Chapter 3

The price of milk

Retail prices

3.1 The Australian grocery market is dominated by the two major supermarket chains, Coles and Woolworths. They have a combined market share in the total grocery market variously estimated at 55–80 per cent.[1] Their market share for drinking milk is somewhat lower, perhaps 50 per cent, reflecting the large numbers of milk bars and convenience stores which also sell milk.[2] However the major chains still dominate the retail pricing of milk, as their 'deep pockets' would deter small local stores from starting a 'price war' for milk.

3.2 The major supermarket chains sell milk in two formats: 'generic' milk (also variously known as 'home brand', 'store brand' or 'private label'[3]) which usually carries the name of the supermarket selling it and 'branded' milk which usually carries the name of the processor.[4] Taking the common two–litre container of standard full cream milk in a major suburban supermarket,[5] a typical price is around $1.75 per litre for a branded product and $1.25 per litre for a generic. Just over half of the milk sold in Australia is now generic (Table 3.4 below).

3.3 The labels on branded milk (and other branded products) tend to be more colourful and there is pervasive advertising, designed to create the impression that the branded milk is a superior product. Under questioning by the Committee, the processors and retailers, somewhat reluctantly, conceded that the branded and generic (full cream) milk were in substance the same product:

> Senator MILNE—… Is there any difference between a litre of full-cream milk that is branded and a litre of full-cream milk that is a home brand?

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1 The ACCC observe 'regular statements being made by industry commentators that the two largest retailers, Coles and Woolworths, account for 80 per cent of retail sales', but their own view is that they 'account for between 55 per cent and 60 per cent of consumer expenditure on grocery items'; *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, pp 45-48. A media release by Dr Emerson (18 September 2009) refers to the two chains having a combined 78 per cent share of packaged groceries.

2 Mr Dunn, Woolworths, *Committee Hansard*, 4 February 2010, p. 38. The Queensland Dairyfarmers Organisation puts the share of the two major chains at 57 per cent; *Submission 30*, p. 8.

3 Examples include You'llLoveColes, Homebrand, Smartbuy and Black & Gold.

4 Examples include Pura, Dairy Farmers, Pauls, Harvey Fresh, Canberra Milk, Norco and Brownes. Some of these are the names of formerly independent processors which have been retained when they have been taken over by large foreign companies.

5 Coles told the committee that the 2 litre pack is the biggest seller (Answers to questions on notice, 12 February 2010) and casual inspection of supermarket shelves supports this.

> Mr Brennen—No. The national health standard…sets the standard and you cannot adulterate white, liquid, fresh milk. You can take a bit of the cream out and standardise it. You cannot put protein in—it is illegal and it will not be done anywhere in Australia.[6]
>
> Senator COLBECK—… the stock standard Pura milk in the blue carton, versus the generic Woolworths brand or the generic Coles brand. What is the difference in the products?
>
> Mr O'Malley—To the best of my knowledge they are broadly the same.[7]
>
> Senator MILNE—… Is there any difference in a generic brand, a house brand product in the fresh milk market in the same category? Let's say we are talking about full-cream milk. Have we got exactly the same product in the packet, whether it is branded or non-branded?
>
> Mr Mara—…They may have some minor specification differences…
>
> Senator MILNE—So as far as you are concerned the home brand product and the branded product are exactly the same and if there are additives added or anything changed, that is not something you know about or have specifications for?
>
> Mr Mara—We may have specifications. I am not the buyer of the milk, but if there are different specifications that we have, we are happy to share them with you.[8]

3.4 The perception of a difference between generic and branded milk, however, allows the retailers to engage in price discrimination. The market is segmented into the more price-conscious/ lower income/ better informed consumers who buy the generic product and the less price-sensitive/higher income/ status conscious consumers who buy the branded product. The latter are then charged a higher price for their milk.

3.5 Prior to the repeal of section 49 of the *Trade Practices Act 1974*, corporations were prohibited from discriminating between buyers of goods of like grade and quality in relation to the price of those goods if that discrimination was of such a degree or a recurring or systemic nature that it would have the effect or be likely to have the effect of substantially lessening competition in the market.[9] Section 49 was repealed in 1995; the view at the time being that price discrimination would still be able to be regulated under other provisions of the *Trade Practices Act 1974* for

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6 Mr Brennen, Challenge Dairy, *Committee Hansard*, 29 January 2010, p. 7.

7 Mr O'Malley, National Foods, *Committee Hansard*, 18 January 2010, p. 89.

8 Mr Chris Mara, Adviser, Government Affairs, Coles, *Committee Hansard*, 4 February 2010, pp 3–4.

9 Steinwall, R., *Annotated Trade Practices Act 1974*, 2004 Edition, Reed International Books, paragraph 71,805, p. 188.

example, sections 45 and 46 of Part IV.[10] (The issue of price discrimination is covered in more depth in Chapter 4.)

3.6 It was suggested to the Committee that the differential between the branded price and generic price (ie the extent of price discrimination) is higher for milk than for other products:

> That 33 per cent difference does not occur in any other generic product…[11]

> …of all the home brands of products which are shelved in the supermarket, milk appears to be the one with the highest margin.[12]

3.7 Table 3.1 shows the differences between branded and generic versions of a range of products. In many cases there are now two generic versions. From this admittedly small sample, the price differences between the generic and branded product do not seem larger for milk than for other products (although there may be larger quality differences between generic and branded products for other goods).

Table 3.1: Generic price as per cent of branded product price

Major supermarket chain, Canberra, 6-12 March 2010

Milk	57-67	Toilet paper	54-72
Butter	52-80	Pasta	26-73
Yoghurt	76-92	Corn flakes	57-86
Cheese (cheddar)	61-86	Weetbix	42-83
Bread	28-69	Tuna	30-92
Sugar	45-75	Tomatoes (diced)	41-65
Flour	37-84	Beetroot (sliced)	43-66
Juice (fresh)	28-47	Baked beans	43-70
Juice	54-70	Soda water	53

Source: Secretariat.

The demand for milk

3.8 The total demand for milk is quite stable and predictable. The demand for milk at an individual store or chain may be more elastic to the extent that customers are able or willing to shop around. While milk is only one of a large number of products sold by supermarkets, it is a staple product that most customers buy.

10 Steinwall, R., *Annotated Trade Practices Act 1974*, 2004 Edition, Reed International Books Australia Pty Limited trading as LexisNexis, Australia, 2004, paragraph 71,805, p. 188.

11 Mr John Cummings, National Association of Retail Grocers of Australia, *Committee Hansard*, 4 February 2010, p. 14.

12 Ms Nola Marino MHR, *Committee Hansard*, 29 January 2010, p. 9.

Supermarkets then need to think about whether high milk prices may deter customers from shopping at the store and thereby lower overall sales.

3.9 A UK study found that, once in a given store, the own–price elasticity of milk is -0.6. (By comparison, the demand for other goods is around -1, suggesting milk has a relatively inelastic demand.) As milk constitutes around 5 per cent of the value of the average British supermarket shopper's basket or trolley, the effect of milk prices on the choice of store is not large, but including this effect raises the total elasticity to -0.8.[13]

Competition

3.10 As well as the elasticity of customer demand, the retail price will depend on whether there is any collusion between supermarkets. A UK study concluded that supermarket prices for milk there were consistent with what estimated elasticities would imply would occur in a competitive market.[14] This may not necessarily translate into the Australian environment as the UK has many supermarket chains with a significant market share whereas Australia has essentially only two. As noted in Table 3. 6 below, retail prices for branded milk are higher in Australia than in the UK.

Variations in retail prices

3.11 Retail milk prices differ across states, as discussed further below (Tables 3.8 and 3.9). Prices also vary to a lesser extent across outlets within cities (Table 3.2), and differ between different sizes of milk cartons (Table 3.3) and across varieties of milk (Table 3.4).

Table 3.2: Retail milk prices across Canberra

(cents per litre for 'Canberra milk', 2 litre; 10 October 2009)

One major supermarket chain		Other major supermarket chain		Independent stores	
Gungahlin	184	Gungahlin	187	Civic	189
Manuka	184	Dickson	187	Kingston	185
Jamison	184	Kippax	187	Florey	197
Belconnen	184	Belconnen	187		
Curtin	184	Kambah	187		

Source: survey by Secretariat

13 Howard Smith and John Thanassoulis, *The Milk Supply Chain Project*, January 2008, University of Oxford, p. 36.

14 Howard Smith and John Thanassoulis, *The Milk Supply Chain Project*, January 2008, University of Oxford, p. 7.

3.12 The variation across outlets within a city has diminished as the major chains have responded to pressure to reduce geographic price discrimination.[15]

3.13 Milk (like most products) is cheaper when bought in larger quantities. This is at least partly a reflection of cost differences: the packaging and handling costs per litre are higher for smaller containers. Whether the cost differences are as large as the price differences is open to question. It may be the case that this is another form of price discrimination.

