Senate Dairy Inquiry Submission **by Dee Margetts**

Who am I and what is my interest in this dairy inquiry?

I consider that this inquiry is vital, as long as the Committee and Secretariat are prepared to look carefully at the evidence that is available.

I am a former Senator (1993-1999) and a former Upper House Member for the Western Australian Upper House for the Agricultural Region (2001 to 2005). National Competition was introduced into Federal Parliament during my time in the Senate and I have been monitoring its outcomes ever since.

When my senate term ended in 1999, I commenced research for a Masters' thesis [1]at Murdoch University. I successfully completed my thesis in 2001, the year I was elected to the Western Australian State Upper House as an MLC for the Agricultural Region.

I am currently undertaking research for a PhD at UWA as part of the UWA Global Studies Research Centre. My PhD Research is on the real outcomes of National Competition Policy and my first major Case Study was in the impacts of NCP on Australia's dairy industry. This case study has had 3 academically reviewed publications (attached).

Introductory comments

Prior to discussing the impacts of pricing changes in the Australian dairy industry, it is useful to discuss how some of these price impacts have developed so the Committee can consider what recommendations to make.

As can be seen from my attached published papers, prior to dairy deregulation, unlike manufactured milk, the price of market milk was negotiated by a range of industry representatives and government bodies. The Hawke/Keating Labor Government assumed this was inefficient so amongst a range of other targets, they accepted the call from the Corporate focussed Industry Commission for farm gate deregulation for the abolition of a range of state-based Statutory Marketing Authorities.

The basis of the Hilmer Report, leading to the introduction of National Competition Policy (NCP), was the Industry Assistance Commission's Inquiry in the late 1980s on Government Non-Tax Charges which was NOT focussed on benefiting consumers or workers but on their assumption that it would reduce the costs (and increase the profits) of corporations in Australia. [2]

Leading up to the introduction of NCP, Paul Keating assumed that if Australia "globalised" and deregulated its internal economy, the rest of the world would be so impressed that they would follow in Australia's footsteps. This has not happened. If fact, since then, those Australians who were pushing the World Trade Organization to

[1]Margetts, D E, 2001 "*Competition Policy, State Agreement Acts and the Public Interest*."
[2]Margetts, Dee, 2007, "*Competition Policy, What's that got to do with the price of milk*?" p 10.

call for an international NCP agreement have failed in their efforts and NCP-type negotiations have been removed from the WTO agenda.

In Australia, one reason for the removal of Statutory Marketing Authorities in a range of agricultural sectors was the long-held assumption that the majority of Australia's agricultural production was exported i.e. so even if Australia's farm sector lost significant market power in the domestic market, the potential benefits to Australia's export sector IF the rest of the world complied with the same type of policy change, could be significant.

This assumption has been challenged by Pat Byrne from the National Civic Council whose submission to the ACCC inquiry included a published academic journal article which concluded that only around 30% of Australia's agricultural produce is exported. Pat Byrne's submission to the 2008 ACCC Grocery Price Inquiry stated that the Agricultural data specialists within the ABS also agreed with his findings and this was confirmed in a special forum hosted by the Queensland National Party in which he says those ABS data specialists participated.

The potential significance of Pat Byrne's publications for this inquiry is that the push for dairy farm gate deregulation coincided with the promotion of the term "international competitiveness" and was based on the assumption that the majority of Australia's agricultural produce was exported. It is vital that this inquiry investigates Pat Byrne's conclusions because the assumption that most of Australia's primary produce is exported has been the basis of Australia's most significant socio-economic policy changes, such as NCP and the continued push for "free" trade.

Whether Pat Byrne's agricultural export data conclusions are correct or not (and they should be properly checked out) whilst around half of Australia's milk production is exported, generally as milk powder, the VALUE of Australia's domestic dairy production should be compared in its dollar value to our dairy exports, not just its farmgate volume. Therefore, the policy changes concentrating on dairy exports did not take into consideration the impact on both dairy producers and the dairy processing sector in Australia. These issues are discussed in some detail in my attached publications.

