18 April 2011

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

Dear Senator Eggleston

I have attached Coles' formal responses to the Questions on Notice arising from Committee hearings on 29 March 2011, and Coles' formal response to the Supplementary Questions submitted by Senator Xenophon.

As you will see, Coles has taken great care to answer all of the questions raised as comprehensively as possible to ensure that the Committee has all the facts so it can make an informed response to the matters before it.

As you will appreciate, the lengthy series of supplementary questions from Senator Xenophon required considerable work to prepare a fulsome response.

Coles looks forward to the report of the Committee.

Yours sincerely

Ian McLeod
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SENATE ECONOMICS REFERENCES COMMITTEE

Questions on Notice

The impacts of supermarket price decisions on the dairy industry — Canberra, 29 March 2011

QoN No.	Hansard Page Reference	Senator	Witness/ organisation	Question
	E 56	Heffernan	Coles	**Senator HEFFERNAN**—But the difficulty is, Mr McLeod—and thank you for your evidence today and your patience and your humour—where do you get your home brand water from? **Mr Durkan**—We would have to take that on notice and come back to you. **Coles' response**: Over 90% of Coles brand bottled water is supplied by Mountain H2O, a 100 percent Australian owned and operated company based in Albury in NSW. All other Coles brand bottled water suppliers are also Australian owned and operated companies.
	E 80	Colbeck	Coles	**Senator RYAN**—Do you do it with other what I might call fresh or quickly perishable products? Milk is a relatively quickly perishable product. Do you have state based pricing for other products with short shelf lives? **Mr McLeod**—Yes, we do. **Senator RYAN**—Such as? **Mr Durkan**—Other dairy products would be an example. **Senator RYAN**—Let us move outside dairy. Other than dairy, do you have state based pricing for things like bread? We all know the symbolic importance of milk to a retail strategy. Do you have it for other products that, if not as important, are at least similar? **Senator COLBECK**—Salad and lettuce, for example.

				Mr McLeod—That again is fruit and veg. **Senator COLBECK—**But that is produced in certain regions and marketed pretty broadly. For example, a large proportion of the pre-packaged lettuce comes out of Tasmania. Why is that different to, say, milk? **Mr Durkan—**We have tried to pick categories rather than individual products. To explain our state based pricing, and be transparent, we picked whole categories so customers could understand where we were going to be, across the state— **Senator COLBECK—**Yes, but it does vary within those categories. **Mr McLeod—**That is a good argument, Senator. I do not want to talk without having the detail behind me, but I will take that on notice and come back to you. **Coles' response**: The product categories covered by the Coles State-based pricing policy were outlined in a media statement on 26 January 2010 (copy attached). Packaged salads are included in State based pricing.

coles

MEDIA RELEASE

Tuesday 26 January

Coles moves to fair and transparent grocery prices

Coles customers will pay the same price for the same product on approximately 97 percent of groceries at Coles supermarkets across Australia, Coles Managing Director, Ian McLeod, has announced.

Ian McLeod said customers have told Coles they think different prices on the same grocery item from suburb-to-suburb or town-to-town in their State is unfair so we have decided to do something about it.

“From 1 February, Coles will apply its lowest prices to more than 8,000 grocery products including meat, seafood, dairy, deli and bakery products across the country and the remaining grocery products will be matched to our lowest prices in each State,” Ian McLeod said.

“Coles customers will also get the lowest possible prices on fruit and vegetables, as supermarket managers will have the ability to match the best prices for similar quality fruit and vegetables in their local market.”

Ian McLeod said the Coles approach would provide what Australian shoppers have been seeking for quite some time - greater price transparency and fairness in grocery prices.

Our approach to grocery pricing is part of a broader renewal program at Coles to give Australian families a shop they trust including moves to provide cleaner and brighter supermarkets, increased grocery availability, improved customer service, better quality fresh food and stronger specials.

Further information,
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Senate Economics References Committee Inquiry into the impacts of supermarket price decisions on the dairy industry

Coles has attached responses to the two Questions on Notice sought by Senator Heffernan and Senator Colbeck.

Most of the matters in the Supplementary Questions to Coles by Senator Xenophon were addressed in detail in Coles' written submissions 11 March 2011 or in oral evidence given by Mr McLeod and Mr Durkan to the Senate Economics Standing Committee on 29 March 2011. Accordingly, we have responded in general to groups of questions or specifically to those that have not already been answered to assist the Committee in its examination of the facts and in preparing its report.

Page 1 of the Supplementary Questions contains a number of points concerning the extent to which Wesfarmers management and the Wesfarmers Board may have been involved in Coles' milk price reductions announcement on 26 January 2011.

Question: To what extent was the Wesfarmers Board briefed on this campaign before the 26th of January?

Question: When was the Board briefed?

Question: What was the Board's reaction?

Question: Did the Board seek any reassurances regarding the impact on dairy farmers?

Question: Did Coles explain there would be an almost immediate impact due to the increase in sales of home brand milk taking market share and profits away from branded milk?

Coles' response: Mr McLeod gave evidence to the Committee in relation to this matter. We confirm that the price reductions decision was an operational matter for Coles and did not require prior approval from, or discussion with, Wesfarmers management or the Wesfarmers Board before the decision was made or implemented (E39). Coles' business strategies and corporate plans are overseen by Wesfarmers management and the Wesfarmers Board but pricing decisions on grocery products offered for sale are matters for Coles.

Question: Did anyone within Coles' senior management try to stop this price cut on Coles home brand milk?

Coles' response: No.

Question: Can Coles explain why they tried to stop the price cut on milk?

Coles' response: Not applicable given previous answer.

Question: Can Coles please explain the difference between the Qld and Victorian dairy markets?

Coles' response: The Senate Committee Report published in 2010 provides a detailed outline of the dairy markets in Victoria and Queensland. Coles has also provided the Committee with additional details of the actions it has taken to maintain production at the National Foods Malanda milk processing site in Queensland.

Question: Where did Coles get the data that 'farm gate prices have increased by 22% in the past year? What state does this data refer to – is it Victoria?

Coles' response: The estimate is based on the media releases by Murray Goulburn about farm gate prices.

Question: If it is Victoria, why is Coles quoting figures that relate to Victoria in this debate when it's evident that only a very small proportion of its milk is used for drinking milk production compared to 95% of Queensland's milk?

Coles' response: Murray Goulburn represents a significant proportion of total farm gate milk purchases in Australia and is commonly recognised as setting the benchmark farm gate price in Australia.

Question: What percentage of Australia's **total** milk production is used by Coles?

Coles' response: Approximately four percent.

Question: What percentage of Australia's drinking milk production is used by Coles?

Coles' response: Approximately 17 per cent.

Question: What percentage of domestic supermarket milk sales is Coles?

Coles' response: Approximately one third of supermarket milk sales

Question: The Managing Director of Wesfarmers, Richard Goyder, was quoted in the Herald Sun on 18 March as saying: 'What Coles is doing is hopefully increasing demand for milk, which will be good for milk producers in the long term'.

Coles' response: This suggestion is erroneous. The relevant comments about the impact of Coles' milk price reductions on dairy farmers in a Western Australian rural newspaper, the Farm Weekly on 17 March 2011, were attributed in that article to an industry spokesman and not to Mr Goyder.

Question: Isn't milk a relatively inelastic product?

Coles' response: Coles provided the Committee with data showing that total milk sales have increased since the milk price reductions on 26 January. This suggests that milk demand is not inelastic.

Question: Mr Goyder was also quoted in the Herald Sun on 18 March as saying that Coles 'reduced the price of its entry-point milk by 4.5 cents a litre'. However, Coles' media release on 26 January stated cuts of up to 33% and 99 cents a litre. Why the inconsistency?

Coles' response: The Coles media release stated that the price reductions related to specific modified milk products whereas Mr Goyder's comments related to the entry level reduction of plain white drinking milk.

Question: Coles stated in a media release on 26 January that: 'By offering the same low price on Coles Brand lite milk we are also enabling more customers to switch to the lower fat option at a price they can afford which is clearly a significant health benefit'. Is Coles genuinely concerned about the health of its consumers? How is this approach reflected in other products?

Coles' response: Coles is responding to customer demand for healthier products across a range of categories including dairy (lite milk, cheese, yogurt and salt-reduced butter), bakery and cereals (salt reduced bread and breakfast cereal), edible oils (lite cooking oil and reduced trans-fats) and fresh nuts (reduced salt).

Question: Coles has consistently claimed that about 55% of all milk production goes **overseas** as exports. However, the dairy industry has advised that approximately 55% of Australia's milk production is consumed **domestically**, significantly more in Queensland (95%), Western Australia (70%) and New South Wales (66%). Can Coles explain where it has sourced the 55% figure from?

Coles' response: Coles has stated that about half of Australia's total milk production is exported (47 per cent according to Dairy Australia), and that the majority of Australia's manufactured milk is exported (approximately 60%).

Question: Has Coles increased the price of fuel in its petrol stations to offset losses on milk?

Geoff Trotter from Fueltrac (the fuel monitoring agency) told AAP that petrol prices rose by up to 15 cents per litre on the weekend of January 29 and 30, days after Coles cut its prices – "I think there is a connection between their (Coles) grocery activities and their petrol activities. If there is an opportunity for them to cross-subsidise, if they are giving away margin on bread and milk, fuel is a wonderful way to recover that margin," he said. Are Australia's petrol prices linked to the Singapore benchmark price and didn't that, and the Australian dollar, stay consistent during that period? Given this, how does Coles explain its increase in petrol prices?

Coles' response: The price of petrol at Coles Express service stations reflects global oil prices, a lagged MOGAS Singapore price and a lagged Terminal Gate Price in Australia. The attached chart shows the price correlation between these benchmark prices. It also shows that while global oil prices have increased by 45% over the last six months, domestic Australian petrol prices have only increased 13% over the same period.

Question: Coles has claimed that farmgate prices are set by the international market but for Qld, WA, NSW, which predominantly supply the domestic drinking milk market, farmgate prices are set mostly by contract arrangements and prices between processors and retailers and the sales of proprietary brands in the domestic market. Is this correct? Given this, on what basis does Coles continue to claim that farmgate prices for the most affected states and regions are set by international prices?

Coles' response: Coles has provided the Committee with references from expert witnesses who expressed the following view:

Dr Terry Sheales, Deputy Executive Director, ABARE, has said: "*Since deregulation prices received by dairy farmers are more closely aligned with what is happening in international markets*".

Mr Wesley Judd, Chair of the Australian Dairy Industry Council also said:"*the benchmark farm gate price for milk in Australia is driven by the export price as approximately half of the 9 billion litres of milk produced in Australia each year is exported*".

Question: On page 11 of Coles' submission, it states that: "It would appear that there are a series of market dynamics at play which are impacting on supply, demand and pricing within the dairy industry. We suggest that the *relatively small change in retail milk price* are not to blame for current events but are acting as a catalyst, particularly for dairy farmers, to express concern about the long term health of the industry". Does Coles consider a cut of 33 percent in retail price is 'relatively small'?

Coles' response: As indicated above, the 33 percent reduction refers to a specific product, not the average reduction in milk prices by Coles. More detailed evidence was provided to the Committee in camera.

Question: If the cut in retail prices by Coles, with the subsequent increase in private label sales, isn't the cause of Queensland dairy farmers milk payments going down this month with the loss of proprietary branded sales to the supermarket's $1 per litre milk – then what is the reason? Is there some other reason their milk payments have declined?

Coles' response: Coles is aware that NSW and Queensland dairy farmers have been in protracted negotiations for at least six months with National Foods over farm gate pricing in those States and suggests the question is best posed to National Foods Coles does not set farm gate prices, they are set by milk processors in negotiations with dairy farmers. . A statement by the Dairy Farmers Milk Cooperative in 12 April 2011 confirmed that new contract arrangements had been agreed with National Foods securing 90% of volume for 20111/12 at tier one pricing. The Chairman of DFMC, Mr Ian Zandstra said: "With this agreement, our members are again well placed to receive a highly competitive farm gate return for their milk."

Question: On page 12 of the Coles submission it states that: "Coles brand milk makes up approximately four per cent of total milk production". This suggests that Coles, by itself, does not have a material influence over Australian milk prices.

If Coles does not have material influence of milk prices, why then did other retailers drop their prices to $1 per litre and further for their store brands after Coles dropped its price of Coles branded milk to $1? And, why is proprietary brands and the 'route trade' losing market share to supermarket $1 milk and why are returns to farmers dropping as a result?

Coles' response: The retail market is very competitive (as the ACCC has previously concluded in previous inquiries) and we suggest that the Committee ask other retailers why they changed their milk pricing, as we are not privy to their pricing decisions. There has been a modest shift from branded milk to Coles brand milk in our supermarkets as a result of the Coles milk price reductions but branded milk still accounts for more than 60 per cent of total milk sales and customer behaviour in the route trade is influenced by a range of other factors including convenience.

Question: On page 16 of Coles' submission it states that: "It is also important to remember that Coles' retail competitors quickly matched our latest private label milk price reductions and reduced prices on some of their private label milk products to lower price points". Is the statement that other major retailers have followed Coles' price reduction an admission that Coles through its actions devalued the whole drinking milk category right across Australia to an unsustainable level?

Coles' response: No, this simply reflects the fact that the retail market is very competitive.

Question: What percentage of Qld's drinking milk production is sold by Coles?

Coles' response: Approximately 13 per cent.

Question: What percentage of Nth NSW's drinking milk production is sold by Coles?

Coles' response: Coles is unable to verify partial State based production from industry data or the specific geographic area in which the milk is sold.

Question: What percentage of WA's milk drinking production is sold by Coles?

Coles' response: Approximately 10 per cent.

Question: Does Coles have any data on how this price cut is impacting corner stores, independent service stations and other small family businesses?