Table 3.3: Retail full cream milk prices by quantity

(a major supermarket in Canberra, 26 January 2010, cents per litre)

	Branded milk	Generic
300 ml	320	
600 ml	222	
1 litre	197	137
2 litres	184	124
3 litres	176	122

Source: Secretariat

3.14 Similarly, higher prices are charged for milk with various additives such as omega 3, calcium and flavouring, or with less fat (Table 3.4). It is questionable whether the cost of additives such as flavouring is anywhere near as much as the difference in price. This may again be a matter of using the additives to sort consumers into those who are price–responsive and charged a lower price and those who are less price–sensitive and are charged a higher price.

Table 3.4: Retail milk prices by type, 2008-09

	Branded milk		***Generic milk***	
	Price (cpl)	(% of market)	Price (cpl)	(% of market)
Regular whole	186	(14)	118	(32)
Reduced fat	210	(16)	135	(15)
No/low fat	214	(5)	164	(0)
Flavoured	371	(6)	212	(0)
UHT	190	(8)	119	(4)

Source: Dairy Australia, *Australian Dairy Industry in Focus 2009*, p. 43.

15 Geographic price discrimination is discussed in the Senate Economics Legislation Committee's report *Inquiry into the Trade Practices Amendment (Guaranteed Lowest Prices - Blacktown Amendment) Bill 2009*, November 2009.

Milk as a 'loss leader'

3.15 Some witnesses claim milk is used as a 'loss leader'; sold under cost to attract customers into stores:

> We also see widespread smaller retailers using the two litre milk as a discount leader to try to get more people through their stores. Milk being the product that it is, basically purchased every day in every household, is an attraction for a retailer or a major fruit shop to put a big sign out the front, saying, ‘Cheap milk: come and get the cheap milk.’ That milk is sometimes sold under cost price to that outlet. It is sold to the outlet and the outlet will sell it under cost price.[16]
>
> The other thing certain stores do is to look at a product like milk as a way of building traffic, so once you are in the store you buy other things which are at a higher margin.[17]
>
> …I got some prices today from one of the major retail outlets in Brisbane, and one has just announced a price reduction on the weekend for a two-litre bottle of whole milk down to $2.09 for their private brand and the advertising was structured in a way that you could possibly term it as a loss leader strategy in terms of marketing as a reduction to get people through the front door of the supermarket.[18]

3.16 In Western Australia milk is sometimes sold at less than a dollar per litre.[19]

3.17 The major supermarkets denied using milk as a 'loss leader':

> Senator MILNE—…Can you tell me: do you ever use milk as a loss leader to attract customers to Coles?
>
> Mr Mara—Not to my knowledge.[20]
>
> Senator O’BRIEN—Does Woolworths use milk as a loss leader?
>
> Mr Dunn—No, not at all.[21]

3.18 They do, however, claim that others engage in the practice:

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16 Mr Colin Lawson, Amalgamated Milk Vendors Association, *Committee Hansard*, 18 January 2010, p. 15. A similar point is made by Julie Gration, *Submission 6*, p. 4.

17 Mr Gerard van Rijswijk, National Association of Retail Grocers of Australia, *Committee Hansard*, 4 February 2010, p.19.

18 Mr Robert Peake, Queensland Dairyfarmers Association, *Committee Hansard*, 4 February 2010, p. 44.

19 This 'deep discounting' was criticised by Mr Peter Evans, Western Australian Farmers' Federation, *Committee Hansard*, 29 January 2010, p. 16.

20 Mr Chris Mara, Coles, *Committee Hansard*, 4 February 2010, p. 5.

21 Mr Ian Dunn, Woolworths, *Committee Hansard*, 4 February 2010, p. 41.

> Packaged milk products are now used in many segments of the non-supermarket retail as a loss leader – to attract customers to make other store purchases.[22]

Wholesale prices

3.19 The supermarket chains buy milk from the processors. The prices paid by the supermarkets, and consequently the profits earned by the processors, are quite different for branded and generic milk but, as noted below, both processors and retailers were reluctant to provide much information about the difference.

3.20 Supermarkets typically have tenders to determine from which processors they will buy the generic milk. The contracts typically run for two to three years.[23] The large supermarket chains generally prefer a single processor for each state or region, or perhaps even a single national supplier.[24] Combined with there only being two major supermarket chains, this preference encourages consolidation within the processing sector as only large processors can credibly bid for the contracts and without any such contract half the drinking milk market is effectively closed to a processor.

3.21 It may be the case that small processors would lack the economies of scale to put in competitive tenders to supply even some of the generic milk for supermarkets in a region. In addition, the scale of the contracts make it very difficult for some smaller processors to participate.

3.22 The highest price processors can secure is limited by the supermarkets' ability to source milk from the next closest source of supply.[25] The lowest price the supermarkets can extract is the marginal cost of producing milk. Where the price settles between these limits will depend on the relative bargaining power of the processors and the supermarkets.

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22 Coles, *Submission to ACCC Grocery Inquiry*, 2008, p. 57.

23 Mr Mara, Coles, *Committee Hansard*, 4 February 2010, p. 10; Mr Dunn, Woolworths, *Committee Hansard*, 4 February 2010, p. 28. In the UK the typical contracts are rolling with notice periods of only three months, so supermarkets can switch suppliers fairly quickly; Howard Smith and John Thanassoulis, *The Milk Supply Chain Project*, January 2008, University of Oxford, pp 10–11.

24 Woolworths has a national contract, with National Foods supplying their Home Brand generic milk while Coles has tenders on a state-by-state basis; Mr O'Malley, National Foods, *Committee Hansard*, 18 January 2010, p. 87. The same occurs in the United Kingdom, although there are more large supermarket chains there.

25 It is not related to the retail price.

3.23 The outcome of the tendering process is that the wholesale price for generic milk may be 20-40 per cent lower than for branded milk, and processors are less able to pass on cost increases to the supermarkets for generic milk than for branded milk.[26]

3.24 Processors prefer to concentrate on making their own branded products, on which they earn much higher profits, and would not bid for a generic contract if it meant reducing production of the branded product.[27] As the retail markets increasingly move towards sales of generic milk, however, they may not be able to sell their whole production run as branded product and the generic milk contracts will become ever more important to them.

3.25 A UK study looked at the market for generic milk and concluded the large supermarkets have substantial buying power due to the existence of substantial economies of scale.[28] The presence of large powerful supermarkets encourages processors to install technology with increasing returns to scale, in turn making smaller supermarkets less attractive customers for the processors.

Slotting charges

3.26 It is advantageous for the processors to have their branded milk prominently displayed at eye-level on supermarket shelves. This may be achieved by the processors paying an explicit 'slotting' fee to the supermarkets for favourable product placement:

> The ACCC in their grocery inquiry recognised that the chains charged slotting fees—that is, if you want to slot your product on their shelf, you pay them.[29]
>
> If you are selling you own product that is a different story because, there, you are placing your product on the shelf and you would do your normal negotiations with the buyer. In those negotiations you would have your pricing and there would be a little bit of negotiation on promotions, ullage, shelf space and all the other things that go along.[30]

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26 ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, pp 234–5.

27 Mr Mallison, Fonterra, *Committee Hansard*, 18 January 2010, p. 67.

28 Howard Smith and John Thanassoulis, *The Milk Supply Chain Project*, January 2008, University of Oxford, p. 4. The study suggested/assumed that mergers between processors would increase the size of the margins earned by the processors at the expense of the supermarkets but would not necessarily affect the retail prices (p. 11).

29 Mr Cummings, NARGA, *Committee Hansard*, 4 February 2010, p. 13.

30 Mr Robert Wilson, *Committee Hansard*, 5 November 2009, p. 39.

> …joining the retail business and seeing how supermarkets operate, is that if you really want to sell your product you have to promote it heavily and pay massive promotions back to them…[31]

3.27 Woolworths denied such explicit fees existed:

> The suggestion, for instance, that there are slotting fees in the marketplace: as far as Woolworths is concerned, that was specifically stated not to be the case to the ACCC…[32]

3.28 Alternatively, the same effect could be achieved implicitly by processors being granted more favourable placement on the shelves in return for offering their branded milk at a lower price to the supermarkets.

3.29 More controversially, favourable placement on supermarket shelves for branded milk may be conditional on providing generic milk to the supermarkets at a low price. If this occurs, it would represent an exercise (arguably an abuse) of the market power of the major supermarkets.

'Waterbedding' effect

3.30 It has been suggested that the market power of the major supermarket chains means that they can force down the price they pay processors for generic milk, and that this leads to the processor charging a higher price on its other sales: generic milk to other retailers, branded milk and other products such as yoghurt.