The Dairy Case study for part of my PhD shows that not only have dairy producers in the market milk sector of the Australian dairy industry been seriously damaged by deregulation but the extra market power for grocery retailers has negatively impacted a large portion of what used to be Australia's dairy manufacturing sector. Even the former head of the ACCC, is quoted as admitting that dairy deregulation has forced substantial amalgamations and reduced the number of dairy processors in Australia:

The NSW Farmers Association cited the Chairman of the ACCC in 2000, Alan Fels, describing how consolidation followed deregulation in areas such as the dairy industry…"

"…*According to Fels, consolidated processors provide retailers with lower transaction costs, more significant volume discounts, improved brand recognition and promotions, improved service and product support, uniformity in store layout and* *stock, and greater control/accountability regarding supply chains and product quality*." (2008, NSW Farmers Org, Sub p 24)

However, they say the restructure and consolidation in the wholesale, retail and manufacturing industries has put a lot of pressure on the other suppliers in the food chain, as illustrated in Figure 7 entitled, "*Pressure Points in the Value Chain*" Ibid, p 25)

It can be challenged, however, in the dairy industry sector, that the consumer has been the main beneficiary, as was a publicly stated assumption of Government bodies such as the ACCC and the National Competition Council.

My research shows that since dairy farmgate deregulation, farmgate and retail dairy prices in Australia have become disconnected and the large cuts in farm gate prices for market milk have been artificially linked to "international milk prices" even though there is no one international milk farmgate price and the prices paid to Australian dairy farmers have been amongst the lowest in the world of international dairy exporters. This has meant that local market conditions have often been ignored despite the growing costs for Australian dairy farmers in times such as drought.

Price discrimination and the dairy supply sector

Another major impact on the dairy industry has been the removal of the Price Discrimination provisions of the Trade Practices Act, which as NARGA explained in the 2nd part of their submission to the 2008 ACCC Grocery prices inquiry, has enabled the major supermarket chains to force their milk suppliers to supply their home brand milk at a considerably lower cost than for branded milk, which, as NARGA suggests, seems to result in a "waterbed effect" and growing price differential between branded and generic products.

The ACCC did admit that one milk processor did indicate that the prices of branded milk:

"*Have sometimes been increased to offset the overall cost increases both for branded and housebrand products*.") (ACCC 2008, p 291)

This does indicate that at least one milk processor has given evidence that the "waterbed effect" for branded milk does exist. The ACCC said other processors apparently stated that they did not "generally" engage in the practice of increasing the price of branded products to offset the cost increases in producing private label products, BUT it may not be so much a reaction to "cost increases" as much as wholesale price reductions for home brand milk products for the MSCs.

The following is a quote from the NSW Farmers' Association submission (No 155) to the 2008 ACCC Grocery prices inquiry:

Q 52. Answer – "*There is a degree of implied market power that runs within the grocery supply chain that although it may not be directly visible, it still plays a part in returns and arrangements. For example, in the dairy industry the fresh milk market in NSW is dominated by two processors. At the time of deregulation, these processors* *competed with each other to achieve contracts for generic milk with the retailers. A contract with the major retailer provides volume of through put and also allows them to sell their higher margin branded milk. In competing for the retail contracts processors reduced their prices to the point where they could not provide sufficient returns for farmers who were supplying the milk. While this would appear beneficial for the customer the rationalisation of the industry has not meant that prices have had to increase at levels higher than the regulated market as processors now compete for milk from farmers*." (Ibid p 14)

In the response to the ACCC Issues paper question No 73, the NSW Farmers Association submission also explained how the MSCs can use their market power to put such pressure to achieve major price differentiation for their generic milk to attract more general customers:

"*Aggressive pricing is most evident in regards to the supply of the supermarkets' generic ("own brand") lines. According to a Financial Review article, these now represent 11 percent of all consumer stock and their aim is to increase this to 50 percent to cater for the consumer preferences for price over brand loyalty. In some cases, the generic produce is identical to the branded label (e.g. milk and eggs) and in other cases there is a quality differential. Supermarkets are able to obtain a particularly low supply price for its generic produce by the commercial attraction to suppliers of:*

