Submission to the Senate Inquiry into the Impacts of Supermarket Price Decisions on the Dairy Industry

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Executive Summary

Recently, a price war, initiated by Coles, has broken out between the major supermarket chains surrounding generically branded milk. This has caused major concerns within the dairy industry surrounding the sustainability of such a policy. The Association is concerned that this undermines the value of the product and compromises the sustainability of the industry in Australia.

Unfortunately, the farmgate price setting mechanism with the unprocessed milk market being driven by retail prices does not provide sustainable future opportunities for the farming sector to develop or increase investments. The limited margins also fail to allow farmers to accommodate the added financial burdens of rebuilding after natural disasters such as those recently experienced across the country. As such farmers are currently making decisions that the cost of repairing after flooding is prohibitive and will therefore be exiting the industry.

Since 2001/02 retail prices for generic supermarket branded whole milk have increased by 4% increase, in complete contrast to the 44% increase in farm costs that farmers have experienced. At the same time the branded (proprietary) processor label milk has experienced a 34% increase. The Association is concerned that the retail driven price is disconnected from the cost of production and therefore will not convey market signals to the consumer, placing the sustainability of the industry at stake.

The Association predicts that there are two possible scenarios resulting from the retail price war.

1. If, as Coles claims, there is no impact on the contract price between the processor and the retailer, the Association expects the processor will bear the direct burdens of reduced margins. This will also mean; further loss of sales in the supermarket of the proprietary branded product, degradation in value of well recognized brands, reduction in competitiveness of smaller retail outlets, possible increases in other product lines, increased market share of the respective home brand milk products, and possible reductions in the farmgate price.
2. If the level of generic supermarket brand product sold increases this will increase the market power and influence when it comes to contract renegotiations between the supermarket chains and the processors. The Association expects that this will result in lower retail/processor prices and subsequently these will be passed onto the farmers, the altered market distribution will further reduce dairy farmers bargaining power, farmers will be forced to produce under cost price, driving sections of the dairy industry out of the market. In the long term, the reduced supply will either; force the price of milk up, or cause milk and dairy products to be imported (most likely in powdered form) from cheaper sources internationally.

The Australian market already faces a significant duopoly and pricing mechanisms similar to this will further accentuate the issue. This pricing structure will drive smaller stores who are unable to provide staple products at such economical prices out of the market. This will increase the market share of the supermarkets in a market structure far from perfectly competitive, making the dairy industry more susceptible to price manipulation in the future.

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1 Introduction

The NSW Farmers' Association (the Association) is Australia's largest state farming organisation representing the interests of the majority of commercial farm operations throughout the farming community in NSW. The Association also represents the interests of rural and regional communities and the important issues associated with natural resource management and trade. Through its commercial, policy and apolitical lobbying activities, it provides a powerful and positive link between farmers, the Government and the general public.

The NSW dairy industry is a complex interaction of supply and demand. The geographic location between the large milk producing regions of Victoria with their processing capacity and export focus, and the solely fresh milk market of Queensland gives rise to complex dynamics of milk logistics. Furthermore, the dominating impacts of large retail outlets, contractual arrangements between farmers, processors and retailers and the timing of these contracts further complicates any direct market messages on supply and demand.

Milk is a perishable product that is a staple need for most Australian families. When consumers visit the retail outlet they expect to have milk available for sale and in most cases the consumer would be expecting to pay a standard price for that product. The consistent demand for the product and the volume of product has given rise to the industry developing contractual arrangements to support this consistent supply of product. However unlike most other perishable products where the retail price can fluctuate with demand, the price of milk remains consistent. The Association argues that the farmer bears much of the cost of ensuring this consistent supply pattern.

