise stated.

Chart 3: Manufacturing share of Australian sector

Per cent of gross value-added (GVA)



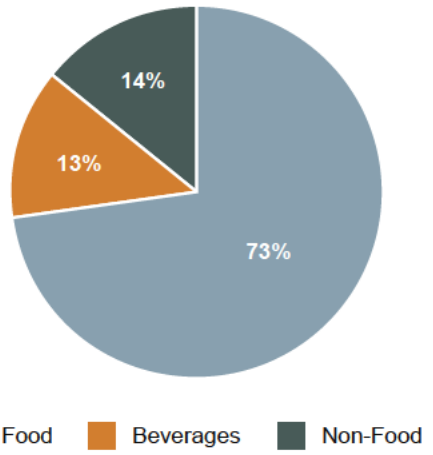
Source: ABS, EQ Economics

Food and grocery manufacturing employed 276,000 people in 2019 with over 40 per cent of these jobs in regional Australia. Indirectly, the sector supports complex supply chains that employ thousands of other people in related industries such as agriculture, transport and logistics, retailing, administrative services and marketing. The sector is a significant contributor to not only the Australian economy but is vital to regional communities where it is a critical source of local employment and incomes, and provides business opportunities to local suppliers and service providers.

The sector has three sub-sectors: food processing, which accounts for 73 per cent of output; beverage production, which includes beer, wine and spirit production at 13 per cent; and non-food grocery production at 14 per cent (Chart 4). Non-food grocery products are essentially all the goods in the supermarket that are not food or drinks, such as toiletries, household cleaning products, vitamins and supplements, and pet food.

Chart 4: Food production is the dominant sub-sector

Food and grocery manufacturing segments



Source: ABS, EQ Economics

The sector is a mix of Australian owned companies and multinational food and grocery manufacturers. The food and grocery sector has a long history of attracting multinational companies to Australia and they remain an important source of foreign investment in 2020.

Some in the sector are focused on production for the domestic market only, while others are heavily focused on export markets. It is a diverse and vibrant sector with many companies operating across a wide range of consumer goods categories.

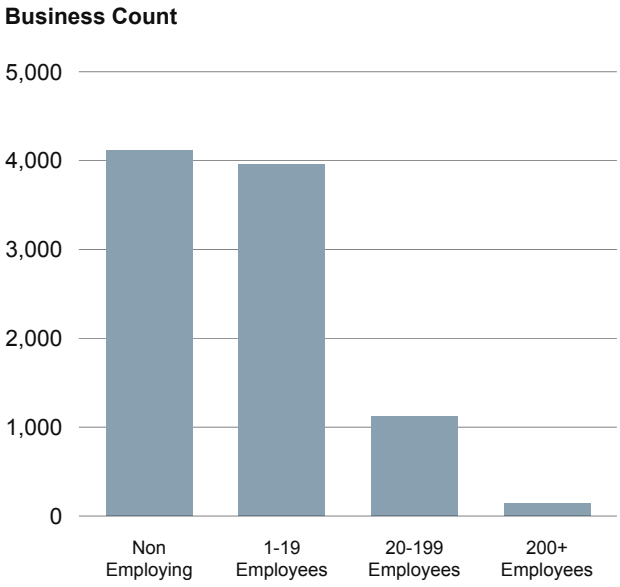
The sector has a large representation of sole traders and small and medium-sized enterprises (SMEs). Chart 5 shows the business count numbers by employee size for the food and beverage segments. Non-employing (sole trader) and small businesses (<20 employees) constitute the largest number of both food and beverage manufacturers.

According to the ABS data there were over 9,000 food and beverage manufacturing businesses operating in Australia in June 2019[5]. Over 8,000 of them were either non-employing or small. There were over 1,600 non-food grocery businesses.

[5] This excludes 4,839 non-factory based bakery manufacturing businesses, 4,289 of which employ less han 20 people.

Chart 5: Food and beverage manufacturing business count

Business count by employee, June 2019



Excluding non-factory based bakery manufacturing.
Source: ABS, EQ Economics

While there is a large number of SMEs in the sector, they account for a small proportion of the sector's turnover and employment.

The majority of the sector's revenue is generated by a small number of large companies according to calculations by EQ Economics.

Most of the output of Australian-based food and grocery manufacturers is for the domestic market. However, international trade is growing and becoming increasingly important to the sector in Australia. This is seen as a way to diversify risk from supplying a concentrated domestic supermarket sector, and to take advantage of growth opportunities overseas. Exports of food, beverage and non-food grocery products were $36.7 billion in 2018/19, equivalent to about 28 per cent of total production.

These aggregate data do not tell the underlying story of trade in manufactured food products in Australia over the last 20 years. These data capture food exports that are defined as manufactured but include food products that are only lightly processed, such as beef and grains. It is this category that has seen much of Australia's export growth in recent years.

While these exports are very important for Australia's economy, the farm sector, and our trading partners, they do not represent substantial added value to the domestic Australian economy in terms of job creation and multipliers to other sectors.

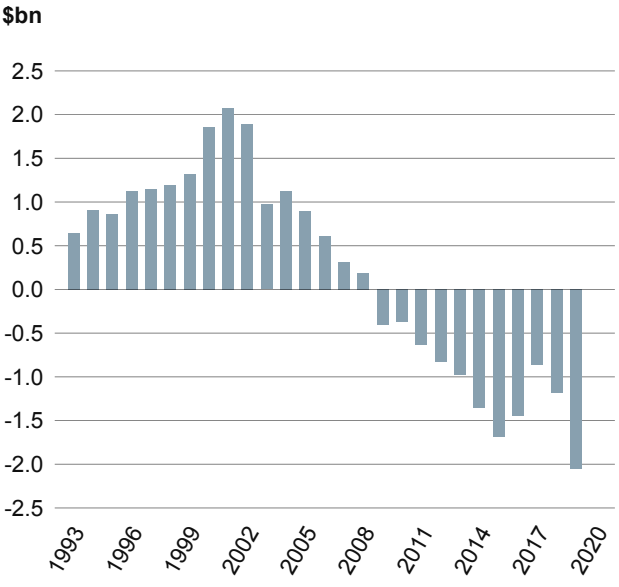
While Australia is a large producer of food and grocery products, a substantial amount of products are imported each year and in recent years these imports have been growing fast despite the big falls seen in the value of the Australian dollar. Imports across the sector were $35.9 billion in 2019, only just below the level of exports.

Australia is a big importer of non-food grocery items having lost a substantial amount of domestic production capacity to cheaper offshore locations over the last 20 years.

Additionally, the sector relies on the supply of imported inputs including ingredients (e.g. cocoa, coffee, tea, some herbs and spices, and some oils), raw materials (e.g. industrial chemicals, processing agents, additives, and preservatives) and other inputs, such as packaging.

In terms of high value-added food, Australia has traditionally been a net exporter. However, over the last 20 years there has been an almost complete turnaround in our high value-added food trade position. As Chart 6 shows, Australia had a trade surplus of $2 billion in high value-added food in 2001, which has gradually weakened over the last 20 years and is now a deficit of $2 billion. This is in part the result of a loss of competitiveness, as well as consumer preferences for certain imported products.

Chart 6: High value-added food international trade position



Source: ABS, EQ Economics

SECTION TWO

COVID RESTRICTIONS HIGHLIGHT FOOD AND GROCERY MANUFACTURING IS AN ESSENTIAL SECTOR

As the COVID-19 pandemic has demonstrated, Australia's food and grocery manufacturing sector is essential – through its contribution to Australia's economic output and jobs, as well as ensuring the supply of food and grocery products for Australian consumers.

During 2020, the COVID-19 pandemic, and health measures restricting community movement, resulted in a surge in demand for many food and grocery items including hand sanitiser, toilet paper, pasta, rice and many more.

This was in part due to a demand shift from out-of-home eating (i.e. cafes, clubs, pubs, restaurants etc.) to consumers eating more at home, and therefore purchasing more supermarket goods. Consumer demand has now returned to more normal levels.

In addition, disruptions to global supply chains and international freight increased the demand for domestic production.

The ability of supermarket retailers to meet this surge in consumer demand was largely due to the ability of domestic manufacturers to lift production in a short amount of time.

The food and grocery manufacturing sector responded primarily by increasing production around the clock and bringing some products forward in the supply chain. In addition, measures such as delivering directly to supermarkets rather than via distribution centres, and allocating stock to areas where shortages were more acute (i.e. remote and indigenous communities) also assisted. The interim authorisation provided by the Australian Competition and Consumer Commission (ACCC) allowed the major retailers, with support from manufacturers, to collaborate in estimating and meeting consumer demand.

Despite the success of the food and grocery manufacturing sector in meeting the COVID-19 challenge, significant additional costs were incurred by the sector and fragility in the supply chains was revealed. The sector is critically reliant on imports for specialist ingredients and other components of food (e.g. food additives, colourings, flavourings and processing aids). In addition, other inputs such as packaging, disinfectants and personal protective equipment (PPE) used during manufacturing are largely imported. Shortages of many of these inputs occurred requiring alternative sources to be identified by companies.

The COVID-19 pandemic and recent international trade disputes have highlighted that international trade can be disrupted by unexpected economic, political and health events. This disruption can impact right across the supply chain from raw materials to final products. In an increasingly difficult geo-political environment, the probability of more disruptive events has increased.

For Australia, having a large agricultural output each year is not enough to ensure food security. Australia is one of the most urbanised countries in the world and the bulk of food that consumers buy is processed in one form or another. For most Australians, a reliable and affordable supply of food depends on our food manufacturing sub-sector.

Non-food grocery manufacturing capability is also of importance to the domestic economy and consumers, as has been demonstrated by the sub-sector's response during the pandemic to meeting a large surge in demand for products such as toilet paper, sanitisers and cleaning products.

While Australia navigated the pandemic well, the same resilience cannot be assumed in the future if import reliance increases or if multiple disruptions occur simultaneously.

COVID-19 has highlighted the need for sovereign capability in flexible, agile and adaptable food and grocery manufacturing as the foundation for resilience in Australia's food and grocery supply.

It is very welcome that the Australian Government's Modern Manufacturing Strategy (MMS)[6] has identified food and beverage manufacturing as one of six priority manufacturing industries, to ensure the competitiveness and resilience of the sector.

[6] The Modern Manufacturing Strategy is a whole-of-government strategy to help Australian manufacturing scale-up, become more competitive and resilient. www.industry.gov.au/data-and-publications

SECTION THREE

MEGATRENDS SHAPING THE FOOD AND GROCERY MANUFACTURING SECTOR

Megatrends represent powerful, persistent but often gradual forces that are shaping the future. Many outlook reports employ the megatrends framework to highlight the opportunities and threats confronting a sector.

As part of the research for this report, the AFGC conducted a survey of CEOs and senior executives within the sector to capture these megatrends.

Survey participants were provided with 18 suggested trends presented in six separate areas.

The most striking feature of the results is the broad range of megatrends chosen by sector participants. This highlights the broad and complex range of forces currently shaping the sector.

Five megatrends stood out from the rest:

1 Retail competition and concentration

Australia has become one of the most concentrated supermarket sectors in the world. The two main retailers, Coles and Woolworths, have buyer power, stringent price control processes, and have raised the cost of doing business. This is the single most important issue facing food and grocery manufacturing in Australia according to this sector survey.

2 Nutrition and health

Manufacturers are focused on responding to the increased consumer awareness of good nutrition and links to health. CSIRO estimates suggest that demand for health and wellbeing, sustainable and premium foods will grow at 3.6 per cent, which is above total sector growth of 2.4 per cent[7]. This is a critical driver for domestic markets and with Australia's great brand for clean and healthy food, this will be a key element of a coordinated export strategy for this high value-added sector[8].

3 Circular economy

Manufacturers are highly active in working to build a circular economy to reduce the environmental impact of packaging and food waste. The sector has set National Packaging Targets to improve the recyclability and recycled content of packaging as well as recycling rates. This requires not only transformation in resource recovery and recycling systems, but also significant research and development into more sustainable packaging formats as well as investment in new packaging capital equipment. As acknowledged in the Australian Government's National Plastics Plan, this will require collaboration and efforts from the whole packaging and resource recovery supply chain, consumers and local, state and federal governments. Circular economy principles are also being applied in manufacturing practices to reduce and re-use food and other waste that occurs in production processes.

4 Climate change

Climate change is a global megatrend affecting many parts of our society and economy. The long-term future of food and grocery manufacturing is intrinsically linked to the land, water and agriculture, which are in turn impacted by a changing climate. Addressing climate change extends to many issues such as sustainable sourcing (of energy supplies, ingredients and other inputs), production, and consumption. The sector recognises it has a part to play in addressing these issues.

5 Food security

This megatrend became prominent after the emergence of the COVID-19 pandemic. Food security is something Australians rarely contemplate but the disruptions to international supply lines in the early stages of the pandemic combined with a surge of demand for food and grocery products highlighted that food security cannot be taken for granted. Australia navigated the pandemic well. However, it raised doubts about Australia's ability to cope with such disruptions in the future if import reliance increases.

A more detailed analysis of the issues facing the sector is contained in Chapter 3.

[7] CSIRO (2017), *Food and Agribusiness Roadmap*
[8] CSIRO (2019), Growth Opportunities for Australian Food and Agribusiness, Economic Analysis and Market Sizing.

SO WHAT?

Food and grocery is not only the largest component of Australia's manufacturing sector it is also essential to people's everyday lives.

The sector is a large employer, particularly in regional Australia. These stable, well paying jobs are critical to many communities across the country.

Food and grocery manufacturing is also an important part of Australia's international trade relationships. Exports are nearly one third of domestic production and imports account for a similar proportion of domestic consumption.

The COVID-19 pandemic has highlighted the importance of food and grocery manufacturing to Australians. In times of uncertainty and restrictions, the food and grocery manufacturing sector ran factories around the clock to ensure that supermarket shelves were stocked.

It is a complex sector, made up of a large number of different businesses and countless product lines. There are many intricate forces currently impacting the sector and shaping the future of food and grocery manufacturing around the world.

This report is focused on understanding the opportunities and challenges for food and grocery manufacturing in Australia over the decade ahead.

AFGC

CHAPTER TWO

GROWTH OPPORTUNITIES FOR AUSTRALIAN FOOD AND GROCERY MANUFACTURING

- Growth opportunities lie in export markets and in innovating to meet rapidly changing consumer demand.
- Food is the world's largest consumer goods market worth US$8 trillion.
- Global population and incomes are rising with around half of the world's population considered to be middle class, with an increased demand for food and grocery products.
- Australia has the potential to rapidly grow its presence in the international food and grocery markets.
- Changing consumer preferences are creating many high value opportunities across the food and grocery sector.
- Health and wellness and sustainability are rising priorities for consumers.
- The desire for increased convenience, personalisation and transparency will require manufacturers to be agile, flexible and digitally enabled.

INTRODUCTION

Whether domestically or in export markets, the demand for food and groceries is generally driven by population growth, rising incomes and consumer preferences.

With populations and middle-class incomes growing globally, particularly in Asia, there is an increased demand for high value-added food and grocery products, particularly those that can demonstrate their authenticity and provenance.

Food and grocery manufacturing is fast moving. The sector is facing an unprecedented level of change in consumer preferences, resulting from the rise in digital technology and social media platforms, which have changed how consumers shop, and heightened their awareness and expectations of many socio-environmental and health issues. Consumers are seeking innovation particularly in the areas of health and wellness, sustainability, premium, convenience and personalisation.

Consumers, rightly, have an increased desire to know what is in their products, where products and their inputs are sourced and produced, whether they are ethically and environmentally responsible, their health impacts, and whether they meet the consumer's individual preferences.

Australia's food and grocery production system – from agriculture through to manufacturing – is well renowned for its quality and safety, which provides a competitive advantage. However, reputation is not enough. To be competitive in domestic and export markets requires manufacturers to innovate by modifying existing, or developing new, products, packaging and consumer experiences, which requires investment in research and development, new production and business systems, processes and skills. It also requires the development of new digital traceability systems and ways to communicate authenticity, provenance and other attributes to consumers, including through mobile devices.

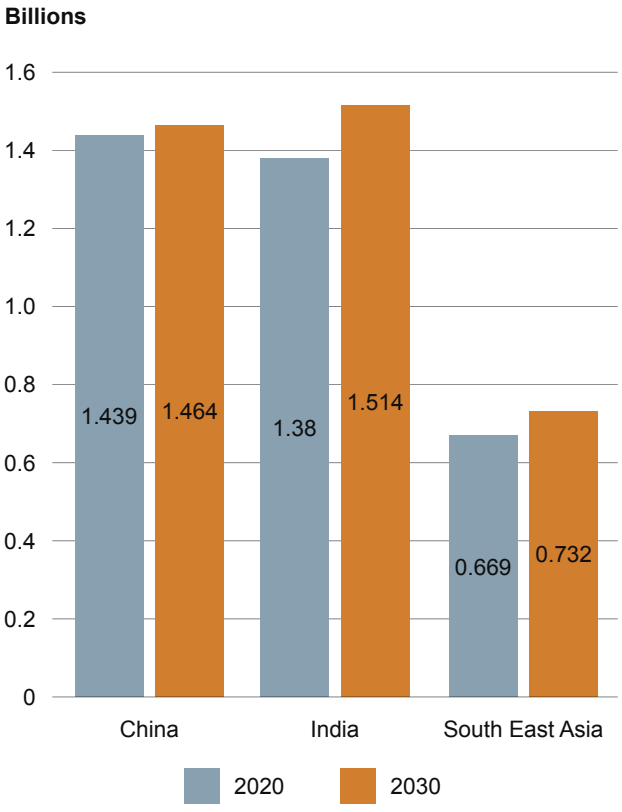
SECTION ONE

RISING GLOBAL POPULATION AND INCOMES

Global population and incomes are rising with 50 per cent of the world's population considered to be middle class. This group is expected to grow by approximately 1.5 billion to 5.3 billion people by 2030, with the growth predominantly in China, India and South and South East Asia[9] (Chart 7).

Chart 7: Population projections 2030

United Nations, 2019



Source: United Nations (2019), *World Population Prospects.*

A general trend observed in many developing countries is that as populations grow and urbanise, and incomes grow, there is greater per capita consumption of meat and dairy products and the demand for more value-added, processed food and beverage products increases. The demand also increases for safe, high quality non-food grocery items such as personal and health care.

In addition, increases in income in advanced economies also drives up demand for food and grocery products that are differentiated for quality, health and wellness and sustainability reasons, providing export opportunities in established markets such as the USA, Japan and the EU.

