Coles Myer Ltd.

25 August 2005

Terry Sheales
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Agriculture and Food Policy Reference Group
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Dear Terry,

Coles Myer Submission

Our apologies for the delay in getting this to you. Thanks for your patience.

We have restricted our comments to *Parts B (3&4), C (5, & 9) and E (11).* This reflects our lack of expertise of other aspects of the Review while hopefully addressing issues being considered by the Group relating to food retailing.

Should you have any questions please feel free to call me on (03) 9829 4141.

Regards

Chris Mara
Adviser, Government Affairs

B. Markets for agriculture and food

International

Coles Myer does not have any international retail outlets but it does purchase approximately 3 per cent of fresh produce and 15 per cent of general groceries from international suppliers. Coles' policy is to always purchase Australian products where quality, quantity and competitive price allow.

Australia is one of the few countries in the world that can feed itself and have enough surplus to sell in overseas markets. In fact Australia sells some two thirds of the food it produces into world markets. Australia is one of the largest exporters of primary produce in the world and is a major international player in key markets such as dairy, meat and grains[1].

Therefore, it is not surprising that Australian supermarkets, including Coles, sell mostly Australian grown fresh produce. In Coles' case this is greater than 95 per cent. This is significantly higher than many OECD countries, where there are substantial imports of fresh as well as packaged food.

Of all the groceries sold in Coles supermarkets, over 85% are Australian made or produced. While lower than fresh produce, this is not surprising given consumers' preference and loyalty for particular types of imported food items.

This preference reflects, for example, Australia's European heritage where consumer fondness for canned Italian tomatoes and sauces, Greek olives and spreads and English jams and cheeses is well documented. These preferences have spawned many Australian made reproductions.

The more recent arrival of Asian migrants has seen Australians embrace foods originating in this region to the extent that Coles sells many fresh, Australian grown, Asian vegetables as well as the imported specialty groceries that our customers want.

Seasonal availability is also a factor, such as when Australian produce is in short supply due to climatic conditions or there are gaps between the various growing areas across the country. There are also some specialty fresh produce that Australian farmers do not grow or that are grown in insufficient quantities to meet the needs of all our stores.

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[1] Australian Food Statistics 2004 – Australian Government Department of Agriculture, Fisheries & Forestry

Domestic
Consumers' choice in purchasing grocery products is a complex one. It includes elements of branding (and marketing), quality and value characteristics relative to competing offers. Changing tastes, trends and even fashions in cooking also influences such decisions.

Currently Coles' fresh produce purchases exceed $4 billion per annum. Coles' purchase of fresh produce from Australian based suppliers is unlikely to vary significantly in the future because of our Australian purchasing policy, the competitiveness (given transportation costs), freshness and quality of Australian grown fresh produce relative to fresh imports.

Coles' purchase of processed and packaged groceries from Australian based suppliers is also unlikely to change significantly, although some categories may see increases in import content depending on factors such as the exchange rate and the relative competitiveness of imports in particular categories.

Coles' policy is to always purchase Australian products where quality, quantity and competitive price allow.

Coles' purchase of fresh produce from Australian based suppliers, currently over $4 billion per annum, is unlikely to significantly change in the future

C. Competitiveness of Australian Agriculture Food businesses

Supply chains
National (and international) brands represent over 75 per cent of most category sales (other than fresh) by volume and over 50 per cent of these groceries are supplied by around 20 suppliers, mainly household brand names owned by international food companies. House branded groceries, such as Coles' own brands, make up the remainder. Coles' policy in developing and purchasing its house brands is to seek Australian suppliers first where quality, quantity and competitive price allow. More than half of Coles' own brands are currently Australian sourced.

Coles has increased the number of direct relationships with Australian agricultural producers in the last decade, a trend well established in the meat sector and one that is increasing in the horticulture sector.

Colestock supply chain
Coles aims to provide the best quality beef, lamb and pork to our customers all year round. Coles is a relatively small purchaser of Australian livestock (around six per cent of total production[2]) and was subject to supply constraints in the early 1990s due to the attractiveness of overseas markets.

[2] Australia slaughtered 8.7 million beef cattle and 27 million sheep/lambs and live exported over 4 million head of cattle/sheep in 2004

As a result, Coles established a group of dedicated graziers to provide a reliable supply of top quality meat. Colestock was established in 1998 and there are now over 1000 Colestock graziers around Australia growing prime quality meat for Coles.