Recently, a price war, initiated by Coles, has broken out between the major supermarket chains surrounding generically branded milk. Coles initially dropped its price of milk from around $1.15/l to $1/l, which was quickly followed by the rival supermarket chains; Woolworths, Franklins and ALDI. This has caused some major concerns within the dairy industry surrounding the sustainability of such a policy. It heralds a shift in the supply chain dynamics from a competitive market place based on the cost of production to a market place where the retailer dictates price terms back to the industry. The Association is concerned that this undermines the value of the product and compromises the sustainability of the industry in Australia.

2 Background to the NSW dairy industry

Since the deregulation of the dairy industry, the NSW industry has been through a large amount of change. The number of dairy farms has decreased from 1,391 to 820. At the same time the level of production has also decreased from 1.3 billion litres to 1.07 billion litres. The average production per farm however has increased from just under 1 million litres per farm to 1.3 million litres per farm, giving rise to differing transport logistics and farmer processor relationships. The location of dairy farms have expanded into new areas of the Riverina, the central west and Tamworth with growing pressures on coastal land availability and prices, further impacting changes in transport logistics for processors.

The NSW processing industry has also faced change. Generally there has been a transition from a cooperative style structure to a more commercial style structure. The four major processing cooperatives in NSW, Murray Goulburn, Bega, Dairy Farmers and Norco have now been reduced to three. The corporate processors of National Foods, Parmalat and Fonterra have increased their presence with the purchase of Dairy Farmers by National Foods in 2009. Furthermore a share of Norco is now under control of Fonterra. The resulting divestiture of National Foods assets as a result of their purchase of Dairy Farmers has provided opportunity for Parmalat to enter the NSW industry both as a buyer of NSW milk off farm, as a processor with NSW based infrastructure, and also a brand. This does provide an additional market for farmers however the full extent of this competition is not yet realised.

The processing structure of the industry and dominance of two major retailers raises questions on the competitive nature of the industry. It is estimated that the two major retail outlets in NSW sell 70% of the supermarket whole milk production or approximately 359 million litres. This accounts for 50% of the total drinking milk sales for NSW. Furthermore additional pressures are placed on processors through the access to supermarket shelf space and the association with supplying the generic homebrand contract and being able to supply the proprietary branded product.

3 Terms of reference questions

The Association has provided responses to the terms of reference of the inquiry below.

3.1 Farm gate, wholesale and retail milk prices;

The NSW dairy farmgate price is influenced by a number of variables. Traditionally it has been expected that as a national industry with a large exposure to the export market the NSW farmgate price is based on the Victorian (largest producer and exporter) price plus freight. However, with the drop in international prices experienced in 2008 and subsequent drop in Victorian farmgate price, the relative stability of NSW and Queensland prices have illustrated that the industry does place a value on year round milk production and availability. It could be argued that until this stage the true value of the domestic fresh milk market had not been acknowledged.

Dairy farmers have experienced turbulent times following deregulation. Initial farm gate prices following deregulation dropped to reflect a single price for milk before correcting with contractions in supply. These subsequently dropped again following the impact of contracting export markets and the resultant drop in domestic prices as a result of the international economic crisis.

