Australian Dairy Industry Council

Submission to the Senate Economics Reference Committee

Inquiry into

The impacts of supermarket price decisions on the Dairy Industry

Australian Dairy Industry Contacts
Australian Dairy Farmers Ltd: Natalie Collard, A/Chief Executive Officer - (03) 8621 4200
Australian Dairy Products Federation: Peter Stahle, Executive Director – (03) 8621 4260

Level 2, Swann House, 22 William Street
Melbourne, Victoria, 3000 AUSTRALIA
Telephone: +61 3 8621 4200
Facsimile: +61 3 8621 4280
ABN: 76 673 412 879

EXECUTIVE SUMMARY

On behalf of its members the Australian Dairy Industry Council (ADIC) is pleased to present this submission in relation to the recent decision by Coles Supermarkets to dramatically discount the retail price of their private label (home brand) drinking milk and the likely impacts of this tactic on its dairy industry suppliers.

The ADIC is the peak body of the Australian dairy industry and is comprised of Australian Dairy Farmers Limited (ADF) and the Australian Dairy Products Federation (ADPF), representing farmers and manufacturers and processors, respectively. The ADF is the national peak representative body of Australia's 7,500 dairy farmers and forms the dairy commodity member of the National Farmers Federation. ADF's members include state farmer organisations that represent dairy farmer interests in each state. The ADPF represents Australian owned or operated companies that process, manufacture and trade milk products domestically and internationally.

In examining Coles' pricing action, which was followed by Woolworths, Aldi, and Franklins and has flowed on to non supermarket sales channels, it is important to identify the core issue that is at stake – that Coles' price cuts are unsustainable. There has been some attempt by Coles, to portray its price reductions as a move that either aims to:

- help reduce food inflation for Australian consumers; or
- address competitive issues within the dairy supply chain.

The dairy industry does not accept that these are the issues of substance in this current situation.

Coles' actions may temporarily lower retail prices for drinking milk across Australia but, as has been acknowledged by their competitors, their price cuts are unsustainable. The last time milk was priced at $1 per litre was around 20 years ago, in 1992. It is the ADIC's view that Coles must raise their prices to a sustainable level if the industry is to remain viable in the main drinking milk production regions.

The issue of competitive balance within the dairy sector was widely canvassed in the 2010 Senate review. The ADF has already publicly endorsed the need to ensure that collective bargaining arrangements provide an appropriate balance between farm suppliers and processors in ongoing commercial negotiations.

For dairy producers the key issues that must be considered in this inquiry are:

1. Consideration of the broader, longer term impacts of such unsustainable pricing on the profitability, sustainability and shape of the dairy supply chain; and
2. The impact of the associated expansion in private label (home brand) retail sales on the dairy industry.

Coles' decision to cut retail prices for drinking milk, butter and cream is clearly driven by a desire to expand its market share of domestic retail food sales at the expense of retail competitors (supermarket, convenience stores and home delivery suppliers). This decision was made either with a poor understanding of, or no regard for the impact on dairy farmers, milk processors, local corner stores, independent service stations or the tens of thousands of other workers who depend on milk for their livelihood.

Coles may see a shift in current market sales channels (e.g. less milk sold at the local corner store and more supermarket private label (home brand) sales). But this is unlikely to generate any lasting change in the national consumption of drinking milk in Australia.

At the same time, the changes in absolute and relative prices of different milk lines are putting dairy industry margins at risk. Coles knows this is the case and needs to acknowledge this fact and work with the dairy industry supply chain to achieve sustainable prices.

Processors and dairy farmers who supply the drinking milk market rely on the margin from branded milk sales for their profitability. Competition from unsustainably priced Coles private label (home brand) milk is taking market share away from branded products.

This reduces the amount farmers receive from processors as an increased share of Coles private label (home brand) milk is being sold at little or no margin and less of the more sustainably priced branded milk is being sold. **Farmers whose milk payments are linked to branded milk sales will see a reduction in their milk cheques as early as mid-March in some cases.**

The claim that Coles will bear the cost of margin reductions on its home brand lines oversimplifies market reality. This is especially true for the greater volumes of drinking milk that are sold outside existing supermarket home brand contracts.

If the reduced pricing structures persist they threaten to permanently strip many millions of dollars of value from the Australian supply chain for drinking milk, a chain that accounts for 25 percent of national milk production and is the mainstay of the dairy industry in Queensland, Western Australia and Northern New South Wales. In Queensland 95 percent of milk production is used for drinking milk.

Even if the fact that Coles is likely to be passing on its losses on milk to other products in its stores is ignored, any perceived consumer gains from Coles' action are not windfall gains. They will mostly come at the expense of lower incomes and margins in a range of businesses across Australia - including dairy farmers, milk vendors, milk processors, route trade distributors and convenience stores.

Dairy farmers are well aware of this risk. This is why Coles' action has delivered a major blow to the confidence of dairy farmers in many regions, particularly those who are dealing with recent and prolonged drought, and now floods.

The uncertainty and instability flowing from Coles' action has broad regional implications. It is likely to negatively affect milk production in those regions of Australia where drinking milk is the major driver of local dairy economics (such as Queensland, Western Australia and Northern New South Wales). This will have immediate adverse flow on effects for local regional communities. It is also likely to increase volatility in these regional markets in future years to the detriment of farmers and even buyers of dairy such as Coles.

The ADIC agrees with previous comments by the Minister for Agriculture, Fisheries and Forestry that it is not appropriate to achieve lower consumer prices, for staple foods such as milk and other dairy products, at the expense of the dairy farming families who produce them. Therefore, we believe there is an urgent need for:

- Coles to acknowledge that its marketing tactic has severe consequences for the dairy industry, cease its current pricing strategy and raise prices to a level that is sustainable for all levels of the supply chain;

- The ACCC to investigate the pricing practices of Coles, including its 'guarantee' that dairy farmers returns will not be reduced, to ensure that predatory pricing is not being practiced and that sustainable returns are delivered to Australian farmers and processors;

- An open dialogue between Australian major retail supermarkets and farm producers on regional supply/demand issues and strategies that will ensure that sustainable supplies of fresh drinking milk can be delivered daily to consumers across Australia through a range of retail outlets;

- Consideration and review of the Competition and Consumer Act 2010 (formerly the Trade Practices Act 1974) to determine if the Act is effective in dealing with actions such as those taken by Coles recently with a view to changing provisions to ensure that such conduct is not repeated; and

- Government to convene, and participate in, an ACCC-authorised roundtable forum of the dairy industry supply chain, from farmers to retailers, to constructively discuss solutions for ensuring a sustainable drinking milk market with fair returns for all.

