Chapter 5

Impact of the retail price cuts at the farm gate

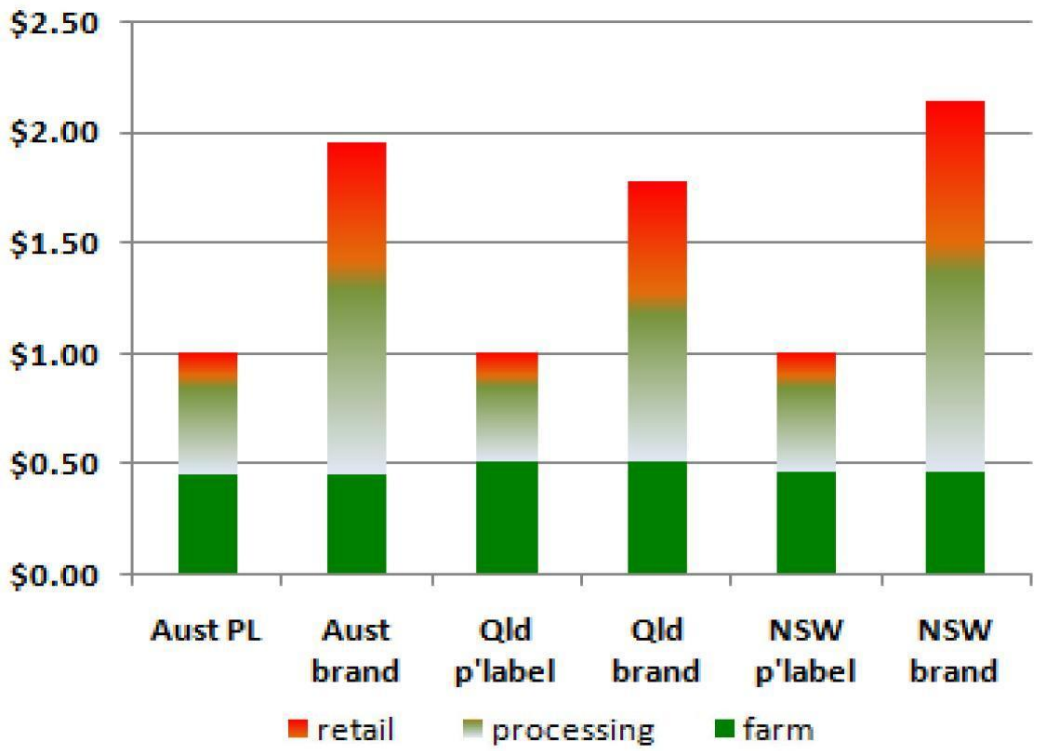
5.1 This chapter addresses the second question posed by the committee in its *Second Interim Report*; namely, the impact of the supermarkets' price decisions on the outcome of renegotiated contracts with the processors and farm gate prices. In so doing, the chapter examines the nature of the processors' pricing structures, the contract negotiation process and the outcomes of renegotiations (or other factors which have affected the incomes dairy farmers receive) since the price cuts were introduced.

Impact on processors and possible flow on effects

5.2 Processors that hold contracts for private label milk balance the low or negative returns they receive from those products with higher returns from their other branded sales. As discussed in chapter 3, this is done for a variety of reasons, including volume management and business stability considerations.

5.3 Figure 5.1 below provides an indicative picture of how the full retail price paid by consumers for private label and branded milk is distributed among the participants in the supply chain.

Figure 5.1: Components of the retail price of milk, brands v private label (March 2011)



Note: As contracts between retailers and processors are generally commercial-in-confidence but farm gate prices are public, the chart reflects some uncertainty about the actual share of revenue received by retailers and processors.

Source: Freshlogic; published in Dairy Australia, *Northern Dairy Industry Regional Industry Outlook—Update: June 2011*, p. 8.