Coles' response: Coles is not aware of any reliable market share data covering these sectors on a category basis.

Question: Has Coles increased sales of milk taken sales from these small family businesses?

Coles' response: Coles is not aware of any reliable market share data covering this sector on a category basis. However, as stated in our written submissions and oral evidence, we are aware that convenience stores have grown by 49% over the last decade.

Question: How are Coles' milk price cuts affecting the route trade?

Cole's response: Coles is not aware of any reliable market share data covering this sector on a category basis.

Question: What is Coles' share of the route trade? Has it increased since 26 January?

Coles' response: Coles does not participate in the route trade.

Question: It has been noted in reports from Coles and Wesfarmers executives that the Coles' discount milk price campaign has seen Coles branded milk sales increase by 15 to 20% (reported 18th February). It has also been noted that vendors have publicly reported significant drops in trade since the Coles discount campaign started on the 26th of January. Since Coles launched its discount milk campaign on Australia Day what has been the effect on vendors of milk?

Coles' response: Coles is not aware of any material impact on vendors as a result of its milk price reductions on 26 January.

Question: Is it true that Coles has ordered some 250 refrigerated delivery vehicles to deliver milk? If so where is this milk being delivered to?

Coles' response: Coles-On Line home delivery service has ordered a number of refrigerated vehicles to make home deliveries as we are moving from third party distribution for our on-line deliveries to Coles' control. This is to ensure cold chain integrity and food safety for a range of fresh and perishable products for our customers.

Question: Coles has claimed in the media that processors were given a contract increase in January 2011. When was the last time before that, that Coles' major milk suppliers received an increase in their contracts? How much was that increase?

Coles' response: The previous contract negotiations with dairy processors were in September 2008. The arrangements are commercial in confidence between Coles and dairy processors.

Question: With regard to the new Coles contracts and the inclusion of rise and fall clauses, what is the trigger for a rise clause? Is it that farm gate prices must rise first as outlined in the submission or are there other events that could be a trigger?

Coles' response: Coles has attached an explanation of how the rise and fall mechanism works.

Question: Has National Foods approached Coles to seek a step up in contract prices following the flood and cyclone affected dairy farmers of Queensland?

Coles' response: No.

Question: What is the gross cost to checkouts to acquire, distribute, refrigerate, display and retail milk? How does this differ in each state?

Coles' response: Coles does not capture or measure these costs at a product level**.**

Question: Coles has stated that it recently renegotiated its contract with National Foods. Were any of the new contract elements detrimental to National Foods? Were there changes in relation to the transportation of milk? Did Coles seek any payments back or rebate arrangements from National Foods in relation to transport?

Coles' response: These are commercial in confidence matters between Coles and National Foods.

Question: Did National Foods advise Coles at any time that the reduced price of 47 cents per litre will force many dairy farmers into a loss making situation in northern Australia?

Coles' response: No.

Question: When did Coles negotiate its most recent contracts with its other suppliers? Did those contracts include any new costs to Coles' suppliers? Were there any rebates for transport or anything else?

Coles' response*:* Coles finalised contract arrangements with all of its milk suppliers in mid-January 2011. The details of the contract arrangements are commercial in confidence.

Question: On page 10 of the Coles submission it states that: "In mid-January 2011, Fonterra offered Coles a lower price as part of the competitive tender in Western Australia. In February 2011, Coles subsequently offered to pay Fonterra an additional five cents per litre if it passed that money direct to their dairy farmer suppliers in WA. Initially, Fonterra decided not to pass on this increase to WA dairy farmers but has now agreed to do so". If Fonterra 'offered' Coles a lower price in January, what changed in the market place for Coles to offer another 5 cents per litre? And what changed in the market place for Fonterra to refuse to pass the five cents on to dairy farmers? Has Coles change the pricing structure of delivery of milk from Fonterra to Coles, and if so in what way?

Coles' response: This matter was address in written submissions and oral evidence by Mr McLeod and Mr Durkan. We also attach a media release that explains the decision taken to provide Fonterra with an additional five cents per litre to ensure the impacts of its retail milk price reductions did not affect dairy farmers in WA. The key change between the milk contract arrangements and Coles' decision was an announcement by Fonterra that it was in discussions to sell Browne's Dairy to Archer Capital. In this environment, Coles wanted to ensure that short term decisions were not taken by milk processors that would adversely affect dairy farmers supplying drinking milk in WA.

Question: Has Coles changed the delivery or cartage payment component from other milk processors to Coles in the January negotiations for new contracts and if so was it an increase or decrease and by how much per litre?

Coles' response: These are commercial in confidence matters between Coles and its milk suppliers.

Question: Is it true that when Coles tenders for milk supply for Coles branded milk it also negotiates with the processors on a range of other conditions besides the price and supply arrangements for that milk, such as supply and retail conditions of the processors proprietary branded products? What retail conditions are typically included in such contracts?

Coles' response: These are commercial in confidence matters between Coles and dairy processors.

Question: On page 11 of the Coles submission it states that: "As stated earlier in the submission, prior to introducing its change to milk pricing, Coles accepted price increases from each milk processor, enabling them to increase the farm gate price to reflect changes seen in the farm gate price for export milk. Average Australian farm gate prices have risen by 20 per cent in the past year". Which processors do Coles have contracts with now to supply Coles branded milk and for which states? What is the time period of these supply contracts?

Coles' response: This matter was addressed in the oral evidence given to the Committee by Mr McLeod and Mr Durkan. A chart is attached that shows which milk suppliers Coles currently has in each State and the relevant contract periods.

Question: In relation to Coles' assertion of paying processors extra to negate any effect at the farm gate level – could Coles explain how this commitment is enforced?

Coles' response: As explained to the Committee, Coles does not set the farm gate price nor have any involvement between the contract negotiations between milk processors and dairy farmers. Coles can only seek to influence supplier behaviour. Coles has made best endeavours to do this by paying its milk suppliers a higher contract price for their milk so that there was no pressure on them to pass on cost reductions at the farm gate.

Question: On page 12 of the Coles submission it states that "It is worth noting that the decision by our main competitor to cease sourcing milk through the National Foods owned Malanda processing factory in Queensland, placed the Tablelands dairy industry at risk. Coles agreed a new contract with volume commitments for the Malanda processing factory to secure the future of the dairy industry in the region". Apart of renewing an existing contract with National Foods in Queensland which covers the region of the dairy farming community of Far North Queensland, can Coles please explain how it 'secured the future of the dairy industry in the region'?

Coles' response: Coles has been advised by National Foods that if Coles had withdrawn volume from the Malanda milk processing site, as our major competitor did, then National Foods may have closed the facility, putting the future of dairy farmers in the region at risk.

Question: Can Coles demonstrate how its home brand milk is not being used as a 'loss leader' advertising agent?

Coles' response: Coles provided evidence to the Committee on this matter in camera.

Question: Many other retailers and dairy industry organisations have stated that the Coles discount prices are not sustainable.

Coles' response: Coles provided evidence to the Committee that it does not agree with the comments by other retailers and dairy industry organisations on this point.

Question: Does Coles believe the price cuts are sustainable for Coles and Wesfarmers shareholders?

Coles' response: Yes.

Question: Does Coles believe the price cuts are sustainable for all of the value chain, retailers, processors and dairy farmers?

Coles' response: Yes.

Question: Does Coles believe its pricing should reflect a sustainable price throughout the value chain?

Coles' response: Yes.

Question: Does Coles have a strategy to grow its Coles home brand milk sales to be the majority or all of its store milk sales?

Coles' response: No. Customers will decide the level of Coles brand milk sales.

Question: Since Coles launched its price cuts what has happened to the market sales of Coles' branded milk products?

Coles' response: Coles has provided details of its milk sales to the Committee in camera.

Question: Has Coles done any modelling on the impact of these price cuts on its home brand milk sales (full cream and lite etc)?

Question: If so, what does that modelling say?

Question: Has Coles done any modelling on how this discount milk price war affects farm gate prices?

Question: If so, by how much?

Question: If not, why not and how can Coles state that the price cut will not affect farm gate prices?

Coles' response: Coles modelling is commercial in confidence. Coles has made best endeavours to do this by paying its milk suppliers a higher contract price for their milk so that there was no pressure on them to pass on cost reductions at the farm gate.

Question: On page 7 of the Coles submission it states that: "Coles anticipated that there would be an increase in the volume of Coles brand milk sold and a reduction in the volume of branded milk sold as a result of its late January retail milk price reduction. We took this into account in the commercial contract price we paid to milk processors in mid-January. We estimate that milk processors will still receive, on average, a net increase in their commercial contract price after any switching and there should therefore be no impact on their margin as a result of our retail price changes. In these circumstances, we believe that there is no reason why Coles retail milk price reduction in late January should have any impact on the farm gate price."

And, on page 14 of the Coles submission it states that: "Although Coles anticipated that there would be an increase in the volume of Coles brand milk sold and a reduction in the volume of branded milk sold, we factored this into the price increase we gave processors in mid-January. The shift has not been seismic and we therefore estimate that milk processors will still receive, on average, a net increase in their commercial contract price after any switching and should therefore be no impact on their margin as a result of our retail price changes. In these circumstances, we believe that there is no reason why Coles retail milk price reduction in late January should have any impact on the farm gate price."

If Coles knew that its milk discounts cause a loss of sales of proprietary branded products to the Coles branded milk and took that impact into account in the contract price set with processors in January, then;

1. What percentage increase in sales of Coles' home brand milk did Coles forecast to occur at the expenses of processor proprietary brands? And how much would this loss equate to in financial terms for Coles and the processor respectively?

2. What has been the actual increase in Coles' brand milk sales for each Coles brand category of Coles' milk discounted since the "Down Down and Staying Down" campaign was started for milk on the 26th January 2011? And what does this equate to in financial terms?

3. If Coles understood that with the discounting the growth in the sales of Coles' brand milk would take market share away from processor brands, did Coles understand that it would affect processor brand sales right across the national market and lead directly to lower returns to dairy farmers?

4. Does Coles understand that the Coles discount has caused the devaluation of drinking milk right across Australia and as such does Coles feel as a major Australian corporation there is some corporate responsibility regarding ensuring the sustainability of our fresh milk industry in Australia?

Coles' response: Coles has dealt with this issue at length in its oral evidence in camera to the Committee hearings and in its written submission to the Committee**.**

Question: Cole's executives have stated publicly that they do not wish to harm farmers. Does Coles understand that by cutting the retail price of milk it has effectively lowered the value of milk and this will, and is already, affecting farm gate returns to dairy farmers?

Coles' response: As appears from the oral evidence to the Committee and in our written submissions, Coles does not agree with this statement.

Question: Where do processors make most of their profits – home brand or branded milk?

Coles' response: Coles is not privy to this information which is in the possession of milk processors.

Question: What does Coles think the impact of increased sales of home brand milk is on processors?

Coles' response: The Committee would need to put that question to milk processors.

Question: What does Coles think the impact of increased sales of home brand milk is on farmers?

Coles' response: Coles believes that on balance increased fresh milk sales should be positive for dairy farmers for the reasons set out in our written submission and oral evidence.

Question: Does Coles see a connection between lower sales of 'branded' milk and lower profits to farmers?

Coles' response: Not as a consequence of the Coles' retail milk price reductions on 26 January, among other reasons because of the fact that the retail price reductions were fully funded by Coles and given Coles provided an increase in contract payments to milk processors prior to the retail price reductions.

Question: Since Coles launched its milk discount campaign, has Coles increased the shelf space 'face' for Coles home branded milk and lowered that available for proprietary brands?

Coles' response: At the time of the launch, Coles Smart Buy range was deleted and replaced by Coles range. Proprietary brand space allocation was not changed.

Question: Does Coles set the price of proprietary branded milk?

Coles' response: Yes.

Question: Does Coles make a higher margin from proprietary branded milk than from its home brand milk?

Coles' response: Yes.

Question: Why is Coles pursuing greater market share for its home branded products if it makes a higher margin out of proprietary branded milk sales?

Coles' response: Customers will decide the level of Coles brand milk sales.

Question: Why is there such a difference between the price of proprietary brands and major supermarket brands?

Coles' response: We suggest that the Committee put that question to milk processors who agree the cost price for branded milk.

Question: Major supermarket milk home brand prices have actually declined in the last decade whereas proprietary brands have kept pace with inflation. Does this not highlight that the price for Coles' supermarket home brand milk is not sustainable?

Coles' response: No.

Question: If this marketing campaign is all for the customer and about trust can Coles explain why it doesn't lower the price of proprietary branded milk?

Coles' response: The retail sell price of propriety brands is determined by Coles with reference to market prices for these brands used by our competitors.

Question: Coles has discounted the Coles brand lite milk category to $1 per litre. Is that the next main target for market share from processor proprietary brands, now that Coles has over 70% market share in the whole milk category?

Coles' response: Coles does not have a market share target in milk. Customers will determine the level of private label and branded milk sales.

Question: On page 16 of the Coles submission it states that "Coles has a much lower proportion of private label products in its stores than supermarket chains in Europe, including German retailer Aldi, which, almost exclusively, sell only their own brands. Given this statement, is it Coles' objective to grow their Coles supermarket brand at the cost of proprietary brands, supply chain and ultimately consumer choice and cost as has been the case in Europe?

Coles' response: Coles does not have a target for growth of its private label brands. Customers will decide the level of sales of Coles brand products.

Page 9 of the Supplementary Questions concerns discussions with, or information provided to, the ACCC, Federal Treasury or the Federal Government before Coles' milk price reductions on 26 January 2011.

Question: Did Coles meet with the ACCC, Treasury or any other Government officials to discuss the 'Down Down' campaign before 26 January 2011?

Question: Did Coles present to the ACCC, Treasury or any other Government officials the plan to reduce its Coles brand milk to $1 per litre?

