



28 March 2008

Mr Graeme Samuel  
Chairman  
The Australian Competition and Consumer Commission  
GPO Box 520  
Melbourne Vic 3000

Dear Mr Samuel

**Re The ACCC Grocery Inquiry**

Please find attached Coles Supermarkets' submission to the inquiry. To assist the Commission, the submission is in two main parts. The first presents an overview and responds to a number of specific issues raised in the Issues Paper released by the ACCC in February. The second part is a report by **Freshlogic**, commissioned by Coles to examine a number of the issues in detail.

I look forward to discussing this issue with you during the course of the inquiry.

Yours Sincerely

A handwritten signature in black ink, appearing to be "Mick McMahon", written over a horizontal line.

**Mick McMahon**  
Chief Operating Officer – Coles



**Public Submission to**

**The Australian Competition and Consumer Commission  
Inquiry into the competitiveness of retail prices for  
standard groceries**

**by**

**Coles Supermarkets**

**March 2008**

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## Executive summary

Coles welcomes the opportunity to contribute to the Inquiry by the Australian Competition and Consumer Commission (**ACCC**) into the competitiveness of retail prices for standard groceries (**Groceries**). Coles views the Inquiry as an important opportunity to raise awareness of the many factors currently affecting retail prices of groceries and to demonstrate the strengths and highly competitive nature of the Australian retail food sector.

Coles wishes to respond to the ACCC by first providing context for our business and then to focus upon the issues raised by the ACCC in the ACCC Issues Paper.

To assist the ACCC, Coles has also commissioned a report by **Freshlogic** that addresses in detail some of the issues raised by the ACCC and in particular areas of their specialist expertise in determinants of food pricing analysis from farmgate to supermarket checkout.

### Coles delivers value

Coles is committed to delivering value to customers every day.

As well as seeking to offer our customers competitive grocery prices, Coles also offers customers a range of ways to help them reduce their cost of living:

- Each week, Coles provides a range of weekly specials on everyday items that help make a real difference to shopping bills.
- Over the past two years, Coles has revitalised its own brand or *housebrands*<sup>1</sup> to introduce a new three-tiered range of products that offer customers quality products at a low price. Strong growth is being experienced in the sales of these products as more customers choose them to increase the value of their shopping budget. Housebrands together with traditional branded products give consumers more choice.
- The Coles fuel discount program, available to all customers who spend \$30 or more in our supermarkets and liquor outlets, continues to be extremely popular, with millions of customers choosing to redeem their fuel discount offer every month. Since its inception in 2005, the fuel discount has delivered tens of millions of dollars of fuel savings to Coles' customers.
- Coles' customers also benefit from an extensive range of rewards through the Fly Buys program, Australia's most popular shopper loyalty program – there is no cost to this program and it is available to all who wish to participate.

We are conscious of the increasing costs of everyday living and seek to provide our customers value and choice.

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<sup>1</sup> Sometimes referred to as *Private label*

## **Competition in the food retailing and wholesaling industry**

Coles' experience is that the Australian grocery industry sector is fiercely competitive.

The Australian food and grocery sector has three major national supermarket chains (Coles, Woolworths and Metcash IGAs), an emerging fourth chain, Aldi, numerous national specialty food chains, a number of smaller state-based grocery chains and some 30,000 independently owned specialty food retailers.

The growth in specialty food retail outlets and the entry and strong growth of Aldi over the last decade, the resurgence of the Metcash supplied IGA chain and the reported impending entry of US based retailer Costco, all point to a competitive market and an increase in the range of grocery services available to consumers.

The consumer driven competitive tension that exists between Coles and other food retailers can and does keep a downward pressure on prices, and also manifests itself in the relatively low profit margins seen in food retailing overall.

### **Price is key for customers**

Price is a key driver of customer behaviour in Australia and Coles seeks to ensure that its supermarkets remain competitive by continuing to offer good value.

In addition, to delivering everyday value across the range of products sold in its supermarkets, Coles has also made a significant investment in the development of new housebrand products that give customers quality products at lower prices.

Coles' commitment to low prices does deliver value customers. The most recent grocery price survey '*Best Value Shopping*' by consumer group Choice<sup>2</sup>, found Coles was the cheapest national grocery chain for Choice's basket of groceries in each of the 23 regions surveyed. Such food basket surveys confirm the fact that the supermarket sector offers consumers competitive prices for their grocery needs and that Coles, in particular, is very price competitive.

While price is a key factor in winning customers in a highly competitive retail market, consumer behaviour is strongly influenced by other factors. These include range, the quality and availability of that range, convenience of the shopping experience and service.

The ability and willingness of customers to switch to other retailers also demonstrates that the food retailing industry is highly competitive. Coles' experience is that customers will 'vote with their feet' and shop elsewhere if a retailer fails to deliver on price or any other key factor in their overall shopping experience.

### **Continuity of supply is vital**

Because Coles is a high-volume, low-margin business, it is essential that it has certainty of supply for all of its 750 supermarkets all year round. Achieving this, in a seasonal growing market like fresh produce, demands a good partnership between Coles and its suppliers.

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<sup>2</sup> Choice publishes irregular price surveys of a basket of food items consisting of five staple items and 28 branded products. The latest survey was conducted in July 2007.

The relationship with suppliers is premised on the need to ensure an ongoing supply of quality products that meet consumers' needs and preferences. To achieve this, the supplier relationship must be open, fair and ensure a reasonable, mutually beneficial return. While it is not unusual for there to be some commercial tension in negotiations between suppliers and resellers, it is not in Coles' long term commercial interest to undermine these relationships by setting out to achieve one-sided outcomes. The vast majority of Coles' suppliers continue to value the relationship – some have been suppliers to Coles for more than 20 years.

### **Coles seeks to absorb cost increases**

Coles has experienced steady increases in the cost of sourcing goods in recent years.

Research by supply chain price experts, Freshlogic, establishes that these increases are principally the result of international markets affecting the price of grain, meat and dairy products and prolonged adverse weather conditions in Australia. Freshlogic's findings are set out in a report attached to this submission.

In response to these factors, Coles' objective has been to absorb as many costs as practicable within our business model. For example, following Cyclone Larry in 2006, the high price of bananas resulted in Coles reducing its gross margin by two thirds in order to minimise the cost impact on its customers.

### **Consumer Price Index comparisons**

Coles believes there are limitations with the current methods used to measure food price inflation and would support moves to change the approach to food monitoring to more accurately reflect the dynamics of consumer buying patterns than the current foods component of the *Consumer Price Index* (Food CPI).

Coles commissioned food price experts Freshlogic to examine this issue in more detail and their findings are attached.

### **Restrictive trading hours limit consumer choice**

Coles believes removal of restrictive trading hour regulations that persist in some states would increase competition to the benefit of customers. Coles' experience is that restrictive trading hour regimes reduce competition by favouring one competitor over another and by limiting consumer choice. This issue is compounded by lifestyle and consumer preference changes. Increasingly consumers seek to "top-up" their food needs and the pace of modern life is seeing a growing desire for the convenience extended shopping hours provide.

Currently, Western Australia, Queensland and South Australia have the most restrictive trading hour regimes. Coles commends and encourages moves towards reform of restrictive trading hours. Ultimately customers will be the winners, with trading hours' reform providing access to a greater range of retailers, and more competitive pricing.

## Specific comments on topics identified in the ACCC Issues Paper

### Freshlogic Report

Coles has commissioned a report from Freshlogic ("*Freshlogic Report*") that addresses most of the broad topics identified in the ACCC Issues Paper released on 11 February 2008. The Freshlogic Report is included in **Attachment A** to this submission.

This section of the submission sets out Coles' specific comments on the topics identified in the ACCC Issues Paper. More detailed information is contained in the Freshlogic Report.

Freshlogic has substantial expertise in these matters. In 2004 Steve Spencer and Martin Kneebone, Freshlogics' Directors, authored a major study for the *Federal Department of Agriculture, Forest & Fisheries*<sup>3</sup> into the determinants of food pricing which included the analysis of pricing through the supply chain from farm gate to supermarket checkout.

### Context of the Inquiry

The ACCC Issues Paper refers to OECD data that suggests that, over the past few years, food price inflation has been higher in Australia than in many other industrialised countries.

Coles believes such international comparisons based on published CPI data are inherently flawed and need to be treated with caution. The Freshlogic Report contains a detailed analysis of this issue and concludes that an assessment of comparative food costs and affordability based on a comparison of CPI statistics across a number of countries is unreliable due to inconsistencies in the underlying method, basket and trade policies.

Coles believes the comparison in the ACCC Issues Paper may overstate the rate of food price inflation in Australia relative to other countries. Additionally, Coles believes the inflationary pressures that are driving up food prices are beyond the control of retailers who have little choice, given retail profit margins, but to pass on increases in the cost of goods they receive.

**Fig 1** shows the relative affordability of food in comparable OECD countries. It presents a ratio of:

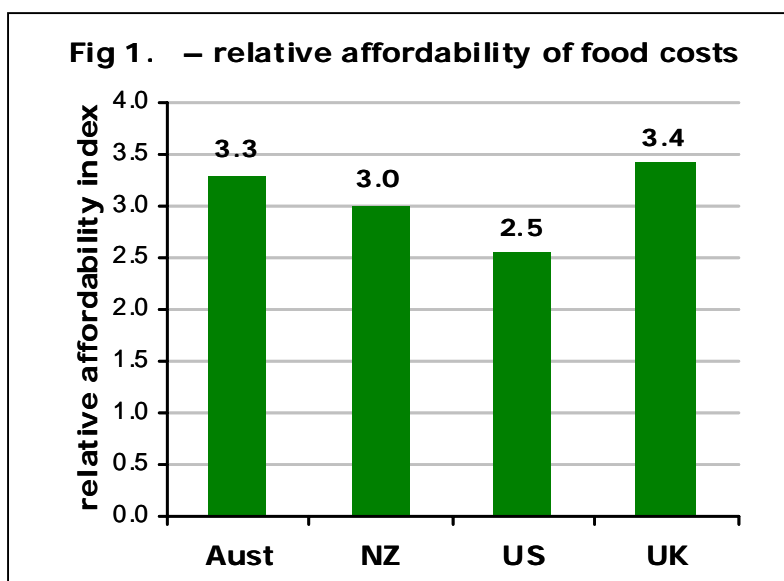
- The latest average full time adult weekly earnings (reported in each case by the Government statistics agency); to
- The current total cost of common food basket items

The higher the number, the higher the spending power and therefore lower the relative food prices.

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<sup>3</sup> Department of Agriculture Forests and Fisheries (DAFF) The Determinants of Food Pricing by Whitehall Associates 2004

The comparison indicates that Australian supermarket prices provide purchasing power parity with other countries, being close to UK food prices in terms of relative affordability, and less expensive than US and NZ prices. A more detailed explanation of the food basket is contained in the Freshlogic submission.



## A. Structure of the grocery industry

Other than food service, there are three national food and grocery distribution channels in Australia; Coles, Woolworths and Metcash supplied IGA<sup>4</sup> supermarkets. Competing with these three channels are Aldi<sup>5</sup>, arguably a fourth chain, Franklins<sup>6</sup> and smaller chains such as FoodWorks<sup>7</sup> plus over 30,000 independent owned or franchised specialty retailers selling meat, bread or fruit and vegetables. US retailer Costco has also announced that is prepared to enter the Australian market in 2009.

### What shapes the structure?

Factors contributing to the structure of the Australian retail food industry include:

- The needs of consumers which shape the retail offer
- The adoption of new technologies such as automated warehousing and warehouse and transport management systems (eg electronic tracking of merchandise) in the supply chain
- Profitability within the supply chain (Retail EBIT margins are among the lowest in the Australian economy )
- Government regulation of food in the areas of food safety<sup>10</sup> and labelling-, eg. country of origin
- The entry (and exit) from the industry of farmers, food processors and food retailers such as Aldi and Franklins<sup>8</sup>.

<sup>4</sup> IGA banner stores have some 1384 stores nationally – Fresh Logic Page 20

<sup>5</sup> Aldi is a privately owned German supermarket chain, which was established in Australia in 2001.

Aldi currently operates 166 stores in the eastern states - Fresh Logic Page 20

<sup>6</sup> Franklins is owned by South African Pick n Pay and operates 80 stores mainly in NSW Fresh Logic Page 20

<sup>7</sup> FoodWorks operates 708 stores nationally – Fresh Logic page 20

<sup>10</sup> HACCP *Hazard Analysis Critical Control Points* where suppliers are required to meet minimum standards and specifications to minimise health risks to consumers from food allergens, chemical residues etc



Superimposed over any structural changes are evolving community and technology changes, common in most developed countries, which oblige retailers to alter their customer offer to remain relevant and competitive. These include:

- Improvements in transport and communications that:
  - Increase the relative efficiency of larger grocery distribution outlets like supermarkets; and
  - Facilitate greater community convenience via *one-stop shopping* at times and locations most suitable to consumers
- Social changes such as a higher percentage of dual income households and smaller households which impact on how often and where consumers buy food and groceries and the type of groceries sought
- Technological changes and product innovation that allow a greater range of foods, including ready to eat meals, to be purchased, stored and prepared or cooked in the home much faster than in previous decades.

The accumulation of these and other competitive factors within each stage of the food supply chain has generally led to the adoption of larger scale enterprises that bring improvements in productivity and greater supply chain efficiency.

### **Market changes**

Over the last decade significant changes suggest that the market remains open, contestable and competitive. These include the:

- Entry of Aldi in 2001 (currently 163 stores but projected to grow to 500 stores)
- Sale and break up of the Franklins in 2001<sup>9</sup>
- Re-branding and growth of the IGA banner group and co-ownership, by Metcash, of key independent chains like *Richies* in Victoria and *Drakes* in South Australia
- Rebranding and growth of FoodWorks (over 700 stores)
- Growth of franchised chains of specialty food retailers like Lenard's Poultry and Bakers Delight
- Growth of specialised fresh food chains<sup>10</sup> such as Harris Farm Markets, Joes Meats, & Coco's
- Sale of Foodland (FAL) to Metcash in 2006
- Sale of the Coles Group to Wesfarmers in 2007.

There are in fact over 30,000 food retailers, 96 per cent of which are independent retailers<sup>11</sup>. Australia's three publicly listed national grocery distribution chains, Coles, Woolworths and Metcash, service some 21 million people. This is about the same ratio as other OECD countries on a population basis<sup>12</sup>. Market concentration is determined by a number of factors including size and dispersion of the population.

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<sup>9</sup> Franklins, was divested by Dairy Farm International in 2001. Most of the stores were sold to independents and Woolworths with South African supermarket operator Pick N Pay retaining some 50 stores and retaining the Franklins name. Franklins currently operate 80 supermarkets.

<sup>10</sup> Specialty food retailers, including franchised chains, make up nearly 50 per cent of the increase in number of outlets over the last five years; ABS Cat. # 8165 ABS Food Retail Division counts of Australian Businesses

<sup>11</sup> ABS Cat # 8501

<sup>12</sup> Access Economics: Submission to the Joint Select Committee on Retailing 1999 p.41

The level of concentration is generally higher where the population or its degree of dispersion is lower.

### **Market concentration**

The ABS devised a number of market share measures in 1999 and advised the *Joint Select Committee on the Retailing Sector*<sup>13</sup>, that its 'Measure 2' was "*the most realistic measure*" of the food and grocery market<sup>14</sup>. This measure was subsequently adopted by the ACCC in its evidence to the Select Committee. Measure 2 includes all grocery items, plus fresh meat, fish and poultry, fruit and vegetables, bread and other specialised food retailing. On this basis Coles market share is in the order of 23 per cent.

The ABS Measure 1, a narrower market definition, is based on AC Nielsen's packaged grocery scan data, and is regularly used to report sales of packaged goods in trade publications. This measure suggests a combined market share for Coles and Woolworths at around 80 per cent, but it substantially understates the food market and omits a large number of food retailers competing in this market.

The Freshlogic report also discusses this issue. Regardless of how the market is defined:

- Coles' achievements have come about as a result of providing a service that customers want and not as a result of anti-competitive strategies or conduct
- Coles does not exert undue influence on suppliers in a manner that increases prices for consumers (witness the low margins made in retail in Australia vs. suppliers) or that prevents successful new entry or competitive conduct by efficient and financially viable companies; evidenced by the growth of companies like Aldi and Bakers Delights.
- At the product sourcing level, Coles' efficiencies of scale and volume are matched by Woolworths, Metcash and other wholesalers. Coles buy prices from suppliers are similar to other large wholesalers with similar volumes<sup>15</sup>.
- At the retail level, prices are constrained by the competitive offers of other retailers at a national and local level including new entrants such as Aldi, together with specialty retailers in many areas;
- Coles rejects claims by some in the retail sector that the ACCC should intervene to prevent Coles successfully competing against them. Such claims reflect a misunderstanding of the purpose of competition laws (which is to protect the competitive process not to protect individual competitors) and the operation of a competitive market - competition laws should be of general application and apply equally and not favour one group of businesses over others - competition laws and competition generally should benefit the consumer
- Coles' position and size in the market has not led to customers paying too much for grocery items. Coles' prices are competitive in Australia, comparable to other OECD countries, and reflect its costs of supply with a relatively small net profit margin.

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<sup>13</sup> Report by the Joint Select Committee on the Retailing Sector August 1999 page 42

<sup>14</sup> Measure 2 comprises ANZSIC classes 5110 plus 5123, 5121, 5122, 5124 and 5129 ABS Cat # 1292

<sup>15</sup> ACCC *Terms of Trade Report 2002*

Access Economics<sup>16</sup> state that these factors, the retail to population density and change of ownership, demonstrate that barriers to entry in the retail industry are no greater than for other sectors of the economy, and that changes in ownership control suggest that there are low barriers to entry for retail businesses.

Coles submits that “*concentration*” is not the relevant factor in assessing competitiveness. The issue is whether, consistent with all competition law principles, the market remains contestable and competitive through the dynamic elements of rivalrous behaviour in the grocery industry. The Australian retail industry clearly remains open, contestable and competitive. The entry of Aldi and reported intention of Costco to enter this market is powerful support for this openness.

## **B. Consumer behaviour and choice of grocery retailer**

The Freshlogic Report illustrates<sup>17</sup> the competitive dynamic of food and grocery retailing, with consumer expenditure shifting away from supermarkets, albeit slowly, as Australians eat out more, buy more take away meals and switch some of their grocery spending towards specialty food retailers. All of which underlines that food and grocery retailers need to continually re-define their offer and formats to keep the customers they have or attract new ones as consumer behaviour and preferences change.

While consumers have access to a broad range of convenient retail formats, the last major review of food and grocery retailing found:<sup>18</sup>

*“High levels of efficiency, superior technology and buying power has led the committee to conclude that consumers are voting with their feet, deciding to frequent the supermarkets because of their price, range of products, extended trading hours and the convenience of one stop shopping.”*

Consumer tastes and preferences have changed significantly since the inception of supermarkets in the late 1950’s, in part reflecting changing market demographics:

- Immigration continues to bring varied tastes and preferences in food
- The number of dual income households is historically high, while the birth rate and number of children per household has fallen to historic lows as modern families leave child rearing until later in life. The average age of the population is rising significantly, again at historic levels.
- The aging population and changing household structures have had a significant impact on the definition of a ‘typical’ Australian family.

Additionally, changing work and social patterns have also reduced the time available for household shopping and cooking.

Coles has adapted to these changes by investing and updating stores to cater to changing food preferences. This includes for example, improved product ranges and more ready to consume convenience foods that reflect the preferences of Australian consumers.

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<sup>16</sup> Access Economics: Submission to the Joint Select Committee on Retailing 1999 p.28

<sup>17</sup> FreshLogic page 22

<sup>18</sup> Fair Market or Market Failure – August 1999 – Report by the Joint Select Committee on the Retailing Sector – The Baird Review.

## **Coles consumer research**

While price remains the key driver, consumer behaviour is also influenced by a complex range of factors. As a retailer, Coles is constantly working to better understand consumer behaviour to anticipate and respond to their preferences. The Freshlogic Report illustrates the effect consumer trends<sup>19</sup> have on influencing shopping choices, particularly in food categories, which are discussed in detail in *Section 9* of its report.

Shopping purpose or consumers' reason for shopping influences consumers' choice of shop and store format. The distances consumers are willing to travel differs by the product(s) they seek and the purpose of their shopping trip, be it a weekly grocery shop at the supermarket or a convenience shop on the way home from work.

In addition to price, for many Coles' customers, choice is influenced by the product quality, accessibility to and in Coles' stores, as well as service. Are their preferred products available? Are the choices offered relevant to their needs? Are the prices right when actually deciding where and when to buy them? The importance of price and quality form key parts of the everyday decisions consumers make when buying food. Again while price remains a key determinate, the relative priority consumers place on these factors vary significantly across the population.

## **Unit Pricing**

Coles supports the provision of simple clear information for customers. Coles already provides a total price and price per unit on a wide range of products including; deli, dairy, and most fresh produce both packaged and labelled. These products display a total price, the price per kilo and weight or, if loose, the details are shown on the register docket.

While price is the critical factor, Coles' consumer research and consumer buying patterns strongly suggest that consumers make more complex judgments on the packaged groceries. This includes, for example, the suitability or fitness for purpose of products offered for sale, and the brand and size of the products. We expect that competitive pressure will continue to ensure innovative and different approaches in marketing to customers that will deliver more benefit to customers than any mandated approach to unit pricing.

In addition there are significant practical challenges in any mandated approach, including difficulties with definitions, different technology platforms and different approaches to marketing and innovation consistent with competing brand propositions.

In short customers will benefit most when retailers are allowed to compete and innovate.

## **C. Competition in the Australian grocery industry**

Coles believes the Australian grocery industry is very competitive and open to new entrants. The growth in specialty food retail numbers and the entry of Aldi over the last decade, the impending entry of Costco, as well as the resurgence of the Metcash supplied IGA chain, all point to a healthy competitive industry. Coles responds to these competitors across its stores every day.

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<sup>19</sup> Freshlogic Section 4

Coles continues to invest in its supermarket business and intends to continue its store opening program through 2008/09, however we have no plans to acquire independent supermarkets.

We aim to provide our customers with very competitive prices for the food and groceries they seek to buy from us. Coles matches prices with our key competitors on hundreds of food items on a daily basis. Coles also offers our customers thousands of promotional price specials on their favourite brands every week.

The competitive tension between food retailers does keep downward pressure on prices. The level of profitability in the industry best illustrates this. Across the publicly listed companies that operate in the retail grocery sector, margins or earnings before interest and tax (EBIT) are generally between 3 to 6 cents in the dollar and among the lowest in the Australian economy.

The most recent grocery price survey, '*Best Value Shopping*' by consumer group Choice<sup>20</sup>, found that Coles was the cheapest major chain for Choice's basket of groceries in all 23 geographic areas of the survey. While such food basket surveys are small, they highlight the fact that supermarkets offer consumers the lowest possible prices for their grocery needs.

#### **D. Competition in grocery wholesaling**

Coles notes the ACCC has chosen to classify it as one of three major grocery wholesalers. Coles does not consider itself to be a grocery wholesaler, because it does not act as an intermediary between manufacturers/producers and retailers.

The degree of vertical integration in the grocery industry is an outcome of the competitive process. The potential advantages of direct sourcing of products are widely acknowledged. The major supermarket chains have sought to improve supply chain efficiency through these direct sourcing arrangements. This in turn has enabled them to compete more effectively and to pass on lower prices to customers. Coles submits that the effect of these arrangements on competition is overwhelmingly positive.

Freshlogic in their report (*Section 6*) note the buying power and structural changes in food wholesaling over the last decade and conclude that the consolidation and integration of the wholesale grocery market has increased barriers to entry for the wholesale supply of groceries to the independent sector.

#### **E. Buying power in grocery supply markets**

It has been a feature of all developed countries like Australia that businesses seek to build economies of scale in their supply chain to improve output and efficiencies, and lower the cost of goods for consumers. If these incremental improvements in productivity didn't occur, prices for many goods and services would rise faster in real terms relative to income.

One feature of scale of economies is typically a reduction in the number of suppliers in the industry. For example, falls in the number of farmers supplying fresh markets continues a century long decline as more farms amalgamate into bigger, more productive farms.

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<sup>20</sup> Choice publishes irregular price surveys of a basket of food items consisting of five staple items and 28 branded products. The latest survey was conducted in July 2007

While Coles has thousands of suppliers, the number of major food processors, across key food categories such as dairy, meat and grocery, consists of a small number of large suppliers. The most popular consumer grocery brands, which make up the bulk of packaged food and groceries in supermarkets, continues to be led by a small number of international food processors and manufacturers.

### **Countervailing power**

Australia's three national food and grocery retailers, and arguably Aldi and Franklins, are able to provide the full benefits that these economies of scale offer consumers.

As noted above, major suppliers and manufacturers in most food categories are usually large international companies. They are often larger than Coles or command substantial market share in the food categories they supply Coles and its competitors. As the **Office of Fair Trading** in the UK<sup>21</sup> noted:

*“The fact that consumers’ purchases tend to be small means that retailers play an important role in preventing the exploitation of consumers by manufacturers; no single consumer would have any bargaining power against powerful manufacturers, whereas retailers can bargain strongly on their behalf.”*

Coles endeavours to work with suppliers. Our daily engagement with customers allows us to better understand their preferences, and means we are well placed to assist suppliers, large and small, to develop or specialise products that appeal to consumers.

### **Supplier Trading Terms**

Coles believes that the price it pays for goods into its Distribution Centres (DC's) and direct into retail store (DSD) are comparable to those available to other supermarket chains and wholesalers<sup>22</sup>. Discounts and rebates offered by suppliers are influenced by sales volumes and, while confidential, are believed to be similar. They are also dependent on retailer/wholesaler performance in settlement days and the provision of marketing support in ranging, layouts and promotions.

This was confirmed by the ACCC's 2002 *Report on Trading Terms*, where it found two layers of discounts:

1. Standard prices plus volume discounts; and
2. Off invoice discounts and deferred terms that relate to the promotion of the supplier's products by the retailer.

## **F. Competitive position of small and independent grocery retailers**

Coles competes vigorously within the supermarket sector and among specialty food retailers, many of whom are in close proximity to Coles' stores and/or in the same shopping centre. However, to some extent, there is a symbiotic relationship between small and larger food retailers that are located in close proximity to one another, which is a key reason why Coles, and owners of shopping centres, design and develop retail shopping centres using a mix of anchor tenants like supermarkets and

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<sup>21</sup> OFT 1997 section 2.1

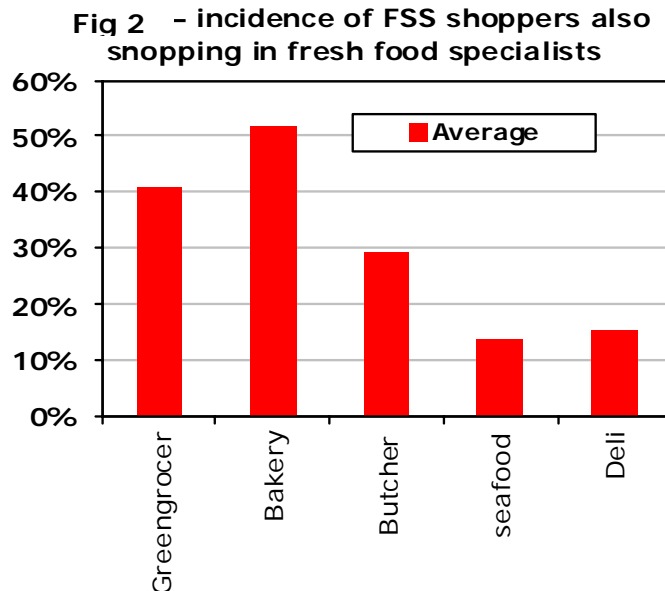
<sup>22</sup> ACCC *Report on Trading Terms 2002*

specialty food retailers. A shopping centre will not be successful unless this mix works and appeals to consumers.

The Freshlogic Report<sup>23</sup> shows a growth in specialist food retailing driven by changes in consumer demographics, affluence and preferences such as increased eating out over the last five years.

**Fig 2** Illustrates where consumers shop for their fresh produce across supermarkets and specialty food retailers.

**Fig 2**



The franchised food retailers in meat, bread and delicatessens identified earlier in this submission continue to expand<sup>24</sup> as do the number of independently owned supermarkets. While the retail mix of these businesses changes with consumer preferences and trends the level of entry and exits from the sector have not altered significantly since the 1970s<sup>25</sup>.

The retail 'offer' provided by these retailers encompasses services not sold directly to consumers, such as the availability of parking, ambience of the store, service levels and expertise, as well as the proximity of other retailers like supermarkets. These factors are significant consumer considerations in terms of convenience and value as outlined in *Section B*.

As confirmed by the findings in the Freshlogic Report, Coles believes it is clear that small and independent grocery retailers remain viable and play an important role in providing choice to consumers. This provides further support for the view that the Australian grocery industry remains intensely competitive.

<sup>23</sup> Freshlogic Section 3 & Fig 3.2 & 3.3 page 21 & 22

<sup>24</sup> Freshlogic section 3

<sup>25</sup> Analysis by Professor Geoffrey Keil; University of Queensland 1996

**G. Factors influencing the pricing of inputs along the supply chain for standard grocery items &**

**H. Impediments to efficient pricing of inputs along the supply chain**

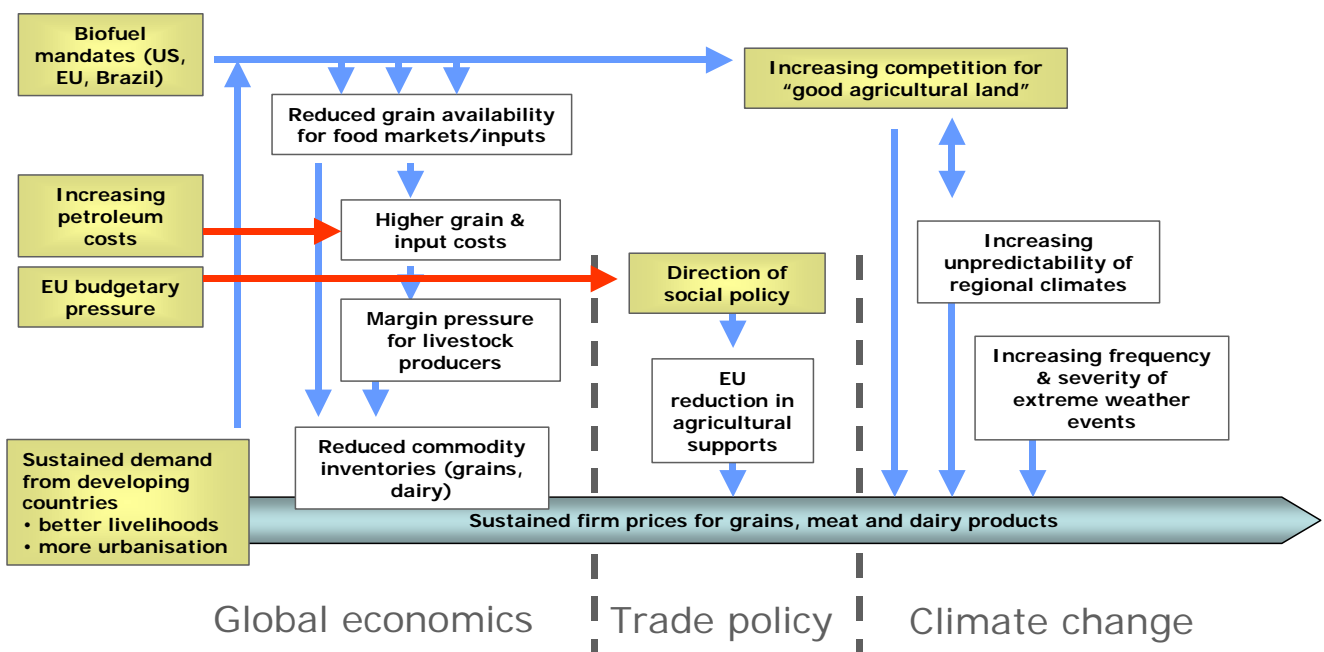
Coles is preparing and providing a comprehensive response to a series of questions seeking confidential information on Coles’ buying and selling prices over a number of years. This forms part of Coles’ confidential response to the ACCC.

