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John Hawkins
Committee Secretary
Senate Standing Committees on Economics
Parliament House
Canberra ACT 2600

Submission to the Inquiry into the impacts of supermarket price decisions on the dairy industry

Dear Mr Hawkins

Dairy Farmers Milk Co-operative (DFMC) welcomes the opportunity to provide a submission to Economics References Committee as part of its Inquiry into the impact on the dairy supply chain of heavy retail price discounting of drinking milk by Australian supermarkets.

DFMC represents 1,820 farmer members from 780 dairy farms in Queensland, New South Wales, Victoria and South Australia. We believe the decision by Australian supermarkets, led by Coles, to promote their own private label milk products through aggressive price discounts is reckless, short-sighted and damaging to the dairy industry. DFMC's position, which will be outlined in detail in this submission, is as follows:

1. Australia's two major supermarkets, Coles and Woolworths, directly influence milk prices at the farm gate by setting retail and wholesale prices for consumer dairy products. The supermarkets' influence is greatest over dairy farmers, such as DFMC members, who supply the consumer market.
2. Aggressive discounting by the supermarkets is reinforcing the dominance of their own private labels at the expense of Australia's many and diverse branded milk lines and eroding value in the drinking milk category.
3. The Coles milk discounting will lead to lower returns for dairy farmers and processors by changing the composition and reducing the value of their product mix (for example initial industry estimates suggest the cost impact could be around $730 million this year).
4. The Coles' strategy is potentially anti-competitive because they are pushing out other retail channels and there is evidence to suggest Coles are now selling private label milk below cost in some markets.
5. The current retail price point for fresh milk in Australia is not sustainable and supermarkets need to urgently begin rebuilding value in the category. This should be supported by a regulatory framework that includes active monitoring of pricing behaviour and increased transparency in the supply chain, including public reporting of supermarket contract terms and wholesale prices.

1. Supermarkets influence farm gate prices

DFMC members produce more than one billion litres of milk per annum. We have a contract in place to supply more than 95 per cent of our milk to National Foods, which uses it to manufacture their range of products, including branded fresh milk (e.g. Pura and Dairy Farmers), flavoured milk (e.g. Big M), yoghurt (e.g. Yoplait) and cheese (e.g. Coon). National Foods also holds the private label drinking milk contracts with Coles and Woolworths in several states.

Through our relationship with National Foods, DFMC is the largest single supplier to the consumer dairy market in Australia. Our members contribute to most of the milk products sold by

Coles and Woolworths in their private labels as well as to many of Australia's leading milk brands. This means our members are part of a fast moving supply chain producing the 2.26 billion litres of fresh drinking milk (around 25 per cent of national production) consumed by Australians annually.

Coles has argued the global dairy commodity market, not supermarket behaviour, is all that determines farm gate prices in Australia. This is a gross simplification. DFMC members and the hundreds of other Australian dairy farmers who are part of this consumer supply chain are not participants in the global dairy commodity market. Our end customer is the Australian consumer and virtually none of our milk is processed into commodity export products or is used as an input ingredient in another product.

The DFMC supply model in particular links our farmers directly to the consumer market. DFMC farmers have a milk contract model with National Foods aligning on-farm milk production to the supply needs of the consumer market. Farmers are required to nominate contract volumes which obligate them to a flatter year round production system to meet consumer demand for daily availability of fresh drinking milk. This comes at a cost to farmers as we are constrained in our ability to produce more milk in spring and summer (when environmental conditions make production cheaper) or less milk when season conditions are less favourable or input costs rise. This supply model has its own particular costs and benefits to farmers but it undoubtedly exists to supply the consumer market, in particular the drinking milk category.