INTRODUCTION

On Australia Day, January 26 2011, Coles Supermarkets announced that it was making significant and permanent reductions to the retail price for its main private label (home brand) lines of drinking milk. It subsequently made similar cuts to the price of its private label butter and cream lines. Other major supermarket competitors responded by making similar price cuts, although the majority indicated they believed the margins associated with the new price structure to be unsustainable. [1]

The ADIC believes that Coles' action has the potential to significantly destabilise the domestic dairy supply chain.

To illustrate these concerns this submission explains:

1. The dynamics of Australian dairy production and milk sales;
2. The difference between the milk markets in Australia;
3. The role of private label sales in the Australian dairy market;
4. The potential consequences for local industry of:
   a. The latest price reductions; and
   b. Continued expansion in the share of milk sold via private label lines.

The submission also addresses certain other issues raised explicitly in the Senate Economics Reference Committee's Terms of Reference.

1. Dairy Industry Dynamics

There are over 100,000 people employed in the dairy industry in Australia. The vast majority of these people are employed in regional and rural areas.

Dairy is Australia's third largest rural industry with a value of over $3.4 billion at the farmgate.

Despite Coles' claims of recent increases in farm gate prices of 22 percent in Victoria, the reality is that milk prices to farmers have dropped by more than 10 percent in New South Wales and 15 percent in Queensland in the last twelve months in these key drinking milk production states. This includes farmers who supply milk which goes into Coles' private label (home brand) milk. To cite Victoria as an example is disingenuous when its key market is export oriented.

As the Terms of Reference note, Australian milk production has declined from a peak of 11.2 billion litres in 2001/2 to an expected 9.0-9.1 billion litres in the 2010/11 season. This fall reflects the intersecting impacts of a complex matrix of factors, which include:

- Extremely adverse seasonal conditions across many farm regions in 2002/3 and 2003/4 and again in 2006/7 which reduced on-farm feed availability and incomes while dramatically increasing production costs for dairy farms. The cumulative loss of milk production in these 3 years totaled 1.7 billion litres;
- The negative financial impact of increased volatility in international food prices since 2001 and specifically the severe downturn in world dairy markets in 2008/9;
- A related rise in on-farm debt across many regions;
- The residual adjustment in farm numbers in some regions following the deregulation of drinking milk arrangements in 2000;
- Increased competition for land particularly in some coastal production regions;

[1] Woolworths spokesman Sunrise February 2011

- Shifts in the regional supply/demand balance in drinking milk regions; and
- Uncertainty generated by announced government policy responses to broader issues such as climate change.

One ramification of these changes has been the increased importance of domestic market sales to overall dairy industry returns.

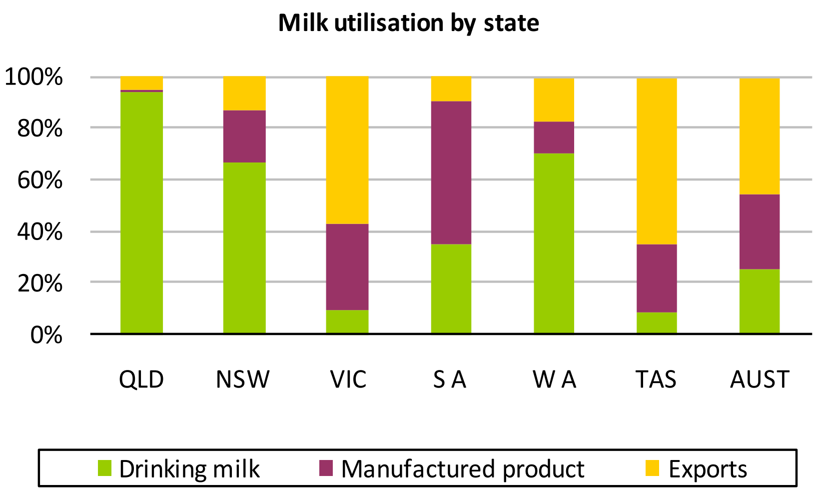
In 2001 export sales accounted directly for 55 percent of Australia's dairy production (on a milk equivalent basis). Domestic sales accounted for around 45 percent (with drinking milk sales accounting for 18 percent of total production).

In 2011 this pattern has reversed. The domestic dairy market now consumes around 55 percent of Australia's milk production with drinking milk sales accounting for 25 percent of total national production. The share and volume of Australian milk exported has declined to just under 45 percent of production.

2. The difference between milk markets in Australia

Exposure to the domestic manufacturing and drinking milk markets also varies significantly between dairying regions. Queensland, Northern New South Wales and Western Australia are now essentially drinking milk regions, with very limited involvement in the export market. South Australia also has a significant percentage of production dedicated to drinking milk production. Victoria and Tasmania remain primarily manufacturing and exporting regions.

Fig 1.