The Freshlogic Report contains a detailed analysis of the factors influencing the pricing of grocery products along the supply chain, including details of the factors affecting the pricing of inputs across categories and specific product groups (refer to Sections 8 and 9 of the Freshlogic Report *Pricing structures in supply chains* and *Factors affecting category pricing*). As noted previously, Freshlogic has substantial expertise in these matters, having previously authored a major study for the *Federal Department of Agriculture, Forest & Fisheries*<sup>26</sup> into the determinants of food pricing which included the analysis of through-chain pricing from farm gate to supermarket checkout.

The Freshlogic Report compares food prices through the supply chain, links these to trade and other factors influencing prices and describes how each link in the chain derives a margin, after input costs, using specific food categories (*Section 9*).

**Fig 3** shows the complex nature of pricing inputs and trends affecting food prices globally.

**Fig 3 – Mega-trends affecting food prices**



<sup>26</sup> Department of Agriculture Forestry and Fisheries (DAFF) Determinants of Food Pricing by Whitehall Associates 2004



The Freshlogic Report makes the following findings:

- Food pricing is based on a complex set of input variables, including target returns sought to cover the costs of doing business and to make a reasonable return on capital employed within the competitive environment in which the business operates which in turn is influenced by national, state and regional factors
- Margins achieved on retail sales in Australia are in the order of 3-6 per cent (ie. 3-6 cents of each dollar spent by consumers), after deducting the cost of doing business, which they estimate is 21-24 per cent among Australian supermarket retailers.

The detailed analysis of these issues is set out in the Freshlogic Report.

## **I. Horticulture Code of Conduct**

In the high-volume, low-margin business of supermarkets, it is essential that Coles has consistent and reliable product supply for all of its 750 supermarkets all year round. Achieving this certainty of supply is a massive logistical task, particularly in a seasonal growing market like fresh produce, and demands strong relationships and co-operation between Coles and its suppliers.

Coles sources over 85 per cent of its fresh produce directly from growers and pack houses or consolidators of fruit and vegetables. These supply arrangements require production to be planned up to a year in advance. Growers enter into contracts with Coles under which the grower commits to supply agreed volumes of produce to Coles for its stores nationally during the relevant growing seasons each farmer has; be it Atherton in Far North Queensland or the Huon Valley south of Hobart.

The relationship with suppliers is premised on the need to ensure an ongoing supply of quality products that meet consumers' needs and preferences. The supplier relationship must be open, fair and ensure a reasonable, mutually beneficial return. While it is not unusual for there to be some commercial tension in negotiations between suppliers and resellers, it is not in Coles' long term commercial interest to undermine these relationships by setting out to achieve one-sided outcomes.

Coles Supplier Relationship Policy which is posted on the Coles Supplier website<sup>27</sup> places a high value on relationships with all its suppliers, many of whom have dealt with Coles for many years. Coles adopts a cooperative approach with suppliers so as to achieve mutually beneficial objectives in commercial dealings.

Coles' buyers receive appropriate training to ensure that they are familiar with the company's obligations towards suppliers. Coles also has a strong focus on ensuring its suppliers are aware of relevant legislative requirements, such as food safety and labeling requirements.

In general, supply contracts that Coles enters into with its suppliers incorporate Coles' Standard Terms and Conditions, which include provisions specifying the process to be used to resolve any disputes that arise between the supplier and Coles.

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<sup>27</sup> [http://www.supplier.coles.com.au/doing\\_business/supplier\\_relationship/supplier.aspx](http://www.supplier.coles.com.au/doing_business/supplier_relationship/supplier.aspx)

The elements of the dispute resolution procedure are outlined below:

- If a dispute arises, there are internal and external avenues where suppliers can raise their grievances. Internal avenues available to suppliers include the automated grievance lodgment process located on the Coles Supplier website, direct engagement with the Buying party and or supermarkets management elevation as required.
- If the dispute cannot be resolved through consultation between the parties, suppliers can access the services provided of the alternative dispute resolution scheme adopted in 2000 under the Produce and Grocery Industry Code (formerly the Retail Grocery Industry Code of Conduct). This provides Coles' suppliers access to an independent Ombudsman who can review their grievance and, if needed, order mediation between the supplier and Coles at no expense to the supplier.
- Where the dispute remains unsettled, the independent Ombudsman can make a determination in favour of one or other party. In the seven years the scheme has been operating no matter involving Coles has been escalated to this stage.

Coles notes the new Horticulture Code, which came into effect on 14 May 2007, incorporates dispute resolution procedures that mirror those under the Produce and Grocery Industry Code. Coles suggests these procedures will be a valuable tool to settle disputes arising in the context of wholesale fresh produce markets.

Coles understands some industry participants have suggested that supermarkets should also be included under the Horticulture Code. Coles' view is that such a step is unnecessary and inappropriate for the following reasons:

- Supermarkets are already covered under the existing Produce and Grocery Industry Code. If supermarkets were included under the Horticulture Code as well this would duplicate the compliance obligations imposed on supermarkets such as Coles.
- Most of the disputes in the Produce and Grocery Industry Code, and for that matter in the new Horticulture Code, revolve around the lack of documented or written terms of trade between growers and sellers of fresh produce – purchased through the wholesale fresh produce markets. Most of Coles' direct supply arrangements (ie. terms and conditions of supply and details of contracted quantities) are written. This approach provides Coles' growers with the certainty they need when planting crops and planning production, because the grower will know in advance the agreed volumes, payments and produce specification. Growers also have the benefit of an alternative dispute resolution procedure that can be invoked under Coles' standard terms and conditions if required.
- In the seven years since Coles has been part of the Produce and Grocery Industry Code there have been only three disputes referred to the independent Ombudsman. Given the volume of produce and the number of Coles' horticultural suppliers, this is a good record and does not justify Coles supermarkets being included in the Horticulture Code of Conduct.

## Closing remarks

Coles' food and grocery prices are among the lowest in the Australian market place. Coles is committed to providing good value to Australian consumers through its broad range and conveniently located supermarkets.

Coles has experienced steady increases in the cost of sourcing goods in recent years but has worked to minimise the impact of these cost increases on the retail price for consumers. These cost increases are evident not just at the farm gate but across the entire supply chain, in the form of rising overheads and input costs incurred by food processors, wholesalers, distributors and retailers. To a large extent, these increases are due to factors beyond the control of growers, processors or retailers.

Coles operates in a very competitive retail environment that is open and contestable to new entrants. Every day Coles must seek ways to compete more effectively and provide better value to customers. This intense competition provides enormous benefits to consumers by putting downward pressure on retail food prices.

Given the nature and scale of Coles' business, surety of supply for its stores all year round is critical. Coles seeks to achieve this by fostering mutually-beneficial relationships with its suppliers.

Coles believes it is overly simplistic to compare farm gate and retail prices without a detailed analysis of the costs incurred by food processors, wholesalers, distributors and retailers. The Freshlogic Report provides a detailed analysis of prices and costs between the two price points.

Coles submits that a more modern and accurate method of measuring food price changes should be considered by the Australian Bureau of Statistics to better reflect consumer buying patterns.

Within the constraints of competition and the need to maintain certainty of supply, Coles sets prices to cover the costs of doing business and make a return on capital employed.

Coles' narrow margins, continued efforts to contain price increases and daily provisions of specials and discounts are providing tangible benefits for consumers.

## Appendix - Overview of Coles Supermarkets

Coles operates some 750 stores nationally, serving nearly two million customers daily. Coles began trading in 1914 in Victoria and became a public company in 1928 with a small national network being established by the beginning of World War II. While Coles was initially a variety store selling a range of consumer products, including up to 400 grocery lines, it was not until the 1960s that Coles opened its first modern supermarket, selling some 1500-2500 grocery lines.

These early supermarkets developed in size from around 1000 square metres to today's 2500-4000 square metre stores, selling on average about 25,000 food and grocery lines. The commercial success of supermarkets is determined by their popularity with consumers, many of whom prefer the convenience and value of one-stop shopping.

During the past decade, Coles has built 229 new stores and has continually refurbished older ones to provide consumers with the modern convenience they expect. Over the same period, Coles purchased 79 stores and closed/relocated another 103. Coles became part of the Wesfarmers Group in November 2007.

### Coles' Community Footprint

Coles' community footprint is a positive influence in Australian society. It provides:

- Employment in almost every Australian community
- Comprehensive training and personal development programs
- Major ongoing investment and shopping facilities in local communities
- Greater choice for consumers to meet their changing economic and lifestyle needs and desires
- Access to food and groceries at affordable prices
- A reputable and safe food supply
- Job creation in allied industry sectors such as building and construction, agriculture and manufacturing
- A reliable demand for farm goods and an important conduit to consumer markets; for producers providing:
  - Clear and transparent written supply agreements,
  - Adherence to the Produce and Grocery Industry Code of Conduct, to which Coles is a signatory
  - Greater certainty to growers for their financial planning
  - Support for local growers affected by extreme weather conditions





**Report on issues relevant to the ACCC inquiry into  
the competitiveness of retail prices for standard  
groceries**

**Prepared for Coles Supermarkets  
By Freshlogic**

**March 2008**

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This report has been prepared for Coles Supermarkets by Freshlogic for inclusion in a submission to the ACCC in relation to the Inquiry into the competitiveness of grocery prices, and responds to the issues raised in the ACCC Issues Paper.

The report has been written by Steve Spencer and Martin Kneebone of Freshlogic.

Insights in the work have been drawn from our existing client-based studies and product work across meat, fresh fruit and vegetables and dairy. In addition, findings from Mealpulse™ (an on-line panel that tracks and analyses the buying & consumption habits of consumers In-Home vs. Out-Of-Home) and Adwatch-fresh™ (which captures and profiles the prices of fresh food advertised by retailers in the domestic market in protein, fruit & vegetable and dairy categories) have been used in this work.

This report has been prepared from data and information gathered from various sources and from primary research carried out by Freshlogic. Freshlogic has used its best endeavours and exercised the best of its skill and ability to ensure accuracy of the data, information and research materials.

Freshlogic does not warrant the accuracy of any of the data or information provided by third parties or of research materials not created by Freshlogic. Freshlogic accepts no responsibility for any error contained in or any omission from the report arising from the data or information provided by third parties or from the research materials not created by us.

Freshlogic provides market intelligence products and consulting services to the food and agribusiness sectors. We have considerable experience in monitoring and interpreting market and supply chain conditions in a number of food categories.

In 2004 as a director of Whitehall Associates, Steve Spencer undertook a major study for DAFF into the determinants of food pricing in a number of agrifood products and industries, which included the analysis of through chain pricing from farmgate to consumer. Martin Kneebone was part of the team of specialists who assisted with substantive aspects of that study.

In 2007, Freshlogic produced FOODmap: A comparative analysis of value chains in the Australian domestic food market for DAFF, as part of our work assessing grocery and food service markets.

# Executive Summary

## Section 1 – Food Industry

### The relative cost of food

1. In our view, comparisons of food costs and affordability should not be based on the simple comparison of food CPI statistics across a number of countries. There are inconsistencies in methods used to calculate CPI in different countries, which are identified in **Section 1.4 and 1.5**.
2. The effect of trade and biosecurity policies over time have meant that the prices of food in some sectors are influenced strongly by export markets (eg. beef, dairy) while other domestic markets (eg fresh fruit and vegetables) are protected from imports by stringent biosecurity safeguards (quarantine) which have led to more volatile consumer prices. Given these policies differ to those of other countries; it does not ensure a straightforward like-for-like comparison of food prices.
3. Australian CPI calculations over time are unduly influenced by major climatic events where the consumption of food groups is not adequately weighted for products in short supply. **Section 1.3** explains the weakness in this regard – illustrating with the effect of the recent rise and fall in banana prices.
4. The most valid approach of comparing food prices across countries is to compare the cost of representative and consistent food baskets with average weekly earnings in each context. The comparison performed in this report in **Section 1.6** indicates that Australian supermarket prices provide purchasing power parity with other countries, being close to UK food prices in terms of relative affordability, and less expensive than US and NZ prices.

### Changes affecting food prices

5. There are major global forces driven by climatic change, trade and government policy affecting grains, dairy, fruit & vegetables and meat sectors that will continue to affect the pricing of primary products and processing inputs in the Australian food market. **Section 2.1** identifies the major cause and effect influences impacting food costs.
6. Drought is one factor affecting food prices in Australia, however the effects of drought cannot be isolated from a number of interdependent international influences.
7. The effects of these changes on the Australian consumer as summarised in **Section 2.2** are outside the control of full-service supermarket (FSS) groups and other participants in the Australian retail food industry.

8. Any meaningful analysis of changes in food prices through supply chains must take account of the significant cause and effect influences that are occurring at the time of this Inquiry.

9. These effects are summarised as:

<i>These are being driven by...</i>	<i>...having significant impact on:</i>
<ul style="list-style-type: none"> <li>o Sustained demand from high-growth economies</li> <li>o Biofuel mandates and user subsidies in the US, EU and Brazil</li> <li>o Increased petroleum prices</li> <li>o The influence of trade and social policies of certain major producers, including the EU</li> <li>o Climate change which has created more frequent, extreme weather events</li> </ul>	<ul style="list-style-type: none"> <li>o High grain prices due to very low global stockpiles</li> <li>o High dairy commodity prices</li> <li>o Reduced margins for livestock producers reliant on feed grain</li> <li>o Fluctuating availability of horticulture lines where they are directly affected by drought</li> </ul>

10. The effects of these changes across food categories are uneven, depending on the extent of direct or indirect exposure to higher raw material prices for food processing or through higher costs of significant factors of production.

### The food industry

11. There is a significant level of competition in food retailing between supermarket groups, specialty retailers and foodservice in urban and regional centres.
12. In view of the nature of competition that occurs in the retailing and wholesaling of food and beverages, it is appropriate that a definition of the relevant market is wider than in terms of supermarket sector or in terms of total sales of grocery items. The rationale for this approach is provided in **Section 3.1**. However, irrespective of how the relevant market is defined and dissected, the food retail sectors are highly competitive and consumers have a wide range of choices.
13. Major grocery retailers have a significant but not dominant share of trade in a number of key food categories. Share of sales does reflect the actual level of competitiveness. In any event, over time, FSS groups have steadily lost share of spend on food and drinks to independent retailers, fresh food specialists, and to food service channels meeting the needs for meals eaten away from home. In terms of the numbers of outlets, the growth in number of networked



## Executive Summary

independent food stores supplied by Metcash has grown much faster than the number of FSS stores.

### Consumer preferences

14. FSS retailers compete with a wide range of other food outlets for consumers' meal choices. Ongoing shifts in consumer preferences and a greater emphasis on convenience as outlined in **Section 4.1** are changing the competitive dynamic in the food industry, which gives rise to intense competition between grocery retailers, specialist fresh food stores and food service outlets. These are contributing to a change from the traditional grocery shopping behavior with a strong trend towards higher frequency of shopping and smaller basket size.
15. The price of food items is one of the many influences on shopper choice, along with range, quality, service levels and store proximity. Depending on the purpose of the shopping trip, consumers will trade-off price against those other factors in selecting a food store and in making a purchase.
16. Food promotional activity – especially print media – influences the relative value within and between categories and with that can influence movement in category share.
17. While there is little existing empirical evidence of consumer demand for unit pricing across all groceries, unit pricing would improve information available to the consumer regarding purchase decisions.
18. Consideration must be given to the costs of implementation of regulations that may underpin such a requirement on food retailers, especially small business independent and specialist fresh food retailers who lack the advantages of scale to systemise the information system.
19. There are a number of well known methods used by grocery and specialist food retailers through which the consumer is provided information on prices and availability of food lines.

### Competition in grocery retailing

20. There are a number of dynamic drivers which explain the nature and intensity of competition in the food industry, including the existing retail networks or food distribution channels, different business models and disciplines, consumer preferences, product innovations and population demographics.
21. The influence of the existing major retail grocery competitors Coles, Woolworths, Aldi and the independent stores serviced by Metcash is manifested in a number of ways in relation to suppliers, competitors and the consumer.

22. The major FSS chains have advantages and disadvantages when compared to small, independent supermarkets and grocery stores and specialist retailers, as outlined in **Section 5.2**.
23. Advantages are principally related to economies of scale which benefit in terms of lower costs, information management and breadth of range; while disadvantages centre on the diseconomies of scale including convenience service levels, consumers' perception of quality and local tailoring capabilities of specialists and independent outlets.

### Barriers to entry

24. Recent entrants to the supermarket sector (such as Aldi), the expansion of independent store networks, and the success of specialty, particularly franchised, food retailers have challenged the perception that there are high barriers to entry to grocery retailing, and evidence the fact that there are comparatively low barriers to entry to grocery retailing.

### Pricing practices

25. There is differential pricing of food to consumers which is influenced by a complex set of factors including national, state, regional and local competitor actions, the particular value proposition offered by the retailer and the costs involved in operating in a particular geographic location.
26. The overall framework for the pricing policy of any retailer aims to maintain or grow market share by meeting customer needs, maintain a satisfactory ROCE, and pass on to consumers the benefit of the efficiencies of scale. Coles' approach is summarised in **Section 5.5**.
27. Major FSS chains are however constrained in applying a formula approach to pricing and other conduct by their FSS rivals, including independent IGAs, discount specialists such as Aldi, together with fresh food specialty retailers in many areas, so as to counter the real risk and known consumer behaviour of switching to another store due to the price and availability of a small number of key staple items in the shopping basket.
28. As a result of the above there will be variations in the prices of some items between stores in the same network depending upon distribution and store costs, the nature and extent of competitive activity, the maturity of the store (a new store will often seek to grow market share by offering very competitive prices), and the cost to service a store (more remote stores typically have a higher cost to serve given the higher supply chain costs involved).
29. Any desktop comparison of store-to-store prices that does not take account of daily competitor activity and relative product quality risks inaccurate conclusions about market behaviour.

## Executive Summary

30. In our experience through analysis of the pricing of several product categories selected by us in the preparation of this paper, retail prices will generally vary with supply prices. When supply prices fall – for example due to seasonal conditions – retail prices generally fall as well.
31. This has shown evidence in a number of categories of pricing practices applied by Coles that result in lower prices being charged to consumers when retailer buying prices fall. This is evidenced in our analysis of price movements in fresh fruit categories, red meat and pork. **Section 9** highlights a number of these instances.

### Competition in food wholesaling

32. There are a diverse range of distribution channels that service the retail sector through grocery, specialist and foodservice outlets.
33. There has been significant rationalisation in the wholesale food sector in the past 10 years including the implementation of supply chain management strategies of major chain retailers, the consolidation of wholesaling to independent supermarket groups, and the consolidation of foodservice distributors.
34. The choice between direct sourcing of food products and purchase through wholesale intermediaries is driven by a number of factors, such as:
  - o the need for consistency of products across a national network of full-service supermarket stores
  - o elimination of non-value-adding steps in the supply chain to improve efficiency
  - o logistical efficiency of handling short-life perishable fresh food
  - o logistical advantages gained from distribution centre consolidation
35. Therefore there is significant competition in the buying of food and beverages between grocery chains and other wholesale businesses in the supply chains for food categories.
36. There are variations between categories in the commercial terms of trade for supply to major grocery chains, due to the nature of the supply arrangements that prevail over the products sold in those areas, and the mix of branded, unbranded and private label products purchased by consumers.

### Retailer performance

37. Retail profitability margins in Australia are generally comparable with those of overseas countries, as summarised in **Section 7.1**. This

analysis is based on a comparison of EBIT margins for the supermarket divisions of major global retailers.

38. The nature and extent of competition in the food industry has manifested itself in low levels of underlying sales growth for major supermarket chains, as shown in “same store” sales performance. The independents grocery sector has recently demonstrated same store growth rates that exceed those of the major FSS chains.
39. Each of the major Australian grocery retailers has sought to address the constraints on “same store” business activity through a number of strategies aimed at improving absolute gross margins while reducing the cost of doing business, as well as enhancing the group ROCE on shareholders funds.
40. Grocery categories have varying contribution to store profitability. **Section 7.4** outlines the structure of an FSS profit and loss statement. The role that the individual category plays in meeting that overall target will vary from time to time given the conditions affecting the consumer demand in that category, and supply conditions. Within the category itself, products will also play different roles from time to time in contributing to returns.

### Private label

41. There has been a concerted effort by the Australian FSS retailers and Independent banner groups to expand the use of private label products in recent years.
42. Private label plays a critical role in a number of areas for the FSS grocery retailer and a number of independent banner groups, such as:
  - o category management
  - o extension of the parent brand, benefiting from the promotion of the retailer brand
  - o driver of loyalty as providing exclusive access to that product which is not available in other retailers
  - o improving percentage gross margin returns
43. **Section 7.5** shows the experience in a number of Australian retail categories, contrasting the private label share of volume in a number of categories, with the growth in value over a 4-year period. It shows a number of categories which have achieved greater product differentiation over that time have increased category value.

## Section 2 - Prices

### Pricing structures in supply chains

44. Any meaningful analysis of pricing of food and beverage items through supply chains requires an understanding of the changes in product form from primary to retail-ready form, yields in transformation, the relative cost and value-added activity throughout the chain, and complexity of the range of end-products that make up a category.

### Factors affecting category pricing

45. **Section 9** of this report identifies such issues relating to meat, dairy, eggs, bread and fruit and vegetables.
46. Across the food groups, a range of different factors are behind the comparison between farmgate and retail prices. Analysis must recognise
  - o each relevant food commodity's ultimate end-use or market destination of the primary product
  - o the structure of relationships in the value chains
  - o the influence of international trade
  - o the yield losses in transformation of products – portions of livestock carcass that do not yield saleable meat products, or the loss of volume in processing fruit or vegetables
  - o by-product or co-products – that may supplement the return of the processor
47. In any analysis of prices through the chain for a specific product group or individual SKU, there is a need to take account of the role that product plays within the category for both the retailer and the supplier.
48. A number of product features are being acknowledged by consumers and as a consequence are generating price premiums. A value hierarchy for these attributes has evolved. **Section 8.3** identifies key influences.

## Glossary of terms

ABARE	<i>Australian Bureau of Agricultural and Resource Economics</i>
ABS	<i>Australian Bureau of Statistics</i>
Box market	<i>A segment of the egg industry supply chain, wherein egg packers supply products direct to independent retail outlets</i>
Cat	<i>Catalogue number in reference to series of ABS data</i>
CODB	<i>Cost of Doing Business, which is a key performance indicators for grocery retailers referring to the full cost of maintaining and servicing a retail store chain and supporting logistics activities</i>
Co-products	<i>Secondary saleable products that are derived from a manufacturing process</i>
Cut and Pack	<i>Refers to a cheese block cutting and product packaging operation</i>
EBIT	<i>Earnings before interest and tax</i>
EDLP	<i>Every Day Low Prices, a strategy used by grocery retailers to offer consistent relatively low retail selling prices on a large number of core grocery food lines</i>
FCOJ	<i>Frozen Concentrate Orange Juice</i>
FSS	<i>Full-service supermarkets</i>
HAL	<i>Horticulture Australia Limited</i>
Issues Paper	<i>The Issues Paper released by the ACCC on 11 February 2008</i>
Mercusor	<i>The trading bloc which includes Brazil, Argentina, Uruguay,</i>
MLA	<i>Meat and Livestock Australia</i>
NLRS	<i>National Livestock Reporting Service, a market reporting service operated by MLA for the meat industry</i>
OECD	<i>Organisation for Economic Cooperation and Development</i>
OTH	<i>Over The Hooks, which is a means of selling a livestock carcass based on dressed weight</i>
Private label	<i>Retail food products that are branded in supermarket brands – otherwise known as “no-name” or “generic” labels</i>
Proprietary brand	<i>Retail food products that are branded in food company brands</i>
QSR	<i>Quick Service Restaurant, which designates fast food outlets including McDonalds, Hungry Jacks, Pizza Hut</i>

ROA	<i>Return on assets</i>
ROE	<i>Return on equity capital employed</i>
SKU	<i>Stock Keeping Units</i>

## Reference to Issues Paper Questions

Summary of the questions in the ACCC Issues Paper and how this report addresses them.

<i>Q</i>	<i>Issue</i>	<i>Section addressed.</i>
1	Main causes for rising food prices	2
2	Accuracy of OECD comparisons of food prices	1
3	Changes in the structure of retailing	3
4	Drivers of change in retailing	3
5	Importance of economies of scale etc	3
6	Measuring market share	3
7	Entry/exit details	1, 3, 4
9	Profitability of grocery retailers	7
10	Changes in grocery wholesaling	6
11	Drivers of changes	5, 6
12	Difference between categories	6
13	Importance of economies of scale etc	6
17-21	Pricing through supply chains	8, 9
22	Choices for the consumer	4
23	Impact of unit pricing	4, 5
24-26	Relative importance is factors affecting purchase decisions	4
27	How do consumers get information on price	4
28	Pricing signalling strategies	4
29	Retailers compare prices	5
30, 58-59	Effectiveness and impact of shopper docket schemes	4
31	Competition in retailing different across products	5
32	Major competitors to grocery chains	5
33	To what degree do major chains compete with each other	5
34	Has entry into petrol retailing affected competition	5
35	Grocery pricing policies	5
36	Grocery prices between urban, regional and country centres	5
37	Sustainable entry of a third major chain	5
38	Inputs required to open a store	5
39-40	Site access	5
41	Disadvantages for smaller supermarkets	5
42-43	Advantages and disadvantages of vertical integration of retailing and wholesaling	5, 6
44	By-passing grocery wholesalers	6

<i>Q</i>	<i>Issue</i>	<i>Section addressed.</i>
45	Impediments to entry into wholesaling	6
46	Purchasing advantages for major retailers/wholesalers	6
47	Are lower prices passed onto to retailers and consumers	5
48	Lower costs for suppliers to large wholesalers or retailers	5, 6
49	Similarity of terms and conditions offered by suppliers	6
50	Do large wholesalers have market power	6
51	Do slotting fees reflect market power	7
52	Other forms of behaviour indicates market power	5
53	How could retailers and wholesalers exercise market power, product listing, product replacement/importation	5
54	Advantages and disadvantages of small retailers	5
55	Differences in wholesale price and terms affect competitiveness	6
61	Effect of consolidation on small retailers	5
70	Changes in retail prices and buying prices	8, 9
71	Flow-on of cost savings	5, 9
72	Nature of supply arrangements	6, 9
73	Evidence of market power in supply to retailers and wholesalers	5
74	Impediments to cost savings	?
75	Consequences for suppliers of retailer market power	5
76	Consequences of suppliers having market power	?
77	Has vertical integration affected prices of inputs	?
78	How does direct supply affect level of competition in retailing	6
79	Nature and effect of the use of private label	7
80	Does pricing between suppliers and wholesalers limit ability to pass on cost savings	?

## **Section 1**

### **The food industry**

# 1. The relative cost of food

## 1.1 CPI analysis

In our view, comparisons of food prices should not be based on the comparison of food CPI statistics across a number of countries, without reference to average earnings of consumers. The comparison of food CPI and average weekly earnings shows that Australian food prices have not become less affordable over time.

- The Issues Paper details some high-level comparisons between the reported food CPI statistics produced by respective statistical agencies of Australia and OECD countries.
- These depict Australia having had a higher than average growth rate in the Food CPI for food over a period of 1990 to 2007.

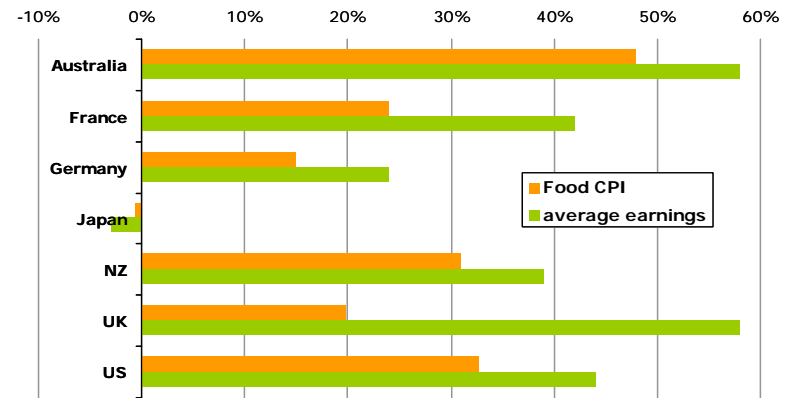
### Relative affordability of food

- We have compared Food CPI to the OECD monitored increases in average earnings over the same period. The comparison of CPI as a stand-alone number does not take account of the relative affordability of food.
- Our analysis of CPI data compared with the growth in average earnings shows that Australia and a number of other countries have recorded food CPI growth that is slower than growth in average earnings over the 1996 to 2007 period. Fig 1.1 shows the comparisons between food CPI and the average private sector earnings as recorded by the OECD.
- In general food prices are rising slower than average weekly earnings, and Australia's cost of food according to CPI are more affordable than at the start of the period of comparison.
- Government statistical data shows Australia recorded an increase of 58% in average adult full time weekly earnings over the same 1996 to 2007 period and was level with the UK (58%) and ahead of several countries (N.Z. 39%, USA 44%, France 42% & Germany 24%)

## 1.2 Contributions to Australian Food CPI

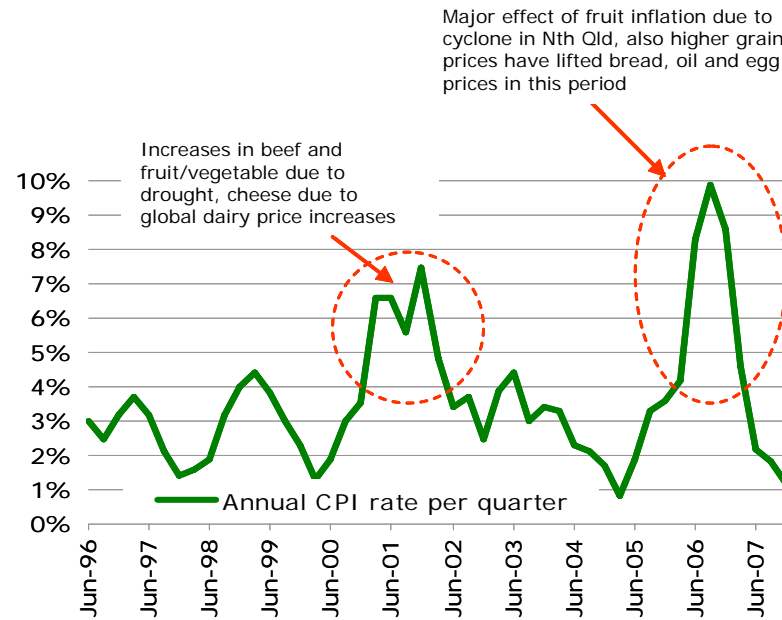
- The rate of Australian Food CPI has varied considerably from time to time. The spikes in food inflation in the past 10 years have been largely associated with climate (droughts and flood), when greatest fluctuations have come from spikes in prices for products which are in short supply due to major events, which seem to unduly influence the index at times when prices rise and fall sharply.
- These anomalies are due to problems with the CPI methodology due to the weightings applied to products which are in short supply, which are outlined further below.
- 

Fig 1.1 – Food CPI v average earnings (1996 to 2007)



Source: OECD MEI food CPI and earnings

Fig 1.2 – Food CPI since 1996



Source: ABS Cat 6401.0

# 1. The relative cost of food

Accordingly, the contributions to Australian food CPI over the period in question have been strongest in individual fresh product areas such as fruit and vegetables, lamb and mutton, pork (each within the meat and seafood category where they are offset by low increases in poultry and smallgoods), and bread products.

