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Lion Dairy & Drinks (formerly National Foods) – Second submission to the Senate Economics References Committee - Inquiry into the impacts of supermarkets' price decisions on the Australian dairy industry

5 September 2011

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1 Executive summary

Lion Dairy & Drinks (formerly National Foods) welcomes the opportunity to make a further submission to the Senate Economics Reference Committee's inquiry into the supermarkets' price decisions in the Australian dairy industry.

Our previous submission to the Inquiry in March 2011 is attached as Appendix 1.

Lion Dairy & Drinks remains very concerned about the impacts of the current retail price of house brand milk on the sustainability of the Australian dairy industry.

The supermarkets' pricing of house brand milk at $1 per litre has been in the marketplace since January 2011. This pricing has had a significant impact on sales volumes and returns across the white milk category.

On 22 July 2011, the ACCC released the results of its investigations into Coles' white milk pricing conduct. The ACCC announced that it had found no evidence of a breach of the predatory pricing provisions in the Competition & Consumer Act 2010.

Following the ACCC's announcement of its findings, Coles confirmed that it would retain house brand milk pricing at $1 per litre "for the foreseeable future".

When reviewing the economic impacts of house brand pricing, it is necessary to consider the impacts across the entire white milk supply chain. House brand pricing has a "ripple" effect across the white milk category and has a direct impact on branded milk economics in grocery as well as white milk returns in other retail channels.

In this further submission, Lion Dairy & Drinks will provide data showing the impact of $1 per litre house brand pricing on white milk sales volumes in both the grocery and non-grocery channels.

The reduction of house brand pricing since January 2011 has not generated increased sales across the white milk category. It has not grown the market or injected additional revenues into the supply chain. Instead, it has simply caused a transfer of sales volumes from branded products into house brands and from the non-grocery channel to the supermarkets, with a corresponding decline in white milk returns for branded manufacturers, distributors & franchisees and small retail outlets.

Accordingly, this data indicates the significant risks posed to the dairy industry and the non-grocery retail sector by retail pricing, and a consumer mindset, that does not attribute sufficient value to the daily accessibility of fresh white milk or the long term importance of the sustainability of the Australian dairy industry.

The continuation of $1 per litre house brand pricing will make it less and less viable for the dairy industry to continue delivering fresh white milk to retail outlets on consumers' doorsteps across Australia. Lower prices may be attractive in the short term – but unsustainably low prices are not in consumers' long term interests.

The daily delivery of fresh white milk to consumers requires the participation and significant financial commitments of multiple players - dairy farmers, processors, distributors and retailers - many of whom are small business people in regional Australia. To ensure the long-term sustainability of the white milk supply chain – and to fund investments in ongoing innovation and product development for the benefit of consumers – adequate financial returns need to be achievable for all players.

Lion Dairy & Drinks submits that the Government should consider options that will promote the long term sustainability of the fresh white milk supply chain and allow dairy industry participants to earn reasonable, sustainable returns from the supply of fresh white milk to all Australian consumers.

2 Overall white milk impacts

In order to fully understand the market impact of $1 per litre house brand pricing, it is necessary to look at the combined impact on sales volumes, revenues and returns across all white milk products sold through the grocery and non-grocery channels.

There is a direct correlation between house brand pricing and (a) sales of branded products through supermarkets and (b) sales of white milk products through non-grocery outlets. House brand pricing affects milk sales across all white milk products and channels and accordingly the impact of house brand pricing must be considered on a “whole of white milk business” basis.

Across its white milk business, Lion Dairy & Drinks has experienced the following impacts since January:

- In grocery, a transfer of volumes from branded to house brand products, with corresponding overall value declines;
- In the non-grocery channel , a decline in total white milk volumes & value with an even greater decline in branded volumes & value; and
- Resulting declines in sales & returns for our distributor/franchisee network, which comprises about 600 small businesses, many of which are in regional Australia.

In our previous submission to the Senate Committee, Lion Dairy & Drinks advised that it had planned for a white milk EBIT margin of just 2% for the year ended 30 September 2011. As previously disclosed, this planned EBIT margin included the recent wholesale price increase secured from Coles to produce & supply its house brand milk.

Following the introduction of $1 per litre house brand pricing, Lion Dairy & Drinks has seen further deterioration of its white milk EBIT margin. For the year ended 30 September 2011, our projected full-year white milk EBIT margin is now expected to be negative.

3 Impact on white milk grocery sales

The data referenced below is sourced from Nielsen Scan Track and Nielsen C-Track.

Total white milk impacts

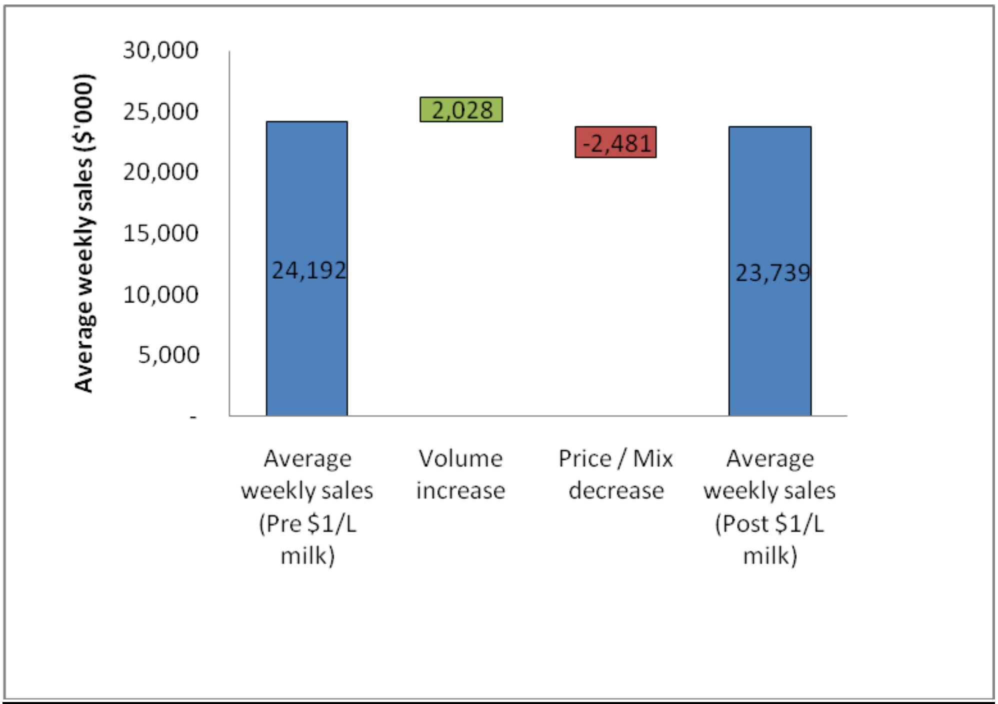
Across the Australian grocery channel, the Nielsen data shows that total grocery white milk volumes have increased by 8.4% since the end of January 2011.

However, average weekly white milk sales value across the grocery channel has decreased by approximately 1.9% (~$0.5 million) driven by significant shifts in price and mix reflecting volume transfers away from branded into house brand products.

Increased house brand market share has resulted in an approximate 14 cents per litre (9.5%) reduction in the average price of fresh white milk across the grocery channel.

These impacts on total grocery white milk sales are shown in Figure 1 below.

