



Submission to the Senate Dairy Industry Inquiry by National Foods

22 October 2009

Committee Secretary
Senate Economics Committee
Inquiry into competition and pricing in the Australian dairy industry
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1. Introduction

1.1 National Foods

National Foods' core activities in Australia are the manufacture and wholesale of drinking milk, fresh dairy foods, cheese and fruit juices.

National Foods is pleased to provide information to assist the Senate Economics Committee understand the Australian dairy industry supply chain and the factors that have influenced competition and prices in recent years.

Further detailed dairy industry information and statistics are publicly available from:

- Dairy Australia: <http://www.dairyaustralia.com.au>.
- ABARE, which publishes a range of information and data relevant to the Australian dairy industry; and
- the ACCC, which has relevantly reported on the impacts of farmgate deregulation in 2001; reported on the competitiveness of retail prices for standard groceries (including dairy products) in 2008; has granted several approvals for smaller industry participants (such as farmers and distributors) to collectively bargain; and has publicly reviewed relevant proposals for industry rationalisation.

1.2 The Australian Dairy Industry

The dairy industry is one of Australia's major rural industries. In 2007/08 it was valued at around \$4.6 billion at the farmgate.

The Australian dairy industry is open (with high levels of trade in manufactured dairy products) and the setting of prices and the terms of supply is unregulated. This has resulted in an internationally competitive industry and is reflected in the fact that around half of Australia's total milk production is exported to more than 100 countries.

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2. Key dairy industry trends

Significant volatility in the international markets for dairy commodities have had an adverse impact on dairy farmers and milk processors in recent years. The background to these events can be summarised as follows:

- international dairy commodity prices hit historic highs during 2007 due to a combination of steady growth in demand and supply shortages. In Australia this resulted in record highs in farmgate prices;
- market conditions weakened in the first half of 2008, as buyers became reluctant to lock in forward requirements at high prices and as farm supply rebounded;
- in October 2008, the extent and devastating impact of the global financial crisis and associated global economic downturn became apparent and international dairy market conditions deteriorated rapidly;
- north American and EU governments reinstated protections for their dairy industries (with the US government buying milk powder and EU reinstating export refunds); and
- in Australia, farmgate prices dropped sharply.

While falling input prices for farmers (such as grain) and improved seasonal conditions, particularly in the Murray Darling basin, should provide some relief, National Foods understands that many farmers are presently facing real difficulties trading through the economic downturn.

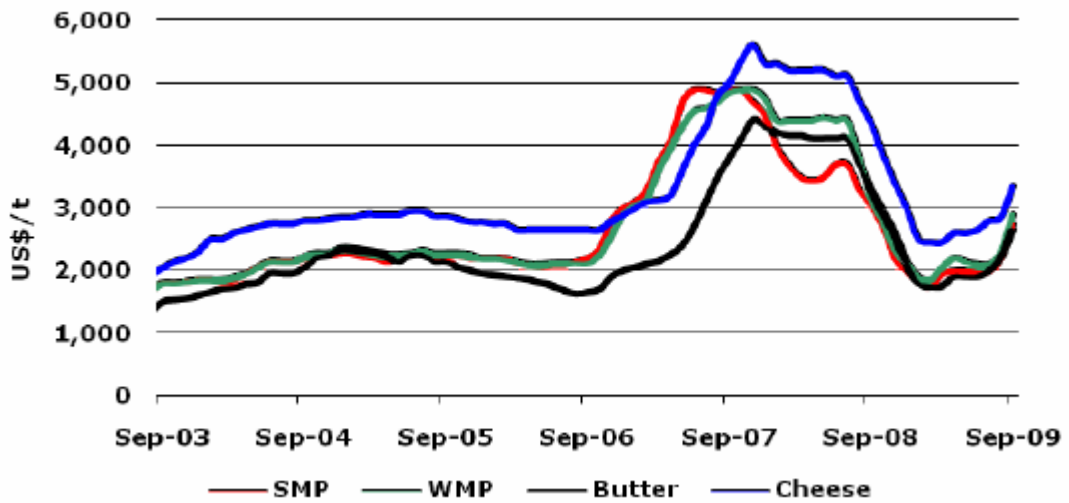
However, the medium term outlook should see more stability, along with the potential for some upwards movement in commodity prices. These signs are positive for a sustainable and internationally competitive industry and are reflected in the most recent Dairy Australia farmer surveys, with 60% of farmers remaining positive about the future of the industry as a whole and 66% positive about their own businesses.¹ This is notwithstanding farmers and processors having just experienced one of the most difficult trading environments in living memory. This industry outlook is impacted by the following key factors:

- Asian economies appear to be recovering and there are modest signs of recovery in both North America and Europe (although in these regions Government protection is likely to remain effective for at least 12 months);
- slowing North American production and the likelihood of lower supplies from the southern hemisphere, coupled with improving demand, are bringing international dairy markets back into balance;
- international dairy commodity prices have increased over the last quarter and this is beginning to flow through to domestic farmgate prices;
- the US dollar has weakened significantly against the Australian dollar and most major currencies. This has eroded returns to exporters, such as Australia, and continues to pose a real threat to significantly improved domestic farmgate prices. However, it also improves the purchasing power of other importing countries and lifts the offer prices of competing exporters in US dollar terms;
- domestic demand for dairy products has remained reasonably firm.

The extreme volatility in dairy commodity prices in recent years (along with the more recent signs of modest recovery) is shown in the chart below.

¹ This farmer survey was conducted by Dairy Australia in September 2009 and the results are reported in the October 2009 *Situation and Outlook* update.

Spot export prices Sep 2003 to Sep 2009



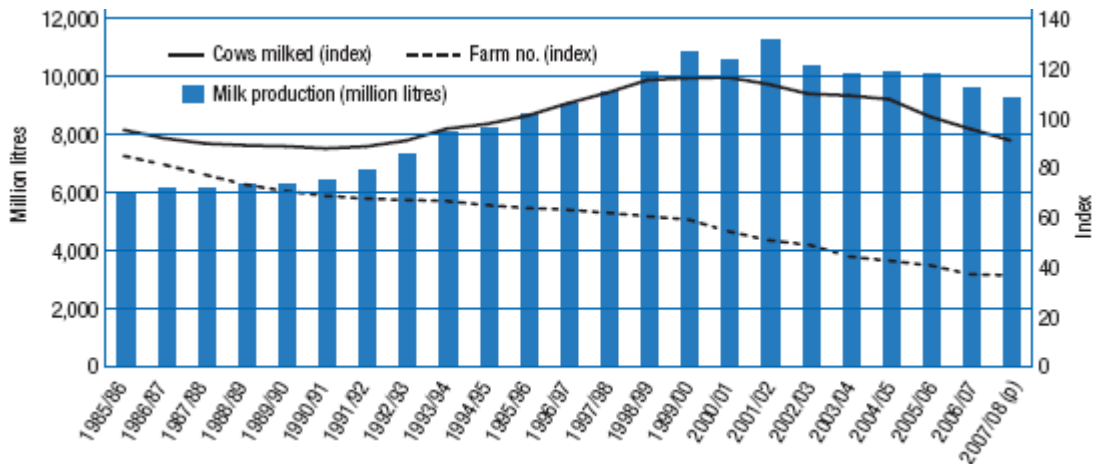
Source: Dairy Australia, Situation and Outlook, October 2009 update.

3. Raw milk production and supply in Australia

Australia's dairy industry is predominantly pasture-based with efficient, low-cost, high-quality milk production. However, in drought conditions which have persisted in many regions of Australia in recent times, most farmers must supplement pasture feeding, which adds considerably to the cost of production.

The number of dairy farms in Australia has more than halved over the last 25 years, reflecting the need for farmers to shift to larger, more efficient operating systems. Over the same period herd size and average annual milk production per farm has more than doubled.

Australian milk production vs indices of farms and cows milked



Source: Australian Dairy Industry in Focus 2008, Dairy Australia.