- o Beef and lamb prices have been increasingly influenced by export markets which compete for product with domestic buyers due to global shortages. This is described further in Section 9.
- o The price increases in vegetables would have seen a higher proportion of value-adding activity at a product level than other categories – a factor which is immersed within the price index but a lack of transparency in the calculation method does not allow this effect to be separated.

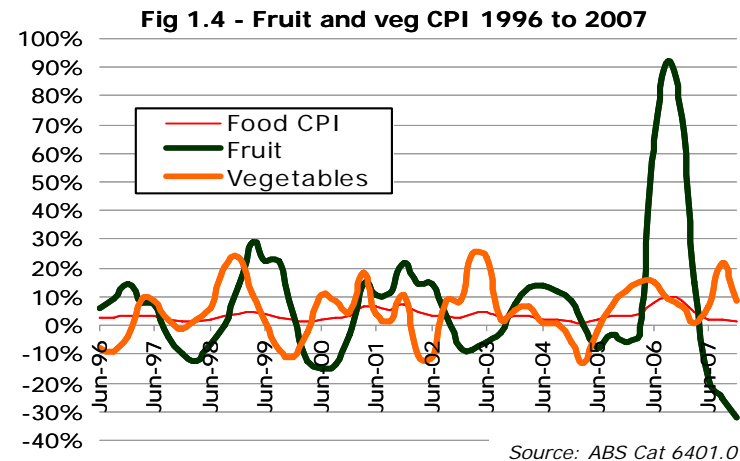
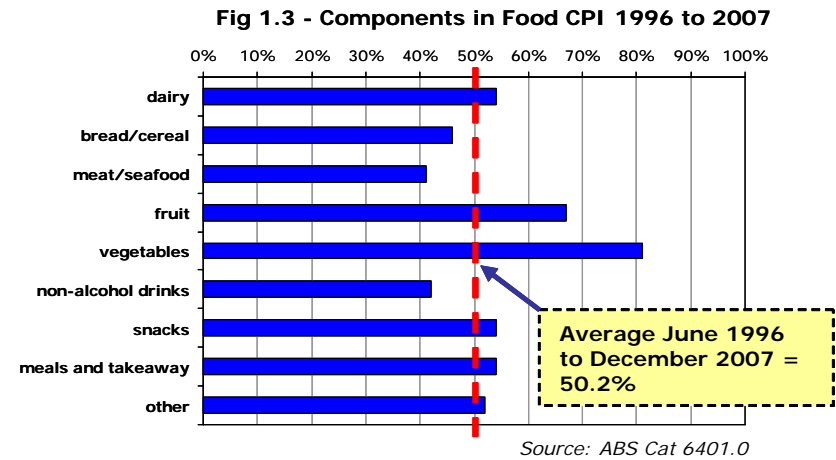
### 1.3 CPI methodology

Our analysis suggests there are inconsistencies in method and trade policy which do not render the comparison valid.

- o There are a number of problems with the CPI methods and calculations regarding:
  - o Weightings given to unusual fluctuations
  - o Contribution to the result from significant events in 2000-2007 – drought and cyclones
  - o No influence of consumption levels
  - o Basket composition
- o There is a resistance of government users and providers to move away from these systems as there is a great deal of systematic decision-making that derives from the CPI system (such as the Reserve Bank’s interest rate decisions, cases for wage increases) from which departure is not likely as it involves far-reaching change.

#### Weightings

- o The ABS does not make available the detail of the item weighting in the basket of fruit items for the fruit CPI. However, they advise that they draw on the Household Expenditure Survey (“HES”) of fruit items. The seasonal availability of fresh fruit products, as shown in fig 9.35, will affect what is used in the fruit basket.
- o In our assessment, CPI is prone to significant influence by volatile items



- o The ABS advises that, while the HES data is used as the basis for determining CPI weights, various adjustments are made to adapt it for use in the CPI. The HES weights are therefore only an approximation of the actual CPI weights.
- o Fruit is weighted to contribute 6.15% to the total food CPI total, but appears to have a disproportionately high impact on Food CPI, as shown in



# 1. The relative cost of food

Fig 1.5 and discussed below. For example, if banana prices did not increase in 2006 food CPI would have been substantially lower.

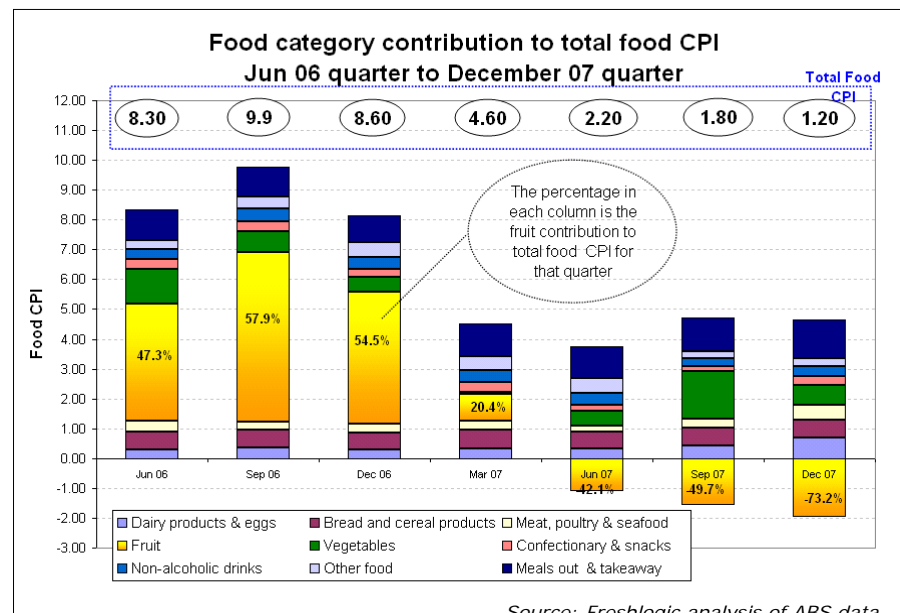
- o The case of bananas is an extreme case of a single item in short supply which has a distorting effect on total food CPI. While prices spiked (from an average \$2.95 to \$11.95 per kg over 6 months) after the effects of Cyclone Larry which destroyed most of the North Queensland crop, the CPI method assumed that consumers continued to purchase the product in similar volumes.
- o This was not valid due to its scarcity of product for much of 2006 until crop production returned to normal. It is known that other wholesale and retail fruit prices also firmed at this time due to the stronger demand driven by limited supplies of bananas. As a result the Fruit CPI jumped significantly as shown in Fig 1.4.
- o There was significant fruit price movement in the five quarters from Jun 06 to June 07, where fruit CPI quarterly increases on the previous year peaked at 92% and averaged 45% as is profiled in the last 5 points of chart 1.5.
- o Based on an assumed basket weighted increase for bananas to 18%, with the increase due to the non availability of other fruit plus an assumed firming of 15%-20% in other fruit lines, we estimate that bananas would have contributed 51% of the fruit CPI increase in the last 3 quarters of 2006. (This is calculated as the average of the fruit components of the CPI movement in June, September and December quarters of 2006 per the bar chart in Fig 1.5)
- o The fruit contribution to total food CPI for the five quarters to the end of June 2007 ranges from 57.9% to -42.1% of the total and is profiled in detail in Fig 1.5.
- o Given that fruit is theoretically weighted at 6.15% of food CPI, the effect of the banana shortage has a profound effect on food CPI when prices are increasing and decreasing.

### Other issues with CPI methods

- o CPI tracking and basket systems are not capturing the new product trends of retailers and manufacturers, such as:
  - o Varietal and quality differentials
  - o Pack size and portion diversity within categories in fresh and combined products

- o The dynamic range expansion which is mostly adding value to products – such as high-fibre and nutrient-enriched bread products, modified and enriched milks, and salad mix products

Fig 1.5 – Contributions to CPI



Source: Freshlogic analysis of ABS data

- o There have been ongoing debates around the validity of the current CPI methods in a number of countries stimulated by the Boskin Commission Report to the US Senate Finance Committee on the study of the Consumer Price Index.
- o Boskin raised that CPI does not appropriately deal with the following factors and hence it is not a valid measure of the cost of living:
  - o Substitute products
  - o Outlet bias – which assumes continued patronage to a consistent pattern
  - o Quality changes

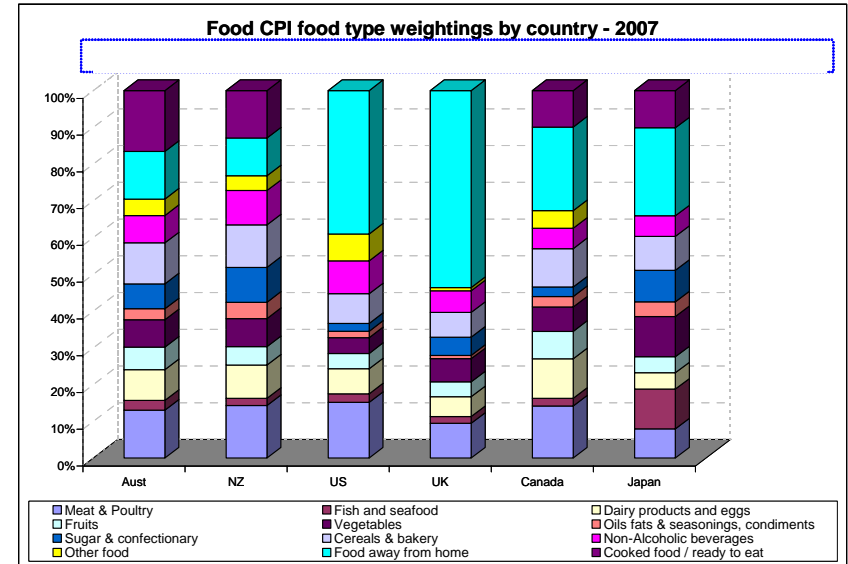
# 1. The relative cost of food

- o New products
- o Boskin has calculated a formula bias in the US CPI to overstate cost impacts, such as bananas. The total bias was quantified in the 1996 report at 1.1% per annum.
- o The work has led to a number of ongoing reviews of CPI methods and generated some changes in the US and other country methodologies to address substitution bias, but in general has not led to major change in approach to address the Boskin report's major concerns.

## 1.4 Comparing CPI methods across countries

- o The Issues Paper makes reference to inter-country comparisons of increases in the cost of food. We have investigated the CPI methods across countries and found that:
  - o There is limited consistency of food products that are included in the Food CPI calculation
  - o Different weightings given to food categories within the food CPI basket (this is dealt with on the following page)
  - o Different range of products in a CPI food basket
  - o There are different weighting revision systems as consumption patterns change across any given year (varying between annual versus 5-yearly updates)
- o It is unclear from the analysis that has been possible in the timeframe permitted in this Inquiry whether food at home and away from home – which varies markedly between countries but is generally trending towards eating away from home – is consistently treated.
- o We have compared the relative composition of food CPI across a number of countries, which are summarised in Fig 1.6. The composition of food groups in the food CPI also varies widely between countries as seen in the coloured bands in the chart on the right. A much lighter weighting is applied to food eaten out of the home in Australia and New Zealand than in the UK and US for example. Australia and some others include “cooked and prepared food” as a category, which does not appear in the UK and US.
- o Classifications of foods into groups have a broadly consistent treatment at a high level but vary substantially between sampling systems at a detailed level.

**Fig 1.6 food CPI weightings across countries**



Source: Freshlogic using data from statistical agencies

## 1.5 Other issues relevant to inter-country comparisons

- o Australia has advanced and implemented a relatively free trade stance in several sectors, and has a high export reliance in some sectors which exposes domestic prices to world conditions (dairy, red meat, pork) yet we have retained strict disease protection in others (fresh fruit). Other countries such as the EU have allowed preferred trading partner status to be conferred on a number of low-cost food suppliers which has helped keep the average cost of food low to their consumers.
- o Australia remains insulated from competitive dynamics in fresh fruit and vegetables, poultry, pork due to stringent local quarantine regimes, and strong ethical credentials in other livestock industries where a significant export role exists.
- o At the same time, such is our strong export dependence in animal production industries that in sectors such as beef, domestic prices have in the past reflected the volatility in global prices affected by supply shortages caused by the implementation and removal of BSE trade bans in key markets.

# 1. The relative cost of food

- o In certain sectors we have not seen the advantages from globalisation being reflected in the cost of food to the consumer. Some of our disease risk management approaches have not enabled global least-cost producers to supply this market – for example in fresh fruit categories such as bananas, apples and pineapples.
- o It is likely that there would have been more stable pricing of fruit and vegetables over time – which earlier analysis shows as the most volatile components that influence CPI under current methods – if fewer import restrictions had applied, and imported product had filled domestic shortages.
- o This paper does not promote such trading freedoms for the purposes of prices alone, but stresses the need to recognise the implications for relative food costs over time of important policies to protect the integrity of local production systems.
- o The US and EU have also protected certain primary production markets which over time through tariff protection, while using separate government policy to stabilise consumer pricing, whereas Australian and NZ tradeable products fluctuate with global market changes.
- o Increasing imports of fresh produce into EU markets have been required as local supplies have, for some time, been unable to meet consumer demand. Large emerging supply sectors of Mercusor, China and South Africa with labour and scale advantages have changed product economics in developed markets. Access by those suppliers to the markets of the EU has enabled average lower prices for food to their consumers, containing food price inflation over time.

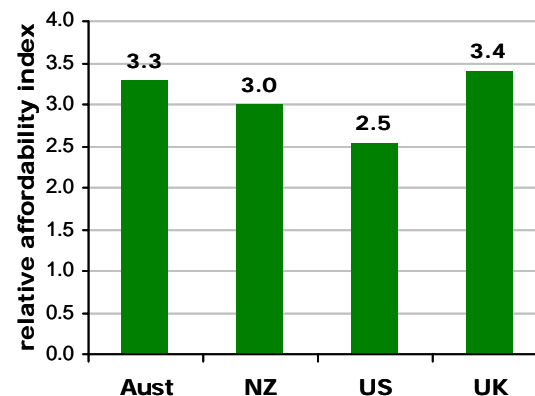
## 1.6 Basket affordability

Given the issues raised with CPI methods between countries, we have undertaken further analysis of the relative affordability of food by comparing the relative cost of a basket of grocery items across a number of countries. This illustrates that Australian food prices are at least as affordable as the US, UK and New Zealand when compared with average earnings in those countries.

### Approach

- o For these purposes, we compared:
  - o The costs of common items in baskets of goods across selected countries (Australia, UK, US and NZ)
  - o Average full time weekly earnings for all persons (including ABS Cat 6302.0)

**Fig 1.7 – relative affordability of food costs**



- o The food basket has been based on the basket of items used in ABS surveys (reported in Catalogue 6403.0 - Average Retail Prices of Selected Items).
- o The basket of items has been supplemented to add a selected number of items to improve the relevance of the basket to current food purchasing trends, including such items as chicken breast fillet, block cheese, yoghurt, mince meat, tinned food, water, juice and soft drink based on our review of category sales data produced by AC Nielsen and supplied by Coles.
- o Current food prices for the same items based on consistent description, pack or portion size were obtained in July 2007 from on-line shopping websites of major supermarket chains in each of the four countries using two retail chains in each other country (in the case of Australia – Woolworths and Coles), with the exception of New Zealand where one was used.
- o Where no pack size match was available, the closest match was used, converted back to the Australian product denomination. In the case of items sold by weight, the Australian standard unit weight (eg. one kg of meat and fruit/vegetables) was determined. The simple average of each retail basket per country was taken as the country average.
- o The chart in Fig 1.7 has calculated the apparent relative affordability of food baskets based on this statistical data as the ratio of:

## 1. The relative cost of food

- Latest average full time adult weekly earnings (reported in each case by the Government statistics agency); to
- The current total cost of common food basket items
- The higher the number, the higher the spending power and therefore lower the relative food prices. The comparison indicates that Australian supermarket prices provide purchasing power parity with other countries, being close to UK food prices in terms of relative affordability, and less expensive than US and NZ prices.

## 2. Domestic and international pressure on food prices

### 2.1 Cause and effect

There are major global forces driven by climatic change, trade and government policy affecting grains, dairy, fruit & vegetables and meat sectors that will continue to affect the pricing of primary products and processing inputs in the Australian food industry. Any meaningful analysis of changes in food prices through supply chains must take account of the significant cause and effect influences that are occurring at the time of this inquiry.

- Food prices are currently rising and are under pressure to continue to follow that trend as a consequence of major changes in global forces affecting supply and demand of a number of commodities.
- The chart at Fig 2.1 on the next page shows the cause and effect interrelationships between major trends that have combined during the past 2 years to drive strong increases in commodity prices which are now affecting many categories within the Australian food industry.
- Those big drivers of change in food costs as shown in the chart at Fig 2.1 include:

#### Global

- Sustained demand from high-growth economies, chiefly in China, India and dependent regional economies; as well as increased prosperity in oil-rich countries of the Middle East.
- Biofuel mandates and user subsidies in the US, EU and Brazil, which has led to increased plantings of grain and oilseed crops for fuel processing, hence reducing the amount of land available for food production.
- Increased petroleum prices due to a tightening of the global oil market with increasing energy demands from developing countries and supply shortages from major oil producers.
- The influence of trade and social policies of certain major producers, including the EU which has reduced budgetary supports for food producers in preference for sustaining regional development and development of new consumer economies.
- Climate change which has created more frequent, extreme weather events such as droughts, floods and ice storms which have adversely affected the reliability of global production of crops.

#### Australian

- Sustained drought across southern and eastern Australia has reduced grain production and reduced the size of dairy, sheep and beef herds

### *The impact to date*

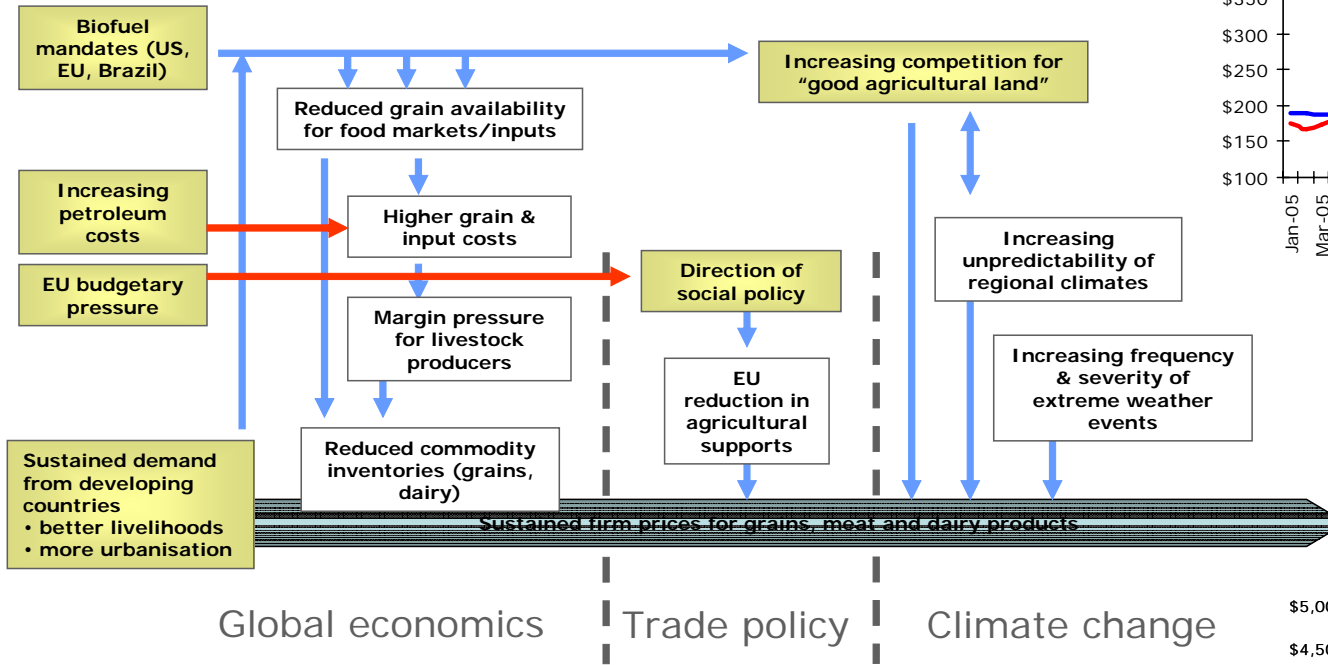
- The effects of these changes across food categories are uneven, depending on the extent of direct or indirect exposure to higher raw material prices for food processing or through higher costs of significant factors of production. In general, these have included:
  - High grain prices due to production shortfalls and very low global stockpiles (refer to Fig 2.2 on the next page).
  - High dairy commodity prices (as shown in Fig 2.3 on the next page) due to product shortages, in turn a partial result from lower milk production by key commodity exporters, and a wind-back of export subsidies by the EU – this has sharply boosted Australia's unit value of dairy exports and lifted average farmgate milk prices by around 50% between 2006/07 and 2007/08 production seasons.
  - Reduced margins for livestock producers (pigmeat, poultry, dairy and beef feedlot) reliant on feed grain.
  - Fluctuating availability of horticulture lines where they are directly affected by drought.

### *Outlook – tight market conditions likely to persist*

- Demand for land to produce fuels will steadily increase with growing mandate commitments by US and EU projected to leave less arable land available for food production. Rising demand for grains, vegetable oils and other crops as primary feedstock for biofuel production in the US, Brazil and EU will be sustained for 5-7 years, according to US industry and government projections.
- This will keep commodity supplies tight and sustain firm prices.
- Higher feed costs are likely to constrain production of dairy and animal proteins.
- Less reliable and more extreme weather events as a consequence of global climate change may continue to disrupt production in traditional supply countries.
- Staple food demand (dairy, meat and grains) in developing countries will continue as economic growth improves livelihoods and consumer demand for nutritious (higher protein) foods such as meat, which in turn places demands on feedstock for cattle, sheep etc.
- As a potential countervailing factor, it is possible that international events such as a recession in the US may temporarily ease the sustained growth in demand in developing markets.

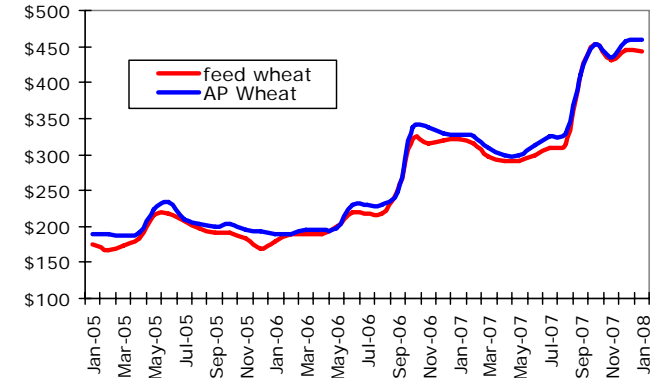
## 2. Domestic and international pressure on food prices

**Fig 2.1 – Mega-trends affecting food prices**



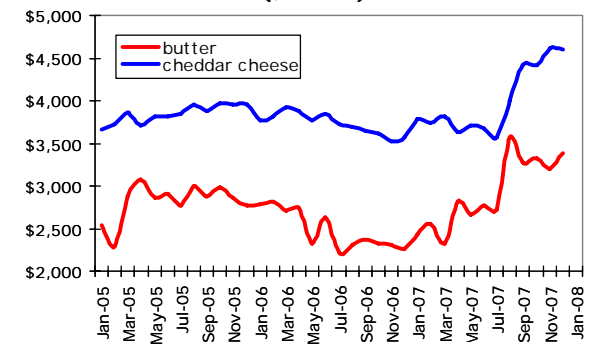
Source: Freshlogic

**Fig 2.2 Grain prices 2005-present**



Source: Australian Crop Forecasters

**Fig 2.3 Dairy export prices 2005-present (\$A/tonne)**



Source: Dairy Australia

## 2. Domestic and international pressure on food prices

### *The effects of drought*

- o There has been frequent over-simplification of the effects of drought on food pricing in general in the media.
- o Much of the Australian arable farm land has been affected by drought conditions since 2002 – the geographic scale and severity of the rainfall deficiencies which define the existence of drought conditions has varied since that time.
- o In 2006, the southern late-winter and spring period realised the lowest rainfalls on record in the Murray Darling basin region. Despite better rainfall in northern Australia and some parts of the southern pastoral regions, several food production regions remain relatively dry with low water reserves in irrigation storages.
- o Drought has affected food production systems and categories to varying extents:

Grain	<ul style="list-style-type: none"> <li>o Reduced crop output for food and livestock feed grains, contributed to global crop shortages which has reduced inventories and increased prices</li> </ul>
Dairy	<ul style="list-style-type: none"> <li>o Reduced feed supplies, and increased forage costs which has forced herd reductions and exits for affected producers</li> <li>o Reduced Australian production since 2001/02 has gradually contributed to a reduction in global supply of commodity products but is not the major cause of higher commodity prices</li> </ul>
Beef	<ul style="list-style-type: none"> <li>o Reduced available feed for grazing producers has forced de-stocking and temporary gluts of stock on the market</li> <li>o Indirect effect of high grain costs has reduced feedlot stock levels, forcing more stock into markets</li> </ul>
Pork and Poultry	<ul style="list-style-type: none"> <li>o Indirect effect of higher grain costs from global market forces</li> </ul>
Fruit & Vegetables	<ul style="list-style-type: none"> <li>o Limited effect through instances of reduced supplies in specific areas directly affected by water shortages</li> </ul>

## 2. Domestic and international pressure on food prices

### 2.2 Impact on Australian consumers

- o Table 2.1 outlines the impact of the major trends on food prices in Australia.

**Table 2.1 – impact on food prices of major trends and events**

<i>Sector</i>	<i>Current key dynamics</i>	<i>Potential future impacts of commodity prices and climate</i>
Grains	<ul style="list-style-type: none"> <li>o Continued tightness in world grains market as the outlook sees demand increasing and supply under pressure with stocks at historic low levels.</li> <li>o Medium-term demand for biofuels affecting growing areas for food and fuel crops</li> </ul>	<ul style="list-style-type: none"> <li>o Higher level of feed costs for intensive livestock users into the medium term</li> <li>o Rising input costs to bakery and pasta products, with varying influence depending on the grain content of products</li> </ul>
Dairy	<ul style="list-style-type: none"> <li>o Australian milk costs driven by global markets</li> <li>o Tight global supplies affected by supply shortages likely to sustain firm world market for the medium term</li> <li>o Australian milk production limited by drought, resulting in stronger competition for milk at farmgate at historically high prices</li> </ul>	<ul style="list-style-type: none"> <li>o Sharp increases in raw milk input costs affecting domestic and international consumer products</li> <li>o Domestic price increases in cheese, milk and dairy spreads which are directly impacted by higher raw milk costs, with potential but less significant flow-on to products less-dependent on raw milk such as ice-cream and yoghurts</li> </ul>
Fruit & vegetables	<ul style="list-style-type: none"> <li>o Shortages of certain fresh categories in regions that are exposed to floods and drought, affecting ability to supply year-round requirements, especially into processing</li> <li>o Increasing net imports of processed products</li> </ul>	<ul style="list-style-type: none"> <li>o Prices will be affected by the ongoing impact of climate on major fresh supply sources</li> <li>o Greater commitment from major buyers in assuring supply security</li> </ul>
Red meat	<ul style="list-style-type: none"> <li>o World market setting returns to Australian market</li> <li>o Steady growth in global demand for beef to continue</li> <li>o Steady increase in use of contracted supply into domestic retail markets reduces volatility in effective wholesale prices</li> <li>o Drought affecting stability of supplies from grass-fed production</li> </ul>	<ul style="list-style-type: none"> <li>o Global market likely to be affected by tighter supplies as all feedlot systems cope with higher input costs</li> <li>o High feed costs causing a fall in feedlot numbers and supply, causing a temporary oversupply of product to domestic abattoirs</li> <li>o World market balance dependent upon ability for consumers to accept price increases sought by producers</li> <li>o Drought adding to temporary Australian supply shortages</li> </ul>
Poultry	<ul style="list-style-type: none"> <li>o Steady rise in domestic demand</li> </ul>	<ul style="list-style-type: none"> <li>o Higher feed costs will increase prices of poultry meat</li> </ul>
Pork	<ul style="list-style-type: none"> <li>o Rationalising domestic industry with import competition</li> <li>o Reducing export competitiveness due to stronger currency</li> </ul>	<ul style="list-style-type: none"> <li>o Higher feed costs will put extreme pressure on production sustainability given the difficulty in gaining price rises across all uses of domestically produced carcasses</li> </ul>
Seafood	<ul style="list-style-type: none"> <li>o Increasing focus on fresh species where production and resource advantages exist</li> <li>o Increasing net imports of processed seafood products</li> <li>o Stronger Australian currency creating improved competitiveness for imported frozen and processed products</li> </ul>	<ul style="list-style-type: none"> <li>o Likely increased price of meat proteins may provide scope for greater consumer demand for lower-price seafood</li> </ul>
Rice	<ul style="list-style-type: none"> <li>o Low water allocations limiting domestic crop volumes</li> <li>o Industry rationalisation</li> </ul>	<ul style="list-style-type: none"> <li>o Sustainability threatening critical mass of domestic production, creating greater scope for rice imports at competitive prices</li> </ul>



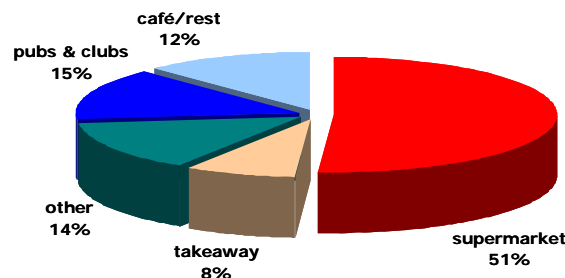
### 3. The food industry

#### 3.1 Total food sector

We view the relevant context in which competition occurs within the food industry as competition for consumer choices in the purchase of food, meals and meal components. Irrespective of how the relevant market is defined and dissected, the food retail sectors are highly competitive and consumers have a wide range of choices.