Source: Dairy Australia

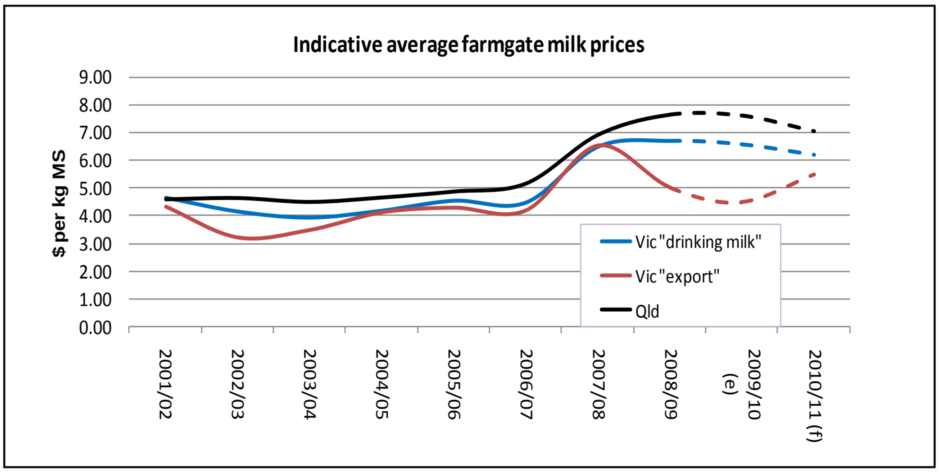
These differences in product and market mix give rise to regional differences in production systems, costs of production and farm gate price drivers. Drinking milk suppliers (particularly farmers operating in Queensland, Northern New South Wales and Western Australia) must operate year-round production systems with limited variation in monthly supply volumes. This significantly increases their production costs relative to producers of export milk who can operate more seasonal farm systems.

Returns for drinking milk and fresh dairy products like yoghurts are less directly affected by returns from internationally traded commodities. In Queensland, Northern New South Wales and Western Australia retail sales of drinking milk are the key regional market and farm gate price driver.

On the other hand farm gate prices in Victoria and Tasmania, where the majority of milk is used in the manufacture of dairy products, are closely aligned to returns from exported products.

In recent years regional issues surrounding the need to balance fresh milk demand and supply have resulted in diverging trends in farmgate prices. As outlined in the chart below, while Victorian prices are currently responding to growing export demand, prices in Queensland reflect the lack of manufacturing opportunities in a region now almost exclusively geared to year round supply of a stable fresh milk market.

Fig. 2



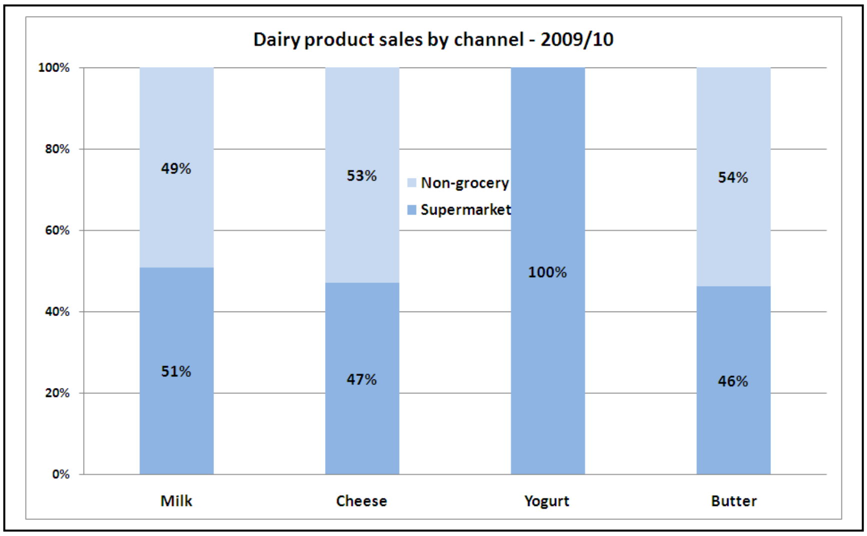
(e) – estimate
(f) – forecast *Source: Dairy Australia*

While the Australian dairy market is generally stable, it is intensely competitive.
This is evidenced by the fact that during 2010 when international dairy prices were rising steadily, the ABS consumer price indicators show that retail prices for dairy products and drinking milk remained unchanged.

3. The role of Supermarkets and Private Label (Home Brand) Sales

Domestic market pricing reflects a number of factors, the most significant of which in Australian retailing are the influential position of local supermarkets and the increasing role of private label (home brand) sales. Dairy Australia estimates that the supermarket channel accounts for 49 percent by volume of domestic market sales for the key dairy categories - milk, cheese, dairy spreads and yoghurt.

Fig. 3

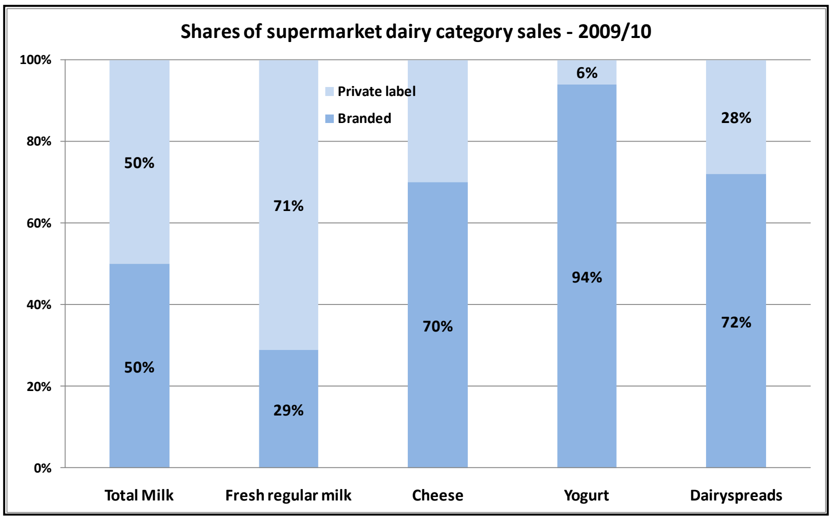


Source: Dairy Australia

Dairy industry returns from domestic sales have also been affected by the rise in private label sales over the past decade. Private labels accounted for 24 percent of the value of retail packaged grocery sales in late 2010. Nielson data suggests that all households buy some private label products.

Private labels tend to hold a significant share of sales of what are termed "'low involvement"' products – those where the product offerings are similar across the range and the consumer decision-making process is relatively straightforward. Staple foods such as regular white milk tend to fall into this product category. As a result, retail dairy sales – and particularly milk – feature a high proportion of private label products.