3.31 This is termed the 'waterbedding effect':

> The 'waterbed effect' is the term used to describe the result when a large player in a market demands lower wholesale prices from suppliers, forcing those suppliers to increase prices to other customers to bring earnings back to a sustainable level. The large body in the middle of the waterbed forces up smaller bodies on the sides.[33]

3.32 It has been described as follows:

> A typical explanation for this is a cost shifting narrative. This explanation relies on suppliers incurring certain fixed costs. If the suppliers recover fewer of these fixed costs from the large buyer (which forced their input price down by bargaining power) or none of them if the powerful buyer negotiates to pay marginal costs, according to the argument the suppliers must recover more of these fixed costs from other buyers. It is argued that

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31 Mr Larry Brennen, Executive Chairman, Challenge Dairy, *Committee Hansard*, 29 January 2010, p. 6.

32 Mr Dunn, Woolworths, *Committee Hansard*, 4 February 2010, p. 33.

33 NARGA, cited in *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p. 353.

> the suppliers must shift more or all of their fixed costs onto smaller/weaker buyers, thereby increasing the total price paid by those weaker buyers.[34]

3.33 The ACCC, however, argue there is a logical flaw in the waterbedding argument:

> A common objection is that this sort of cost-shifting violates standard axioms of profit maximisation – if the supplier is able to charge higher prices of the smaller retailers after the decrease in price charged of the powerful buyer, why didn't they do so before?[35]

3.34 The ACCC also point out:

> Further, even if a waterbed type effect exists and results in weaker retailers paying higher input prices, it is far from clear from the economic modelling what the impact will be on downstream prices. This…will depend partly on the state of competition in the downstream retail sector.[36]

3.35 Independent retailers, however, told the Committee they believed this effect operated:

> …the waterbedding effect in the dairy industry…has worked in two ways: I pay more than the contract price for house brand milk to Fonterra and to National Foods. They have to charge me more so that they can, at the end of the day, make money. I am, in effect, subsidising the supply of house brand milk to those people [major supermarket chains]… I believe we are [also] seeing this waterbed effect in other dairy products.[37]
>
> The track record of private label milk is that its price growth has been less than inflation. The track record of branded milk price is that it is higher than inflation…The waterbed effect is demonstrated by that graph. But, as Mr Cummings said, it is also demonstrated by the fact that the price of other dairy products—the yoghurts and cheese and so on—have also gone up.[38]

3.36 Some independent witnesses' study of the dairy industry led them to the same conclusion:

> …the removal of the Price Discrimination provisions of the Trade Practices Act… enabled the major supermarket chains to force their milk suppliers to supply their home brand milk at a considerably lower cost than for branded

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34 ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p. 321.

35 ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p. 321.

36 ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p. 321.

37 Mr Cummings, NARGA, *Committee Hansard*, 4 February 2010, p. 13. See also NARGA, *Submission 13*, pp 2–3, 6–7.

38 Mr Ken Henrick, NARGA, *Committee Hansard*, 4 February 2010, p. 23.

milk, which…seems to result in a “waterbed effect” and growing price differential between branded and generic products.[39]

Clearly, there is a level of return that a milk processor requires and, therefore, the lower the prices paid by Coles and Woolworths for generic milk, the higher the prices that milk processor will charge smaller retailers for branded milk to make up for the lower returns or shortfall from Coles and Woolworths.[40]

3.37 Despite the ACCC refuting the occurrence of waterbedding, both Fonterra and National Foods gave evidence that suggests it is a reality in the dairy industry:

Senator COLBECK—…Is there a balancing act, if you like, that has to be conducted with respect to returns that you are going to get on the house-branded produced versus your brands?

Mr Mallinson—Ultimately, we will value the import price of the milk going in and what we get on a global quantity basis. So it would have to be a value over and above a global commodity sale. When we look at house brand contracts, we will look at our factory capacity—in particular, with cheese and butter—and whether we can actually produce that sort of volume.

Senator COLBECK—So it almost can be done on a marginal price rather than a base price?

Mr Mallinson—Yes.

Senator COLBECK—…I am just trying to get a sense of those processes…the power to draw through and the cost to the overall business of drawing through on that marginal cost of production and who actually ends up paying that price. It has an impact across the entire business, doesn’t it?

Mr Mallinson—Yes.

Senator COLBECK—If you are getting a flat rate of margin across all products—and I know that it is going to vary depending on the product margin—and you are putting one particular chunk through at a marginal rate, that has to be made up in other areas.

Mr Mallinson—Without giving too much away, we will never do a house brand where we have only enough capacity to do our own brands.

…

Mr Mallinson—It will always be secondary or subservient.[41]

39 Ms Dee Margetts, *Submission 15*, p. 3.

40 Associate Professor Frank Zumbo, *Submission 34*, p. 9.

41 *Proof Committee Hansard*, 18 January 2010, pp 66–67.

> Senator COLBECK—…a fair proportion of your product must be going through into those generic brands because it is a large chunk of what the supermarkets are selling. So that premium obviously impacts across the rest of the business and it has to be recouped in some way...how that is amortised across the business and what the cost of that is to the other product. We heard evidence before—and I know you are in a slightly different situation—that a decision was made not to sell a generic product in a circumstance where they had a quality brand product. You are in a very different situation because you are trying to do both.
>
> Mr Evans—I think, again, as Mr O'Malley has suggested, there is a portfolio of brands that we make available to retailers and obviously some will be more profitable than others, but obviously to give detail on that is obviously highly sensitive.[42]

3.38 It is also noted that in responding to questions on notice at Estimates on 'waterbedding', the ACCC provided conflicting opinion when the organisation replied:

> During the course of the ACCC's 2008 Grocery Inquiry, the ACCC received mixed evidence of the extent to which processors increased the price of branded products to offset cost increases associated with providing private label products. Some processors indicated that they did not engage in this practice. However, others indicated that increased costs for branded products have been able to be recovered in a 'more timely manner' and that prices of branded products have sometimes been increased to offset overall cost increases, both for branded and private label products.[43]

Price discrimination

3.39 It is argued that it is unfair, and potentially detrimental to consumers, that processors sell at lower prices to the major supermarket chains than to other retailers (or to vendors who on–sell the milk to small retailers):

> Clearly, there is a very real danger that price discrimination in the market for milk is deterring or preventing competitive conduct within that market in a way that is substantially detrimental to consumers. In short, price discrimination can be anti-competitive in that a smaller retailer is simply unable to compete as aggressively as possible in the market because of the price discrimination it faces. Consequently, consumers are denied the benefits of vigorous competition between large and small retailers. Needless to say, if smaller retailers are unable to be competitive because of higher milk prices they pay in comparison to Coles and Woolworths, there is a further and very real danger that the smaller retailers will go out of business, thereby further reducing competition.[44]

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42 *Proof Committee Hansard*, 18 January 2010, pp 91–92.

43 ACCC, answer to questions on notice, 10–11 February 2010, Received 1 April 2010.

44 Associate Professor Frank Zumbo, *Submission 34*, p. 9.

3.40 The Committee also received evidence from a Dairy Farmers' (affiliated with National Foods) franchisee outlining that their franchisor:

- forces us to sell milk cheaper than we buy it for;
- forces us to breach the Trade Practices Act – as franchisees we collude in regards to pricing for dairy farmers negotiated rebate customers;
- uses us to prop up their losses in other parts of their business; and
- competes against us (Coles, Woolies and Foodservice) and offers better terms, product range and pricing.[45]

3.41 NARGA also reflected that competition may be improved by the restoration of prohibitions on price discrimination in the *Trade Practices Act 1974*.[46] This is discussed further in Chapter 4.

3.42 Looking ahead, some witnesses feared that generics could ultimately displace branded milk from supermarket shelves as the price difference between them widens:

> So there is quite a significant price differential and that differential now, with this latest marketing strategy by the major retailers, is actually increasing. So that is a real concern for us, because at the end of the day, as that major supermarket chain share increases and more milk goes into the private label volume away from proprietary brands, it means that there is less return back down the value chain to the processor and thus back down the value chain to the farm gate. That situation is an extreme concern for us and we question whether it is sustainable long term. If you were to ultimately follow that sort of branding strategy through to where potentially proprietary brands were not viable any more, the consumer actually could be faced with the situation of having a reduced choice and one could also ask the question about what would happen to the actual pricing to the consumer if there were not a choice and it was only a choice between a number of supermarket brands on the shelf. We do not know the answer to that, but it is certainly a question we would like to see the ACCC investigate more.[47]

Committee view

3.43 The Committee, in its deliberations, noted with concern the apparent discriminatory practices that are occurring in the sale of generic and branded milk in Australia's supermarkets. The Committee is of the view that the long term viability of the domestic dairy industry may be in jeopardy if steps are not taken to curb these practices, although it recognises the complexities associated with government intervention in the market.

