EXECUTIVE SUMMARY

Purpose

The aim of this paper is to identify and explain the determinants of prices in some key grocery product value chains.

The study has addressed three tasks:

1. provide an analysis of movements over time in retail prices paid by consumers in comparison to those received at the farm level;
2. identify the costs and value-adding factors which are determining food prices over time; and
3. provide an analysis of financial performance for publicly listed companies in food manufacturing, marketing and retailing in Australia and other countries.

This report has undertaken analysis of the prices and costs through a number of food categories. Products have been selected and used in this analysis where there is a relatively strong similarity between the physical farmgate produce and the consumer good that appears on the store shelf.

The food industry environment

The study addresses these three core tasks against a background environment of the Australian food sector. The complexity of issues across food industry sectors and the intensity of competition within the food retail market means that simplistic explanations for the relationships between farmgate and retail prices are not meaningful. Any study must therefore make a case by case assessment of relevant influences and determinants.

It is important to highlight that many factors influence and drive the pricing of food in the Australian domestic food sector. These include:

- The impact of international trade is increasingly having an effect on farmgate prices across primary food sectors regardless of the forces in the domestic retail food sector, with a few important exceptions.
- There is a highly competitive and contested retail food market for the consumer dollar. Whilst overall grocery sales are growing slowly, the intense competition for market share between the grocery retail majors, and between majors and independents and over 30,000 specialty food businesses is a major benefit to Australian consumers in terms of price, convenience, range and choice.
- Australia's geography and urban demographics, relatively small consumer market and low population growth present major chain retailers with significant challenges in offering ongoing growth in shareholder wealth.
- Competition for retail market share between the two majors – Coles and Woolworths – Foodland Associated Ltd and Metcash-supplied independents, and newly arrived international food retailers such as Aldi and Pick n' Pay, is closely linked to competition for investor sentiment – each vying for performance advantage and points of differentiation. Future trends in retail will continue to see extensions of the retail format into new areas where synergies are available, though scope for significant organic revenue growth is limited by competition.
- Food retailers are increasingly using loyalty strategies to shape and entrench buyer shopping habits (store cards, fuel discounts, in-store banking services, loyalty reward schemes and so on). This drives repeat store visitations thereby encouraging high sales turnover.
- There is a gradual commoditisation of basic core grocery lines. Processed food manufacturers are increasingly using the 'every day low price' strategies of each of the major chains. The primary aim of such strategies is to share benefits in cost savings between customers and shareholders – suppliers benefit from reliable market access, economic volumes and large-scale production in core product lines.

- The current focus of retail chains in taking costs out of their supply lines enables greater direct control of product movements and economies in logistics. Major retailers are developing more direct supply relationships to better control the quality and cost of supply in the fresh food segment, a trend that will continue to pressure that value proposition offered by traditional wholesale markets in major centres.
- While fresh horticulture markets retain a vital role in the supply chain, poor visibility of market conditions and an ongoing function as clearers of available produce supply contribute to volatile retail pricing and poor signals to suppliers and retailers.
- Where available, increased focus is being given to the growth opportunities in food service and convenience channels as lifestyles continue to bring changes in consumer preference.

Objective 1: Retail – farmgate price comparisons

In core grocery lines, the work has found that simple comparisons of farmgate and retail prices are often simplistic and misleading. Across the food groups analysed, a range of different factors are behind what is seemingly an increasing gap between farmgate and retail prices, and behind claims of a higher share of prices paid at the checkout flowing to the retailer.

Agricultural goods which are non-perishable, undifferentiated and internationally traded have their prices effectively determined by international markets irrespective of domestic post-farmgate 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. What happens beyond the farmgate is essentially irrelevant to a farmer's ability to extract price gains.

The services sector typically has relatively high labour and employment costs which usually rise in line with the general productivity growth of an economy, which in turn generally exceeds inflation.

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.

This further explains why the value of raw commodities, over time, has tended to represent an increasingly smaller component of the sale price of food products, despite competition at all levels of the chain.

But these core or staple products are not the only story of the food sector. These have been selected for analysis by this study due to their significance to relevant industry output and the availability of data regarding prices and costs.

In product areas where greater unit sales value is extracted from the primary food, scope exists for a greater share of margins to accrue to the manufacturer and producer from value-adding activities. Their respective success in achieving that outcome depends upon individual corporate and industry strategy and the quality of information regarding such an opportunity.

Objective 2: Factors determining prices

Pages 6 and 7 provide a summary of the key determinants of prices at key price points across a range of food product groups.