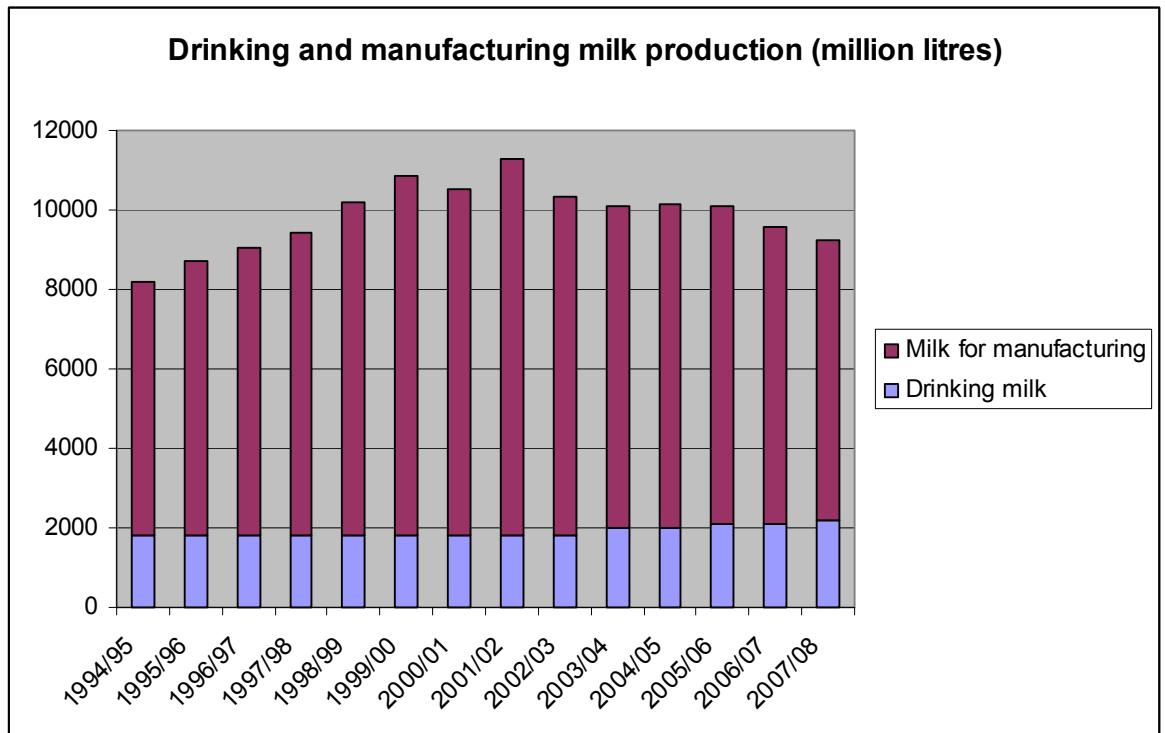
Milk production is concentrated in the south-east corner of Australia, with Victoria, Tasmania and South Australia accounting for around 80% of national output.

Australian milk production (million litres)

	NSW	VIC	QLD	SA	WA	TAS	AUST
2005/06	1,197	6,651	597	646	377	622	10,089
2006/07	1,105	6,297	534	655	350	642	9,583
2007/08	1,049	6,102	485	606	319	662	9,223

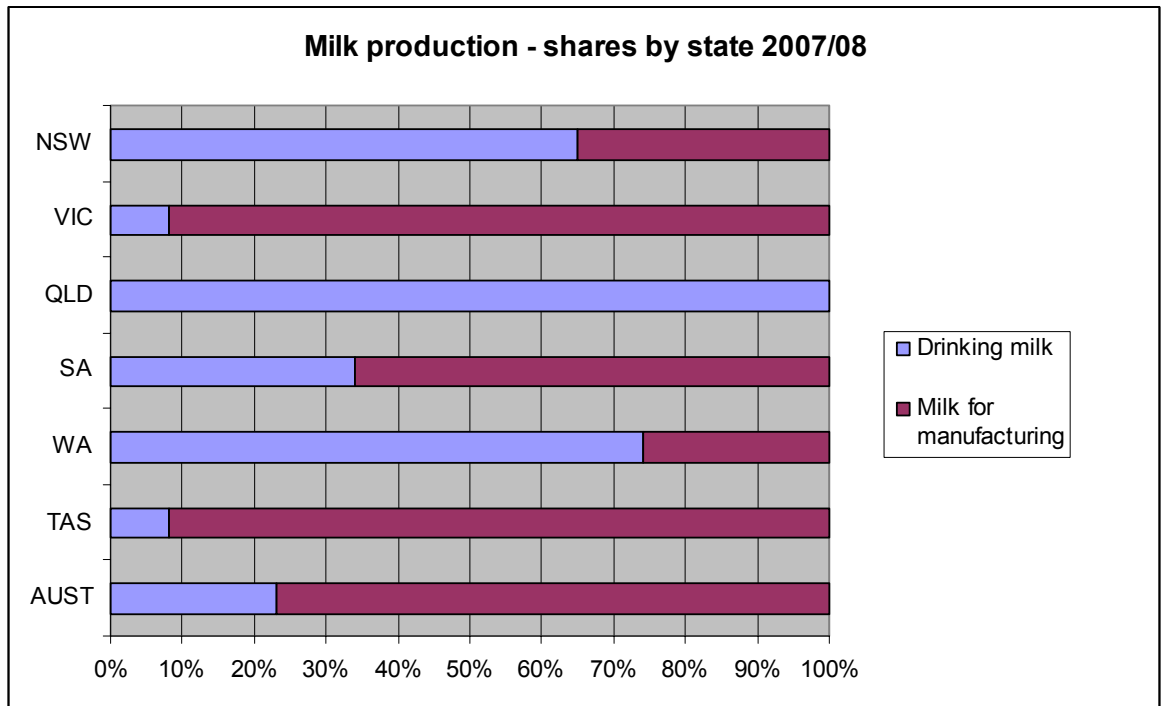
Source: Australian Dairy Industry in Focus 2008, Dairy Australia.

