

6. Issues for consideration

ISSUES FOR CONSIDERATION

Purpose

The project brief requires an analysis of a number of matters which arise from the study of prices.

The subject	Issues for consideration	Conclusion/comment
Competition and market power	<ul style="list-style-type: none"> • What does the evidence from this study indicate regarding the effects of market power in the food sector? • Is there leverage available to producers to resist strong market power beyond the farmgate? 	<p>See figure 123. One of the major determinants as to whether there is abuse of market power is whether super-normal profits can be sustained over time. The competitive nature of retail markets and the level of returns being earned in the Australian food sector (per section 4) do not indicate that there is major abuse of market power to the detriment of food product suppliers.</p> <p>Producer integration in cooperatives is discussed on page 124.</p>
Transparency and visibility in the value chain	<ul style="list-style-type: none"> • What has the study indicated regarding the transparency in food value chains? 	<p>There is decreasing transparency in several food industry sectors in view of the concentration in food processing and marketing, and the consequential sensitivity to movement in margins. Retailers are vigilant for opportunities to reduce costs due to the pressure on major companies to offer increasing shareholder wealth.</p> <p>That issue is quite distinct from a lack of visibility which hampers the effectiveness of fresh food markets.</p>
Value-adding in the food sector	<ul style="list-style-type: none"> • What has the study told us about the incentive for and returns from value-adding activities? 	<p>The major value-adding activities have been identified and discussed in relation to a number of the sectors covered in the study. In this section we distinguish the main types of value-adding activities in food products and likely future directions of product and market development in food retail and food service markets.</p>
Adjustment	<ul style="list-style-type: none"> • What impact is adjustment having on prices and costs in certain sectors of the food industry? 	<p>Pages 131–135 identify specific adjustment factors in the industry sectors analysed and their relevance to the study of food pricing.</p>

COMPETITION AND MARKET POWER

Is there a problem?

There have been a number of studies undertaken in recent years to determine whether or not there is a problem with concentration of market power in the food industry and, if so, its impact on competition and pricing. This study has gained some insights into issues that influence that discussion. However it has not been undertaken specifically to address the question of market power as a primary objective.

The observations from this work include:

- A key defence used by major retailers to the charge that they command excessive market power is that they each face strong competition from more than direct retail competitors (large and small) but also from different food retailing formats in the growing food service sector.
- Retailers contend that despite the costs of doing business in this food market, prices at retail are not rising excessively and businesses are not making super profits by international standards.
- In most of the food lines studied in the project, there is significant direct and indirect competition at retail level.
- There are a number of product lines where trade affects an early supply-chain price and the retail margin fluctuates as such prices are driven by different factors and accountabilities.
- There are a number of instances where those with a command of better market intelligence take advantage of those without. Whether this creates a market failure condition is discussed later but it is the responsibility of relevant industries to ensure that sellers are aware of the commercial realities of the modern retail value chain.

What determines market power?

Market power provides a business with the ability to behave differently from the way it would in a competitive market – it can reduce input prices and raise selling prices, deter other participants from entry, take excessive margins for itself and do so over a considerable time.

From the work done, it is apparent that there are a number of determinants of market power.

Concentration of buying and selling.	Higher concentration provides scope for a major buyer to exert force in negotiations due to their dominance of purchases.
Specificity of the product – the degree to which product attributes can be specified for quality and performance.	A supplier has greater leverage if they perform to specifications in the context of contractual arrangements.
Perishability/storability of the produce.	Highly perishable lines place the supplier at risk of being left with product losses.
Levels of sunk cost in production.	Large sunk costs will tend to make the supplier more risk-averse.
Options open to buyer and seller at the time of committing to production by the seller and at the time of sale.	With multiple options, a supplier or buyer has greater power to choose.
Degree of vertical integration that exists in a value chain – which may be in the form of direct ownership or through the existence of co-dependent alliances.	Greater integration may provide a supplier or a buyer with greater ability to control costs – and therefore better options in pricing particular items.
Degree of transparency – the key issue being the accuracy or extent to which the available information reflects levels of supply and demand at the time of sale.	Greater transparency provides a supplier or buyer with greater understanding of market conditions and options.
Ability to command a super profit in on-selling.	This would require a condition of limited retail competition in short and medium-term time frames.
Whether the position of dominance is sustainable over time.	

