

**Submission to
Australian Competition and Consumer Commission**

**~ Inquiry into the Competitiveness of Retail Prices
for Standard Groceries ~**

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**NSW Farmers' Association
Level 25, 66 Goulburn Street
Sydney NSW 2000**

Ph: (02) 8251 1700

Fax: (02) 8251 1750

Email: emailus@nswfarmers.com.au

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Executive Summary

Farmers are key stakeholders in the grocery supply chain producing the primary products used in the development of almost all food stuffs. Farmers are generally price takers, unable to directly pass on increases in input costs, and as such farmers have a strong interest in ensuring transparency through the supply chain.

Some of the key concerns the NSW Farmers' Association has with the supply chain are as also outlined in the National Farmers Federation submission include the retail prices not reflecting the prices paid or the costs of production on farm, the number of different variables and influences in determining the price, and the balance between rationalisation to achieve efficiencies and market power that assert pricing pressures in the supply chain.

The Association notes in the submission that there have been a number of drivers of rising food prices including oil prices, transport costs, increasing demand, and drought. It is important to note that in any comparison between Australia and other OECD countries there are a number of differences in the grocery supply chain including the level of support provided to farmers and these need to be considered in any market comparison.

There have been a number of drivers in changes in the grocery supply chain. Some of these include changes to demands for convenience, ethnic diversity, and consumer preference. The structure of the farming industry has changed little over the last 10 years with the industry dominated by individuals and partnerships. The large number of farmers supplying a smaller number of processors, wholesalers and retailers has an influence on the type of arrangements between buyers and sellers. Farmers generally receive about 20 to 30 percent of the final retail price of the product sold.

There is a degree of implied market power that runs within the grocery supply chain that although it may not be directly visible, it still plays a part in returns and arrangements. Individual farmers have very little ability to negotiate fair contractual arrangements, as their customers often have significant resources and use these to their advantage.

Frustratingly for farmers the dis-association between retail prices and farm costs does not allow the consumer to understand the real cost of production. Farm costs have shown a gradual increase over the last 6 years with a large increase in the 12 months to 2006. This is expected to increase further with large increases in fertiliser and chemical costs in 2007/08. On the other hand however prices received have not increased at the same rate resulting in the continuing decline in the terms of trade for farming. Farmers have little ability to set the price to reflect the cost of production or any intended rate of return.

In the Association's view there is market power in the supply chain and a number of activities exist which demonstrate a unilateral approach to demand supply arrangements in agriculture. The size of the consumer market accessed through the major retailers definitely leads processors, wholesalers and manufacturers to try compete for access to those retailers and therefore drive price and quality back down through the supply chain. As price takers farmers have little alternative but to accept these prices and drive efficiencies and productivity gains to create margins.

1 Introduction

The NSW Farmers' Association (the 'Association') is Australia's largest state farming organisation representing the interests of the majority of commercial farm operations throughout the farming community in NSW. Through its commercial, policy and apolitical lobbying activities it provides a powerful and positive link between farmers, the Government and the general public.

The Association welcomes the opportunity to contribute to the inquiry into the Competitiveness of Retail Prices for Standard Groceries. As one of the key stakeholders in the grocery supply chain and being responsible for the growing of the primary products, agriculture has a great interest in the transparency and efficiency in the supply chain.

There is concern amongst growers that the inquiry may be interpreted to review pricing structures in the supply chain with the intention of promoting lower prices to consumers. The Association is concerned that such intentions would be detrimental to agriculture driving farm gate prices down and compromising the financial stability of the farming sector. The Association is pleased to note the focus on transparency and the role of other parties in the supply chain.

One of the major issues with the supply chain emanates from its disassociation between the retail end of the supply chain and the production costs and activities at the grower level. In the drive to provide consistent prices and products to consumers retailers have isolated out seasonal fluctuations. While this removes the small discrepancies it can also serve to compound the large fluctuations as has been witnessed through recent grocery price rises and supply shortage with drought. The Association would caution however that there are many factors that contribute to the price of goods in the supply chain and a greater transparency would enable these costs to be better understood.

In this submission the Association has attempted to answer a number of questions that have been raised in the issues paper. As a representative body the Association is able to provide information based on members records. Some of these records are confidential and sensitive in nature and as such the Association asks that they not be made available for public disclosure. Where information is confidential it has been marked as such.

Further the information collected represents one aspect of the whole supply chain. While the Association can provide detailed information on the costs and issues currently facing farmers in NSW, the Association can only speculate on costs and issues in other parts of the supply chain. One of the ongoing issues of the farming community is that information on farm costs is readily available having been collected by the Australian Bureau of Statistics, Australian Bureau of Agricultural and Resource Economics, and other bodies. However information on other sections of the supply chain is limited by corporate confidentiality, promoting speculation and concerns regarding transparency.

