Public submission by Kiama Shellharbour Albion Park Milk Suppliers Collective Bargaining Group

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Introduction

It is our submission that in certain parts of Australia the dairy industry is adversely affected by the conduct of processors and food retailers inasmuch that there is:

- A lack of competition in some markets
- Natural monopolies exist
- Incomplete markets exist
- A lack of price transparency
- The industry is, in part, susceptible to abuses in market power
- The existence of cartel behaviour
- Under investment in innovation and new ideas across all sections of the industry, and
- Constraints to productivity growth.

In this submission we believe that most of the foregoing falls within the range of sections G & H of the ACCC's Issues Paper.

We submit that the foregoing acts to the detriment of true competition and that this is decidedly at an ultimate cost to consumers but to the benefit of processors and major retailers.

Our submission addresses each of these factors and where relevant we suggest possible remedies with the aim to improve competition; improve investment in innovation and capacity across the whole of the Australian dairy industry to the ultimate benefit of all sectors in the supply chain and specifically consumers.

Background

First it is necessary to understand the way in which the domestic dairy industry operates. Rather than a single market the Australian dairy industry has a number of separate and discrete markets. These markets are regionally based and can be described as:

- Northern Australia – Cairns to the Kimberly
- Central Queensland – based around Rockhampton
- South East Queensland & North East NSW – Noosa to Grafton
- Central NSW – incorporating Sydney, Newcastle, Wollongong and the Central West
- Southern NSW, Victoria and South Australia
- Tasmania, and
- Western Australia

In terms of each of these markets or sub markets of the Australian whole we make these comments.

In terms of our submission on aspects of the domestic market for dairy products we are concerned about the conduct of two main processors namely National Foods Limited (NFL) and Dairy Farmers Group (DFG) other market participants are Pauls Parmalat Limited (PPL) and Norco Cooperative Limited (Norco). None of these processing companies have a significant presence in export markets.

Northern Australia – Cairns to the Kimberly

This is a natural monopoly in terms of processing. The single processor DFG processes and also packs milk products from milk produced on the Atherton Tablelands for NFL. These products are distributed across the north of the continent as far as Kununurra. All milk producers are on contact to DFG.

Central Queensland – based around Rockhampton

This is also a natural monopoly based in Central Queensland and serves the middle of the Queensland coast and the western inland areas of the state. PPL operates the processing plant and it is understood does some brand processing for other processors. All milk producers are on contract to PPL.

South East Queensland & North East NSW – Noosa to Grafton

This is the fastest growing market in Australia with growth at approximately four percent a year. There are four processors operating in this market namely PPL, DFG, NFL and Norco.

It presents an interesting situation inasmuch that there are frequent supply shortages. These shortages are due to the contraction of the number of producers both by number and volume. The main period of shortage occurs seasonally from about March to May.

Two things occur to alleviate this shortage. Firstly, milk is carted from Victoria and Southern NSW at approximately 16¢ per litre in freight costs. Secondly, there is the addition of a liquid by-product of cheese manufacture known as permeate which is added to packaged milk. This too is purchased at about 1¢ per litre and carried for 16¢ per litre from Victoria. Permeate is added to milk at up to 12 percent; the rationale used is that it standardises the fat and protein content of the milk. In reality we suspect it waters down the milk.

For 100 litres of milk containing 12 per cent permeate the calculation is:

Farm-gate price of milk 45¢ per litre per 88 litres	=	39.60
Permeate at 17¢ per litre per 12 litres	=	<u>2.04</u>
Net value per litre ¢		<u>41.64</u>

This is a discounted value on the farm gate milk price of 7.5 percent with all of the benefits being taken either by retailers or processors to the detriment of both producers and consumers.

This represents a significant discount on the farm gate price of milk and amounts to a passing back up the supply chain of costs compared to the profits derived by both processors and retailers. This has allowed for so called discounting of milk especially by retailers private brands. Another possible outcome of the addition of permeate is a reduction in shelf life of milk.

