Australian Dairy Farmers

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2 September 2011

Senator Alan Eggleston
Chairman
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Senator Eggleston,

Re: Inquiry into the impacts of supermarket price decisions on the dairy industry

Thank you for the opportunity to provide a further submission to the Senate Economic References Committee's Inquiry into the impacts of supermarket price decisions on the dairy industry.

ADF appreciates the ongoing interest, commitment and hard work of the Committee on this important matter.

In the attached submission ADF has provided examples of the impact of renegotiated contracts on farmers and farmgate prices. It is the unfortunate reality that milk priced at $1 per litre is simply unsustainable for all involved in the fresh milk value chain and dairy farmers and their families are already paying the price for Coles' marketing tactic.

This impact will only get worse in the future as the major retailers try to recoup their costs.

If this situation continues it will lead to ongoing losses to dairy farmers and other businesses in the supply chain and ultimately to less choice and higher prices for consumers, as has been the experience in the United Kingdom.

As such ADF encourages the Committee to adopt ADF's recommendations as presented to the Inquiry.

Yours sincerely,

Chris Griffin
President

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Additional submission to the

Senate Economics References Committee

Inquiry into

The impacts of supermarket price decisions

on the Dairy Industry

Friday 2 September 2011

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Executive summary

Australian dairy farmers are among the most efficient in the world. They supply a unique perishable product, fresh drinking milk, that is an everyday staple of our society.

On 26 January 2011 Coles dropped the price of its home brand milk to $1 per litre. This price is unsustainable.

The considerable amount of work, investment, planning and risk required to produce, transport, process, distribute and deliver a perishable product, fresh milk, on a daily basis is not reflected in the current discount price of milk by major retailers at $1 per litre.

If left unchecked, Coles' actions will lead to a substantial lessening of competition in the market place, a substantial impact on the viability of branded dairy products, less product variety on supermarket shelves, less choice for its customers and in the long term, higher prices for consumers.

The supermarket duopoly in Australia benefits from unprecedented market share and market power. The unique nature of milk provides retailers with an effective means to grow their market share and power, however the consequences for the sustainability of the domestic fresh milk supply chain is significant.

Coles has continually tried to claim that farmers are not being impacted by the pricing of milk at an unsustainable $1 per litre. This is simply not true. Dairy farmers in the key drinking milk markets are being affected.

In Queensland there are farmers losing thousands of dollars a month due to the increase in sales of home brand milk, which is directly related to Coles' unsustainable price discounting.

The cumulative impact up until the end of July for this group of 185 Queensland dairy farmers has been a collective loss of more than $767,000. If these impacts continue the group could collectively lose more than $1.5 million this year.

Also in Queensland there was a recent small farmgate price increase, for one group of dairy farmers, that does not even cover inflation, let alone increases in costs of production which have been much higher than inflation this year. Given the milk supply situation in Queensland this increase should have been much more substantial, however Coles has reduced the amount of money in the value chain which lowers returns to processors and their ability to pay sustainable prices to dairy farmers.

It has been reported that in the early stages of current negotiations with a major processor, Parmalat, New South Wales farmers are being asked to take a drop in farmgate price of 3-4 cents per litre for new contracts to supply milk to a major supermarket home brand contract won by this processor. This again is directly related to the unsustainable pricing of milk at $1 per litre. There is fundamentally not enough money in the value chain, with supermarkets discounting fresh milk to $1 per litre, to ensure a sustainable return to dairy farming families.

Nationally, it has been conservatively estimated that there is the potential for an annual loss of at least $227 million from the value chain with consequent impacts on farmgate prices.

An analysis of the impact of the $1.00 per litre pricing on the Western Australian dairy industry value chain undertaken for the Western Australian Farmers Federation (WAFF) has estimated that the discounting will take $25.2 million per year out of the Western Australian milk value chain.

This analysis is borne out by the contracted price for dairy farmers in Western Australia contracting with Lion (formerly National Foods) dropping from 42.04 cents per litre for 2010/11 to 41.00 cents per litre for 2011/12.

The dairy industry is now seeing the impacts of Coles' actions in pricing milk unsustainably flowing through to those at the start of the supply chain, dairy farmers.

Given the sheer size of the supermarket duopoly and the disproportionate power they wield in the Australian market place the majority of Australian suppliers (particularly of fresh food produce and drinking milk) must have some sort of ongoing commercial relationship with them.

Therefore it is important there is full transparency along the supply chain and that suppliers and farmers have access to timely and cost effective dispute resolution processes in their dealings with major supermarkets.

That is why ADF is recommending the establishment of a:

- Supermarket Drinking Milk Commissioner or Ombudsman; and
- Mandatory Supermarket Industry Code of Conduct.

Further detail is provided on each of the above recommendations in this submission. It is important to note that there is a need for any new code of conduct to have a referee to enforce and police the rules. This is particularly the case when the discrepancies in market power are as extreme as that seen between the major supermarkets, with almost 80% of the market, and the vast majority of their suppliers.

A lack of complaints against the major retailers does not mean there is an absence of market failure but instead represents evidence of significant market failure as smaller suppliers are extremely reluctant to take action or give evidence.

The United Kingdom has already experienced this sort of discounting and the ensuing impacts on farmers and processors. This led them to develop measures to bring about more fairness and transparency in the market.

ADF believes these measures, particularly the UK Groceries Supply Code of Practice (the Groceries Code) provide a good starting point for the basis of Australian legislation establishing a mandatory code of practice and an ombudsman or commissioner.

In addition to the above ADF believes long-term monitoring of farmgate prices is needed, particularly in the key drinking milk markets of Queensland, northern NSW and Western Australia to prevent Coles taking even more value out of future contracts with processors.

ADF recommends that the Senate Economics References Committee examines farmgate prices in the key drinking milk markets annually for the next five years to gain a complete picture of Coles' unsustainable discounting and its impact on dairy farming families.

ADF also recommends that the Committee urge the Government to direct the Australian Competition and Consumer Commission (ACCC) to use its price monitoring powers under section 95ZF of the Competition and Consumer Act 2010 to monitor prices, costs and profits relating to the supply of drinking milk. The Government must ensure that this price monitoring is carried out to the price at checkout, including all possible expenses and variables, and the resulting report by the ACCC must be made public to ensure full transparency.

Summary of recommendations

ADF offers the following recommendations to address the current unsustainable price cuts by Coles as summarised below.

Recommendation 1	**That the relevant Federal Minister give direction to the ACCC to:** • use its price monitoring powers under section 95ZF of the Competition and Consumer Act 2010 to monitor prices, costs and profits relating to the supply of drinking milk.
Recommendations 2-4	**That amendments to the Competition and Consumer Act 2010 (the Act) are made as follows:** • a definition of unconscionable conduct be inserted into the Act; • an 'effects' test be reintroduced; and • a statutory duty of good faith be enacted as part of the Act.
Recommendation 5-6	• that the United Kingdom Groceries Supply Code of Practice be examined with a view to implementing a similar mandatory code of conduct in Australia that would suit Australia's more concentrated market and conditions; and • that a Supermarket Commissioner or Ombudsman be established to enforce the new code of conduct.
Recommendation 7	• That the Senate Economics References Committee examines farmgate prices in the key drinking milk markets annually for the next five years to gain a complete picture of Coles' unsustainable discounting and its impact on dairy farming families.

Impact on farmgate prices

The impact of Coles' unsustainable pricing of milk started to flow through to dairy farmers and their families very soon after the price was dropped at the end of January 2011. It is incorrect for Coles' to claim that farmers are not being impacted by the pricing of milk at an unsustainable $1 per litre.

Approximately 55% of Australia's milk production (drinking milk and manufactured products) is consumed domestically.

In Queensland (95%), Western Australia (70%) and New South Wales (66%) the vast majority of milk production is used for drinking milk. In these states retail sales of drinking milk are the key regional market and farm gate price driver (see table on page 17).

Dairy farmers, particularly in the key drinking milk markets of Queensland, northern NSW and Western Australia, are affected and the impact is being felt now.

<u>Queensland</u>

The most immediate impact was felt by Queensland dairy farmers and their families whose milk payments are linked to branded milk sales under the Pauls Daily Access Scheme (PDA). This group of 185 farmers saw their milk cheques drop in February, the month after the discounting began. Since then they have seen their milk cheques drop by thousands of dollars per farming family.

As Coles takes market share away from branded milk sales these farmers milk cheques go down. This is a direct result of Coles unsustainable discounting of home brand products.

The cumulative impact up until the end of July for this group of 185 Queensland dairy farmers has been a collective loss of more than $767,000. If these impacts continue the group could collectively lose more than $1.5 million this year.

Further information on this issue is provided under the section *Impact on Queensland Farmers* and in the Queensland Dairyfarmers' Organisation submission to the inquiry.

In Queensland, the only farmgate price increase announced since the discounting began did not even cover inflation for tier one milk (fresh drinking milk), let alone increased costs of production, which have been much higher than inflation this year.

Given the limited supply situation in Queensland the increase in the tier one drinking milk should have been more substantial but the unfortunate fact is that Coles has significantly reduced the amount of money in the value chain.

The table below compares the 2011/12 price announced in the week ending 29 July 2011 by Lion (formerly National Foods) with the 2010/11 price.

It is worth noting the annual inflation rate in Australia to June 2011 was 3.6 percent.

Lion		2011	2010	% increase
Queensland	Tableland			
	Tier 1	48 cents	47 cents	2.1%
	Tier 2*	33 cents	33 cents	0%
	South-East Qld			
	Tier 1	47.5 cents	47 cents	1.05%
	Tier 2*	35 cents	28 cents	25.0%

*Tier 2 milk is used for manufacturing dairy products and has increased in price in Southern Queensland reflecting higher demand in the market place. This situation should be reflected for the price of fresh drinking milk which Queensland has been short of supply since January – but it is not, due to the unsustainable $1 per litre price.

It is important to note this announcement follows major cuts to farmgate prices by Lion last year by some 15% for one group of Queensland dairy farmers and by more than 20% for another smaller group of Queensland dairy farmers.

Analysis of ABARE Farm Survey data indicates that average Queensland farm income per litre over the past 10 years has been 10 cents per litre, while farm business profits have been negligible on average, largely reflecting severe drought conditions and suppressed farm gate prices for much of the last decade.

While conditions have improved, 2009/10 farm income was less than 5 cents per litre, and 2010/11 is likely to be significantly lower for the state's flood and cyclone-affected farmers.

The impact of the Coles' unsustainable milk pricing, particularly in a market where over 95% of milk goes to drinking milk consumption, is significant. This impact is being made even worse as, from January to June, Queensland has had a deficit of 16% in its drinking milk requirements (approximately 40 million litres).

The Queensland drinking milk supply chain was already under the greatest pressure before the advent of supermarket discounting, with retail prices lower than the national average and costs of milk production the highest of all the states.

The value of the Queensland drinking milk market has been heavily eroded by supermarket discounting activities, which have seen a shift toward lower margin private label products. The potential impact of the continuation of these trends on farmgate prices would render many Queensland farmers unprofitable.

<u>New South Wales</u>

ADF understands that in New South Wales farmers are being asked, following initial discussions in the week of 22-26 August, to take a drop in farmgate price of 3-4 cents per litre for new contracts with a major processor, Parmalat. Parmalat recently won the contract to supply Woolworths with home brand milk products.

This issue is directly related to the unsustainable pricing of milk at $1 per litre. At this price there is fundamentally not enough money in the value chain to ensure a sustainable return to dairy farming families.

It should also be noted that this follows a drop of more than 10% in milk prices across the board to farmers in New South Wales last year.

On 1 August 2011 Dairy Farmers Milk Cooperative (DFMC) announced the central NSW region milk prices for 2011/12. The tier one milk price was unchanged from the 2010/11 price of 47 cents per litre. The 2010/11 DFMC price of 47 cents per litre was a decrease of 7% on the previous year's milk price.

Given that there is not an over-supply of fresh drinking milk in NSW it would be logical to assume an increase in the 2011/12 price from the 2010/11 price at least in line with inflation and increased costs of production, particularly given the 7% decrease in price in 2010/11.

ADF believes there is strong evidence to suggest this price is also being impacted by the lack of money in the value chain.

It should also be noted that generally incentive payments add an additional 5 cents per litre to the base price. This occurred in 2010/11 and is likely to be a similar amount in 2011/12.