2 OECD Comparison

Q. 1 *What have been the major causes of rising food prices in Australia (e.g. drought, transport costs, etc.)? In particular, what have been major causes of the rising prices of products such as milk, cheese, bread, fruit and vegetables?*

Farmers operate in an almost perfectly competitive market with a large number of farmers selling generic products with plentiful market information. As such farmers are generally price takers and are not directly able to influence food prices. While there has been a gradual increase in farm costs, particularly in the last 24 months with higher fuel, chemical, and fertiliser prices, together with a shortage of supply due to the drought, these do not necessarily transpose through to higher food prices.

The following are a number of issues that are believed to have contributed to increased food costs although they do not necessarily reflect the same influences that have contributed to higher on farm costs. Each one in themselves may not be the sole cause but combined they are believed to have given rise to higher food prices.

World Oil Prices

Oil is an essential component in many of the packaging and manufacturing processes. Many plastics are based on petrochemicals and oil feedstocks. Energy processes for manufacturing relies on power generated from oil based fuels, and transport of goods relies on fuel. With 45-50 percent of every food dollar spent paying for the processing, packaging, transporting and marketing of food items higher oil prices have the ability to have a large impact on food prices.

Fuel Prices

Residents in rural, remote and regional NSW are particularly aware of the impact of higher oil prices on the cost of transport. On average, NSW country petrol prices are 5.79 percent or 5.2 cents per litre higher than Sydney Metro prices. Freight is typically 1.5 to 3 cents per litre greater for country than city delivery¹. With an increasing amount of Australia's agricultural production being consumed domestically, domestic fuel and transport charges will have a greater influence on prices. Furthermore the impact of higher fuel prices will be influenced by the infrastructure mix used to transport the goods. As investment in rail lines reduces a greater reliance is placed on the less fuel efficient road transport industry.

Increased demand for limited food resources

With world populations increasing and the amount of agricultural land remaining static there is an increased demand for a limited food source. In addition the increasing prosperity of large population countries such as India and China have led to an increase demand for more valuable foods as diets shift away from staples to more luxury items.

Drought

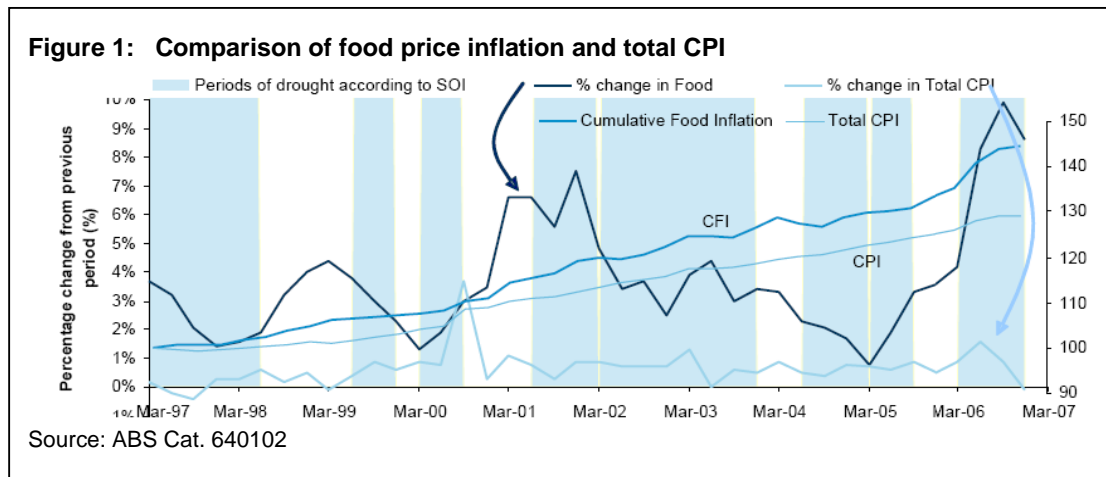
In the natural functions of an equilibrium model, shifts in the supply curve will have a resulting change in prices with demand remaining constant. Naturally a drought impacts on the supply in a number of ways. Firstly for short terms crops a drought will usually result in a loss in production and a sharp contraction in supply. Longer terms crops will have a more gradual impact as growers attempt to protect their asset. Livestock on the other hand have an opposite effect. Livestock producers will usually sell off livestock at the onset of drought, increasing supply in the short term. As the drought breaks graziers will restock and supply becomes short.

