S U B M I S S I O N

to the

Senate Economics Legislation Committee Inquiry into competition and pricing in the Australian dairy industry

Prepared by:
National Association of Retail Grocers of Australia
Suite 9, Level 2, 33 MacMahon Street
HURSTVILLE NSW 2220
Tel: 02 9580 1602

Contact: Ken Henrick

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Introduction

The National Association of Retail Grocers of Australia (NARGA) represents about 4500 independently owned and operated grocery stores in all States and Territories, accounting for about $18 billion of sales annually or about 20 per cent of the national grocery market. Independent grocery stores account for about 57 per cent of employees in the grocery sector on a full-time equivalent basis.

NARGA has long been concerned about the level of market concentration in the retail grocery market, the resultant market power held by the major chains and the impact the exercise of this power has in the grocery supply chain – clearly evident in the dairy sector. Small business minister, The Hon Dr Craig Emerson in his recent media release[1] on competition in the retail grocery sector quoted Neilsen Scan Track data which showed that in 2008 the two major chains had a combined market share of 78% of packaged groceries with Woolworths having a 44% share and Coles a 34% share.

Their dominance of the grocery sector allows these companies to dictate terms to their suppliers and capture a higher proportion of the profit margin available in the total supply chain to the detriment of processors and farmers.

Both companies also have substantial and increasing shares of the markets for liquor, petrol, general merchandise and gaming. The question is whether it is in the national interest for them to continue their current growth trajectory.

The concentration of retail markets results in a capacity of those retailers to increase their prices at a rate greater than they could with normal competitive pressures. The result is higher consumer prices and a greater impact on the CPI than would otherwise be the case.

The level of total retail market concentration can be gauged by a comparison between the ABS retail sales data (August 2009) and the latest available local retail sales data from Woolworths and Wesfarmers. This shows that these two entities together make up 39.1% of all Australian retail sales. It follows that the CPI is captive to their pricing decisions and directly affected by any monopolist profits made by these entities.

That this high market share results in monopolist profits is demonstrated by the fact that Woolworths sales data released each quarter shows profit growth exceeds CPI adjusted store on store sales growth.

Woolworths sales results released this week are a case in point. Woolworths Australian food and liquor division showed a 7.8% year on year increase in sales for the first quarter which translated into 5.8% increase in comparable store sales. Given that inflation for the

[1] 18 September 2009

quarter was 2.1% sales increased at 3.7% in real terms due to a combination of volume, price and margin increases, or at an annualised rate of 14.8%.

A report by the Reserve Bank of Australia[2] highlights the problem. It shows that, whilst the average inflation rate for Australia since 1993 was 2.7%, food inflation on average ran at 4.0% - with a weighting on the CPI of 19%.

Again, in the minutes of the RBA Monetary Policy Meeting on 6 October 2009, one of the reasons given for increasing the benchmark interest rates at that time (as opposed to waiting) was the relatively high level of underlying inflation which contrasted with other developed economies which has seen inflation drift downward to a little below medium term targets.

The question that must be asked is whether Australia's higher level of retail concentration impacts prices, inflation and interest rates – the latter traditionally higher than other developed economies in order to keep inflation under control.

Is it in Australia's interests to further enhance retail market concentration, and if not, how is this to be prevented?

Impact on the Dairy Industry

The market power of the two major supermarket chains has been used to devastating effect within the fresh milk market. It has resulted in the transfer of a substantial portion of market share from branded product to private label product.

During the recent ACCC grocery inquiry we put the following information before the Commission:

'Data from Dairy Australia[3] shows how changes in milk pricing confirm that a 'waterbed effect' has developed since dairy deregulation occurred in 2000.

The reports show that in 2000/01 the supermarket sector sold 1,016 million litres of milk, comprising 591 million litres of branded product and 425 million litres of private label product.

By 2005/06 (latest data available) supermarket milk sales had grown to 1,180 million litres (in a relatively static milk market), with 531 million litres of branded product and 650 million litres of private label product.

This suggests that private label sales had grown from 41.8% of sales to 55.1% of sales.