Around 80% of raw milk is manufactured into dairy products (such as cheese), with the remainder used for fresh drinking milk.



Source: Australian Dairy Industry in Focus 2008, Dairy Australia.

Australian milk production remains strongly seasonal. However, this is less pronounced in Queensland, Western Australia and New South Wales, due to the greater focus on drinking milk in the product mix of those states (which requires year around production).



Source: Australian Dairy Industry in Focus 2008, Dairy Australia.

Raw milk prices are ordinarily linked to milkfat and protein content levels. However, international prices for traded dairy products are the most significant factor in determining the price received by farmers for their raw milk.

Typical prices paid to dairy farmers

		2005/2006	2006/2007	2007/2008
NSW	cents/ litre	34.3	35.7	48.6
	\$/kg milk solids	4.80	5.02	6.73
VIC	cents/ litre	32.9	32.0	50.0
	\$/kg milk solids	4.44	4.32	6.68
QLD	cents/ litre	36.6	38.8	51.8
	\$/kg milk solids	4.99	5.38	7.14
SA	cents/ litre	32.0	32.6	48.6
	\$/kg milk solids	4.49	4.57	6.75
WA	cents/ litre	29.0	32.0	41.3
	\$/kg milk solids	4.09	4.49	5.79
TAS	cents/ litre	33.6	36.5	50.2
	\$/kg milk solids	4.39	4.79	6.63
AUST	cents/ litre	33.1	33.2	49.6
	\$/kg milk solids	4.50	4.51	6.69

Source: Australian Dairy Industry in Focus 2008, Dairy Australia.

The table above shows that prices paid by processors to farmers in 2007/08 reached record highs (typically around 40% higher than the previous year, and over 50% higher in southern regions). Key contributing factors included rising world dairy commodity prices and strong domestic competition for milk among Australian processing companies.

However, the sudden deterioration in the world economy during late 2008 prompted the first raw milk price 'step downs' to be announced during December and January since the early 1970's. These and subsequent price reductions have affected the majority of Australia's dairy farmers.

3.1 How farmgate milk prices are determined

The traditional cooperative dairy company model plays a central role in determining the farm gate prices of raw milk in the Australian dairy industry. Even though the cooperative share of raw milk collection has reduced somewhat, the significance of Murray Goulburn's intake makes it the driver of farm gate milk value from year-to-year in the key southern production regions. The major Australian buyers of raw milk are set out below.

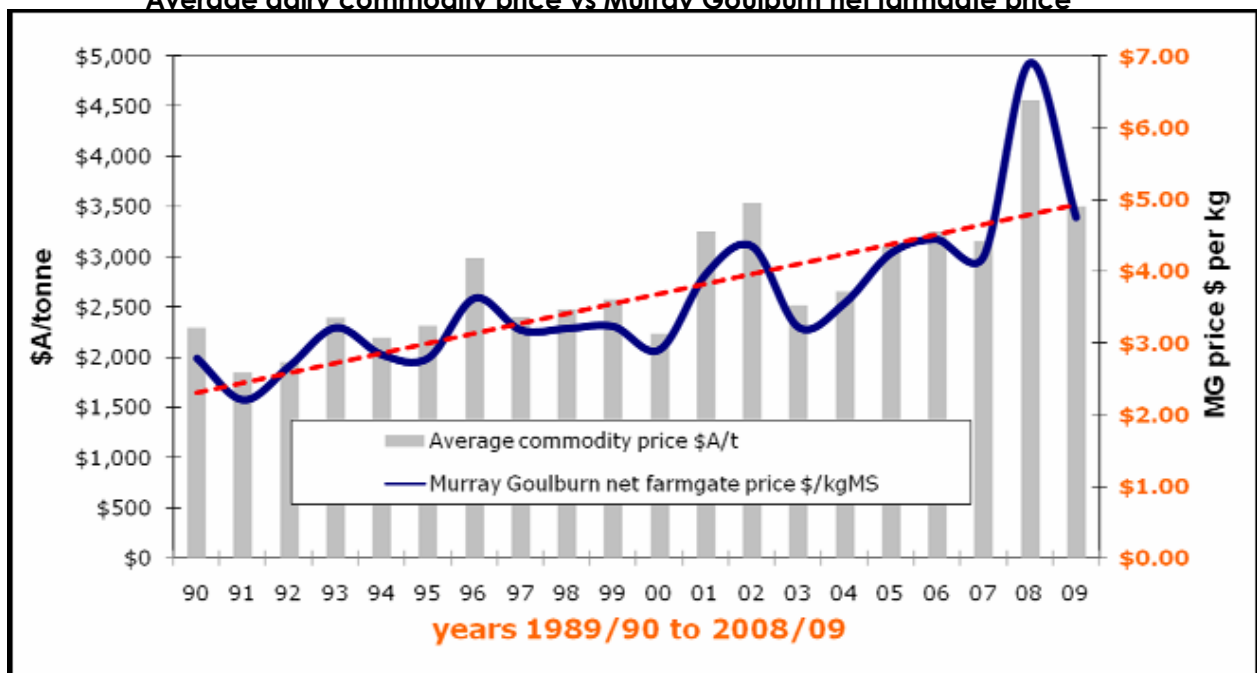
Acquisition of raw milk from Australian dairy farmers

