AUSTRALIAN PORK LIMITED

#2 Submission to

The Australian Competition and Consumer Commission (ACCC)

Grocery Inquiry into the Competitiveness of Retail Prices for Standard Groceries

March 2008

Australian Pork

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1. Executive Summary

Australian Pork Limited (APL) welcomes the opportunity for comment into the Australian Competition and Consumer Commission (ACCC) inquiry into the competitiveness of retail prices for standard groceries.

APL acknowledges that grocery pricing is complex. However, the ACCC has highlighted a dramatic rise in food prices in recent years compared with other developed countries when it announced the terms of its inquiry into the grocery industry. Certainly, to some extent the domination of the retail sector by two supermarkets chains will impact on pricing of food goods and their associated raw materials through their relative buying power. Pork producers have long complained that their prices are low and have in part attributed this to supermarket dominance.

The arguments, however, cannot be viewed so simplistically since grocery pricing is complex and factors such as producer risk management strategies, supply chain engagement, industry structure, drought and international developments all play a part and are interdependent.

Certainly over time the engagement by national retailers with sole producers, producer groups and vertically integrated producers have provided efficiency improvements in supply chain management, with some corresponding effect on quality and price.

Further emphasis on a strong, coordinated relationship from retailers and primary producers has encouraged efforts by retailers to protect their supply channels, including increased pricing for some fresh food resulting from the drought.

Concerning pork, it is important to understand that a divergent market for fresh pork and processed pork exists which leads to different pricing structures and different drivers and that this, in turn impacts significantly on pricing.

In contrast to the fresh market, the domestic processed pork sector is unable to leverage sufficient market power. Uncompetitive pork processors unable to sustain cost pressure (in part due to underutilised capacity) from retailers have encouraged processors to import cheaper pork inputs. The pork industry has also suffered through retailer preference for loss leaders, in particular bacon, to generate store traffic and which in turn has built further pressure to import.

Current Country of Origin Labelling (CoOL) laws hinder consumers from identifying the imported product, enabling imports to capture the manufactured sector more readily. There are suspicions of mislabelled imported pork products being sold as Australian and APL believes that a review of law enforcement in this area is needed, ensuring fair pricing and fair trading in the Australian meat market.

APL considers that without accurate and informative labelling, the integrity of transparency and fairness of pricing throughout the value chain is compromised.

APL encourages healthy levels of competition through the supply chain and retailers that enhance sustainable margins for pig producers and competitive pricing at the consumer level. The ACCC should also consider that pricing for both the fresh and processed pork are interdependent. The pricing of processed pork has significant impacts on producer profitability and the fresh pork market.

2. Background - Australian Pork Limited

Australian Pork Limited (APL) is the national representative body for Australian pig producers. It is a producer-owned, not-for-profit company combining marketing, export development, research and innovation and policy development to assist in securing a profitable and sustainable future for the Australian pork industry. APL works in close association with key industry and government stakeholders.

APL is a unique rural industry service body for the Australian pork industry. The framework for APL was established under the Pig Industry Act 2001[1]. Operating and reporting guidelines are provided for in the Funding Agreement with the Commonwealth of Australia. This forms the basis of APL's operations.

APL's primary funding is derived from statutory pig slaughter levies collected under the Primary Industry (Excise) Levies Act 1999[2]. The levy amounts to $2.525 cents per carcase levy at slaughter and comprised of $1.65 for Marketing activities, $0.70 cents for Research and Innovation activities, and $0.175 for the National Residue Survey (NRS)[3]. Additional research-specific funds are received from the Australian Government under the portfolio of the Federal Minister for Agriculture, Fisheries and Forestry.

The following objectives for the 2005-2010 Strategic Plan focus on a central strategy to drive up domestic demand for Australian pork, while building the industry's capacity to expand exports and compete successfully against pork imports:

1. increasing fresh pork demand;
2. increasing carcase value;
3. reducing supply chain costs;
4. contracts and measurements systems;
5. ensuring industry capability; and
6. managing risks for sustainability.

Structure and Regional Distribution of the Industry

There are currently an estimated 1,500 pork producers in Australia with total pig numbers at approximately 2.7 million. APL's members own approximately 92 percent of the Australian pig production.