5.4 One aspect that is clear from Figure 5.1 is that an increased shift to private label milk at the expense of the branded milk will have significant implications for the revenue received by processors. As noted in chapter 3, there is very little difference between private plain white milk and branded plain white milk in terms of quality and other specifications. Accordingly, any extra costs involved should be attributable to factors like marketing and the need to distribute the products to a larger number of smaller, dispersed buyers.

5.5 The exact size of these additional costs is unclear. The National Association of Retail Grocers of Australia (NARGA) suggested that for a two litre bottle of milk in Western Australia, the difference in the cost of distributing private label milk to Coles versus branded milk to independent stores is about six cents. NARGA also estimated that the marketing component of branded milk equated to about seven cents for a two litre bottle. This results in a differentiation of 13 cents for the processor to provide branded milk compared to private label, yet the wholesale price paid by a smaller store is significantly higher than that paid by the major supermarkets. NARGA concluded:

> It is the same product but there is a $2 difference in cost to the small retailer versus to Coles, and the only extra cost of that processor selling to the smaller store is the … distribution and marketing costs. We have been saying for some time that the only way that the processors can continue to supply cheaper house-brand or generic milk to both Coles and Woolworths is to recoup that margin that they lose on the supply of the product by the sale to other customers. It is clearly happening in this case.[1]
>
> … We have also been saying for some time that we believe we have been seeing the waterbedding effect in the dairy sector in Australia where you have got high prices for ice-cream and yoghurt. Again, I would assume that the processor is recouping margin out of that.[2]

5.6 If the new prices for private label milk are maintained and the market share of private label milk continues to grow, the business model of offsetting low, nil or negative returns on private label milk with higher returns on branded milk and other products could result in significant pressure on the processor.

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1 Mr John Cummings, Chairman, National Association of Retail Grocers of Australia, *Committee Hansard*, 9 March 2011, p. 2.

2 Mr John Cummings, Chairman, National Association of Retail Grocers of Australia, *Committee Hansard*, 9 March 2011, p. 4.

5.7 As noted in chapter 3, Lion Dairy & Drinks has advised the committee that their return on private label milk is now expected to be negative.[3] For the most part, this appears to be an outcome that is a consequence of the processors' business models and their decisions to supply private label milk in the first place. The ACCC warned about arguments focused on the impact of private label milk on branded products, noting that many of them appeared to originate from 'very well-heeled vested interests':

> … our main concern is with the farmers on the one hand and with consumers on the other, because they are the smaller parties in all this. But some of the arguments that are being mounted have little to do with the farmers or consumers; they have a lot more to do with the position of the processors.[4]

5.8 Nevertheless, the degree to which any losses suffered by the processors are passed onto farmers remains a key concern.

Contracts between farmers and processors

5.9 Lion Dairy & Drinks (formerly National Foods) advised that, generally, their contracts with farmers are for a minimum of one year, with a number of two and three year contracts also offered.[5]

5.10 These timeframes generally do not necessarily align with the contracts the processors have with the supermarkets. Woolworths advised that their contracts are for either 12 or 24 months, whereas the majority of Coles' are for three years.[6] The interaction between the contracts the processors have with dairy farmers and those with the major supermarkets was explained by Lion:

> For farmers, the pressures arise because they must make investment decisions about the size and composition of their herds and the nature of their plant and equipment. Those decisions necessitate a longer term investment horizon and exposure to ongoing fixed costs. Consequently, farmers look to the processors to provide guaranteed cash flows over the farmers' investment horizons. However, the processors are not able to commit to supply arrangements with farmers until the processors have finalised their contracts for house brand volumes with the supermarkets.[7]

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3 Lion Dairy & Drinks, *Submission 159*, p. 4.

4 Mr Brian Cassidy, Chief Executive Officer, Australian Competition and Consumer Commission, *Committee Hansard*, 9 March 2011, p. 30.

5 Mr Peter Walsh, Manager, Government Relations, National Foods, *Committee Hansard*, 9 March 2011, p. 66.

6 Mr Pat McEntee, General Manager, Fresh Foods, Woolworths, *Committee Hansard*, 29 March 2011, p. 3; Mr John Durkan, Merchandise Director, Coles, *Committee Hansard*, 29 March 2011, p. 43.