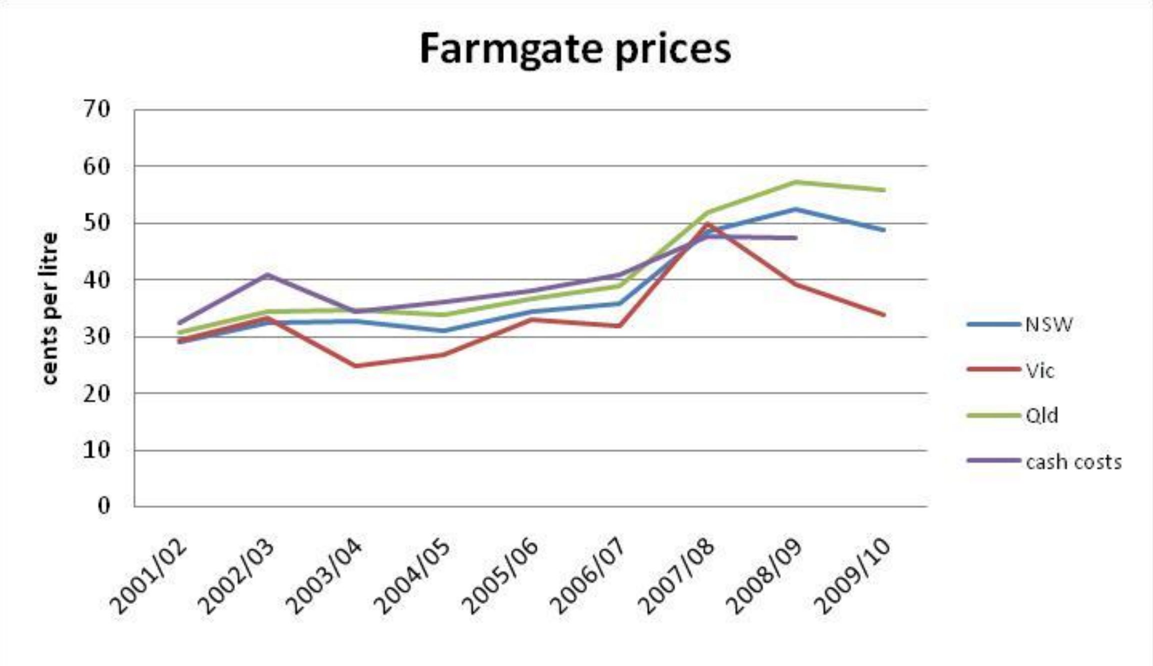
Figure 1 illustrates the farmgate prices for NSW, Victorian and Queensland farmers over the last 10 years. Prices have continued to contract further in the 2010/11 year. These prices are based on an industry average and do not necessarily reflect the actual prices received on farm. For example farmers in NSW may be currently receiving between 30 and 40 cents per litre depending on their location and processor.

The average farmgate prices for Australian farms are comparable to those of other major exporting market dominating countries such as New Zealand. According to Dairy Australia information the Australian farmgate price for 2009 was equal to the US farmgate price and marginally below prices received in New Zealand and the European Union (EU 10), making Australian producers some of the most competitive in the world.

The limited margins fail to allow farmers to accommodate the added financial burdens of rebuilding after natural disasters.

Farm costs on the other hand have experienced a steady increase. ABARE farm income data show that NSW dairy farms have experienced an increase in cash costs of 44% from 33 cents to 47 cents per litre over the 9 years to 2008/09. Furthermore ABARE figures outline that 44% of dairy farmers faced a negative cash income in 2009/2010 financial year illustrating the decrease terms of trade faced by many dairy farmers. Unfortunately the price setting mechanism with the market being driven by retail prices does not provide sustainable future opportunities for the farming sector to develop or increase investments. The limited margins also fail to allow farmers to accommodate the added financial burdens of rebuilding after natural disasters, such as those recently experienced across the country. As such farmers are currently making decisions that the cost of repairing after flooding is prohibitive and therefore may be considering be exiting the industry.

Figure 1 Farmgate Prices



Source: Dairy Australia

Within the coming year, the National Dairy Farmers Survey highlights that only 50% of farmers predict that they will make a margin over their input cost, with a further 25% suggesting they will only break even. Already, 5 per cent of the industry state they will be forced to exit within the next 5 years. These figures were garnered prior to the price war, with even further and growing discontent now present due to the increased vulnerability that the current market situation places on producers, farmers are rightfully concerned about the medium and long term affects this will have on the industry.

Information on wholesale and retail prices is more difficult to obtain. Unlike the United Kingdom where Dairy Co (the United Kingdom equivalent of Dairy Australia) regularly publishes the margins obtained along the supply chain, the prices received by processors in Australia remains a mystery. The Association expects that it costs processors approximately 45 cents per litre to collect, process and package milk. The additional margins made on top of this are uncertain.