Figure 1. Total grocery average weekly sales bridge (pre/post $1/litre milk) – fresh white milk



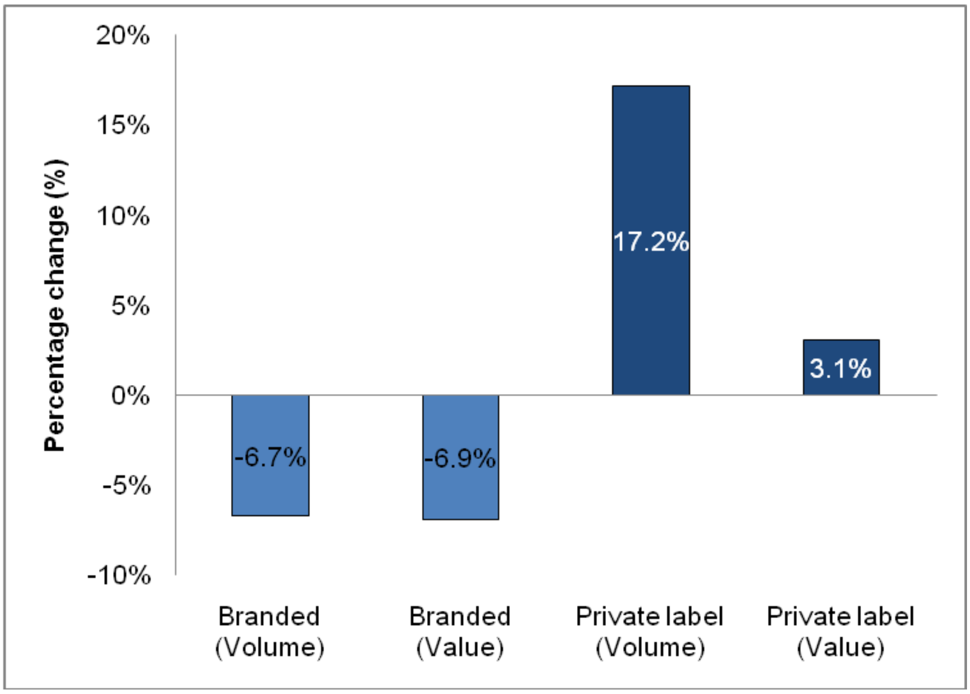
Branded vs house brand impacts

In the 23 weeks since the end of January, average weekly branded white milk volumes across the grocery channel declined by -6.7%, while house brand volumes increased 17.2%.

Whilst value loss in branded products of -6.9% was in line with volume losses, house brand value increased by only 3.1% despite strong volume growth of 17.2%. Accordingly, as a result of significant on-shelf discounting, house brand volume gains did not translate into material value growth.

These impacts on branded vs house brand white milk volumes and values are shown in Figure 2 below.

Figure 2. Grocery volume and value change (pre/post $1 per litre milk) – Branded versus private label fresh white milk



4 Impact on the non-grocery channel

The non-grocery channel includes national Petrol & Convenience outlets as well as the unstructured convenience channel (eg local milk bars, takeaway food shops, corner stores, coffee shops, newsagents). This channel also extends to schools, hospitals, prisons, aged care facilities, day care centres and the like.

A large part of the non-grocery channel is made up of small businesses in regional Australia. Many of those businesses offer employment in their local areas.

Fresh white milk is critical to the non-grocery sector. It is a staple item that is commonly relied upon to attract customers who might purchase other items at the same time. Further volume shifts away from the non-grocery sector into the supermarkets will undermine the sustainability of non-grocery retail outlets.

Processors may find that the viability of their cold chain becomes questionable if the shift to supermarkets, away from the non-grocery channel, continues. Lion's cold chain distribution system delivers chilled products to over 75,000 outlets, many of them small businesses in regional Australia. Sales of fresh white milk tend to underwrite sales drops to these outlets. If fresh white milk sales through this channel continue to decline as a result of sales transfers into the grocery channel, it will become increasingly uneconomic for the cold chain distribution system to service these small regional retail outlets.

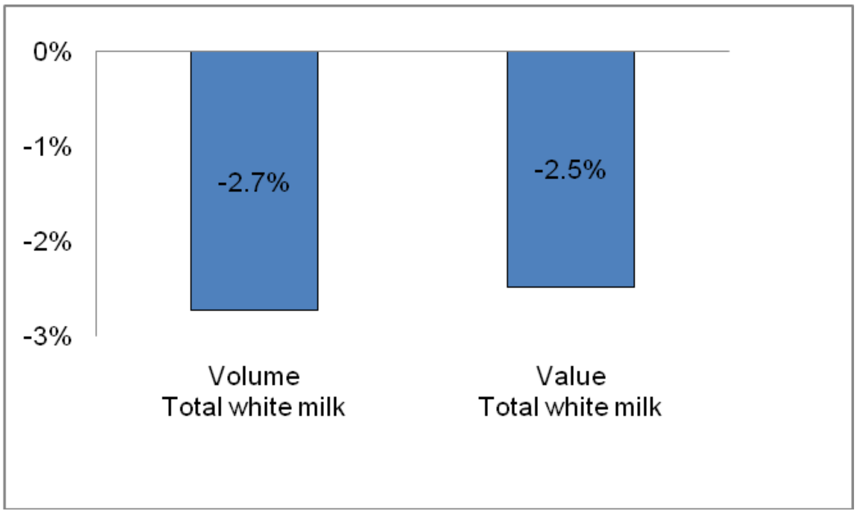
Impact in national Petrol & Convenience outlets

The impact on sales volumes and values in national Petrol & Convenience retailers is shown in Figure 3 below.

The table in Figure 3 represents Nielsen C-Track scan data from selected national petrol and convenience retailers. It represents the percentage change in average weekly sales for the 23-week period up to 23 January 2011 versus the 23-week period up to 3 July 2011.

This data indicates a material channel shift in the fresh white milk category away from Petrol & Convenience retailers to the grocery channel. Following the introduction of $1 per litre house brand pricing, Petrol & Convenience volumes declined -2.7% while Grocery volumes gained 8.4% over the same period.

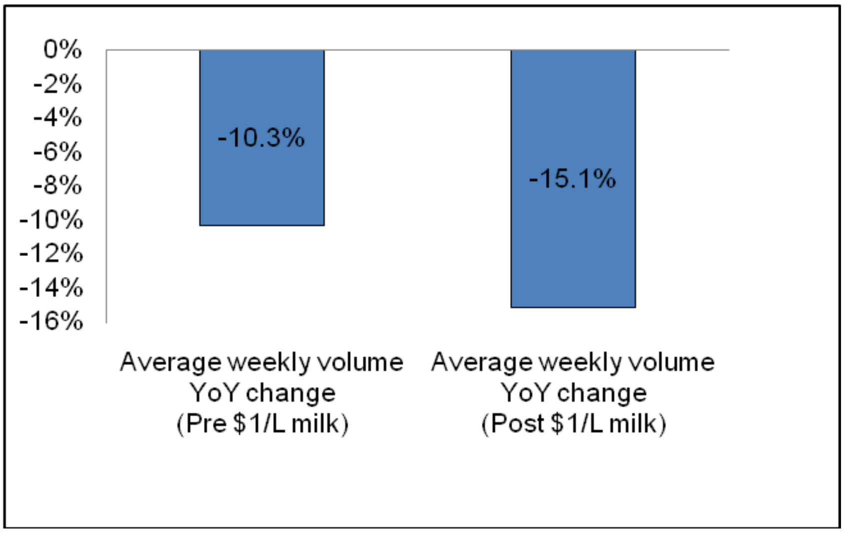
Figure 3. Petrol & Convenience volume and value change (pre/post $1 per litre milk) – fresh white milk



Impact in unstructured convenience channel

The impact on the unstructured/local convenience channel is shown in Figure 4 below which represents Lion Dairy & Drinks internal sales data.

Figure 4. Lion Dairy & Drinks year-on-year change in average weekly volumes: Total local convenience

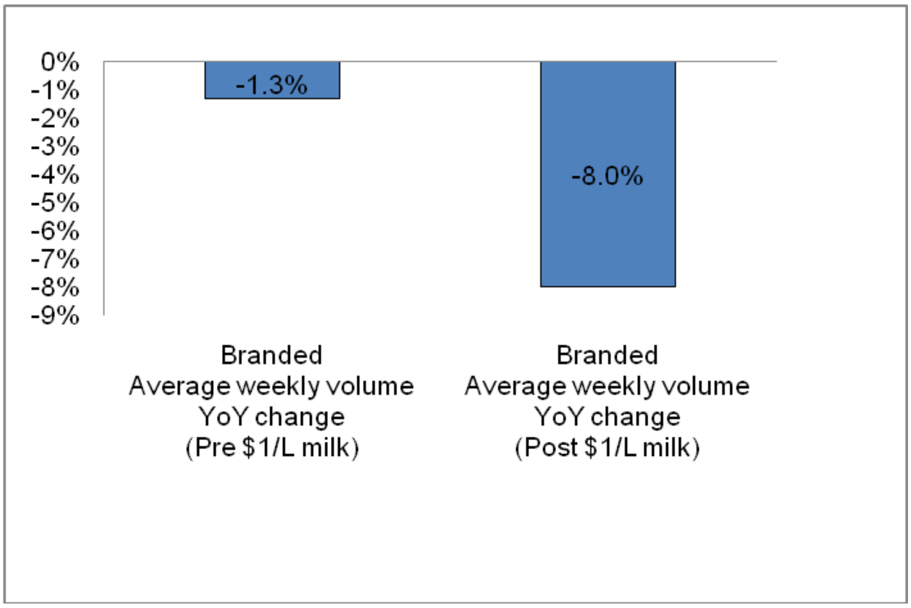


White milk volumes in this channel were already in organic decline as a result of an existing trend of white milk volume transfer from unstructured convenience into grocery and national Petrol & Convenience.

