

The Impact of Two-Priced Cheese on Canada's Pizza Market

Spring 2003

Executive Summary

Under Canada's supply management system, the price and supply of dairy products, such as cheese used on pizza, are tightly controlled by the dairy industry.

In 1995, in response to Canada's commitments under the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO) the federal government introduced Class 5a milk pricing to enable frozen pizza manufacturers to purchase Canadian cheese at lower American prices. This program replaced earlier ones designed to encourage the use of Canadian dairy ingredients in domestic further processing activities and ensure ingredients were available at competitive prices.

With a discounted price on cheese, Canadian frozen pizza manufacturers could better compete with frozen pizza producers in the NAFTA market.

While frozen pizza manufacturers were granted a price discount on Canadian cheese, pizza restaurant operators were not. As a result, Canadian pizza restaurant operators are forced to pay the domestic price for cheese, which is currently about 30% higher than the Class 5a price paid by frozen pizza manufacturers.

This price discrimination exists because current dairy policy arbitrarily differentiates between a frozen product and a fresh product. As the evidence will show, the consumer does not make this distinction. On a daily basis, pizza operators are competing head-to-head with frozen pizza manufacturers for market share.

Supported by the dramatic cost advantage created by the 5a discount on cheese, frozen pizza manufacturers are aggressively marketing new products that are capturing market share from pizza restaurant operators. This price discrimination is costing Canada's 7,500 pizzerias millions of dollars every year in lost business.



Canadian Restaurant
and Foodservices
Association

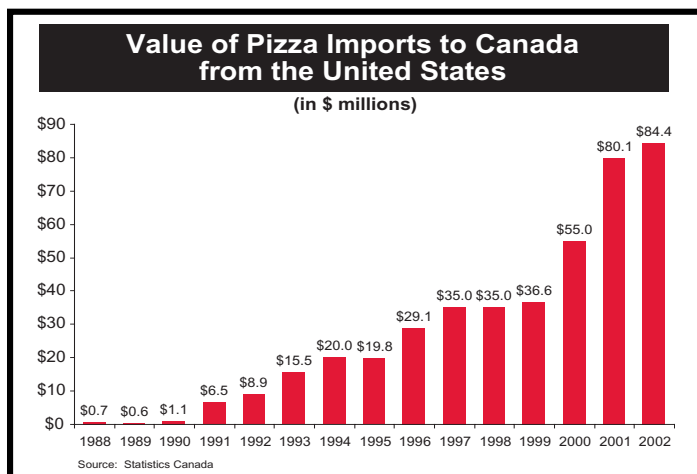
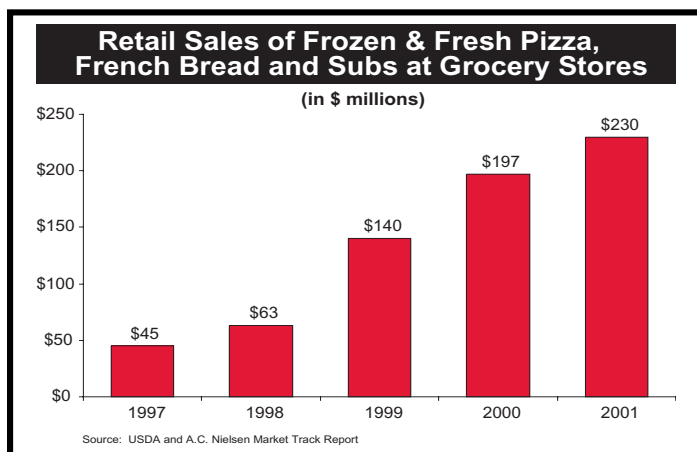
Association canadienne
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Frozen Pizza Manufacturers

In the 1980s, the market for frozen pizza was minimal. Poor quality relative to fresh pizza and a 17.5% tariff on U.S. imports restrained market expansion.