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1 http://www.comlaw.gov.au/ComLaw/Legislation/ActCompilation1.nsf/0/935C1FDED0B51DF1CA256F71005501E2/$file/PigIndustry2001.pdf

2 http://www.comlaw.gov.au/ComLaw/Legislation/ActCompilation1.nsf/0/E231CA546E7CC2DBCA25703F001AA557/$file/PrimIndExciseLevies1999_WD02.pdf

3 http://www.daff.gov.au/agriculture-food/nrs/industry-info/animal

The estimated Gross Value of Production (GVP), for Australian pig production was $906 million for the period 2004-05[4] declining to $889 million in 2005-06[5]. This compares with $944 million for the period 2006-07[6]. Pork currently represents approximately 2.38 per cent of total Australian farm production[7]. This figure has remained relatively consistent since 2005.

The Australian pork industry provides a significant positive impact to local, regional, state and national economies through substantial income generation and employment. In 2004, the pig production sector generated $3.2 billion in output, $967 million in value added and 15,074 full time jobs when flows on effects are taken into account.[8] This compares with an estimated $2.9 billion in generated output, $840 million in value added product and 7,928 full time jobs in 2006/07.[9]

Around 56 per cent of the pigs killed in the Australian industry today are part of an integrated supply chain that includes primary processing and production. Of the total 5 million pigs slaughtered, some 3 million are part of an integrated enterprise including production and primary procession, and that the remaining pigs sold for slaughter are sourced either through saleyards (5 per cent), spot market or forward and general contracts.

Nevertheless cooperation with related and supporting industries will be critical to the survival of the industry and there is a need for continuing vertical integration in the industry to sustain competitiveness. The Australian pork industry requires strong cooperation from retailers for long term security.

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[4] Australian Bureau of Statistics (ABS): Value of Principal Agricultural Commodities Produced 7501.0 2004-05

[5] Australian Bureau of Statistics (ABS): Value of Principal Agricultural Commodities Produced 7501.0 2004-05

[6] Australian Bureau of Statistics (ABS): Value of Principal Agricultural Commodities Produced 7501.0 2004-05

[7] ABARE: Email conversation. Figures based on 2005-06 data

[8] Western Research Institute: Socio-Economic Impacts of the Australian Pork Industry (April 2005)

[9] Western Research Institute; Socio-Economic Impacts of the Australian Pork Industry - preliminary report, Feb 2008

3. Previous ACCC inquiries

APL notes the work completed in February 2007 on the 'Examination of the prices paid to farmers for livestock and the prices paid by Australian consumers of red meat'.[10] While considered useful background in the ACCC's Terms of Reference for the 2008 inquiry, APL supports in principle the ACCC's key fundamental findings that may be useful in assessing saleyard prices for pork producers which have a flow on effect to grocery pricing at the consumer level:

- interpreting movements in the margin between saleyard and retail meat prices over short periods of time should be regarded with caution; short-term movements in margins are not unusual and do not necessarily reflect weak competition at the farm-gate level (however this is not necessarily reflective of the pork industry due to contract arrangements and this is discussed in Section 5);
- the margin between saleyard prices and retail prices can reflect changing costs throughout the supply chain and increased value added at the retail level;
- the cost of livestock is only one element of the total cost incurred by supermarkets and other retailers in providing fresh meat to consumers;
- activities such as slaughtering, processing, transporting, butchering and packaging are value-adding and involve additional costs and that these costs can vary;
- grain costs can be a significant cost input during events such as the drought and import restrictions and can affect meat prices;
- there is trade conducted outside traditional saleyards as a risk management strategy to hedge against significant price shocks and as such saleyard indicator prices will not have a direct and immediate impact on retail prices charged by retailers (and we suggest that this is more appropriate for understanding pork pricing and trade);
- these direct supply arrangements can provide above average prices paid to primary producers, with some impact from production seasonality and level of supply chain integration;
- sales for the domestic and international markets are domestic retailers' most competitive buyers for Australian produce and this can influence the price paid by retailers and therefore consumers;
- while domestic sales within the retail sector are spread across butchers and supermarkets charging unreasonably high prices could erode market share and this would not be in the retailer's interest.