Analysis of ABARE's Farm Survey data indicates that average NSW farm income per litre over the past 10 years has been 9 cents per litre, while farm business profit has averaged just 1 cent per litre. A 3-4 cents per litre cut in farmgate price would render most NSW farms supplying the drinking milk market unprofitable.

The NSW dairy industry is one of the more exposed to the domestic retail milk market, with almost 70% of the state's production utilised for drinking. The New South Wales drinking milk supply chain was already under pressure before the advent of supermarket discounting, with retail prices lower than the national average and costs of milk production one of the highest of all the states.

The value of the NSW drinking milk market has already been eroded by the supermarket discounting activities, which have seen a shift toward lower margin private label products. The potential impact of the continuation of these trends on farmgate prices would render many NSW farmers unprofitable.

In addition, sales are being lost in the non-supermarket or route trade which is damaging the viability of small businesses that distribute and sell milk.

<u>Western Australia</u>

Nationally, it has been conservatively estimated that there is the potential for an annual loss of at least $227 million from the value chain with consequent impacts on farmgate prices.

An analysis of the impact of the $1.00 per litre pricing on the Western Australian dairy industry value chain undertaken for the Western Australian Farmers Federation (WAFF) has estimated that the discounting will take $25.2 million per year out of the Western Australian milk value chain.

A finding of this report is the claim (by Coles) “that if contract prices are maintained for milk going into the private label (home brand) product, there should be no impact on the farming sector is wrong. Farmers are a component of the total milk value chain, if value is lost in the chain as a result of retail discounting, it is illogical to conclude that any component of the chain, including farmers, is immune from the loss of value in the chain.”

Home brand price reduction	$10.2m per annum
Branded price reduction	$9.4m per annum
Customer switch from branded to home brand	$5.6m per annum
Total	**$25.2m per annum**

This analysis is borne out by the contracted price for dairy farmers in Western Australia contracting with Lion (formerly National Foods) dropping from 42.04 cents per litre over the year for 2010/11 to 41.00 cents per litre for 2011/12.

It is estimated that, had the affected farmers received an increase in the order of 1-2 cents per litre, the minimum that would reasonably be expected it would mean an increase of $20,000 to $40,000 annually for the average farm. Instead there has been a decrease in price of 1 cent per litre which means an effective cost to farmers of approximately $40,000 to $60,000 annually.

Farmers supplying Harvey Fresh saw a small price increase of less than 2%, again less than inflation and increases in the cost of production on 2010/11 prices for2011/12 from approximately 38.7 cents per litre to approximately 39.2 cents per litre.

This means that WA dairy farmers supplying this contract are effectively going backwards when inflation and costs of production are taken into account. The figures quoted above are approximate as it is difficult to be exact due to slight variations in contracts between the years.

Southern states

In the southern states, particularly Victoria and Tasmania, improved milk prices, combined with low grain prices and generally favourable seasonal conditions have provided farmers with the best production conditions for more than a decade. In some regions, the excessively wet conditions have actually curtailed feed production and herd productivity.

While cashflows have generally improved, this has merely enabled many producers to restore their financial positions following the shocks of the previous two seasons.

While the benefit of higher commodity prices for Australian exporters has been constrained by the strong Australian dollar, farmgate prices for southern producers have improved strongly in the 2010/11 season.

This highlights the regional differences in Australia’s dairy industry. The southern states chiefly rely on manufactured product and export markets whereas Western Australia, northern NSW and Queensland on drinking milk markets.

To equate farmgate price increases in the southern states with the drinking milk states is not appropriate as they are only marginally affected by a drop in the price of drinking milk.

It is also important to emphasise that the prices seen in the southern states are based on seasonal milk production and not for milk produced 365 days a year which costs more to produce.

Australian supermarket sales trends

The table below shows supermarket sales trends for the five months to June 2011 against the 2010 year.

It clearly shows the significant impact of Coles' unsustainable home brand milk product pricing on branded milk products.

Processors margins on milk are very small and for private label (home brand) products are virtually zero. Increased sales of home brand products do not translate into increased profits for processors or increased farmgate prices for farmers.

Private label (home brand) fresh modified white milk sales have increased 30%. This is a considerable increase and is taking market share and sales away from branded fresh modified white milk.

Processor margins are generally greatest on modified milk products and this increase in home brand product sales is taking market share away from one of the processors most profitable product lines, further compounding the impact.

If this trend continues the amount of money in the value chain will be significantly reduced with consequent flow-on effects to dairy farmers and the farm gate price. This is explored further in the following page.

If sales of home brand 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 also be severely compromised for the drinking milk category.

Aust supermarket sales trends			
5 months to June	**2010**	**2011**	**% change**
Branded Fresh Full Cream White Milk	60,868	60,896	0%
Private Label Fresh Full Cream White Milk	147,557	160,152	9%
Branded Fresh Modified White Milk	101,919	91,578	-10%
Private Label Fresh Modified White Milk	76,237	99,171	30%
Total Branded White Fresh Milk	162,787	152,474	-6%
Total Private Label White Fresh Milk	223,794	259,324	16%
Branded Flavoured Fresh Milk	30,259	35,089	16%
Private Label Flavoured Fresh Milk	2,286	2,144	-6%
Branded UHT Milk	49,978	46,996	-6%
Private Label UHT Milk	15,721	16,358	4%
Total Branded Milk	243,023	234,559	-3%
Total Private Label Milk	241,801	277,825	15%
Total Milk	484,825	512,384	6%

Annualised impact of supermarket price discounting on the dairy industry

This analysis uses the measured trend in milk sales for the five complete months since the commencement of private label (home brand) discounting and annualises them for the current calendar year. The first scenario is soundly based on these trends, while the second scenario assumes a knock-on effect from the supermarket private label strategy to branded products. Whilst both these scenarios have a serious impacts on the Australian dairy industry the second scenario would be catastrophic.

It should be noted that Dairy Australia's wholesale price data currently does not indicate there has been discounting of branded product wholesale prices. However, this data is invoiced milk prices and does not take account of any promotional spend or increased marketing costs to maintain branded shares, which would reduce processor already marginal profitability.

Scenario 1: Post-discounting and year to date trend (February to June 2011) in shift to private label (home brand) products is annualised, branded and non-supermarket channel prices are unchanged.

Scenario 2: Annualised post-discounting and year to date trend (February to June 2011) and branded products are discounted to maintain relativity with private label price in both supermarket and non-supermarket channel.

Future scenarios for the drinking milk market

		Baseline (2010)	Scenario 1	% change*	Scenario 2	% change*
Supermarket	Vol*	1,182	1,249	+6%	1,249	+6%
	Value*	$1,943	$1,917	-1%	$1,846	-5%
Non-supermarket (route)	Vol*	1,102	1,102	0%	1,102	0%
	Value*	$2,161	$2,161	0%	$2,032	-6%
Total market	Vol*	2,284	2,350	+3%	2,350	+3%
	Value*	$4,105	$4,077	-1%	$3,878	-6%

** Volume is million litres, value is A$ mill. Percentage changes are compared to the baseline (2010) value*

Source: Dairy Australia

Impact of future scenarios on dairy industry

		Baseline (2010)	Scenario 1	% change	Scenario 2	% change
Total value of milk sales	$ mill	4,105	4,077	-1%	3878	-6%
Change in processor margin	$ mill		-44		-199	
Possible impact on farmgate price*	cpl	46.6	44.6	-4%	37.5	-20%

**Baseline price is average 2009/10 paid by drinking milk processing companies*

Source: Dairy Australia

The scenarios outlined above are extremely concerning for the dairy industry and farmers. The potential annual loss of at least $227 million ($4,105m-$3,878m) from the value chain with consequent impacts on farmgate prices is very significant.

A loss of $44 million from the value chain due to the shift to private label (home brand) products as outlined in scenario one would lead to a drop of 2 cents per litre in the farmgate price. For the vast majority of northern NSW and Queensland dairy farmers this would result in the loss of any profit margin on their milk.

Scenario two would be catastrophic for all Australian dairy farmers providing milk to the drinking milk market with a projected loss of 20% of the farmgate price or 9 cents per litre for milk supplied to the drinking milk market.

It is important to note that discounting of branded products of up to 25.5% in an attempt to try and hold market share has recently been noted in one sector of the industry.

ADF, and others in the dairy industry, have continued to stress that 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).

As ADF has pointed out in previous submissions to the inquiry, 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.

Supply

Milk supply is a particularly important factor for farmers in Queensland, Northern NSW and Western Australia. In these states, local milk production is utilised primarily for drinking milk (please see the next section for further explanation of this). 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.

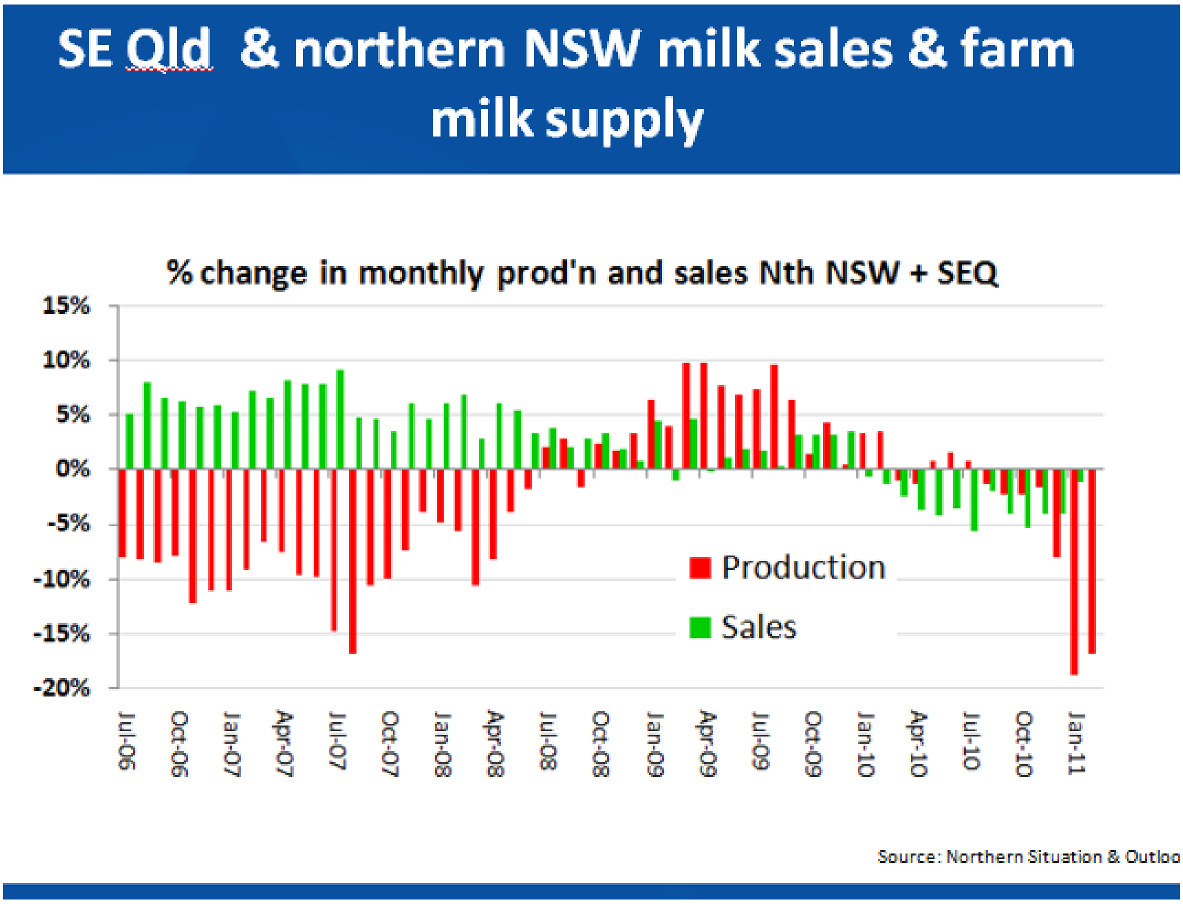
Producing a flat supply curve is more costly for farmers than seasonal production which occurs in the southern production regions, while coping with seasonal peaks and troughs imposes costs on the processing sector. Given these dynamics farm gate prices in Queensland, parts of New South Wales and Western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

Currently in Queensland supply of milk for fresh milk sales is running short as of January this year. This is primarily due to the Queensland floods and Cyclone Yasi .

It is also worth noting that in Queensland almost 40 farmers have left the industry with the majority of them citing Coles' unsustainable pricing as the key factor in their decision to leave.