Colestock producers provide Coles with:

- Guaranteed access to Australia's highest quality livestock
- High standard of food safety and traceability along the entire supply chain
- Consumer driven quality and product preferences
- *Livestock Production Assurance Program*

Coles provides Colestock producers with benefits that include:

- Long term business partnership with Coles
- Costs and producer margins that are agreed up front providing producers with stable and mutually agreed prices
- Surety of payment and consistent pricing based on agreed quality and meat specifications
- Both parties share market information with each other

Over 75% of Coles meat[3] is supplied by Colestock[4] producers, consisting of hundreds of dedicated graziers providing prime quality meat via a supply chain that has traceability from paddock to plate.

Farmgate prices v retail prices

Some mistakenly believe that the retail price per kilogram of meat should be similar to the farm gate price per kilo. Such a view fails to take into account complex activities required to turn a live animal into saleable meat. For example removing the hide and de-boning reduces the saleable weight by nearly two thirds. Some meat cuts are also more valued than others or represent a small proportion of any carcass weight. The table at Attachment 1 shows the various stages of meat production (beef in this case) and the cost impacts on the price per kilo of meat.

Relationships in the supply chain

The key outcomes of various parliamentary reviews on retailing and the farm sector over the last decade have been recommendations for changes to processes to clarify relationships between firms along the supply chain and to the detail of some parts of the TPA. In particular:

- streamlined and simpler collective bargaining for small businesses like farmers under the Trade Practices Act (TPA);
- changes to s46, the misuse of market power section, of the TPA are expected to be part of the current reform program;

[3] Up to 25% of Coles' fresh meat is, depending on seasonality, purchased via saleyards and/or as boxed cuts of saleable meat. This varies according to type – lamb, beef & pork.
[4] Over 1,000 Colestock producers of lamb, pork and beef are located across SA, Victoria, Tasmania, NSW and Queensland. In the eight years this supply chain has been operating no Colestock producer has left the supply chain.

- establishment of the Retail Grocery Code of Conduct and Ombudsman Scheme (now called the Produce and Grocery Industry Code);
- the establishment of a mandatory Horticultural Code of Conduct;

Although incremental, the changes to the TPA currently and prospectively before the Commonwealth Parliament have the potential to substantially change the relationships between parties along the food supply chain. As long as there is no new evidence of major structural sources of market failure along that chain, we believe it would be inappropriate to add to the changes that have already emerged from recent reviews.

Market power

Supermarket retailing is a low margin, high volume business model that requires scale to be effective in delivering a wide range of food and groceries to consumers across a vast landmass at the lowest possible retail prices.

The level of supermarket concentration in Australia is similar to that of other countries and regions of large countries elsewhere, for example the Netherlands, Canada and regions of the United States such as Florida and California[5]. Population is the main determinant of the number of supermarket chain competitors in a country or region along with the geographical density and distribution of the population[6].

Consolidation is occurring in most industries all over the world. It is occurring throughout the food supply chain, not just in retail. It is driven by the desire to achieve greater efficiencies brought about by economies of scale, technological advancement, innovation and reinforced by international economic trends.

A clear indicator of an efficient market is the ability of new entrants, like franchises, to capture market share from larger rivals. Retailing has relatively low barriers to entry and exit compared to other industries. This, according to Access Economics[7], "…*suggests that retailing is in reality likely to be more competitive than other industries with comparable levels of concentration*."

In Australian markets the arrival and expansion of the German retailer Aldi has seen it open 100 stores in four years and already gain five per cent of the NSW market[8]. The South African Pick 'N' Pay, trading as *Franklins* with 60 stores, is another example of new entrants in the last five years. Similarly the independent sector has seen market share gains for Metcash[9] supplied IGA (Independent Grocers of Australia) stores and FAL supplied food retailers such as Action, Dewson's and SupaValu in WA.