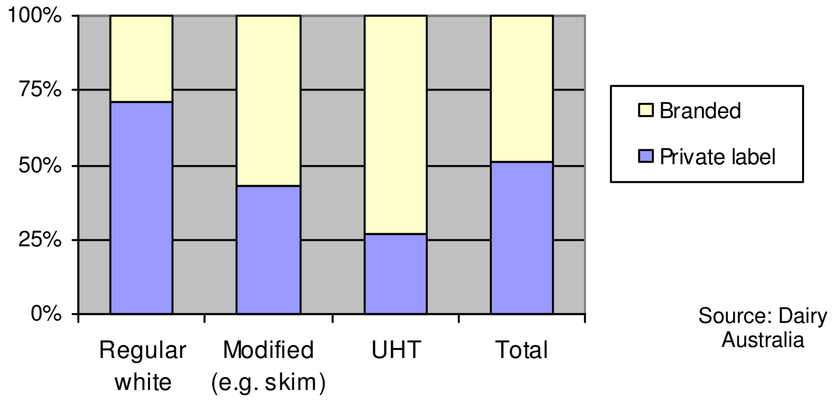
According to Dairy Australia, the supermarket channel accounts for half by volume and more than 60 per cent by wholesale value of the total domestic market for the key dairy categories of drinking milk, cheese, butter and yoghurt.[1] As such, the biggest impact on farm gate returns for the farmers who supply this domestic market is the supermarkets' retail price for dairy products and the wholesale price the supermarkets offer National Foods and the other processors.

The influence of the supermarkets is particularly important in Queensland, New South Wales, Western Australia (WA) and parts of South Australia and Tasmania, where the majority of milk (in Queensland's case 95 per cent) is produced exclusively to supply the consumer market. Indeed, Coles recently acknowledged this fact with its announcement they would increase the wholesale Coles private label contract price by five cents per litre in WA in order to shield local farmers in that state from the impact of their aggressive retail discounting.[2]

2. Discounting is reinforcing dominance of private label milk

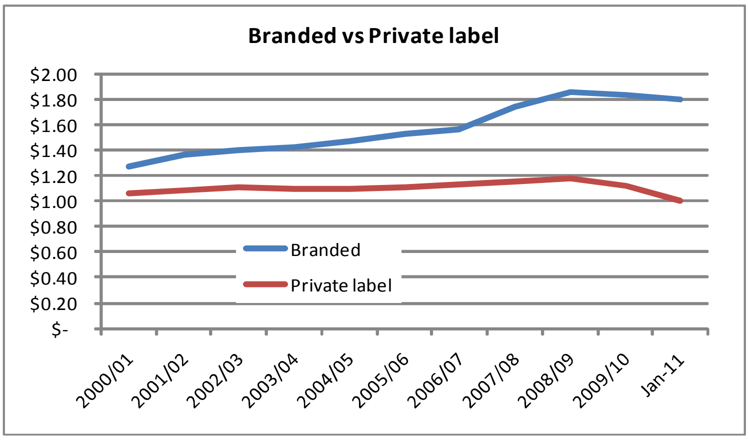
Supermarket private label products (also known as 'house' or 'generic' brands) have been steadily increasing their market share over the past decade. Private label now account for 71 per cent of full cream milk sales in Australian supermarkets and 51 per cent of all milk (i.e. whole, modified, flavoured and long-life milk combined), up from around 25 per cent in the late 1990s.[3]

Market share of grocery milk sales (2009/10)



[1] Dairy Australia, *Dairy 2010 Situation and Outlook*, 2010
[2] Fonterra, the dairy company with the Coles private label contract in WA, ultimately chose not to pass on this increase due to the damage the Coles discounting was doing to overall market returns.
[3] Dairy Australia, *Domestic Sales Summary,* www.dairyaustralia.com.au

This private label market share has been secured and protected through heavy retail price discounting over the past decade. The major supermarkets have not made any sustained investments in product development, research or promotion of dairy consumption in order to market their private labels. Rather, their sales growth has been driven by consistently pricing their product at a significant discount to branded competitors. For example, the current Coles price point of $1.00 per litre for drinking milk is almost half the current retail price of the branded equivalent and is 25 cents per litre less than the average private label price a decade ago.[4]



Source: Dairy Australia

According to Australian Dairy Farmers, prior to the latest Coles led discounting the difference between private label and branded drinking milk averaged between 18-71 cents per litre over the past decade. When this difference is equated across the market share of major supermarket chains the accumulated differential is $414 million in lost revenue to the industry.[5] This estimate is supported by the recent experiences of Australian dairy farmers supplying the consumer market. DFMC members experienced a farm gate price reduction of more than 10 per cent in New South Wales and Victoria and 15 per cent in Queensland this season.