Fig. 4



Source: Dairy Australia

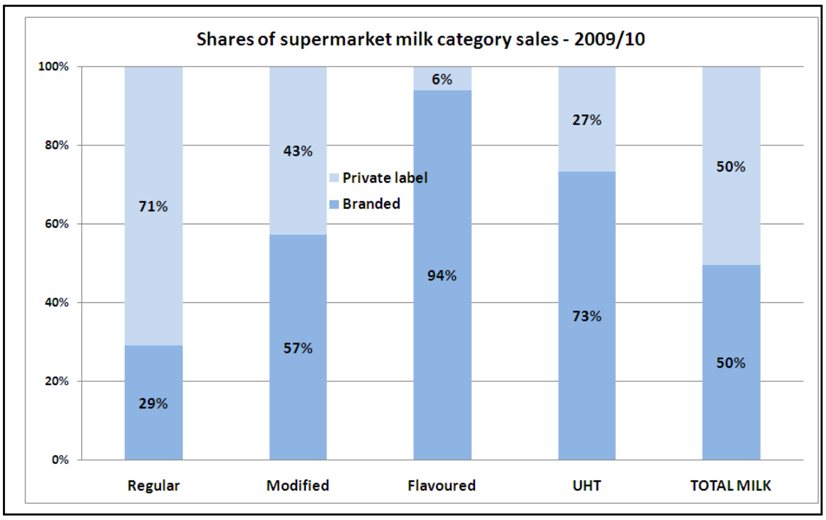
Dairy Australia estimates that private label (home brand) sales now match or slightly exceed those of processor branded lines. Private label products offer lower margins to milk processors compared to branded products.

While changes in scan data suppliers make a long term comparison difficult in the fresh milk category, the share of supermarket sales held by private label lines increased from 43 percent in 2000/01 to 50 percent in 2009/10. Private label penetration is highest in fresh regular white milk sales (rising from 59 percent in 2000/01 to 71 percent in 2009/10).

Processors have been able to reduce the level of private label penetration in the modified and flavored milk categories by product differentiation based on fat content and added nutrients etc. If sales of private label milk continue to climb due to Coles' recent unsustainable price cuts, further eroding profitability for suppliers, then the ability of the industry to innovate through product development will be severely compromised for the drinking milk category.

For farmers on two-tier contracts, the balance between sales of branded and private label (home brand) milk is directly linked to their returns. Farmers have entered into these contracts with an understanding of the historical trends, however the sudden change in market share of private label (home brand) milk caused by Coles' action has drastically altered potential farmer returns with the impact being felt as soon as mid-March this year.

Fig. 5



Source: Dairy Australia

The movement of large retailers (like Coles) into alternative retail outlets (such as petrol stations) has also seen an expansion in private label drinking milk sales in this non-supermarket sales channel with consequent impacts on corner stores, independent petrol stations etc.

Even before Coles' unsustainable price cut private label (home brand) lines provided much lower margins for both processor suppliers and retailers compared to traditional branded lines.[2]

[2] Unpublished Dairy Australia data suggest processor margins on private label drinking milk in 2010 averaged 40c per litre below traditional brand line margins.

For retailers, private label sales offer greater control of their supply chain and help reinforce customer loyalty to the supermarket rather than branded suppliers. Accordingly, in recent years Coles has reduced the shelf space available to branded products and narrowed the range of branded suppliers within specific product categories. This has helped push consumers toward private label sales. In turn it has increased competition between manufacturers for private label contracts often driving down wholesale prices and manufacturer margins.

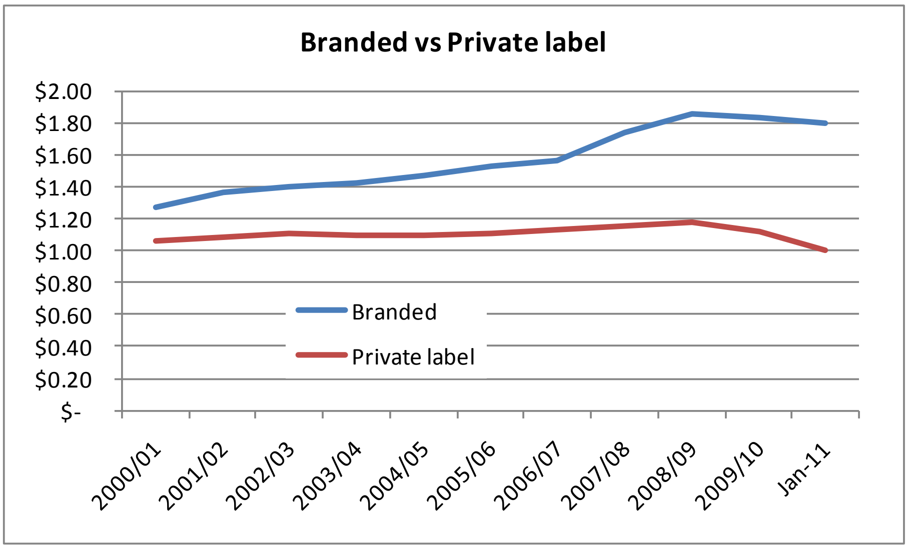
This is similar to the UK experience, where many recently imported Coles' executives hail from, which resulted in more home brand product lines, less product development, less choice for consumers, lower prices for suppliers such as farmers and eventually severe sustainability issues across several industries.

In the case of dairy, local processors have sought to counter the impact of these trends on overall returns and profitability by trying to expand the margins they make on retail sales of branded products.

This has proved a challenge for processors of the major regular white milk category where it is difficult to differentiate between product lines. The characteristics of supply competition in states such as Queensland and Western Australia have also maintained pressure on processor margins in these regions. In Queensland, for example, local competition has resulted in wholesale and retail selling prices for branded fresh white milk averaging well below returns in other states.
For example, the average retail price for branded fresh white milk in Queensland was over 20c per litre below the prevailing price for the same product in NSW and Victoria, while farmgate prices have been the highest on average, due to the higher costs of year round supply in a challenging environment. Therefore, even before Coles' announcement, company margins on drinking milk sales were much tighter in Queensland than in other states. This has an important bearing on how further pressure on margins may translate across industry returns.

