coles

11 March 2011

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

Dear Senator

I have enclosed Coles' submission to the 2011 Senate Standing Committee inquiry into the impacts of supermarket price decisions on the dairy industry.

We are grateful that the Committee agreed to extend its hearings until later in March to enable Coles Merchandise Director, John Durkan, and myself to appear in person.

We are also grateful to the Committee for allowing Coles a longer period to lodge its submission on the inquiry.

We are looking forward to appearing before your Committee on 22 March so that we can clarify Coles' intentions, and the impacts of its late-January 2011 milk pricing decision on the Australian dairy industry.

Yours sincerely

Ian McLeod
Managing Director

Coles Supermarkets Australia Pty Ltd ABN 45 004 189 708
800 Toorak Road Hawthorn East Victoria 3123 Australia
PO Box 2000 Glen Iris Victoria 3146 Australia
Telephone 61 3 9829 5111 Facsimile 61 3 9829 6787

coles

COLES SUPERMARKETS AUSTRALIA PTY LTD

SUBMISSION TO THE SENATE STANDING COMMITTEE ON ECONOMICS

INQUIRY INTO

THE IMPACT OF SUPERMARKET PRICE DECISIONS ON THE DAIRY INDUSTRY

11 MARCH 2011

Coles Supermarkets Australia Pty Ltd ABN 45 004 189 708
800 Toorak Road Hawthorn East Victoria 3123 Australia
PO Box 2000 Glen Iris Victoria 3146 Australia
Telephone 61 3 9829 5111 Facsimile 61 3 9829 6787

1. Introduction

Coles was established by GJ Coles, who opened his first variety store in Smith Street, Collingwood in 1914. Since then, Coles has grown to become a national grocery retailer. This represents an Australian success story of which the Coles family are rightly very proud.

Sadly, through a combination of poor management, poor strategy, complacency and even dishonesty in the 1980s and 1990s, Coles slipped to become a second rate player, out of touch with its team members and out of touch with its customers and suppliers.

Attempts were made to revitalise Coles in the last decade but those attempts failed. This ultimately led to plans for the company to be sold, potentially to foreign owners or private equity players.

Wesfarmers, which also started in 1914 as an agricultural cooperative in Western Australia, and has grown to become one of Australia's top ten listed companies, successfully bid for the Coles Group and kept the business in Australian ownership.

The Coles Group acquisition cost Wesfarmers $19.7 billion, the biggest corporate acquisition in Australian history, and represented an unprecedented retail turnaround challenge.

Wesfarmers appointed a new management team dedicated to restoring Coles to its former position as a respected household icon, with customers at the heart of everything it does. Despite clear improvements in the last three years, the Coles turnaround continues to be one of the biggest global retail challenges.

Many commentators said that this simply could not be done:

"We don't believe that Wesfarmers (or anybody else for that matter) can turn the business around;" David Errington, Merrill Lynch, October 2007.

The new management team looked at what was wrong and what needed to be fixed. Our initial analysis was clear – customers had an inherent mistrust of supermarkets and it was not hard to see why:

- Food prices were higher than in most other developed countries
- Food prices were rising faster than general inflation rates in Australia
- The same product was being sold at different prices in adjacent stores if the supermarket thought it could charge a higher price and get away with it; and
- There was a lack of care in the selection and presentation of fresh food, so quality and price could not be trusted.

In addition to these structural industry issues, Coles specifically had very little focus on its own customers. As a result, Coles' reputation was very low amongst its own customers.

In order to protect profit margins in previous years, stores suffered from chronic levels of under-investment. For example, equipment was so old parts were no longer available, checkout machines regularly broke down, product availability was poor, fresh food quality was poor, pricing was uncompetitive, service was poor as a result of a lack of team members, stores were not cleaned frequently enough, training was poor and morale was extremely low.

In these circumstances, it is little wonder that Coles had low levels of trust amongst its customers, or its team members for that matter.

Since the Wesfarmers acquisition, a five year turnaround plan has been developed which seeks to take the company from continual decline and build it back to a position of strength and in so doing establish a platform that allows the company to prosper in the future.

A central element of this turnaround plan is a desire to restore customer belief that Coles is a shop you can trust to deliver quality, service and value. Indeed, it is more than a desire, it is an imperative.

Given the way in which Australian supermarkets appear to have taken their customers for granted for many years, we are not surprised that any moves we make to restore trust are met with scepticism and cynicism not only by customers but also politicians and the media.

Proof points of change have to be continuously established to positively reinforce customer perceptions over time. The most significant proof point is lower grocery prices. This is why we have, along with building new stores, designing new formats, improving service, improving availability, improving quality and replacing worn out equipment, been reducing prices and driving change to such an extent that we have moved our prices from food inflation to food deflation.

It is important to note that Wesfarmers' commitment is to the creation of long term sustainable value for its shareholders. To achieve this, Wesfarmers follows the highest standards of corporate governance.

Coles fully supports a vibrant and growing Australian supplier base. It is right for the country and it is right for our customers. Many Australian food producers are highly efficient and competitive, and Coles is seeking to work cooperatively with them.

We have also been working hard to help smaller Australian businesses to develop and grow, working directly with rural business owners and individual family growers to develop stronger business relationships than we have in the past.

