Public submission by Clover Hill Dairies to Senate inquiry into milk price.

Date: 28th February 2011

Email: economics.sen@aph.gov.au

Introduction

It is our submission that dairy farmers in parts of Australia who supply the domestic milk market are adversely affected by the current conduct of some milk processors and large retailers in this instance Lion Nathan National Foods and Coles in as much that as:

- The dairy industry is susceptible to abuses in market power
- There is a lack of competition in some markets
- Natural monopolies exist
- Incomplete markets exist
- A lack of price transparency
- The existence of cartel like behaviour
- Under investment in innovation and new ideas across all sections of the industry, and
- Constraints to productivity growth.

We submit that the foregoing acts are to the detriment of true competition and that this is decidedly at an ultimate cost to consumers but to the benefit major retailers.

Our submission addresses each of these factors and where relevant we suggest possible remedies with the aim to improve competition; improve investment in innovation and capacity across the whole of the Australian dairy industry to the ultimate benefit of all sectors in the supply chain and specifically consumers.

Background

First it is necessary to understand the way in which the domestic dairy industry operates. Rather than a single market the Australian dairy industry has a number of separate and discrete markets. These markets are regionally based and our submission is specific to the market in which our regional farmers operate in:

- Central NSW – incorporating Sydney, Newcastle, Wollongong, the Central West and NSW South Coast

In terms of our submission on aspects of the domestic market for dairy products we are concerned about the conduct of the processor namely Lion Nathan National Foods (LNNF). This processor has very little manufacturing capacity, little presence in export markets and supplies the bulk of private label milk to Coles and Woolworths in NSW.

Central NSW – incorporating Sydney, Newcastle, Wollongong and the Central West and South Coast of NSW

This is the largest domestic market in Australia. The major processor in this market is LNNF. Our regional dairy farmers operating in this market supply LNNF via the Dairy Farmers Milk Supply Cooperative (DFMC). The two dominant retailers are Coles and Woolworths.

DFMC are under contract to supply of all of their suppliers milk to LNNF

The current practice is for LNNF to announce what is known as an Anticipated Full Demand (AFD) to DFMC.

For DFMC to meet their obligations under the AFD system our regional dairy farmers are allocated milk allotments akin to quota and sell this milk to DFMC at an announced price. This milk price is known as Tier 1 milk. Farmer suppliers who produce above their allotment or do not hold an allotment receive a lower price which is currently close to 50% of the price of Tier 1 allotment milk. This milk is known as Tier 2 milk. This system forces our regional farmers to have a flat milk supply curve with the extra costs this incurs, has little transparency, acts a restraint to trade, encourages rent seeking and serves to drive costs up. This is a carryover of regulation and serves to diminish competition with resultant supply chain ramifications.

A secondary processor to processor milk markets occurs for Tier 2 milk. There is no transparency at farmer level as to what Tier 2 milk is being sold to other processors for.

General

National dairy production is 9.2 billion litres, of this 2 billion litres is consumed as drinking milk, the rest is manufactured into other milk products, being cheese, powders, yogurts, ice cream and other products. Domestic consumption accounts for 48 percent of total production and exports 52 percent. Consequently overseas commodity prices are always a significant factor in domestic pricing as are exchange rates.

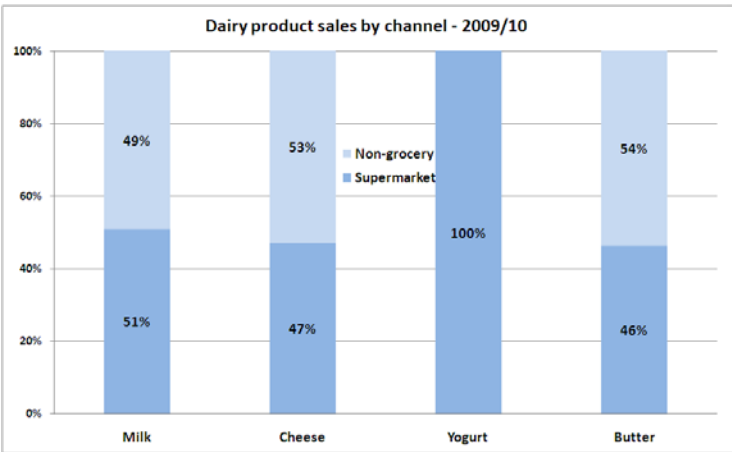
Our regional dairy farmers supply milk into the domestic liquid milk market in Sydney and at is believed over 80% of this milk goes into private label

The following information supplied by Dairy Australia is particularly relevant to the market in which our regional farmers operate.