Company	Milk volume direct supply 2008/09 (billion litres)
Murray Goulburn	3.4
Fonterra	1.8
National Foods	1.6
WCB	0.8
Parmalat	0.6
Tatura	0.3
UDP	0.2

Source: Dairy Australia: Situation and Outlook 2009.

The very close link between the average dairy commodity price and the Murray Goulburn net farmgate price is also demonstrated below.

Average dairy commodity price vs Murray Goulburn net farmgate price



Source: Dairy Australia: Situation and Outlook 2009.

Companies such as National Foods that are not dairy cooperatives and which have different production mixes pay a milk price in southern regions benchmarked against Murray Goulburn (or Fonterra in Tasmania), but which is also sufficient to achieve long term sustainable milk intake volume for their own manufacturing and processing operations. Because National Foods requires year around raw milk supply for its drinking milk business, National Foods pays more than its raw milk competitors in the southern regions (and National Foods' farmer contracts include a minimum price guarantee that ensures the average annual price paid to its farmers is higher than that paid by the major dairy cooperatives).

In areas outside of the southern regions, other local factors also influence farmgate prices. For example, production in NSW and Queensland is more costly than in Victoria because a higher proportion of raw milk is used to service drinking milk demands. In ordinary circumstances this production cost differential leads to higher prices from processors to ensure dairy farmers continue to operate in these regions. The alternative would be for processors to transport milk potentially long distances and bear the associated additional costs.

Finally, the nature and duration of farmer contracts also affects prices for raw milk. In order to secure greater certainty of milk supply, in recent years National Foods has offered contracts to farmers of varying durations. These contracts have begun and ended at different times and this leads to differences in contract pricing being paid to farmers in certain regions of Australia. For example, some contracts still include prices prevailing at periods when world market commodity prices were very high and, as a result of the global economic downturn, more recent contracts have been progressively reset.

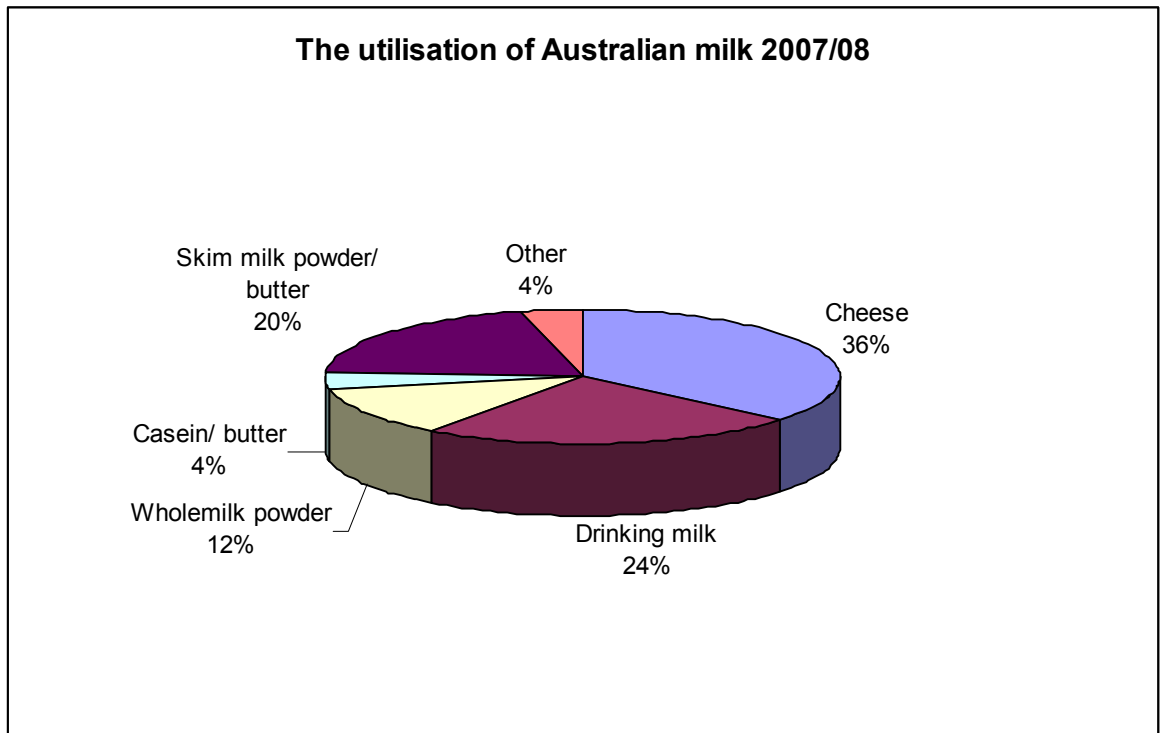
4. Processing of milk and dairy products