However, these volume declines increased significantly post the introduction of $1 per litre house brand pricing - from an average -10.3% decline versus previous year to an average -15.1% decline.

As shown by Figure 5, all of this impact is seen in branded volumes – which moved from a -1.3% decline to a -8.0% decline.

Figure 5. Lion Dairy & Drinks year-on-year change in average weekly volumes: Branded local convenience



5 Impact on distributors and franchisees

The delivery of fresh white milk in the non-grocery sector depends on a sustainable fresh white milk supply chain. Lion Dairy & Drinks' fresh white milk distribution chain extends across Australia, to much of regional and metropolitan Australia. It comprises about 600 distributors and franchisees (all of which are small businesses) and a contracted fleet. It is the only truly national chilled food and beverage distribution system in Australia and is critical to the benefits the non-grocery sector provides to millions of Australians.

The delivery of chilled food & beverage products to over 75,000 outlets across the country is an essential component of Australia's retail landscape. The ongoing viability of a national network of distributors & franchisees is critical to the continuation of this unique chilled food & beverage distribution system.

The majority of outlets serviced by Lion's distributors & franchisees are non-grocery outlets. Our distribution network is therefore suffering the immediate impact of the white milk volume transfers out of non-grocery into grocery.

6 Conclusion

As indicated by the data referenced above, historically low house brand pricing has had significant detrimental impacts on sales volumes and returns across the white milk category since the end of January 2011.

Lion Dairy & Drinks remains very concerned about the impacts of the current retail price of house brand milk on the long term sustainability of the Australian dairy industry.

If consumers are not prepared to attribute sufficient value to daily accessibility of fresh white milk, and pay a price that delivers adequate returns to dairy industry participants, there is a risk that those participants will be forced out of the industry.

Lion Dairy & Drinks submits that the Government should consider options that will promote the long term sustainability of the fresh white milk supply chain and allow dairy industry participants to earn reasonable, sustainable returns from the supply of fresh white milk to all Australian consumers.

Please contact me if you require any further information.

Yours sincerely

Duncan Makeig
Group Sustainability Director and General Counsel

Appendix 1: Submission dated 7 March 2011

National Foods - Submission to the Senate Economics References Committee - Inquiry into the impacts of supermarkets' price decisions on the Australian dairy industry

7 March 2011

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7 Executive summary

National Foods welcomes the opportunity to make submissions in the Senate Economics Reference Committee's inquiry into the supermarkets' price decisions in the Australian dairy industry.

National Foods is very concerned about the effects of the price of house brand milk on the sustainability of the Australian dairy industry.

The Australian dairy industry comprises four vital members - dairy farmers, processors, distributors and retailers - many of whom are small business people in regional Australia.

Distribution of fresh white milk

Fresh white milk is delivered to consumers using a complex distribution system. In National Foods' case, it involves making about 12.5 million deliveries of milk each year, using a world class chilled distribution system. Before the milk can be delivered, it must be collected from over 1,200 dairy farmers across Australia, delivered to processing facilities, processed (including homogenised and packaged) and distributed to over 75,000 outlets, five days a week, all in accordance with strict food standards.

Price of house brand milk

The current retail price of fresh white milk is driven by the price of house brand milk. The price of house brand milk is currently $1 per litre. Consumers have not paid such a small amount for 1 litre of fresh white milk for more than 20 years. The price is simply too low for the Australian dairy industry to be sustainable.

The decision to discount fresh white milk are driven by their desire to attract each other's customers and to draw customers away from the non-grocery channel. In the short-term, the decision mean consumers pay less for their milk. However, the short term benefits of the price reduction are likely to be far outweighed by longer term detriments in the non-grocery channel and in regional Australia.

Fresh white milk and the non-grocery sector

The non-grocery channel includes local milk bars, takeaway food shops, corner stores, coffee shops, newsagents, schools, hospitals, prisons, aged care facilities, day care centres and the like. A large part of the non-grocery channel is made up of small businesses in regional Australia. Many of those businesses offer employment in their local areas.

Fresh white milk is critical to the non-grocery sector. It is a staple item that is commonly relied upon to attract customers who might purchase other items at the same time.

The delivery of fresh white milk in the non-grocery sector depends on a sustainable fresh white milk supply chain. National Foods' fresh white milk supply chain extends across Australia, to much of regional and metropolitan Australia. It comprises about 600 distributors and franchisees (all of which are small businesses) and a contracted fleet. It is the only truly national chilled food and beverage distribution system in Australia and is critical to the benefits the non-grocery sector provides to millions of Australians.

The current price of house brand milk is a real and substantial threat to the sustainability of the fresh white milk supply chain. The inelastic demand for fresh white milk means that a reduction in the price of fresh white milk is unlikely to materially increase the demand for milk. Consequently, a reduction in the price of house brand milk to $1 per litre will not result in more fresh white milk being sold, or increase the earnings of dairy farmers or processors. It will merely increase the supermarkets' share of the milk that is sold.

This will have a number of direct and detrimental consequences for the non-grocery channel and for milk processors and it will most certainly not make dairy farmers any better off.

The unique nature of fresh white milk

Australians have come to think of fresh white milk as an easily accessible right. They expect to be able to purchase fresh white milk on a daily basis and it is a central part of a typical family diet. For example, following the Queensland floods in January, the items that sold out first and had to be returned urgently to the shelves of supermarkets were bread and fresh white milk.

Unlike bottled water or soft drinks, fresh white milk cannot be stored for long periods of time and its production process (including on the farm) cannot be stopped and started on demand.

The enormous effort required to produce, process, distribute and deliver fresh white milk on a daily basis does not reconcile with the fact that house brand milk is currently selling at a substantial discount to bottled water and soft drinks. The average price per litre for soft drinks, about $1.51 per litre, is substantially higher than the price for house brand fresh white milk. The average price for bottled water, about $1.12 per litre, is also higher than the price for house brand fresh white milk.

Capital intensive nature of the dairy industry

The unsustainably low price of fresh white milk does not reflect the capital intensive nature of the dairy industry, from the farm to the consumer. In Tasmania, for example, the average investment on a dairy farm is about $4 million in order to produce 1.3 million litres of milk each year on a 200 hectare property. This investment has a return of about 2.2%. Capital appreciation on land used for dairy farming (which tends to be high value land, in high rainfall areas and close to cities) may be a better investment for many farmers.

Prior to the recent reduction in the price of house brand milk, National Foods anticipated an EBIT (earnings before interest and tax) margin on fresh white milk of less than 2%. This is anticipated to deteriorate further as the discounting of house brand milk reduces National Foods' sales of branded fresh white milk.

National Foods' planned EBIT margin on its fresh white milk includes the recent price increase that National Foods secured from Coles to produce its house brand milk. The price increase reduced National Foods' anticipated EBIT losses from its house brand milk business from loss making to marginally profitable under current distribution arrangements.

Conclusion

National Foods' branded fresh white milk forms the backbone of its chilled distribution system. It is used to supply a staple item to thousands of small businesses in regional and metropolitan Australia.

The decision to reduce the price of house brand milk to $1 per litre will have significant and detrimental implications for the sustainability of the Australian dairy industry.

The price reduction will not generate increased sales of fresh white milk and will not inject any additional revenues into the dairy industry.

Since the price reduction will not generate increased sales of fresh white milk, or inject additional revenues into the dairy industry, it will not benefit any part of the dairy industry. It will not mean that dairy farmers will be able to sell more milk.