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45 Ms Julie Gration, *Submission 6*, p. 6.

46 Mr Cummings, NARGA, *Committee Hansard*, 4 February 2010, pp 16, 18.

47 Mr Robert Peake, Chief Executive Officer, Queensland Dairyfarmers' Organisation, *Committee Hansard*, 4 February 2010, p. 44. See also their *Submission 30*, p. 9.

Recommendation 1

3.44 The Committee recommends that the Government requests that the National Competition Tribunal reviews the effectiveness of section 46 of the Trade Practices Act in preventing price discrimination and consider reinstating anti-price discrimination provisions, particularly to protect those parties participating in industries dominated by multinational corporations.

Farmgate prices

3.45 Processors buy their milk from the farmers. In some cases the prices are negotiated with individual farmers and in some cases with collective bargaining groups. Years ago, many of the processors were cooperatives owned by farmers which would just be aiming to cover the processing costs. Murray Goulburn remains a cooperative, but most of the processors are now foreign-owned companies seeking to maximise their profits.

3.46 For ease of comparison with retail prices, milk prices in this chapter are quoted in cents per litre. As a rule of thumb, a farmgate price of 50 cents a litre is equivalent to a price of around $6.75 per kilogram of milk solids.[48]

3.47 In the short run the marginal cost of milk is almost zero in the sense that a farmer's costs do not drop if his milk is not sold as he cannot 'turn off' the cows. Thus in the short term the market power is all with the processors.

3.48 In the medium term, the market power of the milk processors over the farmers is limited by the farmers not only selling milk to the drinking milk processors. In addition to these sales of what is often termed 'market milk', farmers sell a significant proportion of their milk as 'manufacturing milk', used in the production of cheeses, milk powders, butter and dairy spreads, primarily for export. The proportions differ across the country, as those areas better suited to dairying (mostly in the southern states) will tend to produce more milk than needed for local drinking milk.

3.49 In the former, heavily regulated, market it was possible for the prices for market and manufacturing milk to be quite disconnected, with the former reacting to domestic conditions and government preferences and the latter to global commodity prices. In the current deregulated market, the prices should be much closer, although there will be a premium paid by the drinking milk processors to ensure that they receive a steady supply of milk throughout the year.

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48 Most milk prices are determined by an equation that measures the weight of the solid components of the milk – i.e. the butter fat and protein components and then applies volume and quality incentives and penalties. National Foods defines a standard litre as having 4 per cent fat and 3.2 per cent protein; Mr Beattie, Tasmanian Collective Bargaining Group, *Committee Hansard*, 5 November 2009, p. 26.

3.50 While deregulated, the market for milk is far from perfectly competitive due to the limited (and diminishing) number of processors (as discussed further in Chapter 4).

3.51 The Committee heard claims that the farmgate price is set in global markets and has little to do with domestic conditions:

> About half of Australia's milk production is exported and, as a result, the Australian farmgate price for milk is directly set off the world market price.[49]

> The decline in farm–gate prices in Australia reflects lower international dairy prices in the wake of the global financial crisis, and the reintroduction of export refunds by the European Union in January 2009.[50]

> The pricing structure in Australia domestically is as much driven by international factors.[51]

> The price is set as an international commodity price…[52]

> Milk prices in Tasmania are linked to the international market, despite the fact that the majority of milk products are sold nationally.[53]

> If you look at what is driving it [the Tasmanian farmgate price], which is what the international commodity prices have done in the last two months…they pretty well correlate… It is not driven off what happens in Tasmania; it is driven off what happens in Victoria. Victoria is two–thirds of the national milk production where most of the milk goes into export markets, driven off international prices, and that just flows through.[54]

> …since deregulation, as you would have expected, prices received by dairy farmers are more closely aligned with what is happening in international markets.[55]

> …the Australian dairy industry is integrated into the global market. The main influence on the manufacturing milk price that companies like

49 Mr Wesley Judd, Chair, Australian Dairy Industry Council, *Committee Hansard*, 18 January 2010, p.2.

50 Dr Robert Rouda, Western Australian Department of Agriculture and Food, *Committee Hansard*, 29 January 2010, p. 25.

51 Mr Pearson, Australian Competition and Consumer Commission, *Committee Hansard*, 18 January 2010, p. 76. Similarly, ACCC had earlier concluded 'the ability to transport fresh or processed milk domestically and internationally has the result that farmgate prices in south–east Australia broadly reflect the prevailing international price of milk; ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p. 381.

52 Mr Chris Mara, Coles, *Committee Hansard*, 4 February 2010, p. 10.

53 Tasmanian Department of Primary Industries Parks, Water and Environment, *Submission 12*, p. 9.

54 Mr Mark Smith, Dairy Tasmania, *Committee Hansard*, 6 November 2009, pp 26–8.

55 Dr Terry Sheales, Deputy Executive Director, ABARE, *Committee Hansard*, 18 January 2010, p. 33.

> Fonterra can offer farmers is the global price of commodities set in US dollars.[56]

3.52 This is hard to reconcile with the differences in farmgate prices across the country (Table 3.7). It was also vehemently rejected by some witnesses and treated sceptically by others:

> …it is an absolute anachronism that you expect returns at farmgate in Australia to be benchmarked to the vagaries of the international pricing. This is ridiculous.[57]

> …it is not a global milk commodity price. It is a localised regional price that obviously is largely driven not by international price demands but by regional price changes and supply and demand in the region.[58]

> Mr Tennant—…The company are referencing export prices as a basis for setting the prices that they actually pay us. I understand that [although] in Fonterra's case somewhere between 60 and 65 per cent of their production actually goes into the domestic market….The price is always quoted on the basis of the export market price.

> Senator O'BRIEN—I can tell you that Fonterra say that end of the market is, in their view, an international price competitive sector because they compete with imports.

> Mr Tennant—I think they should be made to prove that. I think it should be a visible process.[59]

> …in a state where the vast majority of your product is for domestic fresh milk production, the fact that it is artificially linked to one of the lowest farmgate milk prices in the world is an indication of market and market power abuse.[60]

3.53 Dairy Australia comment in their annual review that 'international markets prices are the major factor determining the price received by farmers for their milk' but immediately below Chart 3.1 shows large divergences between farmgate prices across countries, with Australian farmers generally being paid less than those in other advanced economies.[61]

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56 Mr Bruce Donnison, Managing Director, Fonterra Ingredients, *Committee Hansard*, 18 January 2010, p. 52.

57 Mr Robert Wilson, *Committee Hansard*, 5 November 2009, p. 31.

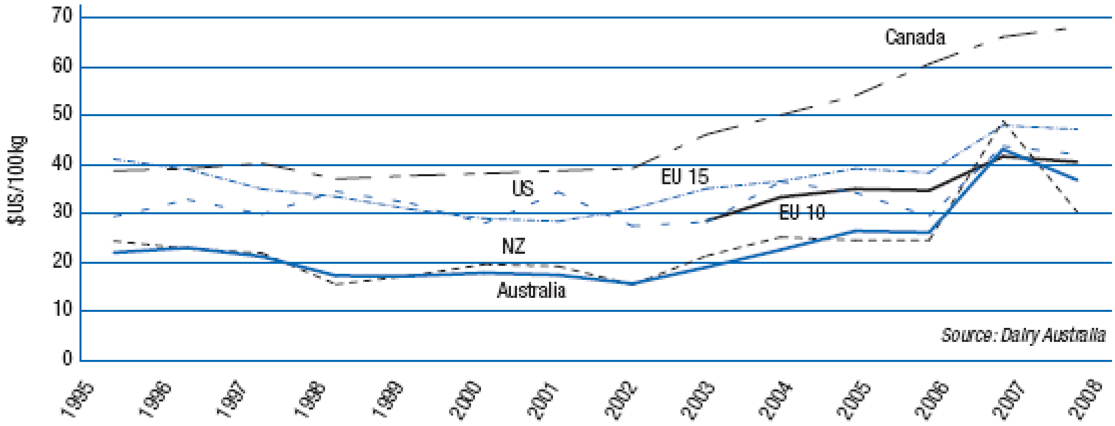
58 Dr McCall, *Committee Hansard*, 5 November 2009, p. 46.

59 Mr Wayne Tennant, Tasmanian dairy farmer, *Committee Hansard*, 6 November 2009, p. 52.

60 Ms Dee Margetts, *Committee Hansard*, 29 January 2010, p. 43.

61 Dairy Australia, *Australian Dairy Industry in Focus 2009*, p. 10.

Chart 3.1: International farmgate milk prices



Source: Dairy Australia, *Australian Dairy Industry in Focus 2009*, p. 10.

