Norco Co-operative Limited

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The Impacts of Supermarket Price Decisions on the Dairy Industry

Summary

Norco believes that if the current discounting of milk by retailers is continued it will adversely impact farmer returns, reduce processor margins, reduce consumer choice, cause significant damage to regional communities in Queensland and New South Wales and, ultimately, see the possible demise of the dairy industry.

What is Norco?
Norco Co-operative Limited (**Norco**) is a diverse agricultural co-operative wholly owned by its dairy farmer suppliers. Norco currently has 260 active members operating 165 dairy farms in northern New South Wales and southern Queensland.

Norco currently purchases all of its milk from its own members, other than for some organic milk that is purchased from two organic dairy farmers. In 2009/2010 Norco's dairy farmers produced 143 million litres of milk, representing about 17% of milk production in northern New South Wales and southern Queensland.

Norco also retails a range of Nimbin Natural cheese, operates an ice cream production facility, operates a Rural Retail business with 24 rural stores in northern New South Wales and south east Queensland, operates a wholesale business and an Agribusiness division incorporating Goldmix Stockfeeds, Crest Seeds and SuperVites that manufactures and sells quality stockfeed, bird seed products and pet food respectively.

Farm Gate, Wholesale & Retail Milk Prices
Norco’s average farm gate milk price for the financial year 2009/10 was 54.11 cents per litre. This price is the actual price paid to producers and it does not include any costs for the collection, processing and final distribution of the finished product. The 54.11 cents per litre paid to Norco’s farmers is approximately 3 to 4 cents per litre above our farmers average break even position, which was documented in the Northern Dairy Industry Cost Model.

The retailers have reduced their price from $2.47 for 2 litres of unbranded milk to $2.00 which is a 23.5 cent per litre reduction. If this reduction were to be passed back down the supply chain, it would result in a farm gate milk price for Norco suppliers of 30.61 cents per litre which is well below the break even milk price of 50 cents per litre which in our view would devastate the dairy industry in Queensland and northern New South Wales.

Norco is concerned about the retailers’ milk pricing strategy. Since the introduction of the lower price in January, Norco has seen a 2% uplift in generic milk products sold and we are expecting to see a larger change over an extended time. The retailers have stated that they will absorb the cost of the milk price reduction but for how long will this last? Selling milk for a loss is not a sustainable pricing model. Norco already sells milk that ends up in retailers outlets at a reduced price in order to ensure that all of Norco's milk is placed and any further pressure on this price cannot be borne by our farmers.

Historically the processing sector has endeavoured to supply smaller independent retailers with a price competitive product to match the major retailers. The current price driven promotions undertaken by the major retailers is a position the processing sector cannot support further along the supply chain without adversely affecting profitability, sustainability and, ultimately farm gate price. Processors rely on a mix of business between branded products and generic products to remain profitable. The price differential and the processor's margins are such that they depend on a reasonable proportion of branded product sales to balance the lesser, and sometimes negative, margins available on generic products. If consumers abandon branded products in favour of generic products some processors may also be forced to leave the industry. Such an outcome would, in Norco's view, inevitably lead to a substantial lessening in competition.

Norco would like to note that the cost of producing milk in the northern part of Australia is higher than southern Australia due to the cost of land, increased temperatures and the fact that farmers need to supply a certain volume of milk 365 days a year to satisfy the fresh milk market. It is our view that these factors, on average, mean that the industry requires an additional 15% to 20% premium compared to southern farmers who operate on a seasonal production system. While it is the case that the majority of milk (64%) is produced in Victoria, northern Australia needs to maintain a dairy industry in order to reduce food miles and also in order to ensure food security across Australia.

Norco is concerned about the impact of the retailers' pricing strategy on our brand and on other processors' brands. As the generic volume increases, as a result of the recent pricing strategy, the retailers will more than likely apply pressure to the processors to reduce their price to keep their brands on shelf. Applying pricing pressure to the processors means that any price reduction must be passed on to the suppliers, which will push the suppliers below the break even position and will see farmers exiting the industry.