Question: What did the ACCC, Treasury or any other Government officials say about the campaign?

Question: Did the ACCC ask if this would constitute a 'loss leader'? And if so what was the response and what information did Coles executives provide to the ACCC.

Question: Did the ACCC question Coles about the impact this would have on the prices paid to dairy farmers? And if so what was said?

Question: Did Coles meet with the Government regarding the price cuts on milk before 26 January 2011?

Question: What did the Government say about the campaign?

Question: Did the Government ask if this would constitute a 'loss leader'? And if so what was the response and what information did the Coles executives provide to the Government.

Question: Did the Government question Coles about the impact this would have on the prices paid to dairy farmers? And if so what was said?

Coles' response: Mr McLeod gave evidence to the Committee that Coles did not meet with, nor seek the approval of, the ACCC for its milk price reductions before 26 January 2011 (E38). Coles confirms that it did not have any meetings with the Federal Treasury or the Federal Government on this matter before 26 January 2011.

The ACCC response of 5 April 2011 to Committee Questions on Notice outlines in detail communications between the ACCC and Coles in February and March 2011 as part of ongoing ACCC inquiries in this matter. Coles understands that the ACCC's inquiries are continuing.

Question: Coles’ executives have promoted Coles home branded milk under the guise of statements such as "Coles is not reducing the price it pays to its milk processors either so this move will not impact them or the dairy farmers who supply them”. These actions of Coles have resulted in lower returns to dairy farmers in Queensland, is that not false advertising?

Question: On page 16 of the Coles submission it states that “We note that, if Coles did not honour its price representations made in respect of milk as part of our "Down Down" campaign, it may give rise to misleading and deceptive conduct under provisions in the Australian Consumer law intended to ensure representations are fully honoured".

If Coles is concerned about giving rise to misleading and deceptive conduct regarding the length of time of its "Down Down" campaign, is Coles not concerned potential misleading and deceptive statements in its advertising campaign including presenting that farm gate increased last year and that Coles' discounting would not harm dairy farmers?

Coles’ response: As previously discussed, Coles does not believe that its retail milk price reductions will have a causative affect on farm gate prices.

Question: On page 7 of the Coles submission it states that “Coles did not intend to and has not sold retail milk at a price below the commercial cost of acquiring it from milk processors. While Coles states it is not selling Coles home branded milk at a price below the cost of acquiring it, is Coles selling its Coles home branded milk at a price less than it costs to get the product to the point of sale to the consumer at the checkout?

Coles’ response: The issue was the subject of detailed evidence to the Committee in camera. Coles has made best endeavours to do this by paying its milk suppliers a higher contract price for their milk so that there was no pressure on them to pass on cost reductions at the farm gate.

Question: Have Coles' profits per store increased on average since the 26th of January?

Coles ‘response: That information is commercial in confidence.

Question: On page 5 of the Coles submission it states that: “Since the Wesfarmers acquisition, Coles has significantly increased competition in the supermarket sector and taken progressive action to reduce grocery prices. Coles’ food prices have fallen by four percentage points, from food inflation of two per cent per annum to food deflation of two per cent per annum. Coles estimates that this shift could save its customers between $800 million to $1 billion per annum and through the suppression of competitor price increases across the grocery industry, save Australian consumers well over $2 billion per annum in total”. If Coles is estimating it is saving its customers $800 million to a $1 billion per annum, then how is Coles making a return on investment?

Coles’ response: As discussed in Coles’ submission, the company has funded its investments in lower prices from internal cost savings and efficiencies that have also enabled Coles to increase returns on investment.

Question: All the available statistics show that milk has been going down in price or remaining stable over the last ten years – why is Coles' discounting milk if it is trying to reduce inflation, is it not causing inflation?

Coles' response: A reduction in milk prices from recent higher levels is deflationary.

Question: If Coles has lower prices on over 5,000 items what has been the happened to the pricing of all of the other products that Coles sells?

Coles' response: Coles has provided evidence to the Committee on this matter in camera.

Question: On page 7 of the Coles submission it states that: "Since the Wesfarmers acquisition, Coles has significantly increased competition in the supermarket sector and taken progressive action to reduce grocery prices. Coles' food prices have fallen by four percentage points, from food *inflation* of two per cent per annum to food *deflation* of two per cent per annum. Coles estimates that this shift could save its customers between $800 million to $1 billion per annum and through the suppression of competitor price increases across the grocery industry, save Australian consumers well over $2 billion per annum in total". When Coles presents in its submission that Coles' food prices have fallen by 4 percentage points – have grocery prices fallen? (ie. Does food = grocery?)

Coles' response: Yes.

Question: Growth in UHT sales in the domestic market have been growing more rapidly in recent years. Who does Coles contract to supply its Coles branded UHT products?

Coles' response: Coles tabled a document at the hearing detailing UHT milk volumes (Appendix IV) sold in Australia and EU countries. The so-called growth in UHT sales is not evident in Australia. UHT volumes have remained stable at 8-9 per cent of consumption for the last decade. Murray Goulburn is Coles' supplier for Coles branded UHT.

Question: On page 18 of the Coles submission it states that: "Coles and all other major retail groups, including Aldi and Woolworths, have been part of the Produce and Grocery Industry Code (PAGIC) and its predecessor for ten years. The PAGIC applies to the entire supply chain of the retail grocery industry, including Coles and dairy farmers. We believe the existing framework in PAGIC is sufficient to ensure the necessary transparency in dealings with suppliers and provides sufficient dispute resolution procedures. In fact, the Horticulture Code mirrors many of the transparent trading terms and dispute resolution procedures set out in the PAGIC". Is Coles aware that under the Produce and Grocery Industry Code farmers do not have the ability to directly dispute with retailers if the supply arrangements are not a direct relationship?

Coles' response: Dairy farmers have the ability to bring a dispute under the Code (or common law) with the buyers of their milk – dairy processors. In turn, dairy processors have the ability to bring a dispute under the Code with the buyers of their processed milk products, retailers and food service.

Question: Given that Coles, not processors, have reduced milk prices, how does the PAGIC help farmers with Coles' unsustainable pricing.

Coles' response: Coles does not believe that in all of the circumstances that the retail milk price is unsustainable.

Question: Why does Coles believe the PAGIC provides the necessary transparency?

Coles' response: The Code and scheme Ombudsman provides a broad and cost free framework to deal with disputes between buyers and sellers in the produce and grocery supply chain outside the legal system.

Question: What is the definition on the table of Brand Non-Grocery, Brand Grocery, Private Label on page 17 of the Coles submission figure 4, Share of Channel Sales (last 12 months)?

Coles' response: Branded non grocery milk sales are proprietary brands sold via the retail route trade or sold into food service sector. Branded grocery sales are proprietary brands sold via retail supermarkets trade. Private label milk sales are retailers own branded milk such as Coles' milk

Question: When will the price discounting campaign end? When does Coles plan stop these unsustainable price cuts?

Coles' response: Coles has indicated to the Committee that its intention at the time of the price reductions on 26 January is for milk prices to stay down for at least six months, if not longer.

The nature and effect of the 'Down Down' program was addressed in Coles' written submissions and evidence given by Mr McLeod to the Committee (E 41).

For the avoidance of doubt, we confirm that statements that 'prices are staying down' reflects an intention that (subject to certain specified conditions) prices will stay down **for at least six months if not longer** compared with the weekly catalogue discount specials commonplace in the supermarket industry.

The ACCC has also conducted an investigation into issues which could arise out of Coles' 'Down Down' programme and we are not aware of the ACCC having any concerns in relation to the accuracy of statements made that prices are staying down or otherwise.

Supplementary Coles' evidence

Coles continues to firmly believe that its fully funded retail milk price reductions, which followed higher commercial contract prices with milk processors in all States other than Western Australia, should not of itself cause farm gate prices to be lowered.

Indeed, as outlined in Coles' written submissions and in Coles evidence to the Committee, the commercial contract price provided to milk processors should be more than enough to accommodate the modest shift from branded to private label milk seen in our stores, and there should be no reason for milk processors to reduce farm gate prices as a consequence of our January 2011 announcements.

Importantly, since Coles completed its contracts with milk processors in mid-January and announced its retail milk price reductions on 26 January 2011, several announcements have been made by milk processors and dairy organisations that confirm improving conditions for dairy farmers including:

- A second increase in farm gate payments to Victorian and Tasmania dairy farmers by Fonterra for the 2010/11 season on 20 January 2011
- A step-up in farm gate milk price to Victorian dairy farmers by Murray Goulburn on 2 February 2011
- A positive outlook for Australian dairy farmers issued by Dairy Australia on 14 February 2011
- The Rabobank Agribusiness review on 17 March 2011 indicated that the price of whole milk powder had jumped $1069 s tonne in the past year and up to $529 a tonne in the past month; and
- The Dairy Farmers Milk Cooperative announced on 12 April 2011 that it had reached agreement with National Foods to supply 900 million litres of milk in 2011/12 and that 90 per cent of that volume would be under tier one pricing for dairy farmers in Queensland, New south Wales, South Australia and Victoria

Coles is also pleased to attach a report by Sapere Research Group * which provides an overview of the Australian dairy industry.

The Sapere research group report concludes:

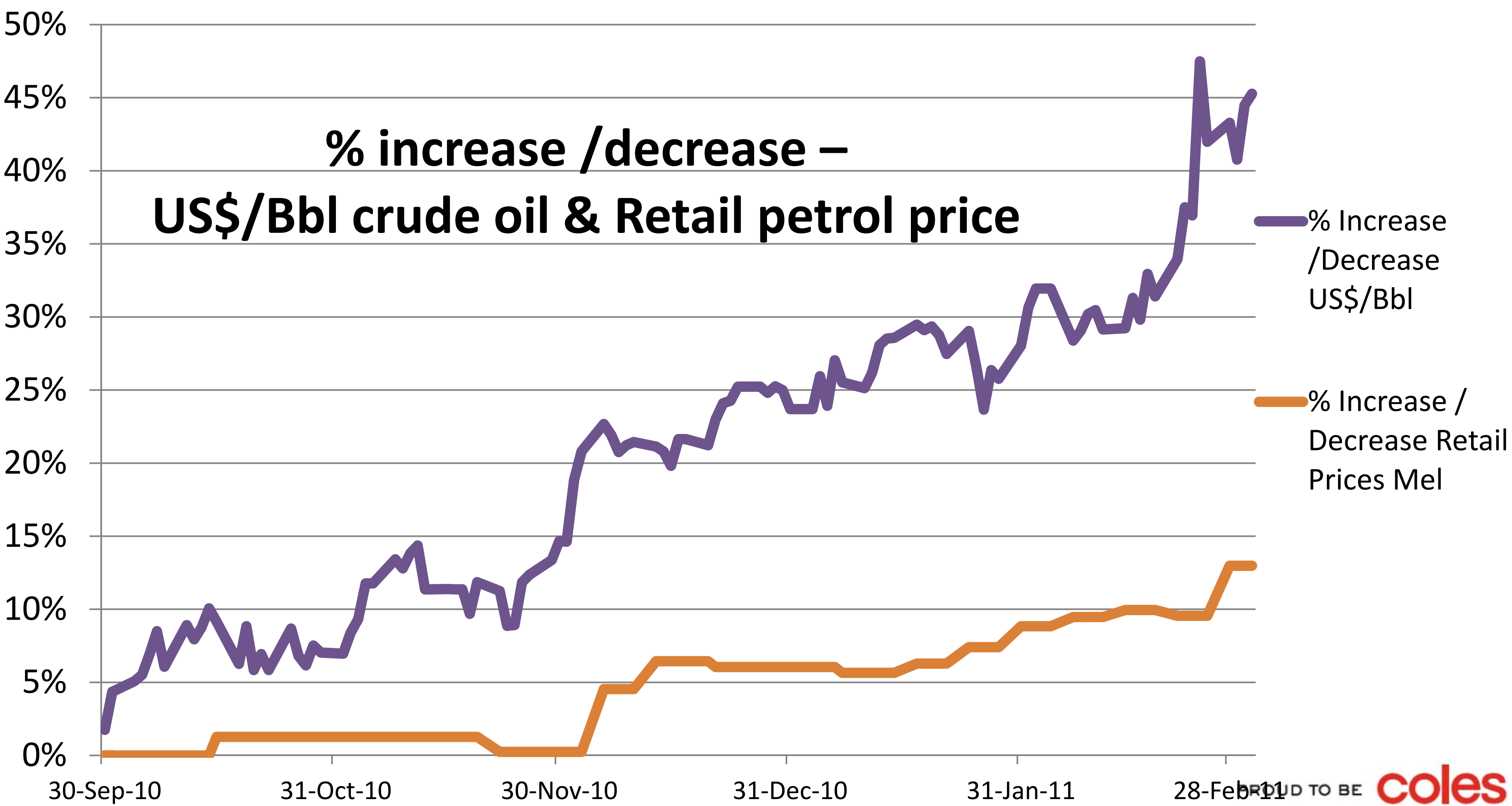
"Fears that price discounting by retail chains will lead to a collapse of the industry are exaggerated. From a consumer perspective, there are benefits in price competition. From the producer perspective, over the longer term discounting may assist in addressing problems in regions where supply for the domestic market exceeds demand, by encouraging increased milk consumption.

There are other pressures that dairy farmers continue to face in Australia, including structural adjustment following deregulation of the industry from 2000, the impact of floods and other natural disasters, and access to water.

In light of such pressures, dairy farming will remain a challenging business requiring high skills and adaptability. Small dairy farms, especially when they are carrying large debts, are particularly vulnerable. However, the evidence provided in this report suggests that price discounting is not, from an economic perspective, a cause of this vulnerability. In overall terms the industry has demonstrated that it is robust and resilient, with a solid future in the world dairy market."