The food market is the largest consumer goods market in the world[10]. Statista puts the value of the global market at US$8 trillion in their 2021 global food report.[11]

The report projects 3.7 per cent annual growth for the food sub-sector taking the global market to US$9.1 trillion by 2025. The largest markets are the USA, China and Germany. Large mature markets are expected to grow at between 1 and 2 per cent while the emerging markets, many of them already some of the biggest in the world, are expected to grow at annual rates above 3 per cent.

Globally, total two-way trade in food was $1.5 trillion in 2018[12]. The USA is the largest market for food imports at US$155 billion in 2018. Imports into the Chinese market were US$123 billion followed by Germany at US$101 billion and Japan at US$71 billion.

The biggest segment of the global food market was confectionary and snacks accounting for 17 per cent of sales in 2019. Meat is the second largest segment (15 per cent) with bread and cereal products (12 per cent), dairy (11 per cent) and vegetables (10 per cent) also significant.

According to Statista analysis, the fastest growing segments over the next five years will be bread and cereal products (total growth of 37 per cent to 2025), baby food (36 per cent) and convenience foods (35 per cent).

Approximately one third of the global packaged foods market will be in the Asia-Pacific region by 2025. The Middle East and the African packaged food market is projected to grow fastest at over 12 per cent a year between 2021 and 2025[13]. India, the Middle East, Africa and Taiwan together will comprise 16 per cent of the increase in market growth in value terms.

[9] Kharas, H & Hamel, K (2018), *A global tipping point: half the world is now middle class or wealthier*, Brookings Institution.
[10] Definition of food according to the Statista report includes fresh and processed (manufactured food).
[11] Statista (2021), *Consumer market outlook – food report 2021.*"
[12] Statista (2020), *Industry report – global manufacturing: food.*
[13] Euromonitor (2020) *World market for packaged food.*

Australia's potential to grow its presence in international food and grocery markets is underpinned by a range of factors including:

- Australia's proximity to the main growth markets.
- Australia's strong reputation for 'clean and green' agricultural, food and beverage products. Australia is seen as safe and reliable across global consumer markets, particularly in Asia.
- Australian food and grocery manufacturers have demonstrated that they can achieve high growth in offshore markets in certain segments. Recent strong export growth in certain categories of Australian food and grocery products also underscores the potential that lies ahead over the next decade. For example, the five-year compound annual growth rates (CAGR) have been high in several categories including pharmaceuticals (21.4 per cent), and cosmetic and toiletries (17.8 per cent).[14]
- Although China is a large and growing market, there are other opportunities across the Asia region. There are many large, fast growing markets in South and South East Asia that Australian manufacturers can target. For example, the alternative protein market in India is a substantial opportunity for Australia producers.
- Australia currently holds a small share of high value-added international food and grocery markets. A small increase in our market share can result in a big increase in export earnings for Australia, and revenues for food and grocery manufacturers.

[14] AFGC (2018), State of the Industry.

SECTION TWO

CHANGING CONSUMER PREFERENCES AND SECTOR REQUIREMENTS

Changing consumer preferences domestically and in export markets provides opportunities for Australia to increase the level of innovation and value-adding.

Two recent reports identify opportunities for food and beverage innovation, which, if realised, could lead to sector growth.

The CSIRO Growth Opportunities[15] report identifies three areas where product innovation will position Australian manufacturers for high growth in domestic and international markets.

- *Health and wellness foods*. The CSIRO identifies a $20 billion+ opportunity in free-from and natural foods, fortified and functional foods, vitamins and supplements, and personalised nutrition.
- *Sustainable solutions*. Alternative proteins, organic waste conversion and sustainable products all have the potential to create value and make a significant environmental saving.
- *Luxury segments*. High value targeted food and grocery products appeal to increasingly affluent consumers both in Australia and overseas. This includes luxury and convenience products.

The opportunities identified in the CSIRO report could translate into an extra $30 billion of annual revenue for Australian food and grocery manufacturers by 2030[16].

The Food and Agribusiness Growth Centre[17], also known as FIAL (Food Innovation Australia), has also released a report on opportunities for Australian food and agribusiness. The report provides a comprehensive overview of the opportunities across the supply chain that have the potential to triple total food and agribusiness value-added by 2030.

The potential for food manufacturers in the report is substantial, making up over half the value of the 19 identified opportunities. The most important relate to health and wellness, traditional proteins and targeted eating.

The report projects $200 billion of food and agribusiness value-added in 2030.[18] To put this in context, food and agribusiness value-added is currently just over $60 billion a year.

Both the CSIRO and the FIAL reports highlight the substantial opportunities that exist, the importance of innovation in driving growth, and the need to tap into global consumer markets to realise the opportunities.

Health and wellness at the forefront of consumer thinking

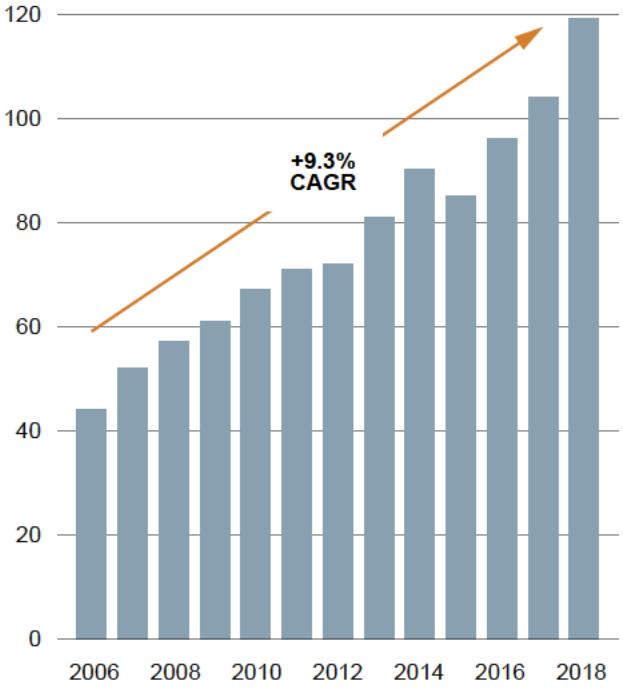
Consumer understanding of health and nutrition is driving manufacturers beyond the trend to reduce the sugar, fat and salt content of processed food. Consumers are seeking new food products with lower levels of certain nutrients; products that are 'free-from' certain ingredients; higher levels of plant-based alternatives; and functional foods that improve wellness, including gut health, for example. In non-food grocery categories, such as personal care and cleaning products, similar trends exist, with an increased demand for natural products free from certain inputs.

In addition to this, consumers are placing a health premium on the attributes of food related to geographic origins, the types of production systems, and technologies employed. Organic food, 'free range' farming and local produce all enjoy a health halo with consumers and as Chart 8 shows there has been significant growth in sales of organic food from 2006 to 2018.

[15] CSIRO (2019), Growth opportunities for Australian food and agribusiness; economic analysis and market sizing.
[16] The CSIRO report identifies $25 billion revenue opportuni ies based on 2018 values. This translates into more than $30 billion of revenue in 2030 dollars in this projection framework.
[17] Food and Agribusiness Growth Centre (FIAL) (2020), Capturing the prize: the A$200 billion opportunity in 2030 for the Australian food and agribusiness sector.
[18] It should be noted that the FIAL report calculations are based on industry value-added whereas this report's calculations are based on production turnover. Industry value-added takes into consideration the value of inputs into an industries production process whereas turnover figures are a measure of he total output of the sector.

Chart 8: Worldwide sales of organic food

US$bn and CAGR



Source: Sta ista (2021), *Consumer market outlook – global food report*, EQ Economics

Sustainability – good for people, the planet and business

Apart from the environmental, humanitarian and animal welfare benefits of sustainability, it can offer several opportunities for businesses including increased consumer loyalty, sales growth, efficiency improvements and can boost a culture of innovation.[19]

Consumer trends for more sustainable products apply not only to food and beverages but also to non-food grocery items, including personal care and household care items.

There are many elements to improving sustainability across sourcing, production and consumption. These include:

- reducing humanitarian and animal welfare impacts through understanding supply chains and making ethical sourcing decisions,
- reducing climate change and other environmental impacts by minimising the product's resource footprint, including carbon emissions, energy, water and oil, and
- reducing product and packaging waste, including reducing food waste in production and consumption.

The benefits to business flow when an integrated approach to sustainability is taken across all aspects of the business, including company brands, and when the business demonstrates authenticity behind its sustainability claims, such as through traceability systems and digital labelling.

Increased personalisation and convenience

Other consumer trends driving the need for innovation include the desire for increased convenience and personalisation, which require manufacturers to be more agile, flexible and digitally enabled.

The trend of convenience continues to provide opportunities for suppliers. Convenience extends beyond convenient product offerings to also include value-added products and meal kits that take the effort out of planning, preparation and cooking; the seamless shopping experience that sees online and physical stores becoming integrated; automatic reordering, and more convenient fulfilment.

COVID-19 restrictions have exacerbated the trend to increased online shopping, and many consumers are merging their physical and digital shopping experiences, searching for information about products while in store, including whether products meet their personal preferences and values.

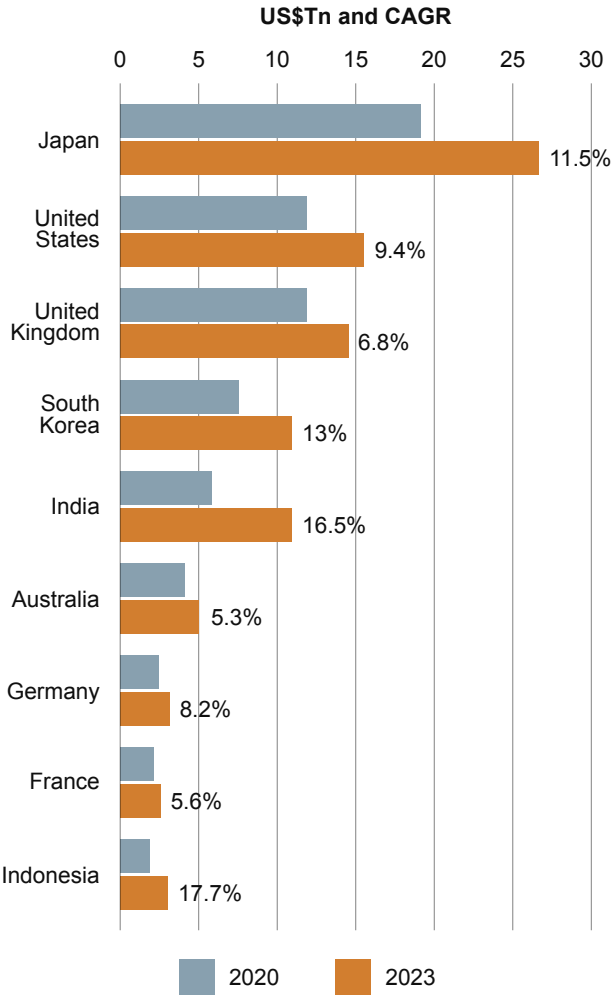
Online grocery sales are one of the fastest growing segments for retailers. Chart 9 shows online sales of food and beverage products around the world. The largest online market for food and grocery is China (not included in the chart) with US$141 billion of sales in 2020. The Chinese online food and beverage market is expected to grow by 12.6 per cent a year to US$201.6 billion in 2023.[20]

[19] Wilson, J (2018),Nielsen, Five reasons to prioritize sustainability in your brand playbook. https://www.nielsen.com/au/en/insights/article/2018/five-reasons-to-prioritize-sustainability-in-your-brand-playbook/

[20] Source: Statista (October 2020), *Statista industry report – global manufacturing: food*, EQ Economics Calculations

The Australian online market is expected to grow at 5.3 per cent a year and will exceed $7 billion by the middle of the decade. Although the online segment is expected to experience high growth rates in all markets, the greatest potential for growth is in the emerging economies of Asia.

Chart 9: Online sales of food and beverage products



Source: Statista (October 2020), *Statista industry report – global manufacturing*: food, EQ Economics Calculations

Manufacturers locally and globally are responding to consumers' desire for personalisation, not only for customisable products but also for exclusive and tailored product offerings, promotions and advertising. Personalisation will become increasingly viable as technology improves and data becomes better integrated.

Consumers are looking for unique products and experiences they can relate to, which requires companies to curate customised products, at greater cost, and adopt virtual reality and other technologies to make their products engaging.

Transparency and traceability

Consumers in Australia and overseas increasingly expect manufacturers to be more transparent about where and how products are made, and to offer technological solutions that validate the authenticity of product safety, provenance, health or sustainability claims.

To meet this need, the food and grocery sector needs to invest in data driven traceability standards systems, processes and capabilities. This includes digitising product information; implementing standardised systems to transfer information along supply chains; integration and interoperability of systems; and providing consumers with product and related information through codes on packaging, via mobile devices and online.

SO WHAT?

As a relatively small player in the global market, the opportunities for the Australian food and grocery manufacturing sector are very real.

To realise these opportunities, the sector and government must confront and mitigate many challenges, both at home and abroad. These challenges are discussed in Chapter 3.

CHAPTER THREE

CHALLENGES FACING AUSTRALIAN FOOD AND GROCERY MANUFACTURING

- Food manufacturing costs have been rising at a higher rate than manufacturers' wholesale selling prices over the past ten years.
- Profits in the food manufacturing sector have been falling since 2010 against the broader trend of rising profitability across the Australian economy.
- Capital expenditure by food manufacturers has been stagnant for the past decade and the sector risks falling into a low investment trap, despite a significant need to invest for sustainability, innovation, competitiveness and resilience.
- The trends for lower research and development (R&D) spending in Australia are in stark contrast to the global experience. Australia is falling behind the global standard in innovation spending.
- Australia's food regulatory system is no longer delivering to the core objectives, whilst imposing greater costs on the sector and inhibiting consumer lead innovation.
- In the global market, Australia is competing on an uneven playing field facing growing non-tariff barriers and competition from a government supported sector in other countries.

INTRODUCTION

The Australian food and grocery sector's ability to realise its growth potential is hamstrung by high costs, an uneven global playing field and a highly concentrated domestic supermarket sector with buyer power, which combined have impacted profitability and investment.

Over the last decade, the sector has expanded production at a modest rate in the face of a shrinking manufacturing base. However, there are warning signs emerging. Non-food grocery has already seen a substantial shift in production capacity to cheaper, offshore locations. Food and beverage manufacturing is losing underlying profitability while investment is stagnating. There is a real risk of a further loss of domestic food and grocery manufacturing capacity over the next decade.

This loss of profitability has triggered a relentless drive for efficiency across the sector. The severity of the decline in profitability has resulted in a slowdown in the sector's employment growth and investment spending has not increased for a decade.

Weak profitability leads to an investment trap, which hinders the sector's competitiveness and ability to respond to heightened international competition. This is exacerbated by the fact that many countries, particularly in Asia, are actively supporting their local food and grocery manufacturing sector within the context of a broader free-trade agenda.

Import penetration in food and grocery is rising while the export of high value-added manufactured food products has not grown in a decade. Australia is now a net importer of both non-food grocery and high value-added food. The greater the extent of processing of food and grocery products, the more vulnerable Australian producers are to import competition, and the less resilient the Australian community's supply of food and groceries will be to global shocks such as pandemics and trade disputes.

Domestic food and grocery production is not keeping pace with growth in domestic demand and is making little headway into the fast-growing markets of Asia outside of certain segments such as meat, wine, dairy and vitamins.

Without a shift in the underlying dynamics of the domestic sector, Australia risks not only losing parts of its existing production capability, but it will let slip the opportunities presented by the world's rising demand for high value food and grocery products.

This will not only mean a lower level of economic output in Australia, it will mean fewer high paying jobs, fewer jobs in key regional centres and a less secure food and grocery supply for Australians than would be the case with a strategic long-term focus on the sector's future.

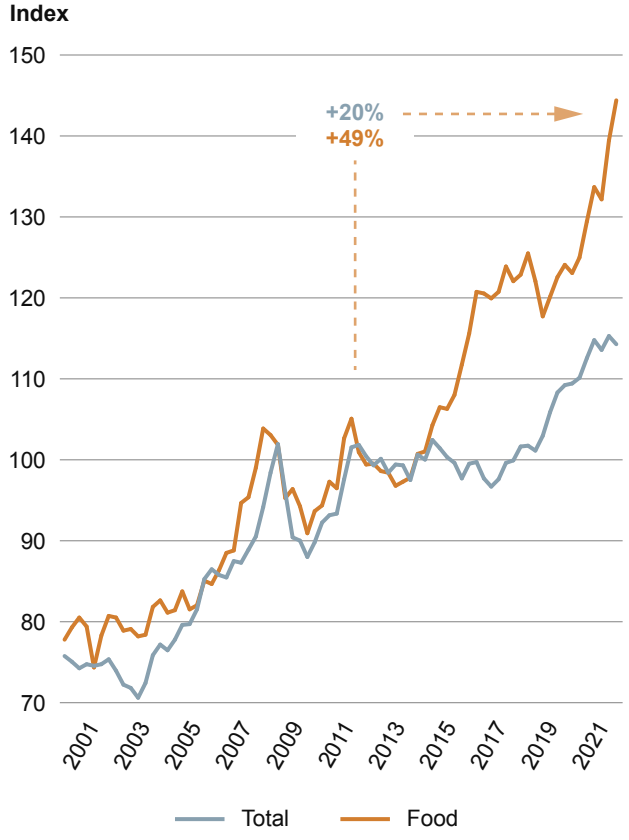
SECTION ONE

COST PRESSURES HAVE BEEN BUILDING FOR A DECADE

Over the past ten years, Australian food manufacturers' input prices have increased at an annual average rate of 4.1 per cent. This equates to an increase in food manufacturers' primary input prices of 49 per cent from 2010 to 2020. This increase in input costs does not include the trade spend costs discussed below.

For the broader manufacturing sector, input prices have increased at an annual average rate of just 1.8 per cent over the same period, which equates to a total increase of 20 per cent over the decade (Chart 10).

Chart 10: Manufacturing input prices: overall manufacturing versus food manufacturing[21]



Source: ABS

As Chart 10 demonstrates, up until 2014 the input cost pressures experienced by food manufacturers in Australia were not all that different from the broader manufacturing sector. This changed abruptly in 2014 when food production costs rose at a much faster pace than input costs for overall manufacturing. This was partly the result of a falling currency and the rising cost of imported inputs as well as stronger domestic agricultural prices.

Most of the major cost lines for food manufacturers have been rising at a stronger rate than their output (wholesale selling) prices over the past ten years.