The influence of supermarkets

Dairy Australia estimates that the supermarket channel accounts for 49% by volume [milk equivalents] and 61% by wholesale value of the total domestic market for the key categories of milk, cheese, dairy spreads and yoghurt.

The proportion of sales made through each channel (grocery versus non-grocery) indicates the importance of the supermarket channel for the industry.



The rise of private labels

Private labels – or retailer brands – continue to make gains in the Australian market with the value share of total packaged groceries up to 24% in the last quarter of 2010. [Volume shares cannot be calculated across all grocery categories.] Household penetration has now reached 100% - i.e. everyone buys some private label products [according to Nielsen Homescan research of late-2010].

Consumer perceptions of private label products have changed significantly over the last five years, with many consumers now seeing the benefits they offer in terms of value-for-money and as a good quality alternative to name brands. These perceptions were reinforced during the recent economic uncertainty when consumers' behaviour changed and most said that they would continue to purchase private label products even when the economy improved.

Private labels tend to gain significant share in what are termed 'low involvement' product categories – or those where the product offerings are very similar across the range on the market and the consumer decision-making process is relatively straightforward.

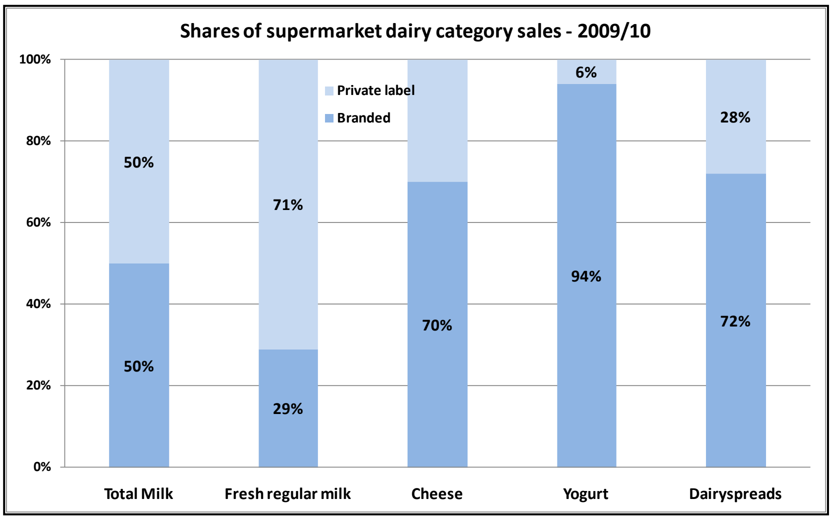
The following table provides the level of private label [volume] penetration across a range of supermarket grocery categories.

Category	Volume share	Category	Volume share	Category	Volume share
Bread	42%	Dairy blends	3%	Nuts	59%
B/fast cereals	13%	Dog food - dry	30%	Pasta – dry	23%
Butter	31%	Eggs	52%	Rice	16%
Cheese	30%	Honey	29%	Sugar	65%
Cordials	19%	Milk	50%	Water – mineral	35%

Private label products generally provide lower margins to both the retailers and manufacturer, but offer greater control of the supply chain, and reinforcing loyalty to the retailer rather than manufacturer brand. Increasingly the use of private label products has seen supermarkets reducing the shelf space available to branded products, narrowing the range of branded suppliers within each category and driving consumers toward private label products. This in turn increases competition amongst manufacturers for the private label contracts, in order to access this important channel to producers, often driving down wholesale prices.