The detailed document has mapped the value chains of such product groups and explored the factors determining prices under a set of headings. This has taken account of the factors that generally govern price setting and competition, which include:

- supply and demand conditions;

- the influence of trade;
- the nature and extent of integration through the value chain between producer and consumer;
- the use of technology and innovation; and
- product competition from direct and substitute sources.

The study recognises each relevant industry's ultimate end-use or market destination of the primary product and the structure of relationships in the value chains. The study also identifies the drivers of performance of major retail chains, the dynamics of relevant consumer markets and the broad set of strategic and category management considerations that affect retail prices in the food store.

Objective 3: Performance of food companies

While a large number of food manufacturers are small private businesses, with their greatest presence in fresh and chilled grocery products, nearly half the total value of grocery sales in supermarkets is attributable to the top 20 companies. Any analysis of the performance of food companies must recognise that many major food businesses are now fully integrated into global operations of major multinational corporations.

A highly competitive retail sector combined with the strong presence of national and international brands has resulted in a low margin, by world standards, grocery sector operating on less than 4 per cent earnings before interest and tax (EBIT).

In Australia, supermarket costs of doing business represent around 22 per cent, whereas United States and European grocery retail leaders operate in the range of 16–20 per cent. While headline sales revenue essentially tracks economic growth rates of around 3–4 per cent 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.

The food business retail model has allowed savings to be passed to consumers thus maintaining the price competitiveness of the major chains and increasing turnover, which in turn further lowers the costs of doing business by spreading fixed store and management costs over a broader sales base.

Despite the context of a highly competitive domestic retail sector, the analysis concludes that the financial performance of Australian-based food companies is not substantially out of step with the performance of international firms or comparable businesses in foreign markets.

Consolidation in food manufacturing and brand ownership has enabled local companies to keep pace with key indicators. Yet the small size and maturity of many segments of the domestic market are limitations on sustaining growth.

In the future, the medium-term impact of an 'every day low prices' culture, and implementation of factory gate pricing by retailers may alter this view, as the scope for price increases and economies in logistics may be less abundant for manufacturers and brand managers.

Several industry sectors are dominated by integrated supplier-owned cooperatives – with several different business models apparent in terms of the extent to which they have engaged in consumer brand management as well as product conversion and manufacture.

The limited scope for access to equity capital needed to underpin strategic business development is a concern across several industry sectors and will limit producer participation in gains from value-adding.

Issues arising from the analysis

There are a number of matters that arise from the study of pricing as outlined above. These are outlined in the following pages and section 6 of this report. They deal with:

- the nature and quality of information in the food industry and the scope for greater knowledge management to enhance the understanding of the factors affecting prices;

- assertions as to market power in the food sector;
- the nature and scope of value-adding in the food sector and the impact that such activities are having on food pricing and returns to each part of the industry; and
- adjustment by parts of specific industries to ongoing changes in market conditions.

Information and knowledge

It is not possible to make valid assertions about the nature, cause and real size of the margin between retail and farmgate prices without reliable information and relevant analysis.

In general, whilst the quality of information useful for a study such as this varies across sectors of the food industry, the study has found a poor state of information relevant to a study of prices through value chains. While food and primary agricultural sectors have increased the specialisation and sophistication of their investments in product and market R&D in recent years, there has been limited investment by most industries in knowledge management and intelligence.

The intensity of domestic competition and the consolidation of food supply contribute to this.

The highly contested nature of the food sector, which manifests itself in aggressive buying practices at wholesale level, has created an atmosphere where suppliers are fearful of giving information away that exposes their underlying costs and margins, or gives a competitor an advantage. The push by retail buyers to identify and share in product cost savings creates an equally strong reluctance by food companies to participate in studies such as this or to ensure greater transparency for the sake of enhancing supplier knowledge.

In general terms the state of industry information that is available in the primary food industries relevant to the lines chosen for analysis in this study is of limited decision-making value. It is invariably the case however that those suppliers who make the investment in knowledge and relationships are well aware of market realities – creating premiums over the average.

Visibility

The lack of visibility of market conditions is a key inhibitor in further development of fresh food supply chains where central markets play a key role. Despite the increasing role that direct supply has for major retailers, fresh wholesale markets will continue to play a central role in enabling buyers to manage quality, volume and price risk.

A great deal of attention has been given to the issues of fresh horticulture markets; much of the information is anecdotal. These markets operate with limited visibility which prevents producer, retailer and wholesaler from optimising value from a matching of supply to demand. Poor industry information (as to prices, demand and supply volumes) and a cash-only mentality among many buyers and agents undermine attempts to improve their functionality. Better price signals and educating growers on meeting consumer demand for produce would provide scope to increase the reward for quality and production to market requirement, and the opportunity for several sectors to increase their value.