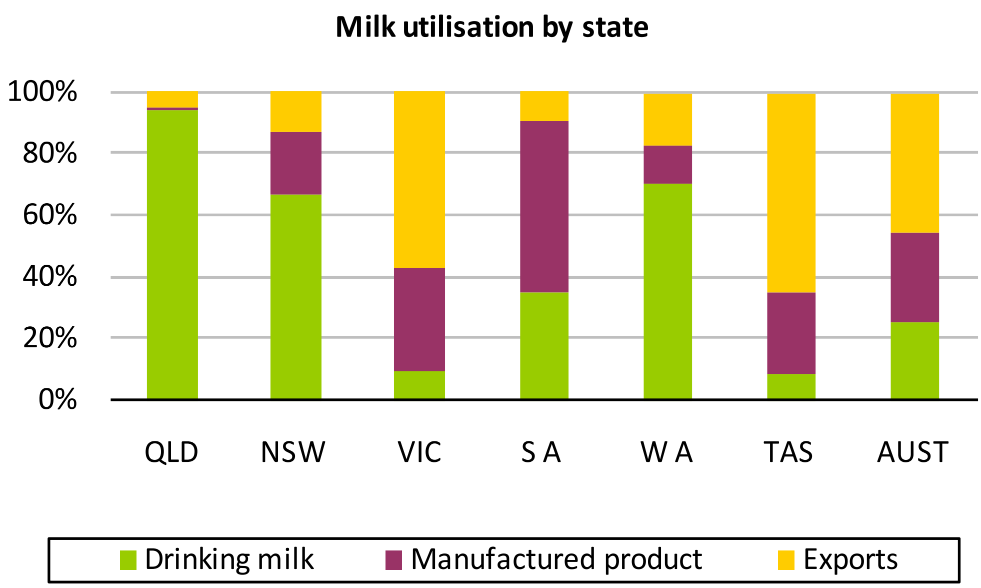
		Jan	Feb	Mar	Apr	May	Jun
QLD Milk Production (000's)	2009/10	46,547	39,636	41,201	38,165	40,544	41,507
	2010/11	37,005	32,598	35,511	34,330	35,831	36,262
	% diff	-20.50%	-17.76%	-13.81%	-10.05%	-11.62%	-12.64%
QLD Milk Sales (000's)	2009/10	42,345	38,338	43,046	40,219	42,055	40,852
	2010/11	42,511	38,777	43,271	41,167	43,713	42,131
QLD Milk Supply Surplus / Deficit	2010/11	- 5,806	- 6,179	- 7,760	- 6,837	- 7,880	-5,869

The table below shows south-east Queensland and northern NSW milk sales and farm milk supply as a % change in monthly production and sales to January 2011. It clearly shows there was no oversupply of milk in this key drinking milk region, which is contrary to Coles' assertions.



Milk utilisation by state

The share of drinking milk production in Queensland is 95%, New South Wales is 66%, Western Australia is 70% and Victoria's share is under 9% (please see the table below). In these states retail sales of drinking milk are the key regional market and farm gate price driver. Yet Coles' executives consistently quote industry statistics from Victoria which is clearly not affected as significantly as the key drinking milk production states of Queensland, New South Wales and Western Australia.

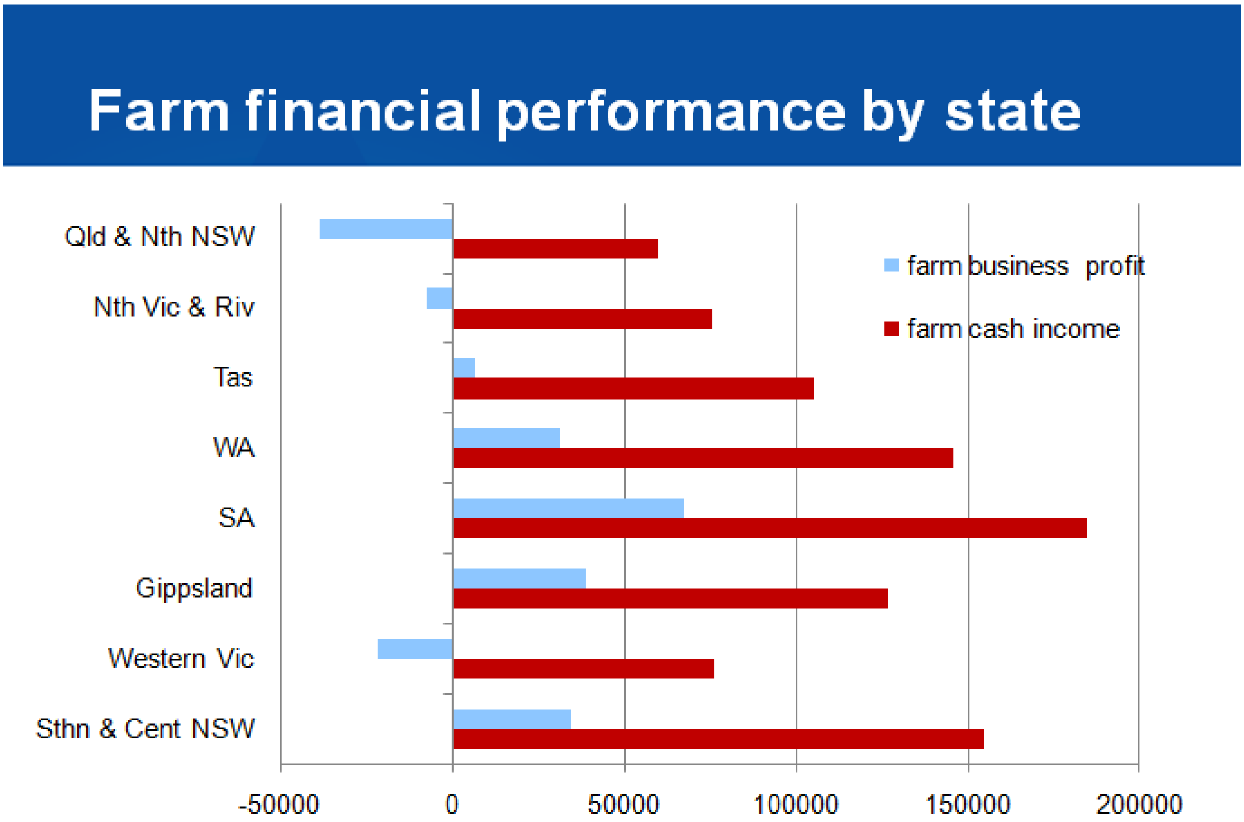


Source: Dairy Australia – 2010

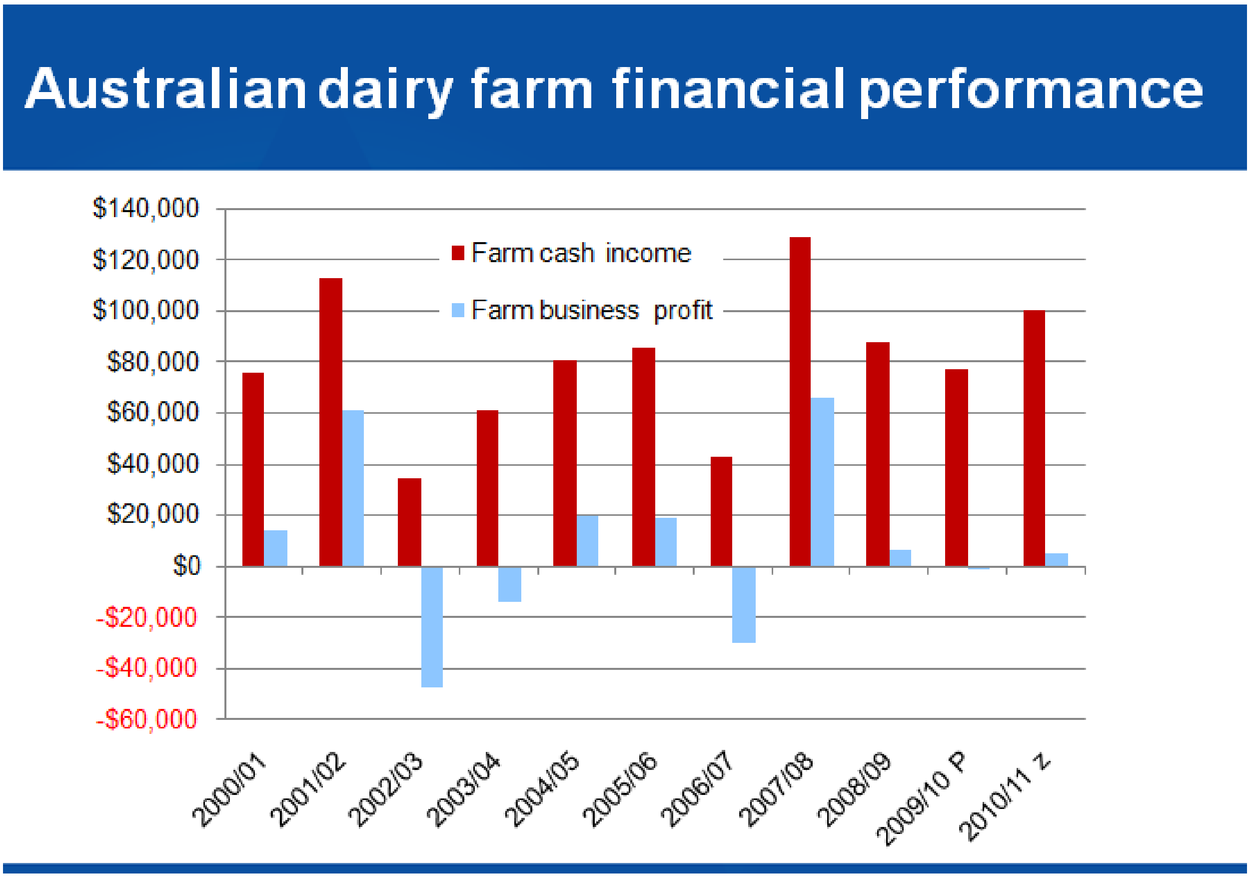
Processors and dairy farmers who supply the drinking milk market rely on the margin from branded milk sales for their profitability. Competition from unsustainably priced Coles home brand milk is taking market share away from branded products, reducing the already slim, or non-existent, profit margins of processors.

Farmer income

Dairy farmers in Australia are among the most efficient in the world and have been so for many years. The table below shows that even though this is the case, they operate on very tight margins and income is not substantial for dairy farming families. To have Coles price milk at $1 per litre is unsustainable and will inevitably reduce dairy farming family incomes further as the reduction in price flows through the value chain.



Source: ABARES – 2010/11



(p) = provisional

(z) = projected

Source: ABARES – 2010/11

The table above shows Australian dairy farm financial performance for the years from 2000/01 to 2010/11. It again shows there is very little room for more value to be taken out of the supply chain by Coles' unsustainable milk pricing.

Farmers in Queensland and Northern NSW generally make less than 2 cents per litre profit on their milk. It is important to remember this when the impact of Coles' discounting is considered.

Coles removed 99 cents per two litre container from the value chain for some of its home brand products, with the price moving from $2.99 to $2.00, trumpeting that "the price of Coles Brand fresh milk is being cut by as much as 33% from today*."

*Coles media release dated 26 January 2011

Impact on Queensland farmers

Many Queensland farmers whose milk payments are linked to branded milk sales under the Pauls Daily Access Scheme (PDA) have already seen their milk cheques drop by thousands of dollars per farmer.

As Coles takes market share away from branded milk sales these farmers milk cheques go down. This is the most transparent and direct result of Coles unsustainable discounting of their home brand milk products. It is an impact that all dairy farmers feel as profits are taken out of the value chain with increased sales of home brand milk.