PRODUCER INTEGRATION

Does integration provide better producer returns?

A debate has arisen on the issue of whether the cooperative provides a better return to its producer-members than other models of supplier integration.

What do cooperatives do for the producer when it comes to achieving a better price for the producer? Based on the evidence from the marketplace, where a cooperative competes with a non-cooperative (public or private) company in a commodity food product, there is little evidence that a cooperative adds to the price of the raw material.

The gains are necessarily in price alone. What a cooperative provides is the sharing of economies of production through the provision of market access for all production. This allows the producer to focus on reaching scale efficiency without the need to deal with finding a market for all output from the farm enterprise.

This is a significant issue in the dairy industry – the gains in productive efficiency in milk production have been achieved due to the existence of major cooperatives. They have provided scope for storing milk and converting it into dairy products which are competitive on the world market.

A greater share of the value added?

Our analysis has shown that major food lines which are of the nature of commodity grocery products are not providing significant returns to processors. The cooperative or producer-owned business provides scope to gain greater margins from value-added products which are an extension of the business from the commodity food item.

In reference to cooperatives there are many value components that combine to reward members.

These include:

- price;
- guarantees of product acceptance by the cooperative;
- dividends on shares;
- capital appreciation of shares or increases in the nominal value of cooperative stakeholdings; and
- farm-level or other member services.

In considering value-adding options, primary producers should also consider the merit of direct sharemarket investment in companies involved in their food supply chain as a way of capturing downstream returns.

Recently there have been proposals to reconfigure some agricultural cooperative models to separate discretionary or optional investment in the value-added component of the business from a member's equity share in the basic supply cooperative that exists to enhance returns for the supply of raw agricultural products.

Use of supplier capital

Some businesses will perform better at managing supplier equity capital than others. The more sustainable the differentiator, the greater the return for the producer-owner. The greater the ability of the business to leverage the contributed capital of the producer, the greater the potential gains from investments in value-adding to foods. Without such integration, it is likely that the farm sector will gain a minor if not negligible share of the benefits of value-adding reflected in the price of the raw material supplied, unless this can be provided through specific contractual arrangements.

Our analysis of certain product margin-sharing depicts a large share of the retail dollar falls under the control of the producer through a cooperative. This share is likely to turn into real price or

dividend advantage where the competitiveness of these core products provides a basis for adding value in other product forms.

TRANSPARENCY AND VISIBILITY

The challenge

In future, increasing competition in the food sector and greater diversity of product and market channels will make transparency more difficult to achieve and sustain.

With strong trends towards greater concentration of retail and certain processing and marketing sectors, commercial advantage through less visibility of prices and costs will be a priority. Less transparency is often a competitive advantage, especially where parties in a relationship are in pursuit of differentiators based on quality, reliability and cost.

There is a strong need for certain information to be made public in any industry – where it aids gross national product data, research requirements and industry arguments in the development of policy. With greater integration through the value chain, industry information becomes increasingly irrelevant to those participants who take advantage of reducing the distance between farmgate and consumer.

- This will lead to increasing irrelevance of average prices from central markets – such as those seen in the wholesale meat markets.
- This will lead, if it has not already led, to a lower investment in industry benchmarking.

It is also apparent that those who bother can get the information they need. There is increasing investment by individual businesses in knowledge and intelligence and private R&D. Indeed, some have asserted that most of the noise associated with a lack of information comes from those who have not made the investment or necessary adjustment in anticipation of change.

Market failure?

In keeping with the requirements of national competition policy, governments have eliminated the regulation of industry activities including prices, supply and business conduct. At the same time however, there has been little or no regard for the retention of information systems critical to industry management in the future.

Under the discipline of national competition policy and its accompanying tests, knowledge management has rarely been given recognition as a public benefit, nor has its loss been strongly regarded as a market failure.