This hit to revenues has come at a time when farmer and processor operating costs have been increasing. For example, the Queensland Dairy Accounting Scheme has found the average farm costs for Queensland dairy farmers have increased by 44 per cent over the past decade.[6] This is in spite of a fall in farm numbers and an increase in farm and herd sizes among the remaining producers, which has improved farmer productivity and efficiency.

Generally, the same processors who produce Australia's major milk brands supply the supermarkets with their private label products. The growth of private labels has meant processors have become dependent on securing the supermarket contracts in order to achieve the volumes required to sustain their overall businesses. Despite the fact private label contracts are often at no or very low margin for the processor, without the private label volumes the processor cannot recover the costs of operating their supply chain (including milk purchasing obligations with farmers), or recovering the sunk costs of their processing facilities. The processor is therefore faced with a serious business problem, a fact that has been a driving force behind recent industry trends including the consolidation of processing companies and downward pressure on farm gate prices.

As part of its Inquiry into retail competition in Australia in 2008, the Australian Competition and Consumer Commission (ACCC) reported processor costs, such as packaging, labour and distribution, were also increasing. The ACCC found increasing costs for the dairy industry were generally reflected in the retail price of branded products but not in private label milk. The ACCC stated: *"The bargaining power of the major supermarket chains means that increases in production costs are not being fully reflected in the wholesale or retail price of private label milk."*[7]

[4] Dairy Australia, *Private label products and the Australian dairy industry*, 2011 and Andrew Jacenko and Don Gunasekera, *ABARE Conference Paper 05:11: Australia's retail food sector*, 2005
[5] Australian Dairy Farmers, *ADF call to arms to Wesfarmers shareholders*, www.australiandairyfarmers.com.au
[6] ibid
[7] ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, 2008

3. Coles' discounts will reduce farmer and processor returns

In January, Coles announced it was cutting the price of its private label milk by as much as 33 per cent and that a two litre bottle of Coles brand milk would now cost $2.00. This announcement, which was supported by a $6 million advertising campaign, was followed by similar discounting of private label milk by the Woolworths, Aldi and Franklins supermarket chains.

Dairy Australia estimate these national price cuts reduced the retail value of private label milk by $74 million per annum.[8] Coles has claimed they will absorb their share of this cost and consequently their retail discounting will not impact farm gate milk prices. This specious and misleading argument ignores the broader impact of the Coles strategy.

Farmer prices in the consumer supply chain are determined by the market returns across a mix of products (e.g. private label fresh milk, branded milk, butter, cheese, etc). This product mix is beyond the control of farmers but it is directly influenced by retailer behaviour. Coles' actions have already begun to change profoundly the drinking milk component of our product mix.

Richard Goyder, Chief Executive of Coles' parent company Wesfarmers, has reported a 15-20 per cent increase in milk sales and a shift to private label since their discounts began last month.[9] Coles' suppliers and competitors confirm the shift away from brands. Fonterra has stated the Coles move has had a "negative financial impact" on its business, while the Amalgamated Milk Vendor's Association is reporting a "slump in demand" and processor Betta Milk has experienced a 10 per cent drop in branded milk sales.[10] There are reports sales of National Foods' Pura brand have fallen by as much as 37 per cent since in February, while Parmalat's sales of the Rev, Physical and Pauls brands have fallen between 20-30 per cent in Coles stores.[11]

The spike in private label sales will increase the amount of low value milk and decrease the higher value branded proportion in the product mix of National Foods and DFMC. Therefore, even if all the supermarkets permanently absorb the full cost of their retail price reductions (which is by no means guaranteed), the discounting will impact prices and market share for branded milk, which in turn with significantly impact farmer returns. The responsibility for this market disruption clearly lies with Coles.

Dairy Australia has undertaken some preliminary analysis on behalf of Australian Dairy Farmers to quantify the broader cost to the industry of the latest supermarket discounting. They estimate if the supermarket discounting leads to a growth in private label sales of 10 per cent, a reduction in branded milk sales through the route trade (e.g. non-supermarket sector) of 10 per cent and a decrease in the branded milk price of 10 per cent in order to compete with private label, the cost to the dairy supply chain would be as much as $730 million across the year, of which Coles and Woolworths have committed to absorb only around $70 million.