For example:

- WA Meat Packers, a family owned and operated business in Perth, employs 140 skilled tradespeople. It re-opened in January 2011 after a $7 million upgrade because of Coles commitment to partner with them and purchase 900 head of cattle per week
- Fresh Select, which employs 60 to 70 local Werribee people, provides Coles with lettuce, cauliflower and broccoli. It is a family owned business that works closely with other smaller local growers by giving them access to food safety, quality and logistics solutions systems
- Rugby Farms in Queensland supplies Coles with a range of vegetable products including baby corn to replace imports. It began as a family business in 1912 and operates in the Lockyer Valley which was recently devastated by the Queensland floods but is back up and running with Coles support
- The Mildura Fruit Company, which supplies Coles with oranges and mandarins, works with over 120 growers in the Sunraysia region and employs over 190 team members. They have invested over $7 million in a major upgrade to supply Coles with new varieties, exclusive to Coles' customers
- The Mitolo Group, a family business employing 270 people in the Mallee, Riverland and northern suburbs of Adelaide, is one of Australia's leading potato and onion producers. They have been working with Coles on product innovation and recently released an exclusive potato product for Coles, the Carisma, that is Australia's only low GI potato, which has nutrition and health benefits for customers with weight or diabetes problems
- Bread Solutions based in Braeside employs 150 team members who supply Coles with over 20,000 cases each week of artisan bread across 20 product lines. It has production technology unique in the southern hemisphere and has expansion plans based on volume commitments from Coles.

Not surprisingly, given the scepticism around the supermarket industry generally, we found suppliers were initially cynical about the promised Coles turnaround. They felt strongly they couldn't trust Coles to make a decision and then stick to it. At the start of the turnaround three years ago, the new management team met with all of our major suppliers personally and they were unanimous in their belief that Australia needed a "stronger number two". They were also able to point out, without retribution, where they felt Coles could improve.

Surveys show that Coles has improved its reputation with our food and grocery suppliers. The latest survey by UBS confirms that Coles has achieved strong perception scores amongst our suppliers for our overall pricing strategy, for offering value for money, for overall presentation of stores, for quality of fresh food and for better on-shelf availability.

The tide is beginning to turn as the company moves in the right direction but there is still much more to do. The scale of change and the time it would take was understood when the company was acquired in 2007. Wesfarmers and the new management team at Coles are in it for the long haul. We remain committed to a successful turnaround and restoring Coles to its former position as a leading Australian retailer that its customers and suppliers trust to deliver quality, service and value.

2. Background

Coles is making this submission in response to the 2011 Senate Standing Committee on Economics Inquiry, '*The impact of supermarket price decisions on the dairy industry*', which, among other things, is inquiring into the discounting of Coles brand private label milk products.

This inquiry follows the 2010 Senate Standing Committee on Economics Report, *"Milking it for all its worth – competition and pricing in the Australian dairy industry"* that looked at the impact on farm gate milk prices of the slump in demand during the Global Financial Crisis.

It also follows the 2008 Australian Grocery Inquiry by the Australian Competition & Consumer Commission into the competitiveness of standard grocery items, because of Government concern about a lack of competition at that time.

The final 2008 ACCC report noted: "*Australian consumers would significantly benefit if Coles and Woolworths faced more competitive threats that encouraged more aggressive pricing strategies."*

The then Assistant Treasurer and Minister for Competition Policy & Consumer Affairs, Chris Bowen, also told South Australian radio station 4BC on 18 July 2008 that:

"*We (Australia) have the highest price food inflation in the developed world. Over the last ten years, we have food inflation in the order of 40 per cent."*

Before Wesfarmers acquired the Coles Group in late 2007, it was clear that there existed an inherent mistrust of supermarket pricing, driven by a continuation of supermarket pricing policies, food inflation above CPI and media, political and consumer suspicion. Food price inflation, as measured by the Australian Bureau of Statistics, increased by more than four per cent per annum between 2002 and 2007.

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.

In this submission, we explain that, while Coles is focused on our customers, we also seek to deal fairly and reasonably with each of our milk and other suppliers consistent with our commitment to a sustainable Australian supply chain. As part of this, to the extent we can in any public forum, we wish to explain how our milk pricing occurs across the milk supply chain and to clarify our pricing strategies.

Coles regularly meets with our milk processors, and we have met with a wide range of dairy industry groups face-to-face to discuss their concerns about the potential impact of lower retail private label milk prices on farm gate prices. We are committed to an ongoing dialogue with dairy farmers and their industry organisations to clarify any misconceptions on our pricing along the supply chain.

We do not believe it is in Coles' interest to compromise the position of milk processors or dairy farmers in Australia. It is not what our customers want to see. Indeed, Coles strongly supports a sustainable and prosperous farming and food manufacturing sector in Australia.

3. Executive Summary

Over the past three years, Coles has improved efficiency, increased productivity and enhanced the quality and freshness of our products. As a result of these improvements across the business, we have created a savings pool that has enabled us to reinvest in better quality, improved service and lower prices for our customers.

During the first three years of the turnaround, our pricing strategy has evolved to include the introduction of stronger discounts for promoted lines, aligning prices within States to enhance retail price integrity, lower prices on over 5,000 items to reduce the cost of the average weekly shopping basket and cutting the price on basic grocery items that frequently appear on the weekly shopping list of Australian families.

