

Submission

Public submission to the ACCC Grocery Inquiry by National Foods

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1 Introduction

1.1 National Foods

National Foods' core activities in Australia are the manufacture and wholesale of drinking milk, fresh dairy foods, cheese and fruit juices.

National Foods is not a participant in the grocery retail sector. However, it is pleased to provide information to assist the ACCC understand the Australian dairy industry supply chain and the factors that have influenced prices in recent years.

Further relevant dairy industry information and statistics are publicly available at the following website: <http://www.dairyaustralia.com.au>

1.2 The Australian Dairy Industry

The dairy industry is one of Australia's major rural industries. In 2006/2007 it was valued at around \$3.2 billion at the farmgate.

The Australian dairy industry is open (with high levels of trade in manufactured dairy products) and the setting of prices and the terms of supply is unregulated. This is reflected in the fact that around half of Australia's total milk production is exported to more than 100 countries.

2 Key dairy industry trends

Continuing drought conditions across some of Australia's major water catchments (such as in the Southern Murray Darling Basin) has led to lower milk production, particularly in irrigation dependent areas. This has resulted in substantially higher input costs for dairy farmers, who either need to pay high prices for scarce water or feed their herds with high cost grain/hay. This significant negative impact of the drought for farmers is in part being offset by high international dairy commodity prices and drought payments to farmers by the co-operatives and milk processors as well as other drought assistance by governments.

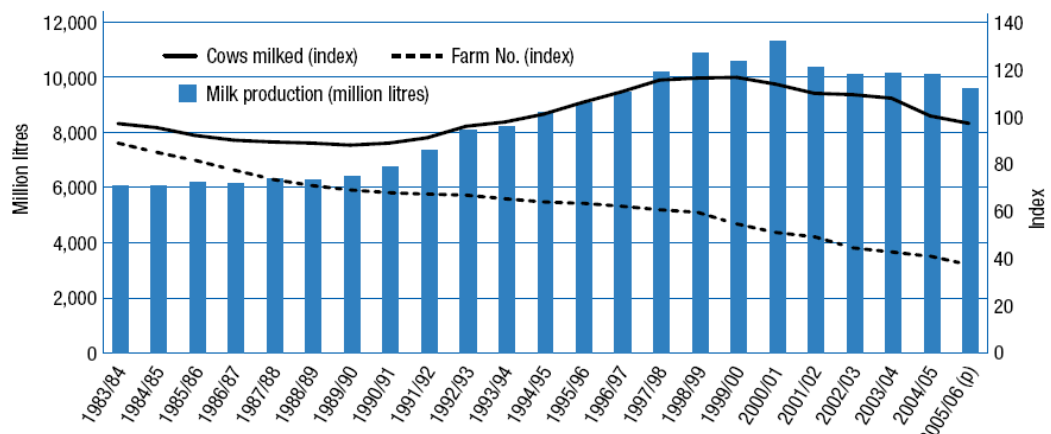
For domestic drinking milk processors (like National Foods), the convergence of reduced domestic milk production, high dairy commodity prices and increased costs for feed necessary for year around production of raw milk, has led to significantly higher milk acquisition prices. This situation, combined with increasingly complex logistics around variable regional milk flows, pressure on margins at the wholesale level, and plant overcapacity exacerbated by reduced raw milk supply, has put pressure on processors to rationalise and achieve greater efficiencies in all aspects of their operations.

3 Raw milk production and supply

Australia's dairy industry is predominantly pasture-based with efficient, low-cost, high-quality milk production. However, in the present drought conditions most farmers must supplement pasture feeding, which adds considerably to the cost of production.

The number of dairy farms has more than halved over the last 25 years, reflecting the need for farmers to shift to larger, more efficient operating systems. Over the same period herd size and average annual milk production per farm has more than doubled.