Such markets will remain dysfunctional and volatile, structured to clear supply rather than match consumer demand. Without change, they will remain places where the ill-informed will continue to be disadvantaged.

Industry must weigh up the pros and cons of investments in better information systems and transaction tracking to overcome these concerns, as there is little role for external intervention beyond mechanisms such as the Retail Grocery Industry Code of Contact and Ombudsman.

Market power

The existence of brand and market power at all levels, but particularly among major manufacturers, distributors and retailers, suggests that one or more sectors or major industry participants may have market power over others. We have analysed the conditions that give rise to market power in a value chain and embellished a list of determinants based on the work done in the study.

These factors may be useful in helping explain and educate suppliers about conditions that give rise to market power and factors that can be used to balance such power.

Value-adding

The retail sector provides tight time windows and highly contestable access to shelf space for new product opportunities. Yet there is significant activity across the food sector focused on innovating for differentiation and extracting better value out of product and proprietary brand extensions. The nature of this domestic marketplace means that food companies must continue to innovate and operate at high efficiency in order to achieve income growth. Fluctuating dynamics of international markets add to that complexity.

Value-adding is a much misused and abused term, meaning many different things to different people. This report has attempted to describe the nature and extent of some of the value-adding activities across the food categories examined in this study. Creating advantage and differentiation in the domestic food sector is difficult – the costs of getting new products on the shelf with sufficient critical mass of market, in the face of tightening margins in commodity lines that have been the backbone of industry development, are the food industry's greatest challenge. The strong 'every day low prices' thrust and the drive for cost reduction in the logistics chain increase the importance of relevant investments in commercialising food industry research, product development and marketing initiatives for our domestically based food companies.

It is not possible to disclose the sharing of the costs and benefits of value-adding that puts new and innovative products on the shelf. Commercial sensitivity prevents disclosure of the returns in the way that has been possible for core grocery lines.

Gains are being shared by those who add the value and who can ensure that differentiation has lasting effect.

In primary industry sectors where supplier integration takes the form of cooperatives or similar corporate models, the producer price shares in those gains only through an ability for the returns from value-adding to offset or partially offset the reduced terms of trade in commodity lines.

Adjustment

The study highlights some key areas where industry adjustment is going on and where pricing through the value chain has gained added complexity in recent times. Primary producers perceive that the cost of adjustment is not being recognised in an adequate return. The report has sought to explain apparent inconsistencies between returns to suppliers and the final retail value.

Examples of these forces are as follows, with a full summary of drivers of prices on the following pages:

- The coincidence of poor world markets and severe drought has recently eroded returns to the total dairy industry. The world market for dairy products remains a driver of returns to the sector in the long term. In recent years, the share of margins in fresh whole milk products has changed substantially, reflecting the role of such products in the domestic retail market.
- In the egg industry, animal welfare requirements for cage egg production drive significant re-investment. Uncertainty as to adoption of requirements by 2008 will cause volatility in pricing. The industry is experiencing a reduction in returns from the supermarket sector as it competes more effectively with the box market whilst cost factors increase with new regulation and feed security.
- With greater fresh produce volumes being purchased by retailers directly, greater pressure will be placed on sectors of industry which do not enhance their product and varietal, differentiation, information and supply management systems.
- Whilst strong export factors drive farmgate prices in beef and lamb sectors, the pork industry faces pressure from the effect of strong import competition in commodity use of meat and from the cost of feed grain. Pork faces a challenge to reposition its value proposition to the consumer and to develop more integrated value chains that enable maximisation of carcass returns.

