

Public Submission to the ACCC Grocery Inquiry

Fonterra Brands (Australia) Pty Ltd on 11 March 2008

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1 INTRODUCTION

FONTERRA GROUP

- 1.1 Fonterra's operations in Australia are primarily undertaken by two companies, Fonterra Brands (Australia) Pty Ltd ("Fonterra Brands") and Fonterra Australia Pty Ltd ("Fonterra Australia").
- 1.2 Fonterra's Australian consumer branded products business is operated by Fonterra Brands. The majority of the milk collection, milk processing and manufacturing is undertaken by Fonterra Australia.
- 1.3 Fonterra's Australian business has evolved rapidly in recent years to include world class manufacturing sites, strong domestic ingredients and consumer businesses, and export operations throughout Australia. The businesses process, manufacture and market for sale an extensive range of dairy products. They also import a range of New Zealand produced dairy products into Australia for sale as both consumer branded dairy products and industrial dairy ingredients.
- 1.4 Fonterra Brands markets and supplies a wide range of branded consumer products, which are sold under some of Australia's leading grocery brands such as Connoisseur, Mainland, Perfect Italiano, Western Star, Bega, Anlene and Brownes. In addition, Fonterra Brands supplies a number of private label products to retail customers.
- 1.5 Fonterra's consumer branded products are sold Australia wide through the major grocery retail and wholesale channels as well as the other channels in which food products are sold such as petrol and convenience stores, cafes, bakeries, delis and similar establishments.
- 1.6 Fonterra Australia is a major processor of milk in Australia. In 2006/2007 Fonterra collected two billion litres of milk from Australian dairy farmers and turned it into leading consumer products and wholesale ingredients for the domestic and export markets. The consumer products manufactured by Fonterra Australia are sold by Fonterra Brands.
- 1.7 Through its domestic dairy ingredients business Fonterra Australia is a significant supplier of dairy ingredients to the Australian food-manufacturing sector. These ingredients are both sourced from local and international production.

THE INQUIRY

- 1.8 Fonterra has prepared this submission in response to the Issues Paper dated 11 February 2008. Fonterra has not been able to provide answers to all of the list of questions raised in the ACCC Issues Paper dated 11 February 2008. Where Fonterra has been able to provide answers or comments to a particular question, we have set out our answers below the question.
- 1.9 In providing this submission, Fonterra has given particular consideration to the issues which impact on the prices paid for milk, cheese and other dairy products.

2 EXECUTIVE SUMMARY

- 2.1 During the past five years the Australian dairy industry has been impacted by a range of significant domestic and international events, including severe droughts, increases in the overall costs of production, and more recently a dramatic increase in the global price for dairy products. These events have collectively contributed to both the processing costs of dairy products and the overall price paid by consumers for their day-to-day dairy products increasing during the period.

- 2.2 While domestic demand for dairy products has shown solid growth in Australia, international demand has reached unprecedented levels. This accelerating international demand has been driven by a range of cultural and economic factors, including the significant economic growth and cultural change of a number of evolving markets such as China and other Asian countries. In addition the global stockpiles of the key dairy commodities traditionally held by the European Union and the United States have been eroded to the extent that in May 2007 they had been effectively emptied.
- 2.3 As dairy producers around the world seek to meet this growing demand, significant restraints on supply have led to an imbalance between the demand and supply of dairy products. This in turn has driven up the global prices for dairy products to an unprecedented level.
- 2.4 This increase in the global price of dairy products not only directly affects the traditional consumer dairy products such as milk, cheese and butter, but also contributes to overall production cost increases across a wide range of food products which incorporate dairy ingredients.