- o There are a number of significant food distribution channels that service the consumer. The grocery sector of food retail – comprising FSS chains and independent grocery stores – is the most significant distribution channel of the domestic food and beverage market.
- o There are a number of potential definitions of the relevant market dimensions that will govern what are considered to be the market shares of grocery retailers.
  - a) **Share of grocery retailing** – This relies on a narrow definition of the relevant food market in which the FSS operate and excludes independent fresh food retailers and represented \$66.7 billion in 2007.
  - b) **Share of spend (as per Fig 3.1)** – we prefer this method because of the competition with other players who are servicing foodservice channels. According to ABS retail trade data (catalogue 8501.0), total turnover from food and drink sales in the year to 31 December 2007 was \$116.7bn, of which the supermarket channel represented 51%.
  - c) **Share of stomach** – include the wider analysis of institutional component of foodservice (sales through healthcare, canteens etc) which does not appear in the ABS retail trade analysis but represents additional competition for food sales of grocery retailers and fresh food specialists.

**Fig 3.1 - Shares of food & beverage spend 2007**



Source: ABS Cat 8501.0

- o Our view is that a definition of the relevant market which is wider than (a) is appropriate. The rationale for this preference is:
  - o Grocery retailers are competing for meal occasions with other channels servicing meal and snack providers, which include independent fresh food specialists, takeaway, dining out and institutional and event food – this is shown in the retail sales trends between major channels referred to below in Fig 3.3.
  - o The diverse range of competitors at wholesale points in food and beverage categories, as identified below in section 6.1.
  - o The numbers of outlets and level of sales out of FSS stores and fresh food specialists (fruit & vegetable, meat) which are servicing local food service and independent convenience store outlets.
- o However, irrespective of how the relevant market is defined and dissected, the food retail sectors are highly competitive and consumers have a wide range of choices.

#### 3.2 Numbers of retail food outlets

There is a strong level of competition in food retailing between supermarket groups, and between supermarkets and specialist retailers.

- o The table below shows the number of outlets of chain stores and independents in 2007, compared with 5 years ago.

Table 3.1 numbers of retail outlets			
	2007 numbers	2002 numbers	CAGR
<b>FSS Chain stores</b>			
Coles	753	666	2.6%
Woolworths	756	698	
Aldi	166	54	
Franklins	80	77	
Others	-	81	
<b>Total</b>	<b>1752</b>	<b>1576</b>	
<b>Independents</b>			
IGA	1384	1082	11.3%
Foodworks	708	136	
SPAR	223	-	
Others	472	591	
<b>Total</b>	<b>2781</b>	<b>1809</b>	

### 3. The food industry

<b>Fresh food specialists</b>		
	<i>2007 numbers</i>	<i>2002 numbers</i>
Brumby's Bakery	328	Not known
Bakers Delight	640	Not known
Lenard's poultry	186	Not known

Source: Retailworld, Freshlogic

- o This shows that chain store networks have increased just 11% in number in that period while the independent outlets have increased 53% in number.
- o There is a mix of store formats within the above numbers of FSS stores, between large format, independent "neighbourhood" stores and express/convenience stores, which are targeting a range of locational and shopping trip requirements.
- o The development of chains and networks of specialists in fresh fruit & vegetable and butchery has not been as pronounced as in other categories. This is attributed to a number of factors including:
  - Skill levels required at store
  - Limited scope to achieve efficiencies of scale in the supply chain
  - High perishability and immediate downside impact of weak store operations
- o The profile of outlets numbers varies across Australian states. Both WA & Qld have more dispersed grocery markets than in NSW, Vic & SA hence were not as attractive initially for capital investment by the major supermarkets chains and the no frills discount grocery chains of Franklins & Jewel.
- o Convenience stores are another important channel for retail sales of grocery lines. Major groups of convenience stores are shown in Table 3.2.
- o Convenience stores are a mix of owner-operated, franchises and commissions agents. Alliances between Woolworths and Coles and respective fuel company partners Caltex and Shell compete alongside separate stores operated by those fuel companies.

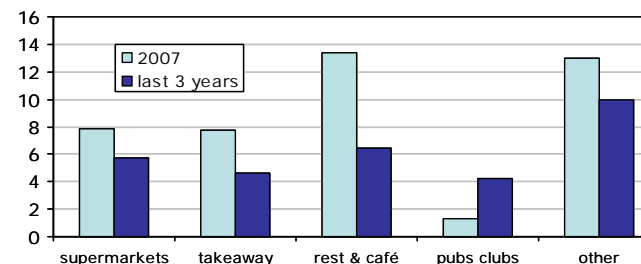
<b>Table 3.2 - numbers of convenience retail outlets</b>		
	<i>2007 numbers</i>	<i>2002 numbers</i>
Coles Express/Shell	594	615
Shell	350	
Caltex/Woolworths	505	415
Caltex	778	
7-Eleven	365	275
BP	284	320

Source: AC Nielson, ACCC

#### 3.3 Changes in channel shares

- o There has been a gradual movement in spend away from supermarkets. **The share of food and beverage sales of supermarkets fell from 52.2% to 51.1% over the 5 years to the end of 2007.**
- o The chart in Fig 3.2 shows the slower growth rate for supermarkets in 2007 and over the past 3 years compared to other channels. This slower growth is significant in terms of the absolute value of annual sales that have by-passed the supermarket channel. We estimate that if supermarkets held their share of 2002 food and beverage sales, lost revenue in 2007 was \$1.4bn.
- o The ABS records volatility in the share of spending from month to month. The chart below at Fig 3.3 shows monthly changes in the level of spending from corresponding periods in the prior year.

**Fig 3.2 - Spending by channel per ABS data – % increase in 2007 and last 3 years**

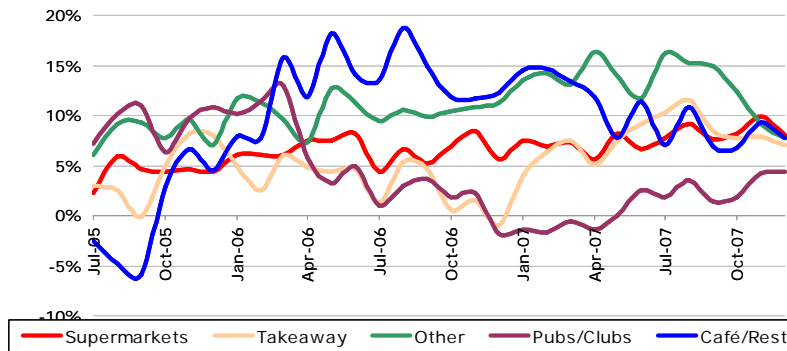


Source: ABS Cat 8501.0

### 3. The food industry

- o The comparison of sales trends per Fig 3.3 in different channels has shown:

**Fig 3.3 - Retail sales by industry group – monthly compared to a year earlier**



Source: ABS Cat 8501.0

- o Consistent revenue growth for supermarkets at levels which are higher than underlying reported food inflation, reflecting small growth in the volume of sales through the sector.
- o Café/restaurants are still growing faster overall but some inconsistency between segments of this channel have been experienced, with the casual dining component showing the greatest improvement. The strength of the levels of business for this channel is a reflection of improving household incomes, improved liquor licensing regulations and the greater versatility of casual dining options which provide faster turnover of customer sittings.
- o Takeaway food sales have also fluctuated indicating some sensitivity in consumer discretionary spending affected by pressures on household incomes, fuel and interest rates. There is a greater shift towards the quick-serve restaurant formats with most chains expanding their networks at the expense of independent takeaway outlets.
- o Continual stronger growth in independent and specialist food retail which is included in "other". This sector includes the small privately owned stores including the local green grocer, butcher and bakery outlets.

- o Major reasons for changes in those shares over time:
  - o Consumer preference for convenience driven by demographic and behaviour change (refer section 4)
  - o Performance of supermarkets v specialists (opening hours, peak trading periods and queues, product quality impact, supply chain sourcing taking up highest quality)
  - o Consumer affluence and changing demographics are driving greater demand for eating out of the home (these points are summarised in section 4)

#### 3.4 Shares of key categories

Major FSS retailers have a significant but not dominant share of trade in a number of key food categories

- o The share of sales made by major chain retailers varies across food categories, as summarised in the table below:

Category	Estimated share held by FSS stores	Comment
Red meat	44% of domestic consumption;	This represents only 16% of total output due to the volume of exports
Fresh pork	20% of total fresh pork output	This excludes the use of pork in the smallgoods sector
Poultry	40-45% of domestic consumption	Per industry estimates which are based on a high foodservice component
Milk	55% of domestic packaged milk consumption	There are limited packaged milk exports
Cheddar Cheese	42% of domestic consumption;	This represents 33% of total product availability
Fresh F&V	45-50%	Per industry estimates

Source: Freshlogic

## 4. Consumer preferences

### 4.1 Determinants of consumer preference

Ongoing shifts in consumer preferences are changing the competitive domain in the food industry, which gives rise to intense competition between grocery retailers, specialist fresh food stores and food service outlets.

- There are a number of trends giving rise to shifts in market share and influences on competition between grocery, specialists and other channels

**Fig 4.1 - the effect of consumer trends**

**Shapers of choice:**

- Household structures changing
- Work-life mobility and balance
- Smaller households
- More complex wants and desires
- Income levels and disparities
- Greater ethical concern
- Health aspirations
- Aging population

**Changes in preference:**

- Break down of meal times
- Less time for preparing and eating food
- Greater time given to commuting - leisure must compensate
- Less planning, more eating on the go
- Affluence affords investment in lifestyle through fitness and diet
- Demand for smaller portions & managed nutritional fix

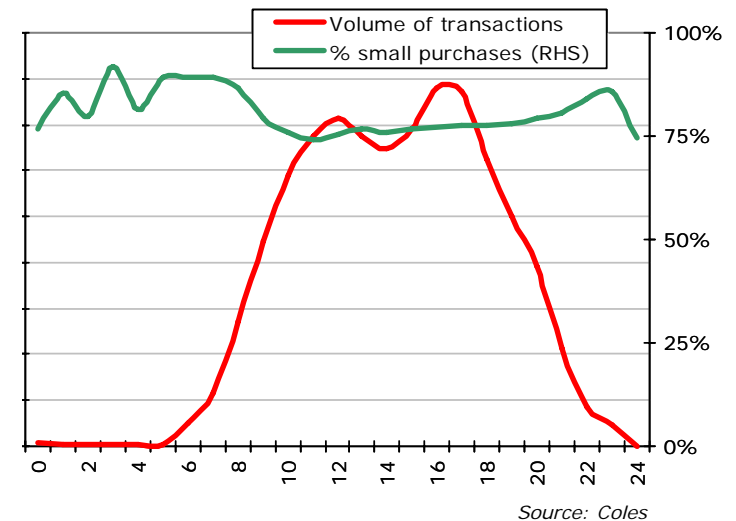
**Which shows up in:**

- Greater focus on the "occasion"
- More diverse options sought for eating away from the home
- Greater demand for casual dining
- More "take-away" ready-to-eat meals presenting a convenient or health option
- Shopping trips purposes changing
  - Top-up v tonight's meal v pantry fill
- More diverse scope for "premium"

Source: Freshlogic analysis from Mealpulse results

- Fig 4.1 outlines the key trends affecting decisions being made by consumer around meals and shopping behaviour. These are contributing to a change from the traditional grocery shopping behavior trends with a strong trend towards higher frequency of shopping and smaller basket size.
- There is far greater incidence of top-up trips and "shopping for tonight's meal", especially in metropolitan areas than in regional and country centres. There is therefore a much lower incidence for a regular large weekly shop, and growing incidence of consumers shopping at different outlets at different times. As a result, Shopping peaks in trading in late afternoon – as shown in Fig 4.2

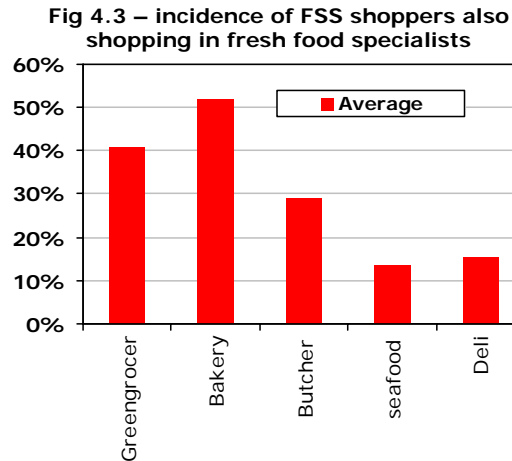
**Fig 4.2 – average trading volumes & transaction sizes**



- The trend towards a change in shopping trips has been evidenced in Freshlogic's research through our Mealpulse consumer panel. This shows a tendency for consumers to use a mix of retailers for fresh food purchases in meat, fruit and vegetables and delicatessen requirements.
- The Freshlogic Mealpulse analysis shows (for final quarter 2007) a relatively high incidence of consumers that list either of the two major FSS chains as their primary choice for food shopping, who also shopped in

## 4. Consumer preferences

green grocer and bakery specialists. Fig 4.3 shows the relative incidence across a number of relevant categories.



### 4.2 Influences on shopper choice

- The Issues paper seeks input on the variables that determine a shopper's choice, and the importance that price plays in that selection. The consumers' value propositions in the selection of a product on the shelf are multi-dimensional.
- We have identified 5 factors affecting shopper choice:
  - Price
  - Quality
  - Range
  - Service
  - Location and proximity
- These factors are part of a compensatory model – depending upon shopping priorities, trade-offs will be made in order to meet needs. Within this set of influences it is difficult to generalise the relative importance of any one of these factors because the preferences of individual shoppers vary widely.

- There is an increasingly complex demographic of the consumers market. The research from Mealpulse shows that consumers who are eating out more frequently are a very diverse group, characterised as eating out across all meal occasions, with different attitudes to the time and price competition for their meal choices, and spending money in a wider range of outlets.

#### ***Demand for convenience***

- Consumer demand is increasingly expanding the dimensions of convenience – over time these are evolving but we see three distinct elements:
  - ***Ease of shopping*** – in terms of accessibility (physical access and trading flexibility)
  - ***Meal readiness*** – through reduced meal preparation time, welcoming meals components rather than “scratch-preparation” ingredients, but also influencing the shift towards speedier, casual dining
  - ***Product form & range*** - balancing portion size, along with the necessary fix of nutrition, indulgence, and/or taste
- The outcomes from these trends are that some consumer segments are spending more on convenience attributes – through higher prices for:
  - products that shorten meal preparation time
  - products that provide tighter portion control tailored to meal requirements, including health concerns
  - a shopping experience that suits their time-poor requirements
- At the same time, while this may point to an increasing risk for the loss of shopper business to specialists or small-format convenience outlets, the one-stop and price advantages offered by the FSS chains ensure the format retains a strong preference for consumers in the face of a wide variety of options.

## 4. Consumer preferences

### 4.3 Use of promotion

There are a number of methods used by grocery and specialist retailers through which the consumer is provided information on prices and availability of food lines. Food promotional activity – especially print media – influences the relative value within categories as well as movement in category share.

#### *Priced advertisements*

- There are many ways in which consumers gain information about prices of food items:
  - External to the store
    - Supermarket brochures, which are generally distributed to all households in store catchment areas through mail boxes, and available at stores
    - Newspaper advertisements
    - Television and radio
    - Other shoppers (“word of mouth”)
  - In store
    - On the shelf price tags including “specials” tags
    - Promotional display gondolas located at the end of aisles and associated point of sale advertising material
    - In store media such as store radio, shopping trolley advertising etc
- It is difficult to categorically summarise which methods are most influential on the shopping decision, given the variation in purposes of shopping trips, price discounting and different shopper demographics.
- Price sensitivity and the response to a promotional price signal will vary according to the amount of time a shopper intends to spend in the store, what food budget discipline they operate with and their receptiveness to various retail offers.

#### *Print media advertisements*

- Print media advertisements are the single highest volume promotional medium physically reaching the consumer regarding product and price. This media is an important channel of communication for brand and private label products to the consumer, as part of the investment in a mix of brand and product promotional activity by suppliers.

- Freshlogic collects and processes the details of fresh food advertisements, including catalogues from food retailers in all states. This provides a database of historical promotional activity, covering the fresh food categories of Bread, Dairy, Fruit, Meat, Poultry, Seafood and Vegetables.
- Major grocery chains and independent groups make a significant investment in print media advertisements, using their advantages of scale. Local fresh food specialists will also use these media for local tailoring and targeting.
- These advertisements have a number of purposes:
  - To influence sales activity through discounts;
  - To raise and maintains the consumer’s awareness of the price/value of key lines, and as a result has a direct bearing on the consumer’s perception of the relative value between competing retailers;
  - To accommodate category growth initiatives by suppliers and retailers including launch platforms for new brands and products;
  - To provide a front-end mechanism to drive trialing, and share switching, and as such is a valuable lever to adjust priorities to reflect supply chain volumes;
  - To influence, and in some cases set the step-changes within a season, seasonal pricing of fresh food lines including fruit, vegetables and protein and cultural promotions such as Easter and Christmas.
- New innovations in future will include greater use of on-line advertising, given the expansion of on-line marketing to consumers.
- We believe that promotional advertisements are especially influential in fresh food categories. The extent of promotional activity and the average level of discount vary from time to time. The 2007 summary of promotional activity in fresh food categories is summarised below in Table 4.1.

## 4. Consumer preferences

**Table 4.1 – fresh food advertisements placed in major print media in 2007 extracted from Adwatch-fresh™**

Category	Number of adverts	Average discount over 2007 (as a % of retail price)*
Dairy	22865	21.6
Meat	14971	27.1
Bakery	9623	28.6
Vegetables	8193	21.5
Seafood	7631	21.1
Fruit	7199	21.7
Poultry	6209	19.0
Snacks	5671	26.0
Delicatessen	5154	23.1
Total	87516	23.3

\* where a recommended or normal retail price is provided in comparison to the advertised price

- Fig 4.4 illustrates examples extracted from Freshlogic's **Adwatch-fresh™** which shows the contrasting variability in advertised prices affected by seasonal supply conditions in fresh fruit categories, with the stability of pricing in chicken products.
- The promotional activity will vary across categories affected by such factors including seasonal product availability, accommodating a seasonal event, affecting volume and value at category, discount periods, different levels of competitive rivalry by category (fragmented v concentrated), and the degree of private label exposure.

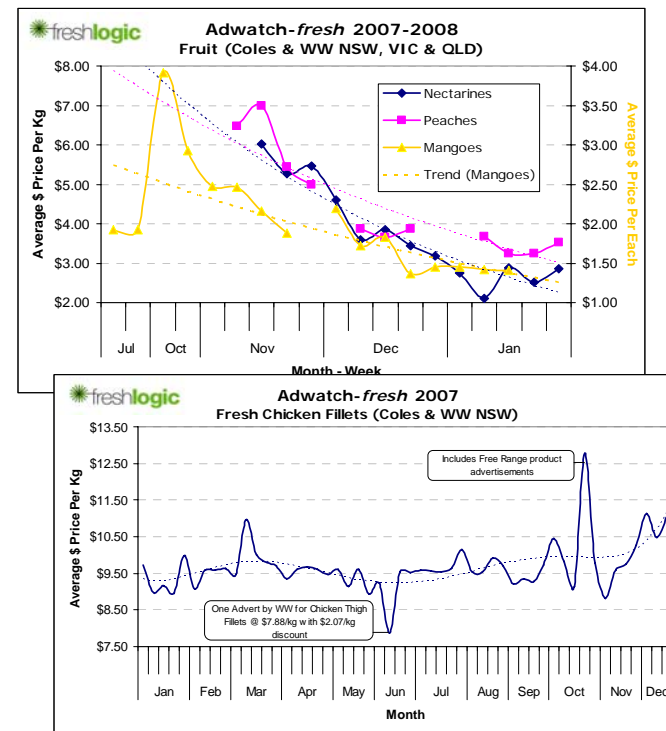
### 4.4 Loyalty schemes

- Successful retailers focus on the importance of intimacy with the customer – the customer is the greatest asset that a retailer has rather than the store itself. Investments in display, storage and technology are made with a strong sense of purpose to enhance the durability of the connection with the customer.
- The micro-strategies adopted by different groups towards greater customer intimacy are diverse and complex, built around core themes that promote

care for food safety, freshness, variety and price consciousness. Loyalty programs have aimed at achieving repeat visitation.

- Major grocery retailers, including independent banner groups, operate a limited number of loyalty schemes. The most significant of these are:
  - fly-buy points that accrue with shopping spend
  - arrangements with financial services providers
  - private label exclusivity
  - the use of price incentives triggered by minimum food spend to purchase fuel through FSS-owned and aligned petrol stations or, in the case of Ritchie's group of IGA stores in Victoria, through a tied arrangement with independent fuel company

**Fig 4.4 – advertised prices in print media promotions extracted from Adwatch-fresh™**



## 4. Consumer preferences

### **Petrol dockets**

- Supermarket retailers first commenced involvement in the petrol retailing market in 1996, which then saw the development of a loyalty initiative using discount petrol dockets involving supermarkets and service stations.
- The shopper scheme conduct was followed by similar actions from Metcash supplied stores IGA, and Foodland.
- There is no available evidence of any corresponding increases in the price of groceries sold by retailers offering petrol discount schemes.
- Petrol retailers use convenience food retailing as a small but important source of income. Thus service stations are increasingly offering food and grocery for 'top-ups', with added incentives for specific product discounts or further fuel savings on minimum purchase levels and impulse purchases in-store.

### **4.5 Unit pricing**

Unit pricing will improve information available to the consumer regarding purchase decisions, yet will impose costs on retailers.

- Unit pricing provides consumers with the price per unit of relevant measure, such as a price per kg or litre, of pre-packaged grocery items, and/or items sold by unit rather than weight. Unit pricing systems provide information in addition to the total price to be paid, usually on shelf labels.
- In our opinion this will improve the information provided to consumers regarding the relative prices of products yet it will add costs to retailers in additional display materials,
- The system would not only extend to fresh food items, but also across packaged groceries to enable ready unit price comparisons between products sold in different pack sizes.
- The objective of unit pricing is to provide better information to consumers so they can make more informed decisions. It has been adopted in parts of the US and European grocery sector several years ago. The approach is being used in fresh and internet sales at present.
- It is used in food sold by weight, and on certain pre-packs etc which are increasing convenience. Although unit pricing information is currently

provided in meat and produce by major chains, there is an increasing development in the speciality food retailers to sell packs of items with no weight or price per kg information provided to consumers. This is most prevalent in specialist fruit and vegetable retailers.

- There is limited recent and publicly available independent consumer research into its use including any that shows widespread consumer demands for unit pricing.
- A study in the US was undertaken several years ago into *Unit prices on retail shelf labels: an assessment of information prominence* by Miyazaki, Sprott and Manning. That work found:
  - Although unit prices have been provided to consumers for nearly 30 years, the format in which this information is presented has been largely ignored.
  - An examination of major grocery retailers found considerable differences in how prominently unit prices are presented to shoppers on shelf labels. Two methodological approaches are then used in this research to examine the prominence of unit prices in a grocery–shopping context.
  - The results of a field study support expectations that, among consumers who are relatively low in price consciousness, the prominence of unit price information has a positive effect on consumer awareness and usage of such information.
  - In a second study, a controlled experiment shows that increasing the prominence of unit price information affects consumers' shopping behaviors by shifting purchases toward lower unit priced items and ultimately reducing grocery expenditures. Suggestions for future research and implications for retailers and policymakers are discussed in this study.
- Consideration should be given to the challenges that such a requirement will present to small business fresh food specialists and independent operators without advantages of scale efficiencies in complying with the information needs.



## 5. Competition in grocery retailing

### 5.1 What drives competitors?

There are a number of major drivers of the nature and intensity of competition in the food industry, including the nature of existing retail networks, corporate disciplines, consumer trends and demographics

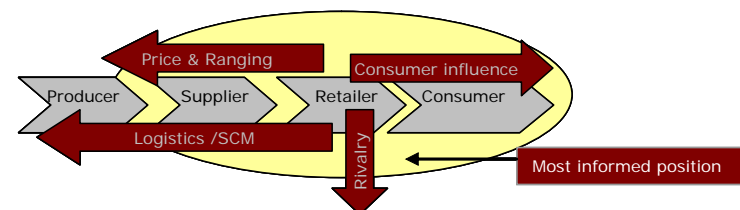
- o The drivers can be described in three major groups:
  - (a) The size and scale of the existing major retail grocery competitors Coles, Woolworths, Aldi and the independent stores serviced by Metcash, is the single biggest influence on retailer behaviour, having regard to:
    - o The share of grocery (but not total food) retail trade
    - o The geographic coverage of stores in urban and regional regions
    - o The logistics supply chain that has been established between suppliers, distribution centres and stores
 The relative scale of the FSS chains is to be considered in the context of the relatively small scale of Australia's total population, the small number of large cities, greater distances between major cities and between production regions and markets, all of which influences costs.
  - (b) Corporate disciplines evidenced by the differing business models of the various food retailers which aim to optimise and deliver growth in shareholder value.
  - (c) There are a number of background consumer trends and demographics which shape the Australian food retail sector. These include a strong retention of needs for convenient access to food retailing from a range of outlet types, as well as for dining out and purchasing from takeaway outlets. These were referred to in section 4.

### 5.2 Nature of competition

The influence of the major grocery supermarkets is manifested in a number of ways in relation to suppliers, competitors and the consumer.

- o The FSS have evolved into a "one-stop shop" food and consumables offer that has earned substantial support from Australian consumers. A typical FSS serves 16,000 to 20,000 people every week and is open 15-20 hours every day.
- o While some retail competitors and supply chain stakeholders are unhappy with the ways FSS conduct their business, this needs to be balanced with

Fig 5.1 – examples of supermarket influence



the high level of consumer support they enjoy, based on choice and service.

- o The essence of supermarket influence stems from their popularity among consumers in the domestic market. The FSS have secured a level of market share that attracts mainstream suppliers to use them, or Metcash, as their major distribution channels to reach Australian consumers. Therefore, the FSS can exert influence on suppliers, and their retail competitors because Australian consumers prefer the FSS mode of food distribution.
- o The share of sales that an FSS has in a category is an important factor in determining its capacity to influence others in the supply chain.
- o The table below describes the five forms of influence that a FSS group possesses:

## 5. Competition in grocery retailing

**Table 5.1 – examples of supermarket influence**

<i>Influence</i>	<i>What is it?</i>	<i>How it is felt?</i>
Price & ranging	<ul style="list-style-type: none"> <li>The influence exerted by the supermarket buyers over suppliers of product to determine if products will be included in retail ranges and if so through what suppliers and on what trading terms.</li> <li>This includes the selection of the suppliers of private label products</li> <li><b>Note:</b> Suppliers choose to seek better category penetration through product extension and innovation. An average supermarket offers 25,000 products or SKU's, and they are continually dealing with thousands of new line submissions. New lines are the growth generators and a supplier's ability to secure ranging with the FSS's has a direct impact on the supplier's growth.</li> </ul>	<ul style="list-style-type: none"> <li>Supplier prices and trading terms</li> <li>Product range decisions</li> <li>Supplier selection based on product performance</li> <li>Prices and margins to suit category strategy</li> </ul>
Logistics/Supply chain management	<ul style="list-style-type: none"> <li>The influence exerted over suppliers to change supply chain arrangements. This is typically centred on reducing the retailers' logistic costs however most suppliers share the productivity benefits that new supply chain strategies bring.</li> <li>It can include QA systems, product specifications, IT systems and packaging systems.</li> </ul>	<ul style="list-style-type: none"> <li>Suppliers implementing inventory management practices to meet retail demand</li> <li>Concentration of distribution hubs</li> <li>Improved matching of available supplies to store replenishment needs</li> <li>Less ability for suppliers to gain economies of scale from supply chain management</li> </ul>
Rivalry	<ul style="list-style-type: none"> <li>Influence exerted in competition within the retail industry. This is driven by the scale of FSS operations which enables an FSS to offer competitive prices to consumers and to compete effectively in the marketplace.</li> </ul>	<ul style="list-style-type: none"> <li>Retail price and range competition</li> <li>Store location choices</li> </ul>
Most informed position	<ul style="list-style-type: none"> <li>Influence exerted on suppliers by reason of the FSS' detailed knowledge of market conditions for the category.</li> <li>This is most common in fragmented supply sectors where the retailer and or their selected intermediary may be the only participants in the supply chain with a full view of the market.</li> </ul>	<ul style="list-style-type: none"> <li>More informed basis for negotiation with suppliers</li> </ul>
Consumer influence	<ul style="list-style-type: none"> <li>The capacity to inform consumers effectively about the availability and relative value of its products.</li> <li>This is achieved through the selection of products, the ways that products are presented on shelf and promoted.</li> </ul>	<ul style="list-style-type: none"> <li>Shelf space position</li> <li>Promotional exposure</li> <li>Increased capture of supplier marketing spend on retailer promotions rather than through other channels</li> <li>Proportion of the retailer own private label in the range</li> </ul>

## 5. Competition in grocery retailing

### 5.3 Competition between retailers

- o While there is competition within the food industry between a range of food retail outlets, within this, there is significant competition between Coles, Woolworths, Aldi and large independent stores serviced by Metcash, which have similar format and offers.
- o The similarity of the proposition to the consumer affects their approach – what one FSS chain does cannot be ignored by the other, therefore there is similarity in promotion, pricing and products as well as consumer positioning.
- o Whether advantage is obtained by one FSS over the other comes down to the following factors for a supermarket shopper:
  - o store location (and proximity to rivals/direct alternatives)
  - o retailer brand perception
  - o the consumer’s assessment of the price/value/quality equation
  - o the quality of the shopping experience – in terms of time, product availability and service
- o There is also significant competition at a category level between one type of outlet versus the other (ie. supermarket v independent and/or specialist). This will be driven by one or more of the following factors:
  - o proximity, store access and ease of shopping experience – differ between a pantry fill (destination) and a top-up
  - o perception of value and range
  - o perception and reality of the quality of products offered
  - o convenience of the full product range, which deals with a shopper’s preference in a given trip for the “one-stop shop” advantages v limited trip purpose
  - o convenience in the time-pressured demand for meal solutions closer to meal time

Major grocery supermarket chains have advantages and disadvantages when compared to small and independent and specialist retailers. Advantages are principally scale related and disadvantages centred on diseconomies that affect service, perceptions of quality and local tailoring capabilities of specialists and independent outlets.

- o The nature and extent of competition varies across food and grocery categories, with greater competition between FSS and specialists in fresh food categories. Section 3.4 summarises the shares of key categories.
- o The relative advantages that FSS chains have over specialists fresh food retailers and independent grocery stores and vice-versa are summarised as follows:

**Table 5.2 – FSS v specialist and independent retailers**

<i>Advantages of major chain retailers</i>	<i>Advantages for specialists and independent retailers</i>
<ul style="list-style-type: none"> <li>o Buying and operating scale and therefore potential for lower unit cost</li> <li>o Breadth of range for completeness of shopping trip (full service, can get it all there)</li> <li>o Marketing communications scale and level of investment</li> <li>o Operating systems and processes</li> <li>o Information and data management capacity - resources to invest in sophisticated modelling and data management to cost-effectively research and operate these evaluation processes.</li> </ul>	<ul style="list-style-type: none"> <li>o Personal service, flowing into higher loyalty</li> <li>o Tailoring for local catchment</li> <li>o Operational flexibility around peak times could be better, ease of access (time in and out of car, ease of shopping)</li> <li>o Avoids high waste and product deterioration in perishables caused by extended trading hours</li> <li>o Smaller format store facilitates easier selection for convenience shopping</li> <li>o Category expertise in fruit and veg and meat (perceived as experts, FSS seen as generalist), can hold staff in specialist areas (better than big chain)</li> </ul>

- o Specialist convenience stores depend strongly on fuel-based purchase compliments, such as snack food and drink; weaknesses of grocery stores to cope with peaks; the ease of access for limited requirements, and the ability to satisfy other emergency purchases.