The single largest input into food production is primary commodities (refer to Table 1). Australia is a globally relevant agricultural producer, exporting primary foodstuffs that feed millions of people around the world. Because Australia is integrated into the global food trading system, local food manufacturers generally pay a global price for their primary commodities. As such, domestic manufacturers do not get any material cost advantage by being located in Australia other than some relief on transportation costs.

Packaging costs average 14 per cent of a food manufacturer's costs so small increases in these costs can have a significant effect on overall costs and profitability. As discussed in Chapter 4, companies are working hard to develop a circular economy, though this will entail cost pressures including from new recyclable or reusable packaging formats as well as recycled content in packaging.

[21] While data are only available for food manufacturing, anecdotally here is a similar trend in non-food grocery manufacturing.

Table 1: Food input and output price pressures

10 Year per cent change in price level 2009-2019

Australian Dollars	Total Price Change 2009-19
Primary Commodities	
Sheep, beef cattle and grain farming	73.0%
Dairy cattle farming	55.0%
Agriculture	56.4%
RBA rural commodity index	48.1%
Operational Costs	
Manufacturing wages	30.6%
Nautral gas	54.8%
Electricity	89.4%
Pulp and paper	30.8%
Road freight	23.9%
Rail freight	43.1%

Source: ABS, RBA, EQ Economics

Australian food manufacturing cost structure

There are three main categories of costs for food and grocery manufacturers:

Major costs

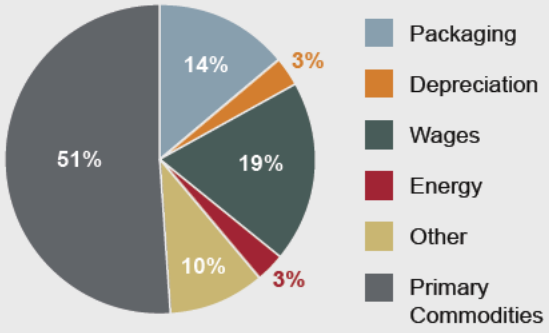
Input costs (40–60 per cent of total costs) are made up of primary commodity inputs into production and packaging materials.

Operating costs (20–25 per cent of total costs) capture all other operational and administrative costs including wages, depreciation, energy costs, rent, marketing, R&D, warehousing, logistics and distribution.

Trading costs*

Trade spend (25–30 per cent of total costs) is now one of the largest costs of doing business for food and grocery suppliers in Australia. Trade spend has been growing at a faster rate than any other major cost.

Indicative cost structure of food manufacturing sub-sector in Australia, 2019 (excluding trade spend)



Source: Sector Estimates, EQ Economics

Another issue related to the cost structure of Australian manufacturers is scale. The Australian market is relatively small compared to overseas markets. Achieving economies of scale that will support a globally competitive sector requires thriving export sales.

****Trade spend** refers to the financial contribution provided by suppliers (manufacturers) to retailers to support products and brands. It can include promotions, in-store displays, merchandising, rebates and other commercial spend.*

SECTION TWO

EFFECT OF RETAILERS' BUYER POWER ON SECTOR PROFITABILITY

Australia's food and grocery retail market is characterised by a very high degree of concentration by the two major supermarket retailers, Coles and Woolworths. The entrance of Aldi and Costco into the Australian market has enhanced competition for consumers. With the fear of losing market share to new entrants and discounters[22], Coles and Woolworths have turned their attention in the past decade to more stringently managing their purchasing costs from suppliers, which represent almost 70 per cent of their total costs.

A supplier may derive 40 per cent of its revenue from one of the major supermarkets yet its business represents a fraction of the supermarket's total revenue. This gives the supplier little influence over the negotiation. If a supplier loses Coles or Woolworths as a customer, then it makes it very difficult to maintain a viable business.

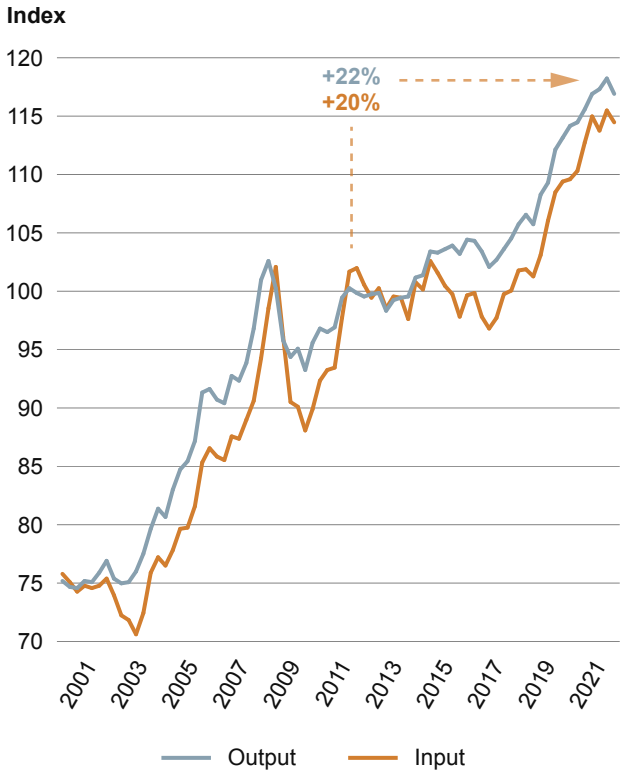
In other markets, where suppliers are less reliant on a particular retailer, they can afford to negotiate harder as there is less consequence for their business if they lose that customer.

Supply chain pricing dynamics and sector margins

Managing input price pressure is normal for all businesses. If cost pressures are sustained, a typical response is to pass some of the higher costs of production onto customers.

Over the last 35 years there has been a stable relationship between overall manufacturing input and output prices in Australia. As shown in Chart 11, output prices tend to respond to input prices, indicating that in most manufacturing industries a sustained increase in production costs has been passed through the supply chain.

Chart 11: All manufacturing input and output prices



Source: ABS

The experience of food and grocery manufacturing has been very different to that of the overall manufacturing sector in Australia over the past decade.

Food and grocery manufacturers have sought to absorb cost pressures or mitigate them through cost efficiencies, though this has come at the expense of investing in innovation, brands and marketing.

However, cost absorption and mitigation strategies have not been enough in the face of sustained input cost increases over the last decade. To remain viable, manufacturers need to pass some of the cost increases on to their customers, as is normal in business.

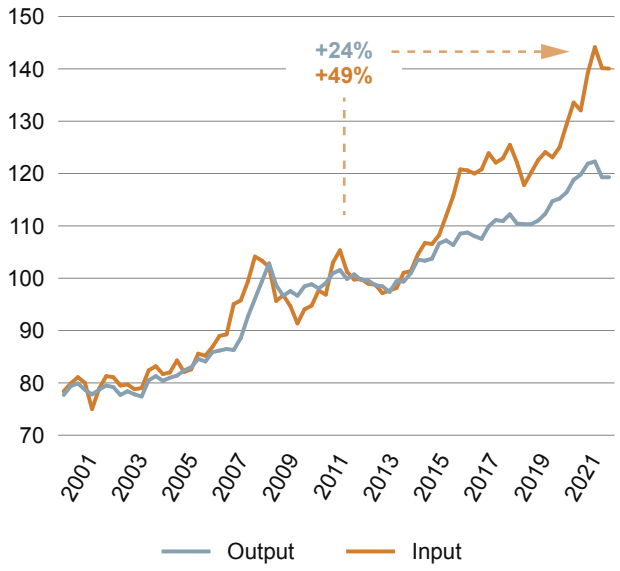
[22] Aldi entered the Australian market in 2001 and steadily increased it market share. Aldi surpassed 5 per cent market share by 2007 and exceeded ten per cent in 2015. At the same time the private label share of food and grocery retail sales and import penetration increased at historically unprecedented rates.

The problem for Australian food and grocery manufacturers is that they have generally been constrained in their ability to pass through rising input cost pressures. Where suppliers have been successful in increasing their wholesale prices, it has generally been only a fraction of the cost increases over the last decade. Additionally, there has been increased pressure to offset supplier price increases through additional payments to retailers such as trade spend.

Over the past decade, food manufacturing input prices have increased by 49 per cent, whilst output (wholesale selling) prices have increased just 24 per cent. It should be noted that the 49 per cent increase in input costs does not include the trade spending discussed below. The 24 per cent increase in output (wholesale selling) prices includes sales into all channels (eg supermarkets, convenience stores and food service). Anecdotally, wholesale pricing into supermarkets has grown significantly less than these other other channels. The actual gap between inout and output prices for packaged foods is therfore likely to be greater than shown here. Chart 12 shows input and output prices for food manufacturing in Australia and the stark contrast to the overall manufacturing sector depicted in Chart 11.

Chart 12: Food manufacturing input and output prices

Index



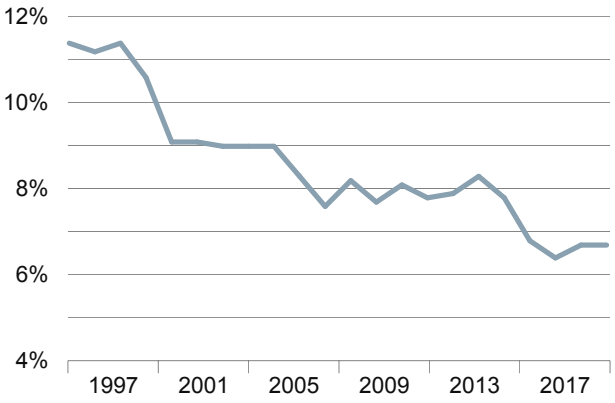
Source: ABS

Even though food and grocery manufacturers have aggressively reduced costs there has still been a sustained downward pressure on operating margins.

Sector consultancy Euromonitor estimates that food manufacturers' margins (excluding trade spend and other indirect costs) have compressed significantly since the late 1990s, from a margin of 11.5 per cent in 1997 to 6.8 per cent in 2018 (Chart 13). This is a 40 per cent compression of food manufacturers' margins over 20 years and a 17 per cent decline since 2009.

Chart 13: Sector margins have been falling for two decades

Food manufacturing gross operating margins (per cent)



Source: Euromonitor

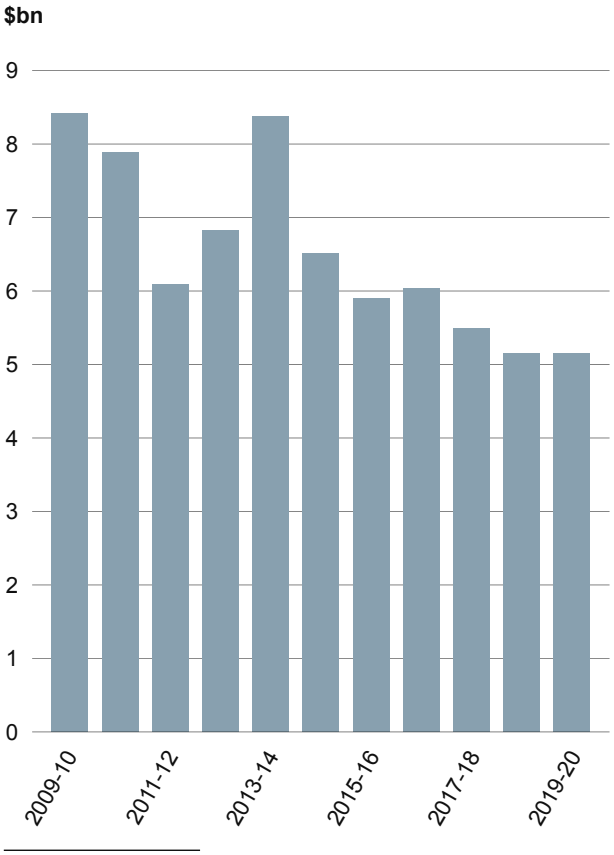
This analysis is indictive and only captures trends in gross operating margins for food manufacturers. The margin compression would be even greater if trade spend costs were included.

Food and beverage profitability

An inability for wholesale prices to keep pace with rising input prices and the resultant decline in operating margins inevitably leads to lower profits. This is precisely what has happened to Australian food and grocery manufacturers over the last ten years.

Profits in the food and beverage manufacturing sector have been falling since 2010 when company profits before tax were above $8 billion (Chart 14). Since then, the profit trend has been downwards, despite turnover increasing in this period. According to the ABS, sector wide profits were just above $5 billion in fiscal 2019, down from over $8 billion a decade earlier.

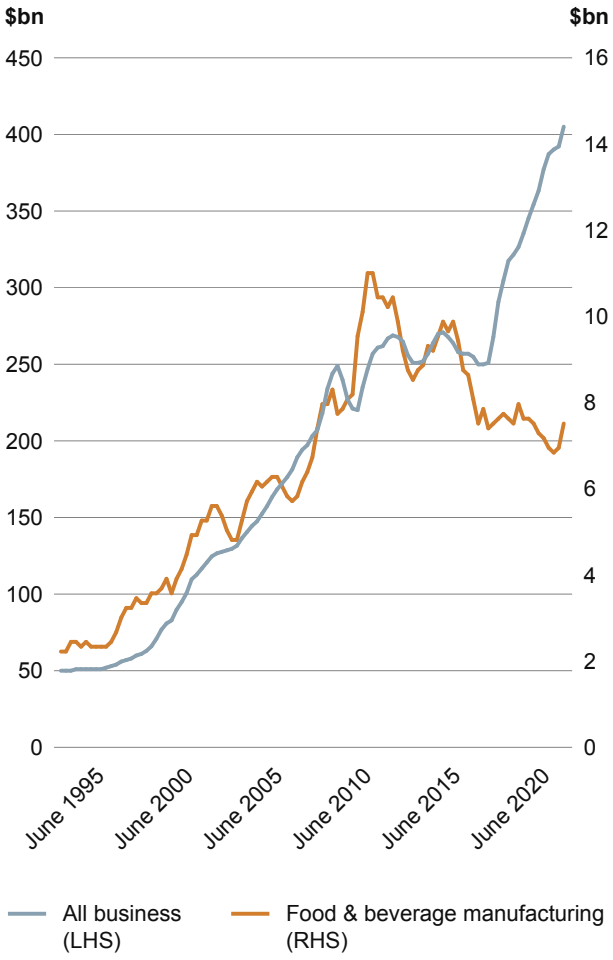
Chart 14: Food and beverage profitability



Source: ABS

Chart 15: Profitability across the economy versus food and beverage manufacturing

Gross operating profits ($bn), annual rolling sum



Source: ABS

It is recognised that falling operating margins and profitability is occurring across many sectors in the economy due to slower nominal economic growth and weak productivity. The global macroeconomic environment has made business growth, particularly for large mature businesses, harder to come by.

This is balanced out by lower than expected returns on equity. As such, some of the decline in sector profitability reflects broader economic factors. However, as the input and output price analysis show, there are clearly sector specific factors impacting food and beverage manufacturing profitability, resulting in a much larger fall in returns than is evident in the broader economy.

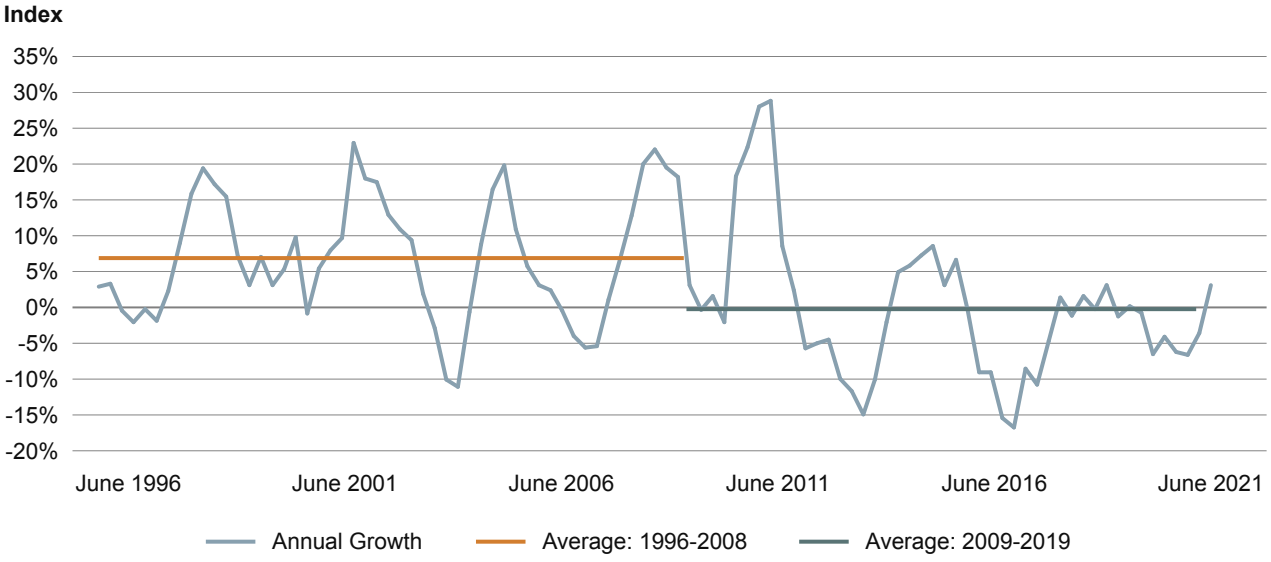
As shown in Chart 15, the greatest concern to the future viability of the domestic sector is the drop in profitability experienced since 2015. This appears to be almost entirely the result of sector specific factors, in particular a limited ability for manufacturers to pass on higher input prices to customers.

There has always been a degree of volatility in profits which is a normal part of operating a business that experiences input price volatility. The annual growth rate of food manufacturing profits can fluctuate widely as shown in Chart 16. Between 1987 and 2010 profit measured quarterly by the ABS would often fluctuate between -10 and +30 per cent annual growth rates. On average profits grew at an annual rate of 6.9 per cent.

This changed in 2010 with profit growth falling to an annual average growth rate of -0.3 per cent over the decade since. The decline in margins and profitability for Australia's food manufacturing sub-sector coincided with the limited ability of manufacturers to pass cost pressures through the supply chain to supermarket retailers. This process started in 2010 and has remained a feature of the market ever since.