The influence of private label on the dairy category

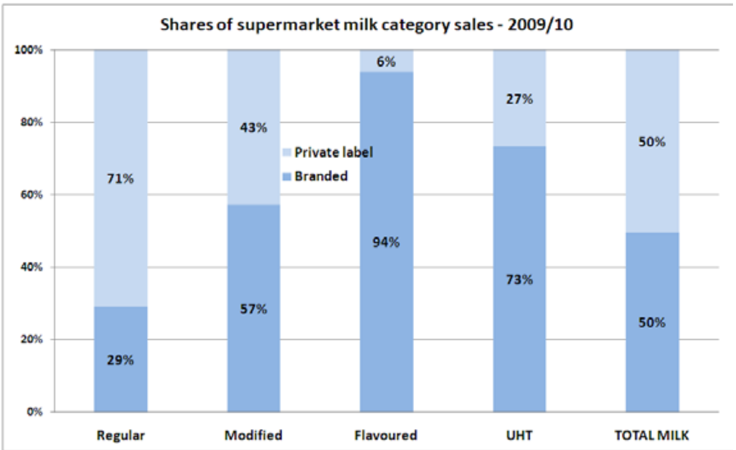
In comparison to other grocery sectors, the dairy – and more particularly the milk – category features a high proportion of private label products. While changes in scan data suppliers make a long term comparison difficult, Dairy Australia's analysis indicates the share of private label in the fresh milk category has increased from 43% in 2000/01 to 50% in 2009/10. Penetration in fresh regular white milk is the highest of all product categories increasing from 59% in 2000/01



to 71% in 2009/10.

Other dairy categories have lower penetration of private label products - currently 30% in cheese, 28% in dairy spreads and just 6% in the yogurt category.

Within the milk category, the level of penetration also varies significantly between segments. The modified and flavoured milk categories have allowed processors to differentiate products based on fat content and added nutrients. UHT is already a relatively low price category with frequent promotional activity.



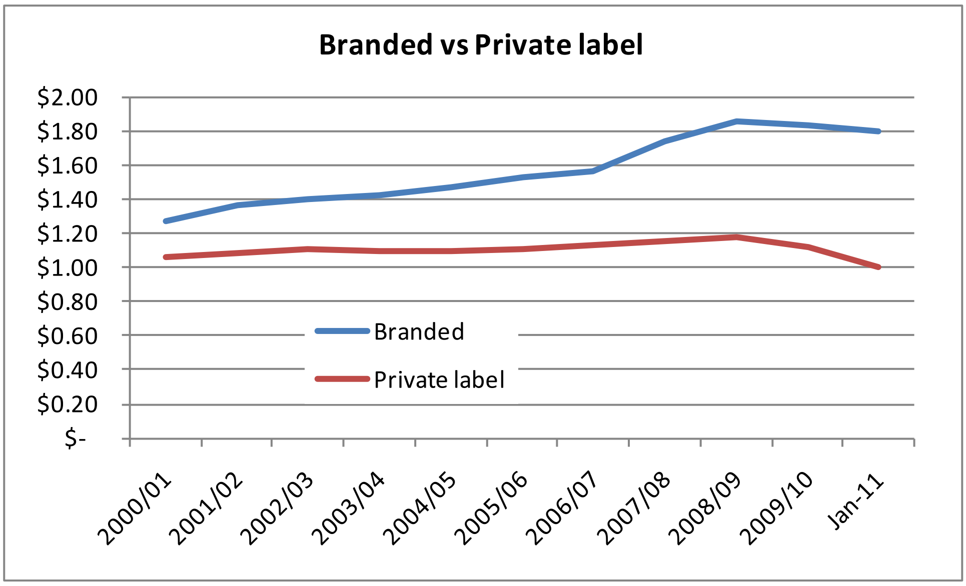
The following table shows actual volumes across the various segments of the milk category split by branded and private – together with average supermarket retail prices in dollars per litre – over the past three years. The fall in retail prices in 2009/10 from the previous year reflected the removal of the dairy structural adjustment levy in mid-to-late February 2009. This was a levy of 11 cents per litre imposed on consumers for nearly nine years to pay dairy farmers to assist in their adjustment to the final step in the deregulation of the dairy industry back in July 2000.

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

Over the past 10 years the retail price gap between branded and private label prices as widened, as their increased share has prompted processors to try and claw back margin through branded products.