Threat to value-adding

The most frequent assertions of a lack of transparency come from fresh fruit and vegetable markets but the instances go much wider than these and are critical issues in sectors of the meat industry.

Investments to address these issues may include:

- education programs which:
 - enhance the use of codes of conduct;
 - improve the understanding of suppliers' rights in terms of commitment to a transaction; and
 - promote standard agreements including terms and conditions of the supplier-wholesaler relationship;
- investment in better systems;
- supply management and planning.

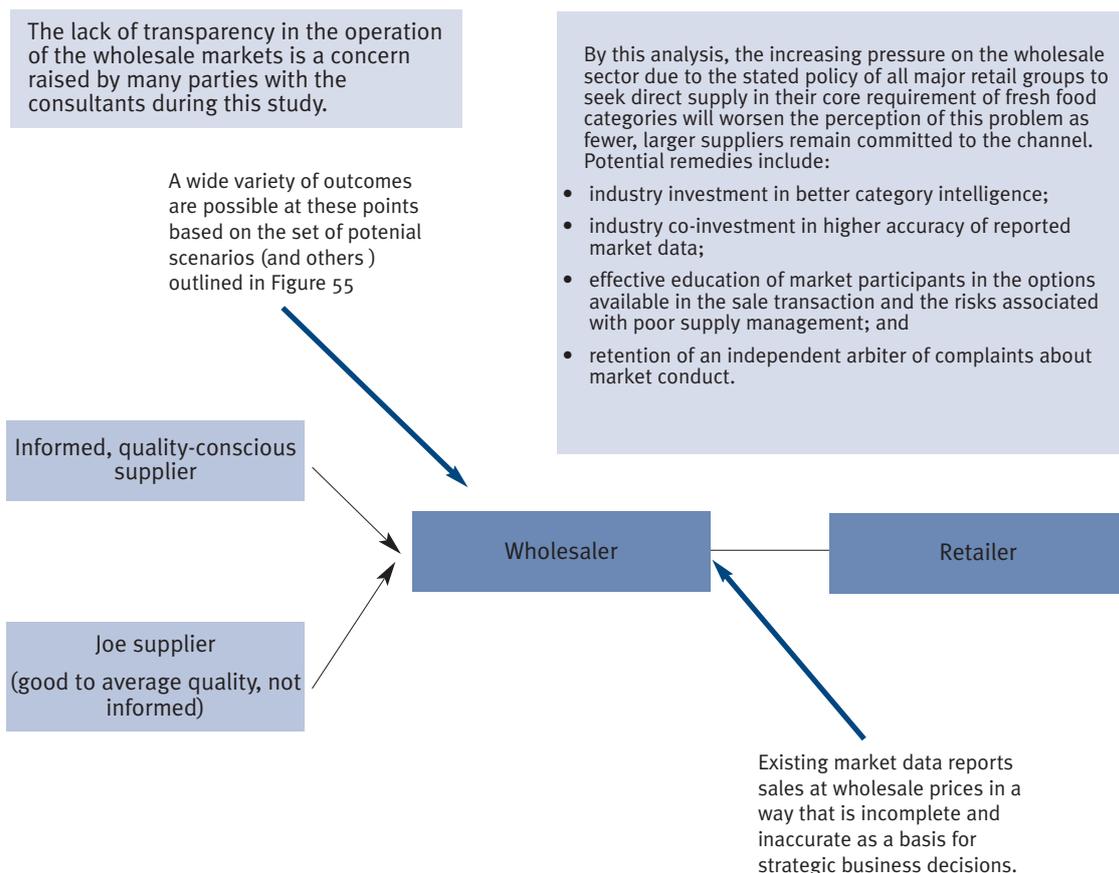
Regulation is never a solution to such issues. It creates inefficiency and fosters an expectation in the weak supplier that someone is there to take care of them (or that someone owes them a living).

Industries have in several cases taken it upon themselves to maintain or create voluntary knowledge-management functions. Alongside those efforts, private providers have developed markets for information products.