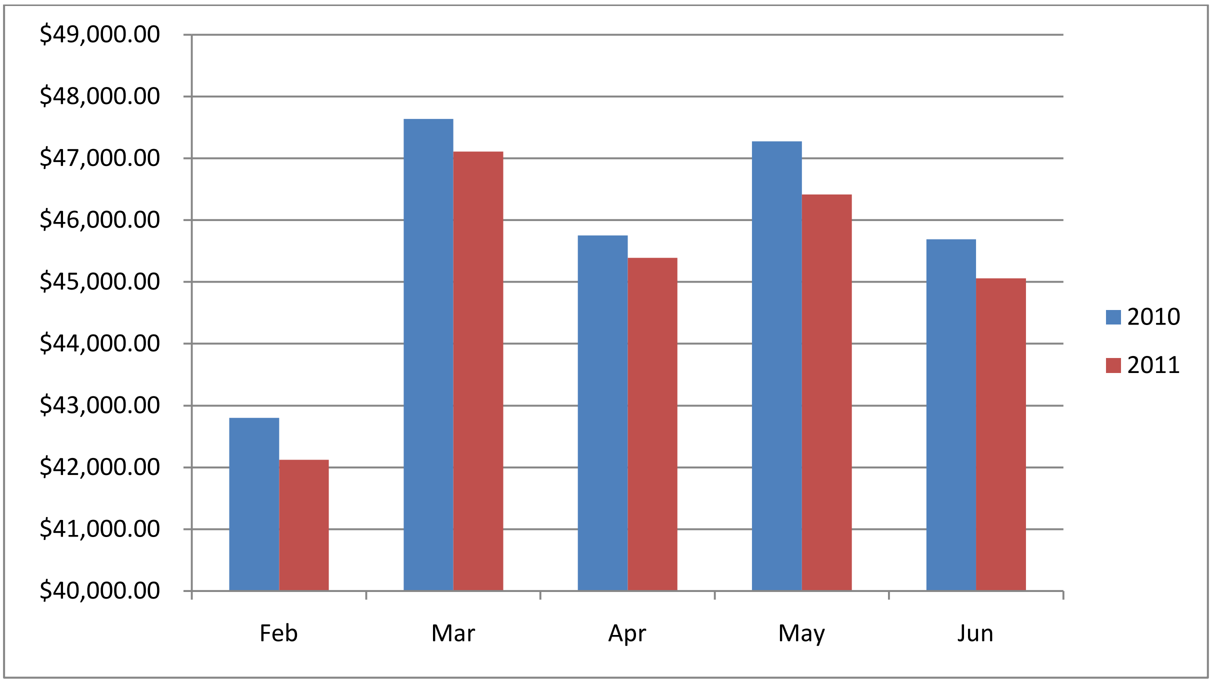
The cumulative impact up until the end of July for this group of 185 Queensland dairy farmers has been a collective loss of more than $767,000. If these impacts continue the group could collectively lose more than $1.5 million this year.

The table below shows the impact on affected Queensland farmers, comparing income for February to June for 2010 and 2011. If the drop in income continues the annual cost to affected Qld farmers will be over $8,000.

This is a very large amount of money for farmers who lost an average of almost $50,000 in the 2010/11 financial year.

Further detail on the impact on Queensland farmers is available in the Queensland Dairyfarmers' Organisation's submission to the inquiry.

Queensland PDA Scheme



Source: Queensland Dairyfarmers' Organisation

Impact on processors

Coles and Woolworths between them have almost 80% of the market and this places processors in a 'catch 22' position. The major retailers are not only the largest sales avenue to consumers for the sale of processors own proprietary branded products but the supermarket 'home brand' milk tenders are now a major component of the overall domestic drinking milk market.

This means that processors are understandably cautious about pushing back on the major retailers due to their market power. ADF has included below some recent media comment regarding the current unsustainable milk pricing of Coles along with comments from processors' submissions to the inquiry.

ADF's reason for doing this is to reiterate the point that Coles' is the only organisation involved in the dairy industry who believes there will not be an impact on farmers and the value chain from its unsustainable discounting.

"It's our view that the current pricing seen in the marketplace, if maintained, cannot deliver a fair return to any of the players in the supply chain..."

Lion (formerly National Foods) spokeswoman A Current Affair – 17 August 2011

"Lion's white milk volumes fell 10.9%, largely driven by the private label contract losses, compounded by deep discounting with consumers switching from branded products to private label."

Adelaide Advertiser – 6 August 2011 – Page 73

<u>Fonterra Submission- 3 March 2011</u>

"The recent reductions in the price of house brand fresh milk by supermarket retailers has fundamentally changed the dynamics of the fresh milk market and this is something all players in the market will have to grapple with – including retailers, milk vendors, processors, farmers and their communities."

"The shift from branded milk to lower priced house brands <u>means lower returns to processors and farmers</u>. It is well recognised in the industry that house brand milk contracts are a cost recovery exercise for processors rather than a profit making venture and for these contracts to be viable processors must balance them with branded milk contracts so that a reasonable return can be achieved once the price is averaged across the entire milk volume."

"The value that is being taken out of the value supply chain will <u>inevitably impact farmers</u>. The level of impact will depend on whether the supermarkets continue to absorb the price reductions, but one has to expect that a new low benchmark price is being set for fresh milk which will change the dynamic of that market for the long term."

Parmalat Submission – 10 March 2011

"In conclusion Parmalat Australia believes that heavy price discounting:

- is placing enormous pressure on processor margins through loss of branded sales;
- has negatively impacted smaller retailers by channel shift to the already dominant major grocers;
- has the potential to destroy the Queensland and Northern NSW dairy industries; and
- will put at risk future investment plans of both processors and farmers."

National Foods submission – 7 March 2011

"The decision to reduce the price of house brand milk to $1 per litre will have significant and detrimental implications for the sustainability of the Australian dairy industry."

"The price reduction will not generate increased sales of fresh white milk and will not inject any additional revenues into the dairy industry."

"Since the price reduction will not generate increased sales of fresh white milk, or inject additional revenues into the dairy industry, it will not benefit any part of the dairy industry. It will not mean that dairy farmers will be able to sell more milk."

"Any increase in sales of house brand milk by the supermarkets will only be associated with corresponding decreases in sales of branded fresh white milk - in supermarkets and in the non-grocery sector."

"EBIT (earnings before interest and tax) margin on fresh white milk of less than 2%. This is anticipated to deteriorate further as the discounting of house brand milk reduces National Foods' sales of branded fresh white milk."

National Foods stipulated that the planned EBIT margin on its fresh white milk "includes the recent price increase that National Foods secured from Coles to produce its house brand milk."

"The price increase reduced National Foods' anticipated EBIT losses from its house brand milk business from loss making to marginally profitable under current distribution arrangements."

National Foods – evidence to the Senate Economics Committee – 9 March 2011

"Just to be clear, that is why I was able to say that generic for us principally is zero. It was loss-making prior to that."

Lion (formerly National Foods) H1 Trading Update – 5 August 2011

"As previously communicated, conditions in both the dairy and juice sectors remain very difficult for farmers and processors alike.

Lion has quality dairy and drinks brands that require investment to reach their full potential and remains committed to patient investment in its core strategic assets – its people, brands and production assets – to deliver sustainable growth over the long term.

Lion's dairy and drinks business is still a long way from achieving an acceptable return on invested capital and continues to face significant margin pressures in both dairy and juice.

The dairy and drinks division delivered operating earnings before interest and tax (EBIT) of $68.3 million, a decline of 43.2%. Revenue declined 9.4% to $1.4 billion, driven by the loss of key private label contracts and a decrease in export sales due to the impact of the strong Australian dollar.

Lion's white milk volumes declined 10.9%, largely driven by the private label contract losses, however this was compounded as deep discounting saw consumers' switch from branded products to private label and from convenience stores to grocery – diluting the profit pool available to all players in the supply chain."

Excerpt from article in *The Land* – When Supermarkets Rule

"Dr McKinna, principal of McKinna et al told the Crawford Fund's Supermarket Revolution conference.

They will see more products 'de-engineered' to meet price points, less choice, less Australian made products, and ultimately, less competitiveness."

In the UK, the source of local supermarket competition strategies, private brands represent up to 70% of some food categories.

As they escalate their own private label war, Australian supermarkets are inflicting huge collateral damage on the proprietary brands, Dr McKinna says.

Most of the food companies in Australia are now on margins too low to sustain ongoing reinvestment. That undermines their ability to reinvest in their brand and their companies.

'The fallout is evident. SPC-Ardmona closed a factory last week. Heinz have closed two factories, McCain's have shifted vegetable processing to New Zealand. The long-term future of these processing companies is not good,' Dr McKinna said.

The milk price wars are causing problems for the milk companies.

Milk is now about 70% private label. Margins on branded milk are a lot less, and the brands are probably selling less volume as well.

It makes you wonder about the dairy companies' ability to re-invest in the future."

The Land – 18 August 2011 – Pg 17

Situation for consumers

ADF does not believe that Coles is absorbing the cost of this marketing tactic. It is ADF's belief that either Coles' customers or dairy farmers are paying for the unsustainable drop in the price of home brand milk, probably both.

It is clear that Coles is trying to take business from corner stores, independent petrol stations and other small businesses. We believe when they have achieved their goal and cornered the market, they will raise the prices on milk again as there will be little or no competition.

If left unchecked, Coles' actions will lead to a substantial lessening of competition in the market place, a substantial impact on the viability of branded dairy products and are likely to lead to less product variety on supermarket shelves.

This aggressive discounting has happened before in the United Kingdom and it is the ADF's belief that Coles' executives are intent on replicating that model here in Australia. It ultimately leads to less choice for consumers, higher prices on products that are not staples and unsustainable pressure on farmers and others in the supply chain. ADF believes that unless addressed this situation is inevitable in Australia.

This unsustainable pressure severely impacts the supply chain by causing higher prices several years after the discounting, due to farmers leaving the industry, and a loss of production for supply.

ADF believes that an article in the Business Spectator on 7 February 2008, illustrates Mr McLeod and his team of UK executives primary goal perfectly, that is 'creating operating environments in which to relieve customers of their disposable income.'

ADF is certainly not the only one who has these concerns and whilst Coles has consistently claimed it is absorbing the cost of the milk discounting evidence from other sources appears to refute this.

- A recent Morgan Stanley research report indicated that "staples pricing continues to be cut while non-staples prices have risen."
- In the July edition of Food and Drink Business on page 10, Silvestro Morabito, CEO of IGA, stated that "IGA regularly surveys a sample of 2500 lines from its rivals and between 70 and 90 per cent of these products are in fact seeing a steady price increase."
- Recent ABS data* analysing average prices for 51 goods show more than half are up when compared with a year ago. The basket of goods includes food, alcohol, household supplies and alcohol.

Even comments by Wesfarmer's CEO Richard Goyder do not appear to support either the claim of 'staying down' or of absorbing the cost.

"Obviously if any product range has substantiated and necessary cost increases, we will look to see if we can absorb that and if we can't, we will pass those on. In the long run milk will be no different"

Courier Mail - 29 July 2011 – page 38

*Australian Bureau of Statistics. Average retail prices of selected items, eight capital cities June quarter 2010 and June quarter 2011.

There have also been several prominent academics quoted in the media recently:

Dr McKinna, principal of McKinna et al told the Crawford Fund's Supermarket Revolution conference.

"<u>One thing he's certain of: consumers ultimately lose if current supermarket-driven trends continue.</u>

They will see more products 'de-engineered' to meet price points, less choice, less Australian made products, and ultimately, less competitiveness.

In the UK, the source of local supermarket competition strategies, private brands represent up to 70% of some food categories."

The Land – 18 August 2011 – Pg 17

"Professor Susan Dann, deputy head of the Australian Catholic University's school of business, said the strategy employed by the two big players in recent months had been to copy each other, as well as upping their rival's claims.

Professor Dann said while the big players were putting pressure on suppliers to cut costs, that strategy could be taken only so far before it led to fewer distributors and less competition between those left.

Both companies are clearly <u>making up for lower profits on the basics with higher margins on other items</u>.

Professor Dann said the only shoppers gaining from the apparent price war were those who bought only the staples and avoided more discretionary items with higher profit margins."

West Australian - 16 August 2011 – Pg 30

Associate Professor Frank Zumbo, University of NSW, School of Business Law and Taxation

"Finally, the ACCC's media comments do not address any allegations of misleading conduct where the various Coles advertisements about prices coming down may give the impression that all or the majority of prices are coming down across the supermarket <u>when indications are that only a fraction of products have been reduced in price by Coles</u>."

Hobart Mercury – 26 July 2011 – Pg 19

Milk is inelastic

The following tables show the inelasticity of milk. The five year average trend numbers in the table below show that the small increase in milk consumption currently being experienced is in line with previous experience and is statistically insignificant.