Chart 16: Profitability in decline

Food manufacturer gross operating profits (per cent)



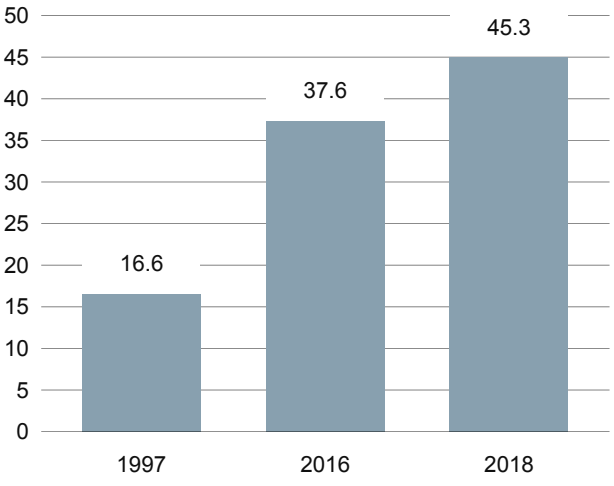
Source: ABS

Rising trade spend

Australian retailer requirements for trade spend have been steadily increasing over the past decade, led by the major supermarket retailers. The latest AFGC Grocery Investment Benchmark Study[23] estimates trade spend at just under half of net sales revenues in 2019. This compares to a level of less than 20 per cent in the late 1990s (Chart 17).

Chart 17: Suppliers' trade spend with supermarkets

Per cent of net sales



Source: AFGC Grocery Investment Benchmark Study, 2019 and AFGC estimates

This represents an increased cost of doing business with retailers and typically comes at the expense of other supplier activities, such as their own independent marketing programs, market research, innovation and product development. It is also a factor impacting supplier profitability.

According to the AFGC study, in 2019 the major retailers accounted for just under 60 per cent of supplier sales but nearly 70 per cent of trade spend.

Trade spend has become a standard feature of today's marketplace. It is a term used to describe all the costs associated with selling to a supermarket retailer, including:

- Trading terms (fixed) – the cost of doing business with the retailer, including base terms, early settlement discounts, warehousing allowance, some basic data access.
- Case deals (variable) – the supplier's support for price reductions (permanent or promotion) within the retail store.
- Co-op (variable) – a broad range of variable spend such as product display, retail catalogue advertising, in-store promotions such as collectable campaigns.
- Other (variable) – a broad range of costs from items such as margin support payments through to fuel levies for retail freight movements.

[23] *AFGC (2019) Grocery Investment Benchmark Study.*

SECTION THREE

LOW INVESTMENT TRAP

The past decade has been an incredibly challenging period for businesses in many sectors of the economy. Weaker growth and inflation have reduced the capacity of businesses to increase prices in response to rising input costs. It has been a decade of cost cutting and efficiency drives. However, as demonstrated, this effect has been greater in food than in the total manufacturing sector.[24]

Cost cutting can be in response to short-term market challenges with temporary cost reductions to minimise the profitability impact of difficult trading conditions. However, the recent experience of food and grocery manufacturing in Australia has gone beyond the temporary. Businesses have had to find structural reductions in their cost base and yet, despite this, have still suffered declining profitability.

Investment is the lifeblood of a manufacturing business. It is critical to maintain and improve the capital stock to improve productivity and competitiveness, and to innovate to meet growing consumer expectations. While margin pressures send the signal to look for efficiencies and better ways of doing business, there comes a point where profitability is pressured to such an extent that investment is jeopardised. This in turn curtails innovation and efforts to increase productivity.

Individual companies and whole sectors can fall into a vicious cycle of weakening profitability and lower investment. It would appear that Australia's food and grocery manufacturing sector has fallen into this vicious cycle.

Investment in the sector in Australia has been weak for the past decade. The core ABS dataset focuses on food and beverage manufacturing although anecdotally, the grocery experience is a downward trend.

The analysis of sector investment is broken down into three broad categories: traditional capital investment as defined by the ABS; research and development (R&D) activities that drive innovation; and investment in brand, customer engagement and product awareness in the community.

Capital investment is stagnant

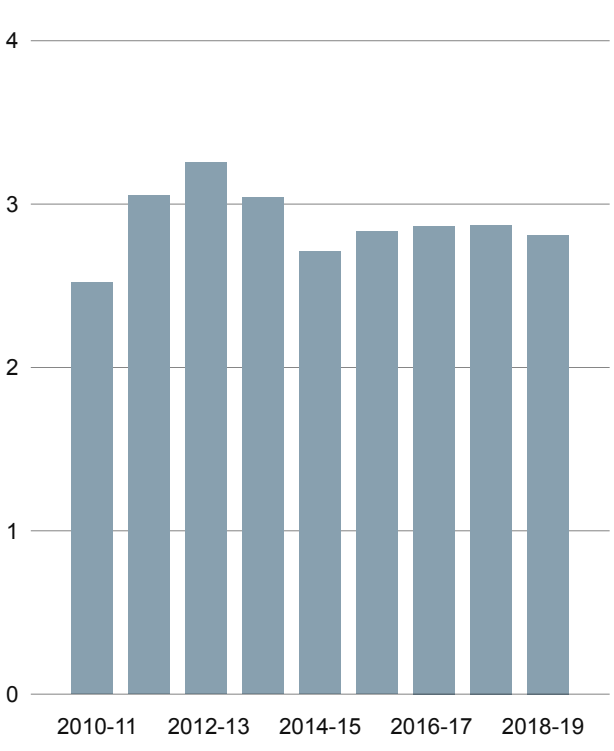
In the last sector outlook report in 2011, AT Kearney identified investment as a point of concern:

"The food and grocery manufacturing industry faces a significant investment challenge. It is highly uncertain if the industry will have the capital or will to make the scale of investment required over the next decade to maintain a vibrant competitive sector".

Unfortunately, it appears that this somewhat gloomy prognosis has come to pass. Gross fixed capital formation, which is capital investment as measured by the ABS, has not grown for over a decade (Chart 18).[25]

Chart 18: Capital investment has not grown in a decade

Annual, food and beverage gross capital formation



Source: ABS

[24] While the data are only available for food, anecdotally the experience is he same for beverage and non-food grocery manufacturers.

[25] Gross fixed capital formation is asset purchases (including intangibles) less disposals but does not include any adjustments for depreciation, hence the term 'gross'.

Food and beverage capital investment has been moving sideways at under $3 billion a year for the past 5 years having reached a high point of $3.3 billion in 2012–13. These data indicate that the sector is not significantly growing its productive capacity, which has implications for the future ability to meet an increased level of growth.

Manufacturers are increasingly tempted to relocate production to lower cost jurisdictions. The often-generous land purchase and taxation concessions available to greenfield manufacturing facilities in places like Thailand or China are economically compelling.

For multinationals with mobile capital, the trends are quite clear. Australian production capacity is being utilised until the end of its productive life, so-called asset sweating, and increasingly the replacement of that capacity is happening in lower cost jurisdictions overseas.

While the capital investment data is for food and beverage manufacturers only, anecdotally non-food grocery manufacturing investment in Australia has declined as products, such as cleaning and personal care products, are increasingly being produced overseas due to a loss of competitiveness domestically.

For those manufacturers who choose to stay in Australia, deteriorating profitability and stagnant capital investment make innovation and international expansion very difficult.

Australia falling behind in innovation spending

A deeply concerning feature of the Australian food and grocery manufacturing sector is a poor climate for innovation. There is no lack of desire to innovate but the headwinds are significant. An ABS survey from 2017[26] showed that the two biggest obstacles to innovation in Australia are a lack of skilled labour and cost.

In the AFGC Grocery Investment Benchmark Study, supermarket margin expectations were cited by 61 per cent of the respondents as having a strongly negative impact on the level of innovation for Australian suppliers and manufacturers.

Australia was at one time a global innovation hub for consumer food products. Many multinational firms had local innovation centres and would use this stable and sophisticated market as a test bed for new products.

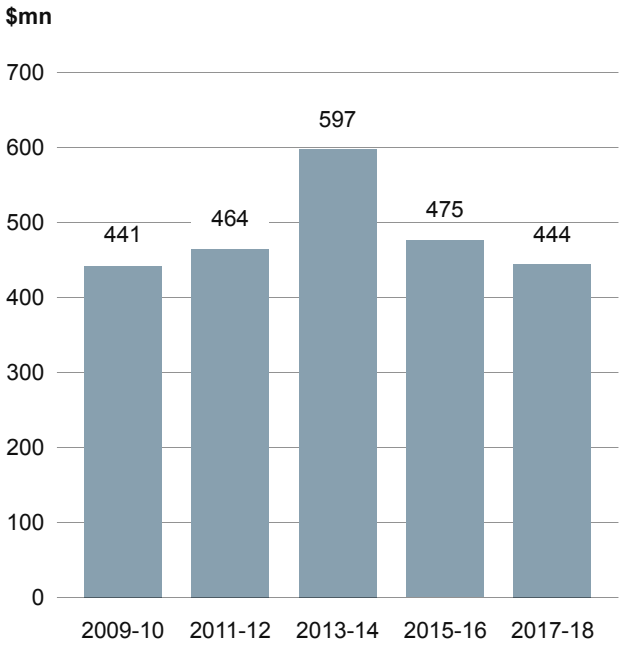
Multinational businesses are increasingly centralising innovation spend in global hubs that offer incentives, while local players are struggling to find the budget to invest in R&D.

ABS data for food manufacturing in Australia highlights that weak profitability across the sector has impacted R&D expenditures in the past five years.

Chart 10 shows food sector R&D spend over the past decade.

Chart 19: A disturbing trend is emerging in R&D spending

Food manufacturing R&D spending (2009–18)



Source: ABS

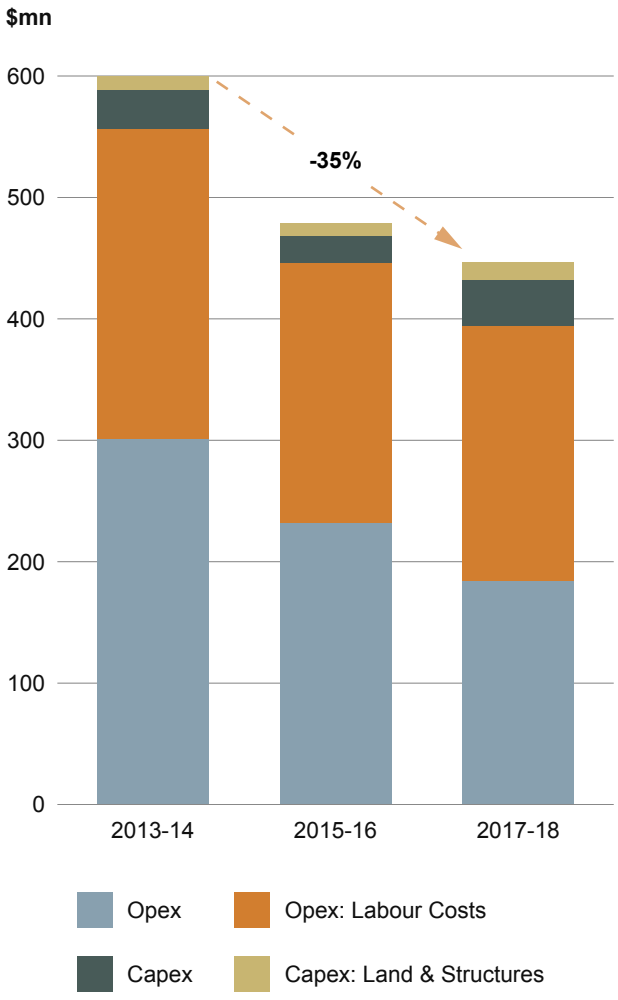
Sector wide R&D spending maintained a growth trajectory until 2013–14. Total R&D spend reached a high point just under $600 million in 2013–14 and has since been in decline. In 2017–18, R&D spending by Australian food manufacturers was at about the same level it was in 2009–10, a very similar outcome to net capital investment spend.

[26] Australian Bureau of Statis ics (2018), *Innovation in Australian Business, 2016-17*. Catalogue Number 8158

The ABS survey breaks R&D into capital expenditure (capex) and operating expenditure (opex). Opex is the dominant component of R&D spend and has been cut heavily over the past five years. Both labour and non-labour operating R&D expenditures have fallen by over one third since 2013–14 (Chart 20).

Chart 20: Weak profitability is driving down Opex R&D

R&D spending component

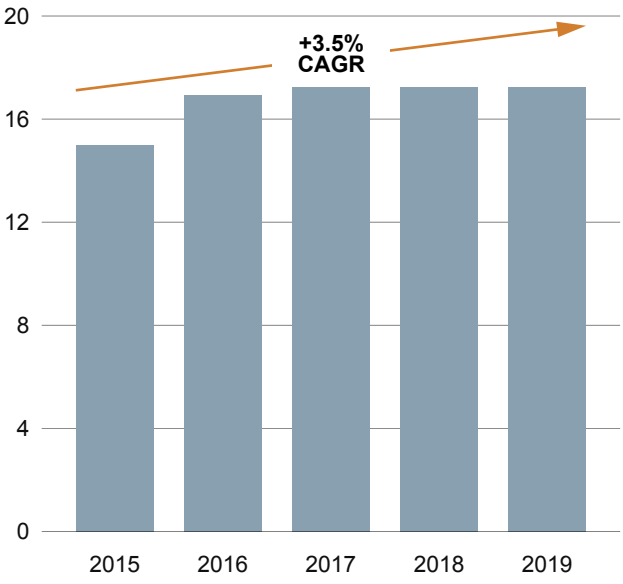


Source: ABS, EQ Economics

These trends for falling R&D spending in Australia are in stark contrast to the global experience. Chart 21 shows that estimates for global R&D spending on food and beverage manufacturing have achieved 3.5 per cent CAGR over the five years to 2019, which is broadly in line with market growth.

Chart 21: Global R&D spend is trending up

Global R&D spending by food and beverage manufacturers



Source: Sta ista, EQ Economics

Australia's share of global R&D spending is shrinking. This will leave us at a competitive disadvantage in the development of new products and world class production processes.

Yet the need for investment is growing significantly

As discussed in Chapter 2, there are many drivers for investment in food and grocery manufacturing: productivity improvements to mitigate high costs; resource efficiency and sustainability lead initiatives to improve environmental outcomes; improving innovation capability and responsiveness to meet changing consumer demands in an extremely competitive global market; and improving the agility and flexibility of manufacturing in response to greater global uncertainty.

These drivers compete for capital within the business and some, such as sustainable packaging, often have low or no return on investment. If businesses cannot make the case for investments to happen in Australia, then companies will lose their competitive edge and manufacturing will move to markets where the business case for investment is enhanced through government support, as discussed in the following section.

SECTION FOUR

FOOD AND GROCERY SECTOR POLICY IN OTHER COUNTRIES CREATES AN UNEVEN PLAYING FIELD

Australia has been a strong supporter of open markets and trade for 40 years. The commitment to market-based solutions to our economic problems crosses party lines.

This commitment to free and open trade, both in the domestic economy and the international arena, should not be mistaken for a view that markets can deliver the right outcomes for the community in every instance. There is a role for government in our economy. What is contestable is how and under what circumstances the government should intervene in a market or sector.

Government intervention in a market or sector should be based on a strong rationale for why that market is not delivering desired outcomes.

Foreign government intervention

Australia's food and grocery manufacturing sector faces international competition from businesses that receive substantial government support. This impacts the relative competitiveness of Australian manufacturers in both the domestic and overseas markets.

Most developed and emerging economies will pursue sector support for food and grocery manufacturing within the context of a free trade framework. This is in part due to sector policies to promote exports but also because the alternative trade restrictions will often result in higher domestic food and grocery prices, which is socially and politically undesirable. So, while globally there has been a fall in tariffs pertaining to food and groceries, there has been an increase in the level of non-tariff measures in many countries, including sector support programs.

The food sector is often targeted by foreign governments to receive support given its role in commerce and trade and its importance to its citizens for food security, health and nutrition.

Food security has been a key motivation for governments to support domestic food manufacturing. The importance of this issue was highlighted throughout 2020 during the COVID-19 pandemic.

With global trade in agricultural commodities highly liberalised, a country that is otherwise deficient in agricultural production can strengthen food security by developing food manufacturing capability and capacity.

Even countries that have strong agricultural sectors provide support for food manufacturing. This ensures the production of final consumer products and enhances the economic value-added by domestic agricultural production.

Foreign governments support for the food sector spans interventions aimed at boosting agricultural production right through to manufacturing and retailing.

Foreign governments also provide financial incentives for non-food grocery industries as part of a broader strategy to build up a domestic manufacturing capability.

It is understood that some countries are currently increasing their levels of manufacturing support to shore up their economies and ensure food security given the effects of COVID-19.

There are a range of sector support measures that governments utilise to promote a successful food and grocery manufacturing capability, including:

Financial

- Tax incentives
- Land incentives
- Investment incentives
- Access to trade finance

Innovation

- Innovation clusters or hubs including technical and scientific research support
- Wage subsidies for scientific and research staff

Economic zones

- Special Economic Zones (SEZs) or Foreign Trade Zones (FTZs) that will provide a suite of support mechanisms including tax incentives and relief, investment incentives, collaboration assistance, and innovation support.

Coordination

- Whole of government policy platform to navigate multiple departments and levels of government.
- Whole of supply chain policies that promote collaboration from the farm to the factory to the retailer.

Food and grocery sector policy: countries similar to Australia

Table 2 shows countries that are similar to Australia, yet have manufactured food exports as a primary focus of their sector policy, and yet provide sector support within a free trade framework.

All these countries have a successful agricultural platform as a starting point to develop a vibrant food manufacturing sector.

They all have a strong reputation for quality and standards, not just in farming and primary produce but more generally across the food sector. This clean and green mantle is highly valued by consumers, the sector and government.

Some of the policy tools that governments use to support the food and grocery sector are outlined in Table 2.

Table 2: Government policy tools, initiatives & programs

Canada	• Foreign Trade Zone with duties and tax relief, infrastructure, and research support • Government funded innovation hubs • Government research funding
New Zealand	• International Growth Fund – government funding for projects, direct exporter assistance (administration & marketing) • R&D tax credits • Regional Growth Fund – infrastructure support and tax incentives
The Netherlands	• R&D investment subsidy including wage subsidy up to 32% • Income tax discounts • Innovation hub funding –"FoodValley" • Government funding for start-ups
Ireland	• "SmartFood" to attract FDI including tax incentives, infrastructure and admin support • R&D tax credits • Preferential income tax rates for target segments within the food sector.