TRANSPARENCY/VISIBILITY OF PRICING INFORMATION FOR THE PRODUCER

Industry	Farmgate	Wholesale	Weaknesses/issues
Dairy products	Moderate – direct supply contracts with suppliers but knowledge of alternatives is mixed, requiring private benchmarking and anecdotal information.	Limited – export spot prices provide guidance as to product market conditions which strongly influence most milk prices.	A major difficulty is the length of the return outlook that can be established due to the international trade environment and the medium to long-term investment needed for herd and milk/feed infrastructure.
Beef and lamb	Good – market prices for carcass and OTH sales.	Limited – wholesale market data from the Sydney markets for major portions. Export prices reported through MLA. Retail price monitoring provides a guide to domestic market.	The complexities of carcass use in a wide variety of retail products and co-products makes trace-through of prices meaningless. Due to the significant volumes of business now being bought direct off farm (through feedlots and other contracted fatteners and producers), wholesale markets lose their relevance.
Pork	Good – market prices for carcass and OTH sales.	Moderate – wholesale market data from the Sydney markets for major portions reflects trade returns.	The complexities of carcass use in a wide variety of retail products and co-products makes trace-through of prices less relevant. The use of imported portions in the commodity end of the industry also provides a layer of complexity which is reflected in wholesale prices.
Fresh fruit and vegetables	Mixed – derived from wholesale data and selected industry reporting of market conditions. Direct supply contracts exist but with mixed length-of-term and price signals. Strong influence of the wholesale markets creates a moderate level of uncertainty in several sectors.	Limited – wholesale data is widely reported and accessible but subject to strong risks of error and manipulation. Limited overall industry intelligence beyond reported data, despite attempts to improve information systems.	Refer to next page. (Figure 130) Uncertainty exists from time to time due to the influence of trade in certain sectors, for example, the impact of the success of citrus marketing in certain key export markets and the impact of frozen orange juice concentrate.
Eggs	Good – producer contracts provide price signals, industry reporting of production forecasts assists with short-term forward expectations.	Limited – wholesale prices vary widely due to the unstructured nature of the box market.	The fragmented state of the industry outside of those players supplying major chains, as well as the general uncertainty regarding production levels to and beyond 2008, makes it difficult for overall intelligence on the industry outlook to be meaningful.

Figure 130. **VISIBILITY IN FRESH MARKETS**



KNOWLEDGE MANAGEMENT

ABS data

In most of the product groups that have been subject to analysis, the work has referred to data collected by ABS.

It is understood that ABS data is used primarily for the collation of consumer price index data. For these purposes it uses a wide-ranging basket of goods to ensure consistency of price samples over time.

ABS publishes a price series of food items in catalogue 6403.0, which it suggests is a selection of the items included in the broader inflation surveys.

Catalogue 6403.0 is available to industry and is widely used as a basis for publicly available retail data. Reference to these data is valid whilst the pattern of consumption in those products remains the same. Over time in certain examples, this has clearly not been the case.

It is not possible to establish the basis for which broad categories of fresh fruit and vegetable products and meat lines are collected, in view of the wide range of options and quality grades that now exist in those categories. Anecdotal evidence suggests that the collected information is a mix of loose and bagged product in some instances – the latter of which will typically be sold at a bulk (lower) price.

There are also significant risks associated with the collection of data in its inconsistent treatment of products on special at intervals during the year.

Examples include:

- **1 litre milk** – this now represents a small share of the category alongside the dominant 2 and 3 litre containers in most retail outlets.
- **Processed cheese slices** – processed cheese now accounts for about a quarter of the total category, whereas dominant product sales are made in natural cheese blocks. It is also a product that is less reflective of cheese market conditions.
- **Frozen chicken** – fresh chicken portions are now the dominant product category as a result of the gains in processing and packaging technology.
- **Oranges** – there are two major varieties of orange (valencia and navel) which are affected by very different supply and demand dynamics due to seasonal factors and the effect of the juice market as a consumer of partial output of both varieties. Greater consistency and clarity of juice variety and pack form would aid use of the published data.

There is a substantial body of unpublished ABS data which is used for various purposes. It would be advantageous to explore the possibility of making some of that data available to industries as part of a process of improving information flows regarding the size and value of industry output, pricing and value added.