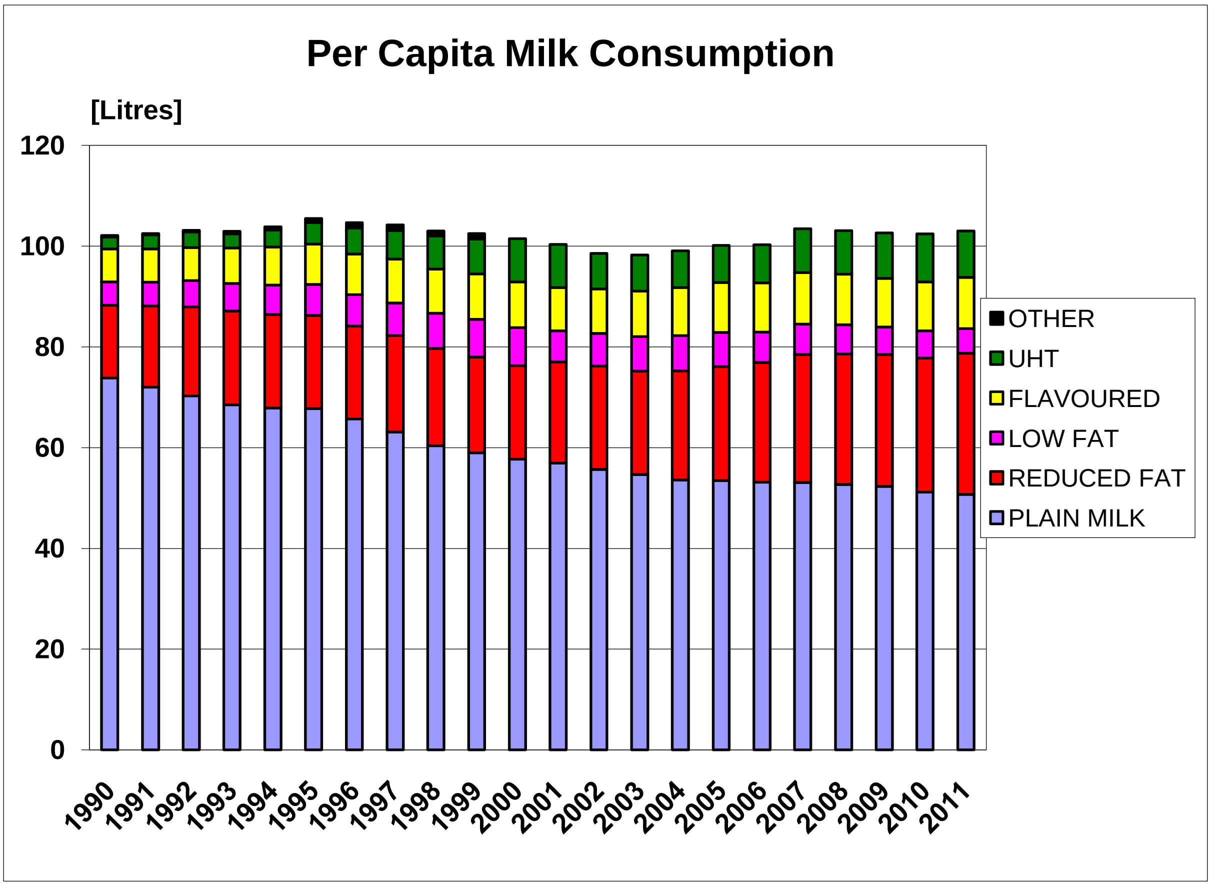
Any claims by Coles to the contrary are misleading and the Committee should challenge them to explain their reasoning. This is particularly the case in light of recent comments by John Durkan Coles' Merchandise Director.

"Farmers were concerned the move towards home-brand milk would continue but Mr Durkan said milk consumption had plateaued."

Farm Weekly – 4 August 2011 – Page 8

PER CAPITA CONSUMPTION - LITRES

Yr to June:	PLAIN MILK	REDUCED FAT	LOW FAT	FLAVOURED	UHT	OTHER	TOTAL	ANN AVERAGE
1990	73.9	14.4	4.6	6.6	2.4	0.3	102.1	
1991	72.0	16.1	4.7	6.6	2.8	0.3	102.5	0.4%
1992	70.3	17.7	5.2	6.6	3.1	0.3	103.1	0.6%
1993	68.5	18.6	5.5	7.0	2.8	0.5	102.9	-0.2%
1994	67.9	18.5	5.9	7.6	3.4	0.7	103.8	0.9%
1995	67.8	18.5	6.2	8.0	4.3	0.8	105.5	1.5%
1996	65.7	18.5	6.2	8.0	5.2	1.1	104.7	-0.7%
1997	63.1	19.1	6.5	8.7	5.7	1.1	104.2	-0.5%
1998	60.4	19.3	7.0	8.8	6.6	1.0	103.0	-1.1%
1999	59.0	19.0	7.5	9.0	7.0	1.1	102.5	-0.5%
2000	57.7	18.6	7.6	9.1	8.6	0.0	101.5	-1.0%
2001	57.0	20.0	6.2	8.6	8.6	0.0	100.3	-1.2%
2002	55.7	20.5	6.5	8.8	7.1	0.0	98.5	-1.8%
2003	54.6	20.6	6.8	9.0	7.2	0.0	98.3	-0.3%
2004	53.6	21.7	7.0	9.5	7.3	0.0	99.0	0.8%
2005	53.5	22.6	6.8	9.9	7.4	0.0	100.2	1.1%
2006	53.1	23.7	6.0	9.8	7.6	0.0	100.2	0.1%
2007	53.1	25.4	6.0	10.2	8.7	0.0	103.4	3.2%
2008	52.7	25.9	5.8	10.0	8.6	0.0	103.0	-0.4%
2009	52.3	26.2	5.4	9.7	9.0	0.0	102.6	-0.4%
2010	51.2	26.6	5.4	9.7	9.5	0.0	102.4	-0.2%
2011	50.7	28.0	4.9	10.1	9.2	0.0	103.0	0.6%



Source: Dairy Australia – 2011

Coles' margins

Recently John Durkan, Coles Merchandise Director was quoted thus – "Mr Durkan said the retail milk price was on a par with the rest of the world and Coles' three per cent profit margins on milk were less than other processors and retail industries."

Farm Weekly – 4 August 2011 – Page 8

Even at the claimed 3% profit margin on milk Coles' profit is a lot better than Lion's (formerly National Foods) 0% margin on home brand milk reported during the Senate Economics Committee's hearing.

It is interesting to note that Coles is claiming that its profit margins on milk are low, yet they are adopting a strategy of discounting milk (and claiming to absorb this) which can only make their margins on milk worse, or erode them completely.

Australian retail milk prices

Australia's retail milk prices are now amongst the lowest in the world. The table below shows prices for Australia, the US, UK and New Zealand.

New Zealand represents the most relevant comparison as it operates in a free trade market and its retail milk price is significantly higher than Australia's.

Only the US had a lower retail milk price and it should be noted that US dairy farmers receive significant trade protection. It is also worth noting that UK dairy farmers receive significant subsidies from the European Union – over £20,000 per farm.

	US	UK	Australia	NZ
Own currency	**$3.48**	**£0.62**	**$1.00**	**$2.20**
Unit	**gallon**	**pint**	**litre**	**litre**
Exchange rate @ Aug 2011	**£1.00**	**£0.62**	**£1.04**	**£1.22**
USD	**$3.48**	**$1.00**	**$0.96**	**$1.80**
Units per litre	**3.7854118**	**0.568261**	**1**	**1**
USD per litre	**0.92**	**1.77**	**0.96**	**1.80**
AUD per litre	**$0.96**	**$1.84**	**$ 1.00**	**$1.88**
USD per litre	**US**	**UK**	**Australia**	**NZ**
	0.92	**1.77**	**0.96**	**1.80**

Situation in the United Kingdom

Coles/Wesfarmers and Woolworths have significant interests across a wide range of areas, poker machines, liquor, office supplies, hardware and home electronics to name but a few. Between them these two giants now account for 43 cents in every retail dollar spent in Australia.

[Sourced from C&I Magazine, 1 July 2011.]

This gives them unparalleled market power that is not replicated anywhere else in the world. The top five supermarket chains in the United Kingdom have 80% of the market, the same as Coles and Woolworths here in Australia. This cannot be good for competition and is definitely not good for their suppliers.

[Sourced from C&I Magazine, 1 July 2011.]

The link below is for a DairyCo (the peak farmer body in the UK) report that contains evidence on the gross margins which are made by farmers, processors and retailers on the sale of liquid milk and other dairy products.

The report highlights the fact that, at a time of falling commodity and farmgate prices, there was no decline in the retail price of milk, with processors and farmers absorbing the full impact of the decline in the dairy market.

http://www.dairyco.net/library/market-information/dairy-supply-chain-reports/dairy-supply-chain-margins-200910.aspx

It is ADF's belief that a similar situation will play out in the Australian market if the current unsustainable discounting continues. ADF believes that Coles' actions will not only hurt dairy farming families but will damage Coles' competitors, such as other 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.

ADF would like to reinforce that it strongly believes this action by Coles impacts the viability of branded dairy products and will lead to less product variety on supermarket shelves, as has happened in the United Kingdom.

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

The following excerpt from Agra Europe, a respected agricultural industry magazine in Europe, spells out the dangers of market concentration and the impacts on processors and farmers.

"Margins between the farm gate and the price paid by consumers for liquid milk and other dairy products and the margins accruing to different sectors of the supply chain vary widely across the EU.

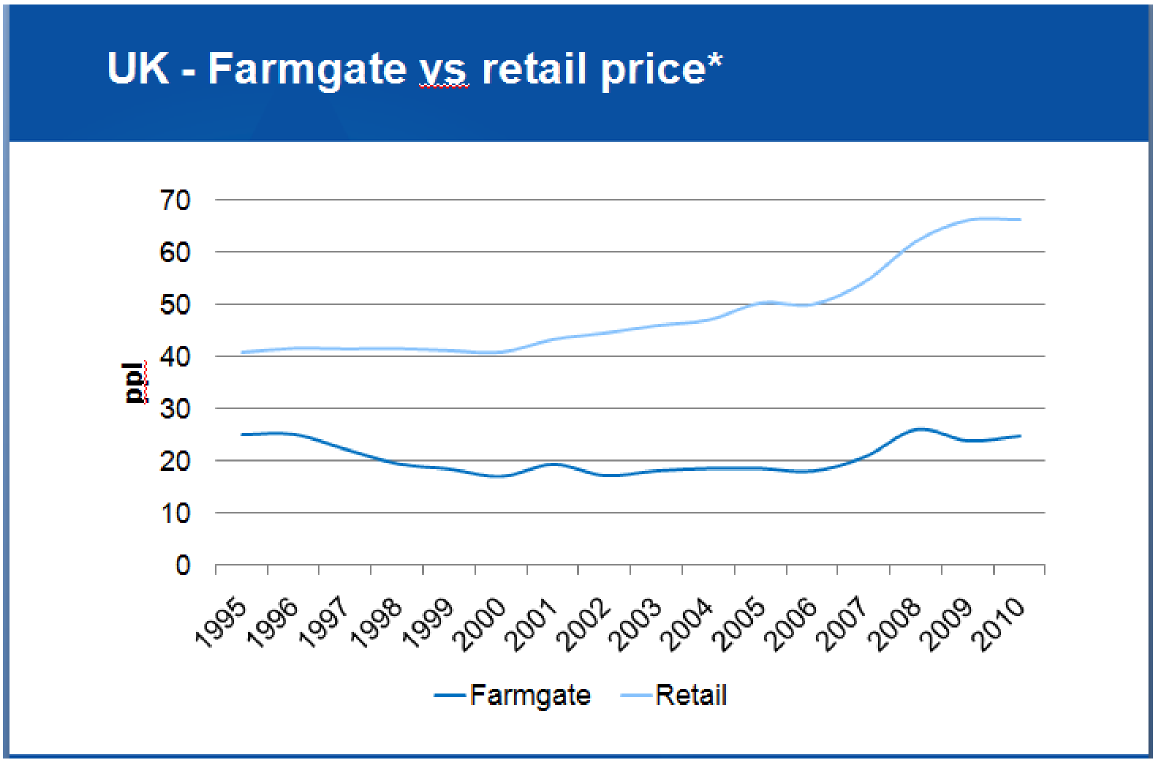
It is possible to generalise that the greater the supermarket share of the market the smaller the proportion of the end price accrues to processors and dairy farmers."