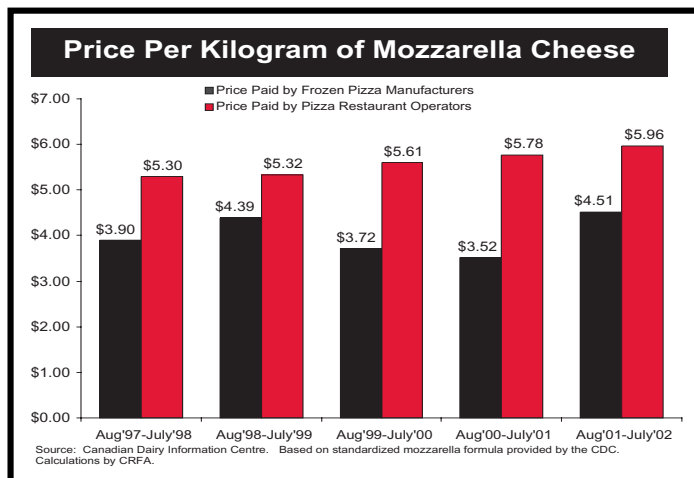
During the 1990s consumer demand for convenient meals led to improved quality and acceptance of frozen pizza. To take advantage of this new market, both U.S. and Canadian frozen pizza manufacturers made sizeable investments to gain market share at the expense of the restaurant fresh-pizza market. Innovation in food technology has vastly improved the taste and quality of frozen pizzas in recent years.¹ There are a growing number of frozen pizzas on the market today to satisfy the tastes of Canadians, from rising-crust to thin-crust, with a variety of toppings and flavours. These efforts have paid off.

Sales of Canadian and American frozen pizza and fresh pizza (combined with the smaller segments of french bread and subs) at Canada's grocery stores grew more than 410% between 1997 and 2001, from \$45 million to \$230 million.² This category now accounts for 17% of total frozen prepared food sales in Canada — double the market share it had in 1997. Frozen pizza is, and has been, the leading frozen food in Canada in terms of growth.³



With the signing of the Free Trade Agreement and steady improvements in product quality, the value of U.S. frozen pizza imports has skyrocketed from \$708,000 in 1988 to \$84 million in 2002.⁴

While improved quality and the growing demand for convenient meals led to consumer acceptance of frozen pizza, it is lower input costs that give frozen pizza manufacturers a decided advantage over restaurant pizza. Without access to 5a permits, pizza restaurant operators paid 32% more in 2001-02 for mozzarella cheese than frozen pizza manufacturers — their closest competitors.



The advertising materials of Canadian producers of frozen pizza sold in retail stores directly target the home delivery and take-out customers of Canadian pizza restaurants. As reported in the Globe and Mail:

The frozen product has gotten better in recent years as manufacturers employ new packaging technologies that allow them to use better toppings and dough that rises in the consumers' oven. In fact, the latest ad campaign by McCain Foods Ltd. of Florenceville, N.B. for its Rising Crust pizza is based on the premise that guests can be fooled into thinking it came from a pizzeria.⁵

The slogan for McCain's Rising Crust Pizza asks 'who can tell it from take out?' The packaging further states 'Pizzeria style pizza with the convenience of cooking it right in your own kitchen.' Another frozen pizza manufacturer states: 'It's not take out, it's Delisio'. According to a Kraft manager in the U.S.:

Digiorno was developed and marketed to compete with take-out pizza and not with frozen pizza brands that were already on the market.⁶

Pizza remains a popular food among Canadians. Based on the above, both frozen pizza manufacturers and pizza restaurant operators are targeting the same market. Despite product similarity and the fact that both products are competing in the same market, restaurant operators pay more for the principal ingredient of mozzarella cheese. With this extreme price advantage, frozen pizza manufacturers have experienced robust growth at the expense of pizza restaurant operators.

1 "Frozen Pizza on the Rise", Consumer Reports, January 2002.

2 "Canada Market Development Reports: An Overview of Selected Segments of The Canadian Frozen Food Industry – 2002", USDA GAIN Report. Data from A.C. Nielsen Market Track Report.

3 Ibid.

4 Statistics Canada

5 "Pizza makers say it's tough to make dough", The Globe and Mail, January 18, 1999.

6 Bronnenberg and Mela, "Market Roll-out and Retail Adoption for New Brands of Non-durable Goods", September, 2002.

Pizza Restaurants

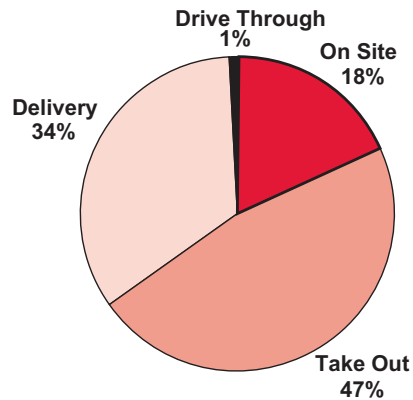
There are approximately 7,500 pizza restaurant operators in Canada. Of these, 47%, or 3,500 are independent pizza restaurants.⁷ Thousands of other foodservice establishments include pizza on their menus, making it the sixth most popular food at restaurants, included in 1 in 10 restaurant meals or snacks.⁸