[2] Trends in Relative Consumer Prices – Reserve Bank Bulletin July 2009
[3] Dairy Industry in Focus: 2003 and 2006, Dairy Australia

During that period, the average shelf price of branded regular milk has increased from $1.27 per litre to $1.52 per litre – an increase of 25c per litre or 19.6%, whilst the price of private label milk increased from an average of $1.06 per litre to $1.11 per litre – an increase of 4.7%.

Prices for branded regular milk in indicative markets have increased by a further 30c per litre since that time.

The data clearly suggests that the low prices paid for private label milk are being supported by higher prices in the branded milk range, giving large supermarket chains a competitive advantage at the expense of smaller stores.

Another way of putting this is that every consumer that buys a branded milk product is subsidising the purchase of a private label milk product – or that the consumer benefit of lower priced private label milk is achieved through the consumer disbenefit of higher priced branded milk – and higher average milk prices.

The absence of price discrimination legislation allows such a situation to develop.'

The ACCC, in its investigation of the milk supply chain did refer to our information and concluded that: *'...the MSC bargaining power for the supply of private label products means that increases in production costs are not being fully reflected in wholesale or retail prices for private label milk.'*[4] - admitting that the price divergence is reflective of *'the buying power of the majors'*[5]

The above conclusion is another way of saying that branded milk purchases are subsidising private label milk purchasers and the supply chain is being squeezed for margin.

The resultant effect on the dairy supply chain is that the MSCs gain a larger share of the fresh milk market through their sale of private label products as well as a proportionately higher margin.

Processors need to stay viable and can respond in several ways:

- Reduce prices paid to farmers to a minimum
- Increase the wholesale price of branded milk
- Increase the wholesale price of milk to independent supermarkets and the route trade
- Increase their margin on other dairy products (making them more vulnerable to import competition

[4] Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries, ACCC, Commonwealth of Australia, July 2008, P. 238
[5] Ibid, P.353

Further evidence of the effect of market concentration on the retail prices paid for milk was provided to the ACCC inquiry as follows:

In a deregulated market, milk prices that used to be set by regulation, can now be set by retailers. This section examines what has happened to milk prices since deregulation in July2000, using current WA consumer pricing as a case study.

MILK PRICES IN WA – FEBRUARY 2008

	Reg			Hi Lo		
	Coles	W/Worths	IGA Glen	Coles	W/Worths	IGA Glen
Brownes						
3ltr	4.59	4.31	4.78	4.59	4.57	5.04
2ltr	3.40	3.40	2.99	3.26	3.26	2.99
1ltr	1.90	1.90	1.49	2.04	2.04	1.49
Masters						
3ltr	4.69	4.69	4.59	---	4.57	4.98
2ltr	3.47	3.47	3.44	---	3.48	3.48
1ltr	1.99	1.99	1.73	---	2.11	1.73
Home brand						
3ltr	3.79	3.79		4.29	4.29	
2ltr	2.59	2.59	2.69	2.99	2.99	2.69
1ltr	1.48	1.48		2.11	---	
Harvey Fresh						
3ltr	5.10	5.04	4.19	5.10	4.49	4.19
2ltr	3.55	3.50	2.99	3.65	3.59	2.99
1ltr	1.85	2.04	1.80	1.80	2.04	1.80

Black & Gold milk – 2L was priced at $2.59 – for both regular and low fat varieties.