Figure 2 illustrates the supermarket milk prices for the 10 years to 2010. Contrary to the price paid to farmers, the graph shows a relatively stable price paid by consumers through supermarket sales. It also shows a 4% increase since 2001/02 in the retail price of private (generic) supermarket whole milk, in complete contrast to the 44% increase in farm costs that farmers have experienced. On the other hand the branded (proprietary) processor label milk has experienced a 34% increase, somewhat closer to the increase in costs of production.

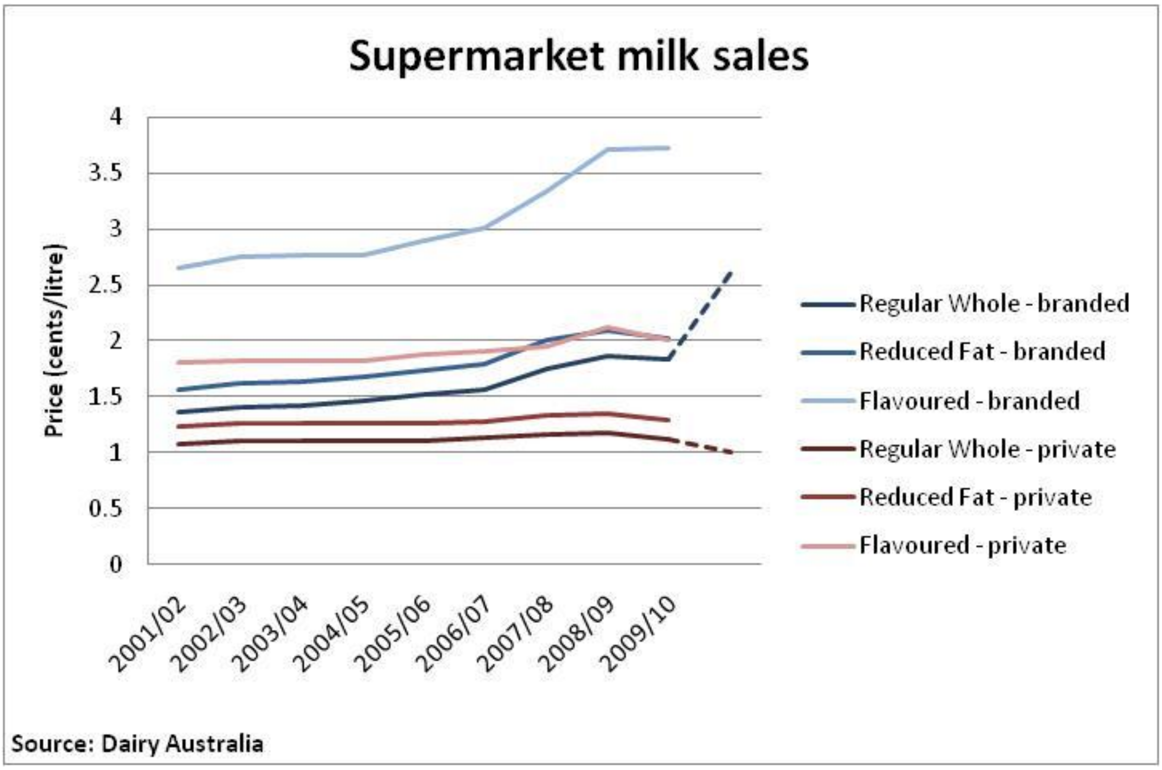
The Association suspects that while the competition among processors to supply the generic label is based on the minimal or zero margin this is in the context that they will also have the opportunity to supply the proprietary brand to recover margins.

One of the complexities of the milk business is the inter-relationship between the proprietary brands owned by the processor companies, their other product lines and the generic supermarket label. The Association suspects that while the competition among processors to supply the generic label is based on the minimal or zero margin for the processor it is in the context that through supplying the generic label product the processor will also have the opportunity to supply the proprietary brand. This product can then be sold at a higher margin and therefore balance out any negative effects of the generic contract.