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[10] ACCC. (2007). 'Examination of the prices paid to farmers for livestock and the prices paid by Australian consumers for red meat, February 2007'. [Online]. Last Acccessed February 19, 2008: http://www.accc.gov.au/content/index.phtml/itemId/780673

4. Nature of competition and grocery pricing practices

APL highlighted in its submission to the Productivity Commission Inquiry into the Regulatory Burdens on Business – Primary Sector in 2007 about general pricing conditions by our largest supermarket retailers:

> *'Trend lines in general for retail prices have increased on an ongoing basis, with prices received by producers remaining relatively flat. Australia is dominated by two major retailers in the supermarket sector and as a result, supermarkets tend to be price makers which in turn can affect price, product specifications, production methods and supply volumes and can promote anti-competitive behaviour. This discrepancy has been confirmed by the Department of Agriculture, Fisheries and Forestry (DAFF) has noted in its Price Determination in the Australian Food Industry 2004 report.'*[11]

Claims that supermarket retailers are unfairly and intentionally driving down prices received for pork producers may be misguided. Nevertheless retailers should be aware of the responsibility they have to sustain primary producers as well as the needs of consumers at supermarkets

APL encourages a position by large retailers to sustain domestic industry: retail chains can have a significant financial flow through effect on producer profitability, whether small or large, through pricing arrangements as specified in contractual arrangements or via the saleyard.

[11] http://www.pc.gov.au/__data/assets/pdf_file/0005/66893/sub044.pdf

5. Factors influencing efficient pricing of inputs along the supply chain

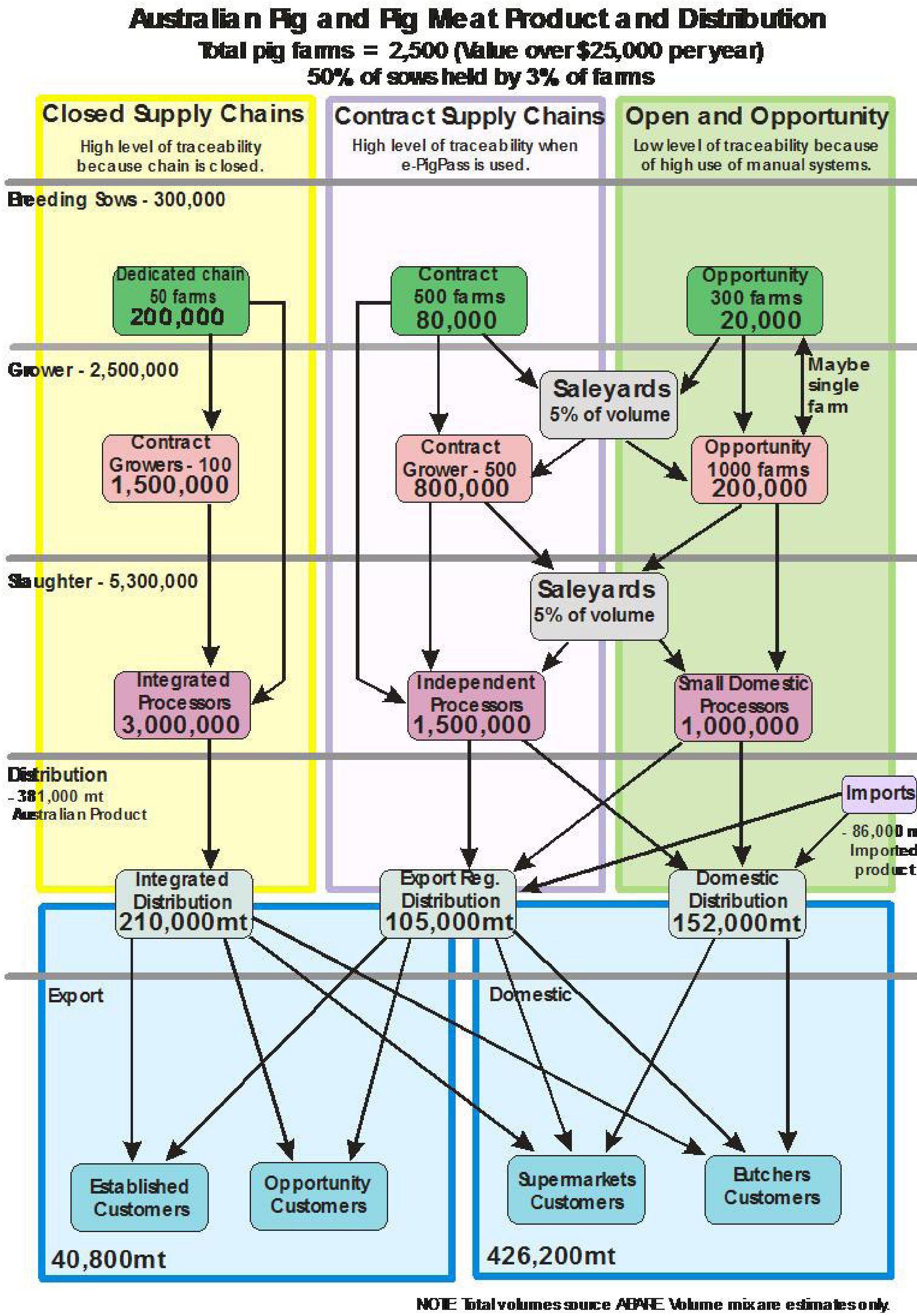
In the ACCC's previous report into the red meat sector, Coles and Woolworths provided the ACCC with information regarding pricing at different levels of the supply chain. Their average buy price is generally higher and less volatile than saleyard price indicators. This is a similar situation for pig production in Australia.

