Pricing

Dairy deregulation and the Australian milk market

The Commission recently released a report into its monitoring of the Australian milk industry following farmgate price deregulation on 1 July 2000. The Commission report, compiled in accordance with a ministerial direction to formally monitor costs, profits and prices in the milk industry from 8 April 2000 to 8 January 2001 under the *Prices Surveillance Act 1983*, indicates that consumers have been the major beneficiaries of a deregulated dairy market.

Before farmgate price controls on drinking milk from 1 July 2000 were concurrently removed by State governments, Australian dairy farming was based on a two-tiered pricing system dependent on the segregation of milk at the factory. Milk channelled into the drinking milk sector in each State, but not the Northern Territory and Australian Capital Territory, was purchased from dairy farmers at prices prescribed by State governments. These prices averaged around 47 cents per litre across Australia for the year to 30 June 2000 after freight and other adjustments. In contrast, payments for milk used in manufactured dairy products were determined on a commercial basis and averaged around 21 cents per litre in 1999–2000.

Under regulation, legislative provisions in each State eliminated arbitrage opportunities from cross-border flows of milk and enabled market milk premiums to be allocated to dairy farmers on a State basis. Because of the respective State ratios of total milk production to drinking milk consumption, more than 40 per cent of milk produced in New South Wales, Queensland and Western Australia attracted drinking milk premiums while only around 7 per cent of Victorian milk was purchased from farms at the higher regulated price.

The system of prescribed payments for drinking milk was originally designed to secure milk supplies in an era when transportation and processing systems for perishable products were considerably less sophisticated. Today, however, less than 18 per cent of Australian milk production is required to satisfy drinking-milk markets. The remainder is used to produce cheese, butter, milk powders and other manufactured dairy goods — the bulk of which are destined for Australia's $3 billion dairy export markets. Clearly the Australian dairy industry had evolved to a stage when regulatory mechanisms were no longer necessary to ensure adequate supplies of drinking milk.

With the removal of farmgate price controls on milk by all State governments from 1 July 2000, the notional separation of milk based on end-use was ended. This followed the removal of retail price controls during the past decade starting with Western Australia in 1990. While prescribed farmgate prices kept dairy farmer incomes artificially high, retail price controls kept consumer prices low. Both policies led to distortions within the industry. At one end of the marketing chain, milk production was encouraged at the expense of other farming activities while retail price controls retarded investment in the value-added sectors and constrained product innovations in milk processing.

Price falls

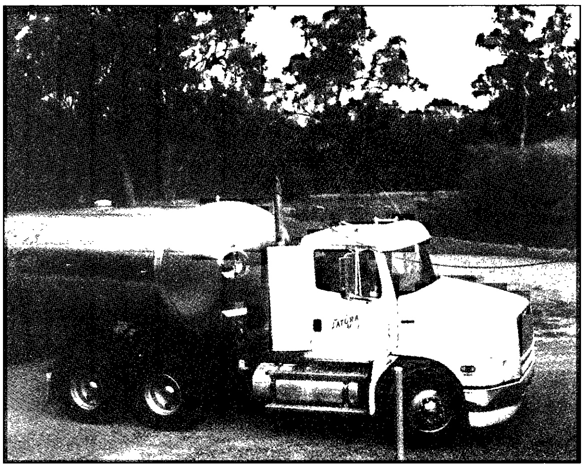
In the first six months of a deregulated dairy market, the Commission found that the price of plain milk sold in Australian supermarkets decreased by an average of 22 cents per litre when measured across all pack sizes and brands. This was despite the introduction of an 11 cents per litre retail milk levy to fund assistance for dairy farmers. Across all categories of milk stocked in Australian supermarkets, including plain, UHT, modified, flavoured and specialty milk, the average price reduction was 12 cents per litre. Price reductions were greatest for generic-labelled products, 3-litre pack sizes and weakly-differentiated branded products. As milk processors can more readily capture any benefits of enhanced value creation for differentiated milk products, these types of products are frequently the focus of product, packaging and promotional innovations and are less susceptible to movements in the broader milk market. In the plain milk category, sales of generic-labelled milk in supermarkets increased from 37 to 62 per cent of total plain milk supermarket sales in the six months following deregulation. Prices also fell in convenience and corner stores, the main distribution channels for products marketed under processor brands, but to a lesser extent. However, substantial falls were apparent for 2-litre plain milk in the non-supermarket sector.