### 5.4 Barriers to entry

Recent entrants to the supermarket sector evidence the fact that there are comparatively low barriers to entry to grocery retailing.

- o Prior to the establishment of a full-service supermarket, there are a number of important pre-requisites that require evaluation in the business case for new store development. These include:

## 5. Competition in grocery retailing

- A sufficient catchment size
- Investment in site acquisition and development cost, and an ability to commit to the resulting occupancy cost
- Investment in suitable store design/fit out
- Regard to competitor density and location
- Available skilled and experienced staff
- Distribution servicing infrastructure, including suppliers
- Branding and product range
- There is a well-established evaluation process used by the FSS chains to assess available food spend and household catchment of potential retail sites. The prevailing share of sales that a retailer has in the sector (based on the experience of established trading outlets) is overlaid on this available catchment to determine a forecast store sales.
- As identified in 5.3, the data capture and analysis strengths of the FSS groups – through scanned transaction-based information – provide an advantage over smaller retail groups.
- There is a strong perception that the nature and extent of the FSS chain networks creates a significant barrier to entry to the grocery retail market. Recent developments in the grocery retail sector suggest otherwise due to the following:
  - The entry of German-based discount retailer Aldi to the Australian market and the rapid expansion of their store network. Aldi has presented a new discount retail format of a kind that had not been seen in Australia in the past, offering a limited range of about 900 core grocery products, using retail stores which are around 20% the floor space of typical FSS stores.
  - The expansion of independently-owned banner retail networks of such groups as IGA and Foodworks. As shown in section 3.2, the network of Foodworks, which includes a number of outlets which compete head-to-head with FSS stores, has expanded from 132 in 2002 to more than 700 outlets in 2007.
  - The planned entry of US-based superstore discount retailer Costco in 2009
- A market that is serviced by the FSS format does not per-se present insurmountable barriers to entry, but rather provides opportunity for other formats including the independent stores, fresh food and discount

specialists to compete, as we have seen in the last 3 years with the growth in networks of competitors.

- Consumers are not always in need of the FSS offer and with more limited-purpose shopping trips, may prefer quicker access and the (often) higher price of that aspect of convenience, or the advantages offered by discounters in a limited range of products.

### 5.5 Pricing policies

There is differential pricing of food to consumers which is influenced by a complex set of factors including national, state, regional and local competitor actions, the particular value proposition offered by the retailer and the costs involved in operating in a particular geographic location.

#### *General practices*

- The overall framework for the pricing policy of any retailer aims to maintain or grow market share by meeting customer needs, maintain a satisfactory ROCE, and pass on to consumers the benefit of the efficiencies of scale.
- The practices adopted by major FSS retailers can be summarised as follows:
  - In general, product lines are priced within categories to achieve an overall category gross margin, which is the combination of product gross margins, trading terms with suppliers, and allowances for direct store-based costs of labour markdowns and wastage.
  - There will be a range of different target margins within categories; target category margins within departments; and departmental margins across the store and the total supermarkets business. This is illustrated in section 7.
  - There are differences between retail food prices between metropolitan and country outlets that are influenced by the need to recover the higher cost of servicing regional and rural locations.
  - There is tactical pricing activity affecting 15-20% of the FSS range for which prices are actively managed to ensure competitiveness against other retailers, to counter the very real risk and known consumer behaviour of switching to another store due to the price and availability of a small number of key staple items in the shopping basket.
  - This comprises:
    - a) Daily matched products at a store level

## 5. Competition in grocery retailing

- b) Nationally compared prices:
- c) Promotional program subject to regular specialising in catalogues, newspaper advertisements and other media.
- o As a result of the above there will be variations in the prices of some items between stores in the same network depending upon the nature and extent of competitive activity, and the maturity of the store (a new store will often seek to grow market share by offering very competitive prices). A desktop comparison of store-to-store prices that does not take account of daily competitor activity and relative product quality risks inaccurate conclusions about market behaviour.
- o Section 8 of this report outlines the complex influences on the retail prices of individual products and prices achieved within categories.

### ***Passing on benefits of lower prices?***

- o FSS chains as well as independent wholesale groups such as Metcash buy at a mix of prices in any category, including a mix which is influenced by the respective levels of private label and branded product volumes and unit values.
- o Where there are multiple suppliers within a category, a weighted average buying price of a specific group of products is relevant in the determination of the mark-ups and retail price.
- o Within that category, there may be small quantities purchased at lower prices. These would have limited impact on the overall category average, and not have any significant bearing on the mark-up and retail price.
- o In our experience through analysis of the pricing of several product categories, retail prices will generally vary with supply prices. When supply prices fall – for example due to seasonal conditions – retail prices generally fall as well.
- o This is evidenced by the analysis included in section 9 of this report which compare retail buy and sell prices over time in a number of fresh categories selected by Freshlogic for analysis. This has shown evidence in a number of categories of pricing practices applied by Coles that result in lower prices being charged to consumers when retailer buying prices fall. This is evidenced in our analysis of price movements in fresh fruit categories, red meat and pork. Not all categories were capable of being examined for this purpose, but in those selected by Freshlogic; there was direct evidence of cost reductions being passed on.
- o We note the evidence from the prior ACCC Inquiry into Prices was that the FSS chains are able to deliver lower nett prices {i.e. through better

performance terms of trade} but that a specialist wholesaler such as Metcash has a similar capability and in fact did achieve better terms of trade than the FSS with some suppliers.

- o In our experience gained in consultation with clients, the major competitive difference in terms of price between the vertically integrated FSS chains and the banner groups and independent stores supplied by a specialist wholesaler such as Metcash is that even when the wholesaler achieves the same terms of trade it does not fully pass them through to the member store of the banner group or independent retailer. Hence the price to the consumer may not directly reflect savings in cost achieved by the wholesaler, and smaller outlets may therefore be at a price disadvantage compared to FSS chains.
- o As the wholesaler also needs to make a return on investment, it takes differential service fees from customers according to the cost of servicing that client

## 6. Competition in food wholesaling

### 6.1 Structure of the wholesale sector

There are a diverse range of distribution channels to the retail market through grocery, specialist and foodservice outlets.

- o There are a number of different wholesale relationships and activities that operate within the Australian food market:
  - o Integrated wholesale and retail operations – retailer sources direct into their warehouses then distributes to their retail outlets (FSS, new Franklins and Aldi). This includes the use by FSS chains of the major fresh category managers and protein processors.
  - o Integrated processor/marketer/distributor – this includes business models that integrate supply to the “route” channel and independent supermarkets distribution. The food processors and marketers that adopt this approach include
    - o Poultry processors,
    - o Milk processors,
    - o Plant bakeries,
    - o Beverage manufacturers such as Coca Cola & Cadbury Schweppes,
    - o Smaller scale integrated meat and seafood processor/wholesaler.
  - o Brokers, co-ordinators and those that provide field-force services for small to medium-sized suppliers to grocery
  - o Wholesale grocery and liquor distributor – the major group operating in this combined role is Metcash servicing IGA and other banner group supermarkets such as Foodworks and independent liquor stores. By their own analysis, Metcash claims to supply groceries to 82% of independent grocery stores, which represents 19% of grocery retail sales.
  - o Cash and carry warehouses – servicing independent outlets and foodservice, and retail sales to Cash & Carry card members.
  - o Foodservice wholesalers – these vary across a wide range of categories, including large national distributors such as Bidvest and PFD, as well as specialists across fresh categories such as protein, fresh fruit and vegetables, frozen goods and dairy products.

- o Terminal fruit and vegetable markets located in each of the major capitals and limited other cities such as Newcastle.
- o Meat and fish markets (which operate in some places eg Sydney, Brisbane)
- o Any study of the wholesale market in food and the competition between buyers and sellers must take account of the diversity of the nature of relationships and business models in operation.

### *Developments in wholesale activity*

There has been significant rationalisation in the wholesale supply to the food industry in the past 10 years including the implementation of supply chain management strategies of major chain retailers, the consolidation of wholesaling to independent supermarket groups, and the consolidation of foodservice distributors.

- o There have been a number of developments in the structure of the wholesale markets over last 10 years:
  - o Purchase of the failing Davids Holdings by Metcash South Africa and subsequent divestment and public listing on ASX of Metcash Australian business.
  - o The Franklins retail and wholesale businesses collapse and the subsequent deal that saw the majority of the wholesale and retail network shared between Metcash and Woolworths, with Coles acquiring the remaining stores.
  - o Woolworths closes its eastern seaboard independent wholesaling business AIW leaving Metcash as the sole large scale operator
  - o Metcash purchases FAL wholesale to complete a nationwide \$8-9 billion distribution network (excluding coverage of Tasmania)
  - o New Franklins (Pick’n’Pay South Africa) begins self distribution
  - o Metcash commences taking equity stakes in multi store independent retail groups such as Ritchie’s in Victoria & Drakes in SA
  - o Significant investment and enhancement by FSS chains in integrated retailer activities including supply chain and logistics enhancements, cost reduction strategies and consolidation of suppliers
  - o Consolidation of foodservice distribution into large groups (Bidvest and PFD) and banner groups such as NAFDA

## 6. Competition in food wholesaling

- Emergence of new supply chains to service fast growing specialty food franchise chains such as Bakers Delight/Brumbys and Lenard's Poultry.
- Terminal fresh produce markets as the sole channel to supply independent fruit and vegetable retailers, have enjoyed growth in throughput. The role of these markets has changed from being a wholesale forum to clear all grades of product, to a valuable distribution channel to independent fruit and vegetable retailers and foodservice.
- These changes have been driven by the following:
  - The need for better retailer performance due to slow growth in underlying food revenues, using new technologies and processes to improve supply chain efficiency and reduce costs of doing business,
  - Competitive threat from overseas retailers using advanced supply chain techniques, such as Aldi and Costco,
  - The collapse of wholesaler and retailers (David's Holdings and old Franklins), and
  - The identification of growth strategies/opportunities that take advantage of evolved weaknesses in the large retail offering and the diverse requirements of the consumer market.

### 6.2 Nature of competition

- Advantages and disadvantages of integrated grocery wholesalers are set out in Table 6.1 on the right:

**Table 6.1 – Integrated FSS functions v independent wholesalers**

<i>Advantages of integrated FSS activities</i>	<i>Advantages for independent wholesalers</i>
<ul style="list-style-type: none"> <li>○ Guarantee, specify and negotiate requirements based on fixed purchase quantities and store execution</li> <li>○ Combined promotional and purchasing plan commitment</li> <li>○ Perishable distribution consolidation, shorter order lead times and higher frequency of store servicing</li> <li>○ Scope for better inventory management</li> <li>○ Takes out the intermediary margin that is earned by a separate wholesale function and achieves cost advantages which can be delivered to customers</li> </ul>	<ul style="list-style-type: none"> <li>○ Can accommodate retailers that can tailor offers locally (autonomy benefit)</li> <li>○ Limited scope for major entrants to gain access to retail customers</li> <li>○ Provides an attractive wholesale distribution option to access the large number of independent retail outlets</li> </ul>

### **Direct sourcing**

The choice between direct sourcing of food products and purchase through wholesale intermediaries is driven by a number of variables

- The major FSS retailers use a combination of direct sourcing (into their logistics and distribution functions) and wholesale intermediaries depending on the category and the products. In general, FSS chains will use direct sourcing, with the exceptions below where an intermediary is used, as follows:
  - Fresh fruit and vegetable
  - Fresh meat
  - Seafood
- In most fresh food categories, there is a still some level of spot buying by the FSS groups.
- The drivers of this approach are:

## 6. Competition in food wholesaling

- The need for consistent lines of products for highly reliable access to product by the consumer in a national network of full-service supermarket stores
- Elimination of non-value-adding steps in the supply chain to improve efficiency
- Logistical efficiency of handling short-life perishable fresh food
- Logistical efficiency advantages from distribution centre consolidation into National and Regional networks (within and across categories) prior to splitting into store deliveries
- The competitive advantages resulting from best-practice in the sourcing/logistical flow are high and the repercussions from creating diseconomies in these parts of the supply chain are unsustainable.
- Direct sourcing has an impact on price and quality of product available to the FSS chain. In addition, there is evidence in categories selected by Freshlogic of Coles buying produce direct from producers at prices above alternate wholesale market averages. In general, FSS stores are paying more for specified perishable grade in order to provide consistency of quality across all stores.

### 6.3 Effect of buying power

#### *Do chains buy cheaper?*

- It is generally acknowledged in business practices that the people that commit to purchasing the greatest volume from a supplier are able to negotiate the best supply price. FSS chains generally achieve the lowest purchase price from suppliers when compared to other wholesale channels.
- Direct supply improves competition and lowers costs by removing intermediaries and improving the scale opportunities i.e. larger more capital intensive efficient horticultural growers and stock producers delivering consistent quality and lower unit prices.
- A wholesalers such as Metcash competes effectively in this regard, achieving competitive buying prices compared with FSS groups, but this does not automatically flow through to the banner group and independent stores.
- In view of the share of independent stores serviced by Metcash, and despite collective agreements with their wholesale supplier, independent retailers have limited buying power and limited opportunity to bypass Metcash or source direct into store from the manufacturers.

### 6.4 Terms of trade with suppliers

There are variations between categories of the commercial terms of trade for supply to major grocery chains.

- Use of trading terms by FSS chains and the major independent wholesalers.
- These trading terms generally include rebates and allowances negotiated with suppliers and may include:
  - New line promotional allowances
  - Volume rebates
  - (ongoing) Promotional allowances
  - Settlement terms
  - Ullage rebates
- The aggregate of these terms are generally on average between 7-9% for major FSS chains. They are most prevalently applied in packaged grocery lines where supplier-branded products are most abundant, and therefore have relatively limited use in fresh produce and meat categories.
- In recent times, most suppliers have opted to accept “rolled up” terms in dealing with supermarket buyers, whereby all price and terms adjustments are combined into a single percentage adjustment to list or gross price. This is preferred as it offers simplified administration for retailer and supplier in terms of accounting for transactions and volume or promotional adjustments. They do not generally apply to the contract supply of private label lines.
- There are variations in the levels of terms applied by department based on the nature of the supply arrangements that prevail over the products sold in those areas.



## 7. Retailer performance

### 7.1 Comparative financial performance

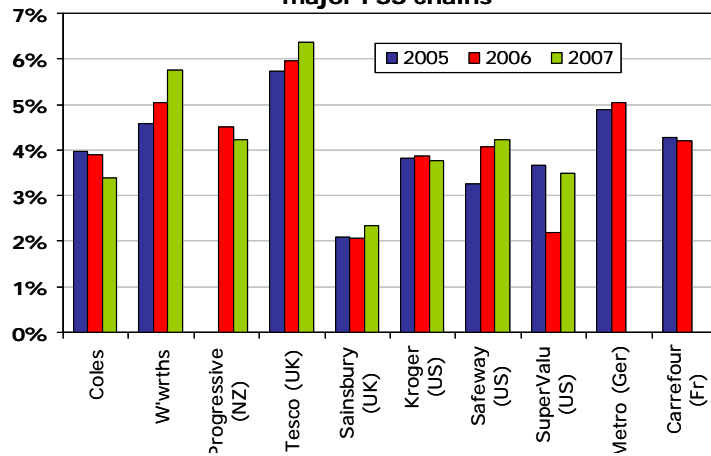
Retail profitability margins in Australia are generally consistent with those of overseas countries. This analysis is based on a comparison of EBIT margins for the supermarket divisions of major global retailers.

- While underlying sales revenue essentially tracks economic growth rates of around 3-4% plus inflation, food retailers have been able to generate earnings per share growth in the low double digits in recent years by increasing their share of the retail food market, and reducing their costs of doing business through scale and supply chain efficiencies.

#### Profitability on sales

- Major FSS retailers run on slim margins in contrast to corporations in other sectors, next to fuel retailing, arguably the lowest EBIT margins in retailing.
- An acceptable form of comparison of retailer profitability is by reference to the profit margin (before interest and taxation) on sales. The chart in Fig 7.1 compares Australian retailers with a number of listed overseas counterparts.

**Fig 7.1 - Comparison of EBIT/Sales margins for major FSS chains**



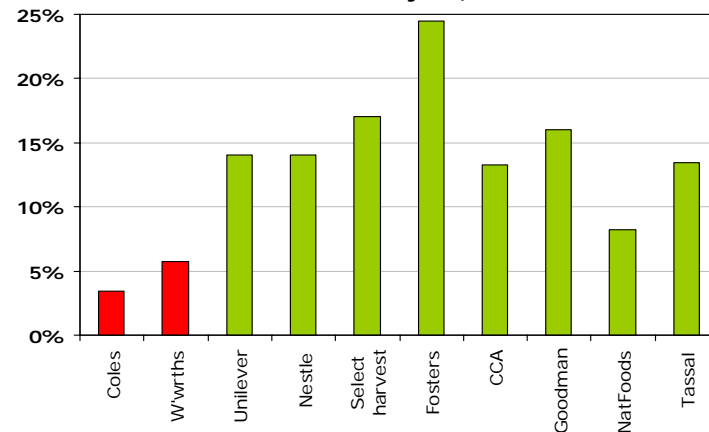
Source: Freshlogic comparison of financial statements

- This comparison has attempted as far as practical from the disclosure provided in financial statements of retail groups to illustrate the returns for food and liquor businesses. Such comparison is subject to
  - Levels of disclosure of food retail activities as discrete business units, affecting the ability to separate directly comparable supermarket operations
  - The inclusion of fuel and liquor as part of the supermarket divisions
  - Extent of merchandise and consumer goods (we have excluded Walmart on these grounds given the higher proportion of consumer goods that are included in their superstore sales revenues).
- In Australia, supermarkets have a cost of doing business at around 22% of sales, whereas US and European grocery retail leaders typically operate in the range of 16-20% of sales.

#### Retailers v food companies

- Listed FSS retailers operate on much smaller margins on their grocery retailing activities compared with food suppliers.
- Fig 7.2 compares food companies (Australian and global) to the EBITs of major Australian FSS retailers.

**Fig 7.2 - Comparison of EBIT/Sales margins for FSS chains and food companies (most recent completed financial year)**



Source: Freshlogic comparison of financial statements

## 7. Retailer performance

- o Food manufacturers and marketers require higher profit-to-sales margins due to the higher capital investments in manufacturing capacity and brand management.

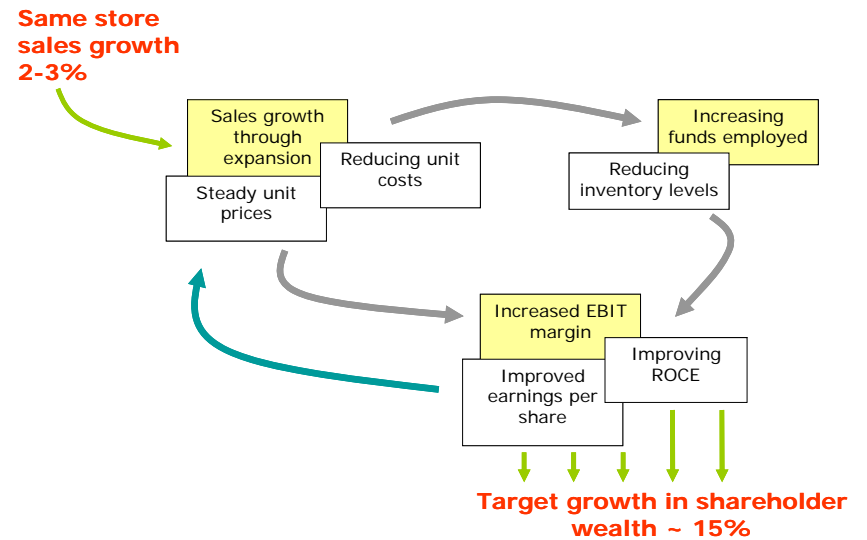
### Return on capital

- o A further measure of the relative performance of major companies is return on capital employed (ROCE), which takes account of the net returns over the invested capital.
- o A number of factors affect the comparability of ROCE between FSS retailers, and it is not simply a measure of underlying food business profitability:
  - o The extent of property investment in stores that is adopted – Australian retailers own comparatively few of their stores, but there are a number of strategies used to secure property assets without having to carry the capital investment on their balance sheets. A group such as Tesco in the UK has a major property investment portfolio.
  - o The practices adopted in working capital management – influenced by inventory management and the terms with suppliers.
  - o The mix of business within the retailer operation – some of the comparables are influenced by low-margin fuels business.
  - o Mix of private label which can contribute to increased percentage gross margin achieved but at retail selling values 10 to 40% below the retail prices of proprietary branded goods can lead to an overall reduction in the category value.

### Management of ROCE

- o The FSS business model provides on the opportunity for FSS retailers to actively manage their financial performance and operate at high ROCE's through working capital management.
- o Fig 7.4 outlines the key elements of growth strategies that are underpin a major FSS group's ability to sustain growth in shareholder value from a slow underlying growth in core supermarket stores.
- o This strategy provides adequate performance in terms of returns to shareholders from the combined effects of a faster growth in revenue through business addition in additional stores and formats; greater efficiency in the recovery of network and corporate overheads; and ongoing management of capital including working capital.

**Fig 7.3 – FSS retailer management of productivity to increase shareholder return**



Source: derived from Woolworths financial statements

### 7.2 Underlying sales growth is slow

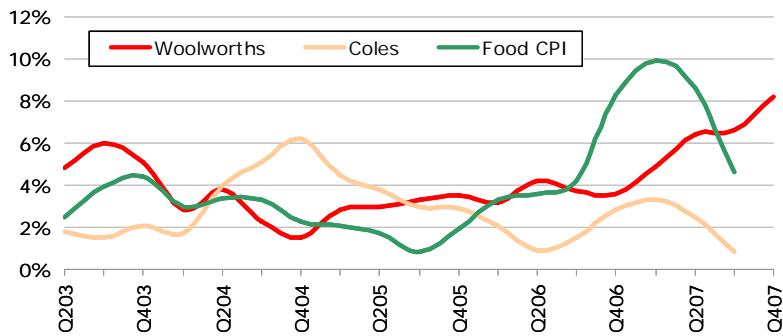
The nature and extent of competition in the food industry has manifested itself in low levels of underlying sales growth for major supermarket chains.

- o Same store sales are reported by major food retailers as an indication of the growth in sales from stores open more than a year in each reporting period, to allow identification of the relative importance of new and existing outlets in contribution to sales growth.
- o Over the past three years, FSS “same store” sales have broadly tracked with the level of food inflation, indicating an underlying lack of growth in underlying sales volumes without the benefit of new store additions.
- o “Same store” (that is stores open for more than one year) growth rates for the major supermarket chains Woolworths and Coles were 6.6% and 1.6% respectively for the respective 2007 financial years. Fig 7.4 compares the major FSS chains over the period 2003 to 2007.
- o After taking into account the underlying rate of food inflation, there was a total of 2% expansion in the “same store” volume of sales in stores

## 7. Retailer performance

between the two major groups. The numbers therefore point also to the loss of volumes by Coles over that period.

**Fig 7.4 – “same store sales” comparison 2003 to 2007**



Source: Freshlogic comparison of financial statements, ABS

- o The independents grocery sector has recently demonstrated same store growth rates that exceed those of the major FSS chains. Metcash posted same store growth rates of 6.5% in the 2007/08 half year and 5.8% in the preceding full financial year for its sales to independent store customers.
- o Sales growth for major supermarkets has been constrained by:
  - o Improved strength of independent retail groups. The major independent groups, led by Metcash, have shown stronger “same store” sales growth over the past year, whilst attempting to improve the servicing of their convenience offer to the consumer.
  - o The expansion of discount retailers such as Aldi offering a narrow product range which targets specific demographic markets.
  - o Increased effectiveness of specialty retailers – these include fresh fruit and vegetable retailers, bakery franchises and meat retailers.

### 7.3 Retailers efforts to overcome slow underlying grocery growth

- o In order to retain market share and continue to meet shareholder and market expectations, supermarket retailers have long adopted strategies to diversify into other sectors of the consumer market while continuing to expand their supermarket operations.

- o This is not only evident within the Australian market, but also in other mature consumer markets, where major global retail chains are facing similar competitive pressures.
- o Each of the major Australian grocery retailers has sought to address the constraints on “same store” business activity through a number of strategies aimed at improving absolute gross margins while reducing the cost of doing business, as well as enhancing the group ROCE on shareholders funds, including:
  - o Increasing the emphasis on private label in key commodity products within major grocery categories. Private label products are increasing within the retail market, increasing competition for shelf space.
  - o Consolidating grocery suppliers to reduce the costs of business interface and streamlining of category management costs.
  - o Ongoing focus on the reduction of costs in the retail supply chains.
  - o Ongoing focus on overhead and store operating costs.
  - o Selective store expansions, including overseas.
  - o Expanding fuel retail businesses and increasing convenience store networks.
  - o Expanding and integrating networks of liquor retailing and distribution.
- o Retailer strategies to offset the exposure to the slow growth in the core food business have also included expansion into other categories aligned with food/beverage consumption, and investment in other consumer goods retail categories and formats – such as office, electronics, IT, department stores.

## 7. Retailer performance

### 7.4 Derivation of retailer profit

#### Grocery categories have varying contribution to store profitability

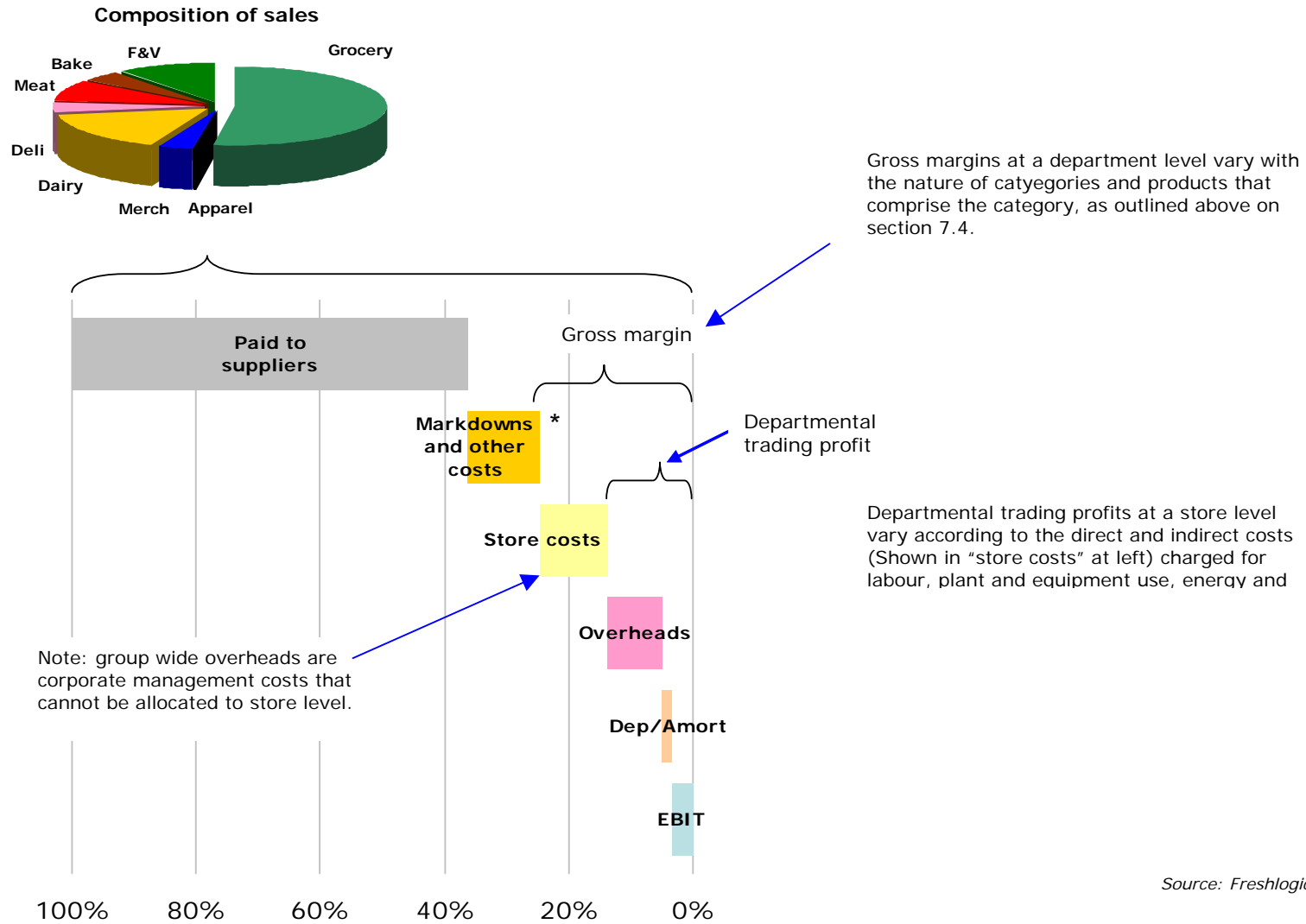
- o The Issues Paper seeks input on the structure of the profit and loss accounts of FSS retailers.
- o Fig 7.5 on the next page provides a diagrammatic representation of the structure of the profit and loss account in terms of the derivation of earnings before interest and tax (EBIT), which is in the range of 3-4% for Coles Supermarkets.

#### Key features

- o The components of store sales are shown as a typical mix of a large store format – this will vary store to store but there is a general store model for a large FSS with 25,000 lines, with variation in certain centres. Inner city “express” stores operate with a smaller footprint, narrower range, and a greater focus on fresh food etc.
- o There are a range of different levels of product or SKU contributions to margins within categories; a range of category margins within departments; and departmental margins across the store and the total supermarkets business.
- o Average category product margins are therefore an average of 26-27% across grocery departments and categories but tend to be higher for fresh foods such as fruit & vegetables, meat and dairy. This is because of:
  - o high spoilage rates,
  - o the higher labour costs in product preparation,
  - o customer service and replenishment,
  - o costs associated with maintaining a cold chain through to display,
  - o stringent regulations on the sale of fresh produce, and
  - o waste or “shrinkage” which can be as high as 10% for some fresh produce.
- o The role that the individual category plays in meeting that overall target will vary from time to time given the conditions affecting the consumer demand in that category, and supply conditions. Within the category itself, products will also play different roles from time to time in contributing to returns.
- o The level of that margin will be influenced by:
  - o The competitive constraints in the market,
  - o The overall contribution (in absolute \$ terms) made by a product,
  - o The volume of sales turnover,
  - o The use of floor and/or shelf space in making the sale – which includes the rate of turnover,
  - o The costs involved in managing the category in the retail store (eg. Fresh food is labour intensive and involves significant additional capital costs such as refrigeration),
  - o The state of the supply industry, and
  - o The consumer sensitivity to the retail price and value proposition.