VALUE-ADDING AND INNOVATION

Food manufacturers and marketers value-add to stay alive. The nature and extent of competition in the grocery food industry and the directions being taken in the domestic retail grocery market indicate clearly that enterprises will continue to innovate beyond core or staple products.

‘Value-adding’ is a much-misused term and has become jargonised in recent years. It is important to distinguish between the following forms of value-adding:

- a) strategies to **substantially differentiate products** for sale into specific or targeted market segments;
- b) strategies to **further process commodity products** to a form which is closer to the final consumer product; and
- c) strategies to **enhance the recovery and return** from processing the whole commodity or its functional components, through processing lower grade, waste or by-products and managing the overall consumption of a raw material by converting a short shelf-life product to storable form.

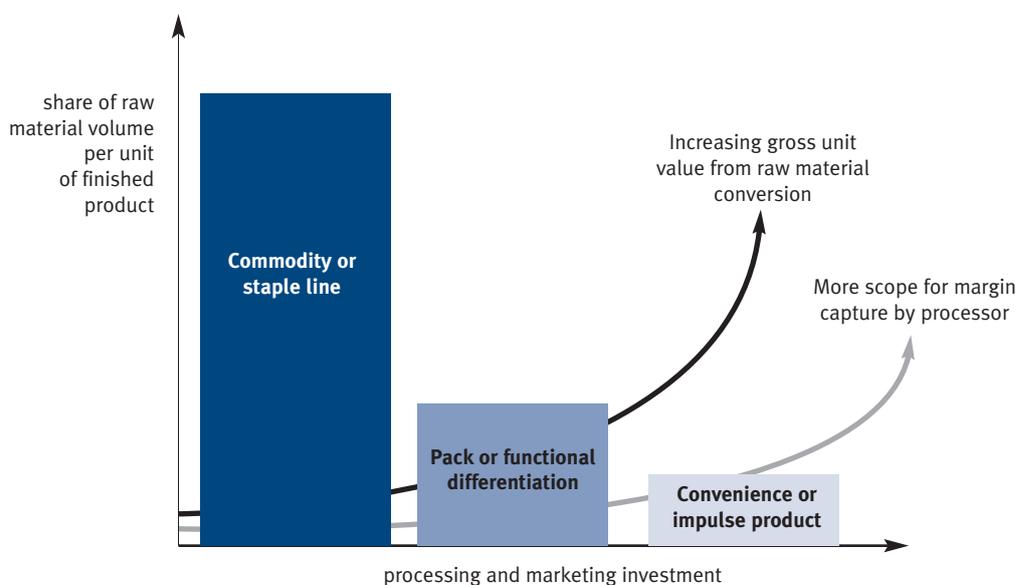
Items (a) and (b) are areas where greatest attention is paid to the concept of value-adding in the food sector.

The basic aim of these forms of value-adding is to create a substantial benefit to the next user or end user of the product – that may be saving time and/or cost, or providing some sort of incremental benefit from the product – health advantage, taste, versatility or storage life. Given the concentration in the retail sector and the strong pressure on margins for participants in commodity food lines, (a) and (b) type value-adding is vitally important to many food marketers and processors.

There is accordingly extreme reluctance to share with this project commercially sensitive information as to the destination of returns from such efforts. The analysis of the share of returns from such innovations is mostly without quantification for that reason.

Such is the nature of competition in the food retail market (domestic and international) that the competition for a sustainable value-adding product is intense.

Figure 131. **THE EFFECTS OF VALUE-ADDING**



As the product moves further to the right and more specific processes and technologies increase the control over volume to match a given demand, the commercial imperative for advantage becomes more important. Visibility of returns and costs also diminish.

COMPETING FOR A SHARE OF THE STOMACH

There are exciting developments in the food industry in terms of the changing lifestyle needs of the consumer. The time-poor, cash-rich city consumer is working longer and harder, seeking greater leisure time when away from work and spending less time doing traditional things in the kitchen. At the same time the greater consciousness of the global village has heightened awareness of cuisine.