Coles and Woolworths must remain competitive against other buyers for both domestic and export markets.

Diagram 1, —Australian Pig and Pig Meat Product and Distribution below, provided by APL and verified by commercial sources, confirms the vertical integration of the industry as discussed above: of the total 5 million pigs slaughtered some 3 million are part of an integrated enterprise including production and primary procession, and shows that the remaining pigs sold for slaughter are sourced either through saleyards (5 percent), spot market or forward and general contracts.

These commercial relations influence the pricing of Australian pork products as it flows through to the consumer.

Diagram 1 – Australian Pig and Pig Meat Product and Distribution



Source: APL

6. Pork production

The long lead times[12] in implementing decisions impact on pork production and consequently on supply volumes. Domestic supply is fairly inelastic and domestic demand is fairly elastic. This will impact on prices for farmers.

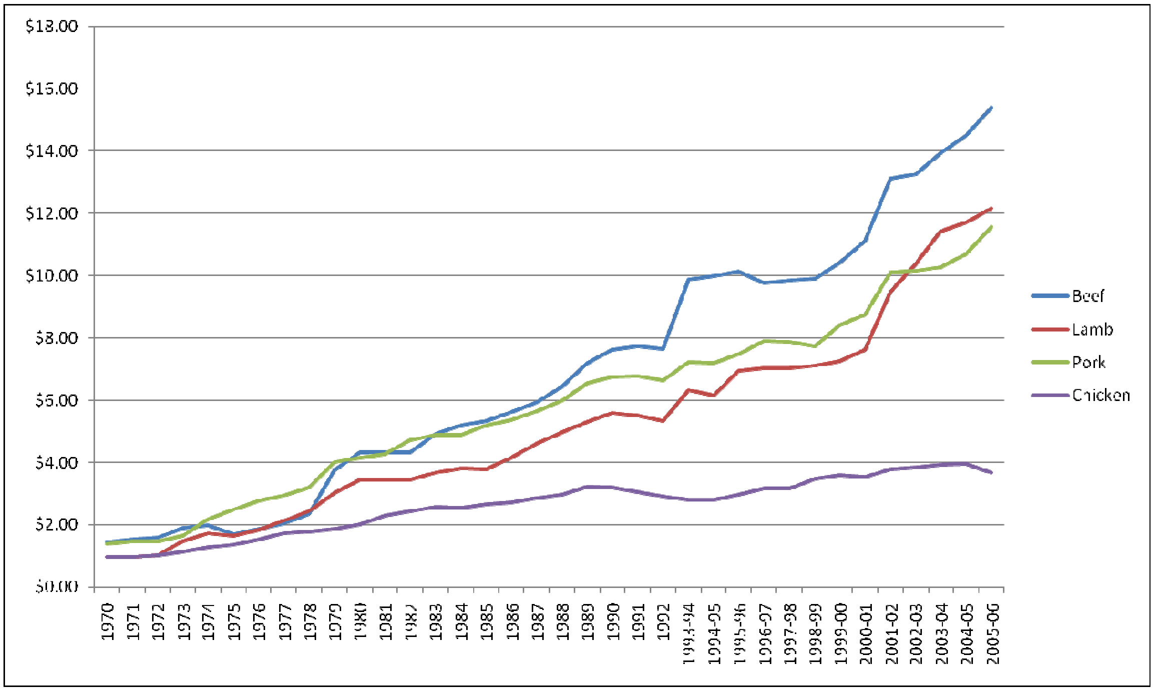
Pigs are unlike cattle, where they can be held over, and contingent on market conditions. In many cases the window for pigs in less than 2 weeks because of weight and fat requirements.