Source: FreshAgenda

Food and grocery sector policies in South East Asia

There are substantial government support programs for manufacturers in other markets, such as South East Asia. For example:

- In ASEAN countries there is a concerted effort to attract foreign investment with substantial incentives and tax breaks, in addition to lower corporate tax rates and wages.
- Thailand: Attracts foreign investment with government policies offering tax breaks and incentives, educated workforce and market access. Corporate income tax exemptions for up to 13 years for companies involved in the food research/innovation hub.
- Indonesia: Three hundred per cent deduction on total cost of R&D; 60 per cent deduction on total investment/expansion in labour intensive industries.
- Philippines: Investment incentives through import tax, duty exemptions. Up to 100 per cent deductions for R&D expenses.
- Malaysia: Pioneer status with income tax exemptions for 70–100 per cent of income for five to ten years.
- Vietnam: Tax exemptions and reduced tax schemes for certain businesses, such as those investing in large scale manufacturing. Technology investments related to production are tax free.[27]

[27] FreshAgenda report prepared for AFGC

SECTION FIVE

EXPORTERS MUST OVERCOME NUMEROUS CHALLENGES

The Australian Government has made progress in lowering the tariffs faced by Australian exporters in many countries through the implementation of regional and bilateral Free Trade Agreements (FTAs). However, it is notable that agreements do not exist with several key markets such as India, Gulf countries and Taiwan.

Despite some success in establishing bilateral free trade agreements with key markets in Asia in recent years – notably China, Japan and South Korea – substantial barriers to international trade remain in Asia and with other countries around the world.

These include traditional restrictions, such as tariffs and quotas, as well as regulatory and technical barriers to trade. The latter range from regulatory requirements at the product level, which are difficult or costly to meet, through to complex bureaucratic processes when getting products across international borders and into markets.

These non-tariff barriers derive primarily from differences in national rules and regulations, as well as variations in implementation and enforcement of regional guidelines and country policies. They create unnecessary complexity, delays, impose costs and increase business risk.

Examples of specific trade barriers to export include:

- Product registration, which varies from country to country in terms of processes and requirements,
- Certification for production systems such as organic and halal,
- Labelling requirements, and
- Testing and documentation with lack of mutual recognition of methodologies.

For Australian food and grocery manufacturers these non-tariff trade barriers add to the natural uncertainty that exists in trying to break into new overseas markets.

Whilst these issues might be considered barriers to export growth at the micro-level, other factors playing out at the macro level add another layer of uncertainty for exporters. These are:

- Disruption of the world trade order and rules-based system and particularly the function of the World Trade Organization's dispute settlement system,
- The uneven recovery from the global recession triggered by the COVID-19 pandemic. The roll-out of the vaccines to over seven billion people will be challenging with the net result that opening of borders and potential for trade disruption will persist into the medium term,
- The rise of protectionism as countries seek to increase self-sufficiency and resilience in food and beverage manufacture and supply as a result of vulnerabilities exposed by the COVID-19 pandemic, and
- Greater geopolitical risks as a result of increasing tension as major powers seek to extend their influence.

SECTION SIX

OUTDATED REGULATORY SYSTEM IMPEDES INNOVATION AND ADDS COST

Another factor impacting the sector is an aging regulatory structure that is no longer fit for purpose. Australia's food regulatory system has not had a major overhaul for 20 years. It is no longer effectively delivering on its core objectives, whilst imposing greater costs on the sector and inhibiting consumer lead innovation.

The major shortcomings of the current federal-state regulatory system relate to governance, and processes for approving health claims, innovative products and processing aids.

Food regulatory governance

The food regulatory system is a legacy of the distant past, placing the primary responsibility for food regulation with the states and territories, despite the food sub-sector operating nationally. Decision making is vested in the *Food Ministers' Meeting* (until recently known as the Ministerial Forum on Food Regulation), comprised of state and federal health and agriculture ministers. The multiple supporting bureaucracies results in inconsistent views on the intent, development and enforcement of the national Food Standards Code.

For example, in a recent application seeking approval for a plant-based protein product, jurisdictions could not agree on whether it should be assessed as a novel food or a food derived from gene technology. In another example, when FSANZ recommended permitting the addition of novel beneficial components to infant formula, different jurisdictions raised different concerns resulting in a directive to FSANZ to conduct an extensive review of the issue. Four thousand hours and $1 million later, this resulted in FSANZ confirming its initial recommendation.

This is in sharp contrast to the arrangements for other fast moving consumer products such as cosmetics, personal care and household cleaning products, which are regulated through national authorities rather than state and territory agencies that co-design and enforce product regulations.

In addition, decision making by Food Ministers sometimes strays into operational detail, which leads to political interference in issues that are more appropriately dealt with by a national regulator based on the best available scientific evidence and risk assessment. Their latest interference overriding the Health Star Rating calculation for non-dairy beverages is a notable example.

Poor coordination of regulatory requirements places an additional burden on the food sub-sector. Currently, the food sub-sector faces changes in four major food label regulations – allergen labelling, country of origin labelling, Health Star Rating front of pack labelling, and added sugar labelling. There is no attempt at all by government to coordinate the timing of implementation to minimise costs on the sub-sector.

Regulatory processes that hamper innovation

Australia enjoys a reputation for producing safe, nutritious, quality food products derived from the recognition that our food production systems are technically advanced, and food safety regulations are sophisticated. Many other countries can also lay similar claims to producing safe, nutritious high-quality products.

Australian food manufacturers compete against many of these products in global markets both overseas and domestically. With food safety a 'given', food companies are looking to leverage other consumer needs to create points of differentiation around health benefits and convenience.

Frequently, regulatory approvals must be secured before those products can go to market either for the label claims that are made, or for new technologies used in the products' manufacture.

The purpose clearly is to ensure consumers have sufficient information for informed choice, and the products are safe.

Of course, food companies have a fundamental, and regulated, obligation to produce safe food and to provide information to consumers to enable them to use the products safely and construct healthy diets.

Notwithstanding this, regulatory systems can be a disincentive to innovation if the approval processes for new technologies are overburdensome on food manufacturers requiring levels of substantiation for benefit dis-proportionate to the risk.

In recent years in Australia the regulatory system has put a great deal of trust in the food sub-sector for 'life and death' issues, such as allergen management, with sector codes and approaches not only recognised as being effective but being endorsed by Government.

Conversely, when a company wishes to introduce novel technologies that confer a nutritional and health benefit to consumers, and may already be in use in other markets, the level of proof needed to convince the regulators that the benefits are real is as high as those demanded for new drugs. This is despite regulations restricting any health claims to foods with healthy nutritional profiles.

The overall result is that the food regulatory system effectively acts counter-intuitively. Where for high consumer-risk issues, the food sub-sector commands a high level of trust, but for low consumer-risk issues where companies are seeking to create a point of differentiation to gain a competitive advantage against other manufacturers, the regulators show next to no trust in the sub-sector.

The overall effect is that the innovation enjoyed by overseas consumers is restricted from the Australian market, and innovation by Australian companies is not supported as strongly as it might be.

Governments are currently undertaking a comprehensive review of the food regulatory system, which provides an opportunity for much needed modernisation and streamlining of responsibilities.

These shortcomings are mirrored to a lesser or greater extent in the regulatory systems for non-food consumer goods. Securing regulatory approvals for chemical constituents of cosmetics, personal care and household products is costly resulting in limited innovation compared to similar products overseas. Likewise, overseas regulatory safety assessments are not sufficient to satisfy local regulatory authorities, which insist on replicating the exhaustive assessments, even when there is an extended history of safe use in other countries with similar regulatory standards.

SECTION SEVEN

SUSTAINABILITY NEEDS INVESTMENT

As outlined in Chapter 3, there can be advantages for companies in adopting sustainable practices across their entire operations. However, it can be difficult for businesses to compete for capital within their business given returns on these investments can be lower than other investment options. In addition, while consumers increasingly desire more sustainable products, studies show that, in general, they predominantly shop on price.

Australia's food and grocery manufacturing businesses are committed to playing their part in developing a circular economy through the National Packaging Targets. The targets aim to achieve:

- 100 per cent reusable, recyclable or compostable packaging by 2025,
- Have 70 per cent of plastic packaging being recycled or composted,
- Use an average 50 per cent recycled content in packaging, and
- Phase out problematic and unnecessary single-use plastic packaging.

Meeting these targets will require research, development, safety/quality testing of new packaging formats, and changes to packaging capital equipment, all of which comes at a significant cost.

The costs arise from the need to invest in R&D and capital infrastructure, as well as the cost of meeting additional regulatory requirements. Such investments are unlikely to generate a return on investment and, therefore, with limited capital to invest they are at a disadvantage compared to other capital needs within the business, such as new or upgraded equipment, which deliver an efficiency or growth dividend.

While significant government funds have been provided to support a circular economy and an increase in recycling rates, much of this has been aimed at the resource recovery sector. There has been little consideration given to the significant costs borne by food and grocery manufacturers to improve the recyclability and recycled content of packaging. In addition to the investment hurdle, there are many policy and regulatory issues that need to be addressed to establish a circular economy. Two major areas that need addressing are the lack of availability and traceability of food grade quality recycled plastic packaging and the lack of harmonisation across jurisdictions. Both hamper the speed at which the sector can move and add unnecessary costs.

SO WHAT?

The challenges are numerous and complex. They require a whole of supply chain and whole of government view of the sector as well as a global perspective.

The COVID-19 pandemic has added to the challenges, particularly in relation to trade and supply chain functionality.

The challenges are not insurmountable but are beyond the capacity of the market or any individual players in the market to remedy.

Australia needs a policy framework that takes a long-term integrated view of the sector. The objectives of which are simple: to fulfill the potential that our comparative advantage offers and to secure Australian food and grocery manufacturing well into the future.

CHAPTER FOUR

FOOD AND GROCERY MANUFACTURING SECTOR SCENARIOS TO 2030

- With the right sector and policy settings, the Australian food and grocery sector could follow a High Growth Path over the decade ahead, doubling in size to $250 billion in 2030, with employment of 427,000 people.
- This scenario will require the sector to lift capital expenditure significantly and accelerate innovation to develop new, high value-added products and experiences that meet changing consumer preferences.
- Alternatively, if there are no changes to current settings, the sector could stagnate or even decline.

INTRODUCTION

To understand the different growth paths the sector could take over the next decade, EQ Economics has developed a projection framework that produces different scenarios for the sector's future. In this chapter, three scenarios are outlined – Muddle Through (the central case), High Growth and Declining Sector (Chart 22).

The differences between the scenarios reflect assumptions about the level of innovation and consumer spending, import penetration and export growth. While there are obviously many other factors that will affect the sector's future, these are the main drivers that have been captured in this sector wide analysis.

The fundamentals of the Australian sector are strong. With targeted policy actions the future of the sector could be 'nudged' onto a high growth path high growh path, doubling in size to $250 billion by 2030. A concerted effort by governments and the sector to fulfill the potential of Australia's food and grocery manufacturing sector, including export opportunities, could result in an outcome that lies somewhere between the Muddle Through and the High Growth scenarios - the high growth path.

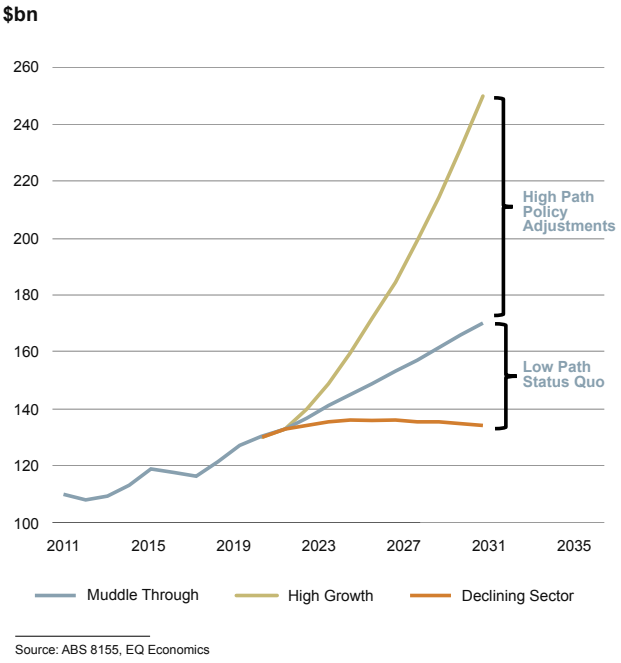
However, under the assumption that there are few changes to policy settings, the sector trajectory, as measured by annual turnover, is likely to occur somewhere between the Muddle Through and the Declining Sector scenarios (Chart 22).

This reflects the challenges facing food and grocery manufacturing in Australia that, if not addressed successfully, could see stagnation or even a contraction of activity. This is the low growth path.

The appendix contains an overview of the projection framework.

Chart 22: Sector scenarios to 2030

Annual turnover



Source: ABS 8155, EQ Economics

SECTION ONE

MUDDLE THROUGH SCENARIO

In the central case scenario, Muddle Through, the broad sector trends of the last ten years are projected on the decade ahead.

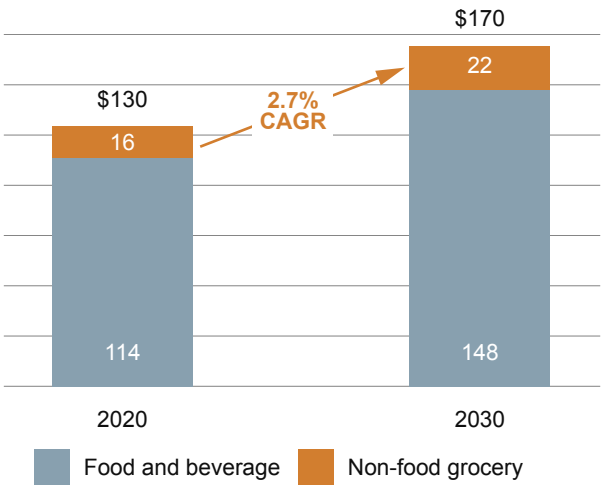
The Muddle Through scenario for the Australian food and grocery manufacturing sector estimates annual turnover of $170 billion in 2030[28]. This is up from an estimated turnover value in 2020 of $130 billion, which is a compound growth rate of 2.7 per cent per year (Chart 23)[29].

In real (price adjusted) terms, the Muddle Through scenario represents an ongoing underperformance given Australia's expanding population and economy. Real growth in food and grocery manufacturing turnover is less than 1 per cent a year over the decade to 2030.

This scenario essentially represents the best outcome possible if no changes are made to policy settings. The realisty is however that the outcome would lie between the Muddle Through and Declining sector scenarios.

Chart 23: Sector turnover projections: Muddle Through

$bn, Annual turnover and 10yr CAGR



Source: ABS 8155, EQ Economics

Food and beverage manufacturing is the largest sub-sector, comprising 86 per cent of turnover, and is projected to experience an annual growth rate of 2.7 per cent over the next decade. This contrasts with non-food grocery sub-sector, which currently makes up around 14 per cent of sector turnover and is projected to grow at 3.1 per cent a year to 2030[30].

Import penetration will continue to rise in the Muddle Through scenario

Strong import growth has been a feature of the Australian market for the last ten years. The Muddle Through scenario assumes this continues right through to 2030. This reflects several forces impacting the sector at both the national and global level.

Domestically, the arrival of international supermarket competition has put downward pressure on retail prices making it harder for domestically produced goods to remain competitive against cheaper imported products.

Suppliers and retailers are increasingly able to access food and grocery products from anywhere in the world to meet consumer demand for a variety of international food and beverages as well as specialist products.

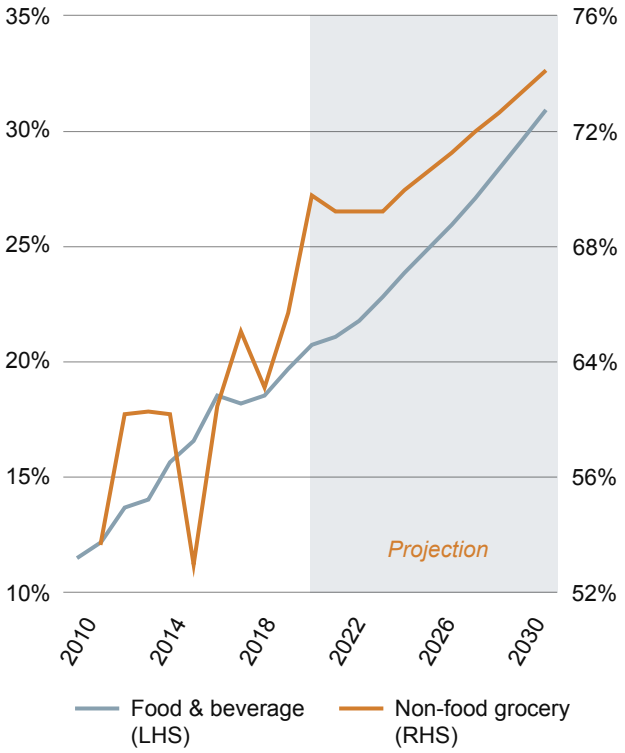
Domestic retailers have tapped into global supply chains as well through private label products and partnerships with retailers in other countries.

Imports of food and beverage products are assumed to grow in line with the ten-year trend rate of 6.7 per cent over the projection period[31]. This will push the import penetration rate up from 21 per cent in 2020 to 31 per cent in 2030. This measure of import penetration was as low as 12 per cent in 2010 (Chart 24).

[28] The underlying data in this analysis is in financial years in line with the ABS Annual Business Survey. In the text the relevant year refers to the financial year. For example, 2030 is the 2029/30 financial year.
[29] Sector turnover grew at an annual average rate of 2.4 per cent over the last decade a lit le lower than the ten year projected CAGR of 2.7 per cent. The difference is the result of a higher inflation assumption for the decade ahead.
[30] Projected growth in non-food grocery turnover exceeds that of food and beverage due to the already high level of import penetration in the Australian market for non-food grocery products. Import growth for non-food grocery has been lower than food and beverage for the last decade and partial data for 2020/21 highlights that this has continued through the pandemic. The central case scenario has food and beverage imports growing at 7% a year with non-food grocery imports growing at 3.5%. This means that a greater proportion of domestic demand growth is met through domestic production for non-food grocery products.
[31] This is the compound average growth rate for the ten years to 2030 which is made of annual forecasts for 2021 to 2023 and a single projection assumption for the period from 2024 to 2030. Hence he projection assumption (2024–2030) will usually be different to the CAGR for the whole decade.

Chart 24: Import penetration: Muddle Through scenario

Imports as % of domestic consumption



Source: ABS 8155, EQ Economics

Non-food grocery products have increasingly moved to globalised and centralised supply chains to take advantage of scale efficiency and cheaper production locations, particularly in the emerging economies of Asia.