The milk processing sector is undergoing continued rationalisation, reflecting the need to achieve improved factory capacity utilisation, greater efficiency and economies of scale. This rationalisation is of particular importance given the drought conditions in many parts of Australia which have constrained the supply of milk to processing facilities. Australian milk production decreased 3.8% in 2007/08 to 9,223 million litres. Dairy Australia forecasts that production for 2009/10 could drop a further 4% from 2008/09 production levels, to around 9,000 million litres.

The Australian dairy manufacturing sector is diverse and includes farmer-owned cooperatives as well as public and private companies. The largest cooperative (Murray Goulburn) accounts for almost 40% of Australia's dairy production.

The major manufactured dairy product streams are:

- cheese;
- drinking milk – fresh and UHT;
- butter / skim milk powder;
- butter / casein;
- whole milk powder;
- fresh dairy products, such as yoghurt, dairy snacks, dairy desserts and cream; and
- specialised ingredients.



Source: Australian Dairy Industry in Focus 2008, Dairy Australia.

Over 60% of manufactured product (in milk equivalent terms) is exported. This contrasts with drinking milk, which is predominantly consumed in the domestic market. Due to weak international demand over the last year a higher overall portion of dairy products have been sold in the domestic market.

5. Drinking milk

Whole milk, which is packaged for drinking, is standardised to a minimum milk fat content of 3.8%, as required under the Australia New Zealand Food Standards Code. Modified, reduced and low-fat milks are standardised to other relevant specifications and have varying milk fat and solids non-fat levels.

Drinking milk sales by State (million litres)

	NSW	VIC	QLD	SA	WA	TAS	AUST
2005/06	656	495	445	198	218	53	2,065
2006/07	684	509	475	207	230	55	2,160
2007/08	682	527	499	205	237	55	2,205

Source: Australian Dairy Industry in Focus 2008, Dairy Australia.

Drinking milk sales by type (million litres)

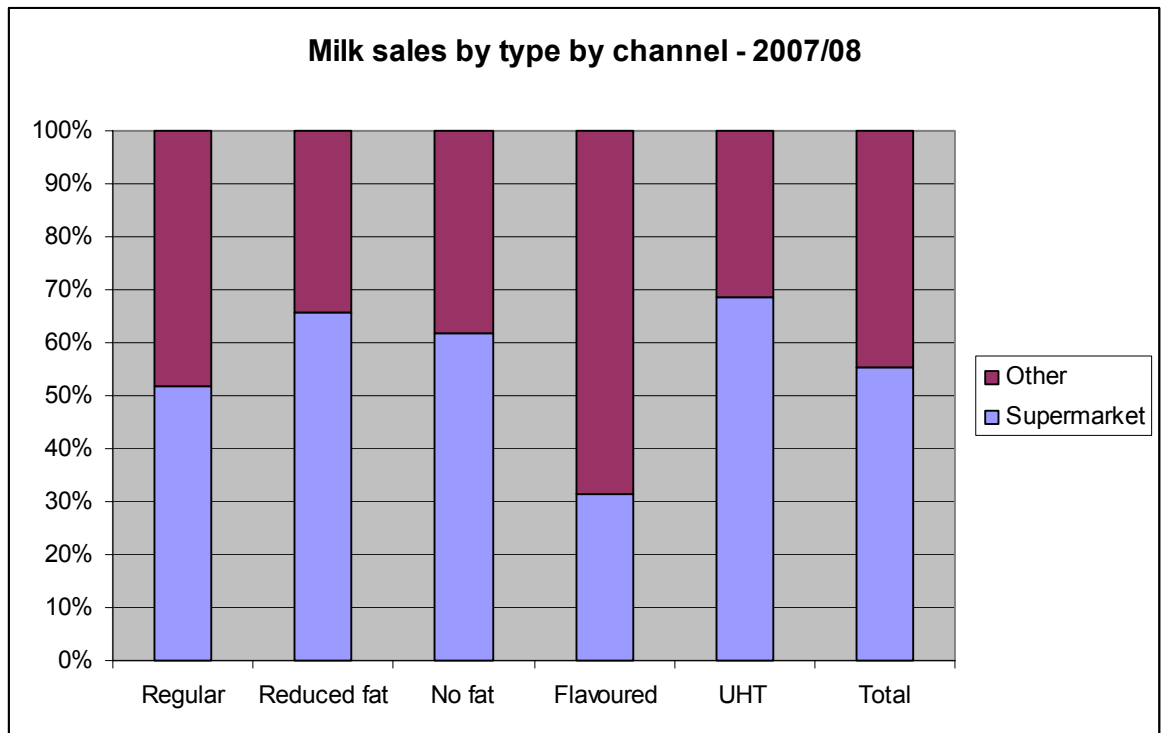
	Regular	Reduced	Low fat/ no fat	Flavoured	UHT	Total
2005/06	1,088	478	140	204	156	2,065
2006/07	1,111	511	147	216	175	2,160
2007/08	1,129	560	118	213	185	2,205