Food marketers are competing in new and innovative ways to take advantage of the new niches in the food market that are being created by the new and emerging differences in where people eat, how they eat their meals and in which segment of the market. Overlay that people buying in new ways: the shopping trip has changed and has become more a fragmented set of trips with different purposes.

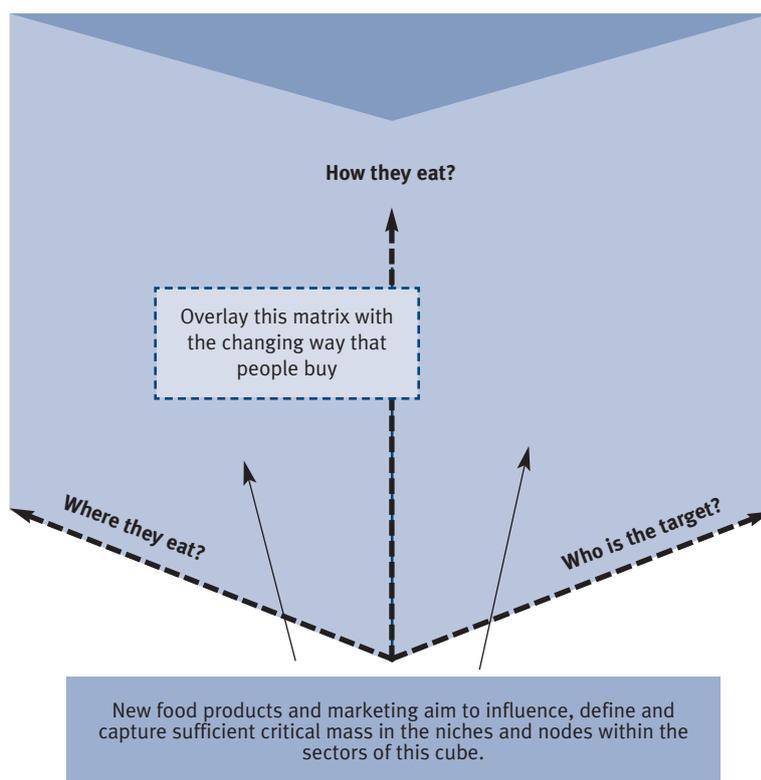
The servicing of these emerging trends forms the basis for the growing importance of the food service sector and the opportunities in that sector for the food production industries. The contest between retail grocery and food service providers for a share of the stomach is one of the greatest challenges facing the food industry in the coming years. As the price-competitiveness of the grocery market intensifies further, with retailers seeking new ways of adding to shareholder wealth, the funding of innovation to meet new delivery systems will stretch the margins and capital of food companies.

At the same time, food manufacturers will have to place increasing focus on meeting the product development and service demands of a growing food service market which potentially offers greater overall growth but sees far more diverse sources of competition.

Several examples of the value-adding drivers have been witnessed during this project. However, as outlined on the previous page, the competitive culture within the industry has prevented the study providing some form of education as to how benefits are derived and captured by the participants.

Governments have a critical role in assisting the industry in understanding and facilitating the development of innovative products to respond to the commoditisation of the food sector and the loss of opportunities for producers, manufacturers and marketers.

Figure 132. **TARGETING THE STOMACH**



VALUE-ADDING IN FRESH FOOD

Not just an elaborate transformation thing

Value-adding is not limited to the fields of development which see a raw material or a commodity form of product transformed into a different form that is easier for the next user or end consumer.

There is considerable value-adding that is undertaken through fresh food chains as product moves from picking or harvesting through to the retail stand in the store.

Fresh food intermediaries – including packers, wholesalers and retailers – are often criticised for adding margin to the final price of the product.

The table on the right identifies some of those processes and the nature of the value-adding that is undertaken.

Does the fresh chain add value?