We understand that only one of the four processors in this market has resisted the pressure to add permeate to milk. We submit that the ACCC may wish to investigate the efficacy of this assertion.

Processor-to-processor dealings are also effectively resulting in a secondary milk market.

In addition PPL as part of its collective bargaining group has a system of quotas. That is the right to produce and sell a given volume of milk at a certain price. Farmer suppliers who do not hold a quota receive a lower price. This system acts a restraint to trade, encourages rent seeking and serves to drive costs up. This is a carry over of regulation and serves to diminish competition with resultant supply chain ramifications.

Central NSW – incorporating Sydney, Newcastle, Wollongong and the Central West

This is the largest domestic market in Australia and it too has similar seasonal supply problems to the market immediately to the north. We understand similar conditions exist in terms of the processing and marketing of dairy products. The two major processors in this market are NFL and DFG. The two dominant retailers are Coles and Woolworths. It is understood permeate is also added by processors to milk for sale in NSW. We submit that the ACCC may wish to investigate the efficacy of this assertion.

Again secondary milk markets occur in this market through processor-to-processor dealings.

Southern NSW, Victoria and South Australia

This region is the epicentre of the Australian dairy industry with more than 70 percent of production occurring here. Most of the milk produced in this region is for processed exports. The area services the domestic markets of Melbourne and southern regional cities as well as Adelaide.

Dominant processors in this market are DFG, NFL, PPL and Murray Goulburn (MG). The predominant retailers are Coles and Safeway.

Tasmania

Most of the milk produced in the state is also destined for the export market.

Western Australia

This is an isolated market and has its own unique production and market problems.

General

National dairy production is 9.6 billion litres, of this 2 billion litres are consumed as drinking milk, the rest is manufactured into other milk products, being cheese, powders, yogurts, ice cream and other products. Domestic consumption accounts for 48 percent of total production and exports 52 percent. Consequently overseas commodity prices are always a significant factor in domestic pricing as are exchange rates.

A lack of competition in some markets

As described earlier the least competitive markets in Australia are those based around the capital cities of Brisbane and Sydney. This is due to a combination of circumstances, being:

- The exercise of market power by major retailers
- Cartel behaviour
- Inadequate price signals, and
- Diminished farm-gate competition for supplies.

These issues are addressed below.

Natural monopolies occur

We have dealt earlier with the existence of natural monopolies and they are by essence caused though isolation and distance and comparatively small population and consequent demand.

Incomplete markets exist

The contracts that processors offer are short term either being one, two or three years and most having onerous conditions attached to them.

Domestic processors in order to coordinate their activities and to share their risks are prone to undertake opportunistic behaviour and thus to trade sequentially and make only limited contractual commitments into the future with their suppliers. Frequently this is forced by their short term view of markets and the consequent imperfections in predictions and their knowledge of other factors impacting upon the market. This is leading to producers refraining from investing in new ideas and innovations and hence capturing productivity gains.

<u>Suggested remedy:</u> Monitor contracts as to:

- Terms and conditions
- The removal of onerous conditions
- Each processor must file with ACCC an approved version and only use that contract,
- The open publication of prices in standard cents per litre format.
- Allow for tradable contracts by time and volume.

A lack of price transparency

Some processors through their contract terms and conditions require absolute secrecy and include sanctions in their contracts for disclosure even after the contract supply conditions have been met.

They also go to considerable lengths to not disclose prices as they misuse the term commercial-in-confidence. This leads to price asymmetry and consequent upon this under investment in innovation and expansion of productive capacity.

<u>Suggested remedies:</u> Monitoring, collection and publication by Dairy Australia on a seasonal basis of all price agreements and price ranges offered by processors by region. Also the publication of retail sales of milk and dairy products by volume and price.