This has proved a challenge for processors as regular white milk is difficult to differentiate. Processors have turned their attention to the modified fat categories, where new product developments have provided different fat and taste profiles, added nutrients and functionality for consumers. Processors have been able to capture the benefits of this innovation in greater margins for their branded product, which in turn has supported category development.

Unfortunately this latest round of retailer price cuts are greatest for this growing modified milks segment, and will test the loyalty of consumers to their preferred brands. The potential dominance of private label in this segment would significantly limit the ability or willingness of processors to invest in new product development, given their inability to capture the benefits in a higher margin branded products.

The outcome for the category could be similar to the UK milk market, where the dominance and periodic price cutting of the retailer private label branded product has stifled innovation and new product development.

Potential impact of private label price cuts on the dairy category – some scenarios

While the price cuts to private label announced by Coles are ostensibly being absorbed by the retailer, if they are maintained they can be expected to flow on to other branded products and channels and ultimately consumers as is already being noted at Coles petrol bowsers. This is of major concern for the dairy industry given the value of this flagship category, and its influence on the regions that are servicing the market.

The move by Coles is aimed at changing consumer behaviour and increasing market share, the table a below outlines a possible scenario for the drinking milk category, as consumers shift to private label. This is a static analysis for indicative purposes only, note the assumptions that have been made, which are detailed below. The total changes quoted in the table assume that all these impact occur, and there is no subsequent response from consumers in terms of their buying behaviour.

	Retail value of drinking milk category ($mill)		
	Supermarket	**Route***	**Total**
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% shift to private label product with no overall consumption increase*	$1,742	$2,350	$4,105
10% shift from route trade to supermarket private label product	$1,853	$2,115	$3,968
10% decrease in branded price to compete with lower private label products	$1,632	$1,904	$3,536
Change from 2009/10 benchmark*	-$284	-$446	-$730

**Assumptions:* route retail price is equivalent 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 for 12 months*

As illustrated in this scenario, while the initial cuts estimated at $74 million are supposedly absorbed by the supermarkets, the flow on effects could be significantly higher, dependent on the degree of consumer shifts, and the adjustments made to branded prices.

The reduction in branded product prices at retail will necessarily flow through to wholesale prices and processor profitability, as will any shift to lower margin private label products resulting from this cut. The table below outlines some possible scenarios for processor margins depending on the magnitude of both the shift to private label and/or the reduction in branded price required to address loss of market share. It should be noted these are indicative margin impacts only, and no allowances are made for any change in servicing and distribution costs processors have as a result of a shift toward supermarket private label products.

	Change in processor margin (cent per litre)	
	10%	**20%**
Shift to private label by	1.07	2.14
Branded price cut by 10%	4.84	4.29
Aggregate impact of shift	5.91	6.43

Assumptions: Difference in margin is estimated at approximately 40 cents per litre between private label and branded products, difference in revenue is calculated on a per litre basis across all milk supplied for drinking purposes, this analysis does not make any allowance for differences in processor business costs for different products or channels – information is not available

Impact of retail drinking milk prices on farmgate price

While the international market is the most important price driver for farmers in southern regions, there is a disconnect in regions such as Central NSW – incorporating Sydney, Newcastle, Wollongong and the Central West and South Coast of NSW, Queensland and Western Australia. Of major concern for NSW suppliers to LNNF into Sydney, LNNF manufacturing capacity is virtually non-existent, with milk production utilised primarily for drinking milk. Drinking milk is not extensively internationally traded – being a perishable product composed mostly of water. Therefore, farmgate price drivers in those regions that are primarily exposed to the drinking milk market mostly reflect the balance between local demand for drinking milk and security of supply.

In the absence of any manufacturing infrastructure, milk production in the region has had to be closely matched with daily fresh demand in recent years. 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 it would be hard to argue that farmgate prices in Queensland, parts of New South Wales and Western Australia aren't significantly influenced by retail prices for drinking milk.