It should be noted that the method of 'water-bedding' has been implemented by the processors and supermarkets, whereby the forgone profit lost through the sale of generic milk is made up for through the sale of premium brand milk. As a result of the price war, the market share of the premium brand milk will decrease, reducing the profit and operating budgets of the processors, which will inevitably be reflected through farm gate prices.

Based on a reduction in the generic supermarket milk to $1 per litre and assuming that processors and retailers will wish to continue similar total sales revenue, the Association has modelled the possible implications for processors. It is assumed that there will be some transition from proprietary branded milk to the generic supermarket label leading to a reduction in sales of about 30%. Based on these assumptions, the Association estimates that the processors will have to increase their retail price of the proprietary brands by 43% to $2.61. Figure 2 illustrates this expected price change. This equates to the proprietary milk being priced at $1.60 more than the generic supermarket brand. This will further erode the competitiveness of the proprietary brand. Alternatively the processor could impose this additional price increase across its whole range of goods disadvantaging it against other competitors, generic supermarket brands include.

Figure 2 Supermarket sale prices



3.1.1 <u>Effect of retail price war</u>

The Association predicts that there are two possible scenarios resulting from the retail price war, assuming the supermarket price of milk remains at the current prices (as claimed by Coles):

1. Retail/processor contracts remain at the same price

Given the assumption that the retail prices will remain the same and there is very little margin between retail and processor prices, one scenario is that the retail contract prices will remain the same. For this to occur it is expected that proprietary brands will have to increase prices to compensate for the loss in margins. Similar to the scenario presented in Figure 2 it is expected that the price of proprietary branded milk will increase by up to 43%.

Implications of this include:

i. Further loss of sales in the supermarket by the processing companies,
ii. Degradation in value of well recognized brands and devaluation of processing companies
iii. Reduction in competitiveness of smaller retail outlets that must accommodate increases in prices of proprietary brands and not obtain benefits of the large supermarket generic branded product pricing.
iv. Possible increases in other product lines of the processor as the processor attempts to spread loss of margin.
v. Increased market share of the respective home brand milk products possibly leading to complete removal of the proprietary brand from the supermarket.
vi. Possible reductions in the farmer/processor price as the processor attempts to pass the reduced returns back to the farmer.

2. Retail/ processor contracts decrease in price

The increased market share will increase the market power and influence when it comes to contract renegotiations between the supermarket chains and the processors (wholesalers). The increased market share will push the processors to further compete for these contracts, offering prices below what are currently available. It is expected that these prices will be passed onto the farmers for the processors to remain profitable.

Implications of this include:

i. The altered market distribution and already monopsony market structure further reduce dairy farmers bargaining power. This will force farmers to accept any new price that is offered by the processors during contract renegotiations. The reduced contractual prices will push a certain amount of farmers to produce under cost price, driving sections of the dairy industry out of the market.
ii. In the long term, the reduced supply will either; force the price of milk up, or cause milk and dairy products to be imported from cheaper sources internationally. The large capital investments required to establish a dairy farm will limit the ability for farmers to re-enter the industry.

History has proven that this type of policy is not sustainable.

- In 2008 the English dairy industry underwent a similar price war, initiated by Asda and quickly followed by its competitors (namely; Tesco and Sainsburys). The price of milk was reduced to 99p for a 2 litre bottle in all the major supermarkets. This was unsustainable then as it was now, and the price was increased again in September 2010.
- Coles has pledged that it will not decrease the prices paid to farmers, however, this is true because Coles do not directly deal with the primary producers, but rather the processors. It has also stated that the current milk price is not temporary, and it will stay at the current levels. In the long term, the supermarket chains will then face a choice to increase the price consumers receive, or, decrease the price they pay to processors. There has been no guarantee that Coles will retain the current price paid to processors and it is likely that this will be the first casualty of the price war. If this transpires, the price cuts will then flow onto the farmers.