AUSTRALIAN DAIRY MARKET CONDITIONS

- 2.5 In Australia over recent we have encountered some of the most severe drought conditions on record. These successive droughts have severely impacted Australia's production of milk and reduced the overall supply of milk available to process for domestic and export customers by up to 25%.
- 2.6 National dairy processing assets well exceed that required to efficiently process the national milk supply. The reduction in the supply of available milk, as a result of the drought and related impacts in agriculture in general, has led to a significant under utilisation of many of these assets. During this period dairy processors have also had to accommodate significant increases in general production costs at a time when plant utilisation was lower than required for efficient production.
- 2.7 The droughts have occurred at a time when overall farm input costs have increased significantly. Costs such as fuel, feed, fertiliser, labour and water have risen dramatically during this period and in many cases dairy farmers have had to reduce their herds in order to allow them to continue to farm through these difficult conditions. While in many regions significant rains have fallen, when reliable seasons return, the impact of the drought on the overall supply of milk will be felt for a number of years still.
- 2.8 The drought conditions in Australia, along with the generally difficult farming conditions and increases in the costs of production, have led to a situation where as milk supply decreased, dairy processors have had to vigorously compete to retain their existing milk suppliers, and at the same time seek to grow their share of milk supply in order to mitigate against reductions in plant utilisation. Combined with the recent growth in the demand for dairy products globally, there is currently a very competitive market for the supply of farm milk as dairy processors compete for this limited supply.
- 2.9 The significant imbalance between demand and supply for farm milk, associated with the strong competition between dairy processors, has led to a significant increase in farm gate milk prices over recent years. Fonterra has accordingly experienced significant increases in the price it has paid to its suppliers in order to secure an adequate volume of milk supply.
- 2.10 This increasing price paid for farm gate milk, being one of the key input costs in the production of dairy products, will put continued pressure on milk processors to recover these increased costs by both efficiency gains across their respective supply chains, rationalisation within the industry and an upward pressure on prices to their end customers such as the grocery retailers and wholesalers.

- 2.11 The global dairy commodity prices are interrelated to domestic dairy commodity prices as dairy commodities are internationally traded commodities. Milk processors must consider the returns that they can achieve across a broad product mix of both domestic sale and export.

CURRENT GROCERY RETAILING AND WHOLESALING MARKET

- 2.12 Fonterra operates in highly competitive consumer dairy categories with a large number of competing brands offering a high level of choice to consumers. This level of competition results in a natural barrier to price increase given the potential of volume loss to other competitors.
- 2.13 Dairy processors such as Fonterra, need to continually review their supply chains in order to obtain gains in efficiency as input costs increase. However, with the continual rise of the input costs associated with the processing of milk, it is inevitable that dairy processors will seek to increase the price of their products to protect the viability of their businesses where efficiency gains themselves are not sufficient to do so.
- 2.14 Fonterra's relationship with its major customers, and the trading terms negotiated with those customers, play an important part in any negotiation to protect its profit margins. Over and above the competitive pressures outlined in paragraph 2.12 above, Fonterra's major customers have significant buying power. Given this, Fonterra is not in a position to simply pass on production cost increases except in a manner where a full range of considerations have been negotiated around the entire trading relationship. While this may include increases to the wholesale price charged to customers, it typically includes a range of other associated conditions, which are negotiated as part of the overall trading terms to meet the combined business needs of Fonterra and the customer.
- 2.15 Fonterra considers that there is currently a very competitive environment in place with the major grocery retailers and wholesalers around some of the key dairy consumer products such as milk, cheese and butter. This competition between the grocery retailers and wholesalers, particularly on the prices charged to their customers for private label brands, has created a high level of visibility of these prices with consumers.

3 FOOD PRICE INFLATION IN RELATION TO DAIRY PRODUCTS

1. What has been the major causes of rising food prices in Australia (e.g. drought, transport costs, etc)? In particular, what have been major causes of the rising prices of products such as milk, cheese, bread, fruit and vegetables?