Australian milk production vs indices of farms and cows milked



Source: Australian Dairy Industry in Focus 2007, Dairy Australia

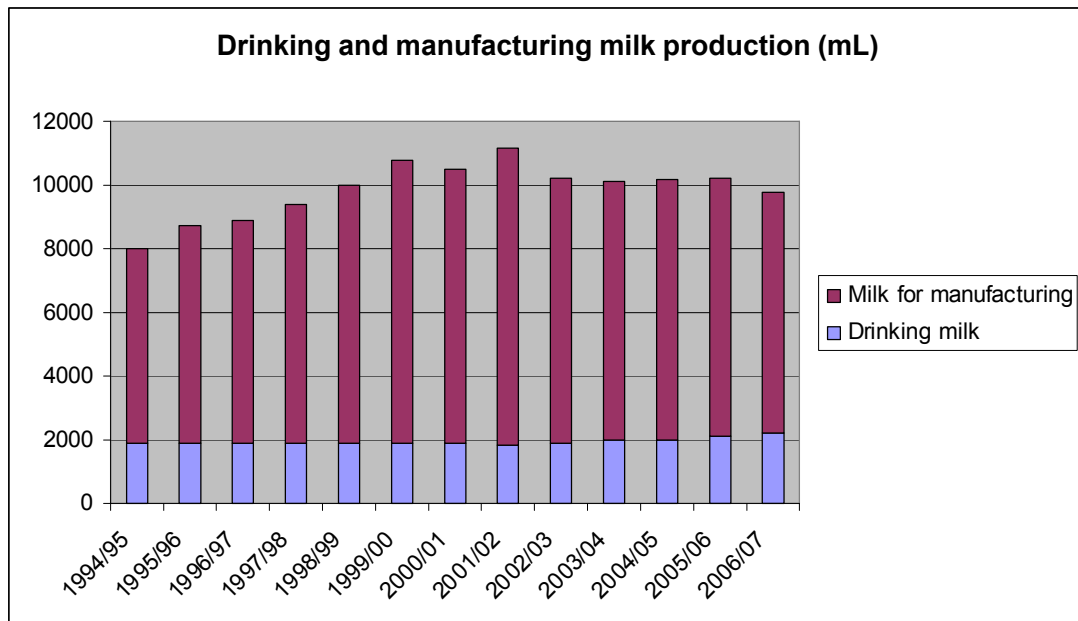
Milk production is concentrated in the south-east corner of Australia, with Victoria, Tasmania and South Australia accounting for almost 80% of national output.

Milk production (million litres)

	NSW	VIC	QLD	SA	WA	TAS	AUST
2004/05	1,218	6,613	619	679	398	600	10,127
2005/06	1,197	6,651	597	646	377	622	10,089
2006/07	1,105	6,297	534	655	349	642	9,582

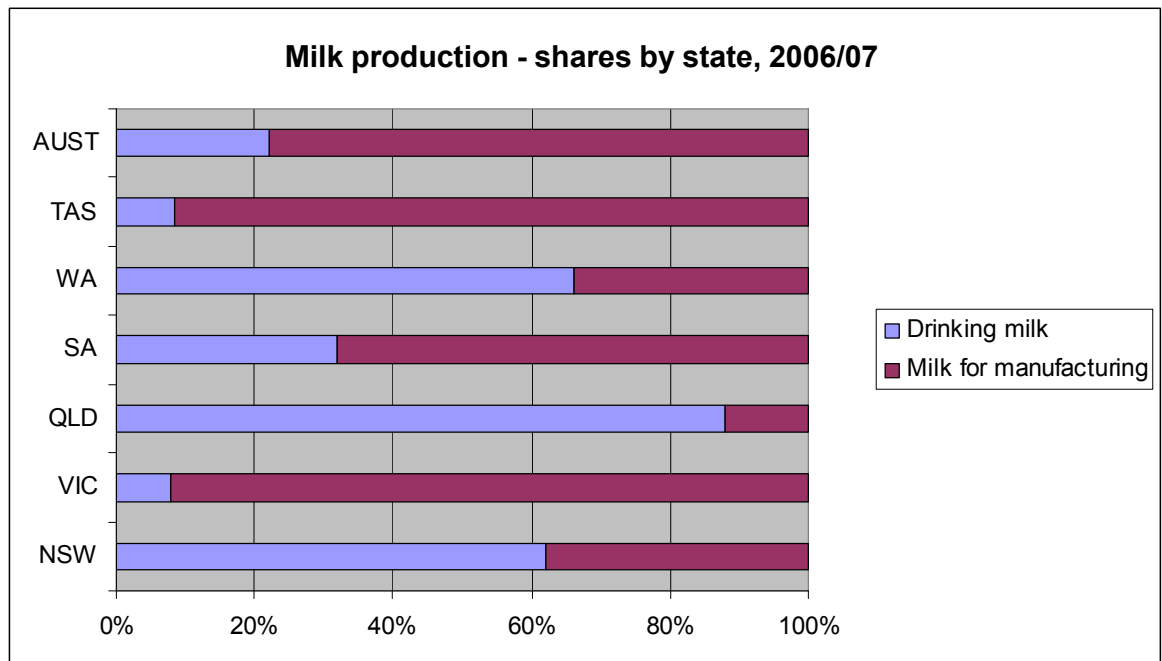
Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Around 80% of raw milk is manufactured into dairy products (such as cheese), with the remainder used for fresh drinking milk.



Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Australian milk production remains strongly seasonal. However, this is less pronounced in Queensland, Western Australia and New South Wales, due to the greater focus on drinking milk in the product mix of those states (which requires year around production).



Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Raw milk prices are ordinarily linked to milkfat and protein content levels. However, international prices for traded dairy products are the most significant factor in determining the price received by farmers for their raw milk.

Typical factory paid prices

		2004/2005	2005/2006	2006/2007
NSW	cents/ litre	32.9	34.3	35.7
	\$/kg milk solids	4.62	4.80	5.02
VIC	cents/ litre	31.5	32.9	32.0
	\$/kg milk solids	4.23	4.44	4.32
QLD	cents/ litre	35.0	36.6	38.8
	\$/kg milk solids	4.84	4.99	5.38
SA	cents/ litre	30.1	32.0	32.6
	\$/kg milk solids	4.19	4.49	4.57
WA	cents/ litre	27.2	29.0	32.0
	\$/kg milk solids	3.89	4.09	4.49
TAS	cents/ litre	30.9	33.6	36.5
	\$/kg milk solids	4.05	4.39	4.79
AUST	cents/ litre	31.5	33.1	33.2
	\$/kg milk solids	4.28	4.50	4.51

Source: Australian Dairy Industry in Focus 2007, Dairy Australia

It is noteworthy that prices paid by processors to farmers in 2007/08 have increased significantly since 2006/07 (typically around 40% higher), for the reasons outlined above.