Processors have had more success in building margins in the expanding modified milk categories, where they have used product developments to deliver different fat and taste profiles, nutrients and functionality for consumers. Processors have been able to capture the benefits of this innovation in greater margins for their branded product lines, which in turn has supported category development. This has seen the price gap between branded and private label retail prices widen over time.

Fig. 6



Source: Dairy Australia

However, Coles' actions threaten this position. The announced retail price cuts are greatest for private label modified milks (30c per litre or more). This will test consumer loyalty to their preferred brands. The potential dominance of private label in this segment will significantly impact returns to processors and dairy farmers and limit the ability or willingness of processors to invest in new product development, given their inability to capture the benefits via higher margin branded products.

This could lead local dairy to a similar situation to the UK milk market, where the dominance and periodic price cutting of the retailer private label product has stifled innovation and product development, leaving less choice for consumers.

(Appendix 1 shows supermarket drinking milk sales – branded vs private label and Appendix 2 relates to the UK milk market).

4. Potential Impact of Reduced Private Label prices on the Dairy Industry

The potential implications of Coles' announced price cuts on dairy are twofold. Firstly they will affect industry sales revenues and through this they will have a flow on effect to regional farm profitability and production.

Coles has narrowly defined the implications of its price cuts. It argues that, while current contracts remain in force it will absorb the reduced margins associated with lower sales prices for its private label lines (some 10-30 cents per litre). At a selling price of $1.00 per litre it is ADIC's belief that Coles' is using milk as a loss-leading product, particularly in regional markets, such as Darwin, Far North Queensland, Kununarra, Broome and even Tasmania.

There is a real question that must be investigated urgently by the ACCC whether such pricing arrangements represent predatory pricing.

At the very least, by default, Coles' move requires firms like Woolworths, Aldi and others to wear the same margin reductions. On an annualised basis it has been conservatively estimated that the Coles move will strip over $70 million from supermarket margins. Coles will wear less than half this loss. Its competitors have already stated that the reduced margins are unsustainable[3]. This suggests there will need to be supply chain price and margin adjustments if these lower prices become permanent.

It should be noted that it has been reported in the media, and not denied by Coles, that the cost per annum to Coles would be $60 million if it did absorb these costs. Dairy farmers certainly do not believe Coles will absorb the price cuts and asks the ACCC to closely watch price increases on other products in Coles' stores or through their service stations which may be used to fund these unsustainable price cuts.

However, the above impact is only one element of the new supply chain dynamic unleashed by Coles. It's 'price guarantee' does not apply to the over 70 percent of local milk that is currently sold outside retailer private label sales. If low private label prices (and margins) are maintained, there is likely to be a flow on to other branded product sales and margins in non-supermarket sales channels, such as corner stores, petrol stations, direct route distribution and home delivery. **The potential loss of sales revenue and margins in these channels is much greater than the first round effect discussed above.** This is a major concern for the dairy industry given the flagship nature of the drinking milk category and its influence on different regions that primarily service this market.

[3] Woolworths spokesman Sunrise February 2011

Coles' move aims to change consumer behavior and increase its market share of sales at the expense of other channels.

The current retail sales value of drinking milk in Australia is over $4.2 billion per annum.

Coles' move is extremely unlikely to increase the aggregate consumption of milk. However it will encourage:

- Lower average selling prices for all private label supermarket sales;
- A shift within supermarket sales from (higher margin) branded lines to low margin private label sales. Initial analysis of supermarket sales for February (and anecdotal evidence by companies) suggests that a shift of 10 percent is easily possible;
- A shift in sales from route trade distributors (eg, coffee shop and independent petrol station suppliers) and corner stores outlets to cheaper priced supermarket private label lines - again early indicators are that shifts of 10 percent are feasible if the price gaps are maintained; and
- Significant pressures on processors and independent supermarkets to reduce wholesale and retail prices (and margins) to maintain sales volumes.
  This is particularly likely in Queensland and Western Australia, where branded products are already regularly discounted to compete with private label sales.

Table 1 presents a simplified assessment of the potential reduction in retail drinking milk sales value if these pressures are realised. This shows that the real risk to industry revenue and margins is many times greater than the $70 Million outlined above. The figure could easily extend to hundreds of millions of dollars per annum.

Table 1. Some Potential Effects on Retail Sales Value of Drinking Milk

Effect	**Retail value of drinking milk category ($mill)**		
	Supermarket	**Route***	**Total**
Historical 2009/10	$1,916	$2,350	$4,266
Initial price cut to <u>all</u> 2 and 3 litre private label products (absorbed by retailers)	$1,842	$2,350	$4,192
10 percent shift to private label product with no overall consumption increase*	$1,743	$2,350	$4,105
10 percent shift from route trade to supermarket private label product	$1,853	$2,115	$3,968
10 percent decrease in branded price to compete with lower private label products	$1,744	$1,904	$3,649
Change from 2009/10 benchmark*	-$172	-$446	-$618
*__*Assumptions:*__* *route price is equal to branded supermarket retail price, cuts to branded prices are made in both supermarket and route outlets, no overall consumption increase reflecting limited price elasticity of milk consumption, price cut maintained 12 months*			

Source: Dairy Australia

An inevitable consequence of Coles' action, if sustained, will be that the overall retail value of drinking milk sales will decline substantially (potentially by hundreds of million dollars per annum). This, in turn, must lead to reduced margins and income for a wide range of businesses (including milk vendors, corner stores, distributors, dairy manufacturers, other supermarkets and dairy farmers).

Stripping money out of a supply chain, over time, will build the pressure on the more vulnerable members of that chain to accept lower prices. Historically farm suppliers have borne a large part of such risk. As Coles' move will result in lower processor margins and take significant value from the dairy supply chain it must put pressure back on future farm gate prices, incomes and rural communities.