7 National Foods, *Submission 97*, p. 17.

5.11 Changes to the contract arrangements between the major supermarkets and the processors can cause significant uncertainty and unease. For example, the holder of Woolworths' private label contract for New South Wales recently changed from Lion to Parmalat. This change triggered significant concern from the Dairy Farmers Milk Co-operative (DFMC), suppliers to Lion:

> We had been hopeful Parmalat would come to an agreement with Lion to continue to source milk through DFMC. This would have created stability and certainty in the NSW market. However, we have been informed the negotiations between Lion and Parmalat have broken down. We continue to push for these negotiations to recommence but in the meantime we understand Parmalat will now be out in the market trying to convince NSW dairy farmers to supply them directly without the support and assurance of working through a Co-operative. Potentially, Parmalat could also begin drawing on milk supplies in Victoria and bringing it into NSW.[8]

Volume and pricing arrangements

5.12 Lion Dairy & Drinks and Parmalat are the major players in drinking milk processing. At the time of this inquiry, both Lion and Parmalat utilised a multi-tier pricing structure in their contracts, however, the milk that is allocated to each tier, and the variation in the prices between each tier, differ. Clover Hill Dairies described how it supplies National Foods, through the DFMC:

> The current practice is for … [Lion] … to announce what is known as an Anticipated Full Demand (AFD) to DFMC. For DFMC to meet their obligations under the AFD system our regional dairy farmers are allocated milk allotments akin to quota and sell this milk to DFMC at an announced price. This milk price is known as Tier 1 milk. Farmer suppliers who produce above their allotment or do not hold an allotment receive a lower price which is currently close to 50% of the price of Tier 1 allotment milk. This milk is known as Tier 2 milk … A secondary processor to processor milk markets occurs for Tier 2 milk. There is no transparency at farmer level as to what Tier 2 milk is being sold to other processors for.[9]

5.13 The Queensland Dairyfarmers' Organisation explained:

> Tier 1 milk, under the Lion payment scheme, includes all milk sold by Lion as bottled fresh milk including both processor proprietary branded milk and supermarket store brand milk.[10]

5.14 Parmalat appears to pay different prices for drinking milk and manufacturing milk, except for the drinking milk which goes into the supermarkets' private label

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8 Dairy Farmers Milk Co-operative, *Letter to suppliers*, 1 August 2011, www.dfmc.org.au/docs/Letter%20to%20Suppliers%20re%20Parmalat%20and%20Woolworths%20Milk%20Offtake.pdf (accessed 23 August 2011).

9 Clover Hill Dairies, *Submission 53*, p. 2.

10 Queensland Dairyfarmers' Organisation, *Submission 94B*, p. 20.

products, which is bought at the lower price. While Parmalat also utilises a two-tier pricing system, unlike the Lion/National Foods model, its tiers are linked to specific end products, and the price of the top tier can vary month-by-month, depending on retail sales:[11]

> There is a group of farmers in Queensland who actually have an arrangement with their company where they get a certain percentage of their cheque from branded sales and then other. With a reduction in branded sales those farmers are expecting to see a cut in part of their margin this year. We do believe that there may be an anomaly in that because of the drop in production in Queensland. So the cents per litre figure might not necessarily change, but the total volume of the branded sales will change. We hope to be able to verify that when we see the milk cheques.[12]

5.15 The operation of Parmalat's Pauls Daily Access Scheme (PDA) was explained in detail in evidence received by the committee:

> The PDA scheme only relates to total PAULS branded milk sales and each farmer in the PDA scheme has an allocated daily milk supply volume under the PDA. PDA dairy farmers can trade PDA volume among themselves according to how much milk they calculated they would want to supply in the coming year.
>
> Parmalat pays a higher price for this PDA (or tier 1 milk) but if the farmer failed to supply the PDA amount across the month as specified by the amount of PDA they held, then penalties would apply. All milk supplied over the allocated PDA amount would be collected but paid at a lower manufactured (or tier 2) price. Currently the average base price for PDA milk is approximately 58 cents per litre.
>
> If Parmalat's PAULS branded milk sales do not reach the total PDA level in the state, then farmers are only paid the percentage that sales were of the total state PDA amount. The rest of the farmer's milk supply would attract the lower manufactured (or tier 2) price, which is currently approximately 44 cents per litre.[13]