## 7. Retailer performance

Fig 7.5 – the derivation of retailer profit (to be read with Section 7.4 above)



Gross margins at a department level vary with the nature of categories and products that comprise the category, as outlined above on section 7.4.

Departmental trading profit

Departmental trading profits at a store level vary according to the direct and indirect costs (Shown in "store costs" at left) charged for labour, plant and equipment use, energy and

\* This is the net of markdown and dissipation costs, and other incomes

## 7. Retailer performance

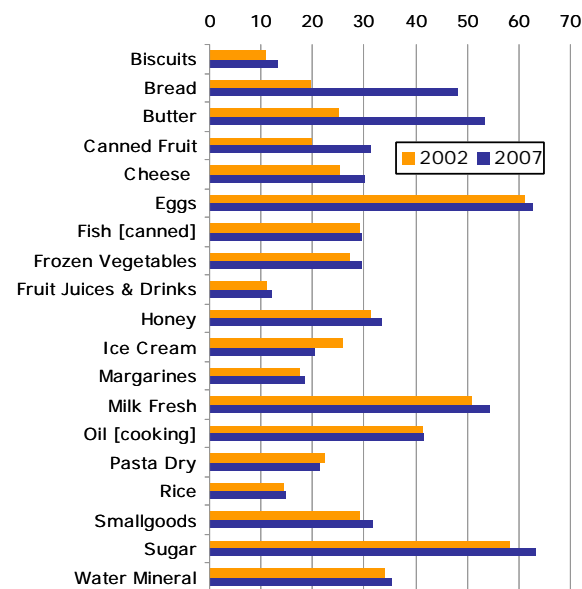
### 7.5 FSS brand management

#### *The role of private label*

Private label presence in grocery retail is steadily growing and will play an important part in retailer strategies.

- o Private label plays a critical role in a number of areas for the FSS grocery retailer and a number of independent banner groups, such as:
  - o category management
  - o extension of the parent brand, benefiting from the promotion of the retailer brand
  - o driver of loyalty as providing exclusive access to that product which is not available in other retailers
  - o improving percentage gross margin returns
- o There has been a concerted effort by the Australian FSS retailers and Independent banner groups to expand the use of private label products in recent years.
- o The major stimulus for this expansion has been based on a strong consumer response to initiatives at the lower end of the market – earlier in Franklins No-Frills, more lately since the arrival and development of a network by Aldi, which follows a global trend being used by discounters.
- o Despite these efforts, the share of private label in the FSS chains has only climbed steadily, reported in 2007 to be 18%.
- o Fig 7.7 shows the data collated by AC Nielsen showing the percentage shares in category sales volumes in 2007 and 2003. The major growth categories over this period have been:
  - o Bread
  - o Spreads (dairy and oil-based)
  - o Canned fruit
- o Over this period, growth in other major categories where private label has a significant share of volume have been low, in the case of packaged milk, cheese, eggs, and oils, where strong performance by suppliers branded products has been gained through product extension and variety.
- o There are differences in the private label strategies adopted by the FSS retailers.

**Fig 7.6 – shares held by private label in grocery categories 2003 v 2007**



Source: AC Nielsen

- o Different value propositions have been created in tiers between budget, mid-range and premium lines – which are being expanded in the different private label propositions of Coles, Woolworths and IGA.
- o In the case of Coles this is being seen with the use of three tiered range of Smart Buy, You'll Love Coles and Coles Finest. Woolworths are using Home Brand, Woolworths and Woolworths Select.

#### **The experience of private label**

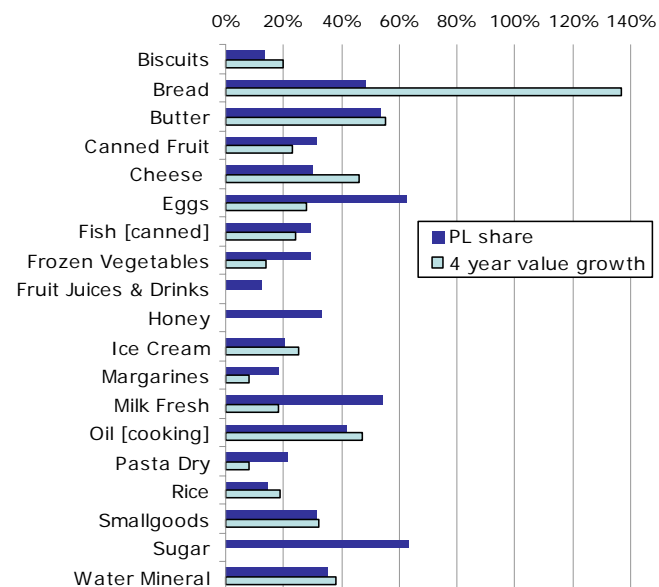
- o Processors struggle with balancing the level of investment in innovation vs commitment to commodity volume efficiencies which are afforded by supply of private label lines
- o There are some risks in rapid growth in private label development, as a significant role of private label products in a category potentially has a major impact on category value over time. The risk facing retailers and

## 7. Retailer performance

suppliers is that a higher proportion of sales at a lower unit selling value may constrain the ability to improve value as average unit prices will be constrained, unless accompanied by a commitment to ongoing successful product innovation that increases category unit value.

- o With slow growth in the total food market (in volume terms), the only scope is through increasing unit value. A supplier's ability to support the marketing for added value branded products that respond to consumer requirement is critical.
- o Fig 7.8 shows the experience in a number of Australian retail categories, contrasting the private label share of volume in a number of categories, with the growth in value over a 4-year period. It shows a number of categories which have achieved greater product differentiation over that time have increased category value – such as bread, spreads, cheese, and cooking oils.

**Fig 7.7 – category growth in value (2003 to 2007) in categories with private label presence**



Source: AC Nielsen

## **Section 2**

### **Prices**



## 8. Pricing structures in supply chains

### 8.1 Pricing terminology

- This section of the report sets out information on the prices between key points in the value chain between farmgate and consumer.
- There are a number of relevant price points along supply chains:
  - **Farm gate price** - Net price paid to the primary producer after the deduction of costs to deliver produce to market.
  - **Factory gate price** - Gross price paid to the primary producer based on its value to the buyer at the factory or market location. In the case of the meat sector, “over the hooks” (or OTH) is a term used for animal sales based on its assessed carcase weight, at an equivalent point in the value chain.
  - **Wholesale price** - The price paid for goods at the point where they enter the retail distribution sector - either at the factory door of a processor or manufacturer, or as sold by a produce wholesaler.
  - **Back of store price** - The price paid by a retailer at the point of delivery to the retail business – whether at a central warehouse facility or at back of an individual grocery store.
  - **Retail price** - The price paid by a consumer for an item at the retail point of sale.
- Whilst the concepts of price are reasonably straightforward closer to the farmgate, at the wholesale points of sale into the retail sector, “price” becomes more complex.
- The net price received by a fresh food supplier is at times net of selling commissions when a wholesaler assumes a role as agent.
- In addition to this, the effective wholesale price is rarely ever a “list price” which is offered by a supplier to a retailer. The price is adjusted by settlement terms, discount or specialising plans, promotional plans and other price adjustments, some of which apply to the individual product line – others which apply across the suppliers’ product range.

### 8.2 Comparing prices through the chain

Any meaningful analysis of pricing of food and beverage items through supply chains requires an understanding of the changes in product form from primary to retail-ready form, yields in transformation, the relative cost and value-added activity throughout the chain, and complexity of the range of end-products that make up a category

- In core grocery lines, simple comparisons of farmgate and retail prices are interesting over time to identify trends, but often simplistic and misleading if the analysis is trying to validate short-term cause and effect impacts.

- Across the food groups, a range of different factors are behind the gap between farmgate and retail prices. Because these factors are not always readily apparent, claims are sometimes made of a higher share of prices paid at the checkout flowing to the retailer. Any such analysis must recognise each relevant industry’s ultimate end-use or market destination of the primary product, and the structure of relationships in the value chains.
  - The yield losses in transformation of products – such as the portions of livestock carcase that do not yield saleable meat products, or the loss of volume in processing fruit or vegetables
  - By-product or co-products – that may supplement the return of the processor
- However, the raw costs of goods generally benefit to a greater extent from improvements in technology, which often lead to the substitution of capital for labour. New technologies are often rapidly adopted across an industry with competition eventually lowering the price of those goods.
- This can lead to a lowering of the original cost of the good as a proportion of the consumer sale price over time, despite sometimes intense competition at all points of the value chain.
- Hence the intrinsic costs of goods generally rise at a slower pace than the costs of services (which includes transport, storage, handling, distribution and retailing) which each involve a high component of labour, and which figure more prominently in the final retail price of a product.
- As a result, it is not always possible to directly trace items through the chain from farmgate to retail and care is needed in drawing conclusions without complete analysis.
- **Section 9** of this document provides some analysis of categories of food, where explanation of key influences on retail prices, and factors affecting prices through the chain are analysed.

#### *Trade has a major influence*

- Many key agricultural exports like meat, dairy, grains and sugar represent a substantial share of Australian production and are in effect determined by international market prices irrespective of domestic post farm-gate production and competition factors.
- In such cases, the return to the farmer is essentially governed by the price point at which a domestic manufacturer or processor could attract product away from the export market or compete with an imported item, whilst what happens beyond the farm-gate essentially being irrelevant to a

## 8. Pricing structures in supply chains

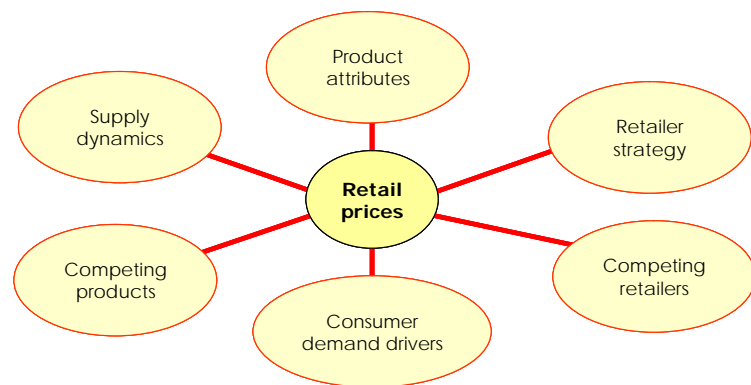
farmer's ability to extract price gains, except where product is supplied at specifications that are directly related to domestic market requirements.

- o In any analysis of prices through the chain for a specific product group or individual SKU, there is a need to take account of the role that product plays within the category for both the retailer and the supplier.
- o It particular there is a need also to understand whole of category value and the variability of pricing and margins that exist within that category.
- o Retail price movements over time tend to track the movements in producers prices, climatic impacts and world prices due to the relative size of food exports from Australia when compared to the limited food imports.

### 8.3 Influences on retail prices

- o There are a large number of factors that can potentially influence the retail pricing of food.

**Fig 8.1 – determinants of retail prices**



- o Table 8.1 outlines the nature of each of these factors and their effect.

<b>Table 8.1 – determinants of retail prices</b>	
<b>factor</b>	<b>attributes</b>
Supply dynamics	<ul style="list-style-type: none"> <li>• Industry structure - concentrated v fragmented</li> <li>• Seasonality of availability</li> <li>• Supply chain efficiency</li> <li>• Information volatility &amp; quality</li> <li>• Transparency of cost structures</li> <li>• Rate of supply industry adjustment</li> <li>• Supplier support</li> </ul>
Product attributes	<ul style="list-style-type: none"> <li>• Cost of production and delivery through the chain</li> <li>• Pack sizes and features</li> <li>• Perishability and shelf life</li> <li>• Seasonality of product availability</li> </ul>
Competing products	<ul style="list-style-type: none"> <li>• Nature of competition from direct/ indirect substitutes</li> <li>• Relative sales activity levels in products</li> <li>• Alternate product formats (fresh, frozen &amp; shelf stable)</li> </ul>
Consumer demand	<ul style="list-style-type: none"> <li>• Effectiveness of advertising &amp; promotion</li> <li>• Extent of brand loyalty and brand attributes</li> <li>• Consumer product awareness</li> <li>• Consumption trends (how people are eating)</li> <li>• Shopping trends and characteristics (frequency &amp; convenience)</li> </ul>
Competing retailers	<ul style="list-style-type: none"> <li>• Format of alternate food retailing</li> <li>• Geographic/demographic zones</li> <li>• Growth rates for alternative concepts</li> <li>• Sales sensitivity of the consumer to price, quality and image</li> </ul>
Retailer strategy	<ul style="list-style-type: none"> <li>• Business factors</li> <li>• Overall return on investment &amp; EBIT contribution</li> <li>• Place in price/quality perception</li> <li>• Product range/sales margin mix needs</li> <li>• Category factors</li> <li>• Destination, support or convenience</li> <li>• Loyalty, shopping trip</li> <li>• Promotional cost</li> </ul>

## 8. Pricing structures in supply chains

### Margins over cost

- A key driver of prices that are set at wholesale and retail are the target returns sought by the retailer in order to cover the costs of doing business (“CODB”) and make a return on capital employed.
- Retailers generally set a margin on an offered cost price from a supplier. In relation to packaged grocery private label lines, FSS chains will seek competitive tenders for the supply of products to a specified service level.

### Consumer response to product attributes

- A number of product features are being acknowledged by consumers and as a consequence are generating price premiums. A value hierarchy for these attributes has evolved. Poultry meat and eggs are most advanced categories in establishing these benefits. (Note; These price premiums are apparent throughout the supply chain, not just at the retail level, reflecting the higher cost of production of these “value added” products.)
- Consumers are in our opinion showing greater interest in and concern for the attributes linked to ethical integrity (whether addressing the need for “green” credentials, organic, animal welfare, fair trade etc) and dietary solutions.
- The base level is now regarded as a standard product and the hierarchy of market values above this is reflected in Fig 8.1.
- These benefits and examples of the price premium being generated,

compared to like standard products, in self serve retail selling environments, are in table 8.1 below.

- The consumer is today – in our view – being provided with a greater range of options that address these requirements than in the past. The Issues Paper seeks commentary on the provision of choice to the consumer.
- Whilst it is true that FSS chains have rationalised the number of supplier brands in certain categories based on the consumer’s support in sales performance, the diversity of product options has at the same time increased. Choice for the consumer has and is in our view steadily increasing over time, which is adding to the versatility of the grocery offering to consumers.
- Our analysis of the average retail prices achieved in various categories analysed in section 9 below provides further examples of these pricing differentials.

Fig 8.1 – Hierarchy of product features & premiums

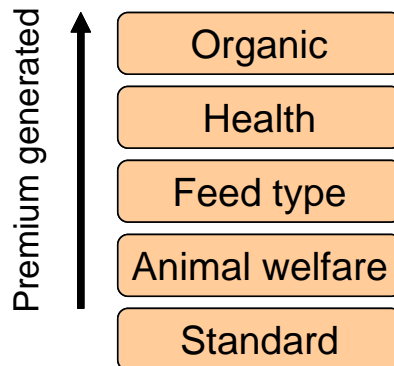


Table 8.1 – hierarchy of values, examples

#### Animal welfare - Free range

- “Free range” Poultry is generating a premium of 15-20%.
- A dozen “free range” eggs of 700g are generating a premium of 30%, and “Barn laid’ are generating 25% premium.
- Free range bacon was found to be generating a 34% premium.
- Otway pork offers “Free range” benefits and generates premium, the quantum of which is estimated at 40% +, but could not be measured by comparison with like product.

#### Health

- Heart smart lamb cutlets are generating a 42% premium.
- “Weight watchers” brand has been used but an absence of directly comparable product prevents the extent of premium being quantified. Similarly Fat reduced and “Fat free” claims are generating a premium.
- Spread products with cholesterol-lowering additives such as benecol are generating retail prices more than double the standard product.

#### Organic

- Organic lamb cutlets are generating a 60% premium.
- Organic poultry in the form of fillets are generating an 85% premium.

## Factors affecting category pricing

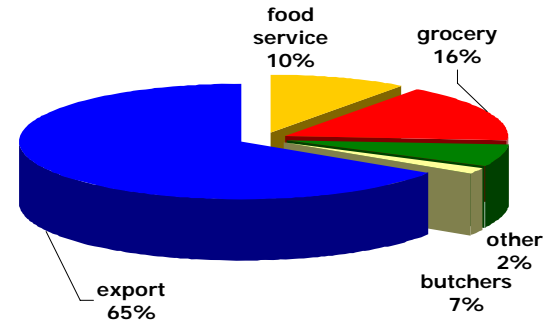
### 9.1 Beef

- o Beef prices are set by the following key factors:

Farmgate	Prevailing average return to industry based on mix of export and domestic market returns.
Wholesale	Competitive pricing against other white and red meat categories, with differentiation according to eating quality. Integrated supply chains with retailers reduces price volatility and stabilises returns to growers
Retail	Competitive pricing to position cuts in the category against other white and red meat lines. Significant differentiation through different grades of eating quality, packaging, product branding, and service (butcher).

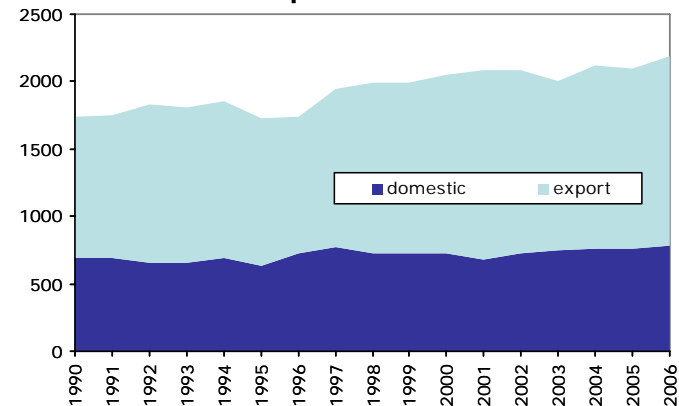
- o The beef industry in Australia is strongly geared for export production, whilst there is static overall domestic consumption. Strong growth in the value and diversity of export markets for the Australian industry has helped underpin the stability of export returns, despite recent food health scares related to beef in major markets. Fig 9.1 shows the estimated market mix of beef consumption from total Australian production, calculated on a carcass-equivalent basis.
- o The proportion of Australian beef production which is exported has remained consistent over the past 10 years at between 60-70%, but in that time the market prices for export beef have risen considerably due to reduced volumes of traded products into the premium markets serviced by the Australian industry (Japan and Korea). Exports do not take the entire carcass as different markets have priorities for certain portions or cuts.
- o The forces of supply and demand in international beef markets drive the level of returns to the Australian industry. In the short-run, these returns are affected by:
  - o Seasonal conditions which affect both quality and quantity;
  - o Exchange rate relativity and volatility;
  - o Trade policy issues such as import quota systems and tariffs which affect market access to Australian exports;
  - o Disease outbreaks and general consumer health and safety concerns;
  - o Competitor meat/protein prices from lamb, pork & chicken; and

Fig 9.1 – beef’s use in market channels



Source: Freshlogic using ABS, MLA data

Fig 9.2 - Beef export and domestic shares of output 1990 to 2007



Source ABARE

- o General economic conditions in consumer markets.
- o The prevailing “farmgate price” at which a major domestic buyer will purchase cattle will be influenced by:
  - o The strength of international demand from time to time;
  - o The domestic demand for store and breeding cattle;
  - o The level of available supply; and

## Factors affecting category pricing

- Prevailing key export price indicators.
- There is significant competition operating in markets at each end of the value chain for beef – buyers compete depending upon the prevailing market and supply conditions, and retailers compete for consumer business in the domestic market.
- When export markets are strong, the producer with reliable, consistent quality will retain leverage in domestic transactions.
- Major retail buyers operate with a variety of models to ensure they cover 3 sets of risks in the face of fluctuations in export demand – price, supply and quality risks. Major FSS retailers will attempt to buy at a target (per kg) buying price to maintain target returns for the category, based on carcass usage, processing cost and competing retail prices for the category.
- Over time the major retail buyers vary the mix of product sourcing between dedicated producers, paddock selection and markets (saleyard and “over the hooks” or “OTH”) based on market conditions, while processing is outsourced.
- Dedicated supply arrangements are usually structured with medium term rolling contracts. When buying off farm or in markets, OTH is the preferred method of buying for processors as it passes risks back to the producer – ensuring that beef is paid on market specifications.
- Retailers have extensive buying options which include sourcing a significant portion through direct supply from processors. Each of the FSS chains has different approaches to this sourcing strategy. Buyers of cattle for the domestic market compete at various points of sale against export buyers, processors and marketers.
- FSS chains generally do not necessarily buy the whole carcass, using their scale and buying influence to capture advantages on the portions of the carcasses they require. While there are strong integrated sourcing activities used by FSS chains, there is a strong role for wholesalers in servicing customers other than the FSS chains, including independents and specialists.
- FSS chains use significant retailer “in-store” preparation operations. Nevertheless it is estimated that about 30% of product is prepared outside the store using retail-ready modified atmosphere packaging (“MAP”). Smaller supermarkets (“Express” format and independent stores) rely on retail-pack product sourced from processors.
- Preparation of meat products in-store involves costs associated with the “break-to-sell” process – FSS retailers buy primal cuts in cartons, and

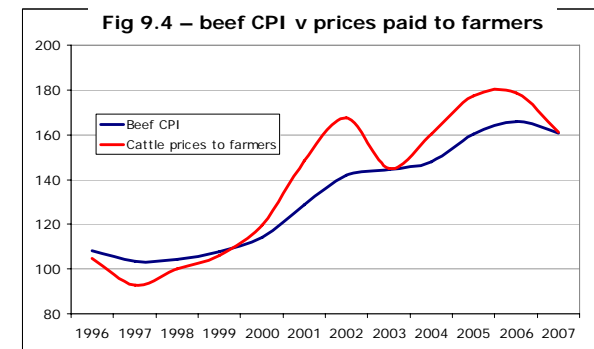
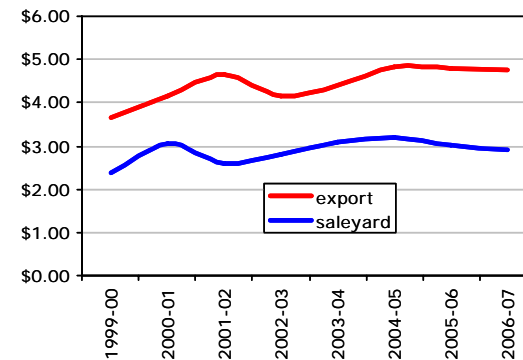
prepare trays of cuts according in various portion and purchase sizes, based on demonstrated customer preference. Compared to other departments of the store, meat has higher cost and waste, which are offset against the margins achieved from “portion recovery” into retail packs.

- Competing sources of meat drive prices at the consumer end of the value chain. Consumers are demanding that eating quality of beef is predetermined and consistent – this factor is important to compete with chicken and pork for the protein dollar.

### Retail v farmgate prices

- Prices paid to farmers will closely track the levels of export returns according to Fig 9.3.

**Fig 9.3 - Beef export prices v saleyard (\$/kg)**



Source ABS/ABARE

## Factors affecting category pricing

- The complex nature of the beef supply chain and the range of variables that affect farmgate returns mean there is not always a direct correlation between farmgate prices to retail. These comparisons are useful for trends over time, but the cause and effect links are tenuous.
- The chart at fig 9.4 plots beef and veal price index (from CPI data) against the producer price index for beef farmers for cattle slaughter (published by ABARE).
- Livestock prices over time fluctuate due to a large number of variables, of which seasonal conditions/climate are a major factor. An on-set of drought and feed shortages can give rise to a glut of supply onto the market and a reduction in livestock prices, while the recovery in herd numbers after drought can increase the demand for cattle for beef fattening.

### Carcase model

- We have taken a “whole of carcass” approach to analysing the structure of prices and costs through the chain. As this report deals with domestic food prices, the work has used case studies based on typical domestic carcass lines which are purchased by meat buyers of major supermarkets.
- The study has undertaken a measurement of the returns from whole of carcass based on a domestic animal that is typical of the animal purchased by FSS retailers. This analysis is valid as a snapshot – it is indicative of how each major sector is involved in the value chain. It shows the gross returns that are available to each major sector through the chain.
- This approach takes account of:
  - Carcass recovery (only about 60% of the total carcass is saleable meat)
  - Wide range of retail values across the cuts available from the meat
  - The value of by-products from the carcass
  - Waste
- The analysis in the model depicted on the right in Fig 9.5 has been based on average retail prices for cuts that make up the typical domestic carcass prevailing in the first half of the 2007/08 financial year of Coles and the average mark-up applied to purchased meat. The analysis is based on a model of the typical usage of a carcass in a domestic market, across the various meat segments.

Fig 9.5 - Beef carcass model

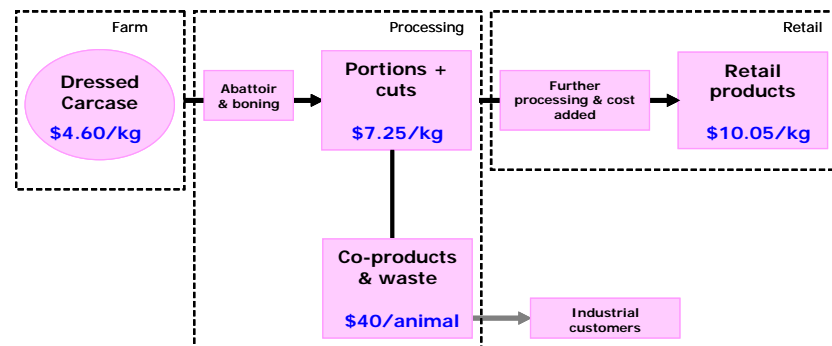
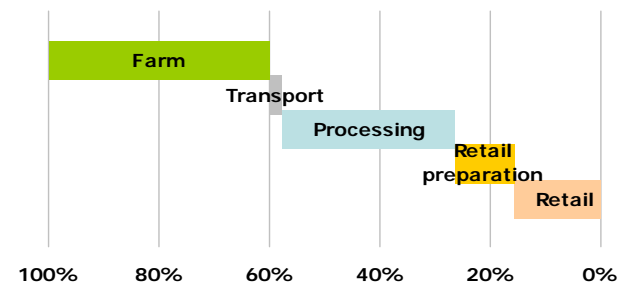


Fig 9.6 Portions of retail value of saleable meat



Source: Freshlogic

- Significant value and cost adding occurs throughout the chain to create retail product from a bred animal. As identified in the assessment, the returns at processor level are driven not only by the prevailing wholesale market for domestic portions, but also by the extracted value of co-products and by products.
- Based on this analysis, fig 9.6 shows the apportionment of the retail value of the carcass across activities in the value chain. This shows the range of returns for the various functions that contribute to a retail product as portions of the average retail price yield.
- Different retailers adopt different models which include a portion of off-site retail product preparation, so that the “retail” element of that chart does not only correlate with the share of the return earned by the retailer.

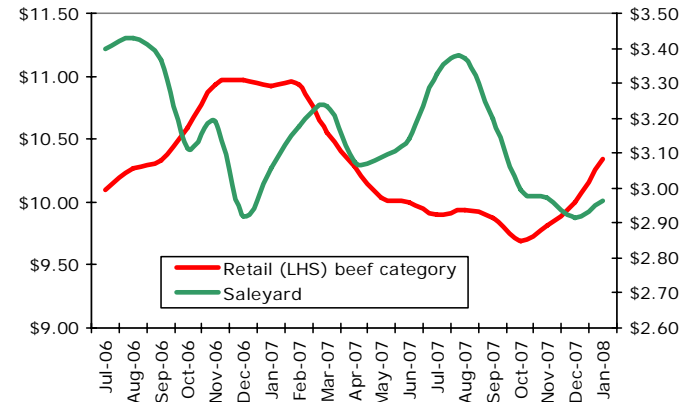
## Factors affecting category pricing

Different levels of cost are also incurred and value-added in the various stages of the value chain.

### Retail pricing

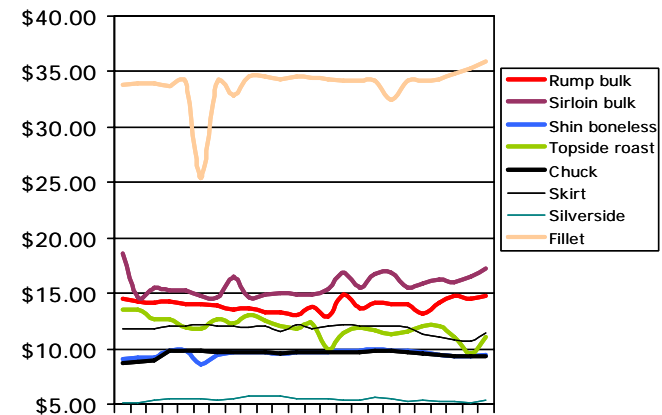
- o Fig 9.7 compares the category average retail price over time with a saleyard price for a typical domestic steer.
- o Retail prices for major selected meat SKUs have been relatively stable over that period as seen in Fig 9.8.
- o The “competitive dimensions” for meat cuts vary – products compete based on meal occasion, preparation method, as well as the comparative value across various protein alternatives.
  - o Stir-fry
  - o Frying
  - o Roasting

**Fig 9.7 - Retail beef prices (for category/kg) v saleyard**



Source: Coles, NLIS

**Fig 9.8 Beef cut prices (Early 2006- Early 2008)**



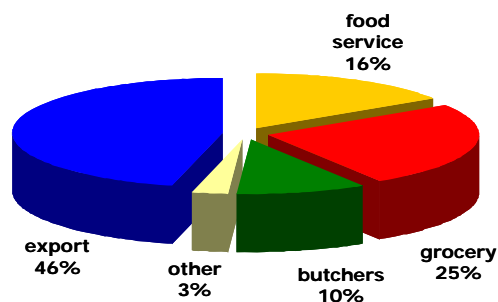
Source: Coles

## Factors affecting category pricing

### 9.2 Lamb

- Lamb prices through the chain are influenced by similar factors to beef.
- Despite a higher proportion of meat going into the domestic market, returns to the lamb production and processing sector are strongly influenced by world trade, through prices demanded by overseas customers. Domestic market consumption is relatively static, and subject to price competition from other red and white meats.