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[5] Access Economics: Update on the State of the Food & Grocery Market September 2003 p 39-40

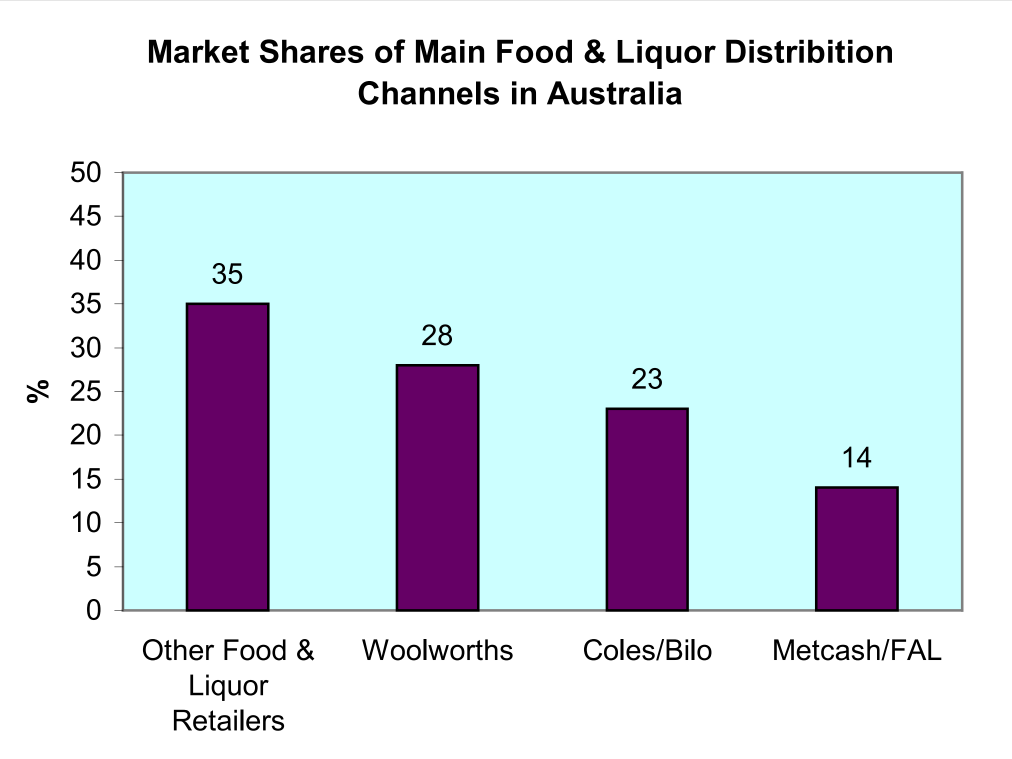
[6] Report by ACCESS ECONOMICS for Coles Myer to the *Senate Economic Reference Committee* into the *Effectiveness of the Trade Practices Act 1974 in Protecting Small Business*: 2003 p 37

[7] Access Economics: Submission to the Joint Select Committee on the Retailing Sector 1999, page 24

[8] Sydney Morning Herald 27 July 2005 page 21

[9] "Grocer Metcash Champions IGAs", Australian Financial Review, 15 July 2005, pg 63

The market shares[10] of the various participants in the food and liquor market in Australia are illustrated below:



Australian supermarket retailing is an excellent example of a dynamic and vigorous commercial environment - characterised by intense, high quality competition amongst chain supermarkets as well as numerous specialty and small food stores.

There are over 100,000 retailers in Australia and of those, 30,000 are food retailers – 96 per cent of these are small businesses. There is the same number of small retail businesses per head of population today as there was 30 years ago.

Quality competition results in retail margins being the lowest of all industry sectors in Australia.

Prices & profitability

Australian supermarkets make less profit per item than supermarket chains in other developed countries. For example our profit margin averages 3.7 per cent (or 3.7 cents in the dollar). In the UK profit margins of the major chains range from 6 to 9 per cent. In the US they range from 5 to 7.5 per cent. In the EU the range is between 4 and 6 per cent[11].

[10] Source: published results of public companies CML/WoW/Metcash/FAL plus ABS data on liquor, specialty foods, and takeaway foods. Other food retailers such as ALDI and convenience stores are estimates. Total food & liquor market is just over $80 billion using third quarter figures from 2005.
[11] Report by ACCESS ECONOMICS for Coles Myer to the *Senate Economic Reference Committee* into the *Effectiveness of the Trade Practices Act 1974 in Protecting Small Business*: 2003 p 37

The consumer is the main beneficiary of these dynamics with Australians enjoying food prices that are low by OECD[12] measures and have fallen, in real terms, by over 25 per cent over the past 30 years[13].

According to market analysts AC Neilsen[14]: ***"****In the supermarket, high levels of price discounting makes the Australian grocery shopping basket amongst the cheapest in the western world".*

Scale efficiencies of large supermarket chains and the intensity and quality of the competition are fundamental to achieving low food prices for all Australians.