The non-food grocery manufacturing base has gradually been offshored over the past 20 years as lower cost countries become production centres in a global supply chain. Domestic production in 2020 makes up approximately one third of domestic non-food grocery consumption, that is, import penetration in the non-food grocery sub-sector is approximately 67 per cent and is assumed to rise to 74 per cent by 2030 in the Muddle Through scenario.

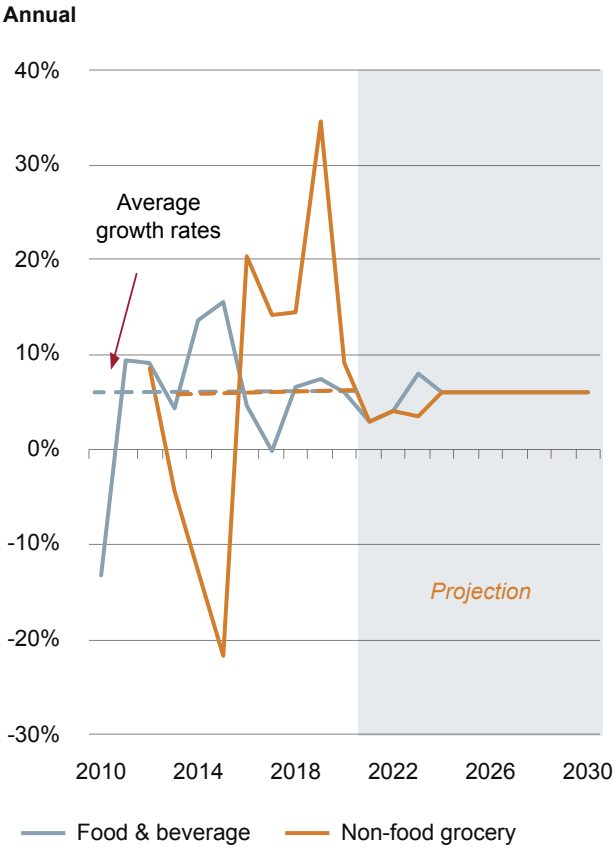
Australia's imports of non-food grocery products are estimated at $19.2 billion in 2020 compared to domestic production of $16.4 billion; $7.6 billion of which was exported (making up domestic consumption of $28 billion). By 2030 it is assumed that imports will reach $26.6 billion, domestic production will rise to $22.1 billion, and exports will grow to $12.6 billion. The domestic market for non-food grocery products will rise to $36.1 billion from $28 billion in 2020.

Exports to exceed $70 billion in 2030

In the Muddle Through scenario, the main driver of domestic production growth is from exports, which are assumed to grow by 5.6 per cent a year to 2030 (Chart 25). This will take total sector exports to $70 billion in 2030 from $41 billion in 2020 (Table 3).

Chart 25: Food and grocery exports

Forecast and projection of annual growth to 2030



Source: ABS 8155, EQ Economics

Australia's food and beverage exports have surged in the past ten years outstripping the increased value of imports. Non-food grocery exports have grown particularly strongly in recent years[32]. Food and beverage exports are projected to rise from $33 billion in 2020 to $58 billion in 2030 while non-food grocery exports rise from $8 billion to $13 billion over the same period.

[32] Much of this overall trade surplus is due to strong exports in lightly processed commodities, while there is a trade deficit for high value-added products. This level of granularity is not addressed in this analysis; rather, it is based on the trends in the overall food and beverage category.

Summary of the Muddle Through scenario

The Muddle Through projection sees a continuation of recent trends, that is, continued moderate growth in domestic demand and strong growth for exports and imports.

A summary of key sector variables for 2020 and 2030, and the projected annual growth rates for the 2020s, is laid out in Table 3.

Table 3: Sector projections: Muddle Through

$bn	2020 estimate	2030 estimate	CAGR
Turnover			
Food and Beverage	114	148	*2.7%*
Non-Food Grocery	16	22	*3.1%*
Total Sector Turnover	**130**	**170**	***2.7%***
Exports			
Food and Beverage	33	58	*5.7%*
Non-Food Grocery	8	13	*5.2%*
Total Sector Exports	**41**	**70**	***5.6%***
Imports			
Food and Beverage	21	40	*6.7%*
Non-Food Grocery	19	27	*3.3%*
Total Sector Imports	**40**	**67**	***5.2%***

Source: ABS, EQ Economics

Capital expenditure will need to increase if sector growth is to be maintained

The sector will require a lift in capital expenditure[33] even if the growth path is unchanged. Assets in the sector are generally aged and in need of replacement. And in a world of rapidly evolving production technologies, changing consumer expectations and increased regulations, the sector will need to lift capital expenditure if it is to maintain current competitiveness levels.

In the Muddle Through scenario, it is expected that the value of new capital expenditure required over the decade ahead will rise to near $50 billion. This is an increase on the total value of new capital expenditure over the past ten years, which was approximately $40 billion.

Sector employment will grow at half the pace of the overall economy

In the Muddle Through scenario, it is expected that the employment level of the sector will rise from 276,000 in 2019 to 300,000 by 2030, with food and beverage manufacturing growing to 276,000 and grocery manufacturing employment rising to 24,000. For the overall sector this is a CAGR of 0.8 per cent over the ten years to 2030, which is only half the growth rate expected from overall employment in Australia of 1.6 per cent.

[33] The estimates here refer to capital expenditure, which is expenditure on new tangible assets only, and hence differs from the capital investment data in Chapter 3.

SECTION TWO

DECLINING SECTOR SCENARIO

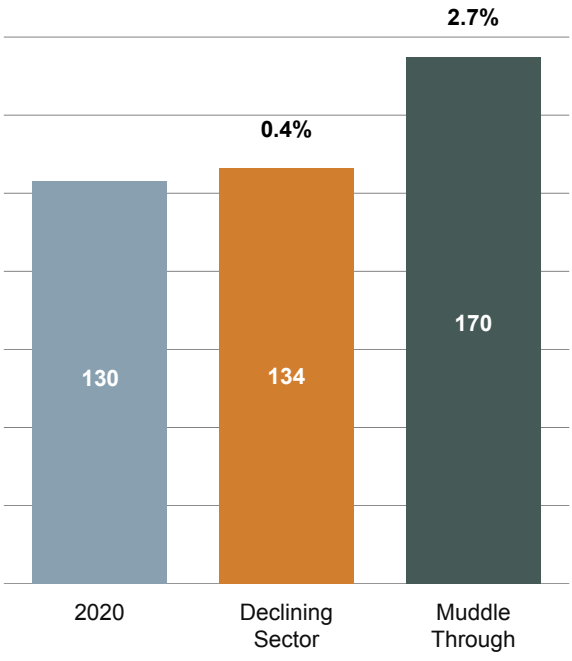
The Declining Sector scenario takes a look at some of the worst-case outcomes that are possible if sector settings are not adjusted and market outcomes become unfavourable to Australian manufacturers.

In the Declining Sector scenario a further erosion of international competitiveness curtails the sector's growth. The challenges of the past decade intensify, and the pressure to offshore production moves beyond non-food grocery products to long life food and beverage products.

Domestic production barely grows over the decade ahead, rising to $134 billion in 2030 from $130 billion in 2020 (Chart 26). In this worst-case scenario, the CAGR for sector turnover is just 0.3 per cent for the decade ahead, compared to 2.7 per cent in the central case; and sector employment falls by just under 1 per cent a year to be 260,000 in 2030 – a loss of 16,000 jobs over the decade.

Chart 26: Sector turnover in 2030

$bn Annual production, ten year CAGR

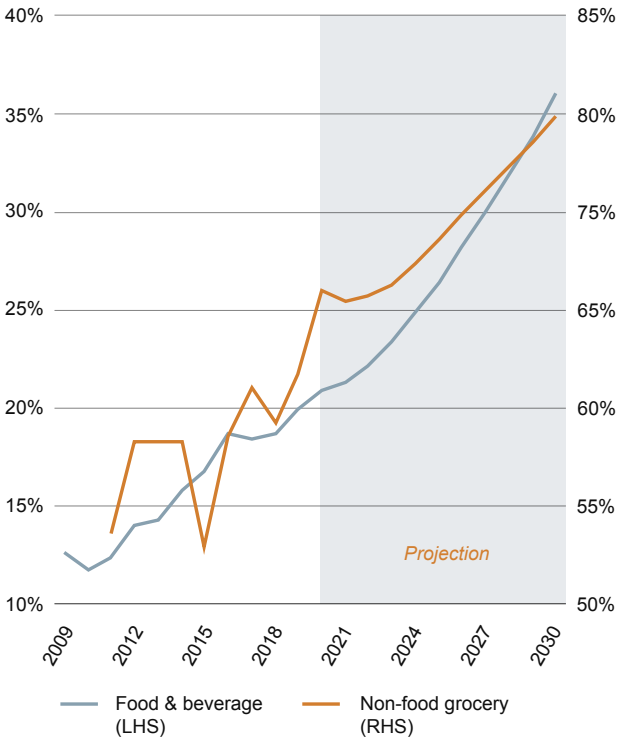


Source: ABS 8155, EQ Economics

As domestic production stagnates, imports continue to rise. In the Declining Sector scenario, food and beverage imports rise to almost 40 per cent of domestic demand by 2030. For non-food grocery products import penetration grows to nearly 80 per cent (Chart 27).

Chart 27: Import penetration: Declining Sector scenario

Imports as a per cent of domestic demand



Source: ABS 8155, EQ Economics

Summary of the Declining Sector scenario

Some of the characteristics of the Declining Sector scenario are outlined below.

1. Manufacturer margins remain under pressure over the decade ahead as manufacturers are limited in their ability to pass input cost pressures through to domestic supermarkets.
2. Manufacturer profitability remains in structural decline.
3. Productive capacity is lost offshore, curtailing domestic production and facilitating a further rise in import penetration over and above the central case.
4. Investment continues to be pressured with a declining trend in capital expenditure, research and development spending and marketing.
5. Export growth is slower than in the central case as manufacturers are unable to take advantage of growing international markets due to the lack of scale, productivity/competitiveness and product innovation.
6. Sector employment shrinks over the decade ahead as production and investment fall. Difficult profitability conditions push manufacturers to find production efficiencies and labour cost savings.

The Declining Sector scenario is not only one of unfilled potential. It is one of diminishing presence in the global marketplace in a sector where Australia once enjoyed a strong presence. In this scenario, Australia loses further competitiveness compared to other countries where their governments are providing substantial support to food and grocery manufacturing to shore up their domestic economic capacity and ensure food security for their citizens.

SECTION THREE

HIGH GROWTH SCENARIO

An alternative, High Growth scenario for the sector has been developed by adjusting the following assumptions:

1. Increasing the level of domestic consumer spending, primarily the result of product innovation and higher quality food and grocery products,
2. Higher rate of wholesale price inflation, reflecting a small improvement in manufacturer margins,
3. Stemming the increase in import penetration, and
4. Increasing the rate of export growth.

To entrench the food and grocery manufacturing sector on a high growth path, action needs to be taken to accelerate sector innovation and the development of new, high value-added products that meet changing consumer preferences particularly regarding sustainability, health and wellness, convenience and functionality.

Such innovation has the potential to grow the share of consumer spending on Australian manufactured products in domestic and international markets.

Even with innovation and strong growth in domestic market sales, scale will only come through tapping into major international markets. Export opportunities are abundant for food and grocery products resulting from the demand of a rapidly growing Asian middle class.

Australia already has a strong connection to Asia. Approximately 60 per cent of Australia's food and agribusiness exports go to the region, a region that is expected to add more than 1 billion people to the global middle classes over the next ten years[34].

In the High Growth scenario, the domestic food and grocery manufacturing sector grows its share of Australian consumer spending through:

1. Product innovation and increased consumer spending on higher value-added food and grocery products (higher share of wallet), and
2. Stemming the recent large increases in import penetration.

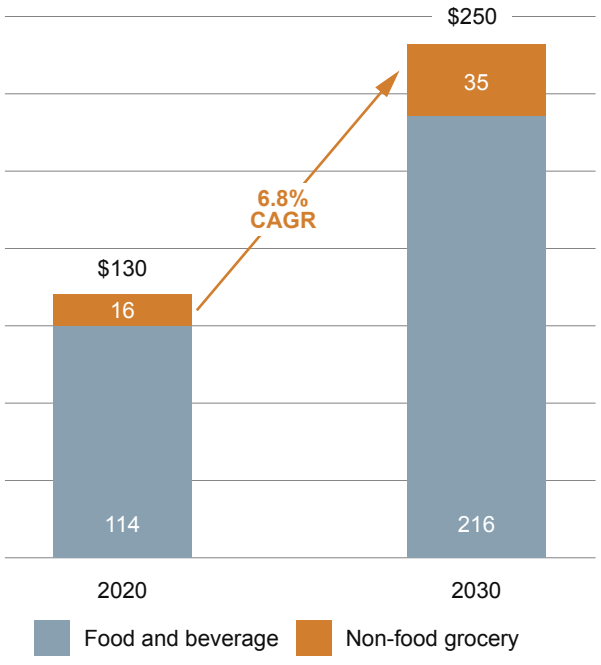
If the opportunities for food and beverage innovation highlighted in Chapter 2 are realised, this will help contribute to an increase in the level of domestic spending on Australian food and grocery products as well as a higher growth trajectory for exports.

High Growth scenario: A $250 billion sector

If the right settings are in place, then the Australian food and grocery sector can expect to double in size over the next ten years to $250 billion in 2030, which is a 6.8 per cent annual growth rate in the 2020s (Chart 28 and Table 4).

Chart 28: High Growth scenario: sector turnover

$bn, Annual turnover and ten year CAGR



Source: ABS, EQ Economics

[34] World Economic Forum, July 2020

Table 4: High Growth scenario: a $250bn sector in 2030

$bn	2020 estimate	2030 estimate	CAGR
Turnover			
Food and Beverage	114	216	*6.6%*
Non-Food Grocery	16	35	*7.7%*
Total Sector Turnover	**130**	**250**	***6.8%***
Exports			
Food and Beverage	33	92	*10.7%*
Non-Food Grocery	8	20	*10.0%*
Total Sector Exports	**41**	**112**	***10.6%***
Imports			
Food and Beverage	21	32	*4.2%*
Non-Food Grocery	19	26	*3.1%*
Total Sector Imports	**40**	**58**	***3.7%***

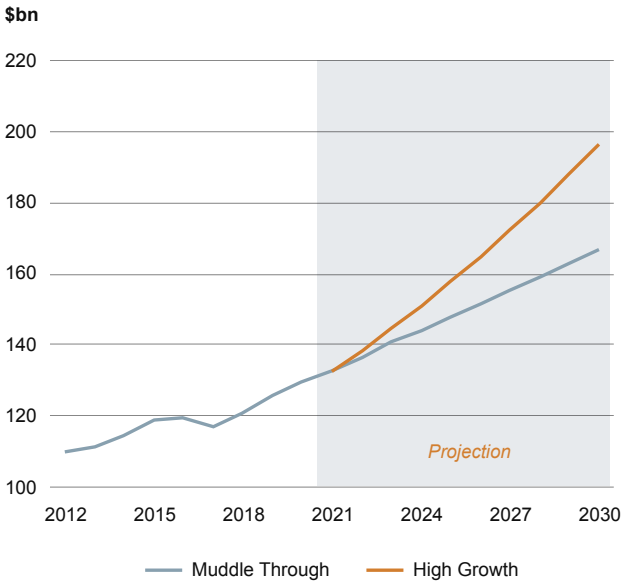
Source: EQ Economics

In this High Growth scenario, domestic population growth, product innovation and a lift in food and grocery wholesale price inflation increase domestic spending on Australian food and grocery products by 4.6 per cent a year over the projection period. The domestic market (consumption) grows to be almost $200 billion in 2030, compared to $167 billion in the Muddle Through scenario (Chart 28).

The $250 billion sector growth ambition is the targeted level of Australian production, which has been derived by subtracting imports and adding exports to the domestic market (consumption) growth.

Chart 29: Domestic market growth: Muddle Through vs the High Growth scenarios

Annual



Source: ABS, EQ Economics

Stemming the rise in import penetration

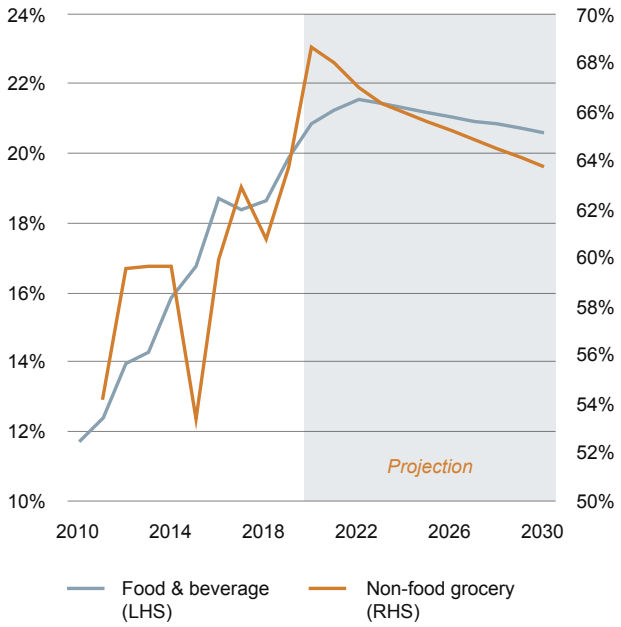
It is not suggested that a sector plan should be about limiting consumer choice through imposing restrictions on imported products. Rather, sector policy should focus on supporting a more innovative and competitive domestic sector that can effectively compete with international suppliers and stabilise import penetration.

In the High Growth scenario, import growth matches, rather than exceeds, domestic demand growth for Australian manufactured food and grocery products over the projection period. For food and beverage products import penetration stabilises at 22 per cent in 2022 before falling back to 21 per cent by 2030 (Chart 30). This compares to import penetration of 31 per cent in the Muddle Through scenario.

This does not mean that Australian's access to global food and grocery products will be curtailed in the High Growth scenario. The value of imported food and grocery products coming into Australia is projected to rise to $58 billion a year by 2030 in this scenario, a 40 per cent increase on 2020 levels.