If the price received by farmers is reduced, this will force out certain farmers, reducing supply. In the long term, this will result in an increase in price or force Australia to import dairy to supplement supply.

- If the price received by farmers is reduced, dependent on the cost structures of the dairy industry, this will force out certain farmers, reducing supply. In the long term, this will result in an increase in price or force Australia to import dairy to supplement supply, forcing the Australian market away from fresh milk towards longer lasting dairy products.

3.2 The decrease in Australian production of milk from 11 billion litres in 2004 to 9 billion litres in 2011, of which only 25 per cent is drinking milk;

The decrease in Australian milk production is caused by two main factors. Firstly the drought has affected a number of dairy farmers directly with reduced cow numbers, low irrigation allocations and reduced milk production. Furthermore it has impacted the whole industry indirectly through increased costs of fodder and grain. Secondly the spike and subsequent drop in international prices have caused an industry restructure for those exposed to the international market.

The contraction in supply has reduced the flexibility in the industry. Whereas the northern industry previously had processing capacity to utilise over production these facilities have been shut down and processors now rely on the spot market to make up any differences in milk supply. This exposes the industry to price fluctuations and possible imports.

3.3 Whether such a price reduction is anti-competitive;

Pricing everyday products below cost price is not a new strategy, large stores commonly implement loss leaders to attract customers to enter, and make up for the losses through inflating prices on other goods. In this case, Coles (followed by its competitors) is trying to claim even more of a market share through its pricing strategies. The Australian market already faces a significant duopoly and pricing mechanisms similar to this will further accentuate the issue. This pricing structure will drive smaller stores who are unable to provide staple products at such economical prices out of the market. This will increase the market share of the supermarkets in a market structure far from perfectly competitive, making the dairy industry more susceptible to price manipulation in the future.

The Australian market already faces a significant duopoly and pricing mechanisms similar to this will further accentuate the issue. This pricing structure will drive smaller stores who are unable to provide staple products at such economical prices out of the market.

The Association supports competition to the degree that it leads to efficient outcomes in the market and should equally distribute economic rent amongst the participants. Indeed competition among processors for farmers milk should lead to better price outcomes for farmers. However under the current structure and arrangements in the dairy industry, one could say that competition is being used to drive the industry out of business.

The sheer size of the major supermarket generic branded milk contracts mean that for processors to remain viable, and support volume through their infrastructure, they compete to obtain these contracts. This allows Coles and other supermarkets to then make the statement "Coles has no direct influence over farm gate prices because Coles buys milk from processing companies, not from dairy farmers." However the processor then will have to push down the price they pay to farmers to maintain their margins and therefore indirectly Coles and other supermarkets have influence the price at the farmgate. Coles has the ability re-distribute any reduced margins across other product lines and therefore minimise their exposure to reduced prices. Farmers on the other hand have one product line and therefore cannot hedge for any price reductions.

The implications of the Coles decision has wider reaching effects. The divergence of generic supermarket milk prices and the proprietary branded milk as mentioned above affects the competitiveness of smaller retailers. If they suffer reductions in sales the milk vendors that distribute these proprietary milk brands will also suffer. Furthermore, local coffee shops and other food service stores may actually just purchase their products directly from supermarkets, directly affecting the milk vendors that had supplied them.

In defining if the actions are anti-competitive one must first define the market. From a consumers point of view the market could be argued to be the local area. In some cases this may involve one, two or more supermarkets within a defined geographical location, each competing against each other for market share. In other cases where there is only one supermarket then the competition comes down to what is on the shelf and the Association would argue that there is no competition. A consumer when faced with the whole milk section of the dairy cabinet has the choice of the proprietary processor brand, priced out of the market to compensate for lost margins on the generic supermarket brand, and the generic supermarket brand, processed and bottled by the same processor. In a sense it is all one product on the shelf with a price differentiation that favours the supermarket and therefore no competition.