4 Processing of milk and dairy products

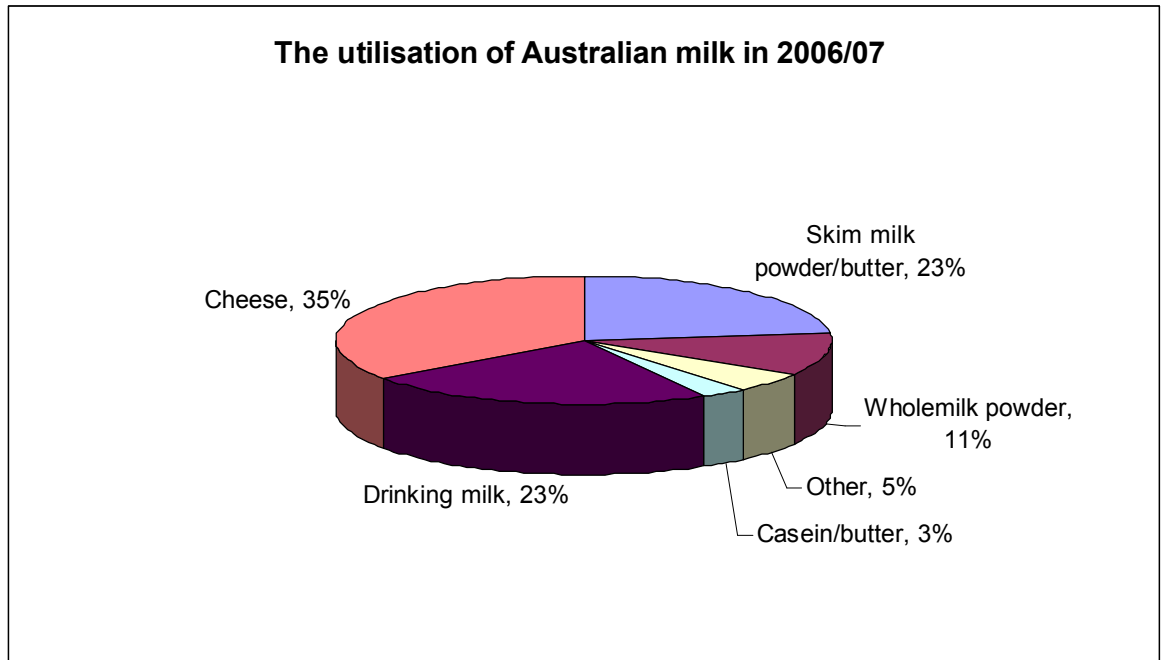
The milk processing sector is undergoing continued rationalisation, reflecting the need to achieve improved factory capacity utilisation, greater efficiency and economies of scale. This rationalisation is of particular importance given the current drought conditions in many parts of Australia which have constrained the supply of milk to processing facilities. The total production of milk in 2007/08 is forecast to be 15% below the level achieved in 2001/02.

The Australian dairy manufacturing sector is diverse and includes farmer-owned cooperatives as well as public and private companies. The largest cooperative (Murray Goulburn) accounts for almost 40% of Australia's dairy production.

The major manufactured dairy product streams are:

- drinking milk – fresh and UHT;
- butter / skim milk powder;
- butter / casein;
- cheese;
- whole milk powder;

- fresh dairy products, such as yoghurt, dairy snacks, dairy desserts and cream; and
- specialised ingredients.



Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Around 68% of manufactured product (in milk equivalent terms) is exported. This contrasts with drinking milk, which is predominantly consumed in the domestic market.

5 Drinking milk

Whole milk, which is packaged for drinking, is standardised to a minimum milk fat content of 3.2%, as required under the Australia New Zealand Food Standards Code. Modified, reduced and low-fat milks are standardised to other relevant specifications and have varying milk fat and solids non-fat levels.

Drinking milk sales by State (mL)

	NSW	VIC	QLD	SA	TAS	WA	AUST
2004/05	641	486	429	200	215	53	2,024
2005/06	656	495	445	198	218	53	2,065
2006/07	684	509	475	207	230	55	2,160

Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Drinking milk sales by type (mL)