Relationship between the January 2011 price cuts, farm gate prices and contract arrangements

5.16 What overall impact have the pricing decisions had on farmers' incomes? Conflicting claims were put forward on this issue. The Australian Dairy Farmers provided the results of modelling undertaken based on current trends being extrapolated for the rest of 2011. One scenario suggested the overall supply chain

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11 Mr Brian Tessmann, President, Queensland Dairyfarmers' Organisation, *Committee Hansard*, 8 March 2011, p. 89.

12 Mr Adrian Drury, Vice President, Australian Dairy Farmers, *Committee Hansard*, 8 March 2011, p. 11.

13 Queensland Dairyfarmers' Organisation, *Submission 94B*, p. 18.

would be devalued by $28 million, the other as much as $227 million. The Australian Dairy Farmers commented:

> 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.[14]

5.17 Coles considers that:

> … conditions for the dairy industry as a whole have improved, with steady to rising farm gate prices by all milk processors so far for the FY12 season. Predictions of imminent and severe reductions in farm gate prices as a direct result of the Coles retail milk price reductions in January 2011 have simply not occurred.[15]

5.18 The overall picture for farm gate prices since January highlights the split in the Australian dairy industry between the regions which produce largely for manufacturing and export, and those that produce to satisfy domestic demand for drinking milk.

5.19 The state of the manufacturing milk regions, particularly for farmers in Victoria, appears relatively solid compared to recent years. Murray Goulburn, the price leader for the southern manufacturing areas, recently announced an opening price for the 2011–12 season which equated to a weighted average of $4.90 per kilogram of milk solids. It also forecast a final price of between $5.30 and $5.50.[16]

5.20 Dairy Australia considers that for the manufacturing regions:

> Improved milk prices, combined with low grain prices and generally favourable seasonal conditions have provided southern 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.[17]

5.21 Dairy Australia qualifies this assessment by noting:

> While cashflows have generally improved, this has merely enabled many producers to restore their financial positions following the shocks of the previous two seasons, and the finance sector is also now generally operating with much tighter controls on debt exposures.[18]

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14 Australian Dairy Farmers, *Submission 150B*, p. 15.

15 Coles, *Submission 131A*, p. 3.

16 Murray Goulburn, 'Murray Goulburn Co-Operative forecasts solid farmgate returns as it releases opening prices to its dairy farmer supplier-shareholders', *Media release*, 29 June 2011. Opening prices can be increased through 'step-ups' throughout the year.

17 Dairy Australia, *Dairy 2011: Situation & Outlook*, May 2011, p. 3.

18 Dairy Australia, *Dairy 2011: Situation & Outlook*, May 2011, p. 3.

5.22 Other developments, such as Coles' announcement that Bega will now produce its entire private label cheese range (half of which was previously imported from New Zealand), are welcomed by the committee and will be a boost to the southern manufacturing regions. However, it is unlikely to offer any comfort to farmers in the drinking milk production focused areas.[19]

5.23 For the drinking milk focused-states, whether the impact of the retail price cuts in private label milk would be felt by farmers immediately, or after some delay when their contracts are renegotiated, appears to depend on whether a farm ultimately supplies Parmalat or Lion (or another processor).

5.24 Lion hinted at what the future may bring:

> … the nature of our procurement with our farmer base is through longer term contractual arrangements and the impact of a sustained discounting arrangement that is beneath what last year we were saying was an unsustainable price will only be fully felt by the suppliers that supply milk to us when those contractual arrangements fall due.[20]

5.25 Any assessment is also complicated by other factors. For instance the uncertainty and disruption caused by changes to the private label contract arrangements in New South Wales noted earlier may also be contributing to pricing outcomes.