An indicator of the size of this risk can be seen from a simple margin analysis. As processor margins on private label (home brand) sales are well below those of branded lines (and route trade), a 10 percent increase in private label (home brand) supermarket sales as a result of the new, lower prices at the expense of branded lines (effectively less than a 3 percent shift in sales across all channels) would cut processor margins by almost $24 million per annum. This represents over a cent per litre for milk supplied for drinking drink sales. Each additional 10 percent shift in supermarket sales to private label products would put a further cent per litre at risk.

Industry data shows that in the most exposed region of Southern Queensland and Northern New South Wales a 10 percent shift toward private label alone would halve farmers' 2009/10 profits should the processors be forced to pass the impact on to farmers.

The stark reality of this is emphasised in Norco Co-operative Limited's submission to the inquiry. In 2009/10 Norco's net profit was $2.3million. If there was a 1 cent per litre milk price reduction then the cost to Norco and its members would be $1.4 million, more than halving net profit.

If fresh milk processors are forced to discount prices (and margins) on branded products in order to maintain sales the risk to industry returns is even higher (over $100 Million or 4 cents or more per litre for a 10 percent rise in private label sales). These long term industry impacts of Coles' actions must be addressed. It should also be noted that these calculations do not take into account the potential impact of lower prices on route trade (corner store and coffee shop suppliers for example) which would lead to an even higher risk than that stated above.

As a first step, the ADIC believes an improved level of transparency and open dialogue must occur through the dairy supply chain. The ADIC therefore asks Government to convene and participate in an ACCC-authorised roundtable forum of the dairy industry supply chain, from farmers to retailers, to constructively discuss solutions for ensuring a sustainable drinking milk market with fair returns for all.

Impact at farm gate

Such impacts are substantial. However, they are not likely to be felt uniformly across individual business or regions.

Farm suppliers in Victoria and Tasmania appear to be less at risk. They may have to bear some of the impact on returns and margins for their companies who are engaged in production and sale of branded milk for route trade or domestic UHT milk.

Farmers in Queensland, Northern NSW and Western Australia are more at risk. In these states, local milk production is utilised primarily for drinking milk. Therefore, farm gate price drivers in these regions reflect the balance between local demand for drinking milk and security of supply. Milk production has to be closely matched with daily fresh demand. This is a challenge for both farmers and processors, as either over or under supply represents significant issues for the regional market.

Producing a flat supply curve is costly for farmers, while coping with seasonal peaks and troughs imposes costs on the processing sector. Given these dynamics farm gate prices in Queensland, parts of New South Wales and Western Australia are significantly influenced by retail prices for drinking milk.

If processor margins and returns from drinking milk are reduced, this will put pressure on farm gate returns. Based on ABARE farm survey data, if local processors pass through the majority of the above margin losses then, based on 2009/10 estimates, this would have eliminated average farm business profit per litre in Southern Queensland and Northern New South Wales.

Average farm incomes in this region are expected to be drastically reduced in 2010/11 due to lower average farm gate prices and the impact of floods on many farmers. Recent Dairy Australia surveys show that milk prices are already a dominant challenge for farmers in this region. The Coles decision has also been separately identified as a major factor affecting farmer confidence and their willingness to reinvest in their businesses (following the floods and cyclones).

This unnecessary blow to farmer confidence comes at a critical time for the dairy industry. If unchecked, it could easily translate into a downward spiral in regional milk production. This will bring further, painful regional adjustment.

It is also likely to add unnecessary uncertainty and volatility to regional industry planning. A further decline in local milk supply in Northern Australia is not consistent with the expected growth in medium term demand for drinking milk as the regional population expands. This suggests that the current Coles' strategy is both short sighted and likely to be self defeating.

Shortfalls in regional milk supply in coming years will have to be met either by offering much higher farm gate prices to local farmers to significantly expand or re-start businesses, or by increased long distance transporting of milk to meet demand. The resulting wholesale prices under either of these outcomes will certainly not fit within Coles' planned retail price structure.

Consumers, therefore, can expect to face renewed and greater price increases than would be the case if local producers and processors had been offered a more sustainable pathway forward.

Other Issues

Horticulture Code of Conduct

The Committee has been asked to assess the suitability of the Horticulture Code of Conduct framework for the dairy industry.

As the ADIC understands, the Code of Conduct was established in 2007 to improve the clarity of transparency of business transactions between horticulture growers, agents and wholesale traders of fresh products. It sets out dispute resolution procedures and guidelines for these transactions. It also provides for cooling off periods in relation to contracted horticulture produce agreements. However, the Code explicitly does not include retail operations within its ambit.

The applicability of the Horticulture Code to dairy is not immediately obvious. Very few dairy farmers would supply milk under agency arrangements as defined in the Code.

In many respects, the issues addressed by the Horticulture Code are already dealt with effectively within current commercial dairy marketing arrangements.

Dairy processors and manufacturers have in place, and make publicly available, the terms on which they will do business with individual farm suppliers. These include advance notice of expected payment provisions based on quality (cell count), milk characteristics (solids count), volume, timing of delivery etc. Quality testing systems are in place for all milk collections (with independent testing agents). These arrangements are often structured in formal supply agreements or contracts between farmers, their collective bargaining group and companies.

The Code would not seem to enhance (or affect) dairy farmers ability to engage in collective bargaining over the sale of their milk.

The explicit requirement of the Code that producers who enter a produce agreement must indicate that they have either obtained independent legal advice before entering the agreement (or that they have deliberately decided not to seek such advice) may be difficult to implement in the dairy industry, for farmers supplying farmer-owned cooperatives.

Therefore, based on current dairy experience it is not apparent that extending the Horticulture Code to dairy would add any significant support or protection to dairy farm businesses, particularly as its provisions do not extend to issues relating to retail sales.

However, this does not preclude the dairy industry from exploring voluntary (non-regulated) arrangements with the whole of the dairy supply chain. The ADIC is happy to work with Government, retailers and other members of the supply chain to examine the issue of sustainability in the fresh milk market. We believe an ACCC authorisation would be required to convene such a forum.