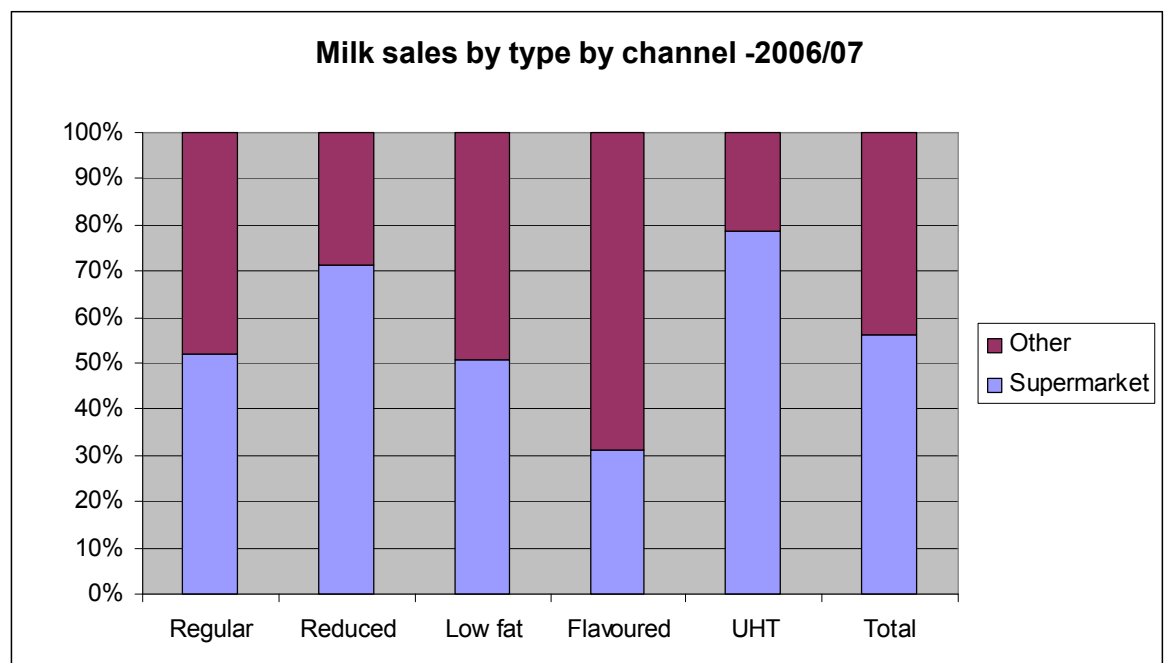
	Regular	Reduced	Low fat	Flavoured	UHT	Total
2004/05	1,078	457	138	200	152	2,024
2005/06	1,088	478	140	204	156	2,065
2006/07	1,111	511	147	216	175	2,160

Source: Australian Dairy Industry in Focus 2007, Dairy Australia

Due to its perishability, milk processors require access to raw milk supplies within reasonable proximity to milk processing factories. In turn, these factories are usually located in areas from which major consumer markets can be easily serviced with packaged fresh milk products. Drinking milk processing facilities are therefore generally situated in the dairying districts located nearest to metropolitan cities and large regional centres.

In most areas the majority of drinking milk is produced by large scale processors, along with a range of smaller regional players. Since deregulation, a number of micro-processors have also developed niche markets by bottling milk on-farm for sale under their own brands.

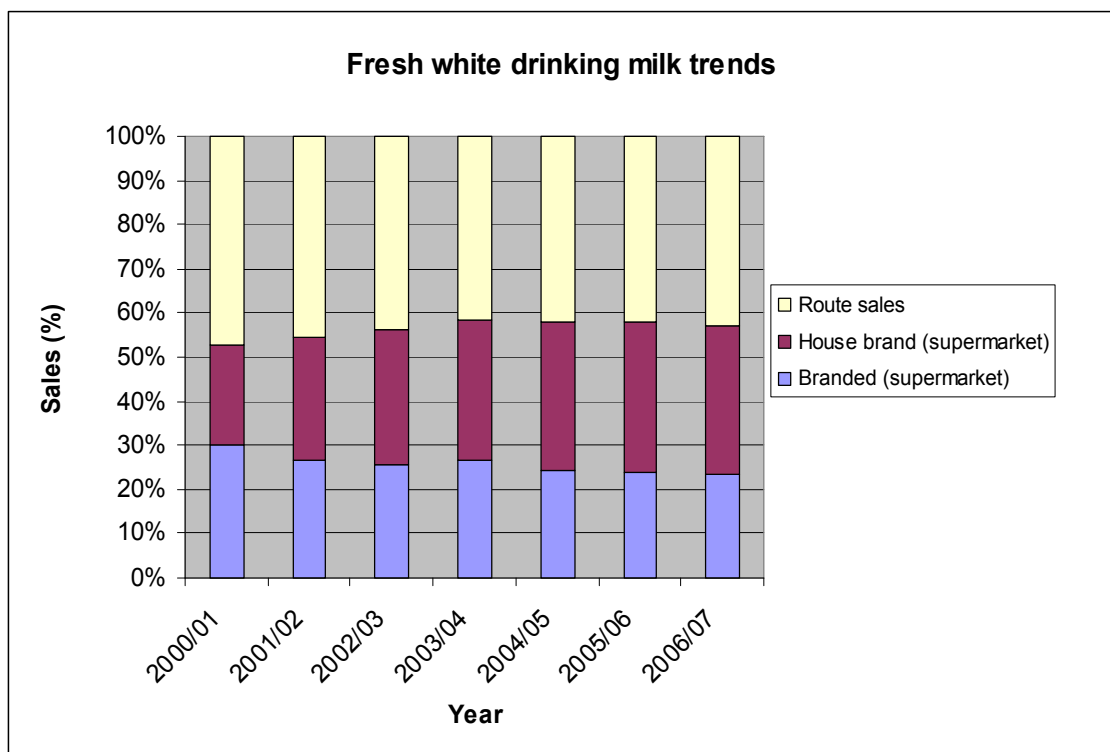
The major supermarket chains account for around 56% of drinking milk sales at the retail level.