5.26 Without dismissing the extent or overlooking difficulties faced by farmers in other areas of the country, developments in three states—Queensland, New South Wales and Western Australia—have been particularly noteworthy.

Queensland

5.27 Dairy farmers in Queensland have had a difficult 12 months, with the floods presenting particular challenges for the industry. In the last year, 40 dairy farmers have left the industry in Queensland.[21] As shown by Figure 5.2, since January 2011 milk production has not met the amount demanded for domestic consumption within the state.

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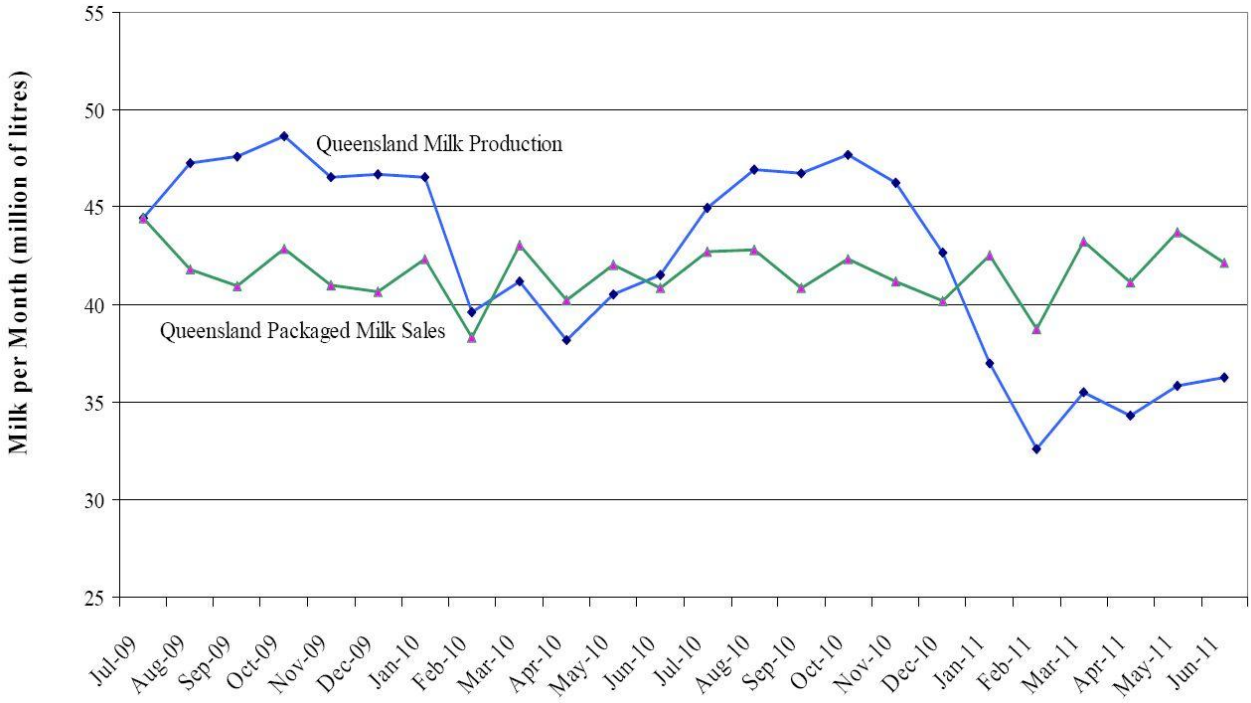
19 Coles, *Submission 131A*, p. 5. Coles submits that Bega will need to source an additional 70 million litres of milk from southern NSW and Victoria to fulfil the deal, and that it will add $30 million to the industry.

20 Mr Peter Walsh, Manager, Government Relations, National Foods, *Committee Hansard*, 9 March 2011, p. 72.

21 Queensland Dairyfarmers' Organisation, *Submission 94B*, p. 23.

Figure 5.2: Queensland milk production v packaged milk sales



Source: Queensland Dairyfarmers' Organisation, *Submission 94B*, p. 24; from Dairy Australia data.