"In the absence of any major move towards greater power of producer groups – unlikely whatever the High Level Group, Commission or Council does – it is therefore likely that the combined power of the supermarkets and a processing sector composed of fewer larger operators will further limit the ability of EU milk producers to maintain their share of liquid and processed milk returns. Most countries are likely to follow the pattern of the UK, where dairy processing is dominated by six processors controlling 93% of the industry and retailing by six supermarkets controlling 65% of liquid milk and 70-85% of dairy produce sales.

This has brought about a significant imbalance of market power in the UK dairy sector."

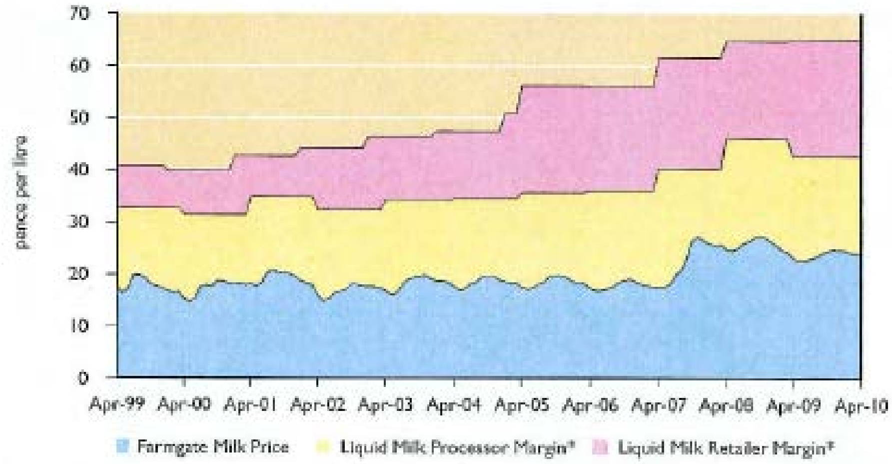
Agra Europe - Friday 5 August 2011

The graph and table below show that as retail prices and margins have increased in the United Kingdom over the last fifteen years, farm gate prices paid to UK farmers have not increased. In a less concentrated market than Australia retailers have reaped the benefits of the discounting cycle and subsequent price increases.



***Source:** DairyCo datum, retail prices estimated from index*

Fig 3 Prices and margins for liquid milk



Source DairyCo

*The gross margin equals the difference between the selling price and buying price for milk

Coles' rise and fall mechanism

Coles makes much of its new rise and fall mechanism in contracts with processors. ADF would like to point out that a key part of Coles' current unsustainable milk pricing strategy is to increase sales of its home brand milk.

In the key drinking milk markets of Queensland, northern NSW and Western Australia where the farmgate price is chiefly influenced by the domestic milk market this will have detrimental impacts.

Coles' current home brand strategy is reducing processor profitability as they are selling less of the branded product on which they make their margin.

This means that, in the future, there will be an inevitable impact on farmgate prices, with lower prices paid to farmers.

As part of the rise and fall mechanism Coles reviews the farmgate price, which has fallen as outlined briefly above, due to lower processor profits, this enables them to lower the contract price, further reducing processor profitability, creating a downward spiral that benefits only Coles.

ADF understands that the wording supplied to the Senate Economics Committee by Coles is a very general overview of the actual rise and fall mechanism and does not include much of the actual detail in the clause supplied to processors.

ADF is advised there is a clause in the detailed rise and fall mechanism document that links farm gate prices to world market prices. As ADF has not seen the full detail of the rise and fall mechanism (this again goes to Coles' lack of transparency) it is difficult to comment but this may prove effective for processors in the export-oriented states of Victoria and Tasmania but ADF calls on Coles to explain its relevance to the drinking milk market states of Queensland, Western Australia and northern NSW.

Australian Competition and Consumer Commission (ACCC)

ADF has major concerns regarding the recent decision by the ACCC that Coles' discounting of house brand milk is not predatory pricing. ADF would like to take this opportunity to suggest that the Committee raise the following issues with the ACCC and Coles:

- There is no detail on the terms of reference used by the ACCC in conducting its inquiry into this matter. It would be appropriate that this information is made available so dairy farmers and other stakeholders can understand the scope of the inquiry and possibly assist with further information.
- ADF would like confirmation on whether the ACCC inquiry looked at the entire value chain and the cost to Coles, including to the checkout, in relation to selling below cost and predatory pricing issues.
- The ACCC has made no mention of price impacts in regional or remote market areas of Australia such as Darwin, Kununurra and Broome. ADF believes it is impossible for Coles to buy, transport, store and sell milk in these areas for $1 per litre without selling below cost. In these same regional market areas processor proprietary brands have lost significant market share to discounted supermarket home brand milk. ADF would appreciate further information from the ACCC on this issue, in particular in relation to s46(1AA) and acting with an anti-competitive purpose.
- ADF believes Coles has undertaken deceptive and misleading conduct by claiming in its advertising that they were not affecting dairy farmers. For a large group of Queensland dairy farmers affected almost immediately by Coles' actions this is clearly not true and they each stand to lose around $8,000 this year due to the clear shift in sales to home brand milk.
- It should also be noted that despite claiming that their actions will not affect dairy farmers Coles has repeatedly refused to rule out dropping prices for processors which would potentially flow on to farmers in future contracts.
- It would also be useful to know the ACCC's perspective on Coles' 'Down, down and staying down' message in its advertising.
- ADF believes Coles has used false advertising as the average consumer would view their slogan 'staying down' as meaning a permanent discount, not for at least six months as Coles executives have said.
- ADF also has concerns that Coles has consistently claimed it is absorbing the cost of the milk discounting yet evidence from independent sources appears to refute this. A recent Morgan Stanley research report indicated that "staples pricing continues to be cut while non-staples price have risen." It would be appreciated if the Committee could ask the ACCC if the claim by Coles that it is absorbing the cost of the milk discounting was investigated and how this was undertaken. Other evidence and inconsistencies that the ADF would like to confirm the ACCC investigated include:
    - In an interview on the 8 March 2011 on 2GB radio with Alan Jones, Ian McLeod, Managing Director of Coles, when questioned about absorbing losses on discounted milk claimed that "No we're not losing, we're making four cents in the dollar." This is completely inconsistent with the often stated claim by Coles that they are absorbing the cost of the milk discounting.
    - In the July edition of Food and Drink Business on page 10, Silvestro Morabito, CEO of IGA, stated that "IGA regularly surveys a sample of 2500 lines from its rivals and

between 70 and 90 per cent of these products are in fact seeing a steady price increase."

- Recent reporting of comments by Wesfarmer's CEO Richard Goyder in the Courier Mail of 29 July 2011 "Obviously if any product range has substantiated and necessary cost increases, we will look to see if we can absorb that and if we can't, we will pass those on," does not appear to support either the claim of 'staying down' or of absorbing the cost.

It would also be appreciated if the Committee could ask the ACCC if it examined the impact of the current milk discounting on competition in the route trade market and future product innovation and choice in the drinking milk market.

It is also important that the Committee ask the ACCC if it examined if Coles' sales of discounted milk in regional markets is below the cost to 'check out' and is subsequently being used as a 'loss leader' to damage the market share of processor proprietary brands in both regional and urban markets.

The ADF is concerned that the ACCC has conducted a narrow inquiry that did not examine this serious issue with the thoroughness that it deserves and that impacts are still accumulating, with some impacts still to be quantified.

It would be appreciated if the Committee could ask the ACCC to address the questions raised above and hopefully go some way to allaying the concerns of Australia's dairy farmers, who feel their product is being fundamentally devalued in the market.

Trust and transparency

Woolworths and other retailers have stated, both publicly and privately, that the Coles' price cuts on home brand milk are unsustainable. The unfortunate reality is that Coles' marketing tactic is sacrificing the true value of milk to use it as a tool to lure customers from their competitors, while at the same time growing the market share and power of their home brand products at the expense of processor proprietary brands.

Dairy farmers do not trust Coles and neither should their customers. Throughout this debate Coles has knowingly used figures that are deliberately misleading, ADF's submission to the senate inquiry of 9 May 2011 provides further detail on just some of these.

Dairy farmers certainly do not believe that Coles is going to absorb the cost of the unsustainable pricing of milk. The question has to be asked 'who will then, Coles' customers or those at the start of the chain – dairy farmers?'

Coles' actions appear to be designed to take market share away from, and 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.

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

These actions will ultimately lessen competition for consumers through increasing prices and decreasing product choice as the experience in the United Kingdom has shown. Coles' is not being up front about its strategy and it is unfortunate that the Senate Economics Committee has experienced this lack of transparency as well as dairy farmers and consumers.

Coles has hidden behind claims that information is 'commercial-in-confidence' in their 'answers' to the Senate Committees Questions.

Coles has also repeatedly been disingenuous in presenting selective statistics and data that suit their argument that they are 'doing no wrong', but do not present the full truth of the situation.

One of the Senate Committee's questions asked of Coles related to what happened to the price of all the other products that Coles has not cut the price on – approximately 15,000 products in a typical supermarket. However Coles' representatives refused to answer the question.

Coles was also asked 'What is the gross cost to checkouts to acquire, distribute, refrigerate, display and retail milk? How does this differ in each state?' Coles' representatives responded by claiming that,
"Coles does not capture or measure these costs at a product level", which is very surprising.

This is yet another deliberate attempt to avoid answering an important question that goes to the heart of the issue – is Coles selling milk below cost as a loss leader with predatory intent?

Coles is willing to repeatedly say they have raised the contract price to processors, yet they refuse to release any information on other aspects of their contract arrangements, apart from the scant detail provided on their rise and fall mechanism, claiming they are commercial in confidence.

Coles also refuses to acknowledge they have not provided increases to cover all impacts, as is currently happening in Queensland with the PDA scheme and the overall impact of a reduction in the sale of branded milk products Australia wide.

It is also worth noting that Coles has repeatedly refused to rule out dropping prices for processors and farmers in future contracts.

Coles must show the transparency it continually advocates for others and reveal the real numbers, strategy and intent behind its price cuts, if only so their customers have the full story. That is the way to gain the trust they claim they are so keen on getting.

ADF recommendations:

ADF's initial recommendations to the inquiry are summarised below. ADF is taking the opportunity with this further submission to expand on some of these recommendations, in particular the need for a mandatory code of conduct and supermarket Commissioner or Ombudsman:

Recommendations 1-3	**That the relevant Federal Minister give direction to the ACCC to:** • Undertake an immediate investigation of Coles for a potential breach of section 46, of the Competition and Consumer Act 2010 in relation to predatory pricing; • Investigate the pricing of all major retailers for potential breaches of the Competition and Consumer Act 2010 in relation to the sale of 'loss leaders'; and undertake ongoing price, cost and marketing surveillance of the fresh milk supply chain; and • Investigate Coles advertising of their discounted store brand milk for potential breaches of the Competition and Consumer Act 2010, in relation to false and misleading advertising
Recommendations 4-8	**That amendments to the Competition and Consumer Act 2010 (the Act) are made as follows:** • a definition of unconscionable conduct be inserted into the Act; • an "effects" test be reintroduced • a statutory duty of good faith be enacted as part of the Act; and • a mandatory Drinking Milk Market Code of Conduct be developed in consultation with industry, under the Act, and that • the United Kingdom Competition Act 1998 is examined, section 18 in particular, with a view to amending the Act along similar lines.
Recommendation 9	That a fresh drinking milk market specific Commissioner/Ombudsman and/or a Supermarket Ombudsman be established.
Recommendation 10	That Government convenes an ACCC authorised roundtable forum of the drinking milk market dairy industry supply chain.

It is important to note that any draft legislation developed must be subject to a thorough stakeholder and industry consultation process.

<u>Proposed recommendations - overview</u>

A Mandatory Supermarket Industry Code of Conduct

Given the sheer size of the supermarket duopoly and the disproportionate power they wield in the Australian market place the majority of Australian suppliers, particularly of fresh food produce and drinking milk, must have some sort of ongoing commercial relationship with them.

Therefore it is important there is full transparency along the supply chain and that suppliers and farmers have access to timely and cost effective dispute resolution processes in their dealings with major supermarkets.

It is therefore appropriate to develop a mandatory Supermarket Industry Code of Conduct under the Competition and Consumer Act dealing with

(i) the conduct of the major supermarket chains towards suppliers and farmers;
(ii) access to supermarket shelves at transparent and reasonable prices, terms and conditions; and
(iii) timely and cost effective dispute resolution processes.