ABARE farm survey information suggests that profitability for dairy farmers in some of the regions exposed to the drinking milk market has ranged between -13 cents to 25 cents per litre over the past two years. For many farmers in these regions who supply milk processors the passing through of these margin losses by processors would eliminate their profits altogether. In the most exposed regions of southern Queensland and New South Wales a 10% shift toward private label alone would halve farmers' 2009/10 profits should the processor be forced to pass the impact on to farmers. Average farm incomes for the region are expected to be drastically reduced in 2010/11 due to lower average farmgate price, as well as the impact of floods on many farmers.

	Dairy farm income and profitability (cents per litre)			
	Income		**Profit**	
	2008/09	**2009/10**	**2008/09**	**2009/10**
SE Qld Nth NSW	14.56	13.39	6.45	2.25
Nth Vic & Riv	2.37	-3.25	-9.50	-13.06
Western Australia	35.00	33.49	25.32	15.41
Source: *Australian Dairy Financial performance of Australian dairy farms, 2007-08 to 2009-10, ABARE Nov 2010*				

Summary

- Private label products have increased their influence over the Australian dairy category – and in particular the fresh white milk category over the past decade. While offering lower prices to consumers, private label products and their dominance are reducing the ability and willingness of processors to invest and innovate in this important fresh food category.

- A number of scenarios are possible as a result of the latest round of private label price cuts. While it is difficult to forecast what the impact of these changes will be, and how they will flow through the supply chain and ultimately to farmgate prices, our analysis suggests that processor profitability will be reduced by a relatively small shift to private label products by approximately 1 cent per litre. Any subsequent reduction in branded prices in order to maintain market share could reduce profitability by up to 6 cents per litre.

- Should processors pass on even a proportion of this fall in profitability the viability of farmers in these regions will be seriously compromised as profits are all but wiped out.

(Source Dairy Australia February 2011)

Further to above information from Dairy Australia we contend there is a lack of competition in some markets

As described earlier the least competitive markets in Australia are those based around the capital cities of Brisbane and Sydney. This is due to a combination of circumstances, being:

- ♦ The exercise of market power by major retailers
- ♦ Cartel type behaviour
- ♦ Inadequate price signals, and
- ♦ Diminished farm-gate competition for supplies.

These issues are addressed below.

Natural monopolies occur

We have dealt earlier with the existence of natural monopolies and they are by essence caused though isolation and distance and comparatively small population and consequent demand.

In the region in which our farmers operate they are forced to supply LNNF through DFMC even though Bega Cheese collect milk from dairy farms 15 kilometres away and Parmalat process milk in Sydney which is only 90 minutes away.

Incomplete markets exist

The contracts that LNNF impose on DFMC for their suppliers are short term either being one or two years and often have onerous conditions attached to them.

Domestic processors in order to coordinate their activities and to share their risks are prone to undertake opportunistic behaviour and thus to trade sequentially and thereby make only limited contractual commitments into the future with their suppliers.

Frequently this is forced by their short term view of markets and the consequent imperfections in predictions and their knowledge of other factors impacting upon the market prone to undertake opportunistic behaviour and to trade sequentially and make only limited contractual commitments into the future with their suppliers. This is stifling on farm employment and expansion. Equally concerning this is leading to producers refraining from investing in new ideas and innovations and hence capturing productivity gains.

Suggested remedy:

Monitor contracts as to:

- ♦ Terms and conditions
- ♦ The removal of onerous conditions

- ♦ Each processor must file with ACCC an approved version and only use that contract,
- ♦ The open publication of prices in standard cents per litre format.
- ♦ Allow for tradable contracts by time and volume.
- ♦ Allow dual contracts for both farmers and DFMC to trade their uncontracted milk (Tier 2 milk) on the spot milk market.

A lack of price transparency

LNNF through their contract terms and conditions require absolute secrecy from their direct LNNF suppliers and include sanctions in their contracts for disclosure even after the contract supply conditions have been met.

They also go to considerable lengths to not disclose prices as they misuse the term commercial-in-confidence. This leads to price asymmetry and consequent upon this under investment in innovation and expansion of productive capacity.