5.28 Early in the committee's inquiry, it became clear that some of the contractual arrangements in place meant that certain Queensland farmers could be immediately impacted by any changes at the retail end of the supply chain:

> … farmers whose milk payments are linked to branded milk sales will see a reduction in their milk cheques. For some this may be as early as mid-March.[22]

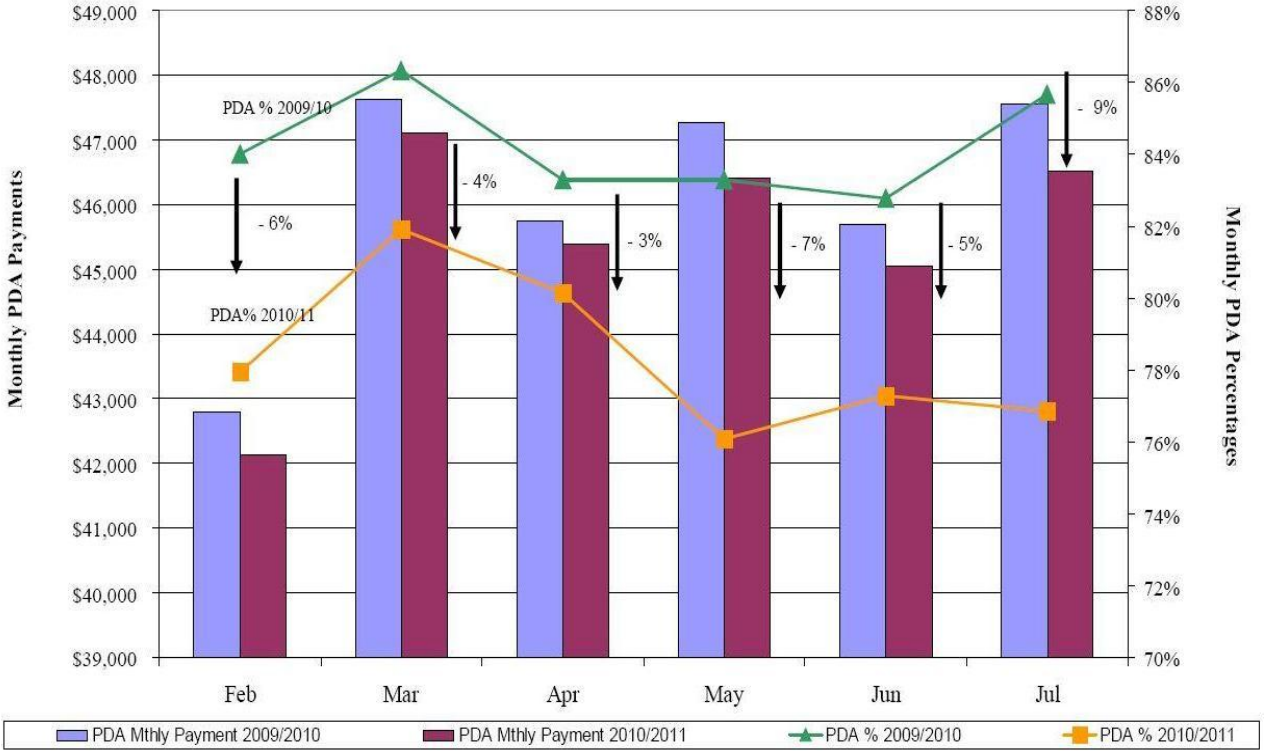
5.29 The implications of the monthly variation built into Parmalat's contract arrangements, and the ease in which shocks would promptly impact farm incomes was explained in detail to the committee:

> With the PDA, Pauls Daily Access, system with Parmalat you get paid your tier 1 each month—your higher priced milk—as a percentage of what is basically your PDA quota. There are two figures that are important in calculating the payment: the actual sales figures and then what they have sold outside the area to bolster up another milk pool in Central Queensland. In February last year the initial figure of sales percentage was 84.23 per cent, which was then bolstered up to 88.8 with what they were selling just outside the region. In November it was 84.59. That is the bolstered-up figure; the original figure was 82.85. But when you come to February 2011 the initial figure is 77.9, so the amount that they get paid their better price