- In 2002, there were more than 351 million pizza transactions at Canadian restaurants for either on- or off-site consumption.⁹

- The vast majority of restaurant pizza is consumed off site. Fully 82% of restaurant meals or snacks that include pizza are eaten off site compared to 57% of all other restaurant meal and snack occasions.¹⁰
- Delivery accounts for 34% of all pizza meal occasions compared to just 2% of all other restaurant meals.¹¹

Most Restaurant Pizzas are Consumed Off Site

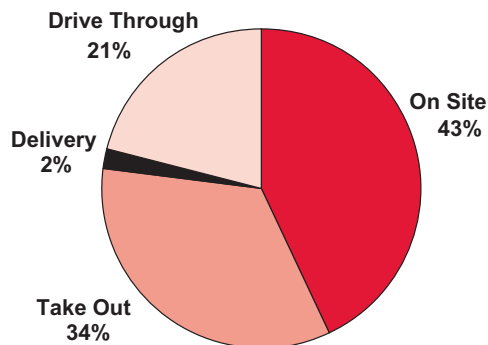
Share of pizza orders by source



Source: CREST/NPD Group Canada Inc. Note: For the 12 months ending November 2002.

Nearly Half of all Other Restaurant Meals are Consumed On Site

Share of restaurant meal orders by source (excluding pizza)



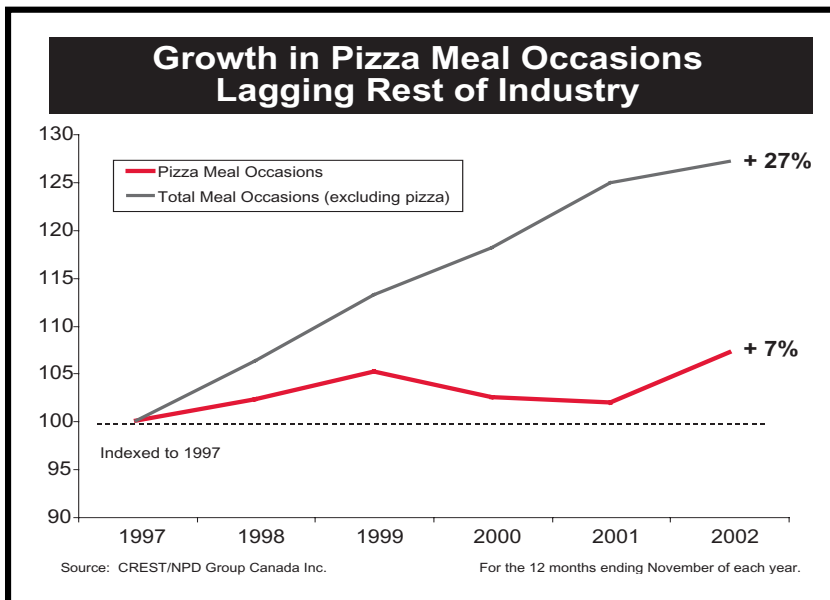
Source: CREST/NPD Group Canada Inc. Note: For the 12 months ending November 2002.

7 ReCount/NPD Group Canada. Based on data for 2001.

8 CREST/NPD Group Canada.

9 - 15 Ibid.

Increasingly, pizza restaurant operators are competing directly with other convenient food products for at-home consumption, particularly prepared frozen meals. The emergence of a quality frozen product at a low price has led consumers to substitute frozen pizza for restaurant pizza.



To compete with frozen pizza manufacturers and provide greater value to consumers, many operators are introducing meal deals, coupons, faster service, greater quality and selection as well as new technology that keeps pizza hot while being delivered.

- Consumers take advantage of a coupon or other special deal for 36.7% of purchases at pizza restaurants, compared to 26.5% of purchases for the average quick-service restaurant.¹²

Despite advances in product development, marketing and technology, pizza restaurant operators have lost market share to frozen pizza manufacturers.

- Between 1997 and 2002, the share of restaurant meal and snack occasions that include a pizza fell from 11.8% to 10.2%.¹³

- While the volume of orders for all other menu items jumped 27.1% between 1997 and 2002, pizza consumption (including individual slices and pizza-stuffed/panzerotti) increased by only 7.1%.¹⁴
- Since 1995, on-site pizza meal occasions (excluding individual slices and pizza-stuffed/panzerotti) have dropped 14%, while telephone delivery orders of pizza averaged just 0.8% annual growth.¹⁵

Cheese accounts for roughly 40% of the cost of a restaurant pizza, making it the most important menu input by far.