In the last 12-18 months, there have been significant increases in the cost of living for Australians. For example, national average electricity prices are up 26.5 per cent, gas prices are up 12.2 per cent, water charges are up 28.8 per cent, interest rates are up 25 basis points, residential rents are up 6.4 per cent, council rates are up 12.3 per cent, total health costs including health insurance costs are up 6.3 per cent, fuel costs are up 5.9 per cent and education costs are up 5.7 per cent (ABS data for June 2009 to December 2010).

There are 4.5 million families in Australia earning the average wage or less, including 1.1 million single parent families or families with an unemployed head of household. We estimate that household disposable income for the average Australian family has fallen by approximately $150 per month over the last 12-18 months due to these cost of living increases.

Coles has also recognised a growing concern amongst Australian consumers on other matters such as food additives, ethical sourcing and animal welfare and we have therefore worked with our suppliers to find ways in which we can improve our position on such issues, particularly animal welfare standards over time. This is a Coles' initiative in response to customer concerns raised with us and conducted in full cooperation with our suppliers.

Milk pricing

In mid-January 2011, Coles increased the contract price paid to its milk processors and included "rise and fall" clauses that allow the price to milk processors to rise if farm gate prices rise during the term of the contract.

Coles' contract prices with milk processors increased except where competition among milk processors in response to competitive tenders led to a lower commercial contract price. For example, Fonterra offered a lower commercial contract milk price in WA which we accepted.

Coles subsequently reduced retail milk prices as part of our "Down Down" campaign in late January 2011. This resulted in a price reduction for Coles brand two litre full cream milk price from $2.09 to $2.00. We also equalised the price of Coles Lite milk at the full cream price to remove a previous price premium, and we deleted our entry level Smart Buy range to simplify our milk range for customers. Coles fully funded these retail price reductions through a lower margin. We did not ask milk processors to help fund these retail price reductions.

The entry price for Coles' retail milk was only reduced by 4.3 per cent, equal to nine cents for two litres of milk or just 4.5 cents per litre. In comparison, our competitors reduced the retail price for two litres of private label milk by eight cents from $2.17 to $2.09 in December 2009. These price reductions were smaller than the reduction in retail milk prices following the removal of the 11 cent per litre Federal Government milk levy in February 2009.

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.

Coles did not intend to and has not sold retail milk at a price below the commercial cost of acquiring it from milk processors. Coles' food price deflation also confirms that we are not raising prices on other products to offset the price reductions on our private label milk range. It has been claimed that Coles has been raising petrol prices to cross subsidise lower grocery prices. This allegation is completely without foundation. Since last September, the average pump price has increased by 13 per cent while the price of crude oil has increased by 49 per cent over the same period.

While our contracts and commercial terms are governed by confidentiality provisions, we are willing to provide information to the Committee on a commercial-in-confidence basis or the ACCC so that it can verify our position.

Coles is supportive of Australian dairy farmers and is supportive of improvements to collective bargaining laws for their benefit. We support greater transparency of farm gate pricing. We believe that these changes, coupled with "rise and fall" clauses in contracts between milk processors and retailers will improve relationships within the dairy industry. We do not want dairy farmers on one hand or consumers on the other to be disadvantaged by any specific circumstances applying in the dairy supply chain.

Sustainability of food production

Coles has a long standing and ongoing commitment to a sustainable Australian farming and food manufacturing sector. Our customers have a preference for Australian grown and made products, and typically want to buy local produce where possible.

Coles is committed to working with Australian farmers and sources 100 per cent of its fresh milk, meat and in-store bread from Australian farmers and food manufacturers and over 96 per cent of all fresh fruit and vegetables from Australian farmers.

Coles seeks to pay our suppliers a fair and reasonable price and we are committed to sourcing products from within Australia wherever we reasonably can. Coles is prepared to work with the Federal Government to review sustainability issues facing the Australian dairy industry.

About one third of Coles' 100,000 team members are based in rural and regional Australia and we aim to generate more jobs as we grow the business. Coles is therefore an important part of rural and regional Australia and we take pride in the contribution and service we provide in these communities.

4. Coles is competitive, customer focused and delivers value

4.1 The Coles turnaround following its acquisition by Wesfarmers

Since being acquired by Wesfarmers, the Coles turnaround has been predicated on rebuilding customer trust on quality, service and value. Customers had lost faith in supermarket pricing generally over many years because of price disparities between stores, high-low promotional pricing that were designed to make customers feel they were getting a good deal while at the same time regular price increases were being approved above CPI.

To redress this, Coles has developed a number of important pricing strategies:

1. Fewer, deeper promotions in our weekly catalogues in 2009
2. Uniform State-based pricing in January 2010
3. A "Down Down" campaign in July 2010 (longer-term non-promotional price reductions on over 5,000 items); and
4. Longer term price reductions on a series of key items for families shopping on a budget which commenced in late January 2011.

From 2002 to 2007, food inflation in Australia was running at over four per cent per annum and peaked at 5.7 per cent in the first quarter of 2008. Concern was so high that the Federal Government instigated the 2008 ACCC Grocery Inquiry.

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.

These pricing initiatives have driven a lower cost of the average weekly shopping basket and also importantly, for us, have significantly improved customer perceptions on value and trust at Coles. The Coles customer perception tracker that by shopping at Coles "I can trust that I won't have to pay more" has risen by over 60 per cent (Coles Market Tracker by The Nielsen Company). Another Nielsen survey of suppliers rated Coles as the retailer of the Year in 2011, substantial ahead of our next major competitor (Nielsen retail Barometer 2011).