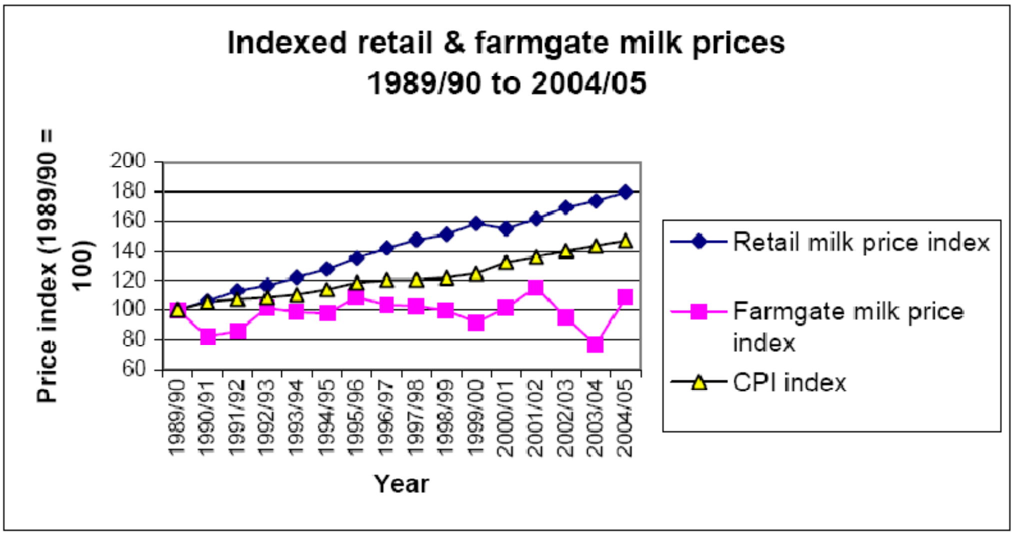
The following questions arise:

- *Why do the major chains charge up to 20c per litre more for their low fat varieties than they do for whole milk?*
- *Why can independents sell the most popular size (2L) of milk at a lower price than the major chains?*

- *Why is there such a significant difference between branded and 'house brand' prices, which come off the same filling line and are in identical packs?*[6]

Dee Margetts, in a paper on dairy market deregulation[7]*, submitted to the current inquiry, draws a number of conclusions:*

- *'It is clear that major retailers have gained sufficient market control of the retail milk market that they can, where required, discount generic brand milk as a loss leader….'(p.80)*
- *'….average milk prices in Australia continue to climb at a rate which exceeds CPI, whilst farmgate prices have fluctuated but generally remained low…' (p.81) – See graph below.*



Data sources: ABS, ABARE 2005d [69]

- *'On the retail level, there is no question that the sector is more concentrated than ever before, and it is argued that the oligopsonistic power that this provides has been to the detriment of Australian dairy producers…' (p.82)*
- *'…as strong co-operatives appear to be necessary to retain a reasonably healthy bottom line in farmgate prices, their future loss in the face of increased retail dominance is likely to be significant.' (p.82)*

Ms Margetts has not examined the question of margins in her paper, but light is thrown on that matter by a recent study conducted at the University of Oxford[8]*, which clarifies where the bargaining power lies in price negotiations.*

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[6] Pricing differentials between branded and 'own brand' milk are greater in east coast states.

[7] Competition Policy: What's that got to do with the price of milk? – Dee Margetts, UWA Business School, Australian Global Studies Research Centre

[8] The Milk Supply Chain Project, Smith H. and Thanassoulis J. University of Oxford, Jan 2008 for DEFRA and MDC

The study provides evidence that the UK supermarkets held the majority of the bargaining power in the supply chain and end up with nearly 90% of the total available supply chain margin – the remaining being shared between the processor and the farmer.

Farmers are in the weakest position and are only able to secure about 3% of the total supply chain margin.

Whilst the study refers to the UK market for milk, it should be recognised that both the retail and processing sectors in Australia are markedly more concentrated[9], which suggests that the power relationships here could be even more skewed.

Milk prices at retail have increased substantially since deregulation – at a rate substantially greater than farmgate prices. The gap between branded and generic (own brand) milk has also increased.

A number of questions arise:

- *Why has the price of milk to consumers increased at a rate greater than the rate of increase of farmgate prices?*
- *Is the margin within the supply chain increasing and where is the additional margin being taken?*
- *What is the basis of the price differential between branded and generic milk? (It cannot be reflective of volume purchasing benefits as fresh milk is a 'direct delivery' item – i.e. branded and generic milk are delivered to the store on the same truck.*
- *To what extent is the lower price of generic milk attributable to supermarket buyer power?*
- *To what extent has the lower price paid for generic milk resulted in higher prices being paid for branded milk?*
- *Has this dual pricing approach by processors resulted in an overall increase in the average retail price for milk?*
- *Is the 'waterbed effect' operating in the milk market?*

The 'waterbed effect' has the following characteristics:

- *Major chains use their buyer power to demand a lower price for a particular product (e.g. generic milk) – a price that could be below the cost of production.*
- *The producer needs to charge a higher price on the balance of that product's sales (branded milk) in order to stay viable.*
- *The result is that the major chains have a substantial price (and margin) advantage over non-chain competitors and are able to sell the generic product at a lower price than the branded product.*
- *The higher price placed on the branded product allows the major chain to increase the price for the generic product.*

[9] Woolworths and Coles at near 80% of the market compared to the top five chains in the UK with a combined 80% share.