Source: Derived from Australian Dairy Industry in Focus 2007, Dairy Australia

There has been strong growth of private label white milk sales in the grocery channel, at the expense of dairy company proprietary branded milk. Nationally, private label sales of white milk in the grocery chains have grown by 65% in volume since 2000/01. This growth is demonstrated in the chart below.

National white milk drinking trends



Source: derived from Australian Dairy Industry in Focus 2003, 2004 and 2007, Dairy Australia.

6 Dairy Structural Adjustment Program

As part of the Dairy Structural Adjustment Program, the Dairy Adjustment Levy was imposed on domestic retail sales of products marketed as dairy beverages from 8 July 2000. The levy is set at 11c/L and payment is expected to continue to the end of the decade.

7 Cheese

Cheese is a major product for the Australian dairy industry, with domestic sales around 230,000 tonnes and export sales around 217,000 tonnes in 2007.

The basic process for making cheese takes the following path:

- raw milk is pasteurized. (White and Blue mould cheese have additional cream added whilst Fetta style cheeses have some of the cream removed);
- starter culture is added to warm milk to produce both acid and flavour;
- rennet is added to form curd and whey;
- the curd is cut and stirred to allow the whey to drain.

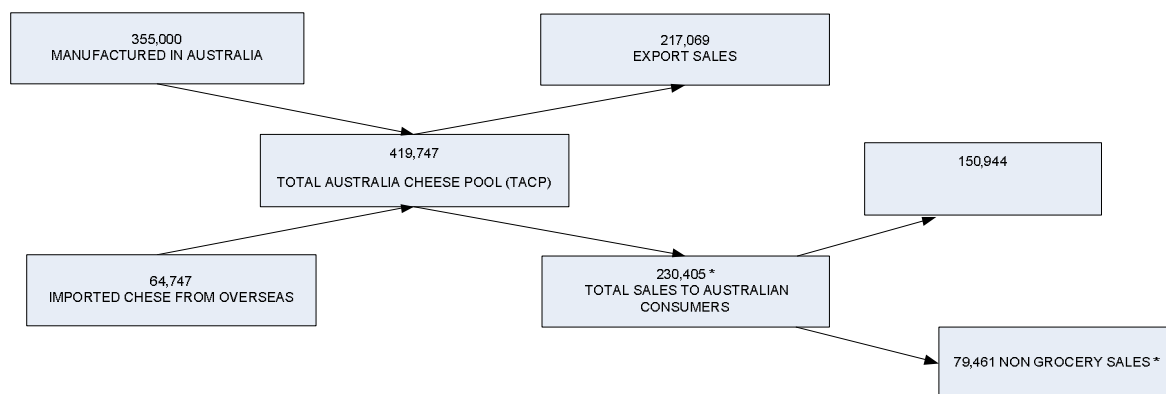
All the different varieties of cheese generally follow these primary steps. However, thereafter a range of processing techniques and skills are applied in order to produce the cheese varieties.