Another regular market survey also shows that Coles has improved its reputation with major grocery suppliers. The latest UBS survey reports that suppliers credit Coles with strong improvements in pricing strategy, offering value for money, overall presentation of stores, quality of fresh food and on-shelf availability. Coles now leads the retail industry on a range of key supplier criteria (UBS, Supermarket Tracker, February 2011).

Coles is encouraged by the fact that our suppliers, both multinational and Australian, have recognised the positive changes that they are experiencing and the sales growth they are enjoying as a result.

4.2 Coles' "Down Down" Campaign

In 2010, Coles introduced its "Down Down" campaign, which focuses on reducing the price of products that customers frequently purchase in their weekly shopping basket. This campaign aims to give Australian families fair prices at our supermarkets. The difference between weekly promotions and the "Down Down" campaign is that it is intended prices stay down for longer periods of time; at least six months, if not longer.

As part of this overall strategy to improve price perception and trust, we reduced the price of all Coles brand milk products in late January 2011. The reductions in the price of Coles brand milk products not only reduced the price of fresh drinking milk to one dollar a litre for two and three litre cartons, but also removed the price premium on litre milk for two and three litre cartons so it was the same price as full cream milk, to benefit price-conscious Australians looking for a healthy, lower price option.

We also believed that a two tier private label strategy on milk was flawed, failing our test on enhancing customer trust. We were charging $2.09 for Smartbuy two litres, $2.47 for Coles brand two litres and $2.99 for Coles Lite two litres. We were charging customers a premium for a healthy option even though it was essentially the same product in both Smartbuy and Coles brand milk.

Although as noted in the 2008 Grocery Inquiry, other grocery chains had, and still have, similar pricing tiers, we believed this approach was flawed and, as part of our lower price program, we had an opportunity to address this position, firstly by aligning prices of Coles brand and Smart Buy and also aligning the price of Lite Milk as we do not consider our customers should be charged a premium for consuming a healthier milk option.

We believe that Coles' price investment in lower private label milk prices in late January 2011 has enabled us to further enhance our position with our customers as a price leader and eliminate these price anomalies at the same time.

Nonetheless, the fact is that we have reduced the entry price of milk by only 4.5 cents per litre or 4.3% to the previous entry selling price for Smart Buy milk. That is less than the reduction which occurred in February 2009 when the milk levy of 11 cents per litre was removed by the Government. It is also similar to the price reductions by our competitors just over a year ago.

Initial customer reaction to the "Down Down" campaign has been very positive.

4.3 Coles has absorbed its late January 2011 retail milk price reduction rather than pass them along the supply chain

Since being acquired by Wesfarmers in 2007, Coles has focused on reducing costs, reducing waste, improving efficiency in its supply chain as well as improving productivity in stores, through better inventory management and process improvement. The savings pool from improved efficiency across the business has enabled Coles to reinvest in lower prices for customers including our "Down Down" campaign in relation to Coles brand milk.

In mid-January 2011, Coles increased the contract price paid to milk processors except where competitive tender arrangements and other factors lead to a lower commercial price. Importantly, these contract renegotiations led to Coles paying a higher price for its milk in most instances than we were paying before.

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.

Coles has also sought to ensure that dairy farmers' payments are not adversely impacted by including “rise and fall” clauses in our contracts with milk processors, which allow for periodic price changes to correspond with farm gate price movements.

Coles remains committed to absorbing the cost of the retail price reductions it has instituted in relation to milk under its "Down Down" campaign and as such has taken all necessary steps to ensure that such reductions are not passed down through the supply chain. Coles has always endeavoured to absorb as many costs as possible within its business model. Coles' fair prices commitment to its customers sits alongside Coles' other commitments to treat its suppliers fairly and reasonably.

4.4 Coles is addressing consumer concerns in relation to animal welfare

Coles is also seeking to build consumer trust on quality and value by addressing consumer concerns in relation to animal welfare. There are growing global concerns among consumers on broader issues such as the environment, food additives and animal welfare. Australia is no exception. Coles regularly receives correspondence from customers and animal welfare groups on such matters and believes that as a leading retailer we should endeavour to make change for the better. This has driven us to work with our suppliers to improve the sourcing integrity of Coles’ products over time.

As part of this strategy, Coles has introduced the following initiatives:

- Hormone growth promotant (HGP) free beef – independent scientific and industry research confirms that beef with no added hormones is more tender than beef with HGPs. Adding HGPs also increases carcass size by up to 30 per cent compared to animals that are allowed to grow naturally. All Coles beef is now HGP free.
- Sow stall free pork – pregnant sows are traditionally kept in stalls for their gestation period of up to 16 weeks. These sows are confined in these stalls which are not much larger than the animal and do not allow for them to turn around. Coles customers have told us that they consider this to be unacceptable, so we have announced a move to be free of sow stalls for both Australian and imported pork by the end of 2014
- Caged eggs – these eggs are laid by hens kept in cages with very limited room to move. We have announced a move to cage free eggs for Coles brand by the end of 2012.

Coles recognises that making changes such as these can be disruptive for our suppliers but we seek to handle this as carefully as we can. Coles and its suppliers are co-operatively implementing these initiatives and Coles has provided commitments to our suppliers to fund higher operating costs or to phase changes in so that our suppliers have time to minimise the impacts of any changes on their operations.