Any increase in sales of house brand milk by the supermarkets will only be associated with corresponding decreases in sales of branded fresh white milk - in supermarkets and in the non-grocery sector.

The corresponding decrease in sales of branded fresh white milk will mean that processors and the non-grocery sector will be worse off. Dairy farmers will be no better off, and will likely be worse off.

Processors depend on the revenues they earn from sales of branded white milk to underwrite the costs of their fresh white milk supply chain.

If their fresh white milk supply chain becomes more costly to operate (due to the fall in sales of branded milk), the price of branded milk will increase.

If the price of branded milk increases, more consumers will switch to house brand milk. That will mean that fewer consumers will buy their milk from the non-grocery sector.

If the non-grocery sector becomes worse off, many small businesses involved in the sector may become unsustainable, with immediate detriments in their local communities.

The costs of operating the fresh white milk supply chain will increase and there will be long term upward pressure on prices.

If all of the participants in Australia's dairy industry (including dairy farmers and processors) are to earn reasonable, sustainable returns, the price of house brand milk needs to be substantially higher than $1 per litre.

The long term sustainability of the Australian dairy industry is in the best interests of consumers. Currently, the sustainability of the industry, particularly in the drinking milk states of Queensland, New South Wales and Western Australia, is being threatened. Commercial responses may eventually lead to suboptimal outcomes in these regions. It would be prudent for Government to explore unintended regional consequences of current market activity and to consider whether the current regulatory regime is cognisant of these likely impacts.

8 National Foods

National Foods is one of Australia's leading food and beverage companies producing household name brands in milk and dairy beverages, juice, fresh dairy, cheese and soy.

Some of National Foods' brands have been part of daily life for more than 100 years and many of them are category leaders – such as PURA Milk, Dairy Farmers, Berri, Yoplait, Dare, Big M and Farmers Union.

National Foods operates processing facilities in all Australian States and in New Zealand employing more than 5,000 people. Within Australia, National Foods has milk production facilities at Crestmead and Malanda in Queensland, Penrith and Baulkham Hills in New South Wales, Chelsea in Victoria, Lenah Valley in Tasmania, Salisbury in South Australia and at Bentley in Western Australia. National Foods uses its facilities to contract manufacture and pack for other dairy companies.

Kirin Holdings from Japan acquired National Foods in 2007 for an enterprise value of $2.9 billion. National Foods then purchased Dairy Farmers in November 2008 for an enterprise value of $0.9 billion. Between 2007 and 2010 Kirin has, via National Foods, outlaid an additional $180 million in capital investments for National Foods' business meaning that Kirin has invested approximately $4 billion of capital in National Foods.

An EBIT this year of approximately $100 million provides a return on invested capital of approximately 2.5%, whereas the accepted cost of capital in Australia is around 10%. The book value for Kirin of National Foods' business was written down by $832.3 million in 2010.

Kirin has a strong commitment to social responsibility and has a longer term focus for delivering acceptable shareholder returns. Indeed, patience has been required by Kirin who recently updated the market in Japan that there has been a significant deterioration in business conditions affecting National Foods.

9 A brief history of the Australian dairy industry

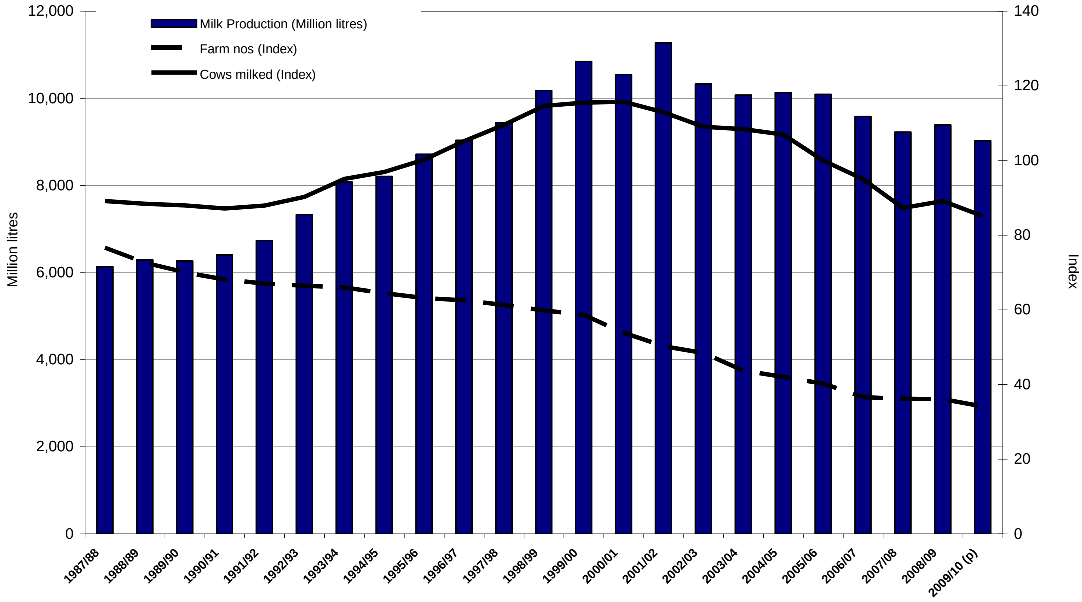
In the 1950s and 1960s, the State and Federal Governments of Australia became determined to improve the nutrition of the general population. Fresh white milk was considered part of the nutritional requirements for the general population. However, the availability of fresh white milk production was patchy and erratic, particularly in Queensland, New South Wales and Western Australia. In addition, the lack of quality refrigeration prevented dairy producers and processors from transporting fresh white milk over large distances.

State-based regulation was introduced in order to ensure there was consistent fresh white milk supply in city markets.

As refrigeration improved, it became possible for dairy producers and processors to transport fresh white milk interstate. This led to a Federal scheme to support the existing State based regulatory arrangements.

During the 1950s and 1960s, the dairy production sector typically consisted of small family-owned dairies. These family-owned dairies were often part of soldier settlement schemes. Technological innovation enabled them to increase their herd sizes and milk production, without increasing their labour costs. However, this ultimately led to rationalisation of dairy farms and, over time, many small family-owned dairies were incorporated into corporate-style family farms (see graph below).

Figure 1: Australian milk production (1987/88 to 2009/10)



Source: Dairy manufacturers, ABS, State Authorities and Dairy Australia

Eventually, the regulated milk market became overly complex, bureaucratic and inefficient. As Government policy shifted towards the promotion of free markets and deregulation, the dairy industry became deregulated.

The Federal Government announced a $1.6 billion structural adjustment program to facilitate deregulation. The structural adjustment program was funded by a levy of 11 cents per litre on milk sales. This levy ceased in 2009.

Deregulation led to a further reduction in the number of dairy farms and the removal of manufacturing capacity.

Prolonged drought, low commodity prices and low domestic market milk prices saw further rationalisation in the production sector up until 2007.

The global financial crisis has since triggered another round of rationalisation in the production sectors of the Australian dairy industry.

10 Milk is a key daily staple

Australians have grown up enjoying all year round access to high quality, safe, fresh white milk. Australians now consider ease of access to fresh white milk as a right, and not a privilege.

Milk-based products are a major source of nutrients in the Australian diet and the consumption of milk has numerous health benefits. Milk foods are the richest source of calcium in the Australian diet and are also important contributors to protein, Vitamin A, riboflavin, vitamin B12 and zinc.[1]

[1] NHMRC, Food for Health: Dietary Guidelines for Australian Adults, A guide to healthy eating, 2003, p.76

Australian demand for fresh milk has been largely unchanged for a number of years. The per capita consumption of drinking milk in Australia is about 102 litres. [2]

11 UHT and powdered milk are poor substitutes for fresh white milk

Industry data suggests that about 60% of fresh white milk is consumed over the breakfast table, with young families that have infants and young adults accounting for the majority of household milk consumption. Taste and quality are essential for these consumers. As a consequence, the substitutes for fresh milk - UHT and powdered milk – are not readily accepted by consumers and do not have the same nutritional benefits as fresh white milk.