Arrangements involving synergies and economies of scope along with competitive tendering by carriers for coordinated milk collection and delivery will save up to 3-4¢ per litre by synergies and competitive tendering by carriers for milk collection and delivery. This would require some standardisation of milk quality definitions – as to fat and protein – and also the penalties that relate to milk quality – namely somatic and bacterial cell counts, antibiotic content and also chemical residues. These efficiency gains distributed along the supply chain will flow through and benefit consumers. However, it will be necessary to have common quality standards.

The industry is in part susceptible to abuses in market power

The purchasing practices of Coles and Woolworths especially leave a lot to be desired in as much that most of their purchasing in particular markets is by running a Dutch auction. This has the effect of putting price pressure back along the supply chain and frequently this is reflected in depressed farm gate prices. Processors complain that they frequently see the store brand sell for significantly less than their branded products.

Similarly some companies most notably NFL choose not to compete for farm gate supplies but are large operators on secondary milk markets and believe they can purchase cheaper milk from other processors at 'spot' prices.

<u>Suggested remedies:</u> there are some significant steps that can be taken to reduce the likelihood of abuses in market power, these are:

- Introducing truth-in-labelling regulations to disclose processor identity as to who packaged a product. This will make consumers aware of price and quality and provide for them a comparison and awareness of true brand identity. A consequence of his could be to move the prices of store brands and processor brands closer together and then in turn lead to some product differentiation. It should also require the disclosure of additives such as permeate.
- Retailers should also have to bid by tender for products rather then rely upon undisclosed supply arrangements. In this way firms acting in the market will know if they have lost the opportunity of bidding fairly and squarely.

- Further the cartel behaviour of Coles and Woolworths particularly should be made to open up to true brand competition by stocking all products for consumer benefit. At present NFL has an exclusive supply arrangement to Woolworths and DFG to Coles. Neither of these retailers stocks much of the other processor's product if they do not have exclusive supply arrangements with them. Such arrangements are uncompetitive and opening up the shelves will give consumers wider choice and often price advantage.
- Open tendering will go a considerable way to reduction of the cartel conduct. It will increase competition at the farm gate for milk supplies.

The existence of cartel behaviour

Earlier we have referred to cartel behaviour. This exists in particular in the Brisbane and Sydney markets. We refer to processor-to-processor agreements that serve to reduce farm-gate competition. Additionally, there are informal agreements between processors that they will not poach each other's suppliers.

Onerous conditions are often placed in contracts making it difficult and punitive for suppliers to change processor.

Suggested remedy: Producers should be able to have tradable contracts and thereby trade their contracts between processors either in long or short-term tranches of milk volumes.

Under investment in innovation and new ideas across all sections of the industry

The dairy industry since deregulation has been beset by a number of problems. Mainly low export prices; drought; lack of water; high input costs especially in respect fuel, fertiliser and grain prices. It is acknowledged that some of these input costs are externalities in the sense that fuel and some fertilisers are linked to international oil prices and price inflation. The same too applies to the relative competition that the production of bio-fuels has on international grain markets which in turn have in Australia's instance have been exacerbated by drought caused shortages.

The price pressures and lack of price transparency have been significant in preventing market-based adjustments to farm gate prices. This has led to under investment in innovations and the adoption of new ideas and improved production praxis. This has also affected the processing sector – except in the export field – leading to higher costs and inefficient production. Freeing up competition in the domestic market will encourage greater investment in capacity and the delivery of better and improved products to the consumer.

Suggested remedies: Opening up domestic markets to further competition and greater price and transactional transparency.

Constraints to productivity growth

As has been demonstrated in the foregoing we submit that there is a considerable amount that can be done to improve the competitive behaviour for firms in the market. Truly free and open markets with properly conveyed price signals along the supply chain will greatly improve investment in the whole dairy industry with resultant benefits for all. This will lead to greater confidence more equitable returns and thus investment in the inputs required for productivity growth. As present arrangements stand they are acting as a major impediment to productivity growth.

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