3.54 It may be more useful to think of the global price (after allowing for transport costs) as setting both bounds on the price that farmers will accept in the medium term for their milk and that processors will pay. If the sum of the world price plus the cost of shipping milk offshore (either directly or after transformation into products such as cheese) is greater than domestic processors will pay, then the farmers will not supply milk to the processors. Conversely if the price demanded by the farmer is greater than the world price plus the cost of importing milk, the processors will import milk rather than buy from domestic farmers.

3.55 Whereabouts the price settles between these bounds in the medium term will depend on the relative bargaining power of the processors and farmers. When, as for example in Tasmania, one or two processors face large numbers of farmers, the bargaining power of the processors is much higher and the price is likely to settle closer to the lower bound. In the UK, a study concluded that milk processors have more bargaining power than farmers' cooperatives, with the processor securing twice as much margin as the farmers.[62]

3.56 In practice, it is unlikely to be economic for processors to import raw milk. Currently the only dairy product imported in any significant quantity is cheese.[63] The effective ceiling on the farmgate milk price is the maximum price that the supermarkets are willing to pay the processor.

3.57 The Committee was intrigued by the way price–setting was described. National Foods appeared to set their prices based on those set by Fonterra, who in turn had based their prices on those set by Murray Goulburn:

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62 Howard Smith and John Thanassoulis, *The Milk Supply Chain Project*, January 2008, University of Oxford, p. 4.

63 Dr Sheales, ABARE, *Committee Hansard*, 18 January 2010, p. 28.

> …normally Murray Goulburn sets the base price and everyone else pays a cent or half a cent more.[64]

3.58 This system of 'cascading' prices does not sound very competitive. It appears the followers are effectively promising Murray Goulburn that their rivals will not attempt to outbid them thereby enabling Murray Goulburn to be more conservative in the opening price they offer farmers.

3.59 Questioned about this, the Australian Competition and Consumer Commission reflected:

> Where you have a market or somebody like Fonterra with that much of the market that it is buying into it, it would not be at all unusual to see that. Again, the collusion issue would be much more obvious if they got together and talked about keeping their price down…It is something that you would see across a range of industries given some of the market dynamics. I would not see it as a form of collusion but there is no doubt that it is the result of the market structure…[65]

3.60 The Committee again noted with interest the ACCC's response when asked at Additional Senate Estimates in February 2010 to clarify the difference between price leadership and predatory pricing to which they responded:

> Price leadership is a general economic term used to refer to pricing behaviour of a dominant firm.
>
> Price leadership is not of itself likely to raise TPA concerns unless the pricing behaviour satisfies the elements of the prohibition against predatory pricing…or is undertaken in contravention of other TPA provisions prohibiting anticompetitive agreements.[66]

3.61 These concerns have been exacerbated as the processing industry has become more concentrated (the challenges this poses are discussed further in the following chapter). As Associate Professor Zumbo puts it:

> …mergers are typically justified on the basis of allowing efficiencies or a reduction in costs to be achieved, but such efficiencies, if any, will only be beneficial to consumers if they are passed onto them. Indeed, the danger of mergers is that any efficiencies or reduction in costs that may be realised through a merger will not be passed onto consumers for the simple reason that as mergers remove competitors from the market, there will be fewer competitors left to take an independent stance to drive down prices to consumers…[67]

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64 Mr McKenzie, *Committee Hansard*, 18 January 2010, p. 28.

65 Mr Pearson, ACCC, *Committee Hansard*, 18 January 2010, p. 80.

66 ACCC answers to questions on notice, 10–11 February 2010.

67 Associate Professor Frank Zumbo, *Submission 34*, p. 5.

Who bears the risk of price fluctuations?

3.62 The preceding analysis implicitly assumed global and domestic demand and supply was quite stable. When there are fluctuations in supply (due for example to drought) or demand (due for example to recessions), the price in a spot market for farm milk would fluctuate. This volatility in prices, which could be followed by volatility in the domestic demand for and supply of milk, could make forward planning difficult for both farmers and processors. In practice, therefore processors have longer term contracts with their supplying farmers.

3.63 The question in designing these contracts is whether these contracts should specify a fixed price for the coming year (in which case the farmer has more certainty and the processor bears the risk); or whether the contracts should allow for prices to vary (giving the processor more certainty of profit and shifting the risk onto the farmer).

3.64 It might be argued that the small number of large processors are much better placed than the many individual farmers to manage risks. As well as having operations diversified across the world, and large capital reserves, the processors are able to access derivatives markets to manage risk.

3.65 In practice, contracts seem to be a mix of the two. The Committee heard in Tasmania that there was a base price which could be 'stepped up' if global demand and prices rose. It may also be 'stepped down' in certain circumstances. The problem was that the conditions that trigger these movements did not appear to be very clear.

3.66 As discussed further in Chapter 5, the Committee found that the distribution of risk was obscured further in the Tasmanian market by the complexity of the contractual arrangements with features such as 'model farms',[68] 28 or 35 day months, differing regimes for different half-years, prices paid by one processor tied in complicated ways to those paid by other processors, actual versus theoretical litres, bonuses and penalties, conditional retrospective payments and so forth, which a number of witnesses characterised as 'smoke and mirrors'.[69]

Recommendation 2

3.67 The Committee recommends that contracts with farmers should offer a clear, consistent formula for milk pricing with unambiguous conditions.

3.68 The terms of negotiation between farmers and processors are discussed further in Chapter 5.

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68 The concept of a 'model farm' unique to National Foods' contracts has subsequently been abandoned.

69 See, for example, Mr Grant Rogers, a Tasmanian farmer, *Committee Hansard*, 5 November 2009, pp 2–3, 9; Mr Beattie, Tasmanian Collective Bargaining Group, *Committee Hansard*, 5 November 2009, p. 14.

Costs faced by farmers

3.69 The seasonal nature of dairy farming conflicts with the need for year round milk supply for drinking milk, the tension between these factors significantly affecting the cost of production for dairy farmers and resulting in discrepancies between the different regions.

3.70 The Tasmanian Suppliers Collective Bargaining Group provided the Committee with evidence from a number of sources that typical costs for farmers in that state were around 40 cents per litre.[70] It was suggested that costs on Tasmanian dairy farms vary within a range of between 32 and 45 cents per litre.[71] One reason is some farmers are supplying milk all year round (for the drinking milk market) while others vary production (for the manufacturing milk market).

3.71 A breakdown of costs was provided to the Committee by the Tasmanian Government, shown in Table 3.5.

Table 3.5: Costs and profitability of Tasmanian dairy farms (cents per litre)

	2005-06	2007-08	2009-10(f)
Animal costs	3	3	3
Feed costs	13	19	16
Overhead costs	14	15	15
Finance costs	3	5	4
Production costs	**32**	**42**	**38**
Milk price	34	49	31
Other income	3	2	2
Total income	**38**	**52**	**33**
Earnings before tax	6	9	-5

Source: Tasmanian Department of Primary Industries, Parks, Water and Environment, *Submission 12*, p. 6.

3.72 Costs are generally lower in Tasmania than elsewhere:

> There is absolutely no question that our input costs to produce milk are among the best in the world in terms of being low. We have a climate that can grow grass. We have very good farmers. They are extremely well

70 Mr Phil Beattie, *Committee Hansard*, 5 November 2009, pp 12-13, and the Group's *Submission 27*.

71 Mr Fergusson, *Committee Hansard*, 6 November 2009, p. 67.

> organised and they are switched on. We have had a lot of people come to Tasmania because of this.[72]
>
> Tasmania is the most competitive dairy region in the country in terms of its production cost.[73]
>
> Tasmania is an ideal dairy area. It is the best dairy area in Australia bar none. We have got good water resources and we have got good land soils…[74]
>
> Tasmanian dairy farmers also have the lowest cost of production in Australia.[75]

3.73 The small Western Australian dairy farming region is also claimed to be more efficient than the northern regions, but views differ about how this translates into farm costs:

> We have a fantastic climate and a fantastic amount of land. We can produce milk here at a cost–effective price compared with just about anywhere else in the world…the cost of production for our farm is 28c a litre.[76]
>
> In Western Australia, we are producing one of the best quality milk products in the world…I understand the average cost of production in Western Australia under Red Sky was 35c a litre.[77]
>
> At the farm level, the costs of production are similar to elsewhere in Australia.[78]

3.74 Queensland is acknowledged as less suitable for dairying:

> We do get paid on average more money than the southern producers, but running a farm in our part of the world is a higher cost system…[79]

3.75 Therefore, although it is less suitable for dairy farming, arguably as the supply is predominantly for the drinking milk market, the fewer dairy farmers receive a higher price to produce milk on a year round basis.