(i) *being able to supply a large volume of produce over an agreed period; and*

(ii) *being able to access supermarket shelf space for branded products. Such access is only available to suppliers who also supply the produce for the generic label. For example, the supermarket will not stock the branded milk unless the company also supplies, at lower price, milk for generic marketing. Such access to valuable, and limited shelf space is critical to the intermediaries' commerce*." (NSW Farmers Assoc Sub p 18)

And as the NSW Farmers Organization indicate, the impact on the dairy supply sector is so great because the use of generic brand milk is so dominant, that it can puts processors and suppliers of branded products in a very difficult position:

"*The Dairy industry is one of the key industries where the dominance of generic private label products is clearly evident. The mix of a highly perishable commodity product with high constant demand makes it very difficult to differentiate and therefore very easy to compete on price rather than quality characteristics. This is perfectly suited to the fresh milk market*."

"***It is understood that processors must first win the generic contract in order to gain shelf space for their own label in the fresh whole milk category**. The shelving arrangement then places the labelled product next to the generic brand, albeit usually in a position slightly out of the line of sight. When two product are exactly the same (in many cases they come out of the same factory) apart from the label the consumer will usually choose the product that is $1.18 a litre rather than the $1.88 a litre product."*

“It is also understood that contract to supply generic labelled products are very tight and with very few opportunities to vary any arrangements through the life of the contract which could be three years. This in turn places limitations on the processors to vary their conditions back to farmers. The only opportunities processors have is to vary the pricing of their own branded milk which in turn increases the disparity between generic brand and labelled milk.” (emphasis added)

(NSW Farmers Org ACCC Sub (p 19)

It is relevant to include here some quotes from a report which was produced as part of the Coles Submission to the 2008 ACCC Grocery Price inquiry as it confirms firstly that MSCs are pushing to reduce their costs and increase their margins (which accounts for the widening gaps between farmgate and retail pricing in much of Australia’s fresh produce sales, and the claim that the greater use of homebrands is to increase MSC margins, which means that if they are selling the SAME milk and creating GREATER margins, their forced wholesale prices for their homebrand products MUST be investigated.

(Paragraph 39 from the Freshlogic Report:

“*Each of the major Australian grocery retailers has sought to address the constraints of “same store” business activity through a number of strategies aimed at improving absolute gross margins while reducing the cost of doing business, as well as enhancing the group ROCE on shareholders’ funds*” (2008, Coles Submission p 26).

(Paragraph 42 from the Freshlogic Report on private label to add to the dairy inquiry submission)

“*Private label plays a critical role in a number of areas for the FSS grocery retailer and a number of independent banner groups such as:*

- *category management*
- *extension of the parent brand, benefiting from the promotion of the parent brand*
- *driver of loyalty as providing exclusive access to that product which is not available in other retailers*
- ***improving gross margin returns***” (p 26 of the Coles’ Submission) (emphasis added)

If the dairy supply chain post-deregulation was actually fair and competitive, suppliers could shift their supply curve if input costs increased, but if they find this difficult because their decreased market power and the increased market power of the MSCs, both the producers and the processors will be finding it more and more difficult to operate in a sustainable manner or even their most cost-effective manner.

Role of the ACCC

Leading up to the farm gate deregulation of the Australian dairy industry in 2000, the ACCC were commissioned to monitor Australia’s dairy retail and supply chain’s post-deregulation margins. However the time over which this monitoring took place was insufficient and this Committee inquiry should consider recommending that the ACCC be required to use their Prices Surveillance powers more regularly to monitor the margins in all parts of the dairy supply and retail chains.

The significance of the dairy section of the ACCC grocery price inquiry (and its implications for other aspects of the ACCC's responses regarding Australia's agricultural supply sector….

ACCC focus on "regular milk" misleading

In Chapter 12 of the ACCC's 2008 Grocery Price Inquiry Report, ("Cost Contributors in the Supply Chain") they begin by stating:

"*The ACCC has been asked to consider all aspects of the supply chain in the grocery industry in this inquiry, including the nature of competition in the supply, wholesale and retail levels*."