SUMMARY

- 3.1 The severe droughts in Australia and increases in the price of international dairy commodities and overall input costs relating to dairy farming and processing, have contributed to increasing retail prices for milk, cheese and other foods which have a significant dairy component.
- 3.2 Drought conditions in Australia, in particular in some of the key dairy producing areas in Victoria have had a significant effect in the reduction of milk produced by dairy farmers. During this period dairy farmers have had to deal with increases in their overall production costs as inputs such as fuel, fertiliser and grain feeds reach record levels.
- 3.3 In the past few years there has been an unprecedented global increase in the international prices paid for key dairy commodities. These increases have arisen as a result of a wide range of issues, which have affected the international dairy market.
- 3.4 There has been a sustained increase in the demand for dairy ingredients on a global scale led in particular by some of the emerging markets such as China and other Asian economies. While at the same time there has been increasing supply pressures due to

a range of factors including the depletion of international stockpiles of key dairy commodities, continued pressures of land use, such as for bio fuels production, and increases in the base agriculture input costs, such as fuel and grain. This has led to a situation where demand for dairy commodities has been outstripping supply and the international dairy commodity prices have increased as a result of these market pressures. While international commodity prices have softened slightly in recent months, Fonterra does not see any immediate changes to the supply restraints, which exist to meet the growing demand.

DROUGHT CONDITIONS AND PRODUCTION COSTS

- 3.5 As mentioned in the Executive Summary above the severe droughts which have occurred in Australia during the past five years, have caused a significant reduction in the production of milk within Australia.
- 3.6 The reduction in the supply of milk available for processing has created a very tight market for milk with farm gate prices paid for milk increasing significantly during the past year as competing milk processors seek to maintain supplies of milk for their businesses.
- 3.7 The reduction in the supply of milk for processing has reduced the overall utilisation of Fonterra's dairy processing assets as less volume of milk has been processed through the supply chain. Fonterra has also experienced other cost increases in transport and packaging costs as fuel prices continue to increase to record levels.

INCREASE IN INTERNATIONAL DAIRY COMMODITY PRICES

- 3.8 From early 2004 there has been a steady increase in international dairy commodity prices. However, in the past two years there has been an unprecedented increase in the international dairy prices for the major dairy commodities as a result of a significant supply/demand imbalance.
- 3.9 During the period from June 2006 to December 2007, there have been increases of between 100% to 150% across international dairy prices for the major dairy commodities.
- 3.10 The sustained demand from growing economies in Asia, which accounts for two thirds of Australia's dairy exports, has been driven by changing consumption patterns as the economies grow and personal income increases. These cultural and economic changes have increased the demand for dairy products, which are highly regarded for their health and nutritional benefits.
- 3.11 As demand for dairy products has accelerated many of the traditional exporters of dairy products have been unable to grow their supply to meet this increasing demand. Fuel and grain prices have reached record levels and there is increasing pressure on land use as other land use opportunities, such as bio fuels production, compete for lands traditionally used for dairy production.
- 3.12 Over this period the European Union and the United States have now emptied their traditional stockpiles of dairy commodities and these no longer impact the demand and supply for dairy products.

AFFECT ON GLOBAL RETAIL PRICES

- 3.13 The increases in the price of global dairy commodities has in many countries led to a significant increase in the prices that consumers ultimately pay for dairy products.

INTERNATIONAL DAIRY COMMODITY PRICE RELATIONSHIP TO AUSTRALIAN MARKET

- 3.14 The Australian dairy industry caters for both the domestic and export markets. Up to 50% of Australia's dairy production is exported. In Australia we have no access restrictions in the dairy market and with the degree of visibility of global dairy commodity prices domestic prices are influenced by the international market.
- 3.15 The increases in the international dairy commodity prices are related to the domestic market for manufacturing milk as processors consider the returns, which can be achieved from the export of dairy products such as cheese, butter, whole and skim milk powder to their export customers versus returns that can be achieved from the domestic market.
- 3.16 In addition to the pressures of international price increases, some local Australian factors, such as the on-going drought conditions in Australia, have also contributed to an increase in the price, which a dairy processor must pay to a dairy farmer for milk due to the increased competition for milk and the resulting shortage of supply.