<u>Suggested remedies:</u>

- Monitoring, collection and publication by Dairy Australia on a seasonal basis of all price agreements and price ranges offered by processors by region
- Publication of retail sales of milk and dairy products by volume and price.
- Arrangements involving synergies and economies of scope along with competitive tendering by carriers for coordinated milk collection and delivery will save up to 3-4¢ per litre by synergies and competitive tendering by carriers for milk collection and delivery. These efficiency gains distributed along the supply chain will flow through and benefit consumers.

The industry is in part susceptible to abuses in market power

The purchasing practices of Coles in particular markets equate to running a Dutch auction. This has the effect of putting price pressure back along the supply chain and frequently this is reflected in depressed farm gate prices. Processors as evidenced by recent events are seeing the store brand sell for significantly less than their branded products.

Similarly some companies most notably LNNF choose not to compete for farm gate supplies and are largely operators on secondary milk markets both as buyers and sellers and believe they can sell non contracted cheaper milk (Tier 2 milk) to other processors.

<u>Suggested remedies:</u>

- ♦ Introduce truth-in-labelling regulations to disclose processor identity as to who packaged a product. This will make consumers aware of price and quality and provide for them a comparison and awareness of true brand identity. A consequence of this could be to move the prices of store brands and processor brands closer together and then in turn lead to some product differentiation. It should also require the disclosure of additives such as permeate.
- ♦ Retailers should bid by tender for products rather then rely upon undisclosed supply arrangements. In this way firms acting in the market will know if they have lost the opportunity of bidding fairly and squarely.
- ♦ The cartel like behaviour of Coles should be made to open up to true brand competition by stocking a diverse array of products for consumer benefit. At present LNNF has an exclusive supply arrangement with Coles in NSW. This arrangement leads to Coles stocking minimal product from other milk processors. Such arrangements are uncompetitive; opening up the shelves will give consumers wider choice and often price advantage.

- Open tendering will reduce cartel type conduct. It will increase competition at the farm gate for milk supplies.

The existence of cartel behaviour

Earlier we have referred to cartel type behaviour. This exists in particular in the Sydney markets. We refer to processor-to-processor agreements that serve to reduce farm-gate competition. Additionally, there are informal agreements between processors that they will not poach each other's suppliers.

Onerous conditions are often placed in contracts making it difficult and punitive for suppliers to change processor.

Suggested remedy:

- Producers should be able to have tradable and dual supply contracts and thereby trade their contracts between processors either in long or short-term tranches of milk volumes.

Under investment in innovation and new ideas across all sections of the industry

The dairy industry since deregulation has been beset by a number of problems. Mainly low export prices; natural disasters; lack of water; high input costs especially in respect fuel, fertiliser and grain prices. It is acknowledged that some of these input costs are externalities in the sense that fuel and some fertilisers are linked to international oil prices and price inflation. The same too applies to the relative competition that the production of bio-fuels has on international grain markets which in turn have in Australia's instance been exacerbated by natural disaster caused shortages.

The price pressures and lack of price transparency have been significant in preventing market-based adjustments to farm gate prices. This has led to under investment in innovation and the adoption of new ideas and improved production praxis. This has also affected the processing sector leading to higher costs and inefficient production. Freeing up competition in the domestic market will encourage greater investment in capacity and the delivery of better and improved products to the consumer.

Suggested remedy

- Open up domestic markets to further competition and greater price and transactional transparency.

Constraints to productivity growth

As has been demonstrated in the foregoing we submit that there is a considerable amount that can be done to improve the competitive behaviour for firms in the market. Truly free and open markets with properly conveyed price signals along the supply chain will greatly improve investment in the whole dairy industry with resultant benefits for all. This will lead to greater confidence, more equitable returns and thus investment in the inputs required for productivity growth. As present arrangements stand they are acting as a major impediment to productivity growth.

Evidence that LNNF is already responding to Coles and Woolworth's milk price war to the detriment of our regional farmers can be seen in this extract from a recent DFMC Chairman communication to our local milk suppliers on DFMC contract negotiations with LNNF

"As per our Milk Supply Agreement, the DFMC Board has been actively pursuing negotiations with National Foods regarding the regional Anticipated Full Demand (AFD) for the upcoming 2011/12 season. To date, these negotiations have proved very challenging. While our relationship with National Foods remains an open one based on mutual respect, National Foods have been adopting a hardline stance on a number of critically important issues.