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72 Mr Robert Wilson, *Committee Hansard*, 5 November 2009, p 36.

73 Mr Mark Smith, Dairy Tasmania, *Committee Hansard*, 6 November 2009, p. 25.

74 Mr Wayne Tennant, Tasmanian dairy farmer, *Committee Hansard*, 6 November 2009, p 53.

75 Tasmanian Department of Primary Industries, Parks, Water and Environment, *Submission 12*, p. 5.

76 Mr Larry Brennen, Executive Chairman, Challenge Dairy, *Committee Hansard*, 29 January 2010, pp 4–5.

77 Ms Nola Marino MHR, *Committee Hansard*, 29 January 2010, pp 10-11.

78 Mr Andrew Weinert, Western Australian Department of Agriculture and Food, *Committee Hansard*, 29 January 2010, p. 26.

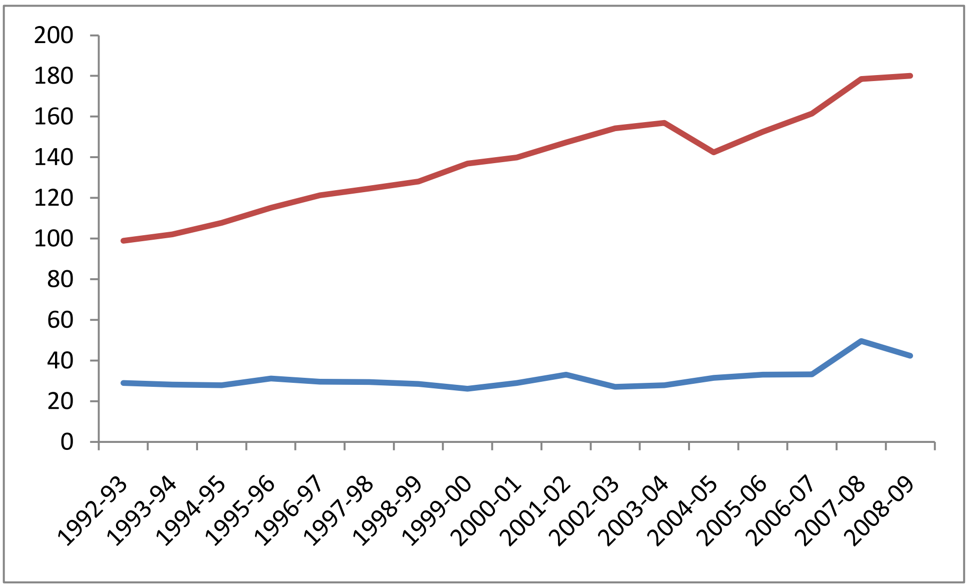
79 Mr Robert Peake, Chief Executive Officer, Queensland Dairyfarmers Organisation, *Committee Hansard*, 4 February 2010, p. 47.

3.76 Some South Australian dairy farmers estimated their costs at around 36 cents per litre.[80]

Quantifying the shares of the milk price

3.77 The ratio of the farmgate price (lower line in Chart 3.2) to the retail price (upper line) has declined over time.

Chart 3.2: Retail and farmgate milk prices (cents per litre)



Retail price is simple average of prices in Sydney and Melbourne. Source: Secretariat, based on data from ABARE, *Australian Commodity Statistics 2009*, tables 81 and 82.

3.78 It is not an easy matter to apportion the typical supermarket price of milk (around $1.75 per litre for a branded product and $1.25 per litre for a generic) between the costs and profit margins of the various players in the chain. Key witnesses such as National Foods were notably silent when asked about this.[81]

3.79 The most useful piece of information was provided by Coles. They gave an estimate by FreshLogic that as of 2008, around 20 per cent of the retail price accrued to the retailer, 45 per cent to the processor and 35 per cent to the farmer.[82]

3.80 Based on this and various other estimates provided to the Committee, Table 3.5 represents the Secretariat's attempt at allocating the supermarket shelf price.

80 Barossa Mid–North Co-operative Dairymen Limited, *Submission 7*, p. 1.

81 Mr Paul Evans, National Foods, *Committee Hansard*, 18 January 2010, p. 93.

82 Coles, Answers to questions on notice, 12 February 2010. Coles gave similar estimates at a hearing, and suggested these proportions referred to generic milk; Mr Mara, *Committee Hansard*, 4 February 2010, pp 3, 5. When Mr Mara was directly asked about the price Coles paid the processors for milk, however, he instead gave the retail price; *Committee Hansard*, 4 February 2010, p. 3.

It was not possible from the information provided to allocate the components fully. There was a residual 'unclaimed' component to the price; a kind of commercial 'dark matter'. (If this is accruing to the participant with most market power, then it is likely the supermarkets' profits are being understated in the table. An odd result is that the numbers in the table suggest that the supermarkets are making less from generic than from branded products, which seems inconsistent with their push towards generics.)

3.81 The Committee is aware that processors and/or retailers may disagree with these estimates but the onus is then on them to provide the actual numbers.[83] This would then form the basis for a better informed discussion.

3.82 Better disclosure of this information would be welcomed by many witnesses:

> Transparency would go a long way [towards a fairer distribution of market power]. For instance, I would love the fresh food people to tell us how much they make out of a litre of milk and how much the farmer and the processor make. Then we would see what the public reaction is.[84]
>
> …there has to be some way that the consumer realises that the $2 per litre that they are paying for liquid milk is broken up into those four sectors: farm, processor, distribution and retail sectors.[85]
>
> So I agree with those people who say we should require the ACCC to use their prices surveillance powers to check the margins in the supply sector, especially of the dairy industry but also of other industries.[86]

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83 Some of these estimates have already been made public during the Committee's inquiry (for example, by Sen. Colbeck, *Committee Hansard*, 18 January 2010, pp 43, 93) and not challenged.

84 Mr Rogers, *Committee Hansard*, 5 November 2009, p. 10.

85 Mr Wilson, *Committee Hansard*, 5 November 2009, p. 37.

86 Ms Dee Margetts, *Committee Hansard*, 29 January 2010, p. 42.

Table 3.5: Estimated components of the cost of full cream milk (cents per litre)

in south-east Australia, late 2009/early 2010

	Branded product	Generic product
Farmers' costs	40[a]	40[a]
Farmers' profit	2[b]	2[b]
Transport costs – farm to processor	3[c]	3[c]
Processing costs – packaging	20[d]	19[e]
Processors' costs – other processing	15[f]	15[f]
Processors' costs – advertising	3[g]	0
Processors' profit	30[h]	1[i]
Transport costs – processor to supermarket	2[j]	2[j]
Supermarket operating costs	21[k]	21[k]
Supermarket profit	14[m]	4[l]
Unallocated residual	*25*	*18*
Supermarket shelf price	175[n]	125[n]

Sources: [a]Tasmanian Suppliers Collective Bargaining Group, *Submission 27*; an estimate of 32-45 cpl was provided by Mr Mark Fergusson of the Tasmanian Institute of Agricultural Research, *Committee Hansard*, 6 November 2009, p. 67. [b]Dairy Australia, *Australian Dairy Industry in Focus 2009*, p. 14 says the typical farmgate price in 2008-09 was 42 cpl. [c]Mr Kevin Tesselaar, Australian Milk Producers Association, *Committee Hansard*, 18 January 2010, p. 22; and Mr Robert Wilson, *Committee Hansard*, 5 November 2009, p. 38. [d]Mr Robert Wilson, *Committee Hansard*, 5 November 2009, p. 38. Mr Richard Bovill estimates the distribution cost as 'less than 20 cpl'; *Committee Hansard*, 6 November 2009, p. 5. [e]The cost is assumed to be a little less for generic milk as the labels are simpler. [f]Mr Robert Wilson, *Committee Hansard*, 5 November 2009, p. 38. Mr Richard Bovill estimates the distribution cost as 'less than 15 cpl'; *Committee Hansard*, 6 November 2009, p. 5. [g]Murray Goulburn spend the equivalent of 4 per cent of sales on advertising, according to their 2009 annual report. [h]Mr Richard Bovill estimates 'National Foods' margin on Pura milk to be somewhere in excess of 70c a litre'; *Committee Hansard*, 6 November 2009, p. 6. [i]Based on accounts in ACCC (2008, p. 384) and elsewhere that profit margins are generally very low on generic milk. Mr Bovill said that National Foods' 'margin' is 30 to 50 cpl; *Committee Hansard*, 6 November 2009. If this is taken to refer to the difference between the farmgate price and the wholesale price, it would be consistent with this estimate. It is also consistent with the estimate from Mr Cummings, NARGA, *Committee Hansard*, 4 February 2010, p. 13 that the contract price for 2 litre milk was 'slightly less than $1.70' and his view that there is not a processor who can afford to just sell generic milk (p. 17). Mr Lawson referred to processors selling generic milk at a 'break-even price'; *Committee Hansard*, 18 January 2010, p. 15. [j]Mr Richard Bovill estimates the distribution cost as 'less than 5 cpl'; *Committee Hansard*, 6 November 2009, p. 5. [k]Woolworths' overall selling, general and administrative expenses plus rent were the equivalent of 19 per cent of sales in 2009. The average milk retail price of $1.50 multiplied by 19% gives 28 cents. Milk is refrigerated but not freezed, handled in bulk and while it possibly has a below average value/shelf space, it turns over rapidly so operating costs are likely to below the average for total supermarket sales. For this table, it is assumed they are three-quarters (if they are less, then supermarket profit is understated in the table). [l]Coles and Woolworths both claim they have a gross profit margin on generic milk of around 24-25 per cent; Mr Dunn, Woolworths, *Committee Hansard*, 4 February 2010, pp 32, 39; Mr Mara, Coles, *Committee Hansard*, 4 February 2010, p. 7. [m]Woolworths said 'we make a very similar gross profit margin…on branded products and on private label products'. This is assumed to refer to a percentage mark-up rather than an amount in cents. [n]Table 3.9.