12 Milk is a perishable product

Milk is a 'live biological system' containing an ecosystem of beneficial and non-beneficial micro organisms that are not eliminated by standard pasteurisation. If milk is allowed to warm to above 5 degrees Celsius, the delicate balance of micro organism can change resulting in flavour taints, physical changes, microbiological spoilage and potential rejection by consumers.

The deterioration of unpasteurised fresh milk is sudden and immediate. Pasteurised fresh white milk ordinarily has a shelf life of between 12 to 15 days. A daily consumer would generally begin to consume fresh white milk which is less than 5 days old (from the time of milking).

There are obvious health risks associated with consumption of fresh milk past its expiration date. That is the reason why expiration dates are set conservatively. The short shelf life of fresh white milk increases the importance of delivering a continual supply of fresh milk to consumers across Australia.

Delivering a continual supply of fresh milk across Australia requires an efficient chilled distribution system - "a cold chain." A large number of Federal and State laws apply to cold chains, including the Food Standards Code which is administered by State-based regulatory bodies such as the New South Wales Food Authority and Dairy Food Safety Victoria. The laws apply to on-farm handling, transportation to and from processors, on-site storage, distribution centres and retail outlets. However, the milk processors are largely responsible for adherence to the applicable cold chain laws.

Cold chain compliance begins at the farm where milk is required to be cooled to 4 degrees Celsius within 3 hours of milking. Typically, milk is collected 3 to 5 times each and every week and delivered to the processor. The trucks collecting the milk are insulated vehicles which require substantial capital investment. Once the milk has been transported to the processor, it is stored in holding storage facilities which can only hold a limited amount of production. The milk is then processed, packaged and dispatched to retailers as fresh white milk within about 24 hours.

Consumers expect fresh, great tasting white milk every time they open a carton or bottle so the importance of cold chain handling extends beyond regulatory compliance. How milk is handled by all members of the milk supply chain is critical to satisfy consumers' basic expectations about milk quality.

[2] Dairy Australia: http://www.dairyaustralia.com.au/Our-Dairy-Industry/Industry-Statistics.aspx

13 Milk cannot be imported

The perishable nature of fresh white milk and the high costs of transportation by sea or air mean that it is commercially unviable to import milk. Therefore, it is highly unlikely that Australia will ever import fresh white milk in any significant volumes.

Milk quality also diminishes rapidly when milk is transported by land. The impact of time on the quality of milk constrains the movement of milk from the major southern milk-producing states (New South Wales and Victoria) to smaller producing States (Queensland and Western Australia).

14 Milk requires a complex supply chain

The daily production and distribution across Australia of fresh drinking milk and fresh dairy products is distinct from the production of processed, storable products like skimmed milk powder which are traded internationally on world commodity markets and do not require a cold chain.

The cost of delivering a fresh refrigerated product is substantially higher than for ambient, storable products, such as water and soft drink.

Milk is unlike water or soft drink which can be stored for long periods of time and their production systems can be stopped and started on demand. Milk cannot be stored for long periods of time, and producers cannot easily limit supply at any given point in time.

The effort to produce, process, distribute and deliver fresh white milk on a daily basis does not reconcile with the fact that house brand milk is currently selling at a substantial discount to bottled water and soft drinks. Data from The Nielsen Company indicates that the average price per litre for soft drinks/mixers is substantially higher in comparison to the current price of milk, sitting at $1.51 per litre. Similarly for bottled mineral/still/spring water (including flavoured), the average price is higher than milk at $1.12 per litre.

Figure 2: Average price per litre soft drinks, mixers and bottled water

National Grocery	MAT TO 26/12/2010		
	VALUE ($000'S)	VOLUME	Avg. price per L
TOTAL SOFT DRINKS/MIXERS	2,035,723.00	1,343,747.10	$ 1.51
TOTAL MINERAL/STILL/SPRING WATER	337,129.70	301,900.00	$ 1.12
TOTAL MINERAL/STIL/SPRING WATER PUR WATR	215,897.90	222,180.70	$ 0.97

Source: Nielsen ScanTrack (MID data) Year to 26/12/10

For all of the reasons set out above, fresh white milk should not be treated as a mere commodity where price is the main concern and quality is not important.

15 Integrity of Australia's milk production system

Australian agriculture has an extraordinary record as a result of the investments by farmers and processors. Australia's regulatory regime and the extent of compliance with the regime ensure that Australia has an unparalleled record in food safety. Australia has never experienced an outbreak of foot and mouth disease or an outbreak of bovine spongiform encephalitis. In contrast, other countries have experienced food safety crises, invariably at significant (and often tragic) cost to the public.

The dairy industry in Australia has an exemplary record at maintaining Australians' confidence in the safety of our food.

It will be necessary for dairy farmers and processors to incur additional capital expenditure if the integrity of Australia's milk production system is to be maintained in the future.

However, farmers and processors require sufficient returns to justify their capital expenditures. The low returns of farmers and processors act as a barrier to investment, create inefficiencies and may threaten the integrity of Australia's milk production system and food security.

16 The demand for milk is inelastic

The demand for fresh white milk is highly inelastic due to fresh milk's central role in Australian diets. In other words, the volume of fresh milk necessary to supply the demand of the Australian market will not vary significantly, irrespective of its price.

The inelastic demand for fresh white milk means that a reduction in the price of fresh white milk will not result in an increase in demand for milk. Consequently, the decision to reduce the price of house brand milk will not result in any significant increase in fresh milk consumption.

17 Current structure of the dairy industry

The dairy industry is one of Australia's major rural industries. Based on a farm gate value of production of $3.4 billion in 2009/10, it ranks third behind the beef and wheat industries. It is estimated that approximately 40,000 people are directly employed on dairy farms and manufacturing plants. Related transport and distribution activities, and research and development projects, represent further employment associated with the industry.

Dairy is also one of Australia's leading rural industries in terms of adding value through further downstream processing. Much of this processing occurs close to farming areas, thereby generating significant economic activity and employment in country regions. ABARE estimates this regional economic multiplier effect to be in the order of 2.5 from the dairy industry.[3]

The Australian dairy industry is characterised by a range of regional marketplaces, some of which predominantly produce manufactured products and some of which predominantly produce drinking products.

[3] Dairy Australia

17.1 Manufactured Milk States

Victoria, Tasmania and southern South Australia are often referred to as manufactured milk States as over 90% of the milk production is used to manufacture goods that are predominantly exported from Australia, including whole milk powder, skim milk powder, casein and cheese. See figures 3 and 4 below.

These Southern States (the Manufacturing Milk States) produce about 7 billion litres of milk annually.

These States account for over 30% of the total Australian drinking milk market (ie domestic consumption of fresh milk products). However, this fresh milk consumption accounts for less than 10% of the region's production.

17.2 Drinking Milk States

Queensland, New South Wales and Western Australia are often referred to as either Drinking Milk States or Market Milk States. The milk production in these States is predominantly to supply fresh milk products for consumption in the region.

As can be seen from figures 3 and 4 below, the overwhelming majority of milk that is produced in Queensland and New South Wales is for fresh milk consumption. This reflects the fact that milk production costs are higher in these States than in the cooler southern states and consequently are at a cost disadvantage in regard to the production of manufactured product. Manufactured products are generally easily transported. In contrast, fresh dairy products are difficult to transport. It is for this reason that sustainable production and processing facilities in the market milk states are principally focused on the fresh drinking milk market.

The sustainability of the Western Australian market is underpinned by the domestic needs for fresh milk products. Consequently, it is also classified as a drinking milk State.