Examples of the role of intermediaries in the fresh product chain in view of the differentials between retail prices and farmgate returns are as follows:

Stage	Value added	Costs added
Grower	<ul style="list-style-type: none"> • Production in accordance with growing specifications • Harvesting to optimise fruit quality 	Production costs
Packing house	<ul style="list-style-type: none"> • Grading for consistency • Packing into market consignments • Storage in controlled environment • Freight product to market 	Packing and storage fee Freight cost
Wholesaler	<ul style="list-style-type: none"> • Collection and presentation of product in a central location to buyers • Marketing produce to retailers either in market or direct to buyers in retail or food service • Storage in controlled environment 	Wholesaler's fee or deducted margin Logistics costs to store
Retailer	<ul style="list-style-type: none"> • Presentation of product to the consumer in retail outlet • Storage in controlled environment 	Retailer margin to cover costs of doing business Costs of storage, display, handling

ADJUSTMENT

Purpose

This report seeks to identify and explain major adjustment challenges facing food sectors and sub-sectors – in the context of a study of the factors determining the prices of food.

There are several situations where rapidly changing market arrangements have created adjustment problems.

In this section:

- key areas are identified where strong adjustment is occurring due to commercial forces, trade impacts or other external factors;
- an illustration is provided of the ongoing and recurring impact that drought has on food supply and pricing.

MAJOR ADJUSTMENT – WHAT’S HAPPENING

THE SECTOR	THE ADJUSTMENTS	HOW THESE HAVE HAD IMPACT	INDUSTRY RESPONSE
Dairy	Deregulation of market milk pricing.	<p>Lower revenues to processors with the reduction of retail and wholesale prices of packaged milk once the fresh milk market moved to a national arena and retailers sought and were offered lower wholesale prices on private label products.</p> <p>Lower average costs for producers in regions exposed to a high fresh-product mix of milk usage. This effect has been exacerbated with lower returns from the export market which have eroded values of milk used in storable dairy products and the deep impact of drought on feed access and costs.</p>	<p>Processor rationalisation of costs.</p> <p>Limited additional response for the production sector is feasible, beyond the assistance provided through the dairy structural adjustment payments to producers to adjust productive capacity and financial position.</p> <p>Exits from dairy production have increased as a result of the impact of drought coupled with low milk prices.</p>
Lamb	Low supply of lambs due to drought conditions. High export prices due to strong export demand and supply shortages.	<p>Tightening of margins for processors who are existing on smaller throughput volumes.</p> <p>Prices have not fully flowed through into retail due to price sensitivity in the face of red and white meat competition.</p>	Promotion of increased lamb production (with the lure of high prices due to persisting strong export demand).
Pork	Commodity imports of pork portions.	<p>Reduced the available returns to processors and producers from the manufacturing sector.</p> <p>Producers’ viability is now governed by the extent to which they can produce pork at globally competitive costs (which includes access to competitively priced feed grain) and align themselves closely to export processors.</p>	<p>Promotion of fresh pork consumption. Taking advantage of price-competitiveness against red meat options. Product innovation in the Australian market to improve overall return from the carcass is crucial to industry profitability.</p> <p>Concentration on fresh chilled exports is critical to this sector.</p>

MAJOR ADJUSTMENT – WHAT’S HAPPENING

THE SECTOR	THE ADJUSTMENTS	HOW THESE HAVE HAD IMPACT	INDUSTRY RESPONSE
Fresh fruit and vegetables	Shift to greater retail direct buying. Rationalisation of suppliers to fewer larger suppliers.	Lower volumes flowing into wholesale markets. Greater focus on wholesale sector sustaining business incomes.	Limited response at industry level on a commodity-by-commodity basis. Fresh food industries are seeking an extension of the role of the Retail Grocery Industry Ombudsman and greater meaning for codes of conduct.
	Individual lines facing declining consumer support.	Lower demand. Lower produce prices at wholesale. Pushing more fruit to co-product streams.	Improved investment in varieties and points of difference. Enhancing category management in conjunction with retailer.
Eggs	<p>Increased use of private label by the retail sector at a significant price reduction from proprietary brands.</p> <p>Requirement for egg producers to meet welfare standards in cage design by 2008 will require major capital overhauls.</p>	<p>Consolidation of egg production, packing, and marketing has been going on for several years post-deregulation of egg production and marketing arrangements on the east coast.</p> <p>Investment in egg production facilities.</p> <p>Investment in greater automation of egg handling through to packing to offset higher fixed costs.</p> <p>Strong seasonal price competition remains at retail and wholesale as non-aligned marketers seek to take advantage of lower production costs.</p>	Industry marketers sought and gained retail price increases due to higher costs.
Sugar	Significant sustained falls in international sugar prices due to changing world market dynamics coupled with poor seasonal conditions.	<p>Lower farm incomes.</p> <p>No loss of certainty of supply of sugar to domestic markets due to the abundance of sugar volumes.</p>	<p>Industry has sought adjustment assistance through state and federal governments.</p> <p>There is no scope for relief through the domestic products market due to its small scale, the decline in sugar consumption and the cost-competitiveness of other sweeteners in industrial uses.</p>