We cannot accept their current offer in relation to anticipated demand for milk from our members given the impact this will have on members' revenue.

As many members would know, the timeline in the Milk Supply Agreement is that National Foods and DFMC should agree to AFD terms by the 31 December each year. However, with National Foods unwilling to move sufficiently on our key issues, no agreement has been reached and we have invoked the Disputes Resolution process within the Milk Supply Agreement.

The Board recognises many members are looking for some certainty of the supply terms for the upcoming season and we have not taken the decision to invoke the dispute resolution process lightly."

Ramifications for the Kiama Local Government area as a result of a collapse of the regional dairy industry.

Kiama is the birthplace of the Australian dairy industry and we are proud to say our dairy farmers still contribute over 90% of the agricultural dollar to our regional economy. This is despite our dairy farmers having the enormous challenge of dealing with the influx of rural lifestylers. Over 80% of our prime agricultural land is now owned by rural lifestylers who have priced our farmers out of the land market with no land being bought for commercial agriculture in the past 25 years.

Tourism and retail drive our local economy and we rely on our dairy farmers to facilitate this as our farmers maintain our beautiful landscape and the rural amenity which our tourists so value.

Dairy farmers also play a pivotal role in our regional economy through their contribution to the retail sector.

Dairy farms are traditionally high turnover and high input businesses. For example a dairy farm business with a turnover of 2.5 million dollars will return more that 85% of this back into the economy

Typically

- Grain merchant $240,000
- Feed by-products $760,000
- Seed and fertiliser merchant $180,000
- Diesel $24,000
- Veterinarian $50,000

A dairy of this size will also employ 10 local people on farm and up to 10 local contractors.

As a testament to our farmers best practice management skills and our region's high quality soils and rain fed pastures, dairy farms in our region deliver world standard best practice environmental outcomes

For example regional farms have achieved:

- 2x industry average cows grazed per hectare
- 5x industry average litres of milk produced per hectare
- 10x industry average water use efficiency per hectare
- Australia's most water efficient milk production systems producing 35x the industry average of litres of milk per megalitre of water used.
- 30% reduction in greenhouse gas emissions per litre of milk produced

On top of this our regional proximity to market (only 90 minutes from the Sydney CBD) ensure a minimal transport footprint and the ability to supply high quality fresh milk to Sydney consumers

Conclusion:

A longstanding challenge to dairy farmer returns has been the growth of house brands of fresh milk in the major supermarkets. This generic and retailer brand milk has grown to the point that now at least half of all fresh milk purchased in Australia in supermarket house brands.

Recently, the decision by Coles to further discount their generic and house brands of fresh white milk has garnered a lot of attention. Coles is now selling all retailer brand milk at $1 per litre and Woolworths and Aldi have followed suit. This means milk is now cheaper than water and soft drinks in our supermarkets.

Our community is very concerned Coles' strategy of promoting house milk brand through aggressive price discounting will have a profound negative impact on the Australian drinking milk supply chain and on farmers in particular.

We have been supporting the dairy industry efforts to highlight the risks associated with the aggressive pricing strategies of Australian supermarkets. We support the statements by Australian Dairy Farmers that selling fresh milk at these prices is not sustainable and undervalues the nutritious product that we all put so much effort into producing.

This is a serious long-term challenge to our regional dairy industry, our farmers and our community fabric and we call on the Senate committee to pursue all the avenues available to them to counter this move by the supermarkets and to ensure they honour their commitment not to pass their aggressive discounting back down the supply chain to farmers.

We agree with DFMC's position that such margin and value considerations between retailer and processor must be sorted out by that part of the supply chain through commercial negotiation and farmers should not pay the price. Farmer margins and viability must not be further eroded by manoeuvrings between the retailers and processors.

We thank you for considering our submission and we look forward to a socially, economically and environmentally positive outcome for our farmers and our community

Submitted by: Lynne Strong on behalf of Clover Hill Dairies

Email: lynnestrong@cloverhilldairies.com.au

Phone: 02 42 360 309