NARGA

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2 March 2011

Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

By email: economics.sen@aph.gov.au

Attention: Mr John Hawkins

Dear Mr Hawkins,

Senate Economics References Committee inquiry into the impacts of supermarket price decisions on the dairy industry

I attach a supplementary submission to this inquiry. This submission is an extract from a research report completed by Accenture Australia and commissioned by the National Association of Retail Grocers of Australia.

The full report was published in November 2010 and is available on our website at www.narga.net.au

Yours sincerely,

Ken Henrick
Chief Executive Officer

5.3 Dairy industry case study

Industry context and background

The value of the dairy industry, a cornerstone component of the food value chain, was estimated at $4.5 billion at production level and at $11.5 billion at processing level in 2008. Australian retail turnover for dairy products was estimated at $6.7 billion in 2008[3]. The dairy industry represented 11 per cent of the total Australian primary production value in 2008, and 13 per cent of the total Australian food processing industry. Approximately 55 per cent of the milk production goes to domestic use (of which 24 per cent is for drinking milk) whilst 45 per cent goes to export[4].

The industry includes approximately 8300 dairy cattle farms employing 23000 people. The dairy processing sector employs approximately a further 20,000 people. This represents 8 per cent of persons employed in primary industry and 10 per cent of persons employed in food processing respectively in 2008.

Current trends

Consumer demand for dairy products is increasing. Consumers are demanding more dairy product variants and are more health conscious. As a result, flavored milk products and variants, such as low fat and pro biotic dairy products, have gained popularity in recent years. These have had a positive effect on innovation rates in this highly commoditised industry.

On the supply side, milk products' value growth has been affected by the removal of the dairy adjustment levy in February 2009, the introduction of private label products and by the related downward trend in retail prices. Dairy farmers are feeling the pressure from these trends from both processor and retailers, who are dealing with lower price ranges and a large switch to a commoditised private-label dairy products range. At the processing level, the dairy industry went through rationalisation and consolidation to cope with these trends. In addition, the Australian market has seen foreign companies such as Japan's Kirin making in-roads through acquisitions.

Issues & challenges

Margin pressures in the production and processing parts of the value chain: The retail pricing pressures from retail grocery market concentration in the hands of two major chains have had a direct knock-on effect on prices upstream, particularly for farmers, to the point where "Some of them have found the situation unsustainable", according to Dee Margetts, a former senator for Western Australia who has researched and written on dairy industry issues.

Private label and innovation: Private label now represents 60 to 70 per cent of milk sales and represents the single biggest change in the dynamics of the category in the last decade. It has resulted in retailers exerting pressure upstream on long-term contract-based wholesale prices for producers and processors.

At a recent conference with the Dairy Industry Association of Australia and Queensland dairy farmers, farmers repeatedly heard the message from conference speakers that the recent global financial crisis had changed consumer spending patterns, resulting in a marked increase in price-focused purchases and a strong increase in market share for private label milk. In contrast, for non-commoditised products such as flavored milk and yoghurt, private label lines are not very big and demand is strongly linked to brands and new innovative products.

This is the key structural challenge for the milk industry today and it has been examined by government in the recent report from the Senate Economics References Committee (May 2010) titled "Milking it for all it's worth". It provides further evidence of the current tension in the value chain in this space:

"There has been a trend towards increased concentration among both processors and retailers of milk in Australia. This is not just a coincidence; the increase in concentration among retailers has been an important driver for the increased concentration among processors and this is likely to continue…

3. Australian food statistics report 2008.
4. Dairy Australia website: 'Australia Dairy at a glance 2008/09'.

the removal of Price Discrimination provisions of the Trade Practices Act… enabled major supermarket chains to force their milk suppliers to supply their home brand milk at a considerably lower cost than for the branded milk, which…seems to result in a 'waterbed effect' and growing price differential between branded and generic products."

Exploring this issue further, in a recent report the ACCC observed that "Major Supermarkets' bargaining power for the supply of private label products means that the increases in production costs are not being fully reflected in the wholesale or retail prices for private label milk"

Industry players recently announced they were working towards increasing product innovation to counteract the rise of private label[5]. However, the structural challenges remain – as outlined by a senior executive of a major dairy processor recently: "This is a month to month challenge" as the retailing end has the smallest risk of investment per litre and highest profit per litre while at the farming end it has the highest risk of investment per litre and the lowest profit.

Increased difficulties in pricing: According to Dee Margetts, the removal of price regulated state markets under National Competition Policy a decade ago has contributed to the reduction of numbers of small milk farmers, who have not been able to obtain profitable returns. There has been a trend by farmers to consolidate operations to become more efficient so that processors could offer more competitive prices to retailers on a long term contract basis (80 per cent of milk by volume is contracted today). This strategy might prove risky in case of drought conditions which put pressure on costs models for such agreements and might result in more players exiting the production side of the business and reducing the supply base for the Australian market.

Future directions

There are a number of options designed to address these challenges that are being discussed in industry circles. One of them involves closer dialogue and co-operation between dairy processors and manufacturers in order to regain a level playing field in the value chain dialogue with retailers.

Another theme revolves around increased drive to innovation and differentiation by dairy processors to allow them to move away from competing purely on price in a commoditised market.

Taking this discussion to a more holistic level – the evidence suggests that there are no easy answers to the current structural issues in the value chain. The economic profits at the production level seem to be harder to come by, and innovation into new products may be at risk, due to price disadvantages that the new branded goods may have to overcome from the cost transfer to support growing penetration of private label products at retail level.

In the short term, one can argue that Australian consumers are winning due to lower prices of private label milk through major supermarkets. In the longer term the conclusions are less clear as the pipeline of new products is slowing down (affecting choice) and production capacity is jeopardized (which will put upward pressures on prices eventually).

5. Article published in 'Queensland Country Life' on 4 September 2010.