Changes to the Trade Practices Act
There have been several recent Federal Inquiries into the operation of the Trade Practices Act. In summary these Inquiries rejected:

- A cap on market share of major companies
- Divestiture orders for firms over a certain size or for breaches of S.46
- An effects test in S.46 to establish predatory pricing

These suggestions were rejected on the basis that they are unworkable and would have unintended consequences for other industries and the broader economy.

- In addition the Dawson *Review of the Competition Provisions of the Trade Practices Act 1974,* warned that:

> *"The competition provisions should protect the competitive process rather than particular competitors. They should not be seen as a means of achieving social outcomes unrelated to the encouragement of competition or as a means of preserving corporations that are not able to withstand competitive forces. Competition regulation should be distinguished from industry policy."*

Whilst the Reference Group is likely to hear requests for further changes, we caution against such recommendations. The Federal Government is currently in the process of introducing legislation to strengthen S.46, the misuse of market power section of the Trade Practices Act, and introduce other changes stemming from recommendations emerging from recent inquiries. It would be premature to make further suggestions until these changes have been introduced and tested at law.

[12] **OECD** *Main Economic Indicators* Volume 2004/8; comparative shopping costs show Australia is ranked 18th out of 22 OECD countries, ie: the lowest cost quartile of shopping costs in the OECD
[13] Jim Lang & Associates analysis comparing after tax earnings with average prices of fifteen staple food items from ABS sample of food price CPI.
[14] [14] AC Nielsen Website June 2005

Whilst the Reference Group is likely to hear requests for further changes to the Trade Practices Act, Coles cautions against such recommendations given pending changes before the Commonwealth Parliament.

Bio-security & Quarantine

Coles Myer supports the retention of stringent bio-security and quarantine services to protect Australian agriculture. We do so because the 13 million customers we serve each week in our stores expect *total* food safety of the products we sell be they fresh fruit and vegetables, meat or imported produce.

If there were to be an outbreak of an animal disease such as foot and mouth, it is critical that the meat supply chain, for example, can have full traceability of livestock from paddock to processing plant. Vigilance is always needed of imported foodstuffs, particularly of fresh products, to ensure consumer trust is not undermined and the supply and distribution channels for foodstuffs are not unnecessarily compromised or shut down by inadequate safeguards.

Coles' supports world-class quarantine and bio-security protocols that are science based risk assessments that focus on prevention (precautionary principle) of threats to Australia's food supply chain.

A domestic trading protocol contingency plan should be developed as part of a broader food industry bio security plan.

Part E. Rural businesses and regional communities

Coles Myer footprint

Coles Myer has over 2,500 retail outlets and 180,000 team members in Australia, a third of which are located in regional centres and areas of Australia. While a number of service providers, both public and private, have rationalised their presence in these areas over the last 20 years Coles Myer has continued to invest in new stores and more recently announced a series of new Distribution Centres nationally, several of which are to be located in regional centres. The most recent example being in Goulburn, NSW.

Coles continues to invest in regional centres and support rural businesses through purchases of fresh produce and services to support Coles network of stores across Australia

Meat value chain (Beef)

Transforming a live animal into meat for retail sale reduces the saleable weight of the animal (de-boning, hides etc) by nearly two thirds. It also involves substantial processing and labour inputs before the meat is ready for human consumption. This transformation is outlined below and highlights the price per kilo of meat from farm gate to supermarket shelf.

	Activities and cost	***Kg of useable meat***	***Whole beast price***	***Price per kilo***
1. Farm Gate	• Stock and grazing • Land and labour	410kg	$799	$1.95
2. Freight	• At $21 per head		$820	
3. Hide credit	• At $55 per head		$765	
4. Processing	• Kill • Processing/boning into primals/packaging • Holding for ageing – chiller (approx 2 weeks)	223kg 65.33% 147kg	$920	$6.26
5. Distribution	• Transport and distribution costs at 10c per kg	147kg	$935	$6.36
6. Retail	• Slicing and trimming of primals • Packaging • Labour • Shrinkage • Promotion and advertising • Store costs • Retail margin	147kg	$1,438	$9.78

It's journey from paddock to supermarket shelf the saleable weight of available meat reduces by 65%. The added value and cost of transforming the meat increases the price per kilo by 80%. The opposite direction of these two variables accounts for the difference in per kilo price between the farm gate and retail price. The average price per kilogram to the consumer is $9.78. Coles margin after costs is around 3.5% or 3.5 cents in the dollar.

The farm gate price can vary significantly during any given period depending on seasonal conditions, international trade and input costs such as feed and fuel.