Overview – main drivers of prices in the chain

	Farmgate price	Wholesale price	Retail price
Packaged milk	Varies with location. Strongly influenced by average industry returns to major production regions of the industry; performance of dairy cooperatives in overall business activities; and suitable margins to encourage stable year-round supplies.	Competitive bargaining for share of chain retail market (private label and branded) – range, brands, volume costs. In less competitive channels and products, suitable margin over costs, with reference to competing products.	Average target margin over cost remaining competitive with alternate retail channels. Retail prices constrained by competition between major chains, independents and new international entrants.
Cheddar cheese	Average returns to major production regions from the mix of domestic and export sales overlaid by the ability of cooperatives to achieve an efficient return on their overall activities.	Competitive bargaining for share of chain retail market (private label and branded), strongly influenced by import parity price of cheese. In less competitive areas and products, suitable margin over costs.	Target margin over cost balanced across the cheese category between bulk and specialist products. Regular discounting sustains turnover volumes. Retail prices constrained by competition between major chains, independents and new international entrants.
Dairy spreads	Average returns to major production regions from the mix of domestic and export sales, over-laid by the ability of cooperatives to achieve an efficient return on their overall activities.	Competitive bargaining for share of chain retail market (private label and branded) strongly influenced by import parity price of butter.	Competitive pricing with alternate vegetable oil-based spreads. Retail prices constrained by competition between major chains, independents and new international entrants.
Beef products	Prevailing average return to industry based on mix of export and domestic market returns.	Competitive pricing against other white and red meat categories, with differentiation according to eating quality. Integrated supply chains with retailers reduce price volatility and stabilise returns to growers.	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).
Lamb products	Prevailing average return to industry based on mix of export and domestic market returns.	Competitive pricing against other white and red meat categories, with differentiation according to eating quality. Integrated supply chains with retailers reduce price volatility and stabilise returns to growers.	Competitive pricing to position cuts in the category against other white and red meat lines. Differentiation through different cuts, eating quality and packaging.
Pork products	Prevailing average return to industry based on mix of export and domestic market returns. Strong influence by seasonal returns which are affected by prevalence of imported product into lower end of processed meat market.	Strongly influenced by end use of cut and its retail positioning. Increasing effect on carcass returns from divergent needs of export and domestic markets in terms of carcass size and quality.	Competitive pricing to position cuts in the category against other white and red meat lines.
Fresh fruit and vegetables	Prevailing balance of supply and demand of fresh produce at the time of marketing. Returns variable depending on use of direct supply to major purchasers or dependence on wholesale markets.	Prevailing balance of supply and demand of fresh produce at the time of marketing enhanced by ineffective transparency at certain stages (including packing and wholesaling). Integrated supply chains with retailers reduce price volatility and increase returns to growers.	Prices set to provide target margin over full costs of produce category. Strong influence of perceived price-sensitive points to consumers, with periodic fluctuation according to fruit availability and quality.

	Farmgate price	Wholesale price	Retail price
Processed frozen potatoes and vegetables	Affordable price to the processor, influenced by contractual incentives for season, quality, consistency and variety.	Competitive pricing from other sources of supply including generic imported products.	Target margin over costs influenced by prices of competing meal choices, existing competition and new international entrants.
Fresh citrus products	Prevailing balance of supply and demand of fresh produce at the time of marketing and, in turn, the absorption of fruit by export and processing markets.	Prevailing balance of supply and demand of fresh produce at the time of marketing enhanced by ineffective transparency at certain stages (including packing and wholesaling).	Strong influence of perceived price-sensitive points to consumers, with periodic fluctuation according to fruit availability and quality.
Fresh citrus juices	Available fresh supplies of fruit and prevailing frozen orange juice concentrate prices to processors.	Margin over processing costs influenced by input pricing available to frozen orange juice concentrate processors (that is, world price of frozen orange juice concentrate).	Strong influence of perceived price-sensitive points to consumers, taking strong account of competitive pricing of other fresh beverages, waters and carbonated drinks.
Flour products	Prevailing world commodity prices for grains.	Suitable margin over cost.	Target margin over cost with retail prices constrained by competition between major chains, independents and new international entrants.
Margarine and cooking oils	Prevailing world commodity prices for oilseeds and alternate grain commodities.	Suitable margin over cost influenced by import parity prices for oils.	Pricing sensitive to changing consumer tastes. Influenced by pricing of competing spreads with suitable margin over costs.
Eggs	Prevailing balance of supply and demand of fresh produce at the time of marketing.	Prevailing balance of supply and demand of fresh produce at the time of marketing strongly influenced by price competition in alternate market channels.	Target margin over costs with a strong watch on competitive pricing against other retail outlets, including box market channels and international entrants.
Refined sugar	Prevailing world price for sugar – effectively set by prevailing European Union and United States subsidies and production levels in Brazil, the major exporting industry.	Import parity price for raw and processed sugars.	Target margin over costs – little direct product competition in a static market, but prices restrained by competition for majors from international entrants.
Packet rice	Average returns to major production regions from the mix of domestic and export sales, overlaid by the ability of the major cooperative to achieve an efficient return on its overall activities.	Suitable margin over cost influenced by import parity price for finished product.	Target margin over costs with a strong watch on competitive pricing of other substitute products including pastas.