Decrease in Australian Production of Milk

The Australian production of milk has decreased from 11 billion litres in 2004 to 9 billion litres in 2011, of which 25% is drinking milk. (Coles state that they represent 5% of the total milk volume. Their 5% though represents 20% of the national drinking milk category). In the northern area of Australia where Norco is situated, 90% of our milk is produced for drinking milk and 10% goes into other products such as ice cream. Pricing pressure on our farmers will result in farm closures and will mean that drinking milk will need to be distributed from Victoria to meet consumers needs, adding cost to the milk via freight. The recent announcement by the Government that it will impose a tax on carbon will exacerbate this additional cost.

A potential reduction of milk production in the northern part of Australia will also mean that milk production in Australia will be confined largely to Victoria. This would mean that Australia's food source area would be dramatically reduced and food security put at risk as a consequence. Dairy Australia's recent Situation Outlook report states that for every dollar spent on farm, three dollars are created in the downstream economy. Consequently if farms exit the industry due to a lower milk price, employment and retail activity will be adversely affected in local communities.

Any reduction in Norco's milk production will also impact the quality of the milk sold in the community. Milk is a staple food in any balanced diet and Norco's brand of milk does not contain permeate. Norco's milk is 100% milk. Some of the other brands use permeate and retentate in their products and although permeate is a legal food, it is not 100% milk. Norco is proud that our product is 100% milk and that we provide a high quality food product to the community.

Norco takes this opportunity to suggest that the government should address food labelling laws so that consumers know when additives such as permeate and retentates are included in their food products.

Norco recommends that the Senate Committee investigate strategies to support the dairy industry in New South Wales and Queensland in order to ensure staple foods such as milk and fresh dairy products are available to consumers at all times.

The recent flooding in Queensland and Norco's capacity to deliver fresh milk to residents in Queensland at that time when other milk processors were not able to do so, demonstrates that food security should be considered when intense climatic or unforeseen other catastrophic events occur.

Is the Retailers' Pricing Anti Competitive?

The retailers have stated that they will absorb the profit impact of their milk price reduction, but for how long? As the generic volume increases, together with the generic facings in the retail space, at the expense of the branded options, the processors will be placed under pressure to reduce the price of their branded products or face the real threat of losing shelf space and/or ranging. This would be anti-competitive behaviour as it would mean that the processors will be forced to reduce their price, or lose the opportunity to have their brands sold through the retailers' outlets.

The retailers should be made to keep their promise of not putting price pressure on the processors in order to keep the fresh milk market alive in northern Australia.

Norco achieved a $2.3m net profit in 2009/10. A 1 cent per litre milk price reduction, if borne by Norco, would cost the Co-operative and its members $1.4m. On that basis Norco could, absorb only a very small price reduction before we would have to pass the price decrease onto our farmers. As our farmers only have a very small profit margin themselves any price reduction passed onto them could put their businesses into a loss situation and result in the closure of their farms and the reduction of fresh milk production in Australia. Does the Australian consumer want to drink fresh milk or UHT? Norco believes that consumers want a fresh milk option, and current market information supports this belief (see Appendix A).

Recommendations have been put forward by the Senate Economic References Committee (see Appendix B) to address the very issue that is now occuring. Those recommendations, in part, were directed to an exploration of the effect of market dominance by two major retail chains and the impact of that dominance on the farm gate price for milk. The recommendations of that Committee need to be implemented so that a proper understanding can be developed regarding the establishment of an equitable system of milk price setting. Norco believes that the industry needs a direction which is based on clear answers to the issues raised, in particular, by recommendations

2, 3, 4, 12 and 13. If such a direction is not forthcoming Norco holds grave concerns regarding the capacity of the dairy industry in northern Australia to survive into the medium and longer term future.

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Yours sincerely
NORCO CO-OPERATIVE LIMITED

(...)

GREG McNAMARA
Chairman

BRET KELLY
Chief Executive Of ice