Chart 30: Import penetration: High Growth scenario

Imports as per cent of domestic consumption



Source: EQ Economics

Growth opportunities to be underpinned by export markets

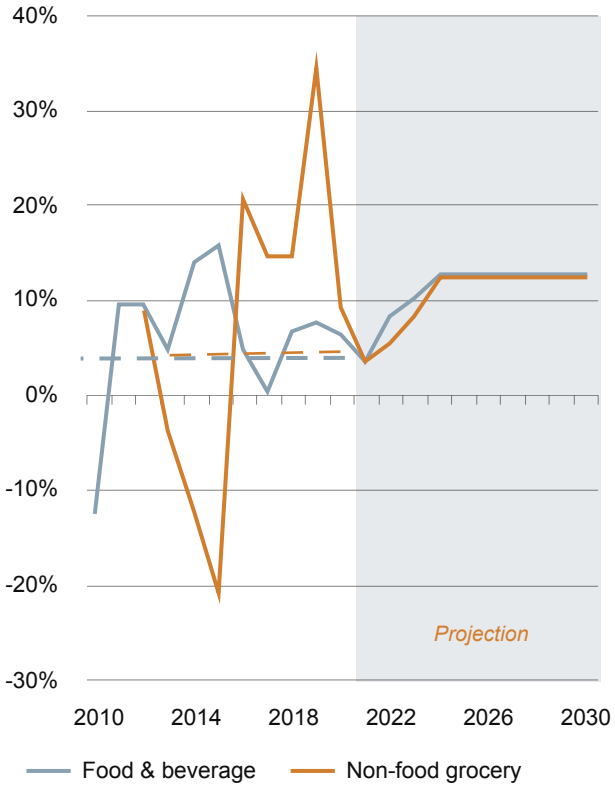
The High Growth scenario assumes that export growth accelerates to a CAGR of 10.6 per cent over the decade to 2030 from 5.6 per cent in the Muddle Through case. This magnitude of export growth is similar to recent strong growth of 11.5 per cent in 2018/19[35] and is consistent with the broad sector growth projections contained in the CSIRO and FIAL reports.

At first glance this may seem ambitious in a low growth world. However, the opportunity of Asia's growing middle class combined with strong product innovation suggests that this rate of growth is achievable. As shown in Chart 31, high growth rates for food and grocery exports have been achieved in the past.

Australia's penetration of offshore markets is very low. Even a modest increase in market penetration in the large Asian markets or the mature markets of North America and Europe can result in strong growth for the domestic manufacturing sector. Under this scenario, exports of food and grocery products grow from $40 billion in 2020 to $50 billion in the next five years before rising to $112 billion by the end of the decade.

Chart 31: Export growth assumptions in the High Growth scenario

Annual per cent



Source: ABS, EQ Economics

[35] AFGC (2019), State of the Industry snapshot 2018/19.

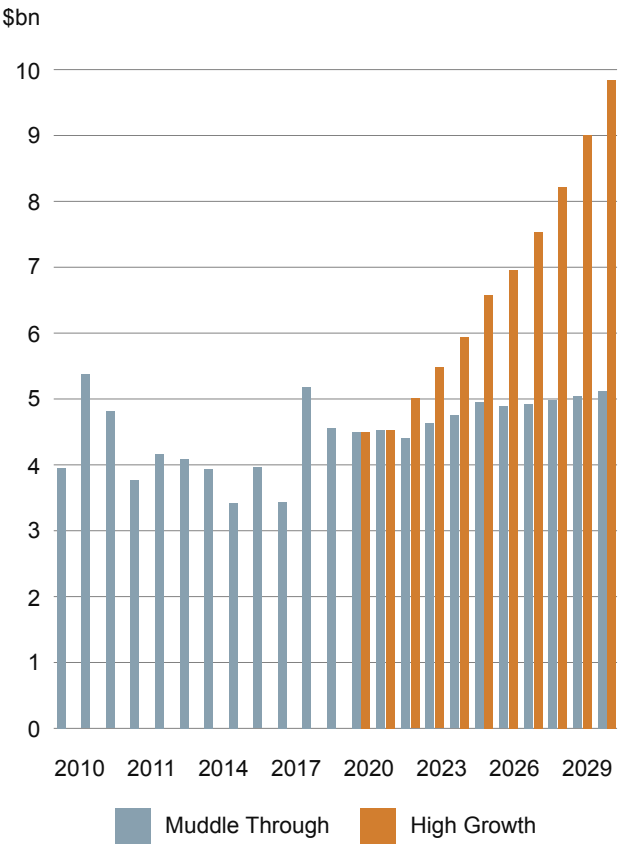
The High Growth scenario: innovation and capital expenditure to drive rising employment

While this High Growth scenario is ambitious, it is plausible with the right focus and settings. This will benefit Australia through strong growth in production, employment and investment in the sector and its supply chains, which will underpin Australia's post-pandemic economic recovery and growth, and ensure Australia's food security for generations to come.

Capital expenditure is critical to achieve high growth

For the High Growth path, the sector will need a large lift in capital expenditure including some catch up in the capital stock to offset the impact of asset sweating over the past decade.

Chart 32: New capital expenditure projections



In the High Growth scenario, total capital expenditure requirements need to lift by a further 50 per cent (compared to the central case) to $75 billion over the decade ahead. This is almost double the value of capital expenditure of the past ten years (Chart 32).

A growing sector will create jobs

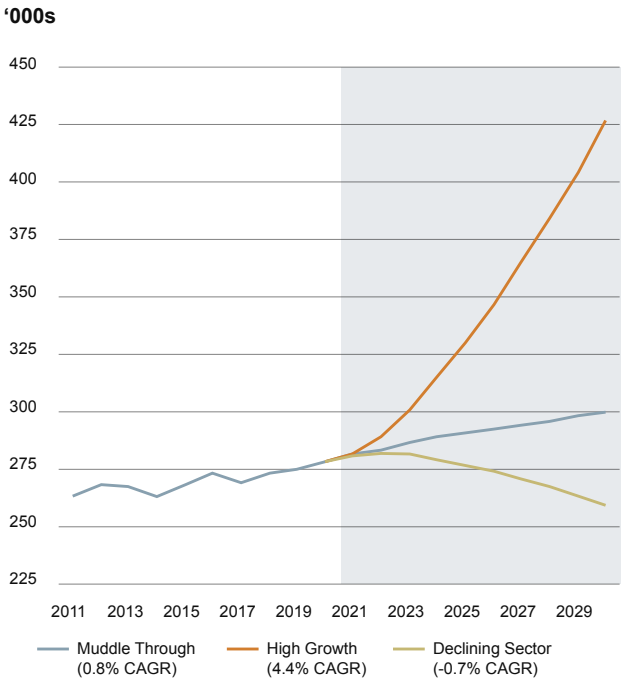
The FIAL report (2020) identified large employment opportunities associated with a high growth sector over the decade ahead. Not only will large numbers of jobs be created but the type of roles that will need to be filled are going to change as the sector invests in new technology. This implies a skills development and enhancement strategy is required as most of the newly created roles will be in higher skilled occupations.

A growing sector is typically a sector that will grow its head count, even if that sector is able to generate labour productivity enhancements through investment or if that sector is capital intensive. Total employment levels in food and grocery manufacturing in Australia were 276,000 in 2019. In recent years, employment in food and grocery manufacturing has been slower than the growth of both turnover and sector value-added due to productivity growth. The compound annual growth rate of food and grocery manufacturing has been 0.6 per cent over the decade.

In the High Growth scenario, employment growth accelerates on the back of higher turnover (production) and capital expenditure. The CAGR rises to 4.4 per cent taking total sector employment to 427,000 people, a 54 per cent increase on 2020 levels (Chart 33).

Chart 33: Employment outcomes by scenario

Employment (000's) for food and grocery manufacturing



Source: ABS, EQ Economics

These numbers should be used as a guide only given the complex range of factors that will determine labour requirements over the decade ahead as well as the diversity of businesses within the sector.

Whatever the characteristics of the evolving production and business models within the food and grocery sector, it is clear that the stronger the growth trajectory for the sector the higher the overall requirement for people. Most studies of the global manufacturing sector show that countries with the highest levels of automation and capital investment are also the countries which have the highest numbers of people employed in manufacturing as well as the highest incomes for those workers.

SO WHAT?

Australia's food and grocery manufacturing sector is resilient, efficient and committed to the Australian market. But the economics of manufacturing in Australia are deteriorating. The rising cost of doing business with Australia's major supermarket retailers combined with highly competitive foreign products is a major headwind to domestic production.

If the current sector settings are unchanged, Australia's food and grocery manufacturing sector is going to struggle to expand over the decade ahead and, more likely, it will start to shrink.

Import penetration has almost doubled in the past decade. If these trends continue it is conceivable that by 2030 a third of consumer food products sold in Australian supermarkets will be made overseas. It was only 15 years ago that less than ten per cent of processed food sold in Australian supermarkets was imported.

However, there is an alternative brighter future for the sector. COVID-19 has reinforced the essential nature of the sector to the Australian economy and consumers. It is now incumbent on sector and governments to work together to put in place the right settings to ensure a vibrant future for the sector, to the benefit of all Australians.

CHAPTER FIVE

AFGC RECOMMENDATIONS

Many reports have been written over several decades about the growth opportunities facing Australian food and grocery manufacturing, however, comparatively little has been written about the challenging realities facing the sector nor the long-term strategic approach needed to overcome them.

The sector makes an important economic contribution and has the potential to grow, with direct and indirect benefits to jobs; skills development; economic development and social cohesion; and security of supply in the face of global disruptions.

Given the importance of the sector to the economic and social development of Australia, particularly in rural and regional areas, its magnitude, significance and contribution need to be reflected in the Government's economic, industry, skills and trade policies to name a few.

This report outlines a potential high growth ambition for the food and grocery manufacturing sector, approximately doubling its turnover to $250 billion by 2030.

The ambition of achieving high sector growth is now more urgent, given the need to ensure resilience in Australia's domestic manufacturing capability as well as grow the economy following the effects of the COVID-19 pandemic and associated restrictions on business and consumer activity. A growing sector will deliver an increased rate of jobs growth.

However, high growth won't happen organically. Indeed, if left without intervention and a strategic approach, there is a real risk that the current trend of off-shoring manufacturing and importing increasing levels of high value-added food and grocery products could continue to the point where consumers will struggle to find high value-added products that are made in Australia.

This is not the result of an inefficient sector, but rather one that is hamstrung by some unique factors that have reduced the sector's domestic competitiveness – high costs, combined with retail buyer power, which have impacted the sector's profitability and ability to invest. The low investment trap has undermined the sector's productivity and eroded its ability to innovate, which has led to a loss of competitiveness and a substantial increase in import penetration over the last decade.

At the same time, Australian manufacturers are facing an uneven playing field in global markets as a result of foreign governments providing significant sector support for research, commercialisation and manufacturing, and/or protecting their industries through non-tariff barriers to trade.

The case for a strategic and long-term approach to the food and grocery manufacturing sector's policy settings is clear. The Government has recognised this through the Modern Manufacturing Strategy (MMS), which identified food and beverage as one of six priority manufacturing sectors.

The MMS Food and Beverage Roadmap[36] and this report share an ambition of doubling the size of the sector by 2030, although this report also includes non-food grocery manufacturing in its $250 billion ambition.

The MMS Food and Beverage Roadmap identifies growth opportunities and outlines areas that the Australian Government could co-fund to boost the sector's competitiveness, scale and resilience. Whereas this report has taken the vision and projected what this would require in terms of domestic production, imports and exports, capital expenditure, and jobs.

This report also focuses on the main policy settings that will help to shift the dial for the sector's future, setting it on the high growth path towards $250 billion by 2030. It should be viewed as the start of a conversation about the sector's future, rather than a comprehensive list of all the issues that need to be addressed nor all of the solutions. Over the coming years, the AFGC will prepare additional papers that focus in more detail on specific issues that require policy change, regulatory reform or funding.

There are several other issues including energy pricing, industrial relations, taxation, infrastructure and climate change that all have a bearing on the sector. The AFGC encourages the government to continue the hard graft of policy reform in these and other areas.

[36] https://www.industry.gov.au/data-and-publications/food-and-beverage-national-manufacturing-priority-road-map

RECOMMENDATIONS

1. Strategic industry policy

1.1 The AFGC recommends that non-food grocery manufacturing be added to the food and beverage priority manufacturing sector within the Modern Manufacturing Strategy.

1.2 The AFGC recommends that the Minister for Industry, Science and Technology, in consultation with other portfolios, develops an annual set of policy and regulatory reforms that move the sector towards its growth ambition of $250 billion by 2030; and ensures any new government policy or regulatory proposals explicitly consider the impact on the sector's ability to achieve this goal.

1.3 The AFGC recommends that the Australian Government task the government-industry taskforce established to develop the Food and Beverage roadmap, with providing on-going advice in relation to achieving the high growth ambition of $250 billion by 2030.

Food and grocery manufacturing has lacked a long-term, strategic policy focus within government, with the sector falling across many portfolios that each take a piecemeal view of the sector.

To achieve the high growth ambition of doubling the sector's turnover to $250 billion by 2030, will require a more coherent approach across government.

The MMS is an important first step in establishing a more strategic approach and is a useful model on which to build. For example, the AFGC recommends expanding the Food and Beverage priority area to include non-food grocery manufacturing. The panic buying during the pandemic has highlighted how important it is to retain local manufacturing of these products.

The Food and Beverage Roadmap identifies many areas that will require the sector and government to continue working together to achieve a doubling the sector's size of the sector by 2030. The AFGC recommends that to support this work, there needs to be a greater role for the Minister for Industry, Science and Technology in driving the sector's growth ambition in consultation with other agencies. This could include developing an annual set of actions to progress the sector towards achieving its growth ambition of $250 billion by 2030, with departments tasked with identifying policies and regulatory reform to stimulate competitiveness and growth; and to review the impact of new policy or regulatory proposals on the ability to achieve this goal. This approach is similar to the government's work on deregulation.

In addition, the AFGC recommends that the government-industry Food and Beverage Taskforce continue and be tasked with reviewing progress and providing advice in relation to the priority areas for achieving the $250 billion growth ambition.

2. Investment incentives

2.1 The AFGC recommends that the Australian Government allocate additional funds to a dedicated co-investment grant program within the Modern Manufacturing Initiative, specifically for food and grocery manufacturers, to adopt modern manufacturing and digital technologies that enhance competitiveness in domestic an export markets, resilience, sustainability and agility.

2.2 The AFGC recommends that the Australian Government implement a co-investment grants program that supports and fast tracks food and grocery manufacturers' research, development and testing of new sustainable packaging formats, and changes to packaging equipment to facilitate a circular economy.

The Australian Government has signalled its willingness to respond to the food and beverage sector's investment challenges through the Modern Manufacturing Initiative (MMI), with $1.5 billion funding shared across six sectors over four years.

This is a welcome step in the right direction, though misses the opportunity to improve resilience and take advantage of the growth potential in non-food grocery products such as vitamins and supplements and personal care.

In addition, the level of funding allocated in the program is inadequate to address the sector's significant need to invest in advanced manufacturing technologies, sustainable packaging changes, digital labelling and traceability.

As stated in Chapter 4, it is estimated that an additional $75 billion in capital expenditure is needed over the next ten years for the sector to achieve its goal of $250 billion in turnover. This is almost double the value of capital expenditure of the past ten years and does not include the significant expenditure needed to achieve sustainable packaging changes.

The Food and Beverage Roadmap identifies smart manufacturing technologies, sustainable packaging changes, digital labelling and traceability as eligible under the program, however only a proportion of the $1.5 billion will be available for the food and beverage sector for such purposes. The majority of the funding - $800 million – is allocated across six sectors to the Collaboration Stream, which is aimed at business to business or business to research projects that build scale.

The food and grocery manufacturing sector is unique compared to the other priority manufacturing sectors. As this report indicates, it is comprised of a large number of highly diverse and highly competitive businesses with limited ability to build manufacturing scale through collaborations between businesses. Instead, the sector's ability to boost domestic and export competitiveness and achieve a growth ambition of $250 million, will come from lifting the bar in smart manufacturing technology across all businesses in the sector, from small to large.

It is therefore recommended that the Government allocate additional funds to a dedicated co-investment grant program within the Modern Manufacturing Initiative, specifically for food and grocery manufacturers to adopt modern manufacturing and digital technologies that enhance competitiveness in domestic and export markets, resilience, sustainability and agility. Such technologies include:

- automation and robotics that improve business productivity to help mitigate Australia's high costs of production. This is essential to the future competitiveness of Australian manufacturing, otherwise businesses within the sector will be attracted to other countries with lower production costs and investment incentives,
- emerging technologies, such as sensors, equipment monitoring systems and predictive analytics that can reduce the amount of resources such as energy and water consumed in the manufacturing process, maintenance time and wastage, which improves environmental outcomes and the sector's competitiveness,
- artificial intelligence and virtual reality which can reduce the speed of new product development and allow businesses to visualise and test different options for products, business models, planning, forecasting and production processes. This enhances competitiveness in the face of rapidly changing consumer demand, and
- digital labelling and traceability systems that meets increased consumer demand for improved transparency and authenticity of product attributes and origin, which also enhances the sector's competitiveness.

As discussed in Chapter 3, packaging costs comprise approximately 14 per cent of a manufacturer's total costs and therefore increases in these costs have a significant impact on profitability given the already thin sector margins. There are significant sustainable packaging changes that companies need to make for a circular economy, which require changes in capital equipment that can cost millions of dollars for a single product range.

In addition, there is a need for investment into research and develop to test and trial new more sustainable packaging formats to ensure they meet functional and consumer safety needs.

It is therefore recommended that the Government implement a co-investment grants program that supports and fast tracks food and grocery manufacturers' research, development and testing of new sustainable packaging formats, and changes to packaging equipment to facilitate a circular economy. This will enable the sector to move more quickly to contributing to a circular economy, in line with community and government expectations.

There are several areas that the community, sector and governments need to tackle together, including sustainability and obesity. The answer to these challenges lies not in taxes and regulation, but in supporting the sector to invest in research and development and capital equipment to improve outcomes.

2.3 The AFGC recommends that the Australian Government alter the eligibility threshold for the temporary full expensing (instant asset write-off) measure to include companies with significant manufacturing capital stock in Australia that don't meet the alternative eligibility test.

The temporary full expensing (instant asset write-off) measure introduced in the 2020-21 Budget, and extended in the 2021-22 Budget, is an important first step to incentivising investment. However, it does not go far enough to capture the businesses that can bring forward investment and help with the COVID recovery, especially given the investment needed for the sector to achieve its growth ambition of $250 billion turnover by 2030.

Eligibility for the measure is determined by either a $5 billion aggregate (global) turnover test, or an alternative income test that was introduced in late 2020, which requires statutory turnover of up to $5 billion and local investment of $100 million over the last three years. These tests exclude several multinational businesses in the sector that generate significant jobs and output in Australia.