THE IMPACT OF DROUGHT

THE SECTOR	DIRECT IMPACT	BACKGROUND FACTORS	EFFECT ON PRICES
Dairy	<p>Less feed available for milk production.</p> <p>Lower supplies at sharply higher prices of feed grain available to milk producers on a spot basis.</p>	<p>Weakened international market due to oversupply from the European Union and a slowing of demand in major markets.</p> <p>Global shortage of feed grains due to poor climatic conditions in key producing countries.</p>	<p>No direct impact on dairy product prices in the domestic market because milk supplies maintained to meet fresh milk market needs.</p> <p>Production flows in major parts of the industry fell but by an insufficient volume to put pressure on national daily milk supplies.</p>
Beef	<p>Producers opted for earlier turnoff rather than feed cattle through to full fattened maturity, so creating a temporary oversupply of beef on the market.</p>	<p>Export beef market experienced sharp decline due to the fall in consumer demand in Japan with a bovine spongiform encephalitis outbreak which depressed world prices.</p>	<p>Lower beef prices at wholesale – little impact on retail prices.</p>
Lamb	<p>Cut in sheep numbers and therefore lamb supply. Reduced volume has placed great pressure on the meat processors who face lower throughputs and tight product margins.</p>	<p>Continuing strong international demand for lamb.</p>	<p>Increased product prices through the chain. Lower increases passed through into retail product due to price competition from other meats.</p>
Pork	<p>Less feed available for pork production.</p> <p>Lower supplies of feed grain at sharply higher prices available to domestic customers on a spot basis.</p> <p>Pork production fell due to poor producer prices.</p>	<p>Increasing imports of pork into the commodity sector of the domestic manufactured meat market. Imports more competitive with the rising value of the Australian dollar.</p>	<p>No impact on retail prices due to retained supply lines of fresh product.</p> <p>Reduced wholesale and OTH prices for carcass and major portions.</p>

THE IMPACT OF DROUGHT

THE SECTOR	DIRECT IMPACT	BACKGROUND FACTORS	EFFECT ON PRICES
Fresh fruit and vegetables	Lower production volumes and quality due to lower water access for feed crop production.	Retail market competition intensifying, direct buying needs of major buyers increasingly precise – requires greater certainty of supply of quality product on the shelf to give living proof of trustworthy fresh appeal.	Shortages of supply pushed up produce prices through to retail point of sale – with varying effect depending upon seasonal and geographic availability.
Flour	Grain supplies fell, prices increased.	World prices for grains rose sharply due to lower available global grain supplies and inventories.	No impact on consumer prices.
Eggs	Higher costs of feed grain (as noted in other areas).	Increasing competition at wholesale and retail levels.	Wholesale and retail prices increased to cover the higher costs of production so as to ensure security of supply to the market.
Sugar	Poor growing conditions reduced cane production.	Worsening world sugar trade position – unaffected by conditions in the Australian production industry.	No impact on sugar prices.
Rice	Less water available for rice growing. Increased costs of production to produce a season's crop.	Lower world supply of rice due to poor climatic conditions in other exporting countries, increasing overall world market prices for medium grain rice.	Higher processing costs due to lower throughput volumes. Industry was not able to take full advantage of better world market conditions due to a lack of domestic supply. Higher prices for rice flowed through into retail prices.