Figure 3: Australian manufacturing and drinking milk markets

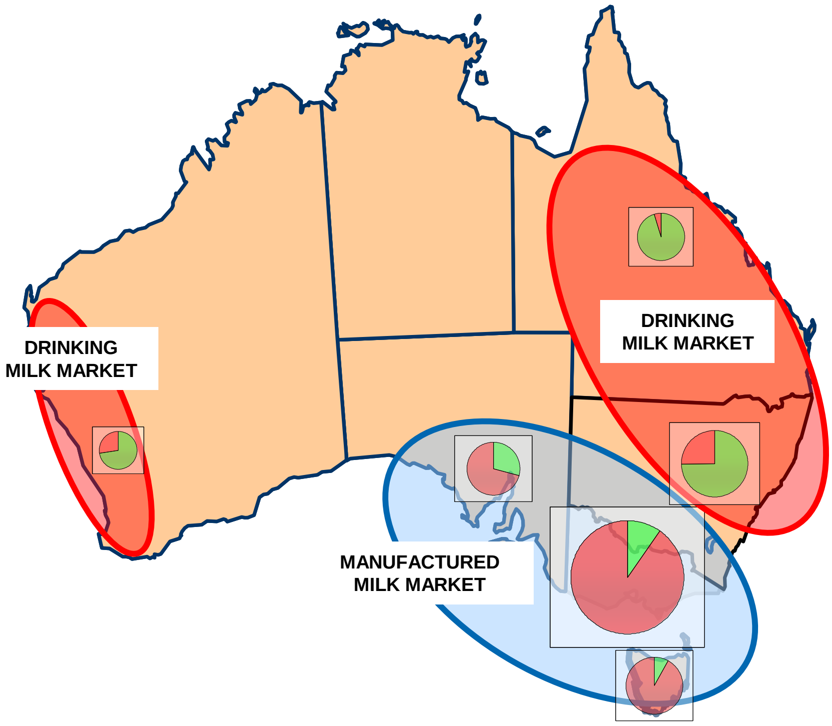
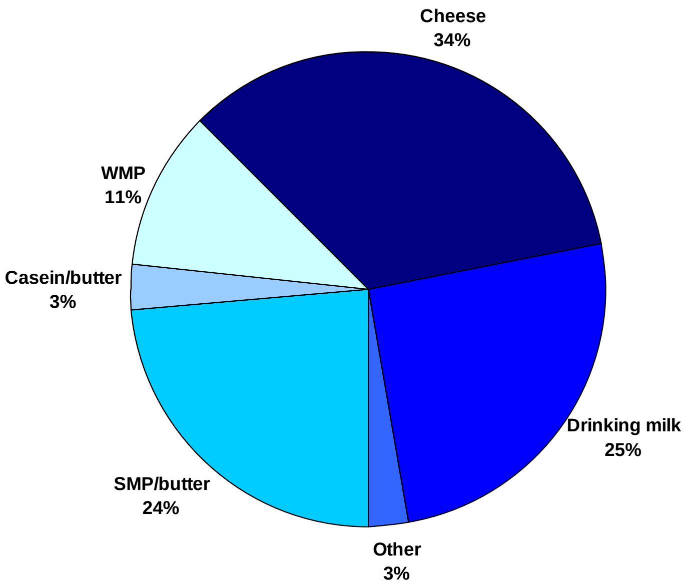


Figure 4: Supply of manufactured and drinking milk by State and Territory

	Supply	Demand (114 litres per person)		Excess	Market Milk Requirement
		Population	Est. Drinking Milk Requirement		
VIC	6,134,839,805	5,297,600	604,297,232	90%	10%
NSW	1,064,607,256	6,967,200	794,748,504	25%	75%
QLD	512,000,000	4,279,400	488,151,158	5%	95%
NT	0	219,900	25,083,993	100%	0%
WA	340,000,000	2,163,200	246,756,224	50%	50%
SA	628,000,000	1,601,800	182,717,326	71%	29%
TAS	708,000,000	498,200	56,829,674	92%	8%
	9,387,447,061	21,027,300	2,398,584,111		

Note: Excess means used for manufactured product and exported
Source: Dairy Australia

Figure 5: Uses of Australian milk



Key: WMP is whole milk power, SMP is skim milk power, WMP and SMP/butter are global market powdered milk categories

As can be seen from figure 5 above, only about 25% of all milk produced in Australia is processed to become drinking milk, with the remaining 75% used to manufacture milk powder, cheese and butter.

17.3 Global commodity prices have significant bearing on farm gate prices in Southern Manufacturing Milk States

The global dairy commodity market has bearing upon price that dairy farmers receive in the Manufacturing Milk States where the majority of production is used for the manufacture of products mainly destined for the export market.

17.4 Global commodity prices are not the principal influence upon farm gate prices in Market Milk States

The global dairy commodity market has a far smaller impact upon farm gate prices in the Market Milk States (New South Wales, Queensland and South Australia).

There are a number of reasons for this:

- TheMarket Milk States predominantly serve the domestic drinking milk market (drinking milk is not exported from Australia or imported to Australia).
- Due to the pattern of demand for fresh white milk, dairy farmers that produce milk for the drinking milk market have a more even year round production.
- The supermarket channel accounts for the majority of National Foods' white milk production. Consequently, the biggest impact on farm gate returns for National Foods' suppliers is the ability of National Foods to secure supermarket contracts at an acceptable return.

- The influence of the supermarkets is particularly important in Queensland, New South Wales and Western Australia, where the majority of milk is produced for the drinking milk market.

17.5 Processing

Dairy processors collect milk from the farm gate and process it into fresh drinking milk, fresh dairy products (such as yoghurt and dairy desserts), whole milk powder, skim milk powder, butter or cheese.

The processing sector in southern Australia is dominated by Murray Goulburn, a milk co-operative. National Foods, Fonterra, Warrnambool Cheese & Butter and Bega also participate in the processing sector.

Figure 6: Milk processors

2009/10`v	Aus		Vic	SA	Tas	Qld	NSW	WA
Total Australian supply **000's litres**	% of Aus 100	9,023	5,790	605	673	530	1,074	350
NFL / DF Farm Supply	18.6	1,682	291	319	150	261	611	51
Murray Goulburn	35.5	3,200	3,000	100	0	0	100	0
Fonterra	22.2	2,000	1,310	30	470	0	100	90
WCBF	8.9	800	700	100	0	0	0	0
Parmalat	5.3	480	215	0	0	215	50	0
Others[4]	9.5	861	275	56	53	54	213	209

Sources: Total Australia Supply: Dairy Australia; Supply by Processor: National Foods' estimate

17.6 Distribution

National Foods' distribution system for fresh white milk is complex, elaborate and arguably world class. It has been described in the preceding sections of this submission.

Dairy processors which do not participate in the drinking milk market do not incur the substantial costs associated with operating a cold chain.

Fresh white milk is a key sales generator in the non-grocery sector and plays a critical role in underwriting National Foods' investment in its cold chain.

4 Others include UDP & Tatura (Victoria /South Australia), Harvey & CDC (Western Australia), Norco, Bega & Hastings (New South Wales and Queensland) and Cadbury & Ashgrove (Tasmania).

National Foods' cold chain ensures that a large number of small businesses in the non-grocery sector (including cafes, coffee shops, aged care facilities, hospitals, schools, day care centres and prisons) receive daily deliveries of fresh white milk, irrespective of whether they are located in a distant regional or metropolitan area of Australia. The non-grocery sector accounts for about 20% of the fresh white milk in National Food's distribution system.

17.7 Retail

The retail distribution of fresh white milk has 2 broad channels - the supermarket channel and the non-grocery channel.

Over time, there has been a steady migration of consumers to large supermarkets away from the non-grocery sector.

The role of the traditional corner store and milk bar is also being slowly replaced by service stations (many of which are owned by the supermarkets) and chain convenience stores such as '7eleven'.

National Foods estimates that the supermarkets' account for in excess of 65% of fresh white milk sales. The two major supermarkets in Australia, Coles and Woolworths are the dominant players.

Processors may find that the viability of their cold chain becomes questionable if the shift to supermarkets, away from the non-grocery channel, continues. Distribution of chilled products to over 75,000 outlets is likely to become uneconomic without the inclusion of fresh white milk.

Further, wholesalers who supply dry grocery goods in the non-grocery sector do not operate cold chains. It would not, therefore, be possible for them to distribute fresh white milk to the non-grocery sector without making a very substantial investment. Fresh white milk is not like dry grocery goods, which can be warehoused and on-sold some time later and which do not require constant refrigeration.

18 Investment and farming costs

As a general rule, capital investment in Australian dairy farms is typically four times more capital intensive than investment in Australian dairy processing.

In turn, Australian dairy processing investment is typically ten times more intensive than the investment at the retail end.

Although the capital investments associated with farming and processing exceed those associated with retailing, there has been a profit margin shift from producer to retailer.