Source: Australian Dairy Industry in Focus 2008, Dairy Australia.

Due to its perishability, milk processors require access to raw milk supplies within reasonable proximity to milk processing factories. In turn, these factories are usually located in areas from which major consumer markets can be easily serviced with packaged fresh milk products. Drinking milk processing facilities are therefore generally situated in the dairying districts located nearest to metropolitan cities and large regional centres.

In most areas the majority of drinking milk is produced by large scale processors, along with a range of smaller regional players. Since deregulation, a number of micro-processors have also developed niche markets by bottling milk on-farm for sale under their own brands.

The major supermarket chains account for around 55% of drinking milk sales at the retail level.



Source: Derived from Australian Dairy Industry in Focus 2008, Dairy Australia.

There has been strong growth of private label white milk sales in the grocery channel, at the expense of dairy company proprietary branded milk. Nationally, private label sales of white milk in supermarket chains have grown in volume from 25% of total milk volumes in 1999/00 to 56% in 2007/08.

One of the findings from the ACCC 'Grocery Inquiry' in 2008 was that increased processor costs were generally being reflected in wholesale prices for proprietary branded milk but that, as a result of binding private label supply contracts and the bargaining power of the major supermarket chains, increased costs of production for processors were not being reflected to the same extent in wholesale, or retail, prices for private label milk.

For suppliers of drinking milk like National Foods, these circumstances have resulted in the dual commercial difficulties of:

- 1 being unable to fully recover cost increases on significant volumes of private label fresh milk; and

- 2 an increasing retail price differential between National Foods' brands and major supermarket chains' private labels. This in turn leads to further consumer demand shifts to lower value private label product.

6. Dairy product distribution and retail

The major purchasers of drinking milk and dairy products from processors are generally categorised as either being in the grocery channel or the route trade.

6.1 The grocery channel

The grocery channel generally comprises supermarkets that operate within the following groups:

- 1 the major grocery chains (Woolworths and Coles), which sell their own private labels and processor proprietary brands; and
- 2 other chain supermarkets including Aldi, which is a growing participant in the Australian retailing sector.

Wholesale sales of dairy products to the grocery channel are often made pursuant to contracts that arise from a competitive tender process, particularly in relation to the supply of private label products.

6.2 The route channel

The route trade generally comprises both independent supermarket stores and non-supermarket stores either in a convenience store format or the traditional corner store as follows:

- 1 independent grocery stores which have centralised purchasing arrangements (often via Metcash), such as:
 - Independent Grocers of Australia (IGA), a large group of over 1,000 retailers with a presence in each Australian state, comprising a range of store types from large format supermarkets, mid-sized supermarkets and small format / convenience stores.
 - Foodworks, an independent group with over 710 supermarket, food and convenience stores spanning seven Australian states and territories.
- 2 petrol stations and convenience stores which purchase centrally, often on a national or state basis. These stores include those operated by the petrol retailers as well as chains such as 7 Eleven. It also includes the major grocery chains such as Woolworths and Coles, who have retail sites alongside major petrol retailers and are increasing their presence in the convenience sector;
- 3 corner stores who are serviced by milk vendors supplied by processors; and

- 4 foodservice providers including cafes, hospitals, hostels, restaurants, and coffee chains.