The Australian market for the manufacture and wholesale supply of cheese is characterised by high levels of international trade. The chart below provides an illustration of the cheese flows into and out of Australia. The chart shows:

- more than 50% of domestically manufactured cheese is exported;
- imported cheese forms a significant proportion of the domestic market (around 28%); and
- the majority of cheese is sold domestically through the grocery channel.

Estimated cheese flows in Australia for 2007 calendar year

CHEESE FLOWS IN AUSTRALIA FOR 2007 '000 kilos



Source: Dairy Australia.

*(includes 15,000 tonnes to reflect non-database contributors)

8 Dairy product distribution and retail

The major purchasers of drinking milk and dairy products from processors are generally categorised as either being in the grocery channel or the route trade.

8.1 The grocery channel

The grocery channel generally comprises supermarkets or independent stores which operate within buying groups as follows:

- 1 the major grocery chains (Woolworths and Coles), which sell their own private labels and processor proprietary brands;
- 2 other smaller chain supermarkets including:
 - Metcash's Action supermarkets which has stores in Queensland, northern New South Wales and in Western Australia;
 - Aldi, a growing participant in the Australian retailing sector.

Wholesale sales of dairy products to the grocery channel are often made pursuant to contracts that arise from a competitive tender process, particularly in relation to the supply of private label products.

8.2 The route channel

The route trade generally comprises smaller, independent supermarket stores and non-supermarket stores either in a convenience store format or the traditional corner store as follows:

- 1 independent grocery stores which have centralised purchasing arrangements, such as:
 - Independent Grocers of Australia (IGA), a large group of over 1,100 retailers in New South Wales, Victoria, Queensland and South Australia, comprising a range of store types from large format supermarkets, mid-sized supermarkets and small format/convenience stores.
 - Foodworks, a group of independent stores established in 1997 operating in Victoria, New South Wales and Queensland, comprising Foodworks supermarkets and FoodWise convenience stores.
- 2 petrol stations and convenience stores which purchase centrally, often on a national or state basis. These stores include those operated by the petrol retailers as well as chains such as 7 Eleven. It also includes the major grocery chains such as Woolworths and Coles, who have retail sites alongside major petrol retailers and are increasing their presence in the convenience sector;
- 3 corner stores who are serviced by milk vendors supplied by processors; and
- 4 foodservice providers including cafes, hospitals, hostels, restaurants, and coffee chains.

There are a variety of different contractual relationships that apply to wholesale sales of dairy products to the route channel. These include:

- contracts with individual retail outlets;
- contracts with dairy distributors that re-sell dairy products to retailers; and
- contracts to supply chains / groups of associated retail outlets that are negotiated centrally.

In each instance contracts are formed in a competitive environment.

9 Price changes for drinking milk and dairy products

In recent years there have been increases in the price of raw milk sold by farmers to processors as well as in wholesale prices for drinking milk and dairy products sold to retailers and internationally¹.

The key drivers of these price changes arise from both domestic and international factors.

- 1 Domestically, severe drought conditions in Australia have had the dual effect of increasing the cost of raw milk production for dairy farmers and reducing milk supply to processors. Both of these factors have driven up farmgate prices.
- 2 Strong international demand for dairy products combined with reduced supply from traditional exporting regions have pushed up dairy commodity prices. World prices in turn have a flow on effect at all levels of the domestic supply chain.
- 3 Milk processors, such as National Foods, are faced with higher input costs (particularly for raw milk and other goods such as petrol) as well as the costs of managing reduced milk supply (which adversely effects efficiency in logistics and plant utilisation).

In short, the recent price changes for the supply of raw milk and for the wholesale supply of drinking milk and dairy products are directly linked to increased domestic costs and

¹ As the ACCC is aware, price changes have also occurred at the retail / consumer level. However, National Foods is not a retailer and is not in a position to provide additional comment on the reasons for these adjustments.

increased world prices for dairy products. National Foods' experience suggests that the Australian dairy industry supply chain is highly competitive and efficient by world standards. This is reflected in the fact that half of Australia's total milk production is exported to more than 100 countries.