What we are seeking to do is to influence change through the initiatives that we take, not to impose it. Whether others follow our example or not is very much at their discretion.

5. The milk supply chain

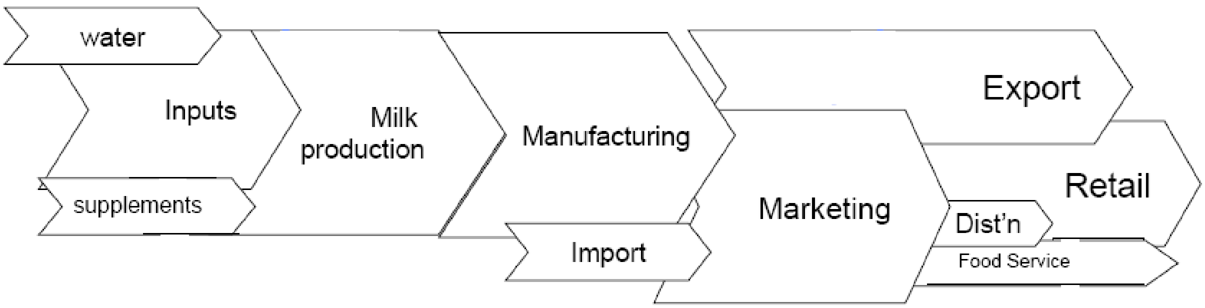
5.1 Overview of the supply chain

As stated earlier in this submission, Coles buys packaged milk from dairy processors who in turn buy raw milk from dairy farmers. We would like to explain how the dairy supply chain operates in general terms and to clarify some misconceptions on our pricing along the supply chain. Figure 1 below shows the key steps in the dairy supply chain.

Figure 1.

Steps in dairy supply chain

Farm gate **Processors** **Retail**



At the processor level, the industry has three major domestic fresh milk processors, National Foods, Fonterra and Parmalat, each owned by corporations based in Japan, New Zealand and Italy respectively. Each of these processors has declared profit margins higher than Coles.

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.

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.

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.

As Coles has fully funded the retail milk price reduction and paid a higher contract price to milk processors, we believe there is no reason why it should result in lower farm gate prices.

Coles notes comments by the Federal Treasury in its submission to the Inquiry that:

"At this time, there is no clear evidence available to suggest that the industry is not capable of maintaining prices sufficient to sustain the industry in the long-term, notwithstanding any short term fluctuations in outcomes at any particular point of the supply chain."

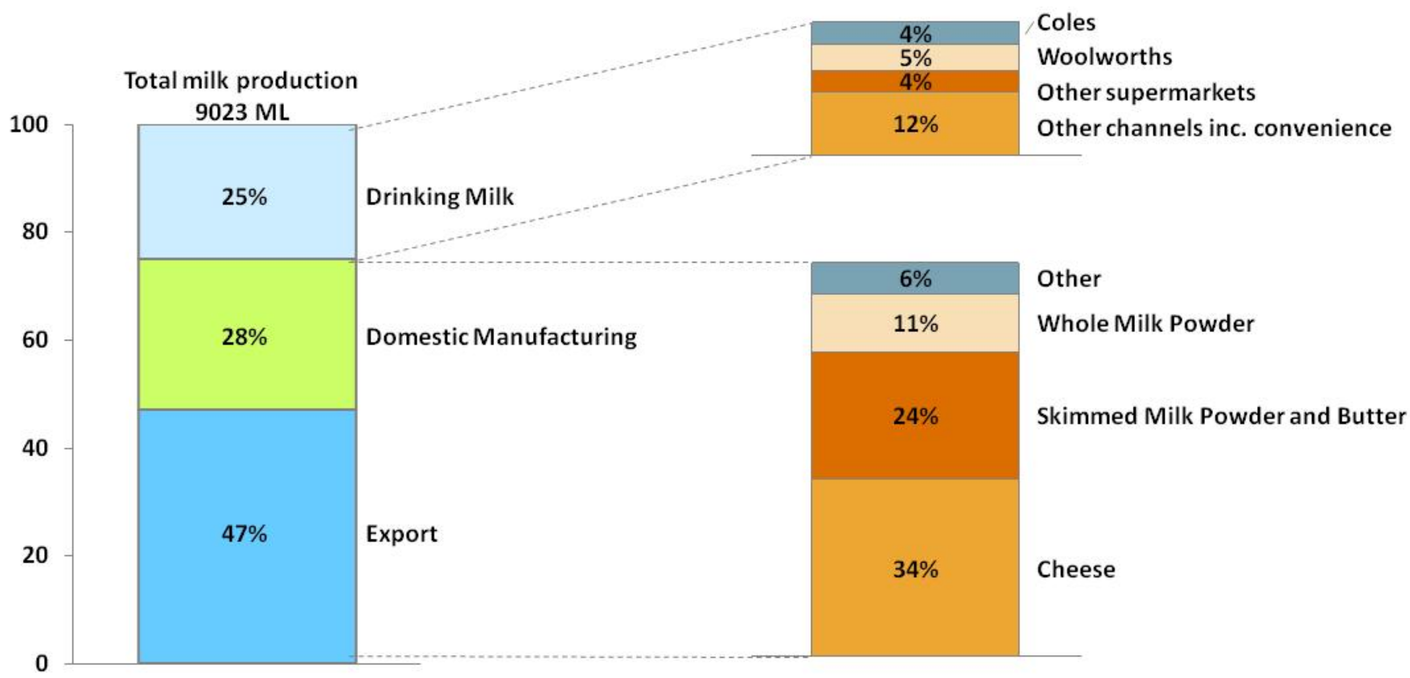
5.2 Farm gate prices are linked to the global milk price

Global price of milk

Approximately 75 per cent of Australian milk production is exported by processors or used in manufacturing. The global price therefore sets the benchmark farm gate price. This was confirmed in the 2008 - ACCC report on the grocery industry.