Canadian Dairy Policy

The Special Milk Class Permit system was established in 1995 in response to Canada's commitments under the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO). This program replaced earlier ones designed to ensure the use of Canadian dairy ingredients in domestic further processing activities. With Canada's decision to pursue trade liberalization in further processed food, it was considered necessary to create a system that would ensure Canadian further processors were not disadvantaged by higher Canadian dairy prices.

In 1989, frozen pizza manufacturers successfully lobbied for access to lower priced cheese in order to compete with the growing number of frozen pizzas coming from the U.S. under the Canada-U.S. Free Trade Agreement. A study commissioned by the Canadian Dairy Commission found that as "tariffs fall over the next decade, pizza manufacturers [in Canada] will be at a severe competitive disadvantage with imported pizza products due to the higher cost of mozzarella cheese in Canada compared to the United State(sic)."¹⁶

While access to lower priced cheese was granted to frozen pizza manufacturers through Class 5a

permits, fresh pizza makers have been denied access even though a study commissioned by the Canadian Dairy Commission concluded that regardless of the source (restaurant or grocery store) or format (frozen, chilled or fresh), the various products in the pizza market compete with one another.¹⁷

In the spring of 1999, the Canadian Restaurant and Foodservices Association (CRFA) made application to the Canadian Dairy Commission (CDC) and the Canadian Milk Supply Management Committee (CMSMC) for access to special class cheese on behalf of its members. This request was rejected. In 2001, CRFA challenged this decision in the Federal Court. The Federal Court denied jurisdiction over the case. CRFA then turned to the Ontario Divisional Court for relief. In its September 25th decision, the Divisional Court acknowledged that the decision-making body was "greatly self-interested." It went on to rule, however, that the court did not have the jurisdiction to intervene in dairy policy decisions being made in Canada.

Canadian restaurants purchase 70% of the mozzarella cheese produced in Canada.¹⁸ Canadian dairy policy should reflect the needs of its largest customers.

Summary and Conclusion

As a result of Canada's supply management system, Canadian frozen pizza manufacturers are able to purchase mozzarella cheese ingredients at significantly lower prices, thereby creating unfair competition for Canada's fresh pizza makers. This price discount was given to frozen pizza manufacturers even though a study produced for the Canadian Dairy Commission concluded that fresh pizza operators compete head-to-head with frozen pizza manufacturers.

While the market share for restaurant pizza fell from 11.8% to 10.2% of restaurant meals over the past five years, demand for frozen pizza jumped 410%, making it the leading frozen food in Canada in terms of growth, and U.S. frozen pizza imports grew by 141%.

Despite the growing body of evidence proving that fresh and frozen pizza are competing for the same customer, and that fresh pizza cannot compete with frozen pizza manufacturers who access lower-priced ingredients, Canadian pizza restaurants continue to be prevented from obtaining access to Class 5a permits.

16 Comparative Canada – U.S. Frozen Pizza Industry – Cheese Prices, Prepared by A.A. Hunt & Associates for the Canadian Dairy Commission – Dairy Task Force, January 1990.

17 Ibid.

18 National Dairy Council, 1998

About Canada's Foodservice Industry

Canada's foodservice industry represents one of the largest sectors of the economy with sales of \$42.3-billion annually representing 4.2% of GDP. There are more than 63,000 restaurants, caterers and bars, 63.7% of which are independents.

The foodservice industry employs more than one million Canadians, making it one of the largest private sector employers. The industry's workforce represents 6.5% of total employment. A further 235,000 workers are indirectly employed by the industry.

The foodservice industry is also a major source of youth and entry-level jobs, employing 432,000 people between the ages of 15 and 24. This represents 18% of total youth employment in Canada and 43% of the jobs in foodservice.

About the CRFA

Incorporated in 1944, CRFA is the largest hospitality association in Canada, representing 16,500 members. CRFA members include restaurants, quick-service establishments, bars, hotels, caterers, institutions and foodservice suppliers.

CRFA's mission is to create a favourable business environment and deliver tangible value to its members in all sectors of Canada's foodservice industry. CRFA provides a variety of services to members including representation to government, research and information, group buying and national trade shows.

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