FONTERRA MILK PRICE PAID TO FONTERRA MILK SUPPLIERS

- 3.17 The increasing international demand for dairy commodities and the resulting higher prices have in turn increased the price paid to dairy farmers as dairy processors actively seek to grow their milk supply volumes. This has occurred at a time in Australia where drought conditions across many of the key dairy producing regions have restricted production of milk. As a result of increased competition for farm milk and restrictions on supply, the farmgate milk prices paid to dairy farmers by dairy processors have increased, which in turn has significantly increased the dairy processors input costs.
- 3.18 Fonterra sources its milk from a range of different sources around Australia. In Victoria the majority of its supply of milk is obtained through a relationship with the Bonlac Supply Company Co-operative ("BSC").

2. Do the OECD comparisons accurately reflect the relative rates of food price inflation in Australia and the OECD countries? Are there other more relevant comparisons? Are there a more appropriate set of countries to compare Australia's food price inflation?

- 3.19 It is difficult to make direct comparisons with OECD countries concerning the retail price paid for dairy products. Many of these markets are subject to tariffs and quota arrangements which distort the real price of the retail products sold in those countries. In addition in many cases there are significant differences between these countries and Australia which is a significant exporter of dairy products.

4 STRUCTURE OF GROCERY INDUSTRY

3. What have been the major changes to the structure of grocery retailing in Australia over the past 5 to 10 years?

SUMMARY

- 4.1 The last 10 years has seen a significant change in the structure of the grocery industry with significant consolidation occurring in the grocery retailing and wholesaling industry. This, together with the competitive nature of these consumer dairy categories, means suppliers to the grocery industry have been under significant pressure to maintain their profitability by driving efficiencies across their businesses as input costs, such as increased commodity prices, place a strain on their profitability.

CONSOLIDATION

- 4.2 During the past 5 to 10 years there has been significant consolidation of retailers and wholesalers occurring within the grocery sector. Retail chains such as Action, Franklin's and Foodland have ceased to exist during this period. As outlined in Appendix A of the Issues Paper circulated by the ACCC, these businesses have been incorporated predominantly into the operations of Metcash Trading, Woolworths and to a lesser extent Coles.
- 4.3 In contrast to this consolidation, we have seen the entry of the German based international discount grocery retailer Aldi who have increased the level of price competition in the grocery market and provided consumers with an alternative to the major grocery retailers.

OWN BRAND AND PRIVATE LABEL

- 4.4 The major retailers have in the past five years actively developed their own private label brands at the expense of existing branded products. The number three to five brands in certain product categories where retailers have developed private label brands, have in many cases been replaced by the retailers own private label products.

FRESH TO STORE

- 4.5 The major retailers have been involved in significant supply chain transformation initiatives in the past five years, which in many cases have focussed on the delivery of fresh and prepared produce into store. This has had an impact on other dry grocery goods as the grocery retailers accommodate these changing patterns of consumption.

GROCERY RETAILING

4. What factors have driven these changes (e.g. changes in trading hours, one-stop convenience of supermarket shopping, mergers and acquisitions, etc). What has been the relative importance of these and other factors?

- 4.6 The major changes in grocery retailing have been driven by mergers and acquisitions with the general consolidation between Woolworths, Coles and Metcash Trading.
- 4.7 To a lesser extent the major retailers strategies to drive growth by developing fresh to store products has led to significant supply chain transformations and changes in the way products are offered for sale in the existing supermarket store formats.

GROCERY WHOLESALING

10. What have been the major changes to the structure of grocery wholesaling in Australia over the past 5 to 10 years?

- 4.8 During the past decade, the major wholesalers and distributors such as Metcash Trading, PFD and Bidvest have grown significantly. While there are some national wholesalers and distributors such as Metcash Trading, PFD and Bidvest, there are still a large number of smaller distributors and wholesalers who operate across the grocery wholesaling industry.