- *The result is that retail prices have increased across the board, and the average retail price paid by the consumer is substantially higher than it was before the discounting of the generic product started.*

None of the questions raised were addressed by the ACCC in the report on the grocery inquiry.   However the ACCC drew the following conclusion in relation to buyer power:

'The inquiry was provided with little evidence to substantiate allegations of buyer power being exercised in an anti-competitive or unconscionable manner. Having said that, however, there were some complaints of buyer power being exercised where the complainant appeared to be genuinely reluctant to provide information to the ACCC out of concern about retribution if details were provided to the ACCC and investigated. ' and -

'MSCs generally buy products on better trading terms than other buyers, and those trading terms have generally become more favourable over time. '[10] and –

'*Confidential information provided to the inquiry indicates that increased payments from suppliers (in conjunction with a number of other factors) are assisting retailers to raise their gross profits.'*[11] and

'*Competition is not sufficiently strong at the retail level to ensure that consumers always benefit from buyer power in the form of lower retail prices.'*[12]

The ACCC did not agree that a 'waterbed effect' existed '*either in relation to groceries generally or milk in particular'*[13] suggesting that suppliers did not have the capacity to recover or make up any margin losses by increasing prices to other customers and explains the ongoing viability of suppliers (in the case of the dairy industry – the processors) in terms of '*changes in the structure of upstream sectors as a result of consolidation and rationalisation. These changes will often improve a suppliers bargaining strength and thus enable the supplier to negotiate more favourable prices.'*[14]

This does not appear to have happened in the dairy sector. The ACCC explains why in another part of the report:[15]

> Unless a supplier of a product has a powerful brand (or is able to build such a brand) which the MSCs perceive as important to a category, the terms that can be negotiated with the MSC will tend to favour the MSC and from the supplier's perspective may erode over time. This broad, but not universal, trend is reflected in the ACCC's analysis of supply terms over time.[4] Further, in some cases, the MSCs were able to shift costs to suppliers and effectively unilaterally alter the terms on which goods are supplied, even after delivery.

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[10] Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries, ACCC, Commonwealth of Australia, July 2008, P. 357
[11] Ibid, P. 352
[12] Ibid, P. 325
[13] Ibid, P. 354
[14] Ibid, P. 354
[15] Ibid, P. 480

Woolworths MD Michael Luscombe recently confirmed that they have the power to push supplier prices down in an article in the Australian Financial Review[16] where he stated that he would be pushing for suppliers who had benefit from the higher value of the Australian dollar to pass on to Woolworths the benefits of any savings. Whilst claiming that 'it is our responsibility as agents for the customer to do that' the available evidence suggests that a substantial proportion of any price reduction stays with the major supermarket chains in the form of additional margin.

Conclusions

- NARGA believes that the abnormally high level of market concentration in the retail grocery sector has enabled the major chains to exercise market power to the detriment of the remainder of the dairy supply chain and consumers.

- Whilst consumers have benefited from the reductions in the price of generic milk, these have come at the expense of higher prices elsewhere.

- NARGA believes that the Trade Practices Act 1974 (the Act) in its current form is not capable of addressing the power imbalances between the major retail grocery chains and their suppliers, and the practices that flow from that imbalance. The Act needs to be changed to ensure that the ACCC has adequate powers to arrest further concentration in the sector and any anti-competitive behaviour that flows from the high degree of market power currently held by the major supermarket chains.

- At a minimum these changes to the Act need to include the promised 'Creeping Acquisition' amendments and a restoration of Section 49 which will allow the regulator to deal with price discrimination matters and help address the power imbalance between suppliers and the major chains.

[16] 'Woolies to squeeze suppliers for lower prices', AFR 22 October 2009, P.19