Pork competes against beef and pricing of pork is held at a level as a maximum. Unlike pork, imports of chicken are prohibited. Pork imports are also subject to zero import tariffs. Cost of production has risen in line with high grain costs, drought events and price has been driven down by import competition, and subsidised by competitor governments. An appreciating exchange rate negatively impacts on export competitiveness and encourages greater imports. Furthermore, pigs unlike ruminants such as cattle and sheep cannot be put to pasture to graze when feed grain costs become prohibitive.[13]

While higher cost of production has hurt all livestock sectors, the beef, chicken and lamb industries have been able to increase their prices to offset higher costs to some degree over time. This benefits producers somewhat in the beef, lamb, and chicken sectors, but indirectly lowers margins for pig producers.

[12] There is an industry lag of some 9 to 11 months from market signals and production outcomes.
[13] http://www.abareconomics.com/outlook/files/day_1/Scott_meat.pdf

Chart 1 - Retail Prices for Meat (in dollars of the day (1970 – 2005/06)



Source: Australian Chicken Meat Federation[14]

a. Pork prices and Producer Income[15]

The issue of price sensitivity is different for fresh pork versus smallgoods (processed). Fresh pork is significantly impacted by the price of other proteins (beef, chicken, lamb).

The cost of feed grain amounts to approximately 60 per cent of the cost of producing pigs. High feed grain cost is a key competitive disadvantage for Australian pork producers. Due to the ongoing drought, average costs for feed grain in Australia (Wheat, Barley and Sorghum) in December 2004 compared to December 2007 show a dramatic 122 per cent increase from $162 per tonne to $344 per tonne respectively[16]. Grain prices peaked in October 2007 at over $410 per tonne for wheat and barley.[17]

Continued low pork prices and high grain costs have exacerbated poor profitability. With the cost of production in February 2008 at approximately $2.76 per kilogram (feed grain price at $400 per tonne) and average price of $2.59/kg pigmeat[18], producers were making a loss of 17 cents (per kilogram or approximately $40 per pig (73 kg carcase weight) in October 2007).

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[14] http://www.abareconomics.com/outlook/files/day_1/Scott_meat.ppt
[15] PC Inquiry, 2007 Submission #1
[16] Source: ProFarmer
[17] Source: ProFarmer
[18] $2.46/kg price for baconers, $2.72/kg porkers.

Historically high imports in the 2006-07 year have exacerbated the normal seasonal effect on prices of higher supply, and have resulted in domestic prices falling below previous years' levels. There has been a "levelling off" of pig price rises for producers in the lead up to the 2006-2007 Christmas season. This is somewhat consistent for baconer and porker pig prices as shown below *(Chart 2 – 60-75kg, Chart 3 – 75-85kg)*.