11. What factors have driven these changes (such as cost savings from large-scale wholesaling operations, changes to the structure of grocery retailing, mergers and acquisitions, etc.)? What has been the relative importance of these and other factors?.

- 4.9 There has been a major shift in consumer consumption patterns over the past decade with more consumers eating out of home. This has led to an increase in the number of cafes and restaurants to cater for these changes in consumer habits. As these developments have occurred, there has been an increasing need to service new food outlets with a wide range of food products.

12. In what ways (if any) do grocery wholesaling operations and arrangements differ by product categories? Please provide details.

- 4.10 While some of the larger food distribution companies seek to provide wide ranging offerings of products, the nature of the wholesale distribution business is such that many provide specialist services to suit certain markets, for example milk and dairy distributors. While some wholesalers provide specialist wholesaling and distribution for particular product categories, they may also operate as a specialist in particular sectors of the food industry, such as the foodservice sectors and the café and convenience channels.

UNDERSTANDING THE GROCERY SUPPLY CHAIN (QUESTIONS 17-21)

- 4.11 The supply chain for Fonterra's Australian business starts with the collection of milk by Fonterra from on-farm milk vats to the manufacture, importation and ultimate sale of a wide range of consumer products and diverse dairy ingredients to a global customer base. It is a complex undertaking, which requires significant investments of capital and comprehensive business support from on farm support to Fonterra's milk suppliers, through manufacturing capabilities to sales, marketing, financial management and a high level of integration into our customer's respective supply chains.

5 CONSUMER BEHAVIOUR AND CHOICE OF GROCERY RETAILER

CONSUMER BEHAVIOUR AND CHOICE

22. What options or choices of retailer do consumers have to purchase grocery products? How far will customers travel for their groceries? How does this differ by grocery product (packaged food, meat, fruit and vegetables, etc)? How does this differ depending on the type of shopping trip (weekly shop, top-up purchases, etc)?

- 5.1 For the purposes of responding to this question we have focussed on consumer's choice relating to dairy products.
- 5.2 Consumers have a very wide range of purchase options when wanting to purchase dairy products. These options, to a certain extent, depend on the type of dairy product which is being purchased, for example fresh white milk which is broadly available from small local convenience stores through to the large national grocery chains. Products such as specialty cheeses and other premium products have less distribution.
- 5.3 Most staple dairy products such as milk, butter and non-specialty cheeses are available across most food retailing businesses, including national supermarkets, petrol stations, convenience stores, milk bars, route trade outlets, fresh food markets and other food stores such as bakeries.
- 5.4 When purchasing dairy products the proximity of retail outlet is important.
- 5.5 As dairy products have a very wide distribution in Australia, across many retail outlets, consumers can generally satisfy their needs for typical dairy products on a regular basis on short notice.
- 5.6 The purchase of dairy products, while included in regular shopping trips, can also be attended to on a more regular basis due to the widespread distribution of these products across the entire food distribution system.

23. Would unit pricing (a requirement that the price per kilogram or per 100 grams etc is displayed on the supermarket shelf or product) improve the ability for customers to compare prices? Should unit pricing be made compulsory? Would unit pricing lower the cost of shopping for customers?

- 5.7 In most cases, our products are sold in consistent pack sizes or by volume alongside competitors' equivalent products. For example, cheese is sold in 250g, 500g or 1kg blocks, and fresh milks by the litre or portions thereof.
- 5.8 We do not consider that unit pricing, in relation to dairy products would improve the ability of consumers to compare prices nor would it lower the cost of shopping for consumers.

24. How important to consumers is the convenience of purchasing from a retailer offering a broad range of grocery products (meat, fruit and vegetables, packaged products, etc)?