Need for a Commissioner or Ombudsman to enforce the Code

ADF believes there is not only a strong need for a mandatory supermarket code of conduct but also for someone to provide oversight of the Supermarket Industry Code of Conduct. The Commissioner or Ombudsman must be able to use the code to investigate complaints from a whole of value chain perspective. The current Coles milk price cut is the perfect example of why this is necessary if the Commissioner/Ombudsman is to have any chance of being effective. The processors lack market power against an entity as big as Coles and as such, any price impacts inevitably flow on to the dairy farmers at the start of the value chain.

Farmers must have the power to complain about the behaviour of retailers (and processors).

Over the last decade major supermarket chains in Australian have significantly increased their market share and power. As this has occurred, the processing sector has been left with less market power and fewer options to sell fresh milk and other dairy products.

A situation has been allowed to develop by Government and regulators in which major supermarket chains have used their purchasing power to place considerable pressure on suppliers, especially for the supply of supermarket branded products. This increasing demand on suppliers has over time led to downward price pressure on the supply chain, which inevitably flows on to the dairy farmers at the start of the supply chain.

Processors are understandably cautious about pushing back on large retail pressure in relation to 'store brand' tenders as the major supermarket chains now provide the largest retail avenue to consumers in Australia for processor branded product sales. Coles' milk sales alone represent approximately 20% of Australia's drinking milk production, which is a significant percentage in anyone's language and is made even more so by the fact that Coles' competitors have been forced to match them in these unsustainable milk prices.

There is a need for any new code of conduct to have a referee to enforce and police the rules. This is particularly the case when the discrepancies in market power are as extreme as that seen between the major supermarkets and the vast majority of their suppliers.

A lack of complaints against the major retailers does not mean there is an absence of market failure but instead represents evidence of significant market failure as smaller suppliers are extremely reluctant to take action or give evidence.

Where should the Supermarket Commissioner or Ombudsman sit?

The ADF believes there are two viable options for where the new Supermarket Commissioner or Ombudsman could sit:

1. Part of the structure of the ACCC as an independent office; or
2. As a stand-alone agency.

Given the view of many in the community of the ACCC as an organisation that has either failed to act, or cannot act due to legislative constraints, when it comes to the major retailers it may be beneficial to have the Supermarket Commissioner/Ombudsman as a stand-alone agency.

As outlined in the AFGC's submission to the Committee it may be appropriate if option 1 is seen as the best alternative for the Commissioner/Ombudsman to report directly to the relevant Federal Minister rather than the head of the ACCC.

The aggressive discounting being seen in Australia has happened before in the United Kingdom and it is the ADF's belief that Coles' executives are intent on replicating that model here in Australia. It ultimately leads to less choice for consumers, higher prices on products that are not staples and unsustainable pressure on farmers and others in the supply chain.

This unsustainable pressure severely impacts on the supply chain by causing higher prices several years after the savage discounting, due to farmers leaving the industry and a loss of production for supply.

Given the above, the UK Groceries Supply Code of Practice (the Groceries Code) provides a good starting point for the basis of legislation establishing a mandatory code of practice and an ombudsman or commissioner.

The following provides a brief background to the UK Groceries Code and reasons for its establishment.

There is also a brief outline of the key measures of the UK Draft Groceries Code Adjudicator Bill which establishes an independent adjudicator to 'police' the Groceries Code.

UK Groceries Supply Code of Practice (the Groceries Code)

The United Kingdom Competition Commission (CC) has found that one of the features that adversely affected competition in the market was the exercise of buyer power by certain grocery retailers with respect to their suppliers of groceries, through the adoption of supply chain practices that transfer excessive risks and unexpected costs to those suppliers.

The CC found that there was a detrimental effect on customers resulting from the adverse effect on competition and published its final report on 30 April 2008.

In the report the CC considered that a package of remedies consisting of the following key elements would be effective and proportionate in remedying the various features of the market identified as having an adverse effect on competition:

(a) the establishment of a Groceries Supply Code of Practice (GSCOP); and
(b) the establishment of a GSCOP Ombudsman to monitor and enforce compliance with the GSCOP.

The key issue the report raised was that some practices by big supermarkets were still having an anti-competitive effect, harming the long term interests of consumers

The new UK Code of Practice (the Groceries Code) was designed to improve the relationship between big retailers and their suppliers by preventing certain practices from occurring.

The Groceries Code came into force on 4 February 2010 and applies to all retailers with an annual turnover of more than £1 billion in groceries in the UK (there are ten such retailers in the UK) and it must be incorporated into contracts with suppliers.

It is worth noting that eight of the current Coles senior executives have worked in the United Kingdom at retailers where the very practices originated that the UK Competition Commission deemed had an anti-competitive effect and harmed the long term interests of consumers.

What does the UK Groceries Code do?

The Groceries Code does the following:

1) Part 1 of the code deals with interpretation and definitions.

<u>Principle of fair dealing</u>

2) Contains an overarching fair dealing principle. A retailer must at all times deal with its suppliers fairly and lawfully. Fair and lawful dealing will be understood as requiring the retailer to conduct its trading relationships with suppliers in good faith, without distinction between formal or informal arrangements, without duress and in recognition of the suppliers' need for certainty as regards the risks and costs of trading, particularly in relation to production, delivery and payment issues.

<u>Variations</u>

3) Part 3 of the Code contains principles relating to variations to the supply chain or to supply agreements. Paragraph 3 prohibits retrospective changes to terms of supply, once they have been agreed by parties.

<u>Changes to supply chain procedures</u>

4) Paragraph 4 obliges a retailer to provide written notice to a supplier when changes are made to its supply chain procedures, or compensate a supplier for any costs incurred by the supplier due to a failure to provide such notice.

<u>No delay in payments</u>

5) Paragraph 5 requires retailers to pay for goods received from suppliers within a reasonable time after the date of the Supplier's invoice.

<u>No obligation to contribute to marketing costs</u>

6) Paragraph 6 prohibits a retailer from requiring a supplier to make any payment towards a retailer's marketing costs unless such a contribution has been agreed in the supply agreement.

No payments for shrinkage

7) Paragraph 7 prohibits completely a supply agreement containing a provision which makes a supplier liable for shrinkage from a retailer's premises.

Payments for wastage

8) Paragraph 8 prohibits retailers from requiring a supplier to make any payment for wastage, although in respect of some types of goods it would be reasonable for suppliers and retailers to share the cost of wastage.

Limited circumstances for payments as a condition of being a supplier

9) Paragraph 9 prohibits a retailer requiring payments in order to secure the stocking or listing of a supplier's product, except in certain circumstances.

Compensation for forecasting errors

10) Paragraph 10 requires retailers to compensate suppliers for erroneous forecasts. Paragraph 10 also requires retailers to ensure that any forecasts are sufficiently transparent so as to allow suppliers to make their own assessment as to the veracity of any forecast made.

No tying of third party goods and services for payment

11) Paragraph 11 limits the extent to which a retailer can require a supplier to obtain goods, services or property from any third party where the retailer acquires a benefit from the third-party arrangement.

No payments for better positioning of goods unless in relation to promotions

12) Paragraph 12 prohibits a retailer requiring payments from the supplier in order for the supplier to secure better positioning or an increase in the allocation of shelf space (except in relation to promotions).

Promotions

13) A retailer will not require a supplier to predominantly fund the costs of a promotion.

Due care to be taken when ordering for promotions

14) Paragraph 14 requires the retailer to take precautions during promotional periods to ensure that it orders only so much of the relevant products at promotional prices so as to cover the expected sales during the promotional period.

No unjustified payment for consumer complaints

15) Paragraph 15 provides that suppliers will be responsible for the cost of customer complaints which are attributable to their negligence or default, while ensuring that payment for customer complaints does not become a ‘profit centre’ for retailers.

Duties in relation to de-listing

16) Paragraph 16 imposes duties on retailers seeking to de-list a supplier. The key factor in determining whether a decision to de-list is justifiable under the Code is whether it is for ‘genuine commercial reasons’. Particular examples where de-listing will not be for genuine commercial reasons are where a retailer de-lists a supplier as a consequence of the supplier exercising its rights under the Code or its supply agreement with the retailer, or the failure by a retailer to fulfil its obligations under the Code.

Dispute Resolution

1) A designated retailer must negotiate in good faith with a supplier to resolve any dispute arising under the Code.
2) If any dispute is not resolved to the satisfaction of the supplier within 21 days from the date the dispute arises, then at any time during a period expiring four calendar months after the dispute arises, the designated retailer will submit to an arbitration request by the supplier.
3) The arbitration will be administered by a dispute resolution body approved and designated by the UK Office of Fair Trading (OFT) and nominated by the supplier in the event that more than one such body is designated by the OFT.
4) To the extent that they do not conflict with Article 11, the arbitration will be conducted in accordance with the Rules of the UK Chartered Institute of Arbitrators (Australia’s equivalent body is the Institute of Arbitrators and Mediators) in force for the time being, or such other dispute resolution body as is nominated by the arbitrator.
5) All costs of the arbitration, including the fees and expenses of the arbitrator, will be borne by the designated retailer, unless the arbitrator decides that the supplier’s claim was vexatious or wholly without merit, in which case costs will be assigned at the arbitration’s discretion.
6) The decision of the arbitrator will be binding and final on both the designated retailer and the supplier. There are appeal and mechanisms under the Code through the UK Arbitration Act 1996.

Supply of information to the UK Office of Fair Trading (OFT)

1) A designated retailer must provide to the OFT any information and documents reasonably required for the purposes of enabling the OFT to monitor and review the operation of the Code.
2) A designated retailer must keep, maintain and produce those records specified in writing by the OFT that relate to the operation of any provisions of the Code.
3) Any designated retailer whom the OFT reasonably believes to have information which may be relevant to the monitoring or review of the operation of any provisions of the Code may be required by the OFT to attend and provide such information in person.

Duty to appoint in-house compliance officer and the role of the compliance officer

1) A designated retailer must appoint a suitably qualified employee as the Code Compliance Officer.
2) A designated retailer must ensure that the Code Compliance Officer:
(a) will be provided with all resources necessary for the fulfilment of its role;
(b) will be available as a point of contact for suppliers and any authority or other body making enquiries in relation to the Code;
(c) will be independent of, and must not be managed by, any member of the Buying Team of the designated retailer.

Recommendation: That the UK Groceries Code be examined with a view to implementing a similar mandatory code in Australia that would suit Australia's more concentrated market and conditions. These needs to take place with the knowledge that the potential for across the supply chain complaints must be permitted.

Further information on the UK Groceries Code can be found at the link below:

http://www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/notice_of_intention_to_make_order_gscop.pdf

UK Draft Groceries Code Adjudicator Bill

As mentioned earlier, the UK Draft Groceries Code Adjudicator Bill establishes an independent adjudicator to 'police' the Groceries Code.

The Competition Commission considered that the Groceries Code would be more effective with an ombudsman in place to enforce it, to act as a referee and police the new rules.

This was because many small suppliers were worried that raising disputes against retailers would jeopardise future commercial agreements with these companies.

The Code came into force on 4 February 2010 but the UK Government did not release a draft Bill to establish the Adjudicator until 24 May 2011. The Bill is now making its way through the pre-legislative scrutiny process, which will involve committee review.

In its current form, the Grocery Code Adjudicator Bill establishes the Adjudicator and gives it power to investigate potential breaches of the Code and arbitrate disputes between suppliers and large retailers. The Adjudicator is also required to report annually on compliance with the Code. Where there is a breach of the Code, it will have the power to make recommendations and require large retailers to publish information (in effect, a naming and shaming power).

However, under the current Bill, the Adjudicator will only have the power to impose financial penalties on retailers if the UK Secretary of State makes a determination authorising financial penalties.

It is ADF's belief that the power of the proposed Commissioner or Ombudsman to impose financial penalties needs to be examined closely in Australia, given the large market share of Coles and Woolworths. Such penalties will assist in ensuring full compliance with a mandatory code of conduct and ADF believes it is appropriate for the proposed Commissioner or Ombudsman to have the power to enforce such sanctions.

ADF recommendations continued...Unconscionable conduct (section 51)

Unconscionable conduct is unfair or unreasonable conduct in business transactions that goes against good conscience. This can occur in transactions between businesses or within transactions between businesses and consumers.

The exact meaning of 'unconscionable conduct' is not defined in the Act. The Act lists several factors that the court considers when deciding if a party has acted unconscionably. However, the court is able to consider any other matters it believes are relevant.