Recommendation 3

3.83 The Committee recommends that the Government requests the Australian Competition and Consumer Commission to use its information-gathering powers, and draw on its work for its recent report on grocery pricing, to provide more accurate estimates of the proportions of the retail price of milk that reflect (i) the costs and (ii) the profits, of farmers, processors and retailers and requests that the results of that review be published by 30 September 2010.

Committee view

3.84 Notwithstanding the degree of uncertainty around the estimates, it seems clear that the farmers' profits from sales of drinking milk are much smaller than those accruing to the supermarkets (especially for generics) and the processors (especially for branded products). This does not seem a fair reflection of the effort required and risks undertaken by the various parties involved in producing the milk which consumers buy at a supermarket.

3.85 The difference between the price of branded and generic milk also seems much larger than can be explained by differences in marketing and labelling costs or economies of scale. The difference appears symptomatic of the exercise of market power by the major supermarket chains, as discussed further in the following chapter.

3.86 The Committee is sympathetic to the views on relative market power expressed by a witness as follows:

> The national tendering process and the amount of volume sold through the big supermarkets enables supermarkets to squeeze the processors, because with that volume it becomes an imperative part of those processors' business to ensure that they do not lose those tenders…The only thing left for the processors to do then is to in turn squeeze the dairy farmer, and the only thing left for the farmers to squeeze is the cow's tit.[87]

International comparison

3.87 Comparing Australia to the United Kingdom (Table 3.6), farmgate prices are similar, but the costs and/or profits of processors and retailers appear to be considerably higher. Similarly, the Southern Sydney Retailers Association argues that while farmgate prices are higher in the United States than in Australia, American retail prices are lower.[88]

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87 Mr Philip Depiazzi, Western Australian Farmers' Federation, *Committee Hansard*, 29 January 2010, p. 17.

88 Southern Sydney Retailers' Association, *Submission 2*.

Table 3.6: Comparison of branded full cream milk (cents per litre)

	Australia	United Kingdom
Farmgate price	42	44
Processing costs – packaging, bottling	20	9
Processing costs - other	15	6
Transport costs – farm to processor	3	5
Transport costs – processor to supermarket	2	9
Processors' profit	30	3
Supermarket gross margin (residual)	63	45
Supermarket shelf price	175	121

Sources: For Australia, Table 3.5; for UK, mostly pence per litre in 2005 from Howard Smith and John Thanassoulis, *The Milk Supply Chain Project*, January 2008, University of Oxford, pp 20, 23, 31 scaled up by 8 per cent for inflation from 2005 to 2009 and multiplied by exchange rate of 1.80 cents per penny; farmgate price from UK Department for Environment, Food and Rural Affairs; retail price from my.supermarket.co.uk.

Price controls and supports

3.88 While the best longer term response to the simultaneous existence of low farmgate prices and high retail prices for milk is increasing the competition between retailers and between processors, in the medium term a possible response would be to cap the retail price and possibly relate it to the farmgate price. It has been suggested for example that it would be reasonable to limit the retail price to a maximum of three times the farmgate price, as is done in New York.[89]

3.89 The simplest form this could take would be a price ceiling on retail milk, which could be varied annually depending on the average farmgate price in the previous year. This would be subject to the usual arguments about the welfare losses resulting from price controls. It might keep prices down for consumers but would not increase prices for farmers.

3.90 A more complex approach, with more subtle effects, would be to tie the retail price of individual supermarket chains to the farmgate prices paid by the processors who supply them. This would introduce a new dynamic whereby a supermarket would prefer to buy from a processor that pays a higher farmgate price. This may then lead to both lower prices for consumers and higher prices for farmers, at the expense of retailers and processors.

3.91 An alternative approach would be to impose a levy on the retail price and funnel that back to the farmers. A similar scheme was in place for a number of years after deregulation:

89 'Under 396–rr of New York State's General Business Law, the price is deemed to be "unconscionably excessive" if the retail price of milk is greater than 3 times the farmgate price'; Southern Sydney Retailers' Association, *Submission 2*, p. 10.

> If you go back a little bit, we had a system here in the Australian industry of having a support, a market milk levy, which assisted farmers that were being driven out of the industry by drought and deregulation. That levy was administered at a federal level, and the levy was some 11c a litre on all market milk. It was in place for a period of years. In my experience of many years, that has been one of the easiest mechanisms to comply with, as a processor. It worked well. It was audited well. The price gained at retail was brought back and paid back into the industry, to farmers. If you were to look at something similar, to support what I am saying, to get a better yield out of the Australian market, you would have to look at that sort of mechanism.[90]

3.92 A levy was supported by some witnesses:

> …I would support a levy and that it should be set up over about a four-year period. But, to stop people coming in to make a killing on the side when they are not entitled to, you would need to base it on the production of, say, the 2008–09 season.[91]

3.93 The levy would be likely to be borne partly by retailers and partly by consumers, and perhaps to some extent passed back to processors. The experience of the earlier levy was that it did not affect farmgate prices.[92]

3.94 Another approach would be to set a floor on the farmgate price.[93] Just banning sales at below a certain price may make matters worse for farmers if it meant that their milk was not being sold at all.

3.95 Alternatively there could be a price/income stabilisation fund, as has been used in the past for agricultural commodities, where farmers pay in during good years and receive support in bad years. A variant would be a loan scheme for farmers with milk price-contingent repayments. A problem with such schemes is that they require a good estimate of the long-run trend in prices to determine whether a fall in price represents a short-term or long-term event. (Chart 6.1 shows that forecasting longer-term prices is, to put it mildly, an inexact science. The spike in milk prices in 2008 was unexpected, and once it occurred it was erroneously expected to continue.)

3.96 An example of such a proposal, which could be run by Dairy Australia or a similar body, was set out by a Victorian dairy farmer:

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90 Mr Robert Wilson, *Committee Hansard*, 5 November 2009, p. 37.

91 Mr John Oldaker, *Committee Hansard*, 6 November 2009, p. 12.

92 'There was no impact on the farmgate price up or down' according to Mr Wesley Judd, Chairman, Australian Dairy Industry Council, *Committee Hansard*, 18 January 2010, p. 9.

93 Dairy Australia note that there are legislative controls over the price milk processing companies pay farmers for their milk in many countries around the world; *Australian Dairy Industry in Focus 2009*, p. 12.

> All product consumed domestically…would have a pricing structure completely separate from the exported product. The authority would set a minimum pricing structure to apply to all domestic product. The authority would determine from the amount of milk that is produced…the component that was consumed within Australia…and this would set the percentage or the amount of the farmer's production to be paid at the rate set by the authority…It would be done in a similar way to the way that the Dairy Structural Adjustment Program Scheme was struck, so that it does not allow people to suddenly come in and flood the market and receive a high percentage. A compulsory levy would be applied to all dairy farmers to help fund the operation of the authority. This is not unusual; it is similar to the research and development levy that currently applies through Dairy Australia. Therefore, this mechanism would be less dependent on government funding for its operation. A farmer could produce as much milk as he chose to, but only a component would be paid at a rate to reflect that consumed domestically.[94]

3.97 In the short to medium term the government could boost the returns to dairy farmers by buying milk, converting it to powder, and providing it to poor and/or drought-afflicted countries in exchange for commitments by them to environmentally sustainable practices. This would have a budgetary cost but could achieve simultaneously a number of objectives. A proposal along these lines was presented to the Committee by some South Australian farmers:

> We note AusAid is currently at $3.7b. The inclusion of dairy product, i.e. skim milk powder could give the government an opportunity to underpin the industry without it being seen as a subsidy.[95]

Committee view

3.98 The Committee is concerned about the increases in milk prices that do not seem to reflect farmgate prices, or be obviously related to other cost increases. At present, however, the Committee believes this can be better addressed by improving competition in markets rather than by direct regulation of retail prices. Should alternative approaches fail, the Committee believes that price controls could be reconsidered.