Chart 2 – National Baconer Prices (Farm Gate), Mar 2006-Mar 2008

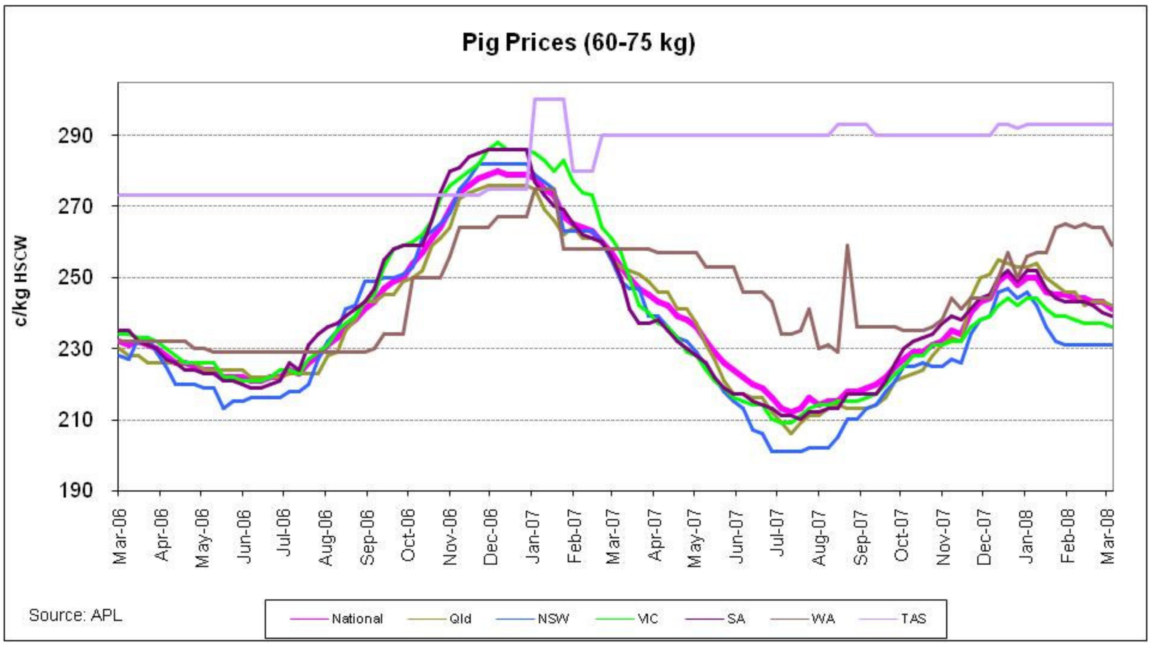
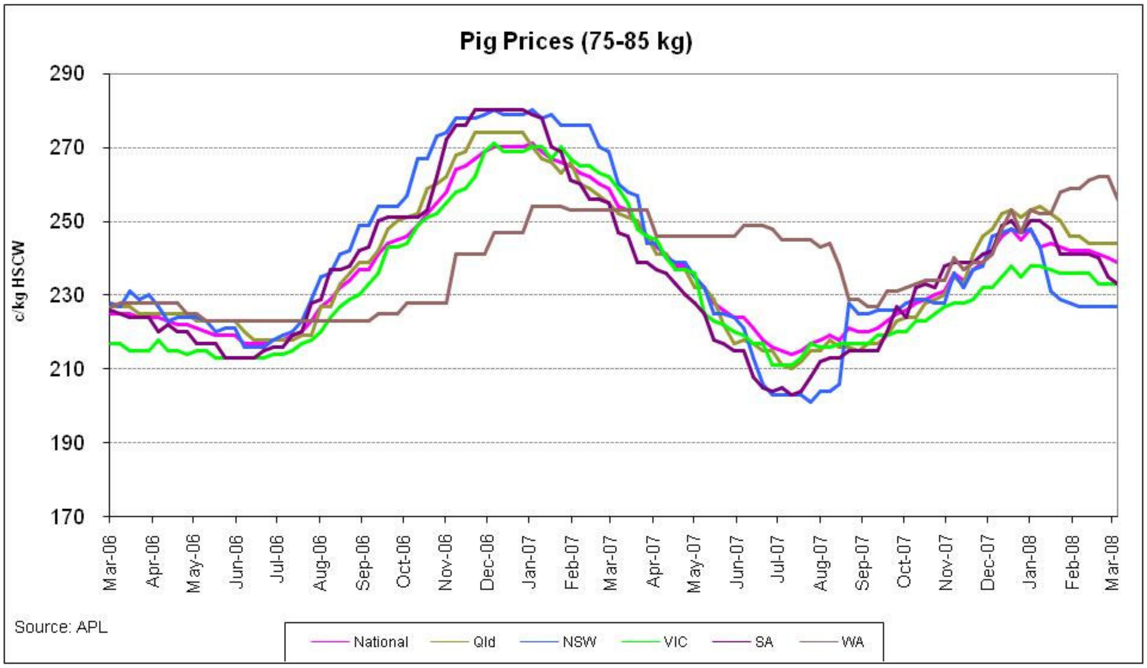


Chart 3 – National Porker Prices (Farm Gate), 2003-2007



Pig prices in February 2008 continue to fail to cover costs of production by a significant margin (by approximately 17 cents); this is unlikely to change May/June 2008 when a further contraction in breeding herd is expected. No significant relief for pig producers from grain prices is expected in this time.[19] Producers of baconer and porker pigs are receiving markedly less at the farm gate and paying higher feed grain costs, despite consumer prices rising at the consumer level. The cost/price squeeze facing pork producers is illustrated in *Table 1* below.

Table 1 - Pig & Feed Grain Pricing, Cost of Production & Profit estimates, quarterly, 2006-2007, Baconer Prices

Time period	**Average Baconer Pig Price[20]**	**Average Feed Grain Price***	**Cost of Production[21]**	**Net Result (Profit)[22]**
Jan 2006 Qtr	$2.37/Kg	$164/t	$2.17/Kg	$0.20/Kg

[19] APL Submission #3 to the Productivity Commission Safeguards Inquiry into the Import of Pigmeat, p.6

[20] Baconer Pig price includes the Eastern Seaboard states (Vic, NSW, QLD, SA).

[21] It is estimated that for every $50/tonne increase in feed grain prices, will increase the Cost of Production (COP) by an average of $0.15/kg carcase weight.

[22] Assumes COP to be at $2.60/kg with grain feed prices to be $300/t.