Associate Professor Zumbo in his submission to the 2010 inquiry into Competition and Pricing in the Australian Dairy Industry recommended inserting a definition of the word 'unconscionable' into Section 51AC of the Act. Section 51AC of the Act was introduced in 1998 to address the problem of small businesses facing power imbalances while dealing with larger commercial entities.

He believes this would be an 'obvious way to provide clear statutory guidance as to what is meant by the term as used in Section 51' and 'would send a clear parliamentary signal to the Courts that the concept is not only broader than the equitable concept, but that s51AC is intended to promote ethical business conduct.' This is particularly important in a country where two dominant players have almost 80% of the market.

Such a definition would not interfere with the driving of a 'hard' bargain, but rather would provide clear statutory guidance as to what is considered unethical, set out a non-exhaustive benchmark for assessing conduct to determine whether or not it goes beyond what is reasonably necessary to protect the legitimate interests of the parties involved.

Associate Professor Zumbo believes the courts are currently defining the term and 'are taking such an onerous view of what constitutes 'unconscionable' that there is a growing danger that s51AC will fall into disuse' and fail to fulfil their original parliamentary intention.

ADF believes that Coles' recent actions are certainly unconscionable, particularly when the intent of the actions is taken as a whole. Coles clearly means to damage other competitors and also put pressure on the dairy (and other commodity sectors) value chain.

It is ADF's contention that Coles' recent actions are unconscionable, particularly when the intent of the actions is taken as a whole. As we have shown Coles' discount tactics are already causing damage to other competitors and lowering returns to the dairy (and other commodity sectors) supply chain.

ADF is of the view that anything that provides clarity for the courts and reduces the limitations of the current Act is worth pursuing.

'Unconscionable conduct includes any action in relation to a contract or to the terms of a contract that is unfair, unreasonable, harsh or oppressive, or is contrary to the concepts of fair dealing, fair-trading, fair play, good faith and good conscience.'

Recommendation: That the definition of unconscionable conduct above provided by Associate Professor Frank Zumbo in his submission to the 2010 inquiry, or a similar definition with the same intent, is inserted into the Competition and Consumer Act 2010.

Enacting a Statutory Duty of Good Faith

It is important in any commercial relationship that acceptable and ethical business be promoted and undertaken. It is ADF's belief that enacting a statutory duty of good faith in the Competition and Consumer Act will assist in ensuring this takes place.

ADF understands that recent case law has provided a framework upon which a statutory duty of good faith could be based.

(1) Acting arbitrarily, capriciously, unreasonable or recklessly;
(2) Acting in a manner that is oppressive or unfair in its result by, for example, seeking to prevent the performance of the contract or to withhold its benefits;
(3) Failing to have reasonable regards to the other party's interests; and
(4) Failing to act 'reasonably' in general.

ADF is of the view that Coles has not conducted its recent price cuts in good faith with dairy farmers – even though Coles does not contract directly with dairy farmers. There are several reasons for this view:

- Coles has consistently quoted misleading figures in the media to make it appear that dairy farmers in milk production areas are doing better financially than is the reality;
- Coles has consistently and repeatedly quoted misleading figures in the media to present the perception to consumers that the Coles discounting will not harm dairy farmers. These misleading statements have included but are not limited to;
    - Coles refusing to acknowledge the almost immediate impact of its actions on some dairy farmers in Queensland due to reduced sales of branded milk; and
    - Coles' strategy ultimately leading to a fundamentally unsustainable re-pricing of drinking milk as a commodity; and
    - Despite claiming that their actions will not affect dairy farmers Coles has repeatedly refused to rule out dropping prices for processors and farmers in future contracts.

In situations where a company with significant market power and vast resources uses its 'muscle' to damage an industry then it cannot be said to be acting in good faith. ADF believes the enacting of a statutory duty of good faith will assist in controlling such behaviour.

Associate Professor Zumbo highlights the fact that Courts are giving growing attention and support to an implied duty of good faith in commercial contracts.

'Clearly the concept of good faith has not only received strong judicial support, but now has reached the point in Australia where its nature and scope is being defined with an increasing degree of precision. Consequently, there is a ready body of law on which a statutory duty of good faith could quite readily and usefully draw upon in seeking to promote ethical business conduct.'

Recommendation: That a statutory duty of good faith be enacted as part of the Act as soon as possible to provide an appropriate and accepted benchmark of standards of ethical conduct within the Australian dairy industry.

Effects Test

The clear intent of the Coles strategy is to extract as much value from the supply chain with consequent pressure on those at the start of the chain. It is also seeking to increase its own market share to the detriment of its competitors and to increase the share of its home brand products in store. Given this it is important that the ACCC have the ability to examine the impact of such strategies in the longer term, with particular emphasis on the impact on consumer choice, farmer viability, the supply chain and future prices.

It should also be noted that ADF is of the firm opinion that the ACCC must take a longer term view of market issues than it currently does on all issues. It must not only look at the impact of issues on the current market but examine potential future impacts – this is particularly the case for misuse of market power issues. The former Section 49 included an ‘effects’ test – does the conduct in question have the effect or the likely effect of bringing about a substantial lessening of compensation.

ADF believes it is well worth reinstating this to assist the ACCC in taking a longer term view of issues and discovering the true impact for consumers, farmers and others of strategies undertaken by those with significant market power.

Recommendation: That an ‘effects’ test be reintroduced into the Act.

Attachment 1

IMPACT OF THE $1.00 PER LITRE PRIVATE LABEL MILK PRICING ON THE WESTERN AUSTRALIAN DAIRY INDUSTRY VALUE CHAIN

STEVE HOSSEN RURAL CONSULTING PTY LTD

Conclusion

The lower price private label milk has taken $25.2M per year out of the Western Australian milk value chain.

Summary

In January 2011, Coles lowered the retail price of private label milk to $1.00/L, with the promise to keep the price down. Woolworths lowering its private label price rapidly followed.

The retail price change for the private label milk, has had an effect over all Australia, I have restricted my analysis to Western Australia. Milk pricing and sale in one sector of the retail industry should not be looked at in isolation, sales data since January 2011 discounting, illustrate the price and volume impact on the different market sectors.

1. Changes in total milk demand resulting from the lower milk price. The price elasticity of demand for milk has historically been seen as low, that is milk is regarded as an essential and a lower price will have little impact on the overall demand. The sales figures available do not provide data on this effect, all milk sales need to be recorded and in a consistent way across all retail sectors, branded fresh, private label, UHT and powdered milk for this determination to be made. It is expected that total milk sale would increase with lower prices, but the reported sales changes is not a measure of more milk being sold but a change in customers behaviour as they move to the lower priced product, perhaps from higher priced products in smaller retail outlets or new customers to milk as a beverage, I believe the largest factor is a product change and not a switch to milk. Consumers have moved from smaller retailers, without access to the $1/L milk to retailers with access to this discounted product, customers are likely to move at the margin from UHT milk to the $1.00/L milk, as well as the more visible transition from branded milk to private label milk.

2. In all situations the rate of change in customer preference is not static. The move to the lower priced product is driven by the relative prices for what they consider to be like products; customer awareness of the price differences; the customers perception of value of the lower cost milk relative to the alternatives and relative shelf exposure. It is likely that over time the relative market share of the competing alternatives will stabilise, at the time of writing this report stability has not yet been achieved, the private label market penetration is still increasing but at a diminished rate.

3. The claim that if contract prices are maintained for milk going into the private label product, there should be no impact on the farming sector is wrong. Farmers are a component of the total milk value chain, if value is lost in the chain as a result of retail discounting, it is illogical to

conclude that any component of the chain, including farmers, is immune from the loss of value in the chain.

4. The loss of milk value at the retail level is not an issue that should be seen in isolation. Lower returns in the supply chain can act as a stimulus for productivity improvement in that supply chain, that is, if productivity improvements are possible. These improvements can be made anywhere in the supply chain from the dairy farmer, milk collection, milk processing through to milk distribution to the retail. If market pricing power is not in the long term balanced between the farmers and the processors a disproportionate amount of the impact will be transferred down the supply chain, in this case the farmers.

The objective of this report is to focus on the impact of the private label change from a WA Dairy Industry perspective, and the value chain immediately above the farming sector. I am aware that there is a wide range of potential economic impacts to the customers, retailers, milk manufacturers and farm sector.

Economic Impact

The manufacturers were very reluctant to provide detailed information about the sales and pricing of their branded lines of product, before and after the $1.00/L initiative, directing me towards the published data. The retailers were not asked to provide the same information from a WA perspective but I strongly suspect that they would have responded in the same way and directed me to the published data.

The value decline measured at the retail level is made up of a number of components, that have changed as result of the introduction of the $1.00 per litre private label milk:

1. Lower price for private label milk.
2. Branded milk price response following the private label price drop, the branded milk could have remained at its previous level, but the branded price product price fell, I assume in an attempt to protect sales.
3. The change in the relative sales volume, that is the increase in private label and the fall in branded milk categories as customers shift to the lower priced private label milk.
4. The interaction with UHT and Corner Store milk sales. The lower priced private label milk will cause a corresponding drop in price for UHT or the small retailer branded milk sales. If there is not a corresponding price fall in these categories, then it is likely that sales in these category will decline over time. I do not have access to the Corner Store milk sales or UHT sales statistics. It would be logical to assume that the price drop for the private label milk will also impact on these sectors within the market.

Milk Market in Transition

The available milk sales data suggests that the milk retail market is now near a new stable level post the impact of the $1.00/L private label milk, the initial changes have been significant and are now the new norm.

Private label price is down by 4.3% to 32.7%[1], the weighted average is not known but the Aztec data shows that the April 2011 private label price was $1.02/L in Western Australia, in April 2010 the corresponding price was $1.23/L and prior to January 2010 the price varied but was always above $1.25/L. In my calculation of the price drop I have assumed a price drop from $1.20/L to $1.00/L.

The price impact is not confined to the private label milk, branded full cream milk has fallen from $1.64 to $1.57 and branded modified milk prices have been stable at $1.67 in 2009-10 to $1.66, quarter ending May 2011[2]. In Western Australia about 1.5 litres of branded while milk is sold for every litre of branded modified milk, and as such I have assumed the average branded price has declined by 5 cents per litre, from $1.65c/L to $1.60c/L.

The wider price gap between private label milk and branded milk has resulted in increased sales of private label milk relative to the branded product. Private label sales increase varies greatly across Australia from 0.5% in NSW, full cream to 28.3% in QLD for modified private label[1]. In WA the private label full cream sales increased from 1.46ML to 1.86ML (April 2010 to April 2011) or 27%[2].

David Losberg, Policy Manager, ADF calculates that the WA private label increase is 9% in WA, this appears to be a conservative estimate of the change in sales, I have used this estimate in my calculations.

The relative size of each market, private label verses branded milk impacts on the value chain loss, assuming all the private label milk is reported within the Aztec data then the annual sales of private label milk totals 51ML up until April 2011.

The total sales of milk from all sources, is approximately 240ML in Western Australia.

Estimated Impact (WA)

Pre Discount	**Market Share**	**$/L**	**Post Discount**	**Market Share**	**$/L**
Branded	79%	$1.65	Branded	75%	$1.60
Private Label	21%	$1.20	Private Label	25%	$1.00
Weighted Average		$1.555	Weighted Average		$1.45

Value lost per litre of sales measured at the retail point 10.5c/L, a decline from $1.55 to $1.45/L, based on 240ML sales per year in WA the impact is $25.2M.

[1] - NF producer presentation WA June 2011.

[2] - Aztec milk sales data.

There are three sources of value loss associated with the reduced price of the private label milk

Plain Label Price Reduction	51 ML	$10.2M per year
Branded Milk Price Reduction	189ML	$9.4M per year
Customer switch from Branded to Plain Label		$5.6M per year

Supply Chain Response

In the months since the $1/L price initiative, there has been very little visible supply chain response to the lower value, essentially there are three ways to restore profitability or at least close the gap:

1. Reduce costs in the manufacturing controlled sections of the supply chain; milk collection, manufacturing efficiency and distribution to retail.
2. Lower the price of milk paid to suppliers, forcing a heightened search for on farm efficiency gains.
3. Manufacturers develop other milk markets to better offset their fixed capital in place and labour.

The financial impact on the milk value chain is $25.2M. The quality of the data is not perfect and as such there is a range likely with respect to the value and I expect the loss to be within $22-$28M per year in Western Australia.

Yours faithfully

Steve Hossen

RURAL CONSULTANT