In addition, as shown by Figure 2 below, 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.

Figure 2
Market shares in Australian milk production



Source: Dairy Australia

As Coles does not buy raw milk from the farm gate, it does not have precise knowledge of the exact farm gate prices. We note that Woolworths similarly stated in its submission to the Inquiry that:

"Woolworths does not have any insight into, or control over, the contractual arrangements, such as price, that dairy processors enter into with dairy farmers. That is, Woolworths has little to no ability to directly influence the farm gate price paid to dairy farmers by processors."

However, it is generally accepted that farm gate pricing is linked to global demand for Australian milk products, and more so in regions which are export focused, including Victoria, Southern NSW, Tasmania and South Australia (Australia is the third largest export of dairy products internationally), rather than driven by competition between Australian retailers.

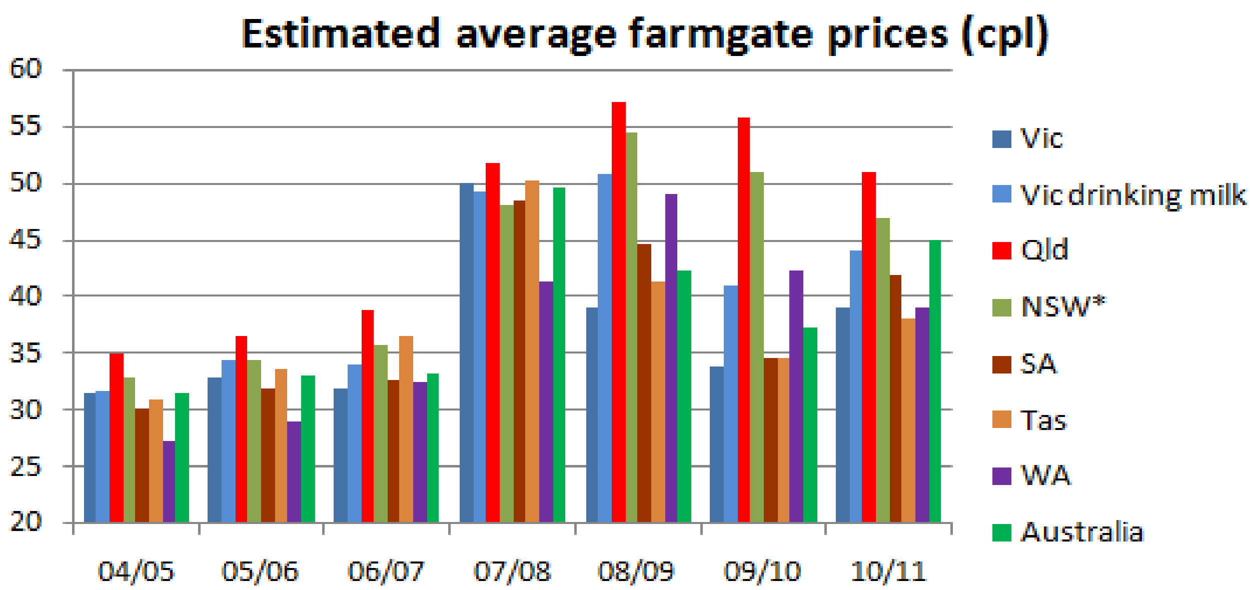
Dr Terry Sheales, Deputy Executive Director, ABARE, has said:

"*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*".

It is also important to note the latest press release from Murray Goulburn, dated 2 February 2011 which confirms that the average price paid to farmers for milk has risen by approximately 20 per cent over the past twelve months. In addition to this, Dairy Australia has forecast in another recent press release that the global demand for milk is expected to increase which will in turn lead to higher prices at the farm gate.

Figure 3 below shows the estimated average farm gate price on a state by state basis.

Figure 3



Source: Dairy Australia

Note: The rise in prices (Australia total) from 04/05 to 07/08 of 57.5 per cent was due to strengthening demand in global markets.

6. Impact at the farm gate on dairy farmers and need for greater transparency in dairy farmer – processor pricing

6.1 Greater transparency of the farm gate price between farmers and milk processing companies is required

By reducing Coles brand milk prices in our stores, Coles has not sought to, nor wishes to harm dairy farmers. Such an outcome would be contrary to the requirements of our customers who want fresh, quality Australian milk and to our interest in having a strong local supply chain. It is important to Coles that we have a commercially viable supplier base including dairy farmers who can continue to supply consumer needs. For this reason Coles fully absorbed the lower retail milk prices in its own retail margins as part of our “Down Down” campaign rather than ask milk processing companies to pay for it.

In an effort to ensure retail milk price reductions would not adversely impact farmers and to demonstrate our commitment to sustainable dairy farming, we increased the contract price paid to milk processors shortly before the "Down Down" price reductions on Coles brand milk.