Dairy farming

Dairy farms are very capital intensive enterprises. For example, on mainland Tasmania the average investment on farm is about $4 million in order to produce 1.3 million litres of milk on a 200 hectare property. This investment has a return of 2.2%. Plant machinery and equipment typically cost $400,000. Total livestock costs are approximately $600,000 and land and improvements about $3 million.[5]

Dairy farming is also very labour intensive with a minimum of 2 milkings per day across the entire year. Labour is often valued at a very low rate.

Production of milk for the drinking milk market tends to be even more capital intensive than the production of milk for the manufactured milk market. This is because fresh drinking milk is required year-round and the dairy farmers who produce it cannot rely on seasonal pasture growth alone to feed their cattle to even out their annual milk supply curves. The farmers attempt to even out their supply of drinking milk through the use of feeding supplements, split calving of their herds and more intensive animal husbandry and crop production systems.

The need for feeding supplements means that each year, to supplement pasture growth, farmers must purchase more grain for feeding than the average dairy farm.[6] This not only increases their operational costs, but also tends to necessitate some investment in capital equipment in the form of grain production and/or storage handling/milling/mixing facilities.

Processors

Processors who supply fresh white milk need a large number of assets spread across a large area, largely because they need a chilled chain to distribute their fresh white milk to grocery and non-grocery outlets. The assets are considerably more capital intensive than the assets required by processors who do not supply fresh white milk and who only participate in the manufactured milk market. The processors who only participate in the manufactured milk market do not require a chilled chain. This important difference in the capital requirements of processors means that processors who do not supply fresh white milk cannot easily gear up to supply fresh white milk.

19 National Foods’ involvement in house brand (or private label) milk

The first national house brand contract for milk was awarded to National Foods by Woolworths in 2002. This contract was renewed with National Foods in 2005. Around the same time, Dairy Farmers had a number of house brand contracts for Coles.

When National Foods and Dairy Farmers were combined in 2008, virtually all house brand milk for grocery retailers was produced by National Foods. Subsequently, other processors secured house brand supply contracts.

Initially, National Foods tendered for house brand contracts to maintain relationships with its key grocery customers and farmers. House brand milk was also a way to dispose of surplus milk without terminating contracts with farmers.

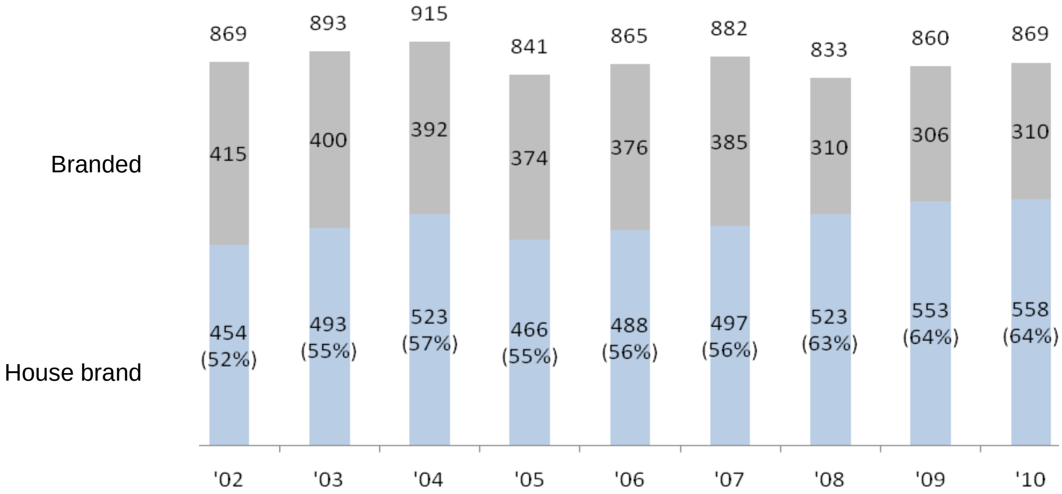
In addition, when the volumes of house brand milk were relatively small compared to the rest of National Foods’ fresh white milk production, the lower price of house brand milk was justified on an assumption that branded milk would continue to recover any fixed costs of the business.

[5] Davey and Maynard 2010, Comparison of King Island and Mainland Tasmania Dairy Returns 2010-11, December 2010

[6] ABARE-BRS, Australian dairy industry; technology and management practices 2008-09, 2010

The growth in volumes of house brand milk is reflected in the increased volumes of fresh white milk supplied by the processors to the supermarkets in the house brand contracts, creating significant pressures for farmers and processors each time the house brand contracts come up for renewal. Figure 7 below demonstrates the steady increase in volumes of fresh white milk supplied by the processors to the supermarkets under house brand contracts, rising from about 52% in 2002 to about 64% in 2010, an increase of about 12%.

Figure 7: Grocery white milk volumes and private label penetration 2002 to 2010



Source: Australian Dairy Industry in Focus (02-04) – Dairy Australia; Nielsen Scan Data MAT 25/11 (05-10)

For farmers, the pressures arise because they must make investment decisions about the size and composition of their herds and the nature of their plant and equipment. Those decisions necessitate a longer term investment horizon and exposure to ongoing fixed costs. Consequently, farmers look to the processors to provide guaranteed cash flows over the farmers' investment horizons.

However, the processors are not able to commit to supply arrangements with farmers until the processors have finalised their contracts for house brand volumes with the supermarkets.

The processors are exposed to the risk of significant loss when their milk supply arrangements with farmers extend beyond the term of their house brand contracts. In the last year, changes in the configuration of demand for fresh white milk caused National Foods to lose approximately $20 million on its fresh white milk contracts.

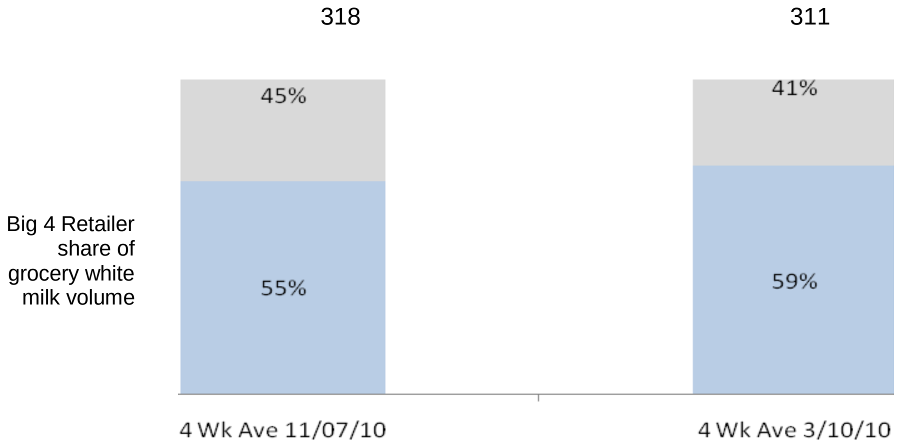
20 Economics of fresh white milk and the impact of recent price decisions

National Foods views fresh white milk as a relatively inelastic category. That is, consumers do not typically drink more milk because the price has been reduced. Rather, decreases in the price of house brand milk is likely to result in a further shift from branded milk sales and from the non-grocery channel to the large supermarkets.

The experience in the United Kingdom

This is consistent with the experience in the United Kingdom, when, in 2010, the big 4 retailers reduced the price of house brand milk. While the price reduction did not increase the demand for grocery fresh white milk, the big 4 retailers were able to increase their share of grocery fresh white milk (from 55% to 59%) in just 3 months, as depicted in figure 8 below.

Figure 8: UK Grocery white milk market – weekly sales volume (mL)



Source: *The Grocer*, UK (6 Nov 2010)

Further, after the big 4 retailers in the United Kingdom reduced the price of house brand milk, herds declined and more milk imports increased to the United Kingdom.

Despite this international experience, National Foods recognises both the attraction to Coles of using low price milk to draw store traffic, and the difficulty for many consumers to continue justifying the increasing price premium of branded fresh white milk.