**Fig 9.9 – lamb's use in market channels**



Source: Freshlogic derived from MLA/ABS

- A major influence in recent years has been the decline in product availability on the world market from other major production countries in the face of rising demand in major markets of the US, Japan and EU. Lamb prices have risen over this period due to the global shortage of lamb meat, and growing demand in consumer markets.
- With growing export influence of the sector, supply of lambs and accordingly the prevailing prices over time are driven by other factors which include:
  - Exchange rate relativity and volatility;
  - Seasonal conditions which affect both quality and quantity of stock. Drought may delay new season or sucker lambs onto the market, causing shortages. Rainfall provides good feed and quicker turnoff of lambs which may increase supply and lower prices ;
  - As the incidence of feedlotting of lamb increases, there will be a greater exposure to commodity risks such as grain prices, import regulations etc; and

- The returns from wool – although with the strong role played by cross-breeds in sheep, and increasing specialism in lamb production, this influence is weakening.
- The behaviour of consumer segments in key markets such as the US will continue to drive change through the lamb sector and increase the focus on specialisation of production for those markets.
- In recent times, the strength of export demand, coupled with a reduction in the total available lamb production as a result of the drought, has increased prices paid for lambs over time at producer and processor level.
- As with beef, the major retail buyers operate with a variety of models to ensure they cover price, supply and quality risks. Buyers seek to achieve a target buying price to maintain target returns for the category, based on carcass usage, processing cost and competing retail prices for the category.
- Over time the major retail buyers vary the mix of product sourcing between dedicated producers, paddock selection and markets (saleyard and “over the hooks” or “OTH”) based on market conditions. With the strong seasonal production surge that usually comes in the spring, the use of market sources increases as a percentage of sourcing intake.
- In 2002, Coles estimates that approximately 40% of lambs were sold were from the market, 60% over the hooks. In 2008 40% of lambs are sold on the market, yet 45% are over the hooks and 15% on contract.
- Dedicated supply arrangements are less commonplace in lamb as opposed to beef, generally structured with medium term rolling contracts. When buying off farm or in markets, OTH is the preferred method of buying for retailers and processors as it passes risks back to the producer – ensuring that meat is paid on market specifications.
- Retail pricing factors for lamb are similar to those affecting beef. Seasonality is a factor that affects different cuts – summer is BBQ season and demand for lamb chops increases at this time. Winter is the prime sales season for roasts including legs of lamb.

#### **Retail/farmgate comparisons over time**

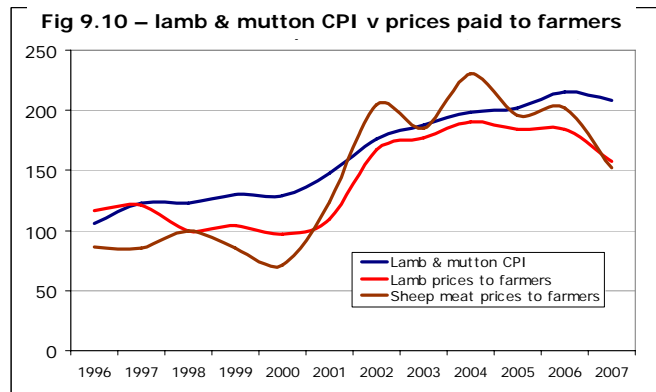
- Fig 9.10 compares retail and farmgate price trends over time using indices, showing a close tracking of prices paid to farmers and retail prices to consumers. Sheep meat retail prices have closely tracked the rate of change in lamb and sheep meat prices over the past 10 years
- The price comparison in Fig 9.11 shows that there is a general price trend which sees broad consistency in movement across sale yard and retail



## Factors affecting category pricing

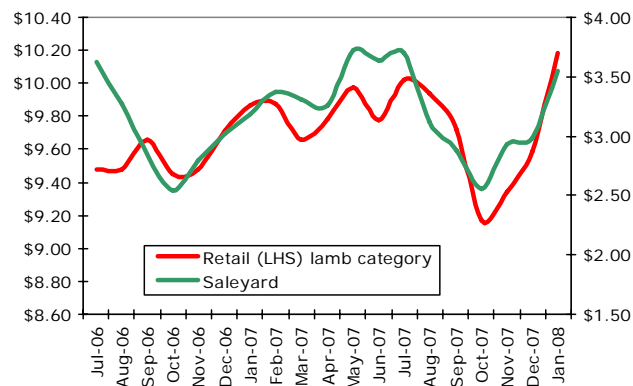
prices compared with that seen in beef. In the past couple of years where export returns have led farmgate prices, prices at retail have generally followed those at wholesale and farmgate.

- o The portion of lamb production sold into export markets has risen steadily over the past 10 years to now be almost 50% of output.



Source: ABARE/ABS

**Fig 9.11 Retail lamb prices (for category/kg) v saleyard**



Source: ABARE/NLIS

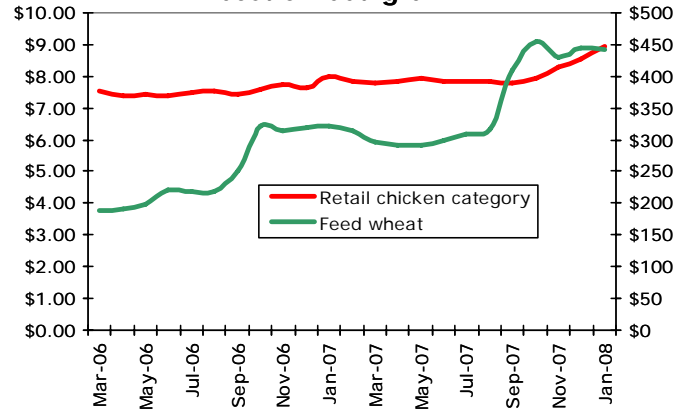
### 9.3 Poultry

- o The poultry industry is dominated by integrated supply chains which are managed by processors. The following key features are relevant:
  - o There is no farmgate as such - processors are integrated.
  - o Production units are contract bird feeders, supplied with day-old chicks and feed.
  - o Processors undertake virtually all retail product preparation for FSS retailers – different to other meats, retailers just have to sell chicken, delivered in a form that takes away later stage costs and waste. This is different to some fresh chicken specialist retailers who buy chicken carcasses and operate “back-of-house” preparation functions.
  - o The major processors have a consumer brand franchise – which tends to strengthen the negotiating position of suppliers.
  - o Poultry is strongly consistent product due to the intensive, systemised production process.
- o The total market size for chicken meat is growing in Australia. Per capita consumption levels calculated and reported by ABS have steadily increased over time due partly to the expansion of foodservice markets for poultry, gaining at the expense of beef and lamb. The end-use of product is highly diverse maximising bird recovery opportunities for the processor.
- o The drivers of returns to the processors that play such a major part in the industry supply chain are:
  - o The ability to maintain supply infrastructure tightly aligned to demand.
  - o The ability to achieve bird/carcase recovery and yield across different end uses and product forms.
  - o Margin over feed costs (grain is a large % of the live-bird production costs).
  - o Further processing of low-value meat into acceptable grade product – QSR, frozen snacks, etc.
- o Chicken meat is competitively priced to position cuts in the category against other meat lines for meal occasions and preparation methods. There is differentiation in pricing is achieved through different cuts and portion packaging.

## Factors affecting category pricing

- There have been significant cost pressures on poultry processors due to the sharp increases in grain costs. These cost increases have not yet been fully passed on in chicken meat prices.

**Fig 9.12 Retail chicken prices (for category/kg) v cost of feed grain**



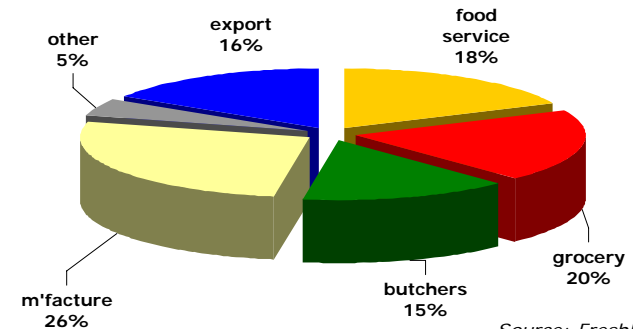
Source: Coles and Australian Crop Forecasters

### 9.4 Pork

- Pork is a major retail fresh meat category, yet its fortunes are largely determined by its end use in processed meats, a market to which other red meats are less exposed. The pork sector has undergone significant adjustment in recent years with the removal of restrictions on the importation of meat.
- Approx 60% of Australian pork production is consumed in the manufactured meat and smallgoods sectors – this volume varies according to the competitiveness of local product in the face of commodity imports.
- Fig 9.13 shows the shares of fresh pork use in the export and domestic markets. This excludes the volume of meat going into the manufacturing sector from imported sources.
- Various factors have affected the pork value chain in recent years. Producers' margins have been affected by cost pressures associated with the drought and high feed prices, as well as the increased imports of

cooked meats. Export returns have been reduced by the higher value of the \$A.

**Fig 9.13 – use of fresh pork in market channels**



Source: Freshlogic

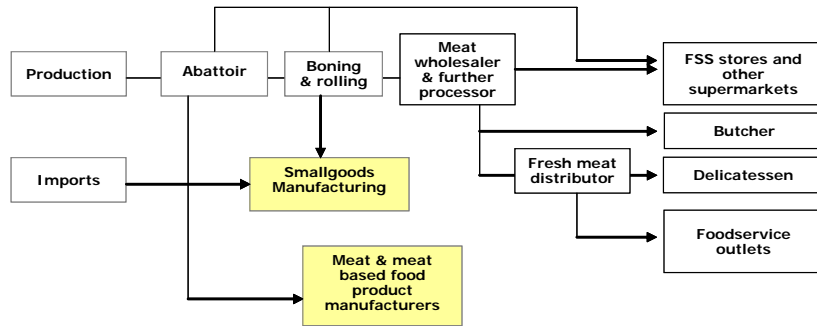
- Retail fresh pork has enjoyed increased consumption over the last few years, influenced by consumers moving from increasing beef and lamb retail prices towards pork cuts which have been seen as a cheaper protein alternative. FSS retailers operate similar buying and preparation strategies for fresh pork as with red meat.
- Demand in the retail and food service fresh markets for pork is shifting towards a preference for portions of carcass and not for the carcass as a whole.
- Smallgoods manufacturers and retailers however, have benefited from the increased availability of lower priced imported product, and lower domestic prices for fresh pork in comparison to other meats.

#### Carcass returns

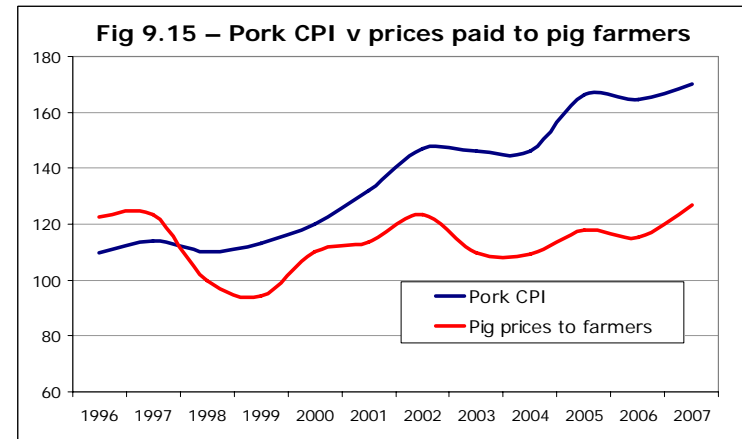
- As with the example of beef provided above, we have considered a "whole of carcass" approach to analysing the structure of prices and costs through the chain. As this report deals with domestic food prices, the work has used case studies based on typical domestic carcass lines which are purchased by meat buyers of major supermarkets.
- The study has undertaken a measurement of the returns from whole of carcass based on a domestic animal. This analysis may be valid as a snapshot – it is indicative of how each major sector involved in the value chain. It shows the gross returns that are available to each major sector through the chain.

## Factors affecting category pricing

**Fig 9.14 – fresh pork product flows**



- o The difficulty with pricing the pork carcasse for only the fresh market consumption of pork is the influence of the high percentage of the carcasse use in smallgoods manufacture. Any analysis of the overall returns to the product category would have to take account of the effect that smallgoods has on overall carcasse returns.
- o Comparison of retail and farmgate prices over time using ABS/ABARE indices in Fig 9.15 shows a disconnect between pork prices and an index of prices paid to pig producers due to the effects outlined in this section.
- o The carcasse return which drives the wholesale value of primal pork cuts and “over the hooks” prices for carcasses is strongly influenced by the returns from the processed meat market, which consumes 60% of output and is subject to import competition. Increasing imports of bacon and ham from the northern hemisphere have adversely affected overall carcasse recoveries for domestic pork production.
- o Within the domestic wholesale market however, prices for the portions of the carcasse that are exposed to competition from imported processed pork (bone-in leg and shoulder prices) are often deflated as processors seek to discount fresh pork for encourage retail consumption as opposed to offering at lower “import-parity” prices into the manufacturing sector.
- o There is little transparency in this stage of the market, and smallgoods manufacturers (who are also integrated pork primary processors and distributors) are using increasing quantities of imported product in their smallgoods products (which have cost and yield advantages) alongside domestic portion purchases.
- o A higher proportion of the locally-produced pork carcasse is accordingly being sold on the spot wholesale market, pressuring overall pork prices and overall returns for the portions and cuts involved.



Source: ABARE/ABS

- o Processors are seeking to extract optimum value from the domestic fresh retail segment of the market, subject to red meat and chicken meat competition.
- o Domestic pork production is under extreme feed cost and income pressures which are expected to result in a large number of growers are scaling back production and some exiting the industry. This is likely to flow onto reduced breeding stock and ultimately total pigmeat production.
- o With declining export volumes, domestic meat availability has remained consistent yet there remains an oversupply in the market (from local and imported sources) in the lower-value bone-in cuts.

## Factors affecting category pricing

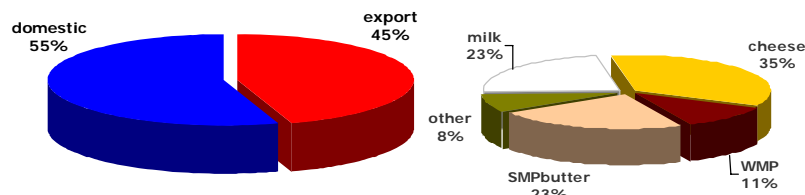
### 9.5 Dairy

- The dairy industry supply chain is highly exposed to demand factors and forces in export and domestic market segments which have had a profound effect on the returns to the overall industry.

#### Industry returns

- A significant portion of the industry's milk output is exported in the form of dairy products such as milk powders, cheese and butter, as well as a range of added-value ingredients applications and processing by-products. The chart at fig 9.16 shows total industry output and the share exported over the past decade or more.

**Fig 9.16 - Australian dairy industry overall market and product mix 2006/07**



Source: ABARE/ABS

- In 2007/08 it is estimated by Dairy Australia that about 22% of national milk production on farm will be processed into fresh milk products which are sold in domestic food markets. A further 33% of milk will be processed into products sold in the domestic market, chiefly consumed in cheese and dairy spreads (butter and blends).
- Due to the fact that cheese and butter products are also exported and that Australia allows imports without tariffs from New Zealand, the wholesale product prices of these lines are directly influenced by export returns. About 20% of domestic cheese consumption is imported by processors and marketers.

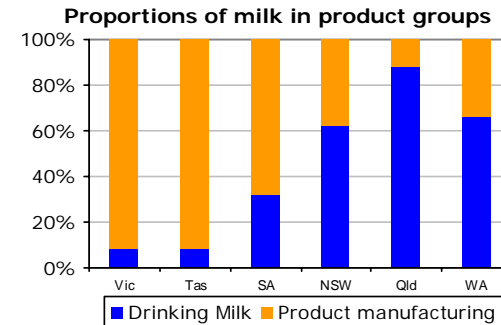
#### Farmgate prices

- As a result, over time given the influence of the world market on factory returns from milk processing and manufacturing, farmgate milk prices in southern Australia, which produces about 75% of milk, are directly determined by export market returns.

- The end-product use of milk differs across the various milk production regions as shown in Fig 9.17. Farmgate prices are determined by different factors in each region.

**Fig 9.17 - Farmgate average per region (c/litre)**

2008	48	47	48	49	51	43
2007	32	36	33	36	39	32



Source: Dairy Australia/Freshlogic

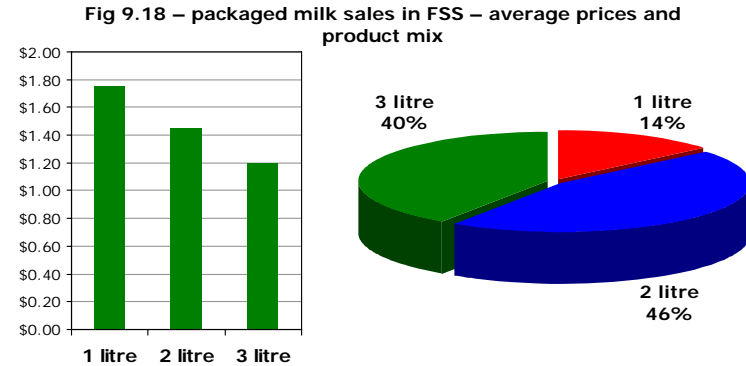
- The mix and efficiency of end-product use has a major bearing on the relativity of farmgate prices over time. The strong rise in export returns in 2007/08 has closed the traditional gap between average southern region pricing (Victoria and Tasmania) and those for fresh milk regions of Queensland and NSW, but farmgate prices in those regions are rising due to the concerns held by processors regarding longer-term milk security given the strength of local fresh market demand from consumers. WA prices are lower than the eastern state comparables due to milk supply which is in excess of fresh market requirement yet insufficient for scale product manufacturing.
- Returns for drinking milk and fresh dairy products are less directly affected by returns for traded commodities. While these products account for little more than 20% of national milk production, in a region such as south-east Queensland returns from these higher value products are the major determinant of farmgate prices.
- Whilst cooperatives tend to set base prices in regions, public-listed and privately-owned companies – which are driven by different performance accountabilities to cooperatives – will pay “what they have to” in order to get a suitable milk flow to match their business needs.

## Factors affecting category pricing

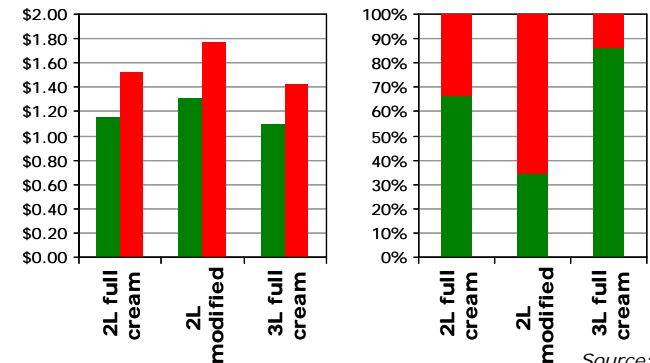
- When considering the pricing of dairy products through the chain, a number of critical features of the industry and its value chain must be taken into account.
- Whole milk pool produced on farm is generic at farmgate, with a value determined by the value of its butterfat and protein constituents, yet is converted into a range of processed forms that are influenced by different factors.

### 9.6 Packaged milk

- The packaged milk category contains significant diversity in terms of product attributes and pack sizes, which influence overall average selling and buying prices.
- Over the past decade the returns from the packaged milk sector have been strongly influenced and driven by the strength of private label growth. Aggressive price competition has seen a widening of the price gap between the proprietary and private brand prices in supermarkets.
- In the 3 years from 2004 to 2007, the average supermarket selling price per litre across the full packaged milk category increased marginally from \$1.34 to \$1.40. Within the milk product range however there are vastly different product options and unit prices.
- As shown in the Fig 9.18, total supermarket sales volumes in terms of total litres are mostly in 2 litre and 3 litre packs, with the larger pack size providing a significantly lower unit price per litre.
- Average selling prices also vary between private label and branded products. The average per litre price for the entire milk category sold in supermarkets in private label products was \$1.18 in 2006/07 whilst branded products averaged \$1.88.
- There is however far greater product differentiation and specialisation in branded lines in respect of low and reduced fat lines, calcium enriched products and flavoured milks which increase the average unit selling prices achieved across the category.
- The comparison of private label and branded lines on a like-for-like basis on core, high-volume white milk lines is shown in Fig 9.19.
- Branded products across these lines are generally priced at levels 30-35% higher than private label lines, which over time has seen more share of sales volume drift to the private label.

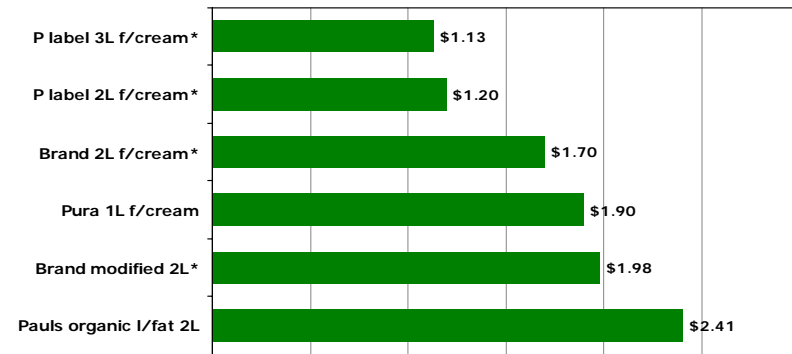


**Fig 9.19 – packaged milk sales in FSS – pricing and brand mix**



Source: Dairy Australia

**Fig 9.20 – per-litre prices for selected milk products**



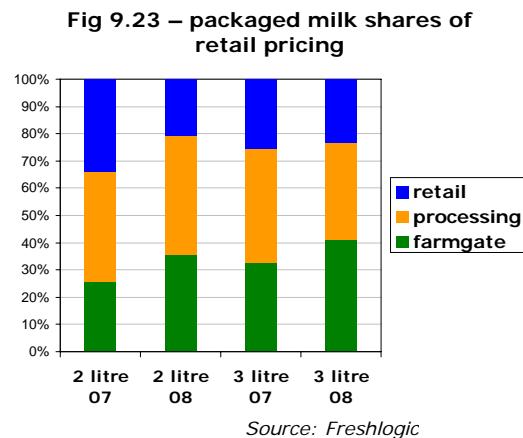
Source: Coles (\*refers to category average in 2007/08)

## Factors affecting category pricing

- There is large variation in the product pricing within the category, as the range of products has expanded across the 1 litre and 2 litre pack sizes to accommodate consumer preference for a range of specialty and functional products alongside conventional full-cream, reduced fat and low fat lines. Full cream milk products now make up 47% of the volume of sales through the FSS chains, of which private label makes up 35%.
- The chart in Fig 9.20 shows the price points at present on a per-litre basis across a range of supermarket SKUs to further illustrate the price ranges.
- Retail prices in the non-supermarket sector are generally higher than those in major grocery supermarkets; however there are frequent instances of discounting of 2 and 3 litre lines by independent stores and specialty fruit & vegetable grocers in order to attract custom.
- 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.

### Prices through the chain

- Through chain pricing of milk products is valid given the relatively small loss of milk in converting raw milk to a retail product. The chart below in Fig 9.23 illustrates the relative portions (in terms of % of the average retail selling prices) for major volume products that accrue to each of the three major sectors engaged in the value chain, determined by reference to farmgate and wholesale prices.



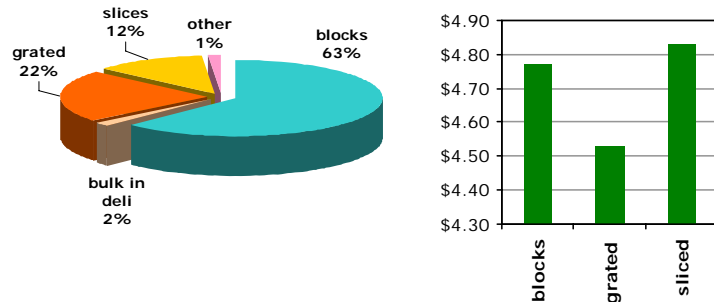
- The above analysis is an assessment of an industry-wide average – differences exist in farmgate prices depending on the supply region, and at wholesale level depending on the business and product mix. This blends retail prices for branded and private label lines.
- Farmgate prices used in an analysis of the packaged milk pricing are based on prices paid by processors for year-round supply of milk.
- This is based on Freshlogic’s estimates of a national average milk buying price by fresh milk processors, based on our monitoring of farmgate milk prices.

## Factors affecting category pricing

### 9.7 Cheddar cheese

- o Cheese products use 45% of milk consumed in manufactured dairy products, or approximately 36% of total milk usage, making it the largest product category for the dairy industry. There are up to 50 style categories in the cheese cabinet of the retail market, differentiated on the basis of production method, fat content, texture and appearance.
- o The vast majority of cheese manufacture is owned by farmer-owned dairy manufacturers and milk pricing offered by such companies is weighted average prices paid from returns on a range of manufactured products from export markets, given the influence of exports on milk use and imported cheese volumes.
- o Cheddar is the largest variety category within the cheese products group with about 55% of total output. Australia exports about the same total volume of cheese that it consumes in domestic markets. Due to the influence of the world market prices for cheddar cheese, and the high volume of imported cheese, the world market strongly influences domestic wholesale prices for products in the category.

Fig 9.24 – product mix and average pricing in cheddar

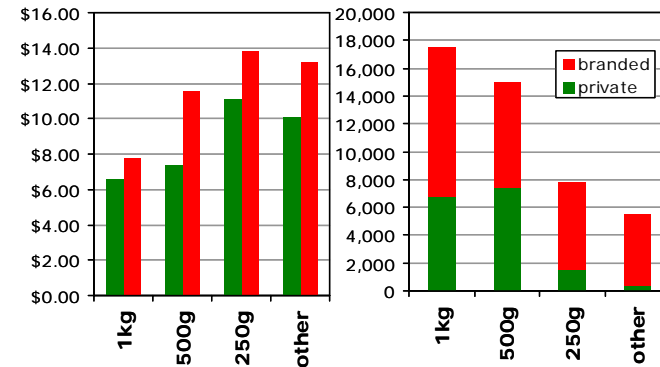


Source: Dairy Australia

- o The cheddar cheese category is dominated by block cheese, but pack size varies considerably. There is substantial variation in retail prices of cheddar cheese products across different pack sizes and maturity grades – which range from mild to vintage or extra tasty.
- o Fig 9.25 compares the variation across pack sizes. The 1kg product is a bulk discount line – with discounts driving consumption throughout the year, and suppliers periodically providing price support to facilitate the retailer’s discount program in order to sustain activity levels in these

products. Therefore it achieved lower gross product margins for retailer and processor.

Fig 9.25 – cheddar pack sizes in FSS – pricing and brand mix



Source: Dairy Australia

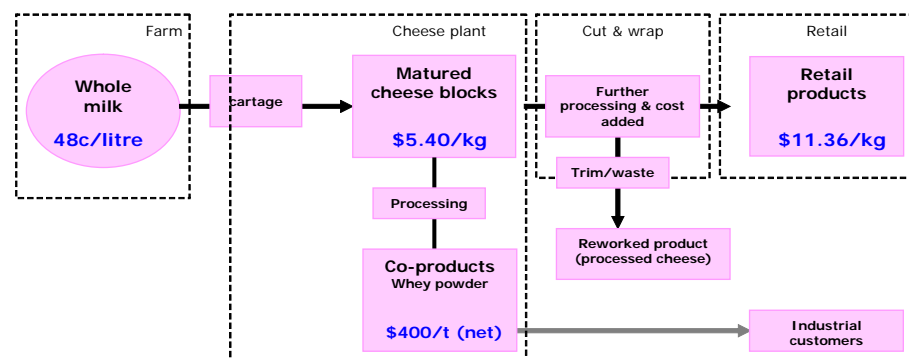
- o The unit price of cheese has risen steadily over the past 3 years – over the entire category (which includes a mix of cheddar and other varieties) the average price rose from \$10.29 in 2004/05 to \$11.36 in 2006/07 – rises 5.7% and 4.4%. There has been a strong rise in the world cheese price over this period.
- o Fig 9.26 compares the trends in retailer buy prices (based on Coles’ data) with the average cheddar price for export over the past 2 years. Fig 9.27 compares the changes in export returns (which strongly influences wholesale cheese prices) with retail prices for the high-volume 500g cheddar between the first quarter of the 2005 calendar year and the last quarter of the 2007 calendar year.

## Factors affecting category pricing

### Pricing through the chain

- o As cheddar cheese is a storable commodity dairy product, cheese-making facilities are generally located in lower-cost seasonal milk production regions in the south of Australia which see much of the output generated in the spring and summer months of the year.
- o Milk prices are accordingly structured to manage the flows of milk during the year by offering incentives which promote higher production of milk in months when grass-fed production is most difficult. Prices contain incentives to also promote optimum composition of butterfat and protein.
- o The nature of the value chain for consumer-pack cheese products requires a cautious approach when comparing farmgate returns and the levels of wholesale and retail pricing. It is overly-simplistic to draw direct comparisons between individual retail products and the value of the milk at farmgate, due to the diverse array of products that are produced from milk and the stages of conversion of milk to bulk cheese and by-products; and then into cheese blocks, slices and grated products.
- o In so doing, we have taken a “whole of milk” approach to analysing the structure of prices and costs through the chain, to take accurate account of
  - o conversion yields,
  - o costs and value added in product conversion
  - o by-products yielded from the process.
- o This is a similar approach to that taken in the pricing of beef through the chain. The results of this analysis are shown in Fig 9.28.
- o The pricing analysis for this study has been based upon a selection of major retail products, which provide a combination of two major product lines – 500g and 1kg matured cheddar. These have been chosen as they are – in combination – indicative of the level of return from the major matured cheddar products.
- o This model has aggregated private label and branded products to assess the returns across the volume products in the cheddar cheese category. There is considerable to variation in pricing between these products and further with the variation in terms of pack size and maturity grades.

Fig 9.28 – cheese supply chain analysis



Source: Freshlogic

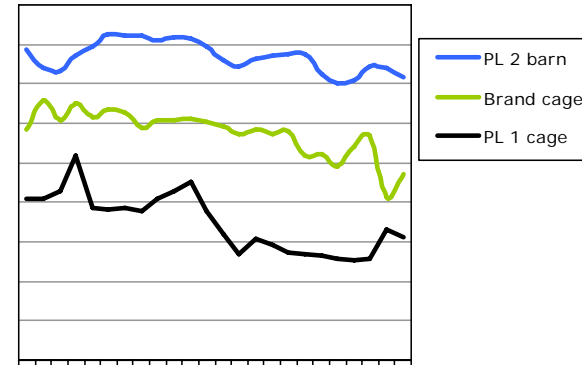


## Factors affecting category pricing

### 9.8 Eggs

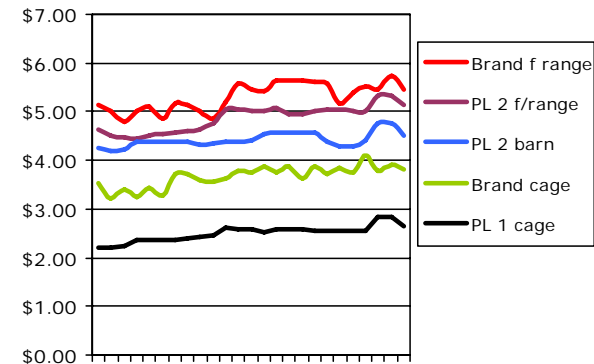
- o Egg production features high barriers to entry, and production – once committed – is relatively inflexible.
- o The concept of a “farmgate” is less applicable as a stand-alone sector in the larger scale end of the industry due to the greater incidence of integrated production, grading and packing operations, which are seeing more use of in-line systems that reduce egg handling.
- o It is estimated that 48% of eggs are sold through major and independent retail supermarket chains, 30-35% through the “box market” via specialty food retailers and markets and the rest is into the route trade and convenience retail segments. The “box market” is characterized by small retailers who have the ability to make the local decision on purchase terms and prices.
- o The pricing of eggs through the chain has been affected by the increased costs of feed grains. Despite this increased cost, retail prices of products have not lifted materially in the past 2 years. Fig 9.29 shows Coles retail data of the decline in product margins for selected lines – reflecting stable retail prices while the buying price from suppliers has increased as the input cost of grain to egg production has risen.
- o In 2006/07, AC Nielsen data on national supermarket sales indicated that 71% of retail grocery sales are cage eggs (down from 79% 4 years earlier), with free range representing 19% (up from 12%) and barn eggs 5% (down from 7%). Specialty and organic eggs make up the remaining 5%
- o Fig 9.30 shows the variation in price points for eggs across these various classes and branded versus private label products.
- o Egg production & supply fluctuations are an inherent feature of the industry. Fluctuating prices in the marketplace and fluctuating costs of feed tend to create volatility in the number of birds brought into production.
- o Fluctuations in supply exist due to the effect of lead times – a flock lays for 76 weeks, but it can take up to 50 weeks to get a hatchling into production – yet production can be cut very quickly (by slaughtering the layer). Egg production & supply fluctuations are an inherent feature of the industry. Fluctuating prices in the marketplace and fluctuating costs of feed tend to create volatility in the number of birds brought into production.