But they then add, "*The ACCC could not investigate in detail supply chains for all relevant grocery items in preparing this report. Accordingly, the ACCC has undertaken case studies of cost contributors in the supply chain for a number of standard grocery items…*"

For the dairy supply chain, the ACCC chose only to include a "case study" of "*white full cream drinking milk*". This provides a significant challenge to the ACCC inquiry's "findings" on Australia's milk supply chain, because of all of the milk produced in Australia, in 2006/07 <u>only 23%</u> of it was used for drinking milk (35% cheese, 23% skim milk powder/butter, 11% wholemilk powder, 3% casein/butter and 5% "other"). (Freehills, *Public Submission to the ACCC Inquiry by National Foods*, 14 March 2008, p 6)

But National Foods submission also provide data to show that of the sales of drinking milk in Australia, "regular" milk accounts for just over half of the quantity sold, other types being reduce fat, low fat, flavoured, and UHT. [3]

Similar to bananas, "Regular" or full cream milk is far more likely to be used by retailers to attract customers (more than the other low fat, flavoured or UHT varieties), so the price rises for "regular" full cream milk in the post deregulatory environment have tended to be on average far lower than reduced fat, flavoured and UHT milk, and, in addition, my research into the dairy industry has found that the price increases for manufacturer dairy product such as cheese rose considerably after dairy farmgate deregulation despite the stated prediction the Productivity Commission (who were a major pusher for dairy farmgate deregulation), that the prices for manufactured dairy products would fall after farmgate deregulation. (Margetts 2007 p 74)

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[3] Just over half of 23% means that they inquired into only around 12% of Australian dairy production, and they did this far from effectively.

As mentioned above, the use of MSC market buying power to purchase wholesale homebrand milk at a price considerably lower than branded milk, has therefore been used to try to attract more customers to the MSCs, but the ACCC should have also looked at the overall **average** milk and dairy retail price increases to assess whether the gap between farmgate and retail dairy prices has been significantly growing, given that "regular" milk in 2006/07 accounted for under 12% of Australia's milk production. (Freehills, 2008, National Foods submission…, p 6)
And, not surprisingly, in their "milk case study", the ACCC totally left out any mention of the evidence that I provided them).

National foods' ACCC submission also includes a graph which shows that although just over 50% of Australia's "regular" milk is sold in supermarkets, over 70% of reduced fat milk and nearly 80% of UHT milk are sold in supermarkets, and the overall total shows that the sales of ALL milk varieties are a higher percentage than for just "regular" milk, so to leave the price data out for overall milk sales makes no sense.

In the "Freshlogic" section of the Coles (submission No 157) to the 2008 ACCC Grocery Pricing inquiry, they have confirmed the volume and retail pricing impacts of their generic milk sales push:

"***Over the past decade the returns from the packaged milk sector have been strongly influenced by the strength of private label growth. Aggressive price competition has seen a widening of the price gap between the proprietary and private brand prices in supermarkets***." (Coles, 2008, p 77) (OR Duopsonistic buying power by the MSC's that requires milk suppliers to supply very low price generic milk below cost if they wish to be allowed to sell their branded varieties of milk, which then have to be at a waterbed price in order for the milk suppliers to survive and for them to be able to pay milk producers.)

They said "***In the 3 years from 2004 to 2007, the average supermarket selling price per litre across the full packaged milk category increased marginally from $1.34 to $1.40 within the milk product range, however, there are vastly different product options and unit prices***". (Ibid, p 77) (i.e. low fat and flavoured milk etc is much higher in price even through its production cost is not – see below)

"***Average selling prices also vary between private label and branded products. The average per litre price for the entire milk category sold in supermarkets in private label products was $1.18 in 2006/07 whilst branded products averaged $1.88.***"

"***There is however far greater product differentiation and specialisation in branded lines in respect of low and reduced fat lines, calcium enriched products and flavoured milks which increase the average unit selling prices achieved across the category***." (Ibid, p 77) (This is a very strong reason why the ACCC should not have limited their milk pricing analysis simply to while whole fat milk, because all it did was look at generic prices vs branded prices instead of what has been happening to the milk supply sector)

"***Branded products across these lines are generally priced at levels 30-35% higher than private label lines, which over time has seen more share of sales volume drift***

to the private label." (That is not the least surprising, and this means that the wholesale prices for private label milk over the past few years for MSCs MUST be investigated, because this strategy and use of market power will be making the situation for both milk processors and milk producers worse and worse.)