While competing supermarkets have matched the price reduction of Coles, they have publically stated that it is not sustainable. The Association also notes that smaller independent supermarkets and corner stores are placed at a disadvantage. They do not have the large sales volume that allows them to establish generic supermarket milk but rather sell the proprietary milk available from processors. The decrease in generic milk and the expected increase in price of proprietary milk will impact the ability of these smaller corner stores to compete against the larger supermarkets.

3.4 The suitability of the framework contained in the Horticulture Code of Conduct to the Australian dairy industry;

The horticultural code of conduct (HCC) was set up to clarify the relationships between vendors, agents, wholesalers and retailers in the horticultural industry. The Association believes it is not entirely appropriate when applied to the dairy industry, especially with issues of this nature.

The Association believes the horticulture code is not entirely suitable to resolve the current matters in the dairy industry.

3.5 The recommendations of the 2010 Economics References Committee report, Milking it for all it's worth – competition and pricing in the Australian dairy industry and how these have progressed

The Senate Economics Reference Committee report on the inquiry *Milking it for all it's worth - competition and pricing the Australian dairy industry* provided some useful recommendations for the industry. The Association provides comments on these below.

Recommendations 12 and 13 regarding collective bargaining provisions provide some good suggestions to correct the imbalance of power in the farmer/processor arrangements. Collective bargaining groups provide an avenue for farmers to address the imbalance of market power. The Association is currently assessing involvement in collective bargaining groups and has identified the condition that an organisation cannot be involved in various groups as a limitation to the effectiveness of collective bargaining groups. Furthermore the requirements of the participants in the groups and the non-committal nature also reduces the effectiveness of the groups.

Recommendations 1, 4, and 7 regarding pricing discrimination within the industry provide an avenue for addressing some of the concerns that have given rise to this inquiry.

The Association wrote to the Federal Agricultural Minister in September 2010 requesting the Government's response to the inquiry recommendations. In particular the Association requested information pertaining to recommendation 3, calling on the ACCC to use its investigative powers to review the pricing and profits in the dairy industry. The Association has not received a response to this correspondence nor is the Association aware of any Government response to the recommendations in the report. The Association fears that this current Senate inquiry will again provide no tangible changes to the industry.The Association calls upon the Government and Opposition to introduce legislative measures in response to the recommendations from this and previous Senate inquiries.

While there were a number of promising recommendations contained in the 2010 Senate report the Association fears that like the 2010 report, the 2011 inquiry will not provide any tangible outcomes.

3.6 The need for any legislative amendments

The industry is currently reviewing the Competition and Consumer law in the context of the current situation to determine if any changes could be made to resolve these issues. The Australian Dairy Farmers believes there is a prima facie case under section 46, including 46 (1AA) of the Trade Practices Act 1974 (now the Competition and Consumer Act 2010) that Coles' actions constitute predatory pricing.

The Association notes that numerous reviews and comments regarding the provisions currently contained in section 46 indicate that it is not operating to effectively accommodate the changes and removal of the previous section 49 that dealt with anti-competitive price discrimination. The Senate report of 2010 stated that, "from evidence taken during the course of its inquiry the Committee takes the view that the current operation of section 46 is inadequate and is not providing protection against price discrimination." The lack of prosecutions under section 46 despite ongoing concerns in industry suggest that it may not contain the powers necessary to overcome problems within industries such as the dairy industry. The Association suggests the Government consider reviewing the powers under section 46 with a view to reinstating some of the previous provisions contained within section 49.

The Association suggests the Government consider reviewing the powers under section 46 with a view to reinstating some of the previous provisions contained within section 49.

Furthermore the Association suggests the Government review the current anti-trust legislation in the United Kingdom and United States to identify where their legislation provides solutions to such problems.