Given the long-term nature of manufacturing assets, the pressure on sector profitability in recent years and the stagnation in capital investment across the sector, there are several Australian-based multinational companies that are not able to demonstrate a local capital spend of $100 million over three years. Yet it is precisely these sorts of businesses, with significant levels of aged capital stock in need of upgrading, that this measure should incentivise to invest in Australia, rather than risk losing them to other countries.

The effect of excluding these businesses from the temporary full expensing provisions is not just the lost growth potential for jobs and investment, but also the risk of losing some of these large manufacturing facilities from Australia. Multinational companies have mobile capital and will be attracted to relocate manufacturing capacity, and therefore jobs, to other countries that have more advantageous tax incentives and grants for food and grocery manufacturing. We have already seen this happen in a number of instances as Australia loses competitiveness. With a change in the test for the full expensing provisions, and the introduction of additional co-investment grant programs, it is possible to not only stem this loss, but potentially re-shore manufacturing capability and build domestic scale for growth.

3. Skills

3.1 The AFGC recommends that the Australian Government provide funding for:

- a skills audit to understand the gap between the sector's current skills capabilities and the needs of a more automated and digitalised food and grocery manufacturing sector,
- a sector-wide, advanced food and grocery manufacturing training centre with access to virtual and augmented reality technology to help train local workers to operate advanced manufacturing equipment and digital technologies, and
- a grant process that supports food and grocery manufacturers to offer on the job training or integrated learning programs that connect the sector with education/ training providers.

Capital investment and sector skills go hand in hand, with the lack of advanced manufacturing skills often acting as a barrier to greater technology adoption.

The modernisation of manufacturing - including robotics, virtual reality, 3D printing, AI, and predictive analytics - brings with it the need for higher skills to install and operate automated production equipment and digital based systems.

Australia lacks the necessary skills, with the sector often relying on overseas markets to recruit the necessary skills and experience. The lack of access to higher skills in Australia, and the lack of support for relevant sector training programs, is often a barrier to companies investing in advanced manufacturing technologies. The success of other programs in stimulating capital investment will be constrained if not coupled with an advanced skills development program. The COVID pandemic has further highlighted the need to develop local capabilities to ensure the future resilience of the sector in Australia.

The sector continues to work to improve productivity but investment in some areas particularly research, development and workforce training still lags behind sector norms, suggesting targeted government assistance would be effective.

Upskilling of the workforce needs to occur right across the sector, from small to large businesses, to ensure employees are capable of using new advanced manufacturing equipment, and digital information and analytics systems, which are essential to the future competitiveness of the sector in domestic and export markets.

With nearly 40 per cent of the sector's jobs in rural and regional areas, a skill development program can enhance job opportunities in these areas and ensure the ongoing viability of regional manufacturing.

The AFGC proposes that Government undertake a study to better understand the gap between the sector's current capabilities and skills needed to support the adoption of advanced manufacturing technologies, and evaluation of current training programs. Funding to develop a sector-wide training centre and in-house training, tapping into global expertise, virtual reality and augmented reality technology, will not only assist in building the skills base for the future, but will also help overcome a shortage of skills exacerbated by COVID restrictions on people movement.

4. Regulatory reform

4.1 The AFGC recommends that the primary responsibility for setting and enforcing food standards (including composition and labelling of foods) should be centralised to a national agency, with states and territories responsible for food safety enforcement.

Responsibility for Australia's food regulatory system is held by Council of Australian Governments (COAG) Food Minister's Meeting (the Forum) under arrangements which are essentially unchanged since 2001. The system is currently being reviewed with the intent of modernising it. The system's governance, the Food Regulation Agreement (between the Commonwealth, States and Territories) and the Food Standard Australia New Zealand (FSANZ) Act (2001) are all within the scope of the review.

The food regulatory system review provides an opportunity to overhaul the system to ensure that it serves both consumers and the food manufacturing sector well. More specifically, the 100-year-old legacy embedded in the current system, which places the primary responsibility for food regulation with the States and Territories, should be reformed to centralise food standard setting and enforcement into a national agency. In particular, food composition and food labelling standards are essentially national standards and could be enforced by a national agency, such as FSANZ. The enforcement of food safety standards (i.e. food production and processing) requires 'on the ground' inspections so responsibility should remain at the local level under the control and direction of states and territories.

With centralisation through a national agency the Australian Government could have greater power to determine the priorities for food standard setting, and to secure proportionate regulatory outcomes protecting public safety and health, whilst facilitating sector growth and profitability. Reforming the governance arrangements would be consistent with the recommendations of the recent Conran Review[37] which calls for a more strategic focus and less bureaucratic processes of ministerial councils, including the council with responsibility for food regulation.

More efficient development, amendment, and updating of food standards would result, and more consistency in advice to the sector on the intent of standards and how they will be enforced. Risk assessment processes to approve new foods and technologies and associated product health claims could be streamlined, with outcomes being more predictable and providing more certainty for companies investing in new, innovative products and technologies.

4.2 The AFGC recommends that FSANZ assessments should be allowed to reference international assessments and international standards with appropriate stakeholder consultation on a case by case basis.

Many technologies being adopted in Australia have previously been approved by competent authorities overseas and often have an extensive history of safe use. They should not require a repeated exhaustive risk assessment by FSANZ. It adds cost, but no public benefit.

4.3 The AFGC recommends that greater emphasis should be given to sector self-substantiation in assessments of amendments of the Food Standards Code, and greater use of industry codes of practice within an appropriate risk assessment and management framework.

If the Government is committed to best practice regulatory policy and the principle of proportionate response, then it should recognise the value of sector self and co-regulation codes of practice to address matters where there is less risk to the public.

[37] Review of COAG Councils and Ministerial Forums Report to National Cabinet Peter Conran AM October 2020 Review of COAG Councils and Ministerial Forums - Report to National Cabinet - Peter Conran AM (pmc.gov.au)

5. Digital labelling

5.1 The AFGC recommends an industry-government taskforce be established to develop an agreement for meeting regulatory compliance through digital labelling

In the past, and indeed still, the primary means for providing information to consumers has been through mandatory and voluntary information on product labels (such as ingredients and nutritional information, recyclability and country of origin). This has been supported by other traditional methods such as advertising (print and broadcast) and consumer call centres.

However, as discussed, consumers and retailers in Australia and abroad are increasingly seeking more information and accountability; evidence of authenticity and traceability; engagement and experiences from brands. This includes information and verification about the origin and impact of ingredient/ input sourcing and methods of production. In addition, the regulatory requirements for labelling have increased, including health star ratings, country of origin labelling, and changes to ingredient, allergen and recycling labelling.

Beyond the consumer, the data needs within supply chains are also increasing – with retailers and suppliers seeking to improve the accuracy and management of inventory and reduce product waste.

These changes have two main implications for consumers and manufacturers:

- the increased information and limited space on the label have resulted in smaller font size, which is difficult for consumers to read, and
- the frequency of regulatory changes to labelling imposes substantial costs on business.

Technology offers a solution to these challenges. Existing barcode data carriers are inadequate for the amount and type of information that needs to be stored. There is a need to migrate to new data carriers that can be read by smart phones and other mobile devices. This could be coupled with apps that could be personalised by the user so that only information of interest is prioritised for display (e.g. an alert for particular allergens). The appropriate technology to use is best left to the market to solve.

There may not necessarily be a one size fits all solution, however it is critical that all options are based on global standards and are interoperable.

The ability of manufacturers to adopt digital labelling is constrained by the high costs involved and the effect of declining profitability on investment. In addition, it is happening in an ad hoc way. While sector solutions such as SmartLabel have been introduced in the US and other countries, the uptake has only been at a slow to moderate pace.

The adoption of an industry-wide solution in Australia would be expedited by an industry-government agreement for meeting regulatory compliance through digital labelling. This would provide the sector with regulatory certainty about which information no longer needs to appear on pack. This would incentivise the sector to invest future avoided costs of re-labelling into the development of digital labelling.

5.2 The AFGC encourages manufacturers and retailers to adopt the electronic Product Information Form as a first step towards digital labelling

Digital labelling requires information about products to be ‘digitised’, or stored in a standardised, coded form.

In July 2017, the AFGC launched an electronic Product Information Form (ePIF™), as the first element under the AFGC Authorised Food Data System®. This initiative will assist companies to better source, manage and provide information about their products. The ePIF contains more than 1000 data fields covering a wide range of product attributes including all of the information mandated by regulation.

The primary purpose of the ePIF is to facilitate information exchange between businesses along the supply chain. The digitisation of the data, however, means it can also be used for other purposes including being the source data for digital labelling.

The Australian Government has recognised the ePIF and digital labelling as eligible activities for funding under the Modern Manufacturing Strategy, however as discussed in recommendation 2, the level of funding is inadequate for the significant investments needed for a sector-wide approach to labelling.

6. Retail-supplier relationships

6.1 The AFGC recommends that the Australian Government monitor the effect of supermarket buyer power on manufacturers' profitability and investment levels; and the effectiveness of the Food and Grocery Code of Conduct.

As this report demonstrates, the buyer power of the major supermarket retailers has had a significant impact on the profitability of food and grocery manufacturing, which has negatively impacted investment levels. While issues of market structure are difficult to address, it must be recognised that further consolidation not only in supermarkets, but other markets into which manufacturers sell, could have a further detrimental effect on the food and grocery manufacturing sector. If this profitability impact and underinvestment continues, then the food and grocery manufacturing sector risks decline which not only has implications for economic activity and jobs, but also for consumers through a reduction in choice. It is therefore recommended that the Government monitor the effect of supermarket buyer power on manufacturers' profitability and investment levels, as a turnaround in these levels is crucial to achieving a high growth food and grocery manufacturing sector.

Given the challenges in addressing market structure issues, the focus in recent years has been on the effect of supermarket concentration on retailer behaviours towards manufacturers. The Food and Grocery Code of Conduct has been an important tool for manufacturers, and retailers' commitment to it has generally resulted in improvements in trading relationships. It does however require ongoing monitoring to ensure that it achieves its aims of improving fairness and transparency in trading relationships. Of particular importance over the next two years is a functioning dispute resolution process that delivers trust and cooperation across the value chain.

7. Export growth

7.1 The AFGC recommends that all governments and sector develop an export growth strategy that aims to deliver food and grocery export growth of 10 per cent per annum to 2030.

If the sector is to achieve a high growth path then a significant amount of that growth will need to come from export trade, given the relatively small size and growth opportunities in the domestic market. While high growth rates have been achieved in certain categories, such as meat, dairy and pharmaceuticals, there is a need to adopt a concerted effort to increase the growth rates in other areas, particularly more heavily processed food products.

Australia's reputation alone will not deliver an average rate of growth of 10 per cent, which is an increase from $41 billion to $112 billion over the decade to 2030. This will require a co-ordinated strategy that addresses issues such as innovation, investment, tariff and non-tariff barriers, digital traceability and trade promotion.

7.2 The AFGC recommends that the Australian Government adopt the recommendations from the AFGC's report "Non-Tariff Measures Impacting Australian Processed Food Industry Exports"

Australia has negotiated several bilateral and multilateral free- trade agreements over the last two decades, which have created opportunities for the sector. For example, there has been a large increase in food and grocery exports to China as a result of the China-Australia FTA.

However, the ability to further grow exports is hampered by the many non-tariff barriers to trade, which have risen over the same period.

The AFGC's NTM report identifies a number of priority cross-cutting NTM's affecting the processed food export sector across a range of markets. They are:

- Process and information requirements associated with product registration which cause product registration delays and concern for exporters around product/ process IP
- Lack of transparency around certification requirements, with specific challenges associated with halal certification
- Inconsistent labelling approaches, regulations and implementation which increases costs for exporters and incurs delays
- Unnecessary and prescriptive testing requirements and lack of recognition of methodologies an laboratories, which increases costs for exporters
- Lack of use of electronic documentation, which causes inefficiencies and further impacts IP risk.

The NTM report recommends the following:

- Harmonising product registration requirements across markets,
- Implementing mutual recognition of standards and certification – in particular, halal and organic certifications,
- Encouraging the adoption of digital processes and improved data security through use of electronic portals. This could help streamline certification processes, increase transparency, and serve as a repository of information for rules and regulations in Australia and across regional markets,
- Streamlining and harmonising global/ regional standards and ensuring predictable and risk-based/ scientifically justified regulations, and
- Implementing mutual recognition of sampling and testing processes, where technically valid.

APPENDIX
THE PROJECTION FRAMEWORK

The scenario analysis takes an sector-wide view of production through forecasts of food and grocery demand, and international trade. This approach is transparent and simple but requires careful attention to how assumptions interact because the projection framework is not a dynamic economic model of the food and grocery sector.

The projection framework views the sector through the lens of international competitiveness where lower import penetration and higher export growth (increasing competitiveness) result in a higher growth path for sector activity. Conversely, declining competitiveness (higher imports/lower exports) results in weaker domestic production over the decade ahead.

Domestic influences are incorporated into the framework through forecasts for the demand for manufactured food and grocery products, that is, domestic consumption. Forecasts of the consumption of manufactured food and grocery products anchors the sector projections. Overseas demand for food and grocery products are incorporated into the framework via the export assumptions.

The value of manufactured food and grocery production has been estimated by using the identity:

Production = domestic consumption
plus exports minus imports

The domestic demand (consumption) for manufactured food and grocery products is based on three variables: population growth, consumption per head and output (wholesale) prices.

Population growth

Population growth assumptions are outlined in Chart 1. Following the unusual disruptions to population numbers from the global pandemic of 2020 and 2021, population growth is assumed to return to a rate in line with Australia's recent history, as per the Australian Government's budget assumptions[38].

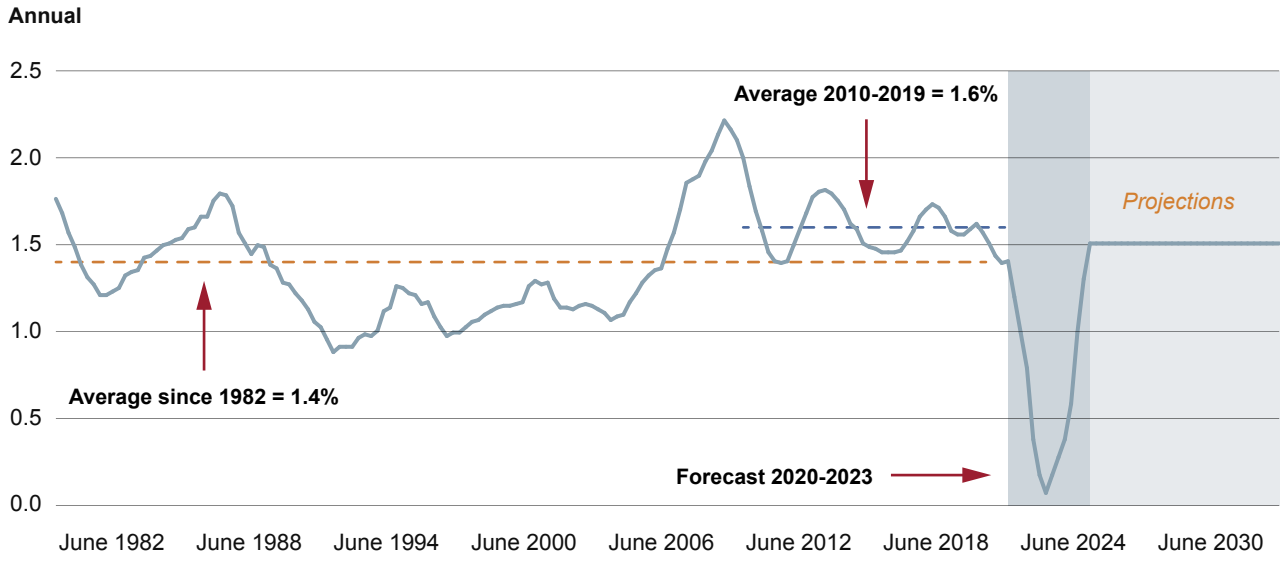
Population growth drops to just above zero in 2021 after averaging an annual rate of 1.4 per cent for the past 40 years. The decline in population growth in 2020–2022 is almost entirely the result of border closures and a fall in net overseas migration. Once international border restrictions are removed, assumed to be in 2022, population growth rises back to 1.5 per cent a year over the projection period, in line with the current Government forecasts and policies.

The population and economic assumptions underpinning the projections do not change between scenarios.

[38] Commonwealth Government Budget Papers, October 2020.

Chart 34: Australian population growth

Annual growth



Source: EQ Economics, Australian Government Treasury, United Nations

Food and grocery consumption per head

Food and grocery consumption per head (consumption intensity) is driven by household income growth. Changes to consumption intensity will reflect a combination of higher quantities of food and grocery consumed per head as well as higher quality of products consumed.

Critical to this analysis is the observation that innovation and product development will increase consumer spending on higher value-added food and grocery products.

Innovation drives both a greater share of domestic consumer spending as well as helping Australian manufacturers grow exports and international market share.

Consumption intensity is adjusted in each scenario to reflect different states of sector innovation and, hence, consumer spending intensity.

Food and grocery prices

Food and grocery price inflation measured at the wholesale (factory gate) level determines the total value of sector turnover. The central case (Muddle Through) assumes that over the next ten years, manufacturers' prices rise broadly in line with overall consumer price inflation of about 2 per cent per annum.

For the Declining Sector scenario the food and grocery inflation assumption is dropped to 1 per cent per year. In the High Growth scenario, the assumption is increased to 2.3 per cent a year. Given that the economic assumptions are fixed across all scenarios these adjustments to the inflation assumption translate into changes to manufacturer margins, which strengthens their ability to invest.

International trade assumptions

The framework utilises different assumptions about import and export growth (in nominal terms) that broadly reflects the international competitiveness of the sector. The Australian dollar is assumed to be unchanged at end 2020 levels over the projection period and across all scenarios.

Estimates, forecasts and projections

Estimates for 2020 and 2021, and forecasts for 2022 and 2023, are employed to ensure that the starting point for the long run projection assumption (2024 to 2030) has an appropriate starting point.

These estimates and forecasts consider the economic cycle and, more importantly, the disruption to the economy and sector from the COVID-19 pandemic.

The pandemic and economic recession of 2020/21 have had a variable impact on the sector because of restrictions placed on the food services sector, higher supermarket sales, higher unemployment, and the temporary dip in population growth.

Australian Food and Grocery Council

[redacted]