Fig 9.29 – Gross margins on selected eggs 700g SKUs (Early 2006- Early 2008)



Source: Coles

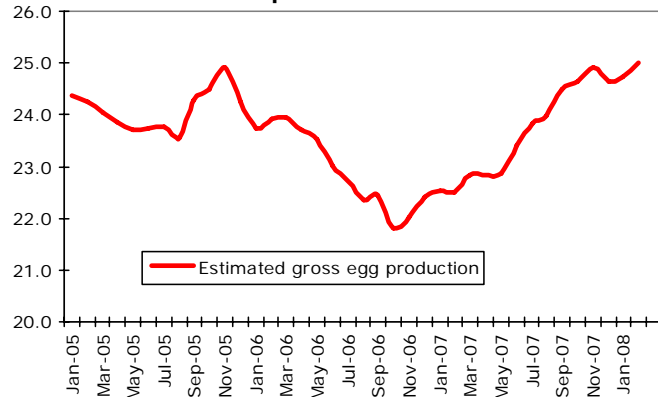
Fig 9.30 Prices for dozen eggs 700g (Early 2006- Early 2008)



Source: Coles

## Factors affecting category pricing

**Fig 9.31 – Estimated gross egg production (eggs) per month**



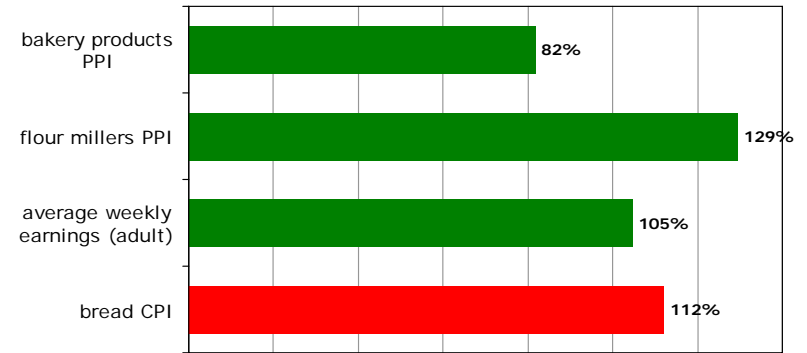
Source: Australian Egg Corporation

- The ongoing short-term fluctuations in output creates the need for producers to seek markets for their eggs through direct sales channels – offering prices which frequently undercut the prices offered in FSS stores.
- The average retailer margin as a percentage of retail value has changed in recent years with the rapid move to dominance of the category in major retail by private label product. This is a higher volume, lower margin product for the retailer compared with proprietary brand due to the significant retail price differential that has developed in the past 2 years. Aggregate retail return has increased with the volume growth through the supermarket sector.

### 9.9 Bread and bakery products

- The pricing of bread is frequently used in simplistic analysis of food price movements, and associated with the incidence of drought and fluctuations in the cost of grain.
- Grain makes up a very small portion of the total cost of bread products. The majority of the costs of bread production are due to labour, energy and packaging. Recent public criticism of bread pricing contrasted with food CPI failed to take account of the lack of connection between general food price increases and the factors that cause the cost of bread to increase.
- Fig 9.32 compares the cost increases relevant to the increase in cost of bread reflected in the bread component of CPI.

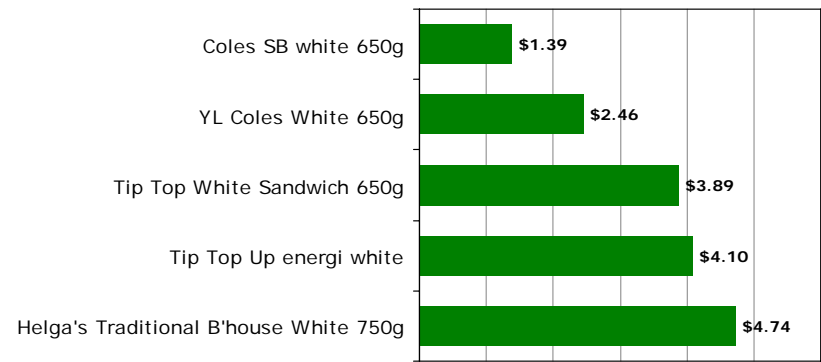
**Fig 9.32 – bread CPI v relevant cost factors 1990 to 2007**



Source: ABS

- It is also critical in the comparison of bread prices over time using the CPI sampling process to ensure that there are appropriate like-for-like comparisons of the bread products in the CPI data as there has been an increase in the variety of the bread products offered to the consumer.
- Greater variation in pricing due to the existence of a variety of high-fibre products and products with active ingredients such as Omega 3 etc. CPI is calculated based on a coverage of the category, therefore changes in product form which have increased the average unit prices of the category have been included in that selection.
- Significant differences exist in the price points in white bread, as noted in Fig 9.33. This gets greater when considering grain products which were far less prevalent in the past.

**Fig 9.33 – example white bread product pricing (\$/loaf, Feb 2008)**



Source: Coles

## Factors affecting category pricing

### 9.10 Fresh fruit and vegetables

- Information regarding the market share held by different retail channels is not readily available due to the diverse range of categories within fruit and vegetables, and the poor quality of category-level information. The chart in Fig 9.34 illustrates the Freshlogic estimated share of the total fresh fruit only sales of major chains and independent outlets, which will provide a guide as to the shares of vegetables. There is limited analysis of sales into non-retail channels.
- Key determinants of price and value
  - Alignment of supply and demand, which includes the effect of seasonality in production volumes
  - Consistency of quality
  - Intra-category competition at the cost of incremental consumption – trade offs of major staples within a basket of consumption occasions and affordability
  - Retailer promotional activity, especially with an impact on seasonal prices
  - Product form, especially where it addresses degrees of convenience
  - Short-life perishable nature and pressure to “spot market” surpluses
  - Constraints around product positioning and communicating benefits to consumers – little scope for effective branding
  - Core requirement to move majority of crop output locally into domestic market. Exports limited and in decline
  - There is a limited role for imported products across the total fresh food category, and in the case of Coles, it is estimated that 96% of produce is sourced from Australian growers.
- Many import suppliers are however seeking market access to the Australian consumer, as we represent a small but important niche to large low-cost producers in the northern hemisphere. Subject to the resolution of a number of import risk assessments in fresh fruit categories, imports will potentially provide a new dimension of supply in future.

#### Fruit category dynamics

- Much of the volatility in fresh produce pricing is associated with fruit seasonality and the volume variations in supply. Fruit has clear seasonal peak in supply in the summer months, which coincides with higher volume of sales, as shown in Fig 9.35.

Fig 9.34 - shares of retail fruit sales markets

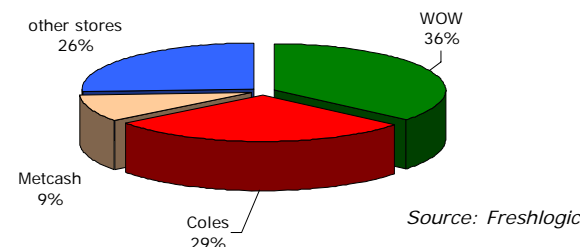
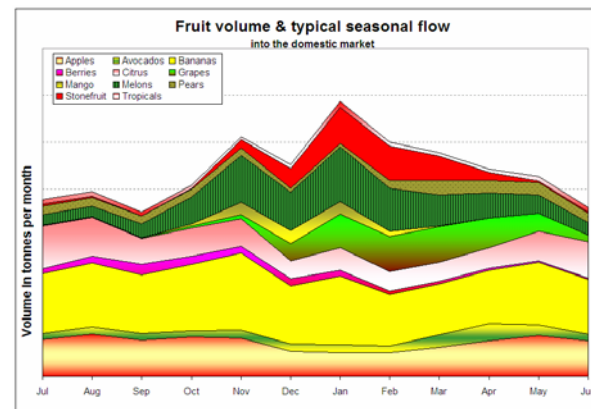


Fig 9.35 – annual fruit seasonality



Source: Freshlogic

- Vegetables in comparison have a shorter production lead time (10-15 weeks) and production planning can be more closely aligned with the market. However adverse weather can eliminate large blocks of supply, causing price volatility.
- Some products have delivered quality and value consistency whilst others vary substantially due to a combination of natural weather variables and the way the market works.
- As the volumes of locally produced fruit vary the local market has balanced supply and demand by varying price. This has served to sell product and at times has generated a mixture of price peaks and troughs.

## Factors affecting category pricing

It has also created some long lasting precedents, which sees several categories anchored in commodity conditions.

- o Early season product, which is in short supply, is typically offered at higher prices. Unfortunately early season product is not always in the optimum eating condition.
- o Fruits with the capacity to be stopped or stored in their product lifecycle have higher scope for managed supply consistency.
- o FSS chains have raised their buying grade standards in order raise the quality delivered to consumers. Unfortunately, due to the combination of extended trading hours and the temperature and light stress that places on products along with skilled labour shortages, some product quality is often lost in the retail store environment.
- o In most fruits there are moves towards “managed supply chains” where the crop is planned and produced for a market. This has lead to more concentrated interfaces and in some instances challenges for smaller scale producers who are now required to supply their product through the retailers nominated category manager in certain fresh produce categories.

### Processed products

- o Consumption of fruit into processed products varies by category, with the greatest volumes in citrus, pineapples and grapes, as shown in Fig 9.36. There are different exposures to imported fruit pulp and juice concentrates in these categories which has a significant impact of average crop returns to growers.

Fig 9.36 – estimated portion of processing of fruit

Fruit Crop	Production	Processing	%age
Apples	276,427	45,100	16.3%
Avocados	34,005	1,190	3.5%
Bananas	209,560	3,143	1.5%
Berries	48,650	1,460	3.0%
Citrus	698,680	234,820	33.6%
Grapes	210,710	129,000	61.2%
Kiwifruit	3,500	88	2.5%
Mangoes	58,000	6,000	10.3%
Melons	176,418	4,410	2.5%
Pears	142,400	50,229	35.3%
Pineapples	110,400	82,800	75.0%
Summerfruit	190,829	65,500	34.3%
Tropical	9,530	953	10.0%
<b>Total</b>	<b>2,169,109</b>	<b>624,693</b>	<b>28.8%</b>

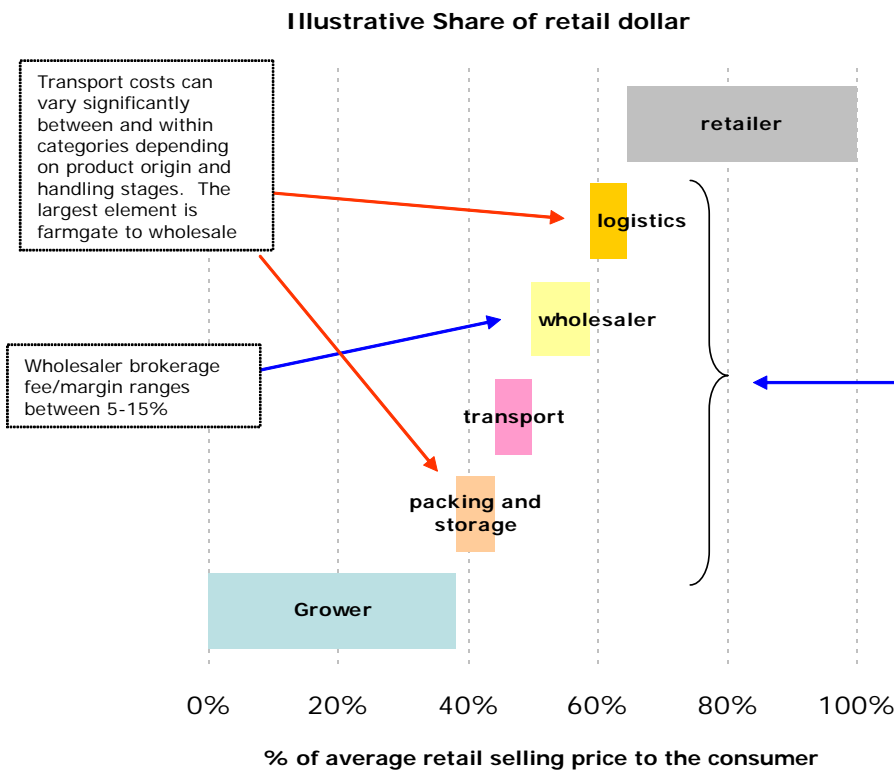
Source: Freshlogic

### Supply chain structures

- o The key steps in the value chain are shown in the chart on Fig 9.37, from Producer/Grower, Packer/storer, Wholesaler/category manager and retailer. This provides an illustrative dissection of the shares of the gross retail value of produce across the various functions in the value chain.
- o Large growers also integrate packing and storage functions into their enterprises, as well as some parties integrating packing and category management activities.
- o FSS retail direct sourcing will provide different cost impact through the supply chain compared with one that features a discrete wholesaling function through fresh produce markets
- o Securing the volume of fruit product required for the FSS has led the major retailers to negotiate direct supply arrangements with producers. This buying strategy, which mirrors changes in other developed markets, has provided security supply but has lead to the balance of the crop being distributed by the capital city central markets
- o There are a number of challenges of retailing fresh fruit and vegetables
  - o Volatile demand dynamics including fluctuations attributed to daily weather changes
  - o Seasonal and extreme weather quality impacts (such as cyclones affecting banana supplies)
  - o Ranging and inventory management, with potential costs of waste or lost sales incurred by reason of poor practices and unplanned surpluses
  - o Higher labour cost of maintaining and restocking product display
  - o Extended trading hours and the impact on perishable product – this affects associated waste cost and quality impact
- o The specialist retail fruiterers were under intense competitive pressure in the 1990's during an aggressive period of expansion by the major supermarkets and the move of the old Franklins into its Big Fresh & Franklins Fresh formats.
- o However, as the competitive aggression eased with the old Franklins chain collapsing and the supermarkets increasingly struggled to meet the high demand peak around 5pm, the better fruiterers have recaptured market share.

# Factors affecting category pricing

Fig 9.37 – Supply chain structures in fresh fruit and vegetables



Cost & value-adds between farmgate and retail

	Ripening	CA/short-term storage	QA inspection costs	Variety management fees	Pre-packing	Category promotion costs
Banana						
Apple & pear						
Avocado						
Citrus						
Table grapes						
Mango						
Stone fruit						
Berries						
Melons						
Potatoes/Carrots						
Tomatoes						
Lettuce						
Broccoli						
Onion						

## Factors affecting category pricing

### Retail/farmgate comparisons over time

- Vegetable prices have risen highest according to sub-group CPI data. Fresh vegetables are highly perishable chilled products and have a short life, restricting access to the market to local supply.
- There have been greater developments in value-adding in vegetable and salad lines compared with fruit product, with the focus on delivering convenience in pack size and meal preparation, increasing the effective unit selling price of the produce by weight.
- It is inevitable that the CPI sampling method has picked up a mix of value-added and conventional whole vegetable lines, resulting in a faster-rising price index over time.
- The charts on in Fig 9.38 and 9.39 plot vegetable and fruit price indices (from CPI data) against the producer price indices for payments to vegetable and fruit farmers (which is published by ABARE each year as part of their Commodity Statistics).
- While CPI has risen, the prices paid to farmers has on average very closely tracked consumer price increases.
- Compared with vegetables, fruit is more commonly tradable in fresh form, as a number of fruit lines can be stored for longer periods for release to market and/or shipping into overseas markets.
- Over time, there is a greater influence of trade and the returns from processed volumes affecting farmer prices for fruit.
- Lower grade fruit products which are processed into juice (e.g. oranges and apples) and flavourings are exposed to imports of frozen juice concentrate and pulp, which tend to constrain farmgate prices for the commodity.
- While CPI has risen, the prices paid to farmers has lagged consumer price increases in the period through to 2004, but followed upward trends since that time.
- At a category level, our analysis of prices through the chain in a number of categories has been performed using wholesale data where available. It is difficult to draw meaningful conclusions about the share of margins using reported wholesale data, due to: (i) the weaknesses in approach in collation of the wholesale data; and (ii) the growing portion of retail buying direct into warehouse at prices which are different to the published wholesale values.
- A more accurate comparison can be made via traced sales through the markets into the retail market to ensure there is like-for-like comparison.

Fig 9.38 – Vegetables CPI v prices paid to farmers

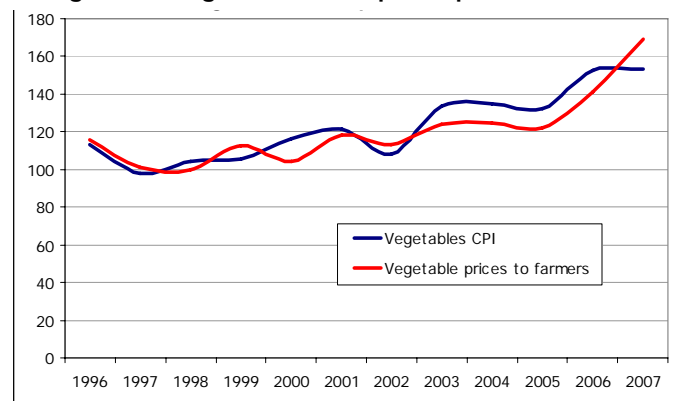
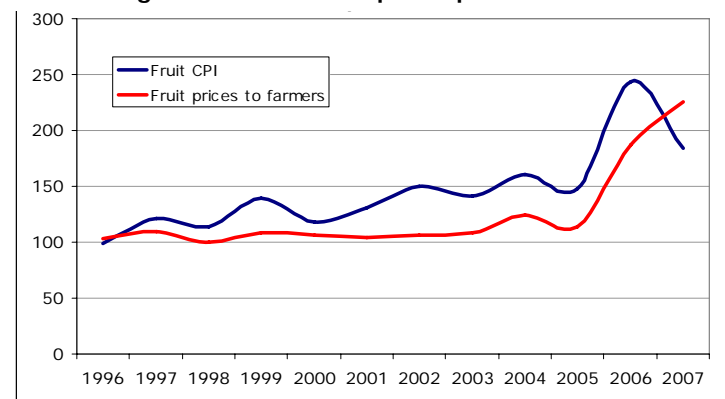


Fig 9.39 – Fruit CPI v prices paid to farmers



Source: ABARE/ABS

### Fresh promotional activity

- While fluctuations in supply have a major bearing on unit value, FSS promotion influences the market price for categories and lines and directly affects share movement between alternate fruits. The promotional activity conveys important signals to the consumer (and competitors) about product availability and value.
- The promotional activity is vulnerable to sticking with “safe lines” without stronger investment to support smaller-volume, higher value products, as

## Factors affecting category pricing

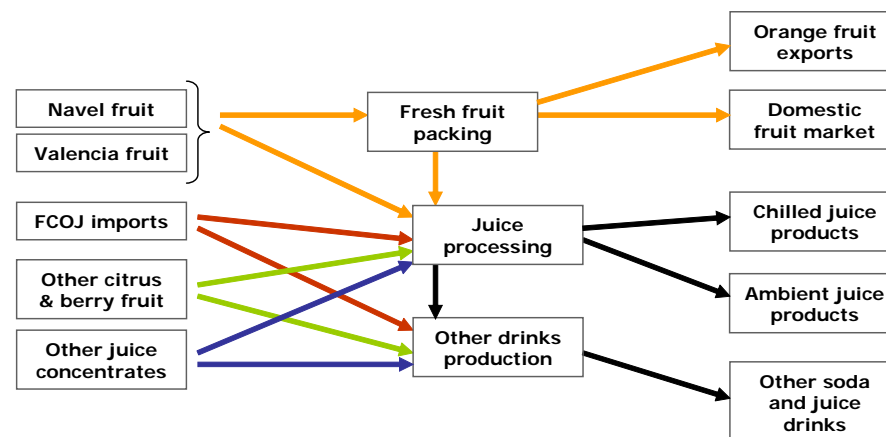
retailers will not support product where there is any danger of undersupply.

- Products with short supply windows (as in the mango example) are led by the promotional activity, in the case where the higher value of the product in early season promotion may not be sustained as the seasonal window unfolds. FSS retailers aim to price products commensurate with the market rate rather than take a loss-leadership approach on high volume lines. In other cases, product price positioning of certain branded lines (such as Pink Lady apples) confirms consumer acceptance of a higher value item compared to other varieties in the category.

### Oranges

- Any assessment of the pricing of fruit through the chain for citrus including the major category oranges, involves recognition of an overall usage of orange production in three key markets – fresh fruit exports, domestic fresh fruit sales and juice processing.
- The complexities of the use of fruit across a range of end-products and markets (as shown in Fig 9.40) affect returns for fruit that are achieved by growers.
- The following points are important:
  - There are two main varieties of fruit – eating fruit (Navel varieties) and juicing fruit (Valencia varieties). Surplus production in each variety is sold into juicing and fresh markets respectively as well as seasonal volumes are available.
  - Australian fruit production is significantly affected year-to-year by climatic factors.
  - The effects of drought and reduced water allocations has limited total crop output in recent years across major growing regions, with the result that much of the Valencia fruit is being used in processing into chilled juice products, and Navels primarily sold in eating fruit.
  - The proportion of orange production which is processed to juice varies year to year depending upon fresh fruit availability and pricing, and the relative value of FCOJ. In 2005/06 Freshlogic estimated processing throughput to be around 41% of orange production (and 34% of the citrus category).
  - FCOJ imports are used in ambient and long-life juice products. FCOJ prices have increased over the past 2 years due to crop shortages in the US and Brazil.

Fig 9.40 – product flows involving oranges



Source: Freshlogic

- Fruit exports has accounted for about 19% of domestic fruit production over the 3 years to 2006/07 (source: Australian Citrus Growers).
- The influence of the mix of product that goes into each of the end uses has a bearing on the prices available to growers from each major variety. Prices of Valencia oranges that are received at farmgate will fluctuate over time due to the use of a significant portion of fruit in processing, which affects volumes of available supply onto the fresh market.
- Valencia prices will be linked to world FCOJ prices but mostly governed by the relationship between supply and processor demand. Australia's current fresh chilled juice processing requirements are not capable of being met by domestic fresh fruit supplies, which has effected a capping in juice supplies.
- Farmgate prices of Navels will be more closely linked to fresh eating fruit returns from domestic and export markets.
- Export returns are affected by a range of factors including the presence of major competitors in target markets, as well as the various approaches taken by the Australian industry to secure market access – in the US market the industry sells through a single importer arrangement, yet in many other markets there is a competitive approach which typically results in a lower return.

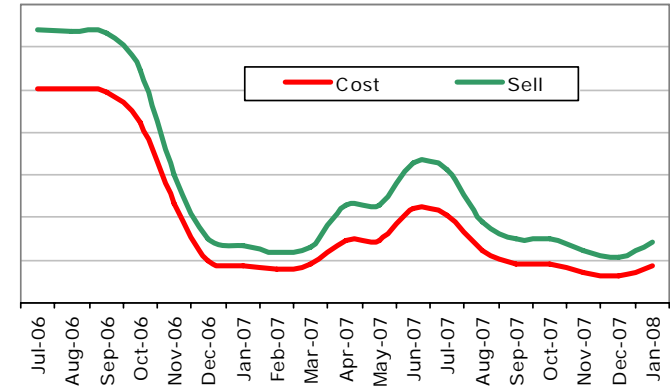
## Factors affecting category pricing

- At retail, oranges compete with other fruits and refreshments – seasonal availability can provide advantages but there is increasing availability of range across the board in other fruits to remove such advantage.
- Oranges are sold to consumers on a “per kilo” basis and have a history of differential prices with a portion of sales of low value pre-packs of oranges at substantially lower prices than loose product.
- There is a lack of suitable quality market data that would – in the time permitted for the preparation of this report – allow an adequate matching of varieties to ensure a reliable comparison of retail buy prices and wholesale market prices.
- The mix of product in retail sales data does not also permit an accurate tracking of the relationship of buy and sell prices for Coles. The mix of fruit sales between varieties over the year varies, and while Valencia amounts to about 15% of fruit sales, the variation in mix over the year varies between 5% and 25% on a monthly basis.
- When local shortages of Navel oranges are experienced, imports of higher priced US product are sourced. The imported products have different cost and margin structures which affects the category-level comparison of buy/sell prices over time.

### Bananas

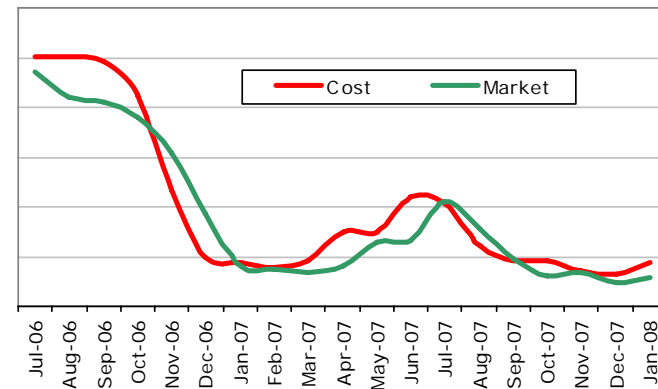
- The Banana category is a high value staple fruit line. It has a comparatively short production timeframe to other fruits and can be harvested and transported green. The Australian production has a limited varietal mix, with 95% of the local crop the Cavendish variety.
- Bananas work well for grocery retailers, as they are a high-turnover, easy-handling product. They are regularly featured in FSS promotional advertising as supply and high levels of consumer participation can be assured, and as such is a primary line for competition between FSS stores and between FSS and independent fruit retailers.
- The steady pattern of production volumes reflects the relatively consistent nature of the crop, other than for the effects of natural disasters. Total supply chain income is driven by volume supply management, and affecting demand through consistency of quality and ripening process.
- We have compared the Coles’ buy/sell prices for the product over the past 2 years in Fig 9.41, which shows a close relationship and consistent margin level. In addition in Fig 9.42, we have contrasted the retailer buy price against the wholesale average market price, which indicates Coles practice to source much of their requirements direct at or above the wholesale market.

**Fig 9.41 – Cavendish bananas –retail sell v buy price**



**Fig 9.42 – Cavendish bananas – wholesale market v retail buy price**

Source: Coles



Source: Coles/Ausmarkets

### Apples

- The Apple category is a mature consumer product that enjoys extended annual availability due to storage technologies. Apples have an even flow of product into the domestic market.
- The peaks are after harvest and in the winter and early spring months. This flow pattern is affected by storage volumes, timing to exploit the

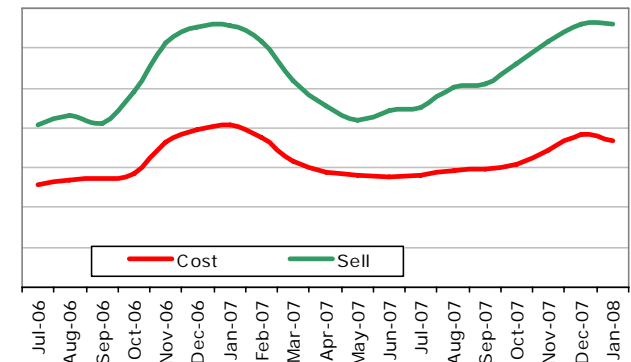


## Factors affecting category pricing

- availability of competing fruits and efforts to keep a staple range of apples available throughout the year.
- The crop is harvested from February to April and a proportion of the new season product is flowed directly into the market. The balance of the crop is then placed in short or longer term storage controlled atmosphere (CA), and released over the following 9 to 12 months. The product attributes and technologies that allow apples to be stored create the platform for a managed supply chain.
- The pattern of production volumes reflects the biennial nature of the crop. Over the last 5 years the volumes have varied from 265,000 to 320,000 tonnes.
- Products prices are established by the wholesale sector. Factors affecting price peculiar to this category
  - Production volume - seasonal production variation is biggest driver of prices and returns
  - Seasonal quality
  - Degree of processing and processed pulp/juice cons landed cost. Depending on production levels, about 15-20% of the crop is processed for juice and other pulp products
  - Storability and scope for managed supply
  - Product or varietal differentiation
  - Role of exports and impact on availability
- At retail, apples compete with other fresh fruit lines such as stone fruit and bananas – seasonal availability can provide advantages but there is increasing availability of range across the board to remove such advantages. Apples are predominantly consumed as a snack and distributing first grade whole fruit into the retail channel generates the highest price.
- Other key “in season” fruit items (mainly oranges/mandarins and bananas) affect the choice of apple purchases based on their relative value and quality during the apple season. Over time, other snack food options have also greatly affected the demand and potential returns for apples.
- The apple industry still suffers from a reputation for having highly variable quality and availability between and during seasons. Variations by region, time of season, retailer, variety, etc also causes much fluctuation in apple retail pricing and adds to consumer uncertainty/confusion.

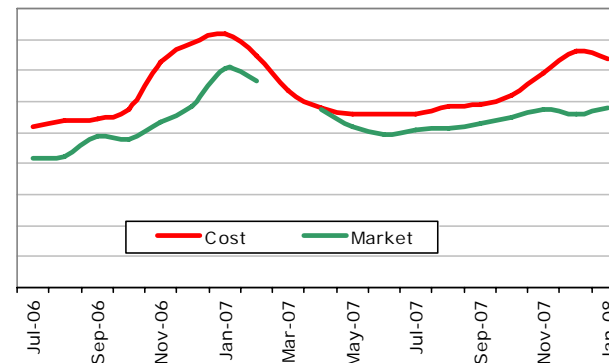
- Varietal prices vary greatly depending on consumer preference and supply. Pink Lady is the lead variety and has increased over 10 years to 20% of the crop. Other major varieties include Granny Smith 21%, Red Delicious 15% and Gala 14%. There are currently no apple imports into Australia to affect market supply/demand. The main issue is the restriction on the import of NZ apples due to quarantine concerns about fire blight.
- We have compared the Coles’ buy/sell prices for the Pink Lady category over the past 2 years in Fig 9.43, which shows the close relationship and consistent margin level. In addition in Fig 9.44, we have contrasted the retailer buy price against the available wholesale average market prices, which indicates Coles practice to source much of their requirements direct at or above the wholesale market.

**Fig 9.43 – Pink Lady apples –retail sell v buy price**



Source: Coles

**Fig 9.44 – Pink Lady apples – wholesale market v retail buy price**



Source: Coles/Ausmarkets