There are a variety of different contractual relationships that apply to wholesale sales of dairy products to the route channel. These include:

- contracts with individual retail outlets;
- contracts with dairy distributors that re-sell dairy products to retailers; and
- contracts to supply chains / groups of associated retail outlets that are negotiated centrally.

In each instance contracts are formed in a competitive environment.

7. Role of the ACCC and *Trade Practices Act* in safeguarding competition in the Australian dairy industry

Each element of the dairy industry domestic supply chain has been examined by the ACCC in recent years. On each occasion healthy and sustainable competition has been identified. These findings are consistent with the significant industry research and statistics available from Dairy Australia and ABARE.

7.1 Dairy farmers

The *Trade Practices Act* ordinarily prohibits businesses from joining together to fix prices and determine other conditions of the sale of goods. Indeed, the Federal Government has recently introduced criminal sanctions for cartel conduct with jail terms of up to 10 years for individuals involved.

However, when required the ACCC has taken action to grant broad exemptions from the competition laws for dairy farmers so that they can collectively bargain with dairy processors. National Foods believes these arrangements are appropriate and has worked cooperatively with collective bargaining groups formed pursuant to these ACCC 'authorisations' around Australia for many years.

7.2 Milk processors

As noted above, the milk processing sector is undergoing continued rationalisation, reflecting the need to achieve improved factory capacity utilisation and economies of scale. This ongoing need to improve efficiency is also driven by: the need to respond to the bargaining position of the major grocery chains and increasing pressure on brand performance against private label propositions; the ongoing pressure to innovate with new products that consumers want; the pressure to achieved growth in export markets; increasing complexity of supply chain logistics; and competition for raw milk in circumstances where supply security is uncertain.

At the milk processing level most recently this has seen:

- National Foods complete the purchase of Australian Cooperative Foods (Dairy Farmers);
- Fonterra purchase the Australian fresh dairy business of Nestle;
- Bega cheese purchase certain assets from Kraft;

- Parmalat acquire drinking milk businesses in NSW and SA from National Foods (as required by the ACCC, following the Dairy Farmers acquisition).

Each of these proposals was publicly reviewed by the ACCC to ensure there was no lessening of competition in any dairy market in Australia.

In relation to the regulatory approval process involved in the National Foods purchase of Dairy Farmers and the subsequent sale of drinking milk businesses to Parmalat, National Foods notes the following:

- 1 National Foods first approached the ACCC in March 2008 (before the Dairy Farmers proposal was public);
- 2 The ACCC commenced a comprehensive public review process in April 2008. This involved consulting with all levels of the dairy industry;
- 3 The ACCC granted regulatory approval, subject to court enforceable undertakings in July 2008 and published a public competition assessment;
- 4 National Foods completed the Dairy Farmers transaction in November 2008;
- 5 National Foods commenced a sale process for the NSW and SA 'divestment businesses' in December 2008, as required by the ACCC;
- 6 National Foods completed the sale of the NSW and SA 'divestment businesses' to Parmalat in July 2009, after receiving further ACCC approvals; and
- 7 The ACCC confirmed this sale was in accordance with the undertaking requirements in August 2009.

Every step of this process was closely reviewed and monitored by the ACCC. National Foods submits that it is difficult to conceive of a more thorough and comprehensive regulatory approval process (which spanned 18 months), while remaining within the realms of commercial reality.

7.3 Major grocery chains

In 2008 the ACCC reported on the competitiveness of retail prices for standard groceries (including dairy products). The inquiry commenced in January 2008 and reported in August 2008, after considering enormous volumes of written material from industry participants (much of which was obtained under compulsion) and conducting public hearings around Australia. National Foods, along with all other substantial industry participants, was required to provide information and data to the inquiry as well as attend a public hearing to answer ACCC questions.

From National Foods' perspective the key conclusions from that inquiry were:

- the acquisition of milk from the farm gate is competitive and set by market forces of supply and demand;
- the prices domestic milk processors offer to farmers are primarily determined by international factors;
- the domestic wholesale markets for dairy products are broadly competitive. In particular, increased costs of production of drinking milk

for processors are not being fully reflected in wholesale or retail prices for private label milk; and

- there has been little change in the competitive environment at the retail level in recent years. End consumers are benefiting from the buying power that the major supermarket chains have against milk processors in sourcing private label milk.

7.4 Farmgate deregulation

In 2001 the ACCC conducted a review of the impact of farmgate deregulation on the Australian milk industry. In short, the ACCC concluded that Australian milk consumers were better off and that the significant benefits arising from deregulation had not been captured by major retailers or milk processors.