*Source: "An Overview of the Australian dairy Industry", Stephen Bartos and Dr Alistair Davey, Sapere Research Group, March 2011

% increase /decrease – US$/Bbl crude oil & Retail petrol price



Rise and Fall Mechanism

Coles will carry out a review of the milk price on 30 June each calendar year for the remainder of the contract term.

The milk price which will apply from January 2011 until the first price review date shall be calculated as follows:

1. Base Milk Price = x cents per litre
2. Resin Price = y cents per litre
3. Suppliers Costs = z cents per litre

    a. Coles will compare the base milk price for the previous period, against the actual milk price for the previous period.
    b. Coles will compare the resin price for the previous period with the actual resin price; and
    c. Coles will set the milk price which is to apply on and from the price review date and for the 12 month period immediately following thereafter by adding the base milk price, the resin price and the supplier’s cost as at the relevant price review date.

coles

22 February 2011

Coles to protect WA dairy farmers

Coles has made a five cent a litre price increase to WA milk processor Brownes, to further ensure WA dairy farmers are not impacted by Coles' recent cuts to its retail milk prices.

Coles Merchandise Director John Durkan said that Coles has asked Brownes, owned by New Zealand milk processing company Fonterra, to pass the price increase directly onto its dairy suppliers in WA.

"We've said from the outset that Coles was fully funding the price cut on our own brand milk, and that we had no intention of this retail price cut being passed onto dairy farmers," Mr Durkan said.

"We believe this additional payment to Brownes should give WA dairy farmers greater comfort that they will not be impacted by the Coles brand retail milk price cuts."

"Mr Durkan said the additional payment in WA was made after discussions with Brownes and WA dairy farmers.

"The farm gate price for milk in Australia is largely set by global dairy price movements, and is not driven by supermarket milk prices," Mr Durkan said.

"However, as most WA dairy production is sold as drinking milk, we felt this additional payment would further insulate the local dairy industry."

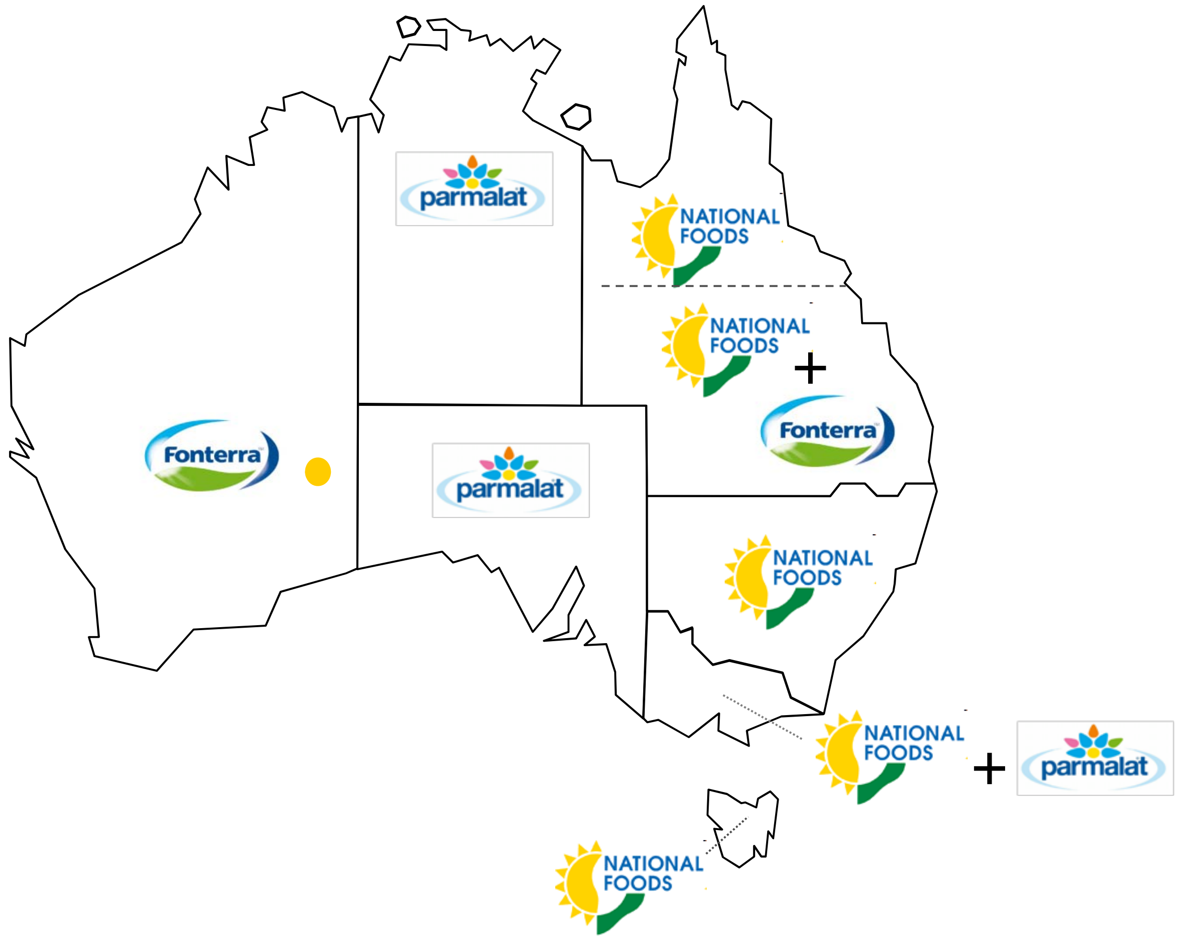
Coles five cent a litre price rise to Brownes becomes effective on XXX.

Further information,
Jim Cooper
Ph (03) 9829 4354

MEDIA RELEASE

Coles has long term supply contracts in Australia

January 2011 milk tender introduced 3-year contracts in all States



An Overview of the Australian Dairy Industry

Stephen Bartos, Dr. Alistair Davey

March 2011

About Sapere Research Group Limited

Sapere Research Group is one of the largest expert consulting firms in Australasia and a leader in provision of independent economic, forensic accounting and public policy services. Sapere provides independent expert testimony, strategic advisory services, data analytics and other advice to Australasia's private sector corporate clients, major law firms, government agencies, and regulatory bodies.

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Executive Summary

Australia has a large dairy industry, producing more than 9 billion litres of milk annually. Milk production exceeds domestic consumption, and our dairy industry is a major exporter. Export markets for Australian dairy products include Japan, China, Singapore, Indonesia and the Philippines.

Domestic drinking milk accounts for around a quarter of milk consumed in Australia. Of that around 10 per cent is flavoured milk, 10 per cent UHT milk, and the remaining 80% either whole fat or modified drinking milk.

In that context, there is little prospect that discounting of some lines of drinking milk by major retailers will be a threat to the long term viability of the dairy industry in Australia. The more important factor by far for the future of the dairy industry is international market conditions.

The global outlook is positive for dairy. Although at present the high value of the Australian dollar is depressing returns for rural exports, demand for milk products is strong and likely to grow as the effects of the global economic downturn recede. For our major export markets in Asia the outlook continues to be for growth. It is too early to forecast the impact of the earthquake and tsunami in Japan on dairy exports to that country; while growth will be lower in the short term, there may on the other hand be increased demand in the recovery phase.

This international outlook indicates that the dairy industry in Australia is sustainable and will remain competitive, able to supply both domestic and international markets.

Fears that price discounting by retail chains will lead to a collapse of the industry are exaggerated. From a consumer perspective, there are benefits in price competition. From the producer perspective, over the longer term discounting may assist in addressing problems in regions where supply for the domestic market exceeds demand, by encouraging increased milk consumption.

There are other pressures that dairy farmers continue to face in Australia, including structural adjustment following deregulation of the industry from 2000, the impact of floods and other natural disasters, and access to water.

Structural adjustment is likely to continue in line with changing markets. For example, the comparative advantage of Victoria in dairy production means it is likely to continue to grow at the expense of other milk producing States. Regional impacts of adjustment will be mixed, and some farmers will continue to face difficulties due to such regional factors.

In light of such pressures, dairy farming will remain a challenging business requiring high skills and adaptability. Small dairy farms, especially when they are carrying large debts, are particularly vulnerable. However, the evidence provided in this report suggests that price discounting is not, from an economic perspective, a cause of this vulnerability. In overall terms the industry has demonstrated that it is robust and resilient, with a solid future in the world dairy market.

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1 Introduction

1.1 Purpose of the paper

The purpose of this paper is to examine milk pricing in the broader context of the economics of dairy in Australia.

Recent reductions in milk prices by Australia's two major retail chains have prompted debate about the dairy industry. Some dairy farmers and industry representative bodies have expressed apprehension about the longer term consequences of price competition. Media coverage of the issue, at times accompanied by alarmist headlines[1], has heightened concern.

These concerns are understandable given the dairy industry has been through considerable change in recent decades. Structural adjustment pressures have been driven by a combination of factors including the deregulation of formerly tightly controlled marketing schemes, changes in global markets and internal competitive pressures in the industry.

The paper demonstrates that the dairy industry in Australia is robust and competitive, and has weathered these structural changes well. The key economic factor affecting the industry is the global market; Australia's dairy industry has shown a capacity for resilience in the face of global trends.

From a consumer perspective, there is little likelihood that price competition in milk will lead to a collapse in the market for fresh milk. In fact it could have some benefits for consumers in encouraging greater differentiation of milk products. If consumers are prepared to pay a premium for milk identified as fresher, or of a higher quality, there is no economic reason why dairy farmers in Australia would be unable to meet this demand for such consumers.

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[1] Eg "Price war milking farmers dry" ABC Online 1 March; "Milk wars 'may kill off farms'" The Australian 2 March; "Fresh Milk Under Threat" Gympie Times, 16 March;"Qld dairy industry under siege" Queensland Country Life 24 March

This is not to suggest that the impact of price competition will be uniform across Australia; some regions will be affected more than others. Australia's largest dairy producing State, Victoria, is better placed to cope with any impacts than are other States. Overall, though, recent pricing decisions will have at most a minimal impact on the market for milk and other dairy products in Australia.

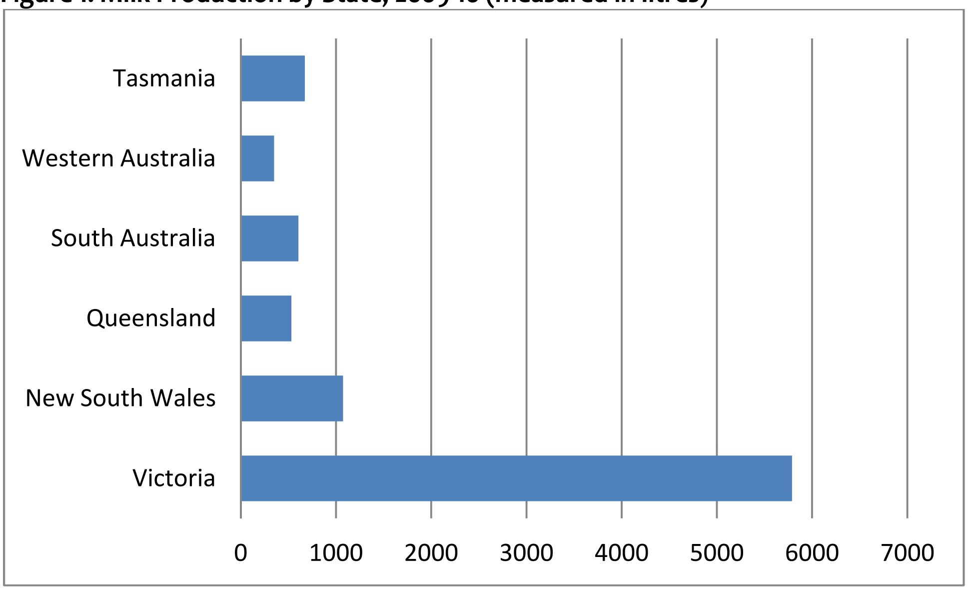
1.2 Overview of dairy industry/milk production in Australia

1.2.1 Production

As at 30 June 2010 there were 7,511 dairy farms operating in Australia. Australia's dairy herd consists of around 1.6 million cows which in 2009-10 produced just over 9 billion litres of milk (Dairy Australia Limited, 2010a, p. ii). Current forecasts are for milk production to be somewhere between 9.0 and 9.1 billion litres in 2010-11 (Dairy Australia Limited, 2011, p. 5). The Australian Bureau of Agricultural Resource Economics and Sciences (ABARES) (2011, p. 89) forecasts Australian milk production of 9.75 million litres by 2014-15.

Most milk production takes place in the south east states, especially Victoria, although all states have dairy industries that supply fresh drinking milk to nearby cities and towns (Dairy Australia Limited, 2010a, p. 9). An outline of milk production by state is provided in the bar chart in Figure 1 below.

Figure 1: Milk Production by State, 2009-10 (measured in litres)



Source: Dairy Australia Limited, (2010a, p. 18)

Milk production is generally highly seasonal due to the pasture-based nature of the industry with milk production peaking in October and tapering off in April (Dairy Australia Limited, 2010a, p. 18). However, the seasonality of milk production is much less pronounced in Queensland, New South Wales and Western Australia due to a greater focus on drinking milk and fresh products in these states (Dairy Australia Limited, 2010a, p. 18).

The Senate Economics Committee (2011, p. 38) has previously noted that dairy farmers receive a premium from processors to ensure they receive a steady supply of milk throughout the year for the production of drinking milk.

1.2.2 Industry structure

Milk processors acquire raw milk from dairy farmers, and transform it into various dairy products for sale to retailers or for export (Australian Competition and Consumer Commission, 2010a, p. 4). The Australian milk processing sector is made up of a diverse range of corporate structures which includes farmer-owned co-operatives, public, private and multinational companies.