Retail value of drinking milk category (million)	
2009/10	$4,266m
Initial price cut to private label products	$4,192m
10% sales shift to private label product	$4,105m
10% shift from route trade to supermarket private label product	$3,968m
10% decrease in branded price to compete with private label	$3,536m
Change from 2009/10 benchmark	**-$730m**
Assumes: no overall consumption increase, cuts to branded prices are made in both supermarket and route outlets and price cut maintained for 12 months	

It is worth noting, Coles' own comments confirm the loss in branded market share at the expense of private label to date has been greater than the assumptions used in Dairy Australia's calculation. This suggests Coles and Wesfarmers are knowingly eroding the value of drinking milk and in so doing are willfully causing damage to the Australian dairy supply chain.

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[8] Dairy Australia, *Private label products and the Australian dairy industry*, 2011
[9] ABC Radio, *Wesfarmers announces healthy profit, defends milk price cuts*, 17 February 2011
[10] Fonterra Australia, *Media Statement*, 23 February 2011; Andrew Marshall, 'NSW dairy voices say Coles milk price to ruin farmers', *The Land*, 22 February 2011; ABC, *Milk price war affects sales*, 15 February 2011
[11] Leslie White, 'Milk brands take a beating', *The Weekly Times*, www.weeklytimesnow.com.au

4. Coles' strategy is potentially anti-competitive

There is evidence to suggest Coles' milk pricing strategy is a misuse of market power and potentially involves predatory pricing and loss leading.

Coles' discounting strategy is radically changing the distribution channels for drinking milk in Australia. Non-supermarket retailers, including milk bars, convenience stores and foodservice distributors, now cannot compete with the supermarkets on price due to the extreme discounting by Coles of their private label milk and are losing market share to the supermarkets.[12] The end result of Coles pushing out these alternate sales channels is the dairy industry is left with fewer paths to market and consumers have less choice in terms of retail outlets for milk. In short, Coles' actions are leading to less retail competition.

This further reinforces the dominant position of the supermarkets in the Australian grocery sector, which is already far more concentrated than in other countries. Australia is the only developed country where two players have close to 80 per cent of the grocery market and the top five largest retailers have more than 95 per cent market share. In the United Kingdom and the United States the top two retailers have a market share of 47 per cent and 20 per cent respectively.[13]

As demonstrated above, for processors the impact of Coles' behaviour will be further growth of private label milk at the expense their brands. The impact of this trend will be particularly acute on lower volume brands and products. The smaller brands, which are often regionally based small businesses, cannot match the wholesale price the large scale processors have extracted from the major processors. For example, Aussie Farmers Direct has stated their milk acquisition costs in south-west Victoria had been in excess of $1 per litre for the past two years.[14] The smaller processors also usually have higher conversion cost and fewer economies of scale in their distribution network. Given the price differential now enforced by the supermarkets between private label and these smaller brands, the differentiation strategies of these smaller brands will be extremely difficult to maintain and their future is under threat.

In relation to retail prices, it has been widely reported that Coles is now making a loss on private label milk due to its aggressive retail price discounting.[15]

In 2008, the ACCC found: *"Broadly speaking, gross margins on higher price private label products (Woolworths milk and You'll love Coles) were generally in the range of 25 per cent to 30 per cent ... and gross margins on lower priced private label products (Coles Smart Buy and Woolworths Homebrand milk) general ranged from 15 per cent to 20 per cent."*[16] Between 2008-2010, average private label milk prices declined by four cents per litre.[17] On top of this, according to their own announcement on 26 January, Coles have cut their retail milk prices by up to 33 per cent to bring it down to $1 per litre. Coles has also stated publicly they have recently increased the wholesale contract prices for their private labels.[18] A decreasing shelf price and increasing wholesale costs suggests Coles is now selling private label milk at a loss.