"***Packaged milk products are now used in many segments of the non-supermarket retail sector as a loss leader – to attract customers to make other store purchases***." Ibid, p 78) (But the market buying power of the MSCs means they keep their whole milk prices lower at the expense of both milk producers and processors, and retain their own margins!!)

Farmgate Prices

As part of the Coles' submission to the 2008 ACCC Grocery Price inquiry, the report commissioned by Freshlogic says the "*…farmgate milk prices in southern Australia, which produces about 75% of milk, are directly determined by export market returns*." (Coles ACCC Submission p 76)

"*The end-product use of milk differs across the various milk production regions as shown in Figure 9.17. Farmgate prices are determined by different factors in each region*." The Graph, "*Proportions of milk in production groups*" which shows that Victoria has the lowest proportion of drinking milk and Queensland is the highest, followed by WA. They also include a table of state by state farmgate prices:

Farmgate average per region (c/litre)

State	Vic	Tas	SA	NSW	QLD	WA
2008	48	47	48	47	51	43
2007	32	36	33	36	39	32

(Source: Dairy Australia, Freshlogic) (Ibid p 76)

Freshlogic say "***The mix and efficiency of end-product use has a major bearing on the relativity of farmgate prices over time***. ***The strong rise in export returns in 2007/08 has closed the traditional gap between average southern region pricing (Victoria and Tasmania) and those for fresh milk regions of Queensland and NSW,*** (It was actually Competition Policy driven farmgate deregulation which "closed the gap"!!) ***but farmgate prices in those regions are rising due to the concerns held by processors regarding long term milk security given the strength of local fresh market demand from consumers. WA prices are lower than the Eastern States comparables due to the milk supply which is in excess of fresh market requirement yet insufficient for scale product manufacturing.***" (Ibid p 76) (This last statement is wrong because of the growing WA milk shortage, NOT OVERSUPPLY – As this is mostly drinking milk, the question needs to be asked as to how much retail price pressures are having a major negative impact on the WA farmgate milk prices and the sustainability of the sector)

The ACCC Grocery Price Inquiry Dairy Chapter

Quote from ACCCs Grocery Price Inquiry Submission No 129 (NARGA's Submission Part 2)

"*There is no doubt that the independent sector suffers from the waterbed effect on pricing."*

"An example is the price increase of 2L of milk in WA stores by up to 25% in the last 6 months, while the supply of house brand milk has not increased by the same. The cost of procurement of the milk and processing of it is the same, branded or house branded." (NARGA Submission 2 p 66)

Question 57: Estimate the differences in wholesale costs faced by smaller and independent retailers compared to the MSCs**.**

"*Across the board do not know, but in the case of milk could be a 45% difference in price charged for house brand milk compared to the milk that the supplier would like us to sell. No doubt the supplier cannot afford to sell all milk at the lower price so this must be the waterbed effect*." (NARGA Submission 2 p 67)

Conclusions

The reason I undertook research into the dairy industry is that it was one of the clearest examples of increasing market power for corporations whilst reducing market power for primary producers and other participants in Australia's food supply chain.

Dairy farm gate deregulation as well as the removal of the Prices Discrimination provision from the Trade Practices Act have both had significant impacts on the dairy supply sector, but the manner in which National Competition Policy was implemented meant that there was NEVER any requirement to check wether the assumptions of "Public Interest" were correct.

On the contrary, the National Competition Policy roll out is continuing largely unchecked. Even those sectors where even the National Competition Council and the Federal Treasury agreed that regulatory control remains in the public interest continue to be regularly challenged, whilst most of those sectors where corporate market power has been enhanced via NCP deregulatory changes have largely been left unchecked.

I am more than willing to come before the Senate inquiry to give evidence and answer any questions you wish to ask me regarding the research I have undertaken or the conclusions I have reached.