Price reductions were largely the result of competition between milk processors for supermarket contracts and supermarkets introducing new lower national prices for generic-labelled milk. Milk processors were seeking to firm-up market shares and reduce excess processing capacity in the fully deregulated market while supermarkets used milk to drive store traffic and compete with convenience outlets.

This illustrates the importance of staple products such as milk in shaping general consumer perceptions of pricing relativities between competing food retailers. It also reflects the value of discretionary purchases, which are often made when consumers initially enter a store with the intention of buying basic items such as milk, bread or newspapers.

ACT and NT

Although the Commission found that average milk prices fell in all States after farmgate price controls were removed, some milk prices increased in the Australian Capital Territory as did milk products retailing in the Northern Territory. This was because the additional costs of the retail milk levy could not be offset by lower farmgate prices for raw milk. Similarly, milk used as an input to UHT milk products previously attracted regulated farmgate prices that were considerably lower than those applying to market milk. UHT milk prices also rose with the introduction of the new retail milk levy, inducing some consumers to switch to plain milk. Interestingly, the total volume of milk



sold in Australia was largely unchanged after milk sales were deregulated as these are largely dependent on consumption patterns for tea, coffee and breakfast cereals. However, sales of milk through supermarkets increased from 48 to 51 per cent of total milk sales over the six months to December 2000.

Price is not the only way retail outlets compete. Consumers consider a range of factors when buying products such as milk. These include price, store location, product range and quality, queuing time, opening hours and access to car parking. For stores such as supermarkets that have traditionally targeted the bulk grocery market, price plays an important part in this mix. However, smaller stores often compete on the basis of convenience with many consumers prepared to pay higher prices for hassle-free shopping. This creates a nexus between price and convenience that underpins competition across competing retail outlets despite price differentials.

Consumers increasingly have the opportunity to weigh-up a range of price and convenience factors when deciding the type of milk they purchase and the retail outlet from which milk products are bought. Importantly, standard prices for generic-labelled milk now apply in major supermarket chains giving most Australians access to low-priced milk.

Farmgate prices

The Commission found that prices paid to dairy farmers for drinking milk fell by 19 cents per litre to around 34 cents in the six months after deregulation. This brought farmgate prices for drinking milk broadly into line with raw milk purchased from dairy farmers for use in manufactured dairy products. At the same time, farm incomes have been supplemented by the proceeds of the 11 cents per litre retail milk levy. This levy is designed to generate around $1.8 billion in structural adjustment assistance for Australian dairy farmers over the next eight and a half years.

The Commission also found that supermarket margins on milk sales decreased by an average of 19 per cent on a per litre basis in the first six months of deregulation while processor margins contracted by an average of just over 18 per cent in the same period. Supermarket margins were calculated by taking the difference between wholesale and retail prices (gross margin) because of the difficulty in accurately apportioning store overheads to specific product categories. Processor margins were calculated by deducting expenses incurred in the processing of milk, including the costs of purchasing raw milk, from wholesale milk prices.

Consumer savings

Savings to Australian milk consumers in the 12 months since dairy deregulation are anticipated to exceed $118 million from supermarket sales of milk alone. When savings estimates for milk sold in convenience stores, petrol stations, traditional corner stores, milk bars, delicatessens and take-away food outlets are taken into account, total consumer savings since dairy deregulation will far exceed the savings made by supermarket shoppers.