3.7 Any other related matters.

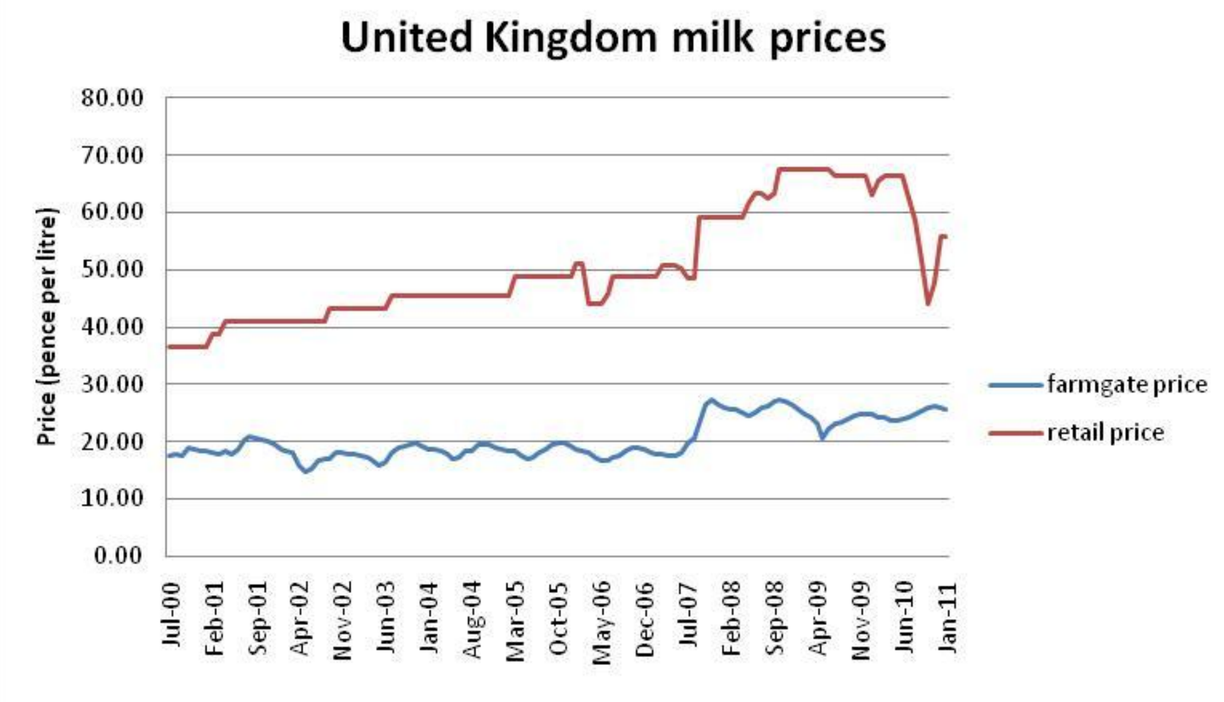
The Association is aware that similar pricing strategies have been implemented in the UK dairy industry.

In some instances there is evidence that there was a resulting price reduction passed back through to the farmers. In March 2006 retailers dropped the retail price of milk by 14%. Arla, one the UKs major milk processing companies subsequently announced in June 2006 that it would be reducing farmgate prices paid to farmers.

In other instances there was a correction in the retail prices to above previous levels. In July 2010 ASDA started a price war dropping the price to 55p per litre. Other supermarkets followed however in December Tesco lead an increase in prices to 68p per litre which was 2p higher than before the July discounted price. Resulting in no net benefit to the consumer but rather turmoil in the industry and no doubt uncertainty among UK dairy farmers.

Figure 1Figure 3 illustrates the retail and farmgate prices in the UK for the period between 2000 and 2011. It shows that while increases in farmgate prices are usually reflected in the retail prices, decreases in farmgate prices are not reflected in retail price drops.

Figure 3 United Kingdom milk prices



Source: Dairy Co