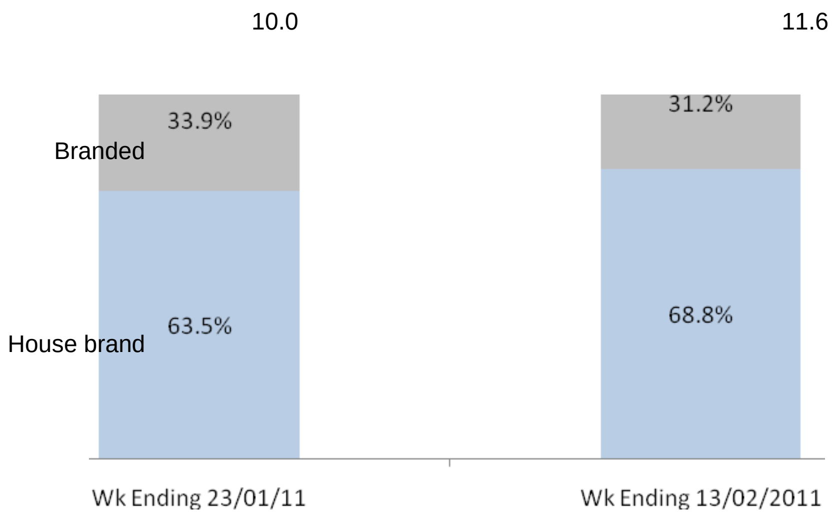
The effect of the price reduction in Australia

National Foods is not surprised that Coles, and to a lesser extent Woolworths, have reported a significant increase in house brand milk volumes and store traffic since the reduction in house brand milk prices. National Foods assumes that the bigger increase for Coles' sales is attributable to the high levels of advertising and instore support:

> *"Our milk sales were up by 15 to 20 per cent since we put this in place."*
>
> *"The aim is get price trust and I can tell you, customers love it."*
>
> *"Milk is all about providing a core staple to our customers at great value."*

(Wesfarmers, 17 Feb 2011)

Figure 9: Australian grocery white milk sales – volume (mL)



Source: AC Nielsen Scan Data (until 6/02/2011); Coles daily data (13/02/11) provided by Coles; Woolworths (08/02/2011) estimate for 2L from Aztec

Figure 9 above indicates the short term effect of the reduced price of house brand milk on sales of branded milk in Australia.

While industry level data is not yet available, National Foods anticipates that this price reduction will also result in a further shift in milk sales from independent grocery stores (e.g. IGA, Ritchies, Foodland, Franklins) and the non-grocery channel.

The effects of the price reductions are likely to be greater in Australia

Nationals Foods expects the impact of the price reduction to be more dramatic in Australia than it was in the United Kingdom given:

- The significantly higher concentration of grocery retailers in Australia (Australia has one of the highest level of grocery retail concentration in the world).
- The increasing shift in volumes to the grocery channel in Australia will increase the cost of distributing milk to the non-grocery channel, and possibly the price of milk in that channel, particularly in rural, remote and regional areas.
- Reducing house brand milk prices may (at least in the short term) provide cheaper milk for consumers who are easily able to access a supermarket on a daily basis, but it will not benefit consumers who cannot easily access a supermarket on a daily basis. Given the price differential between house brand and branded milk, many consumers who can easily switch from purchasing their milk in the non-grocery channel to purchasing their milk from supermarkets are likely to do so. Those who cannot easily switch from purchasing their milk in the the non-grocery channel are likely to have to pay more for their milk, as distribution costs to the non-grocery channel will likely increase. National Foods expects this cost increase would likely be passed on as increased prices to consumers.

- Participants in the non-grocery channel may move away from the daily delivery of milk, reducing the availability of fresh white milk to consumers. This may mean that some participants in the non-grocery channel might lose the white milk distribution platform, making their ongoing operation unsustainable.

Effect on National Foods

National Foods had planned a fresh white milk EBIT margin of just 2% for 2011 which had already deteriorated prior to the reduction in retail prices for house brand milk. This result includes branded fresh white milk profit margin being offset by house brand losses despite house brand representing the majority of fresh white milk volumes.

These results include the recent price increase that National Foods secured from Coles to produce its house brand milk which reduces National Foods' anticipated EBIT losses from this business from loss making to marginally profitable under current distribution arrangements.

While National Foods would like to improve the profitability of its fresh white milk business it has limited ability to impact the largest aspects of its cost base for servicing grocery customers and would be extremely reluctant to place further pressure on farmers. For example:

- The largest element of National Foods' cost base (~54%) is associated with sourcing raw milk from the drinking milk market States. In those States, the price which National Foods pays for its milk reflects return in the domestic regional market. National Foods pays a premium in the drinking milk market States to ensure the quality and consistency of its supply. In the manufactured milk market States, the price paid by processors for manufacturing milk is largely set by international commodity prices and National Foods has no ability to influence or reduce those underlying raw milk prices.

- The second largest category of costs is that associated with distribution of the daily delivery of fresh white milk where National Foods has an industry leading cold chain that it uses to deliver fresh white milk to over 75,000 outlets each day. Reducing costs in this area will directly impact the availability of fresh white milk in the non-grocery channel (and therefore impact consumer access to fresh white milk).

- Recent studies indicate that National Foods has a highly competitive cost of processing, National Foods has a range of investments that will drive efficiency gains in our processing. These include capital upgrades of our processing facilities in Queensland and New South Wales.

Therefore, National Foods believes it has limited scope to reduce costs without significant impacts on the sustainability of the milk industry.

21 The suitability of the framework contained in the Horticulture Code of Conduct to the Australian dairy industry

National Foods understands that the Horticulture Code of Conduct was prescribed as a mandatory industry code to improve the clarity and transparency of transactions between growers and wholesalers of fresh fruit and vegetables.

The key issues that the Horticulture Code of Conduct sought to address were:

(a) a lack of clarity about when a wholesaler was trading as an agent of the grower, or as a merchant, when dealing with growers;

(b) a failure to invest in written documentation of trade, including written transaction information and written trading agreements; and

(c) the need for an effective dispute resolution process, including independent assessment of transactions and compulsory mediation.[7]

For the reasons set out above, these challenges are not faced by dairy farmers.

Further, in the Australian dairy industry, smaller farmers have formed collective bargaining groups which have been authorised by the Australian Competition and Consumer Commission.

As such, the framework contained in the Horticulture Code of Conduct is not well suited to the Australian dairy industry.

22 Conclusion

The decision to reduce the price of house brand milk to $1 per litre have significant and detrimental implications for the sustainability of the Australian dairy industry.

The price reduction by the supermarkets will not generate increased sales of fresh white milk and will not inject any additional revenues into the dairy industry.

Since the price reduction will not generate increased sales of fresh white milk, or inject additional revenues into the dairy industry, it will not benefit any part of the dairy industry. It will not mean that dairy farmers will be able to sell more milk.

Any increase in sales of house brand milk by the supermarkets will only be associated with corresponding decreases in sales of branded fresh white milk - in supermarkets and in the non-grocery sector.

The corresponding decrease in sales of branded fresh white milk will mean that processors and the non-grocery sector will be worse off. Dairy farmers will be no better off, and will likely be worse off.

Processors depend on the revenues they earn from sales of branded white milk to underwrite the costs of their fresh white milk supply chain.

If their fresh white milk supply chain becomes more costly to operate (due to the fall in sales of branded milk), the price of branded milk will increase.

If the price of branded milk increases, more consumers will switch to house brand milk. That will mean that fewer consumers will buy their milk from the non-grocery sector.

If the non-grocery sector becomes worse off, many small businesses involved in the sector may be forced to close, with immediate detriments in their local communities.

7 Explanatory Statement to Legislative Instrument 2006 No. 376 (the Explanatory Statement to the Horticulture Code)

The costs of operating the fresh white milk supply chain will increase and there will be long term upward pressure on prices.

If all of the participants in Australia's dairy industry (including dairy farmers and processors) are to earn reasonable, sustainable returns, the price of house brand milk needs to be substantially higher than $1 per litre.

The long term sustainability of the Australian dairy industry is in the best interests of consumers. Currently, the sustainability of the industry, particularly in the drinking milk states of Queensland, New South Wales and Western Australia, is being threatened. Commercial responses may eventually lead to suboptimal outcomes in these regions. It would be prudent for Government to explore unintended regional consequences of current market activity and to consider whether the current regulatory regime is cognisant of these likely impacts.

Please contact me if you require any further information.

Your sincerely

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Duncan Makeig
Group Sustainability Director and General Counsel