- 5.9 Consumers are becoming increasingly time poor and as a consequence they are looking for ways to save time with their day to day activities such as shopping. Typically a large scale supermarket will provide the consumer with the convenience required to do all their shopping in one location, quickly and efficiently.
- 5.10 In contrast, there is also a growing trend for consumers to seek out specialist food traders for a greater range and quality in certain product categories, for example the local butcher, fishmonger, deli, green grocer or bakery.

25 How important is price for consumers when they decide where to buy groceries? Does this differ depending on the grocery product?

- 5.11 Price is an important factor to certain consumers. However, other factors may also influence purchasing behaviour, such as proximity, parking, product range, cleanliness and quality.

26. How important are factors such as distance of travel, freshness of perishable items, product range, etc? Does this differ depending on the grocery product? If so, how and why?

- 5.12 Issues such as distance of travel, freshness of perishable items, product range etc are all very important factors to a consumer. In the case of frozen foods and other perishable products such as milk and cheese, the issues such as distance to travel and freshness will be far more important than for dry non-perishable goods.

27. How do consumers gain information on the pricing of grocery retailers (advertising by grocery retailers, word of mouth, comparisons of key grocery items, etc.)?

- 5.13 The grocery retailers all use an extensive range of media to advertise and promote their businesses and the prices at which they sell groceries.

6 BUYING POWER IN GROCERY SUPPLY MARKETS

46. Are large grocery wholesalers or retailers able to acquire products from suppliers at lower prices or on better terms than smaller wholesalers or retailers? Does this differ by product type?

- 6.1 Given the relative size of orders, typically a large grocery retailer or wholesaler will be able to purchase at lower prices to a smaller retailer or wholesaler. The pricing may differ across dairy product groups but similar factors, as mentioned above, may apply in the trading terms negotiated with the customer and these factors may be weighted differently depending on the particular product group.

48. Do suppliers incur lower unit costs in supplying larger wholesalers or retailers? What are the sources of these costs savings (bulk sales, purchase guarantees, etc.)? Are these reflected at the retail level?

- 6.2 Fonterra achieves a lower unit cost when selling its products into a larger wholesaler or retailer who can provide Fonterra with higher volume purchases. The major sources of cost savings are in supply chain and are linked to volume. There are also additional benefits achieved where a large-scale customer has consistent purchasing patterns, which enable manufacturing efficiencies.
- 6.3 Fonterra is not privy to the cost structures of its customers and accordingly is not able to provide any comment on whether their lower purchase costs are passed onto consumers.

49. Do suppliers offer the same terms and conditions to all grocery wholesalers or retailers? For example, if a small wholesaler offered to purchase the same volume as a large wholesaler, would the small wholesaler receive the same volume discount?

FONTERRA PRICING POLICY

- 6.4 As a general principle for Fonterra's consumer branded products, which are sold to the grocery retailers and wholesalers, Fonterra has a uniform pricing model across its product range.
- 6.5 The approach to pricing of Fonterra products involves establishing a wholesale list price for those products.
- 6.6 Fonterra will then negotiate trading terms with its key customers, taking into account a wide range of considerations such as:
- (a) the volume of their business with Fonterra;
 - (b) the efficiencies of managing the account relationship;
 - (c) the benefits they can deliver to our business, for example;
 - (i) support and ranging of our products;
 - (ii) business development strategies that support a product category;
 - (iii) promotional support and related activities instore;
 - (iv) access to new promotional concepts and in-store initiatives.
- 6.7 By this process of business partnering with its customers, Fonterra's trading terms with its key customers may incorporate a range of discounts or rebates in conjunction with other activities that support the sale of its products.
- 6.8 It is difficult to make a direct comparison between customers as there are a wide range of factors involved which affect the ultimate trading terms under which we trade with a customer.
- 6.9 If a smaller wholesaler or retailer was to purchase the same volume of our products as a large wholesaler or retailer, then in general, they may be able to achieve similar discounts to a larger wholesaler or retailer where the overall relationship was comparable.

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