22 Mr Christopher Griffin, Vice President, Australian Dairy Farmers, *Committee Hansard*, 8 March 2011, pp. 2–3.

for has come down significantly. The bolstered-up figure is 80.89. That shows already a significant drop off, even since September. Particularly when you compare month on month with a year ago—because months do vary, normally—that is a significant fall, down from the base figure in southeast Queensland of 84.23 to 77.94. To a dairy farmer that is a significant drop in his income for that month.[23]

Figure 5.3: Pauls Daily Access one million litre dairy farm monthly returns and percentages, February to July 2009–10 compared to 2010–11



Source: Queensland Dairyfarmers' Organisation, *Submission 94B*, p. 19.

5.30 The Queensland Dairyfarmers' Organisation estimates that one group of 185 producers who supply Parmalat have lost about $767,000 up to July 2011 as a result of the private label discounting. They further estimate that this would total $1.5 million for the entire year if the sales trend continues.[24]

5.31 It appears that farmers who supply Lion Dairy & Drinks in Queensland are also facing lower incomes as the renegotiated contracts for 2011–12 yielded a real decrease in their prices. Table 5.1 shows the prices paid by Lion Dairy & Drinks (formerly National Foods) for the 2010–11 year announced at the end of July, compared to their 2010–11 prices. On these figures, Australian Dairy Farmers

23 Mr Brian Tessman, President, Queensland Dairyfarmers' Organisation, *Committee Hansard*, 8 March 2011, p. 84.

24 Australian Dairy Farmers, *Submission 150B*, p. 8.

commented 'it is worth noting the annual inflation rate in Australia to June 2011 was 3.6 per cent'.[25]

Table 5.1: Outcome of Lion Dairy & Drinks 2011–12 prices in Queensland

	2011–12	2010–11	% change
Tableland			
Tier 1	$0.48	$0.47	+2.13
Tier 2	$0.33	$0.33	-
SE Queensland			
Tier 1	$0.475	$0.47	+1.06
Tier 2*	$0.35	$0.28	+25.00

* Australian Dairy Farmers submitted that Tier 2 milk is used for manufacturing dairy products and has increased in price in Southern Queensland due to higher demand in the market place.

Source: Australian Dairy Farmers, *Submission 150B*, p. 9.

5.32 The Queensland Dairyfarmers' Organisation argued:

> … with higher margin processor proprietary branded milk losing market share to supermarket store brand milk with little or no margin, the overall return from the sale of Tier 1 milk by Lion has declined. Consequently Lion's ability to improve farm gate prices has been undermined directly by the current supermarket price war.[26]

5.33 Although Coles contend:

> Coles fully funded lower retail milk prices and substantially increased contract payments to its major milk processors in Queensland in January 2011. The payments to our milk processor suppliers were sufficient to offset any impact on their margins from the expected shift from branded to private label milk. As a result, there should not have been any impact on farm gate returns as a direct result of Coles' pricing initiatives. Coles' position is supported by the fact that farm gate prices offered to dairy farmers in southern Queensland and far north Queensland have been broadly steady or increased for the FY12 season.[27]

New South Wales

5.34 Dairy farmers in New South Wales have also faced some specific challenges recently as a result of changes to private label contract arrangements. As noted in

25 Australian Dairy Farmers, *Submission 150B*, p. 9.

26 Queensland Dairyfarmers' Organisation, *Submission 94B*, p. 20.

27 Coles, *Submission 131A*, pp. 7–8.

chapter 3 and at paragraph 5.11, Parmalat recently gained the contract previously held by National Foods to supply stores in New South Wales. Given the volume associated with private label contracts, this change caused significant uncertainty for producers in the state. Negotiations over farmers' contracts as Parmalat attempts to source supply to fulfil its new contract have also been difficult. The Australian Dairy Farmers submits:

> 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 … 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.[28]

5.35 The NSW Farmers' Association pointed out that, for a farm producing one million litres a year, a two cent decrease in price per litre represents about $20,000 lost income. It also noted:

> Short term changes in contractual supply with processors is putting dairy farmers very business at risk as they cannot turn the milk tap on and off at a whim.[29]

Western Australia

5.36 The Western Australian dairy industry has faced challenges and uncertainty for some time, with events such as the collapse of Challenge Dairy in late 2010 compounding matters.