Co-operatives previously dominated the processing sector but now process less than 40 per cent of Australia's milk production (Dairy Australia Limited, 2010a, p. 21). However, the largest milk processor in the country is still a cooperative, the Murray Goulburn Cooperative Co. Limited (MG) which is owned by around 2,600 supplier shareholders. MG acquires just over one third of Australia's annual milk production from dairy farmers in the south east region of Australia comprising Victoria, the Riverina area of New South Wales, central and south east of regions of South Australia and Tasmania (Australian Competition and Consumer Commission, 2010a, p. 2). MG manufactures a range of milk and dairy products, including fresh dairy products (fresh white milk and cream), and 'non-fresh' dairy products (cheese, UHT milk, milk powder, butter, and whey products) (Australian Competition and Consumer Commission, 2010a, p. 2).

Smaller regional cooperatives include Challenge Dairies In Western Australia, Norco which operates in northern New South Wales and southern Queensland, and Hastings Valley which operates in the mid north coast of New South Wales.

There are two large multi-national dairy companies operating in Australia: National Foods, which is a wholly owned subsidiary of the Kirin Holdings Company Limited of Japan, and Parmalat Australia Ltd, which is wholly owned subsidiary of the Italian based global dairy company, Parmalat SpA. National Foods manufactures fresh milk, fresh dairy foods, juice and cheese (Australian Competition and Consumer Commission, 2010a, p. 5). Parmalat manufactures fresh milk, cream and yoghurt (Australian Competition and Consumer Commission, 2010a, p. 5).

Fonterra is a co-operative owned by New Zealand dairy farmers, and in Australia it operates primarily through Fonterra Brands (Australia) Pty Ltd and Fonterra Australia Pty Ltd (Australian Competition and Consumer Commission, 2010a, p. 5). Bonlac Supply Company acts as an agent for Fonterra Australia Pty Ltd for milk supply in Victoria and Tasmania and Bonlac shareholders are milk suppliers to Fonterra (Australian Competition and Consumer Commission, 2010a, p. 5).

The Warrnambool Cheese and Butter Factory Company Holdings Ltd (WCB) is a publicly listed company trading on the Australian Stock Exchange (Australian Competition and Consumer Commission, 2010a, p. 3). WCB sources milk from farmers in south western Victoria – principally the regions surrounding Allansford, Simpson, and Ballarat; and the Adelaide Hills and Fleurieu Peninsula regions of South Australia and produces cheese, whey protein, cream and butter, milk powders, fresh white and flavoured milk, as well as supply bulk raw milk to industrial users (Australian Competition and Consumer Commission, 2010a, pp. 3-4).

Bega is a private Australian-owned company whose main activities are the manufacture of cheese and cheese products, which it does from its manufacturing facilities in Bega, NSW and North Coburg, Victoria (Australian Competition and Consumer Commission, 2010a, p. 5). In April 2007, Bega acquired a 70% shareholding in the Victorian-based dairy company, Tatura Milk Industries Limited, which manufactures cream cheese, powders, infant formula and nutraceuticals (Australian Competition and Consumer Commission, 2010a, p. 5).

1.3 Recent History of the Australian Dairy Industry

1.3.1 Regulation, deregulation and structural adjustment

Prior to 2000 the dairy industry was regulated by state and Commonwealth governments through various measures. At the state level, state dairy authorities controlled the sourcing, distribution and pricing of drinking milk. At the Commonwealth level, the Domestic Market Support Scheme (DMS) provided support for manufacturing milk (ie milk used for butter, cheese, powder etc) (Parliament of Australia Parliamentary Library, 2000). The DMS was funded through the imposition of two levies: one paid by farmers on all milk sold for fresh consumption and the other paid by dairy product manufacturers on all milk used for dairy products consumed in Australia (Parliament of Australia Parliamentary Library, 2000).

State and Commonwealth regulation was removed from the dairy industry, effective from July 2000. Deregulation was accompanied by the implementation of the Dairy Structural Adjustment Program (DSAP).

Under the DSAP, a Dairy Adjustment Levy of 11 cents per litre was imposed on consumers of products marketed as dairy beverages. This levy was used to fund quarterly DSAP payments to Australian dairy farmers over an eight year period. The levy was removed by the Commonwealth Government in February 2009.

The DSAP was the largest package provided to an Australian agricultural industry to assist with structural adjustment pressures (Department of Agriculture, Fisheries and Forestry, 2011). A total of $1.92 billion was collected under the levy over the course of its eight years.

Australian dairy farmers now operate in a deregulated and open market with the only government involvement being in the administration of food standards and food safety assurance systems.

There has been a long term trend decline in the number of dairy farms in Australia, with the number of farms contracting by around two thirds in the last three decades. According to Dairy Australia Limited (2010a, p. 12), falling farm numbers reflect a long-term trend observed in agriculture around the world, as reduced price support and changing business practices have encouraged a shift to larger, more efficient operating systems.

1.3.2 Trends in milk production

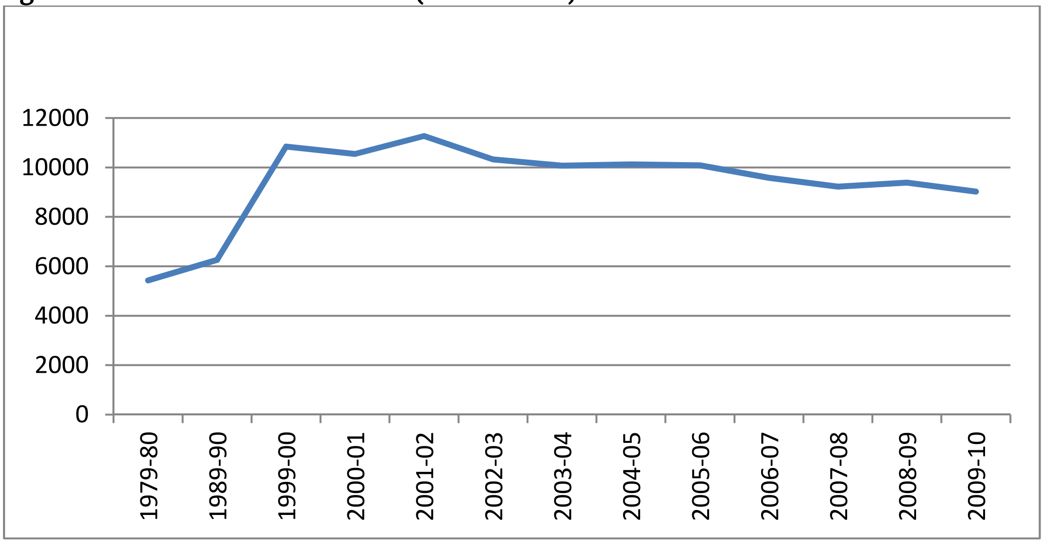
While farm numbers have been steadily declining over the past three decades, milk output has generally increased, due to increasing cow numbers and improved cow yields (Dairy Australia Limited, 2010a, p. 17).

Milk production in Australia peaked in 2001-02 at 11.2 billion litres but has been in gradual decline since then (2010a, p. 18). According to Dairy Australia Limited (Dairy Australia Limited, 2010a, p. 17), following the major drought of

2002/03, milk production has plateaued with falling cow numbers and seasonal conditions constraining production.

Australian milk production is outlined Figure 2 below.

Figure 2: Australian Milk Production (million litres)



Source: Dairy Australia Limited (2010a, p. 18)

According to dairy farmers, the major challenges facing them include the price of milk, the cost of feed-grain, and the effects of climate/drought/flood (Dairy Australia Limited, 2010a, p. 6).

Drought conditions have been persistent through recent seasons across many dairying and grain growing regions, further reducing cow numbers and limiting any growth in milk production. Despite recent droughts, there have been significant on-farm adaptation strategies employed to manage the highly variable conditions of recent years, particularly in the inland irrigation regions of northern Victoria, and central and southern inland New South Wales where water allocations have been very low for a number of years (Dairy Australia Limited, 2010a, p. 17).

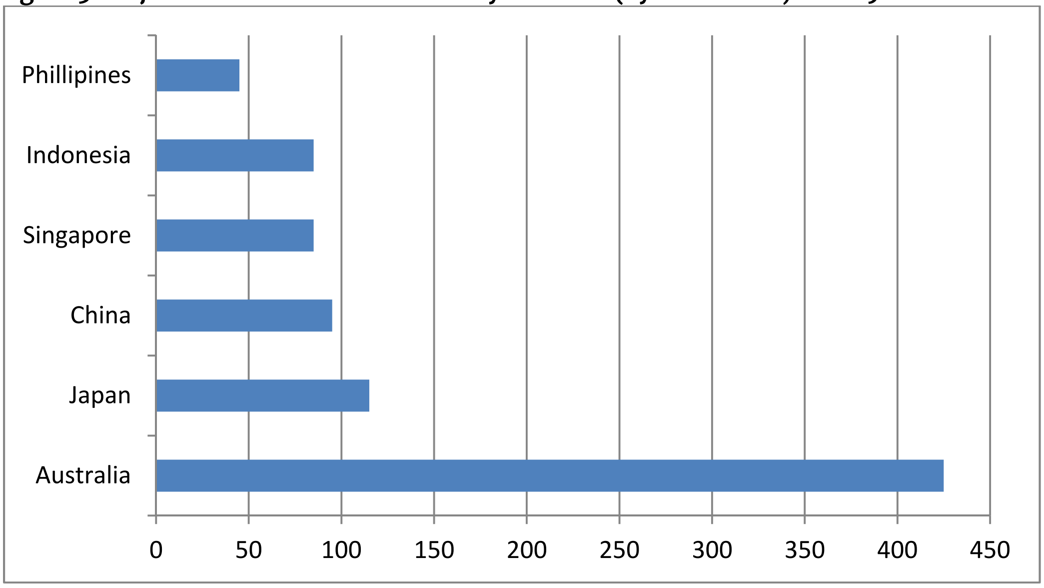
2 Markets for dairy products

2.1.1 Export markets

As the production of milk in Australia far exceeds the volume required for domestic consumption, a significant proportion of the milk produced is ultimately exported following processing (Dairy Australia Limited, 2010a, p. 21). In the period between 1996-97 and 2009-10 between 40 to 60 per cent of Australia's milk production has been exported (Dairy Australia Limited, 2010a, p. 22).

Major markets for Australian dairy products are outlined in Figure 3 below.

Figure 3: Major Markets for Australian Dairy Products (by '000 tonne) in 2009-10



Source: Dairy Australia Limited (2010b, p. ii)

2.1.2 Milk products and their markets

The major manufactured product streams from raw milk are:

- drinking milk – fresh and ultra heat treated (UHT) long life;
- skim milk powder (SMP)/buttermilk powder (BMP)/butter;
- butter/casein;
- cheese;
- wholemilk powder (WMP);
- other consumer products such as yoghurts, custards and dairy desserts; and
- specialised ingredients, such as whey proteins, nutraceuticals, etc. (Dairy Australia Limited, 2010a, p. 21),

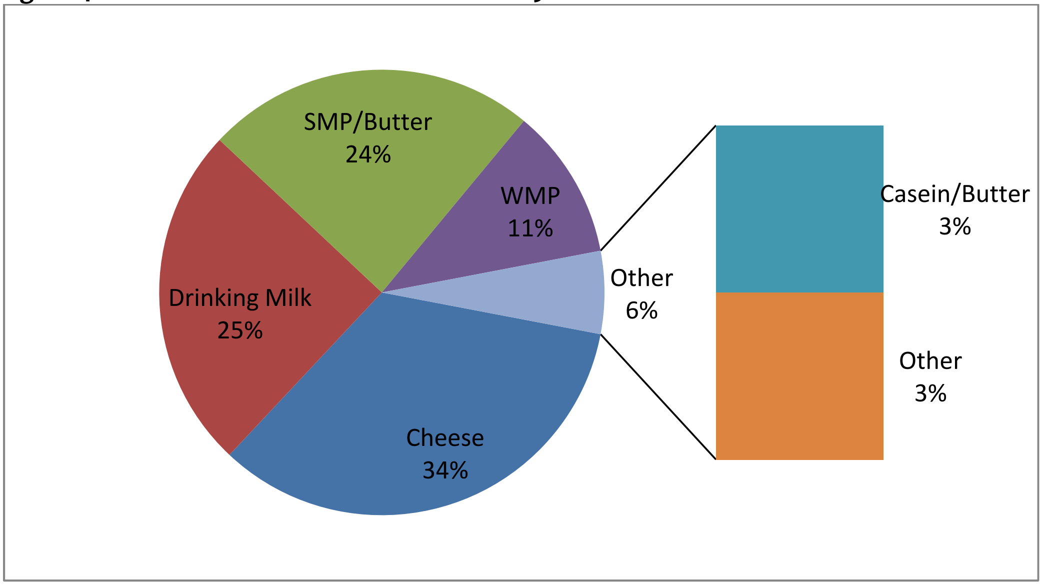
Only around one quarter of raw milk in 2009-10 was used to produce drinking milk (Dairy Australia Limited, 2010a, p. ii) around 97 per cent of which is consumed domestically (Dairy Australia Limited, 2010a, p. 21).

Fresh milk is composed of three products: regular, modified and flavoured. Regular and modified (mostly reduced fat) milk made up around 81 per cent of domestic drinking milk sales in 2009-10, flavoured milk just under 10 per cent and UHT milk just over 9 per cent (Dairy Australia Limited, 2010a, p. 25).

With the consolidation that has occurred within the milk processor sector in the last decade, there is now only two major corporate players in Australia engaged in the production of drinking milk: National Foods and Parmalat Australia Ltd. There is also number of other smaller players with strong regional brands (Dairy Australia Limited, 2010a, p. 26). Around 51 per cent of drinking milk is distributed through supermarkets (Dairy Australia Limited, 2010a, p. 26). Supermarket private label brands account for around half of all their drinking milk sales with the balance made up of processor branded products (Dairy Australia Limited, 2010a, p. 26). The average price of supermarket private label brands is significantly less than processor branded products (Dairy Australia Limited, 2010a, p. 26).