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.

Coles believes that in these circumstances, the critical issue for the dairy farmer is not the retail price but the transparency of the farm gate price between farmers and milk processing companies. Coles believes that increased transparency at farm gate pricing and improved ability for dairy farmers to collectively negotiate would assist farmers.

6.2 Coles negotiates with milk suppliers in a pro-competitive, commercial way

While our contracts and terms with milk processors include confidentiality clauses, we would be happy to provide information on a commercial-in-confidence basis to the Committee or the ACCC so that it can examine milk pricing and, in particular, the rise and fall provisions which are designed to provide protection to dairy farmers.

6.3 Coles is committed to Australian farming and grocery production

Coles has a long standing and ongoing commitment to a sustainable Australian farming and food manufacturing sector. Our customers have a preference for Australian grown and made products, and typically want to buy local produce where possible.

Coles is committed to working with Australian farmers and sources 100 per cent of its fresh milk, meat and in-store bread from Australian farmers and food manufacturers and over 96 per cent of all fresh fruit and vegetables from Australian farmers.

Coles acquires large amounts of fresh fruit and vegetables directly from Australian farmers in a range of growing regions in every State of Australia including 270,000 tonnes of bananas, 348,000 tonnes of oranges, 440,000 tonnes of tomatoes and 1,200,000 tonnes of potatoes.

Coles works closely with the livestock industry in various States and sources 350,000 cattle, 375,000 pigs, 1,500,000 lambs and 36,500,000 chickens every year for our fresh meat products.

Coles also acquires 375,000,000 litres of fresh packaged milk that goes into both our own Coles brand and private label products in our stores.

The nature of our sourcing requirements, the diversity of growing regions, the seasonal nature of production, the extensive nature of the logistics and distribution network required to get fresh produce to market requires a significant investment in time and money by Coles to support Australian grown and made produce.

A total of 3,500 private label grocery items, or 70 per cent of Coles total private label range, is made in Australia.

Coles also works very closely with Australian farmers, and provides annual volume commitments that give growers confidence to make investments in quality, innovation, extension of seasonal growing periods and import replacement.

Coles has attached supplementary case studies that highlight how we are working with Australian farmers to improve quality, innovation and reduce imports. In the dairy industry, Coles also has worked hard to ensure that retail pricing strategies do not have adverse impacts on milk processors that supply us with packaged milk, nor their dairy farmer suppliers.

These initiatives demonstrate Coles long standing and ongoing commitment to “Australian grown and made” product in our supermarkets. Our "Down Down" campaign and our animal welfare and ethical sourcing initiatives are all aimed at selling more Australian made product in our stores.

7. The supply of milk to the consumer market is highly competitive and the reduced price of milk is pro competitive

7.1 Reducing prices to consumers is not anti-competitive and has a pro competitive purpose or effect

To put Coles' current milk price reductions into context, it should be remembered that there have been several bigger milk price reductions in the last few years. In March 2009, all commercial and retail milk prices were reduced by 11 cents per litre as a result of the removal of the Dairy Industry Adjustment levy. In December 2009 our competitors led a price reduction in their private label products from $2.17 to $2.09. Coles followed this price reduction on our Smart Buy range. 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.

Aldi and Woolworths have made it clear in their submissions to the Inquiry that they consider private label milk price reductions to be pro-competitive. Both of our major competitors have publicly confirmed in their submissions to the Inquiry that they have fully absorbed the retail milk price reductions.

Our "Down Down" campaign is designed to build customer trust in better value at Coles. It is intended that our milk prices will stay down for at least six months, subject to cost increases by suppliers and, in the case of dairy products, commodity price increases impacting on farm gate prices.

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.

7.2 Coles is not selling milk below cost nor cross subsidising lower grocery prices through higher petrol prices

It is not Coles' intention to sell private label milk at a price below the cost of acquiring it from milk processors. Furthermore, Coles is confident that in implementing its "Down Down" campaign across Australia, it has not sold milk at prices below the cost it acquired it from milk processors. While we are contractually obliged not to publicly disclose confidential pricing information, we would be pleased to co-operate with the Committee on a commercial-in-confidence basis or any ACCC review of our milk pricing.

Coles' food price deflation confirms that we are not raising prices on other grocery products to offset the price reductions on our private label milk range. It has also been claimed that Coles has been raising petrol prices to cross subsidise lower grocery prices. This allegation is completely without foundation. Since last September, the average pump price has increased by 13 per cent while the price of crude oil has increased by 49 per cent over the same period.

7.3 The focus by Coles in own brand products is a response to demand from consumers and is happening globally

Coles is committed to providing our customers with choice. Coles has a long history of private label brands that dates back to the 1950's. From Embassy to Farmland to Coles' brand, this has always been the case. It is not new or unusual for business to sell private label goods and services.

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.

We are providing our customers with choice – of a quality product at a competitive value price - and of an alternative Australian brand to the many global brands they are familiar with and which account for some 80 per cent of the supermarket range by volume. This customer demand is a global trend that was noted by the ACCC in its 2008 Grocery Inquiry.