ACCC

The ADF has written to the Minister for Agriculture, Fisheries and Forestry and the Treasurer, on behalf of the dairy industry, seeking their support for an urgent ACCC investigation into the recent unsustainable price cuts by Coles on their home brand milk, butter and cream.

The ADIC 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. We also believe the ACCC should ask Coles to explain how it is in a position to guarantee that farmers will not be asked to accept lower returns and whether such a claim is merely a deceptive marketing tool aimed at consumers.

It is our belief that Coles' actions will damage their competitors, such as other major retailers, corner stores, independent petrol stations and other small retailers of milk, and will lead to a substantial lessening of competition in the market place.

We also believe this action by Coles impacts the viability of branded dairy products and will lead to less product variety on supermarket shelves.

It is our view that these actions will ultimately lessen competition for consumers through increasing prices and decreasing product choice as the experience in the United Kingdom has shown.

The ACCC must urgently examine this marketing tactic of Coles with specific reference to regional and remote areas.

As outlined above the ADIC also calls on the ACCC to investigate Coles' 'guarantee' that dairy farmer's returns will not be reduced as this is clearly not the reality of the situation. Increased sales of Coles home brand milk are taking market share away from branded products. Many farmers contracts have payments linked to the sales of branded products and farmers in Queensland will see their milk cheques drop this month as a direct result of the Coles marketing tactic.

Coles 'guarantee' that processors will pass on any increases in price also brings into question third line forcing issues.

The ACCC must undertake a thorough forensic investigation into Coles' conduct.

It is also worth noting that a representative from Coles gave evidence to the Senate inquiry last year that margins were about 20 percent on the prices then of approximately $1.20 per litre. They have now reduced the price by up to 33 percent to $1 per litre, this would appear to mean that Coles cannot be making a profit on their milk sales and is using the entire category as a loss-leader.

Senate Economics References Committee inquiry and report – *Milking it for all it's worth – competition and pricing in the Australian dairy industry*

ADIC welcomed the inquiry last year and the interest shown by the Senate Economics Reference Committee in the difficult position faced by the Australian dairy industry and continues to appreciate the ongoing support and interest by the Committee members.

ADIC is particularly supportive of recommendations 2, 3, 4, 12 and 13 of the *Milking it for all it's worth* inquiry. ADIC appreciates all endeavors that support transparency in milk pricing and continues to work hard alongside ADF to communicate the underlying market drivers for reduced milk prices to farmers.

Conclusion

Lowering the price of milk may initially appear to be good news for Australian consumers. But an inevitable consequence of this will be that the overall retail value of drinking milk sales will decline (potentially by hundreds of million dollars per annum). This, in turn, will lead to reduced margins and income for a wide range of businesses (including milk vendors, corner stores, distributors, dairy manufacturers and other supermarkets). These firms, along with dairy farmers, will bear the brunt of Coles' decision.

Coles' actions are stripping money out of the dairy supply chain. The impact has been almost immediate, with evidence that pressure is building on the more vulnerable members of that chain to accept lower prices. Coles' move will take significant value from the dairy supply chain and put pressure back on future farm gate prices, incomes and rural communities.

Coles says it is unfair for farmers (and presumably other small businesses) to unnecessarily bear lower returns. Yet any reasonable assessment of its' marketing tactic would suggest that this is almost certainly the likely outcome of its action.

Milk priced at $1 per litre is simply unsustainable for all involved in the value chain, including Coles and its customers are likely to be paying the price on other products.

It is our view that Coles' actions will ultimately lessen competition for consumers, increase prices on non-staple and decrease product choice as the experience in the United Kingdom has shown.

The ADIC urges Coles to raise milk, butter and cream prices to a sustainable level.

Appendix 1: Supermarket Drinking Milk Sales

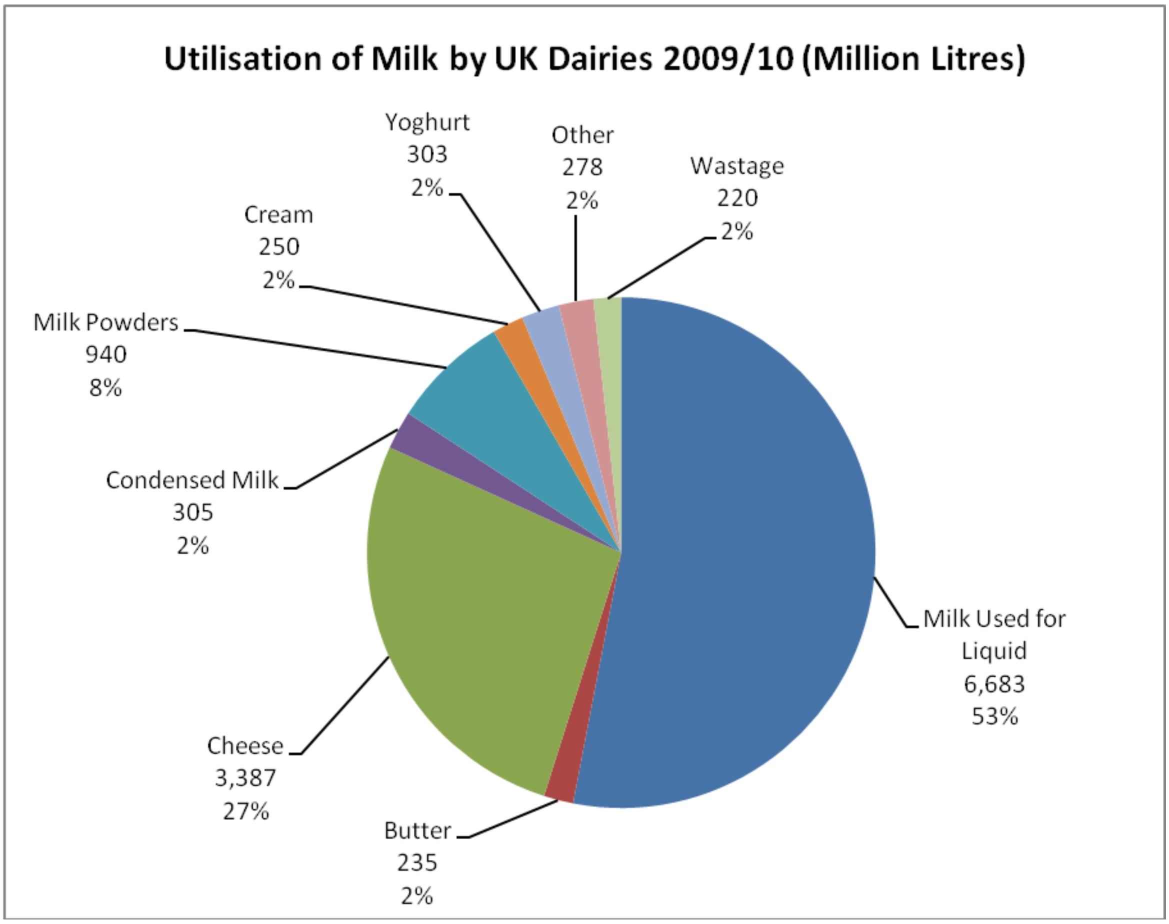
Supermarket Milk Sales - Branded vs Private Label [million litres]