Jan 2007 Qtr	$2.78/Kg	$307/t	$2.61/Kg	$0.17/Kg
Percent Change	+17	88		
Oct 2006 Qtr	$2.49/Kg	$245/t	$2.44/Kg	$0.05/Kg
Oct 2007 Qtr	$2.19/Kg	$336/t	$2.74/kg	-$0.55/Kg
Percent Change	-12	37		

** Average Feed Grain Price combines the Industry average 'Best quoted grower bids' for Wheat, Barley and Sorghum*

A sustained increase in producers' cost of production over a long time period has substantially reduced producer capacity to continue to financially sustain these losses. Retailers can monopolise buying opportunities, and producers may not command higher saleyard prices for their pig production, nor pass on costs sufficient to cover the pattern of losses described above.

7. Processed Market

There is a direct link between imports and domestic wholesale pork and farm pig meat prices. Imports prevent the industry from recovering from the cost increases caused by, inter alia, droughts. This link between imports and domestic prices was acknowledged by the Productivity Commission in the 1998 Safeguards Inquiry, including as verified through econometric modelling. The Productivity Commission in its report summarised the impact of imports on prices when demand increases as follows:

> *"In particular, with import competition, an increase in demand for hams, or other processed products which use importable pigmeat, will not translate into an increase in the domestic price of legs and pigs. If imported leg pork is highly substitutable with local leg pork, seasonal premiums for hams, for example, could be eliminated altogether. Imports thus effectively impose a price ceiling on the price of pork legs, with the height of the ceiling determined by international prices rather than local market conditions."*[23]

This statement is equally valid today as shown in APL's own economic modelling clearly shows the strong correlation between increasing import volumes and decreasing domestic pig prices.

Prices for pork typically have a seasonal trend. Prices fall in the middle of the year as supply increases and then rise as demand rises and supply tightens in the run-up to Christmas.

The high value pig meat cuts i.e. loin and leg meat represent 60 per cent of the carcase weight and approximately 75 per cent of the carcase value. Importing these high value cuts at significantly lower prices places huge downward pressure on Australian pig meat prices.

The costs of production of eggs and milk have also increased but have been partially offset by a rise in the retail price, which takes pressure from these producers. However, processed pork retail prices remain relatively steady indicating that imports have played a part in suppressing farm-gate prices for pork.[24]

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[23] Productivity Commission (1998) Pig and Pigmeat Industries: Safeguard Action Against Imports, Inquiry Report, Report No. 3, 11 November 1998, p. 43.
[24] Government of SA, Submission #1 PC.

8. Country of Origin Labelling (CoOL)

Current CoOL regulations increase consumer confusion and work against the original intention of giving consumers real choice when it comes to processed pork products. The current Federal Government recognises the problems with current food labelling. The ALP's Election 2007 Policy Document - Labor's Plan for Primary Industries, states:

> *"Food labelling is confusing. Food labelling is regulated by the Trade Practices Act, which sets out requirements for use of 'Made in' or 'Product of' labels for both food and non-food products. Research has found that for packaged foods, consumers are often confused and do not understand what is meant by 'Made in' and 'Product of' labels. For example, fruit juice sold as 'Made in Australia' can contain 100 per cent imported juice."*

APL has had concerns for some time relating to suspicions of mislabelled imported pork products being sold as Australian. These concerns have been based on:

- Industry experts expressing doubt as to the labelling of certain products based on their experience of what an Australian product would look like compared to an imported one (e.g. "short cut" bacon)
- Industry rumours of illegal processor/ manufacturer behaviour allegedly sourced through former employees for example
- A perceived mismatch of the potential markets for imported pork products but much higher imported pork volumes
- More recently, brands originating from foreign slaughter establishments being found on rind-on bacon products sold under the "Product of Australia" claim.[25]

The extremely rapid penetration of the processed pork sector by imported product has caught consumers unaware. APL observations and anecdotal evidence indicates that the vast majority of consumers believe that they are purchasing an "Australian" product whenever they buy bacon or ham. This is despite the fact that around 70% of bacon and ham sold in Australia is sourced from overseas pigmeat.

The problems with the "Product of…" and "Made in…" label claims is that they do not allow consumer choice; yet "product of" and "made in" labels set the point of reference for Country of Origin labelling for processed pork products. There is no incentive for processors to provide additional information, particularly given processed pork products are in around 70 per cent of cases comprised of imported pigmeat. Consumers are left with the impression that they are consuming an Australian product when purchasing "Made in Australia" (as discussed above). There are also problems of the imported components in brine which further prevents the labelling of 100% Australian sourced pork as "Product of Australia." This

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[25] APL 3rd submission to the Productivity Commission Safeguards Inquiry into the Import of Pigmeat, 58

situation is not an issue for the horticultural or seafood industries and is thus unique to the Australian pork industry.