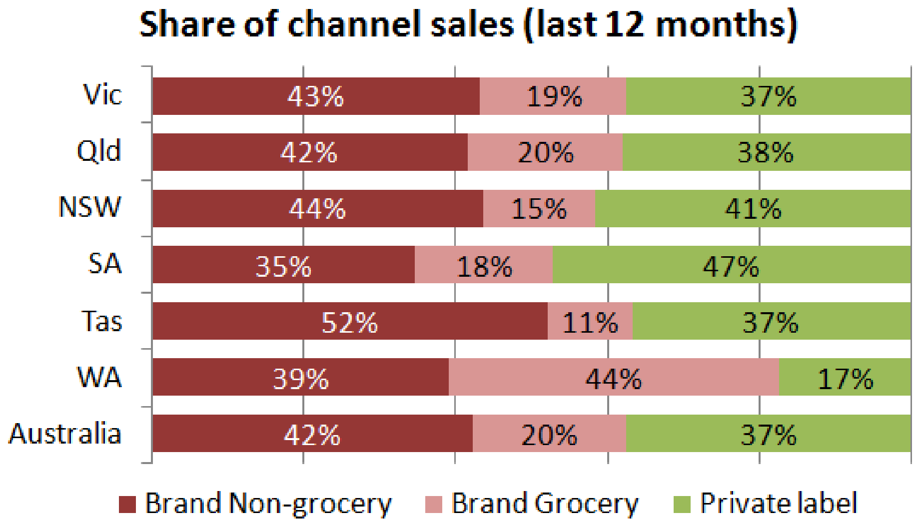
It is also relevant to note that there is no material difference in the composition of the majority of branded and unbranded milk (that has not been modified).

This was raised during the 2008 Grocery Inquiry, in which the ACCC concluded that:

"The introduction of a private label product at a lower price point to existing comparable proprietary brands offers customers additional choice and is pro-competitive, all things being constant. The ACCC is satisfied that consumers as a whole are not worse off from the growth in private label products …"

Figure 4 below shows the private label and branded share of milk sales across all channels for the previous 12 months:

Figure 4



Source: Fresh Logic and Dairy Australia

In summary, the growth of private label products is a global trend and is not a new development and is likely to continue. Further, Coles brand is a relatively small proportion of our product range and we aim to ensure they are good value for money. Consumers should be free to choose which products they buy and from whom.

8. Existing competition laws and the suitability of the Horticulture Code of Conduct

8.1 Existing competition laws are comprehensive and cover the field

Existing competition laws are comprehensive and provide a strong measure of protection to consumers. In particular, the laws in relation to predatory pricing were amended in 2007 and no case has been made for further amendment. The ACCC Chairman, Graeme Samuel has publicly stated that the current laws provide the competition regulator with adequate power to take action in relation to predatory pricing. As such, we do not believe that there are any competition policy issues that need to be addressed in this Inquiry.

In light of the pro-competitive purpose and effect of Coles' grocery pricing decisions and the benefits it provided to consumers, we believe that no question of a breach of the predatory pricing provisions could arise. Further we do not believe that a case has been put forward for amendment to section 46. The existing laws are adequate and there would also be no benefit to be obtained by legislative amendment. In this regard, we note ACCC Chairman Graeme Samuel's statement before the Senate Estimates Committee hearing on 21 February 2011 that: *'If there was a deliberate act of predatory pricing that fell foul of section 46, of the Act, which of course has been amended to enhance our ability to deal with predatory pricing issues, clearly we have power in that context'.* We also note that the Federal Treasury submission to the Inquiry comprehensively covered the repeal of price discrimination laws. It also said: "*Concerns that the current conduct of supermarkets amounts to anti-competitive conduct would, if proven, appear capable of being dealt with under the existing prohibitions of the CCA, particularly section 46, which deals with the misuse of market power."*

The Law Council of Australia submission to the Inquiry notes that the repeal of price discrimination laws in former Section 49 has been repeatedly supported by one expert committee after another including the Swanson Committee (1976), the Blunt Committee (1979), the Hilmer Committee (1995) and the Dawson review (2003).

8.2 The current Produce and Grocery Industry Code (PAGIC) is a more appropriate code for the entire supply chain of the retail grocery industry

The term of reference of this inquiry include the suitability of the framework contained in the Horticulture Code of Conduct to the Australian dairy industry. Coles does not believe the Horticulture Code of Conduct is an appropriate code for the Australian dairy industry. Primarily, the Horticulture Code of Conduct covers the interface between growers and traders and under its current framework would not extend to Coles if it were to be applied to the dairy industry.

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.

Coles set out its position in its response to the 2008 ACCC Inquiry into the competiveness of retail prices for standard groceries. In general, supply contracts that Coles enters into with its suppliers incorporate Coles' standard terms and conditions, which include provisions specifying the process to be used to resolve any disputes that arise between the supplier and Coles.

Given that Coles negotiates milk supply terms with large multinational dairy processors, we submit that it is not necessary or appropriate for there to be a similar form of horticulture code applying to those arrangements.

We do however support increased ability for farmers to collectively negotiate with processors and also submit that to increase in some circumstances their ability to negotiate and achieve efficiencies in their businesses, that those collective bargaining arrangements include some form of additional consultation with appropriate accountants or such advisors to assist their organisations.

Coles notes that the submission to the Inquiry by the Australian Food and Grocery Council (AFGC), which represents the multinational milk processors, does not support the extension of the Horticultural Code of Conduct to the dairy industry.

The ACCC and Law Council of Australia submissions support the view that there is sufficient regulatory oversight of the grocery industry and that there is no need for any additional legislative amendments or new regulatory structures.