Figure 4 below provides a bar chart of raw milk utilisation in Australia in 2009-10.

Figure 4: Australian Raw Milk Utilisation in 2009-10



Source: Dairy Australia Limited (2010a, p. 2)

Note: Casein is a protein found in milk and are used as ingredients in processed foods as well as have various industrial applications. SMP is skim milk powder.

2.1.3 Differing geographies of product markets

In its assessment of various mergers amongst dairy processors that have occurred over the past decade, the ACCC has identified several product markets for dairy products which vary in terms of their geographic scope.

The ACCC (2010a, p. 8) has defined a product market for the acquisition of raw milk from dairy farmers on a regional basis where the region is defined as the distances between dairy processors' plants and the dairy farms that supply, usually within a radius of less than 400 kilometres.

The geographic scope of the product market for raw milk is constrained by costs of transport to pick-up raw milk from the dairy farm and deliver it to the processor. According to the ACCC (2008a, p. 8), transportation costs and the perishability of raw milk affect the distance over which it may be feasibly transported from farm to processor. In most milk pricing agreements the full cost of transport is deducted from the milk price received by the dairy farmer.

The ACCC (2008a, p. 9) has defined a product market for the manufacture and wholesale supply of whole (regular) and modified fresh white milk on a state basis.

According to the ACCC, there is high level of supply side substitutability between the manufacture and supply of modified fresh white milk and whole fresh white milk in regard to production facilities, inputs and distribution.

There would also appear to high degree of demand side substitutability between whole and modified fresh white milk as consumers responded in 2008 to rapidly increasing retail prices by switching away from modified fresh white milk to the relatively lower-priced regular full cream milks (Dairy Australia Limited, 2010a, p. 25). On the other hand, the ACCC (2008a, p. 9) has observed there is limited demand side substitutability between fresh white milk and other products such as flavoured milk, soy milk and UHT white milk.

The ACCC (2008a, p. 9) also considers there to be a separate and distinct product market for flavoured milk on a state basis with the price of other dairy and non-dairy beverages not providing much scope for substitution possibilities for consumers. Given its long shelf life, the ACCC (2010a, p. 8) considers there to be a national market for the manufacture and supply of UHT white milk.

Given it is a long-life product most of which is exported, the ACCC has come to the view that there is a national market for the production of powdered milk.

The ACCC (2010a, p. 9) has observed that there are regional markets for the supply of bulk raw milk. Bulk milk is delivered to customers straight from the farmgate and is used an ingredient in the manufacture of other foods (Australian Competition and Consumer Commission, 2010a, p. 9).

The ACCC (2010a) has also identified separate national product markets for the supply of non-fresh dairy products – cheese, butter, packaged cream and whey products.

During the process of standardising milk for retail consumption, cream is separated from the milk and pasteurised. This cream in turn can be used either as an input in the manufacture of thickened cream and other products such as butter, yoghurt and dairy desserts, or it can be sold in bulk to other manufacturers who use cream as an ingredient for various food products (Australian Competition and Consumer Commission, 2010a, p. 10).

Bulk cream becomes unusable after around five days and is a low-value product whose transport costs relative to its value means that supply over long distances may be uneconomic (Australian Competition and Consumer Commission, 2010a, pp. 10-11). On this basis, the ACCC has come to the view there is a regional market for the supply of bulk cream based on proximity to processing facilities. On the other hand, the ACCC (2010a, p. 11) considers there to be a separate national product market for packaged cream as it has a shelf life of up to 35 days.

Whey is a by-product of the cheese manufacturing process. Around 30 per cent of Australia's whey production is used domestically in the production of infant formula, biscuits and ice cream while the rest is exported (Dairy Australia Limited, 2010a, p. 32).

3 Who sets the farmgate price of raw milk?

One of the major cooperatives, MG, is highly influential in setting farmgate prices for raw milk across Australia. According to Australian Dairy Farmers:

> … Murray Goulburn Cooperative (MG) has a major role in setting milk price in Australia. As a farmer cooperative, MG sets its opening price

> based on its cost of production plus returns to farmers. As MG purchases the largest volume of milk, is a significant exporter (eg trade exposed) and also supplies to supermarkets domestically, this price tends to set a signal for the industry. (Australian Dairy Farmers, 2009, p. 4)

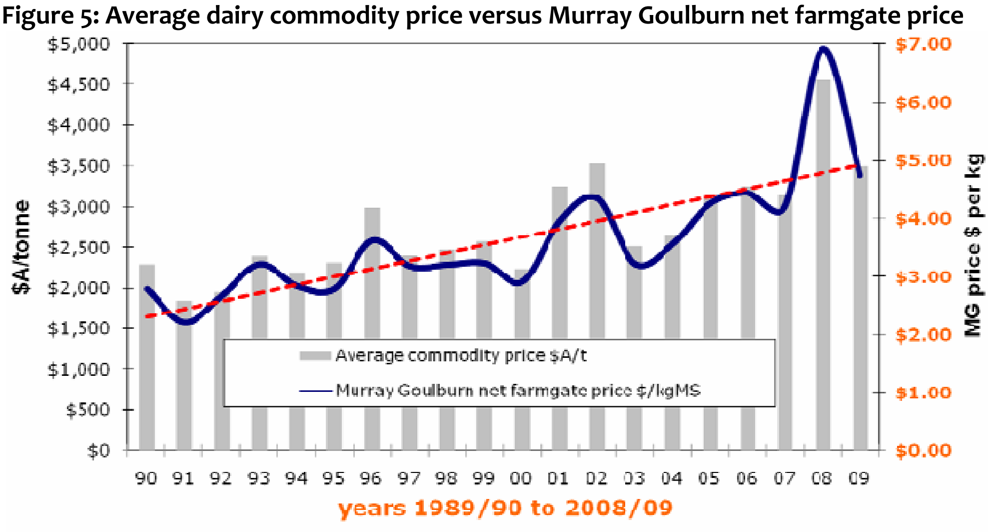
Similarly, the United Dairy Farmers', has opined that:

> Murray Goulburn's pricing sets the signals for pricing structures in Victoria … (Victorian Farmers' Federation, 2009, p. 4)

While it appears that MG occupies a position of price leadership, the available evidence suggests that MG occupies a position of what is known in the economics literature as 'barometric price leadership', where the price leader commands adherence by rivals to the price set because its price reflects market conditions with tolerable promptness. That is, the 'barometer' firm is considered to be reliable and tolerably accurate in its pricing decisions, and therefore others tend to copy it.

According to National Foods (2009, p. 6), there is very close link between the average dairy commodity price and the MG net farmgate price as demonstrated by the Figure 5 below.

Figure 5: Average dairy commodity price versus Murray Goulburn net farmgate price



Source: National Foods Limited (2009, p. 6)

The critical question then becomes: how does the international price of dairy products influence the farmgate price received by dairy producers? The "law of one price" applies due to arbitrage opportunities. If the price of a product is different in two different markets, then an arbitrageur will purchase the asset in the cheaper market and sell it where prices are higher in order to earn a profit.

According to Lamont and Thaler (2003, p. 201), the logic as to why the law of one price must hold is simple: if the same asset is selling for two different prices simultaneously, then arbitrageurs will step in, correct the situation and make themselves a tidy profit at the same time. Despite the inherent logic surrounding the law of one price, many studies fail to find significant support for the law of one price (LOP) in commodity markets (Pippenger & Phillips, 2008, p. 915). However, Pippenger and Phillips (2008, p. 924), conclude that once pitfalls in previous studies are accounted for, there is no empirical evidence that would lead them to reject the law of one price in commodity markets.[2]

The law of one price suggests that prices for dairy products manufactured in Australia should be the same or closely related to international commodity prices. Product substitution possibilities for Australian milk processors between export markets and domestic markets means that any attempt to artificially lower product prices in the domestic markets will be defeated through more product being shifted into export market channels where higher returns can be earned. This point has previously been articulated by Fonterra (Fonterra Brands (Australia) Pty Ltd, 2008, p. 7) in its 2008 submission to the ACCC grocery inquiry:

> The increases in the international dairy commodity prices are related to the domestic market for manufacturing milk as processors consider the returns, which can be achieved from the export of dairy products such as cheese, butter, whole and skim milk powder to their export customers versus returns that can be achieved from the domestic market.

The ACCC has described how international commodity prices for dairy products in turn affect the prices received by milk producers by milk processors at the farmgate which results from milk processors competing for milk supply from milk producers:

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[2] According to Pippenger and Phillips (2008), those pitfalls are (1) using retail prices, (2) omitting transportation costs, (3) ignoring time, and (4) not using identical products.

> … there appears to be a close link between global prices and domestic farmgate prices for fresh milk. Such a close link may initially appear surprising given milk is a non-traded item due to its high water content. However, a linkage exists between global and domestic prices due to the ability of producers to export milk in powdered or processed form—hence creating arbitrage pricing. (Australian Competition and Consumer Commission, 2008, p. 45).
>
> With around 50 per cent of domestic raw milk production being exported (after processing), primarily in the form of milk powders and cheese, processors of dairy products to satisfy domestic demand compete directly for raw milk with production aimed at export markets. Accordingly, processors of product for domestic markets are required to match world dairy prices to ensure supply. (Australian Competition and Consumer Commission, 2008, p. 284)

On this basis, the ACCC (2008, p. 274) concluded that because milk products are internationally traded, the prices domestic milk processors offer are primarily set by international factors.

Similarly, Fonterra in its submission to the 2009-10 Senate Economics Committee Inquiry into competition and pricing in the Australian dairy industry commented in relation to farmgate milk prices paid to farmers that:

> Fonterra's business is based on dairy manufacturing and around two-thirds of the milk we collect in Australia is manufactured into products sold on dairy commodity markets.
>
> These dairy commodity markets are highly competitive and truly global. Trades occur every day and involve some of the largest food companies in the world. Even local commodity sales involve competition against international dairy producers.
>
> With this exposure to commodities, the returns we receive on commodity markets determine the farmgate prices we can offer suppliers. This is true for most of the industry in Victoria and Tasmania.… (Fonterra Australia Pty Ltd, 2009, pp. 4-5)

In the case of milk producing regions that are not export orientated, it can still be expected that commodity prices will have an influence on farmgate prices. This is because the farmgate price from other regions plus the cost of freight will become the marginal source of supply in non-export orientated regions. This point has previously been articulated by Vince Houlihan, the General Manager of Commercial Development with Parmalat Foods in testimony before the ACCC grocery inquiry in 2008 when discussing farmgate prices in Queensland:

> As to what the processors here are doing, they in fact do pay a price in this region significantly above the prices being paid in southern areas, which really reflects the fact that ultimately, you know, it's the milk in, say, our Victorian region, plus freight to Queensland, sets an economic maximum above which it would not be rational to pay, you know, a milk price. As a result, there is a significant local incentive paid to keep production in this region, and milk production in this region actually does cost somewhat more than it does in southern regions, primarily because the pattern of milk flow is much flatter, which is a significantly more expensive exercise for a farmer to achieve. (Australian Competition and Consumer Commission, 2008b, pp. p-52)

Similarly, ABARES (2011, p. 93) has observed that farmgate milk price differentials in Northern New South Wales and Queensland reflect different farm costs for milk production and the cost of transporting milk between regions. According to ABARES (2011, p. 93):

> … the highest differential payable would reflect the transport costs of buying lower priced milk from the south plus any premium that may be required to secure a contract with dairy farmers in those regions.

Consistent with this, the ACCC (2008, p. 285) found that farmgate prices are generally higher outside of the export region of south-eastern Australia and that prices in these other regions are influenced primarily by local supply and demand conditions. Similarly, according to Australian Dairy Farmers in its submission to the 2009-10 Senate Economics Committee Inquiry into competition and pricing in the Australian dairy industry:

> Farmers supplying fresh milk processors in regions such as northern New South Wales and southern Queensland are somewhat buffered from the impact of international markets by the need for year round supply close to large population centres and the high freight costs of alternatives supplies for other dairy regions. (Australian Dairy Farmers, 2009, p. 3)

While non-exported orientated milk producing regions have a degree of protection afforded by distance and associated freight costs, nonetheless they are still subject to the market forces of supply and demand.

For example, it has been suggested that there is currently an oversupply in the milk producing regions of Queensland and northern New South Wales. According to Freshlogic:

> Northern milk suppliers will see lower prices in 2010/11 due to an oversupply of milk compared with local fresh market requirement. (Freshlogic, 2010, p. 7)

There appears to be overwhelming evidence to suggest that the price of farmgate milk is closely linked to international commodity prices. In announcing increases in farmgate prices paid to milk producers in January and March this year, Fonterra made the following public statements:

> Fonterra's National Milk Services Manager, Heather Stacy said the increase reflects conditions in global dairy commodity markets where prices have held and then strengthened during December and January. (Fonterra Australia Pty Ltd, 2011)

and

> Fonterra's national milk services manager, Heather Stacy, says the increase reflects strong demand for dairy products internationally.
>
> "It really reflects the positive marketplace signal that we're seeing come through, driven by good demand for dairy products and powders, particularly out of the Middle East, South-East Asia and China," she said.
>
> She says she is confident there will be more step-ups this season. (ABC News, 2011)

According to the United Dairyfarmers of Victoria (UDV), the dairy commodity section of the Victorian Farmers Federation:

> … prices for most dairy farmers in Victoria are heavily influenced by world trade prices for dairy products, which are distorted by the use of export subsidies and intervention buying in the US and EU, and various trade barriers in many dairy markets for Australian products. The Victorian dairy industry is therefore highly exposed to fluctuations in the world market. (Victorian Farmers' Federation, 2009, p. 3)

According to Dairy Australia (Dairy Australia Limited, 2010, p. 8):

- The majority of wholesale dairy product prices in the domestic retail, foodservice and industrial products markets are directly influenced by prevailing international prices and world market conditions.
- Due to the transparency of world market prices, the open market for dairy imports, and the structure and practices of the retail grocery sector, there is no effective sustainable premium over time for sales into the domestic market compared to export returns, when all costs are considered.
- As a result, farmgate prices - particularly in the regions of Victoria and Tasmania where the majority of milk is used in the manufacture of dairy products - are closely aligned to returns from exported products.