	2007/08		2008/09		2009/10 (p)	
	Million litres	Price/Litre	Million litres	Price/Litre	Million litres	Price/Litre
Branded Milk						
Regular Whole	147	$1.74	152	$1.86	148.07594	$1.83
Reduced Fat	184	$2.01	178	$2.10	185	$2.03
No Fat	63	$2.06	59	$2.14	59	$2.07
Flavoured	64	$3.33	67	$3.71	74	$3.72
UHT	82	$1.91	86	$1.91	110	$1.63
Total Branded Milk	**540**	**$2.08**	**542**	**$2.20**	**576**	**$2.12**
Private Label						
Regular Whole	341	$1.16	357	$1.18	359	$1.12
Reduced Fat	149	$1.34	167	$1.35	177	$1.30
Low Fat	3	$1.63	3	$1.64	4	$1.63
Flavoured	3	$1.95	3	$2.12	5	$2.01
UHT	46	$1.18	46	$1.19	40	$1.15
Total Private Label Milk	**542**	**$1.22**	**577**	**$1.24**	**585**	**$1.19**
Total Milk	**1,082**	**$1.65**	**1,119**	**$1.71**	**1,161**	**$1.65**

Source: Synovate Aztec

Appendix 2: The UK Drinking Milk Market – A case study

The UK dairy industry is dominated by the drinking milk market, which accounted for 53 percent of milk produced in 2009/10.



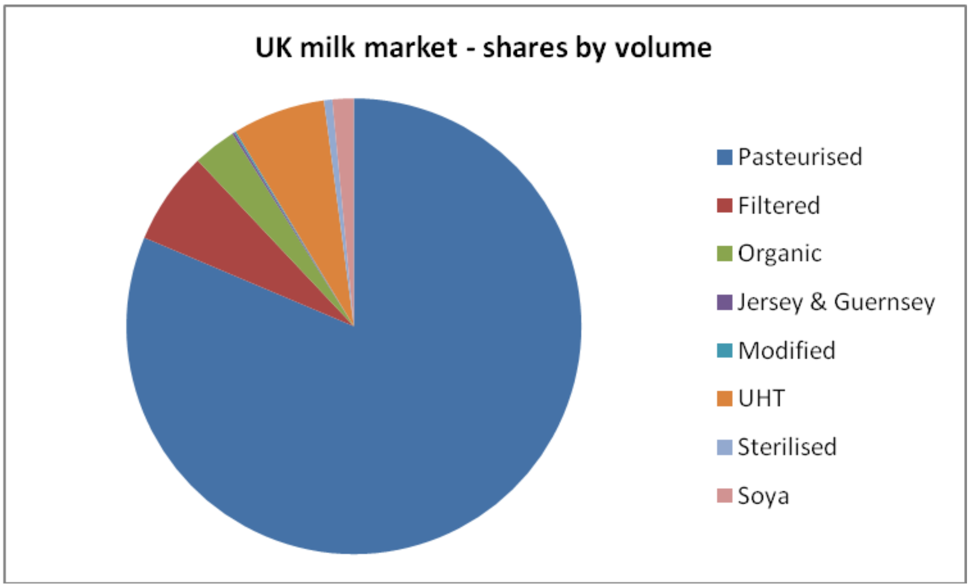
The UK market grocery sector is less concentrated than the Australian supermarket sector. Nevertheless it is estimated that the "big four" – Tesco, Sainsbury's Asda and Morrisons – account for 75.6 percent of the total grocery market.

- A 2008 study by Oxford University estimated the big four accounted for 70 percent of the milk market in the UK. In turn private label (or retailer brand) products account for around 71 percent of total milk sales. UK retailer brands have been highly successful due to the strength of the parent brand.

- In response, processors have struggled to develop viable differentiated brands in this market. The effect of this private label dominance has been to stifle innovation, as evidenced by the lack of product differentiation in the UK milk market. The Oxford Study noted the shift in dominance in the dairy industry supply chain from processors to retailers, with only a small percentage of the supply chain profits attainable for farmers and processors.

- A 2010 study by DairyCo on dairy supply chain margins noted the absence of any decline in retail prices for milk at a time of falling commodity and farmgate prices, **concluding that processors and farmers absorbed the full impact of the decline in the dairy market.**

- Comparing 2009/10 with 1999/2000 indicated the retail price of milk increased 60 percent compared to a general food price increase of 36 percent. Over the same period the average farmgate price increased 34 percent and the estimated wholesale price increased 31 percent.



Sources:
The Milk Supply Chain Project
Howard Smith and John Thanassoulus, Department of Economics,University of Oxford, January 2008

Dairy Supply Chain Margins 2009/10, DairyCo, October 2010