5.37 The committee was advised that in Western Australia, the farm gate price announced by Lion for the 2011–12 season was 41 cpl, compared to 42.04 cpl the previous year. The committee was also advised that for Harvey Fresh suppliers, their price increased by approximately 1.3 per cent (less than inflation) to about 39.2 cpl.[30]

5.38 The operators of a dairy farm located in the south west of Western Australia advised they had been informed they will receive a one cent per litre reduction (on average) in their farm gate milk price as a result of the retail discounts:

> A reduction of one cent per litre probably sounds insignificant. In reality it is just the rounding that occurs at the supermarket checkout, which often goes unnoticed by the consumer. However, to a dairy farmer, one cent per litre can be the difference of any particular dairy farmer remaining in the

28 Australian Dairy Farmers, *Submission 150B*, pp. 9–10.

29 NSW Farmers' Association, *Submission 124A*, p. 4.

30 Australian Dairy Farmers, *Submission 150B*, p. 11.

> dairy industry. For a farmer producing three million litres of milk annually, this equates to $30,000![31]

5.39 It has been estimated that the private label milk price cuts will take between $22 million and $28 million out of the Western Australian industry,[32] although Coles disputed these findings claiming, among other things, that the analysis did not appear to take into account factors such as the collapse of Challenge Dairy.[33]

Committee view

5.40 One key area of concern for the committee was the speed and ease in which a certain group of farmers in Queensland contracted to Parmalat were affected by the cuts in the retail price of private label milk led by Coles.

5.41 These contract arrangements appear to enable that processor to reliably source and manage the supply of milk for their brand. However, the processor also competes for tenders to supply private label product. Under these arrangements, it appears the risk of any retail price movements or other shocks that affect the sales of branded products are in large part being passed immediately onto the farmers. It is not clear why this should be the case; in most other industries, companies performing an intermediate function in a supply chain do not seem to have the ability to change the price of their inputs so readily.

5.42 The monthly variation in prices under some arrangements also leads to some concern, as they likely affect medium-term planning and investment decisions and create further uncertainty for dairy farmers.

Recommendation 1

5.43 The committee urges processors to make their pricing structures for sourcing drinking milk:

- **reflect the volume they estimate they require to meet their total commitments;**
- **offer more stability in prices rather than changing frequently; and**
- **not be dependent on the final retail sales of branded versus private label milk.**

5.44 The committee also reiterates the following recommendation from its 2010 report *Milking it for all it's worth*.

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31 Ms Lisa Armstrong, *Submission 154*, pp. 1, 2.

32 Steve Hossen, Steve Hossen Rural Consulting, *Impact of the $1.00 per litre private label milk pricing on the Western Australian dairy industry value chain* (see Australian Dairy Farmers, *Submission 150B*, Attachment 1).

33 Coles, *Submission 131A*, p. 7.

Recommendation 2

5.45 The committee recommends that contracts with dairy farmers should offer a clear, consistent formula for milk pricing with unambiguous conditions.

5.46 The committee is particularly concerned about evidence received regarding the deficit in drinking milk production in Queensland, and, given current market signals, the likely ability of the dairy industry in the drinking milk-focused states to meet future demand.

Recommendation 3

5.47 The committee recommends that the Government commission a study of the dairy industries in Queensland, New South Wales and Western Australia. The study should focus on the future sustainability of the dairy industry in each of these states and their capacity to meet future local consumer demand. The report of the study should also examine possible policy options and be tabled in the Senate.