The likelihood the current retail price for private label milk is below cost for Coles is even greater in geographic areas in Australia where there is no dairy industry (such as the Northern Territory) or where milk acquisition costs are higher (such as northern Queensland). In 2010, the average farm gate milk price in Queensland was around 55 cents per litre, which is the highest in Australia and reflects, among other factors, the higher operating costs associated with dairy farming in sub-tropical conditions. It is difficult to see how collecting, processing and packaging this milk as well as transporting and distributing the consumer product to every supermarket across the state could cost less than 45 cents a litre, which is what would be necessary to ensure Coles is not selling private label milk below cost in Queensland.

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[12] For example, the Australian Association of Convenience Stores Executive Director Sheryle Moon has stated "when families see milk down, and bread down and some of those key sales categories down that they use frequently it does drive traffic away from convenience stores and corner stores".

[13] National Association of Retail Grocers of Australia, *The challenge to feed a growing nation*, 2010

[14] Simone Smith, 'Milk no cash cow, says CEO', *The Weekly Times*, 2 March 2011

[15] For example, one industry source is quoted as forecasting the Coles discounting would lead to business losses of $50 million across the year. Eli Greenblatt and Mark Hawthorne, 'Cut price milk strategy sours as supermarket war turns nasty', *Sydney Morning Herald*, 12 February 2011

[16] ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, 2008

[17] Dairy Australia, *Private label products and the Australian dairy industry*, 2011

[18] Coles Supermarkets, *Coles milk pricing fact sheet*, February 2011

5. Rebuilding value for the dairy industry
Other than Coles, all participants in the dairy supply chain, including Woolworths, believe the current retail price point for fresh drinking milk in Australia is not sustainable. In order to recover from the damage caused by the aggressive private label discounting the dairy industry needs a genuine, long-term commercial solution. That is, we need to begin to rebuild value in the fresh consumer milk category so farmers, processors, wholesalers and retailers operate in a truly competitive environment where each receives a fair return for their product. For consumers we need to protect choice in product range and retail outlets for milk, while achieving an economical price point that supports a fair return for the supply chain and ensures a future for fresh dairy production in Australia.

This solution would require Coles and Wesfarmers to abandon its unconscionable 'Down, down, staying down' marketing campaign. Indeed, if Coles does not increase its retail price soon but then does so in the future it will be a clear demonstration of the predatory, uncompetitive nature of their strategy. As by then Coles will have reinforced the dominance of its private label milk at the expense of competitor brands and competitor retailers and pushed down farm gate returns to such a point that it can make windfall profits at the expense of Australian consumers.

The commercial objective of rebuilding the retail value of milk should be supported by a policy and regulatory framework that ensures a sustainable and genuinely competitive dairy supply chain. Such government intervention is necessary to address the market failure of the current situation where a dominant retailer is using its market power to further strengthen is share of a staple food product and doing so through a promotional campaign that is damaging the businesses of farmers, processors and distributors and destroying alternative retail channels.

In the short-term, the ACCC must implement the recommendations from the Senate Economics References Committee report of May 2010 that it undertake monitoring of the pricing practices within the dairy chain with a view to establishing whether predatory pricing or misuse of market power is occurring and it complete a study of the implications of increasing shares of private label dairy products taking into account the economic viability of farmers and processors. These reviews need to be well resourced, fast-tracked and their terms of reference need to include the latest private label discounting by Coles and its impact on the entire dairy supply chain.

There has been a suggestion the framework contained in the Horticulture Code of Conduct should be applied to the dairy industry. The Horticulture Code of Conduct seeks to formalise commercial arrangements between participants of the horticulture supply chain, however we would suggest these arrangements are already well established and contract-based in the dairy industry. Nonetheless, we strongly support the objective of improving transparency in the dairy supply chain, especially in relation to the commercial dealings between the processors and the retailers.

We would recommend the government require Coles, Woolworths, Aldi and Franklins supermarket chains publish the contract terms and wholesale prices of their private label milk contracts with processors in each state. Such public price reporting would address information asymmetries in the supply chain and would help farmers and consumers understand the value of fresh milk in this country. It would also clearly demonstrate whether the supermarkets where abusing their market power.

DFMC appreciates the opportunity to provide this submission to the Senate Economics References Committee.

Yours sincerely

Ian Zandstra
Chairman