According to DairyTas Board (DairyTas Board, 2009, p. 4):

> The Tasmanian dairy industry has been driven by the international market conditions for dairy products and international commodity price movements. Farmers have been forced to adjust to the variability of returns from these markets.

This is further reinforced by the Department of Primary Industries, Parks, Water and Environment, Tasmania (2009, p. 9):

> Milk prices in Tasmania are linked to the international market, despite the fact that the majority of milk products are sold nationally. The international market price coupled with the relative value of the Australian dollar therefore largely drive the local price.

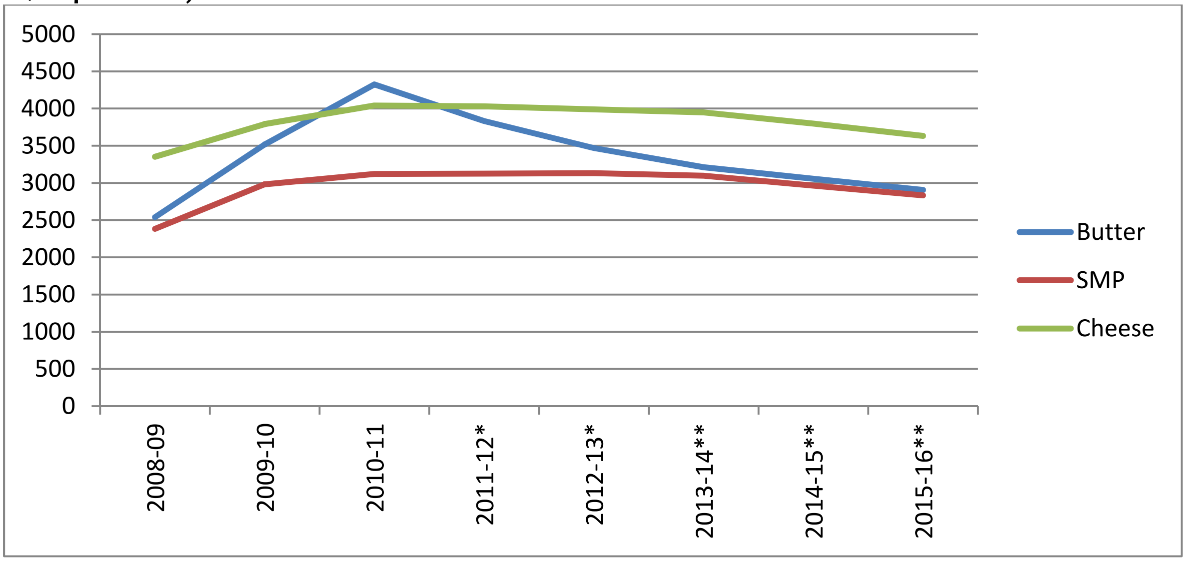
National Foods Limited (2009, p. 5) has previously commented that:

> … international prices for traded dairy products are the most significant factor in determining the price received by farmers for their raw milk.

According to ABARES (2011, p. 89), while world dairy product prices are forecast to increase slightly in 2011–12, returns to Australian dairy exporters are expected to be offset, to some extent, by an assumed high Australian dollar.

ABARES forecast and projections for world dairy product prices are outlined below in Figure 6.

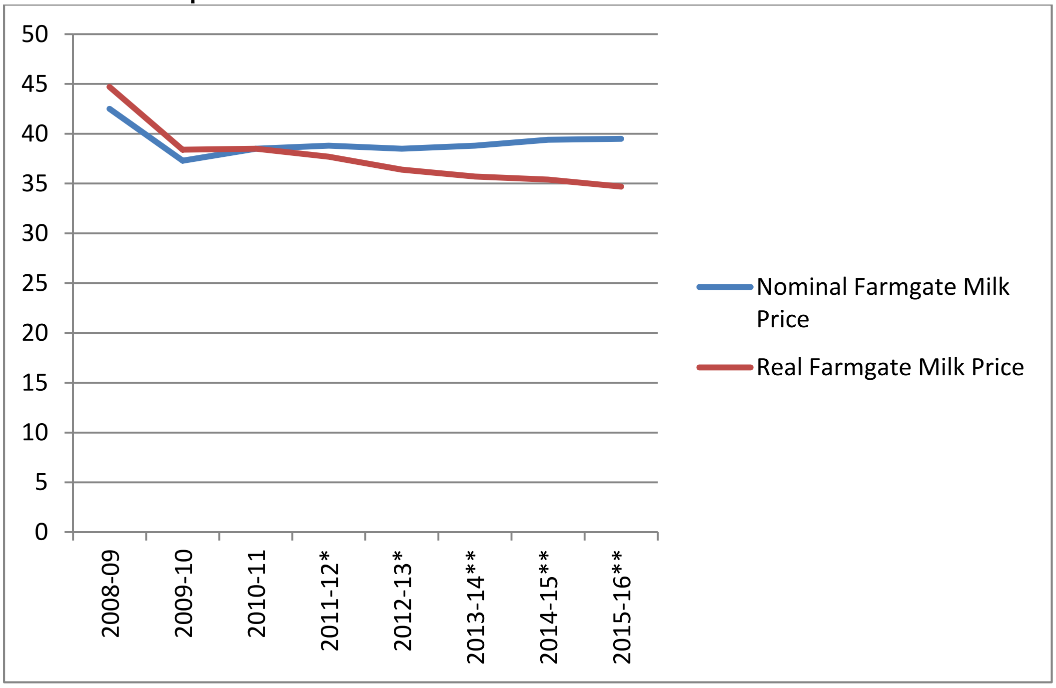
Figure 6: Indicative World Butter, Skim Milk Powder (SMP) and Cheese real prices (in 2010-11 $US per tonne)



Source: Australian Bureau of Agricultural Resource Economics and Sciences (2011, p. 95)
* Forecasts
** Projections

ABARES (2011, p. 89) is forecasting that Australian average farmgate price for milk will average 38.8 cents a litre in 2011–12, around 1 per cent higher than the forecast average farmgate milk price in 2010–11, although they are projected to fall slightly over the outlook period and to reach 34.7 cents per litre (in 2010–11 dollars) in 2015–16, reflecting weaker international dairy prices towards the end of the outlook period.

Figure 7: Australian Farmgate Milk Prices Nominal and Real (in 2010-11 Australian Dollars) in Australian cents per litre



Source: Australian Bureau of Agricultural Resource Economics and Sciences (2011, p. 95)
* Forecasts
** Projections

4 Drivers of Change in the Australian Dairy Industry

Milk producers have undergone substantial change over the last 30 years with the number of dairy farms falling by two thirds from 21,994 in 1979-80 to 7,511 in mid-2010 (Dairy Australia Limited, 2010a, p. 11).

This is an ongoing trend. According to a survey of dairy farmers conducted in mid to late 2009 by the Australian Bureau of Agricultural and Resource Economics (Dharma & Martin, 2010, p. 8), an estimated 16 per cent of dairy farmers expected to leave the dairy industry and 10 per cent expected that they would reduce milk production over the course of the following three years. According to this survey, 37 per cent of producers in Tasmania, 29 per cent of producers in Northern Victoria and Riverina, 28 per cent of producers in South Australia, and 25 per cent of producers in Western Australia were expected to exit the industry (Dharma & Martin, 2010, p. 8).

4.1.1 Challenges faced by dairy farmers

There are a number of challenges that milk producers face to stay in business around the country. In the northern dairy regions of northern New South Wales and Queensland it appears that the supply of fresh drinking milk now outstrips supply putting pressure on farmgate prices for raw milk. According to Dairy Australia Limited:

> In northern states, conditions for dairy farmers have been relatively benign over the past year, with contract prices remaining in place for most dairy producers, and seasonal conditions remaining generally favourable. As a result, **milk production has expanded beyond the requirements of fresh milk processors in the region.** This adds to margin pressures being experienced due to the lack of wholesale price improvements in the retail market. As a result, processors are building in sharper signals designed to limit further growth into new supply contracts. (Dairy Australia Limited, 2010, p. 3)
>
> and
>
> - Prices are under downward pressure in Queensland and NSW regions as regional milk flows exceed fresh market demand requirements, and intense retail competition has limited processing margins…
> - Prevailing farmgate prices in effect in 2009/10 were largely struck in 2007/08 or earlier when seasonal conditions threatened the ongoing adequacy of local milk flows, and southern milk prices were significantly higher than those expected in 2010/11. A large percentage of Parmalat's Queensland milk supply is contracted at firm prices until the end of the 2012 calendar year.
> - With a major renegotiation of milk prices by other buyers in the region, downward revision of farmgate prices will occur. In addition to this, pressures to closely align milk supply with market demand have ensured there will be significant change for many suppliers supplying DFMC and NatFoods in NSW and Queensland with the implementation of a new milk supply arrangement… (Dairy Australia Limited, 2010a, p. 38)

Other pressures include competition for land from alternative uses. According to one recent study:

> … increased competition for land in many of Australia's traditional dairying regions from both alternate agricultural and non-agricultural activities has increased the effective cost of operating dairy businesses. (Alford, Garcia, Farina, & Fulkerson, 2009, p. vi)

In regard to South East Queensland, Vince Houlihan, the General Manager of Commercial Development with Parmalat Foods made the following observations in testimony before the ACCC grocery inquiry in 2008:

> … one of the real emerging issues in South East Queensland has been urbanisation of land and rising land values. In fact, one of the big structural issues post deregulation was that you had land at places like the hinterland and the Gold Coast which simply was not viable for dairy it, had to get turned into housing blocks, and producers look at it and say, "I'm not making any income out of dairying," when in fact their land is worth 10 times what it was five or 10 years ago.
>
> The South-East Queensland dairying environment is actually still going through a major transition of farmers having to migrate out of highly urbanised areas into areas like the Darling Downs and the Western Downs. Until that transition is completed, in another five, six or seven years, there will be individual farmers in South-East Queensland who will never make money out of dairying because their land really belongs in a housing lot. (Australian Competition and Consumer Commission, 2008c)

The CSIRO (Khan, Abbas, Rana, & Carroll, 2010) has also highlighted competition for dairying land from alternative land uses in a report prepared last year. In relation to dairying in the North Coast (Richmond River District) of New South Wales it identified as one of the key issues that land values were impacting on the viability of dairy operations (Khan, Abbas, Rana, & Carroll, 2010, p. 34). In the Coastal South East Region of the Sub Tropical Dairy Program region it observed that land value increases were impacting on the viability of dairy operations while in South East Region of the Sub Tropical Dairy Program region it identified competition from other land users (ie urban) as a major issue (Khan, Abbas, Rana, & Carroll, 2010, p. 46). In the South East Region of South Australia it identified one key issue being competition for resources from developments that are supported by tax-effective investment schemes (Khan, Abbas, Rana, & Carroll, 2010, p. 53). In the Harvey Irrigation Area of the Western Australia dairy region it identified increased competition from other land users – more intensive agriculture and lifestyle/hobby blocks (Khan, Abbas, Rana, & Carroll, 2010, p. 72).

Despite recent heavy rainfall and floods across much of southern Australia, a further challenge facing dairy farmers is ongoing access to water. According to the CSIRO (Khan, Abbas, Rana, & Carroll, 2010, p. 74):

- Dairy is a major water user in the agriculture industry.
- Most water use is for growing pastures through irrigation.
- Less water is available for maintaining sustainable irrigation supplies due to impacts of drought and climate change.

The dairy industry of the Murray-Darling Basin is focused in the Victorian Goulburn-Murray Irrigation District, but includes some farms in the New South Wales Central Murray and in South Australia (Murray–Darling Basin Authority, 2010, p. 86). Based on its draft plan to limit the amount of water that can be taken from the Murray-Darling Basin, the Murray-Darling Basin Authority has suggested that the gross value of irrigated agriculture production of dairy in the Basin could contract by 10 per cent (Murray–Darling Basin Authority, 2010, p. xxxvii).

4.1.2 Opportunities arising from milk discounting

While milk producers face a number of serious challenges to their ongoing viability, the discounting of milk initiated by Coles does present an opportunity.

Based on observations about supply and demand, Professor Stephen King of Monash University has suggested that milk producers will benefit from recent price discounting of fresh milk in the grocery sector. Professor King has suggested that price discounting of fresh milk by Coles will increase demand for fresh milk by consumers, which in turn will drive higher farmgate prices for milk producers. According to Professor King:

> … the one fact that stands out in the strategy of Coles is that Coles is certainly not going to need less fresh milk; almost certainly it is going to need more fresh milk. We would expect milk sales from Coles supermarkets to go up. Unless milk is an extraordinarily unusual product—in other words, it is a product for which demand has not slowed down—milk sales generally will go up as prices go down. As other sellers of milk products are forced to lower their prices to match Coles to keep their customers, you would expect total milk sales to go up… (Senate Economics Reference Committee, 2011, p. E43)
>
> and

> Dairy farmers will find that they're being enticed to produce more milk. How do you entice somebody to produce more? You've got to be paying them more. (ABC Television, 2011).

In a situation where one of the difficulties faced by dairy farmers in at least some regions of NSW and Queensland, as discussed above, is that supply is exceeding demand, the increased demand stimulated by price discounting will to some extent alleviate these pressures.