Far from providing consumer choice on Country of Origin, the current laws in fact suppress meaningful consumer information. This is no fault of the pork industry, but does result in damage to the industry and it needs to be corrected.[26]

Producers require a national approach to assured compliance with CoOL laws through much more robust structures and systems than exist today, and efforts in this regard could be significantly beneficial to the pork industry, in particular considering the potential improvements in domestic pig prices being passed onto producers and consumers.

Any action in this direction would be embraced by the pork industry, and likely other industries where potential mislabelling of imported produce exists (for example honey, seafood, and horticulture). APL predicts that actions to ensure compliance would be actively supported by consumer groups. [27]

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[26] APL 3rd submission to the Productivity Commission Safeguards Inquiry into the Import of Pigmeat

[27] APL 3rd submission to the Productivity Commission Safeguards Inquiry into the Import of Pigmeat, 58

9. Codes of Conduct

APL highlighted in its submission to the Productivity Commission Inquiry into the Regulatory Burdens on Business – Primary Sector[28] in 2007 about the role of the Horticulture Code of Conduct:

> *'APL believes that there is an opportunity to introduce a mandatory Horticulture Code of Conduct alongside legislated powers by the Australian Competition and Consumer Commission (ACCC). The voluntary Retail Grocery Industry Code of Conduct introduced in 2000[29] is also a way in which the regulatory conditions can be managed.'*

The voluntary Retail Grocery Industry Code of Conduct[30] voluntarily commits participants to:

- 'promote fair and equitable trading practices amongst industry participants;
- encourage fair play and open communication between industry participants as a means of avoiding disputes; and
- provide a simple, accessible and non-legalistic dispute resolution mechanism for industry participants in the event of a dispute.'

The Code is not binding and can be rendered ineffective if no evidence can be brought to demonstrate the effectiveness of the Retail Grocery Industry Code of Conduct.

In 2006, the major supermarkets were excluded from a new mandatory Code of Conduct designed to give growers, particularly the fruit and vegetable industry, greater clout in contract negotiations.[31] The ACCC could investigate a new Retail Grocery Industry Code of Conduct which includes major supermarket retailers.

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[28] Australian Pork Limited. (2007). Submission to the Productivity Commission Inquiry – Annual Review of Regulatory Burdens on Business: Primary Sector. [Online]. Last Accessed – February 19, 2008: http://www.pc.gov.au/__data/assets/pdf_file/0005/66893/sub044.pdf

[29] This has since been reviewed. The Retail Grocery Industry Code of Conduct was launched on 13 September 2000. On 11 February 2005, the Retail Grocery Industry Code Administration Committee voted unanimously to change the name of the Code to raise awareness of its scope and to better reflect the appropriateness of the organisations that are represented on the Committee. The Code is now known as the Produce and Grocery Industry Code of Conduct (PGICC).

[30] http://www.produceandgrocerycode.com.au/

[31] http://www.abc.net.au/rural/news/content/2006/s1599028.htm

10. Conclusion

APL acknowledges that grocery pricing is complex. Certainly to some extent the domination of the retail sector by large supermarkets chains will impact on pricing of food goods and their associated raw materials through their relative buying power.

Pork producers have long complained that their prices are low and have in part attributed this to supermarket dominance. The arguments, however, cannot be viewed so simplistically since grocery pricing is complex and factors such as producer risk management strategies, supply chain engagement, industry structure, drought and international developments all play a part and are interdependent.

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Further emphasis on a strong, coordinated relationship from retailers and primary producers has encouraged efforts by retailers to protect their supply channels including increased pricing for some fresh food resulting from the drought.

In contrast to the fresh market, the processed pork sector is unable to leverage sufficient market power. Uncompetitive pork processors unable to sustain cost pressure from retailers have encouraged processors into import cheaper pork inputs. The pork industry has suffered through loss leaders, in particular, bacon to generate store traffic which has built further pressure to import.

Current Country of Origin Labelling (CoOL) laws prevent consumers from identifying the imported product, enabling imports to take over the manufactured sector more readily. APL believes that a review of law enforcement on this matter is needed, ensuring fair pricing and fair trading in the Australian meat market.

APL considers that without accurate and informative labelling, the integrity of transparency and fairness of pricing throughout the value chain is compromised.