3.99 The Committee observed the UK model which relies on a formula to set the retail price although ruled out such a response in Australia given the prohibitive level of regulation it would introduce and the different composition of the Australian market.

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94 Ms Judith Clements, *Committee Hansard*, 18 January 2010, p. 48. See also her *Submission 19.*

95 Barossa Mid-North Co-Operative Dairymen Ltd, *Submission 7*, p. 2.

Varying prices in different states

3.100 Both retail and farmgate prices vary across the country, but not in a directly related way. The variation in farmgate prices is shown in Table 3.7. Over the medium term, prices tend to be lower in the southern states where climatic conditions are more conducive to dairy farming.[96]

Table 3.7: Typical farmgate prices (cents per litre)

	2008–09	Average 2002–03 to 2008–09
Queensland	57	41
New South Wales	52	38
South Australia	45	35
Tasmania	41	35
Victoria	39	34
Western Australia	49	33

Source: derived from data in Dairy Australia, *Australian Dairy Industry in 2009*, p. 14.

3.101 The prices received across states may also vary according to how the milk is used in the market place:

> …if you are in an area which supplies mainly drinking milk then prices tend to be higher—for example, in northern New South Wales and southern Queensland. If you are in an area where the preponderance or the bulk of the production is manufacturing milk that will ultimately go to export, then prices tend to reflect what is happening more closely with what is happening in the world market.[97]
>
> In Queensland there has been a contraction of farms and milk over the last 10 years since deregulation. It has only been in the last year that that decline in milk, which was compounding at about six per cent per year, has actually started to come back up. Now, obviously, pricing signals needed to be put in place in those areas to ensure that there was a fresh milk supply in Queensland for everyday milk. In the Queensland market, most of the manufacturing capability in that state has now ceased and it is really a market milk, predominantly state.[98]
>
> Queensland milk producers have received higher prices…than their southern counterparts because of the nature of the Queensland industry. The

96 As Chart 2.1 shows, dairying in Western Australia is concentrated in the south-west corner.

97 Dr Sheales, ABARE, Committee Hansard, 18 January 2010, p. 34. See also Senate Select Committee on Agriculture and Related Industries, *Food production in Australia, Third interim report*, November 2009, p. 3.

98 Mr Jeffrey, National Foods, *Committee Hansard*, 18 January 2010, p. 96. See also National Foods, *Submission 11*, p. 7.

industry is structured around the fresh milk market and is not strongly influenced by export market fluctuations.[99]

3.102 However this interpretation was also questioned by one witness:

> Yes, one price buys all milk. We do not get differential pricing. It is interesting: if companies are in different products, you would think there might be a variation of farm-gate price, but there is not.[100]

3.103 One interpretation was that the differences reflected previous attempts to lock in longer term contracts:

> …one of the issues that we have been well aware has been brought up in this discussion has been where one region has been paid substantially more than another. That is not necessarily driven by the circumstances of today but by the circumstances of 18 months or two years ago, where some of those regions were experiencing very harsh seasonal conditions and the companies made judgments about their long–term ability to source milk. Out of the discussions and negotiations at that time they went into contractual arrangements, which is not uncommon. They went in in good faith in that discussion with the producers and the groups involved in the companies and put contracts on the table for a period of time which they felt secured a base in their milk supply.[101]

3.104 In the shorter term, farmgate prices will reflect differences in the keenness of competition. The Committee heard that National Foods was offering farmers in New South Wales 44 cents per litre while only offering Tasmanian farmers 33 cents per litre.[102] A Tasmanian expert gave the following explanation:

> Mr Smith—The costs of production are probably higher in New South Wales because they are generally having to bring in more feed. We can grow feed more cheaply here.
>
> Senator MILNE—So you think it is because there is competition in the marketplace in New South Wales [that prices there are higher].
>
> Mr Smith—Yes.[103]

3.105 National Foods also referred to differences in competition, albeit somewhat more obliquely:

> …in Tasmania, Victoria or South Australia it is a different competitive set in terms of procuring milk…[104]

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99 Hon Tim Mulherin, Queensland Minister for Primary Industries and Fisheries, *Submission 24*, p. 1.

100 Mr Harris, *Committee Hansard*, 29 January 2010, p. 39.

101 Mr Judd, Australian Dairy Industry Council, *Committee Hansard*, 18 January 2010, p. 6.

102 Mr Richard Bovill, *Committee Hansard*, 6 November 2009, p. 2.

103 Mr Mark Smith, Dairy Tasmania, *Committee Hansard*, 6 November 2009, p. 26.

3.106 The Australian Bureau of Statistics measure average retail prices for milk in the capital cities, shown in Table 3.8. It is notable that the lower farmgate prices in the southern states appear not to be translated into lower retail prices.

Table 3.8: Retail milk prices across cities

(cents per litre for 2 litres whole milk; December quarter 2009)

Sydney	174	Perth	158
Melbourne	179	Hobart	185
Brisbane	159	Canberra	186
Adelaide	172	Darwin	213

Source: ABS, *Average Retail Prices of Selected Items, Eight Capital Cities*.

3.107 The ABS data in Table 3.8 refers to the average price paid for milk so will be influenced by differences in the proportions of branded and the cheaper generic milk in each city; and differences between the proportions of milk sold in supermarkets as opposed to convenience stores, milk bars and service stations.

3.108 Alternative sources, distinguishing between the prices of branded and generic milk, and not subject to these compositional effects, were used to compile Tables 3.9 and 3.10.

Table 3.9: Retail milk prices across cities

(cents per litre for 2 litres full cream milk; 7 February 2010)

	One major chain		Other major chain	
	Generic milk	Branded milk	Generic milk	Branded milk
Sydney	124	188 (df)	133	199 (pr)
Newcastle	124	188 (df)	124	177 (pr)
Canberra	124	188 (df)	124	187 (cm)
Melbourne	124	170 (pl)	133	186 (pr)
Brisbane	124	159 (df)	124	170 (df)
Cairns	na	na	124	175 (pl)
Adelaide	124	173 (df)	na	na
Perth	124	176 (hf)	na	na
Hobart	na	na	120	187 (pr)
Launceston	na	na	120	187 (pr)

df: Dairy Farmers; pl: Pauls; hf; Harvey Fresh; pr: Pura; cm: Canberra Milk.
Source: Secretariat based on supermarkets' online shopping websites.

104 Mr O'Malley, National Foods, *Committee Hansard*, 18 January 2010, p. 96.

Table 3.10: Retail milk prices across cities

(cents for 1 litre full cream milk; February — April 2010)

	One major chain		Other major chain	
	Generic milk	Branded milk	Generic milk	Branded milk
Sydney	137	224df	137	224df
Melbourne			137	239re
Brisbane			137	191pl
Perth	137	218pr	137	218pr
Adelaide			137	208pr
Hobart			137	208pr
Darwin	137	219pl	137	227pl

df: Dairy Farmers; pl: Pauls; hf; Harvey Fresh; pr: Pura; re: REV. Source: visits to supermarkets.

3.109 There is still no clear pattern of milk being cheaper on the supermarket shelves in areas where the farmgate price is lower, suggesting it may be competition (or lack thereof) in various retail markets that determines the prices charged there. This was conceded by Woolworths:

> But the retail price will move more often in those three years than the cost price will and it will move between stores and between regions and between areas, even though the cost may not change. That is just an effect of competition.[105]

3.110 Questioned on the difference in prices between cities, Coles replied:

> …the major difference in state prices could be attributed to the different timing of contract negotiations which applies for us at different times in different states.[106]

Committee view

3.111 The Committee brings to the attention of government the inconsistencies in price setting at the farmgate and retail levels of the domestic drinking milk market.

3.112 Throughout the course of its inquiry the Committee heard evidence of the established practice of Murray Goulburn effectively acting as a price leader, announcing their farmgate price and then being followed by the remaining processors of National Foods and Fonterra despite the different markets to which the companies sell.

105 Mr Dunn, Woolworths, *Committee Hansard*, 4 February 2010, p. 32.

106 Mr Hadler, Coles, *Committee Hansard*, 4 February 2010, p. 7.

Recommendation 4

3.113 The Committee recommends that the Government requests the ACCC to undertake monitoring of the pricing practices within the dairy chain with a view to establishing whether predatory pricing or misuse of market power is occurring.