5 Market Power of Dairy Farmers

Buyer power refers to the circumstance in which the demand side of a market is sufficiently concentrated that buyers can exercise market power over sellers (Noll, 2005, p. 589). In the event a firm can exercise buyer power then it will be able to extract quasi-rents from suppliers. A quasi-rent is the difference between a supplier's total revenues and short-run total costs (Noll, 2005, p. 593). A quasi-rent value of an asset has also been defined as the excess of its value over its salvage or its value in its next best use to another renter (Klein, Crawford, & Alchian, 1978).

Countervailing power refers to the ability of milk producers to thwart any attempt by dairy processors to impose price cuts upon them in the provision of raw milk.

There is evidence available to suggest that dairy farmers currently exercise some degree of countervailing power in the sale of raw milk.

According to Professor John M Staatz (Staatz, 1987, p. 91) of Michigan State University, farmers' co-operatives exercise countervailing power to prevent the appropriation of quasi-rents by purchasers:

> Much of the potential of farmer cooperatives to use countervailing power to redistribute income lies in the ability of these associations to limit the appropriation of rents by farmers' trading partners. (Staatz, 1987, p. 91)

The largest purchaser of raw milk in Australia, MG, is a co-operative. This gives its individual suppliers very strong countervailing power in dealings with MG. As a co-operative, MG is owned by its suppliers. Any attempt by MG to misuse a position of buyer power would ultimately be to the disadvantage of its members who must be dairy farmers. Under these circumstances, dairy farmers are in a very strong position to discipline MG Directors, and thereby in turn MG management, in the event that MG sought to engage in activities detrimental to the interests of dairy farmers. In this regard, MG suppliers already have the means at their disposal to impose serious sanctions against MG Directors and management for actions detrimental to their interests.

There is also regulatory assistance available to dairy farmers. Authorisation is the process of granting immunity for some arrangements or conduct that might otherwise breach the anti-competitive conduct provisions of the Trade Practices Act. For agreements that may substantially lessen competition, it must be demonstrated that the agreement results in a public benefit which outweighs the anti-competitive detriment. Dairy farmers are permitted to collectively bargain with purchasers of raw milk through an authorisation granted by the ACCC in 2006 to Australian Dairy Farmers (ADF). There are currently 15 collective bargaining groups (CBGs) for dairy farmers operating across Australia using the ADF authorisation.

There is some evidence to suggest that the ability to collective bargain has provided dairy farmers with some degree of countervailing power against purchasers of raw milk. According to ADF:

> Notwithstanding the other factors at work in the market, it is the understanding of ADF that the consistent trend of a higher price per litre of milk in areas where CBGs operate is in some part attributable to the successful operation of farmers negotiating collectively. (Australian Dairy Farmers, 2010)

History also suggests that dairy farmers possess some degree of countervailing power. A move by Warrnambool Cheese and Butter Factory Company Holdings Ltd (WCB) to cut raw milk prices to dairy farmers in April 2009 was defeated through dairy farmers finding other purchasers for their milk. According to an ASX announcement by WCB on 14 April 2009:

> Following the decision to cut milk prices from 1 April 2009, a number of milk suppliers representing a significant amount of WCB's total milk supply moved to other competitors and there were indications that further suppliers may also move. Given this situation, WCB made the decision on 8 April 2009 to reinstate milk prices for milk supplied from 1 April 2009 to 30 June 2009 to levels consistent with prices announced in January this year. (Warrnambool Cheese and Butter Factory Company Holdings Limited, 2009)

6 Benefits of Competition

There appears to be universal agreements that the main goal of competition policy is to promote economic efficiency, particularly allocative efficiency. According to the Organization for Economic Cooperation and Development (1994):

> There is general consensus that the basic objective of competition policy is to protect and preserve competition as the most appropriate means of ensuring the efficient allocation of resources – and thus efficient market outcomes - in free market economies.

In the Australian context, this view has been reflected in both the 1993 independent committee of inquiry into National Competition Policy (Hilmer report) and the independent review of the competition provisions of the Trade Practices Act chaired by Sir Daryl Dawson (Dawson report):

> Competition policy is not about the pursuit of competition *per se*. Rather, it seeks to facilitate effective competition to promote efficiency and economic growth while accommodating situations where competition does not achieve efficiency or conflicts with other social objectives. (Hilmer, Rayner, & Taperell, 1993, p. xvi).

> Competition is an important mechanism for achieving the advances in efficiency and productivity that are essential to enhance welfare. Competition creates an environment that provides incentives and disciplines for continuing improvement. In a competitive market, each participant seeks to constrain costs to maintain its position in the market and achieve some advantage over its competitors. Business decisions made in response to competitively determined prices direct resources within the economy to where the best opportunities lie. Ultimately, consumers benefit as increases in productivity are reflected in lower prices in the short term or through greater choice in the longer term. Their welfare is enhanced. (Dawson, Segal, & Rendall, 2003, p. 30)

Allocative efficiency where resources used to produce a set of goods and services are allocated to their highest valued uses (ie those that provide the greatest benefit relative to costs (Hilmer, Rayner, & Taperell, 1993, p. 4). The efficient pricing level (ie that which achieves allocative efficiency) is where price is equated to the short-run marginal cost. Marginal cost is the cost of producing an additional unit of output.

The advantage of pricing at marginal cost is that it will generally result in a maximisation of both consumer and producer surplus. Consumer surplus is the amount that consumers benefit by being able to purchase a product for less than what they would be prepared to pay. The producer surplus represents the amount that producers benefit by selling at a market price that is higher than the lowest amount they would be willing to sell for.

Price discounting behaviour, such as is occurring with fresh drinking milk, generally improves welfare because it will force prices back down towards marginal cost and therefore closer to the point where the market is allocatively efficient. The ACCC has stated that the theoretical case for competition laws has been traditionally founded on the need to protect allocative efficiency (Australian Competition and Consumer Commission, 2002a, p. 226).

The one exception to price discounting behaviour being beneficial is in the event that there is predatory pricing. While there are disagreements over a precise definition of predatory pricing, it generally involves temporary selling, at prices below its costs, by a firm (or group of firms) to drive out or crush a competitor (Yamey, 1972, p. 129). Any potential concerns that recent milk price discounting could be predatory pricing can be addressed under Australia's competition law, as it is unlawful under section 46(1) and section 46(1AA) of the *Competition and Consumer Act 2010*. Section 46(1) prohibits businesses that have substantial market power from taking advantage of that power for the purpose of eliminating or substantially damaging a competitor, preventing the entry of a person into a market or deterring or preventing a person from engaging in competitive conduct in a market. Section 46(1AA) (also known as the Birdsville amendment) prohibits businesses with a substantial share of a market, having regard to the number and size of its competitors in the market, from selling goods or services for a sustained period at a price below their relevant cost of supply.

In regard to current fresh milk price discounting by Coles, prominent small business advocate Frank Zumbo (2011, p. 6) has observed:

> … from a competition law point of view it needs to be established whether or not Coles is selling home brand milk below cost. If Coles is not selling the home brand milk below cost, then that is the end of the matter under the Birdsville amendment.

However, evidence before a Senate Committee hearing from the Chairman of the National Association of Retail Grocers of Australia, Mr John Cummings, would suggest that moves by Coles to sell private label two litre milk for $2 is not predatory pricing:

> I am told that the cost of production of two litres of milk in Western Australia is around $1.40. In addition to that $1.40, which is the processors' cost of production, there is a 4c a unit distribution cost to get that milk to Coles, which is their generic or house brand…
>
> We estimate that the Coles price for two-litres of private-label milk, after all of their terms and after the stripped down net, net costs, to be about $1.50. It could be $1.60, but we are not sure. (Senate Economics Reference Committee, 2011a, p. E2)

Price equalling marginal cost is the outcome achieved under the model of perfect competition which is used by economists to assess the welfare implications of real world market situations. On the other hand, a firm able to push its price above marginal cost is generally said to be exercising market power (Lerner, 1934). Firms exercising market power on the selling side of the market usually cutback production and raise prices to consumers.

American economist John Maurice Clark contended that the economic model of perfect competition was an inappropriate benchmark by which to assess real world outcomes because it "does not and cannot exist and has presumably never existed" (Clark, 1940, p. 241). Instead, Clark was the first to articulate the concept of workable competition.

In the Australian context, the definition of workable competition has generally been taken from the decision by the former Trade Practices Tribunal (TPT)[3] in the matter of *Re Queensland Cooperative Milling Association Ltd, Defiance Holdings Ltd (Proposed mergers with Barnes Milling Ltd)* (QCMA). In its decision in QCMA the TPT commented:

> As was said the United States Attorney-General's National Committee to Study the Antitrust Laws in its Report of 1955 (at p 3320): "The basic

[3] The Trade Practices Tribunal was the predecessor of the Australian Competition Tribunal.

> characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new potential entrants into a field, would keep this power in check by offering or threatening to offer effective inducements… .” Or gain, as if often said in United States antitrust cases, the antithesis of competition is undue market power, in the sense of the power to raise price and exclude entry. That power may or may not be exercised. Rather, where there is significant market power the firm (or group of firms acting in concert) is sufficiently free from market pressures to “administer” its own production and selling policies at its discretion…
>
> In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price product service packages offered to consumers and customers. (*Re Queensland Co-operative Milling Association Ltd* (1976) 8 ALR 481, 515)

Recognising that perfect competition rarely if ever exists, the application of competition law in Australia has been directed towards preserving workable competition as enunciated by the TPT.

In its 2008 grocery inquiry, the ACCC (2008) found overall that supermarket grocery retailing in Australia was workably competitive but expressed some concerns. One of those concerns was the apparent lack of incentive for Coles and Woolworths to compete strongly on price (Australian Competition and Consumer Commission, 2008, p. xvii). It would appear that the ACCC’s previous concerns are being addressed.

In considering the long term viability of milk processors, it needs to be borne in mind that supermarkets have tenders to determine which processor they will purchase milk from for their private label brands (Senate Economic Reference Committee, 2011, p. 25). These contracts usually last for two or three years (Senate Economic Reference Committee, 2011, p. 25).

Tendering occurs under circumstances where markets are thin and information is imperfect (Menezes, Pitchford, & Wait, 2003, p. 347). Tenders are also referred to as reverse auctions. The conduct of a tender or reverse auction offers a number of benefits to purchasers:

- It overcomes problems with asymmetric information and adverse selection;
- It is transparent; and
- It improves allocative efficiency. (Burford, 2007)

There are now only two major players in Australia engaged in the production of drinking milk. It is presumably the case that these players would not submit tenders for supermarket contracts that price the product below the cost of production. It is also submitted that two major players in the production of drinking milk should be in a position to exercise some countervailing power against supermarkets.

Around one quarter of milk produced in Australia is used for drinking milk and around 51 per cent of drinking milk is distributed through supermarkets. This essentially means that supermarkets account for sales of around 13 per cent of Australia's milk production. It is absurd to suggest that a discount war for drinking milk amongst supermarkets will in turn threaten the future viability of Australian milk production for the remaining 87 per cent of milk production. This is reinforced by the fact that dairy farmers receive premiums for being able to produce milk all year round for the production of drinking milk.

In this regard, the recent comments by the Chairman of the ACCC, Graeme Samuel, regarding supermarket milk discounting are particularly pertinent:

> … I do think we've actually got to start looking at others in the supply chain, and treat with a healthy scepticism some of these protestations about concerns of the farmers, when it may well be that the primary concern is for these corporation's bottom line, their profits. (Christian, 2011)

Product differentiation can be highly beneficial to consumers through providing product innovation and quality improvements. The processor branded products are an example of product differentiation as they sell for more than the supermarket private label brands.

Economic theory is generally neutral in regard to the welfare implications of product differentiation. According to Baker (Baker, 1997, p. 42):

> Differentiation itself is not unambiguously good or bad. Buyers typically benefit from the availability of a wide variety of product offerings to serve

their differing preferences. Yet differentiation can also facilitate the exercise of market power.

Hence, the welfare implications of product differentiation are such that it would appear to raise welfare concerns only in the event that it facilitates the exercise of market power. It may be that recent price discounting by supermarkets of home brand products has eroded the market power of processors from product differentiation of their branded products. From an economic welfare perspective, this would be a positive development as consumers benefit from cheaper prices and the production of drinking milk would increase.

7 Conclusions

There are a number of challenges dairy farmers face to remain in business. There are demand and supply imbalances in some parts of the country. There is competition for land from alternative uses. There is also the challenge of ongoing access to water. Farmers are also exposed to the vagaries of international dairy commodity prices. Hence, dairy farmers face ongoing pressure for structural adjustment from several sources.

While dairy farmers face a multitude of challenges, recent price discounting of drinking milk by supermarkets does not pose a threat to the long term viability of the Australian dairy industry. The weight of evidence suggests that farmgate prices for raw milk are set by international dairy commodity prices, even in parts of Australia that are not export orientated. The farmgate prices for the year round provision of raw milk for the production of drinking milk attract a price premium, further benefitting dairy farmers. The increased demand stimulated by price discounting will to some extent alleviate demand and supply imbalances where they exist.

There are several avenues through which dairy farmers can exercise countervailing power against processors. Dairy farmers have traditional organised themselves into cooperatives and the largest processor in Australia is still a co-operative owned by dairy farmers. Dairy farmers also have the means at their disposal to engage in collective bargaining. Dairy farmers have also shown the ability to defeat price cuts from processors by switching to other processors.

Price discounting behaviour of fresh drinking milk by supermarkets generally improves welfare because it will force prices back down towards marginal cost and therefore closer to the point where the market is allocatively efficient. It is also the case that recent price discounting by supermarkets of home brand products may have eroded the market power of processors from product differentiation of their branded products. This is beneficial as production will increase and consumers will enjoy lower prices.

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