¹ Caltex, 'Petrol Pricing - The Plain Facts December 2004', http://www.caltex.com.au/pricing_pla.asp#q10

Despite these natural fluctuations in supply retailers have attempted to smooth the impact of supply shifts by promoting a more constant price. A study carried out by Pricewaterhouse Coopers² observed;

‘That certain approximate periods in which sustained drought conditions have persisted, according to the calculation of negative values for the Southern Oscillation Index (SOI) as measured by the Bureau of Meteorology, coincide with rising food inflation’, (Figure 3). However, there does not appear to be any consistent pattern or correlation between negative SOI values and food inflation.’

Figure 1 demonstrates that since March 2005 food prices have shown a significant increase contribution to CPI increase, which corresponds with the 2005 and 2006 dry periods. However in the early part of 2007 food prices actually showed a decrease despite the ongoing drought conditions. Similarly the period between 2001 and 2004 saw food prices having a smaller inflationary effect despite the corresponding dry period.



Reduced competition in the retail sector

According to the study carried out by Pricewaterhouse Coopers the rate of price increase in food as a whole and in fresh food in particular can be traced to an increasing concentration of the retail grocery market and the vertical integration of fresh food supplies and not necessarily to drought. The report highlights that Woolworths and Coles between them now account for around 80 percent of grocery sales. This has increased from about 35 percent market share in 1975. This degree of market concentration removes effective competition and allows a duopoly to extract higher margins.

Q.2 Do the OECD comparisons accurately reflect the relative rates of food price inflation in Australia and the OECD countries? Are there other more relevant comparisons? Are there a more appropriate set of countries to compare Australia’s food price inflation?

It is not clear from the information provided whether the issue of agricultural subsidies were taken into consideration when comparing the Consumer Price Indices between OECD countries and Australia.

² Pricewaterhouse Coopers 2007, The economic contribution of small to medium-sized grocery retailers to the Australian economy with a particular focus on Western Australia. Report to National Association of Retail Grocers of Australia

While OECD countries provide a reasonable basis for comparison as they broadly are in similar stage of economic development, there are, nevertheless, some important differences among these countries that need to be recognised when making comparisons. More specifically, differences in productivity levels and growth may reflect different resource endowments, different price environments, differences between countries in exploitation of 'catch-up' opportunities, the use of different technologies and differing institutional and regulatory arrangements.

In OECD countries that heavily subsidise their agriculture, any cost of production increases could be diluted by the subsidy whereas in Australia some of it has to be passed on which may have contributed to the higher CPI for food products. Of the 38 member countries that make up the OECD, Australian farmers receive the second lowest levels of subsidies (6 percent), behind New Zealand (1 percent). By comparison, in 2006 American farmers derived on average 11 percent of their annual income from government support, while the OECD average for farm subsidies is 27 percent³.

If OECD consumer price indices comparisons are going to be used in the final report, it is suggested that more information is provided to clarify that the difference in the food price indices between OECD countries and Australia. Comparison of countries is complex as it reflects a number of domestic and international variables including higher fuel costs, lower agricultural subsidies in Australia, climatic conditions, government regulations etc.

³ Organisation for Economic Co-ordination and Development, producer and Consumer Support Estimates Database available from http://www.oecd.org/document/59/0,3343,en_2649_201185_39551355_1_1_1_1,00.html [accessed on 18 March]

3 Structure of the Grocery Industry

Q.3 What have been the major changes to the structure of grocery retailing in Australia over the past 5 to 10 years?

The major change has been the pace at which the retailing sector has evolved. The evolution has been driven both by input factors such as technological developments, and demand factors such as changes in consumer preferences. Some of the factors that have changed the landscape of the Australian retailing sector over the last decade include;

- the entry of foreign players;
- the expansion of retailers into new areas; and
- the use of technology to expand market reach reduces prices (in some instances with home branding and imported products), increase the range of products available to consumers, and improve the convenience by which they can be delivered.

Q.4 What factors have driven these changes (e.g. changes in trading hours, one-stop convenience of supermarket shopping, mergers and acquisitions, etc.)?

Convenience

One of the most important trends that have driven change in the retail sector is the need for products that save time and offer convenience. The pace of life continues to increase and many people struggle to balance a myriad of activities that demand their attention, including work, recreational time, and the children's extra-curricular activities.

The push for decreasing meal preparation time affects participants at every level of the food system. Retailers increasingly sell consumers bundled products that offer meal solutions instead of ingredients scattered across the store. Manufacturers are also responding by developing products that are ready to eat.

Ethnic Diversity

Australia continues to expand its cultural diversity. Australians are increasingly seeking new food dishes and as a result producers, manufacturers and retailers are increasing the range of food items to cater for these changing tastes.

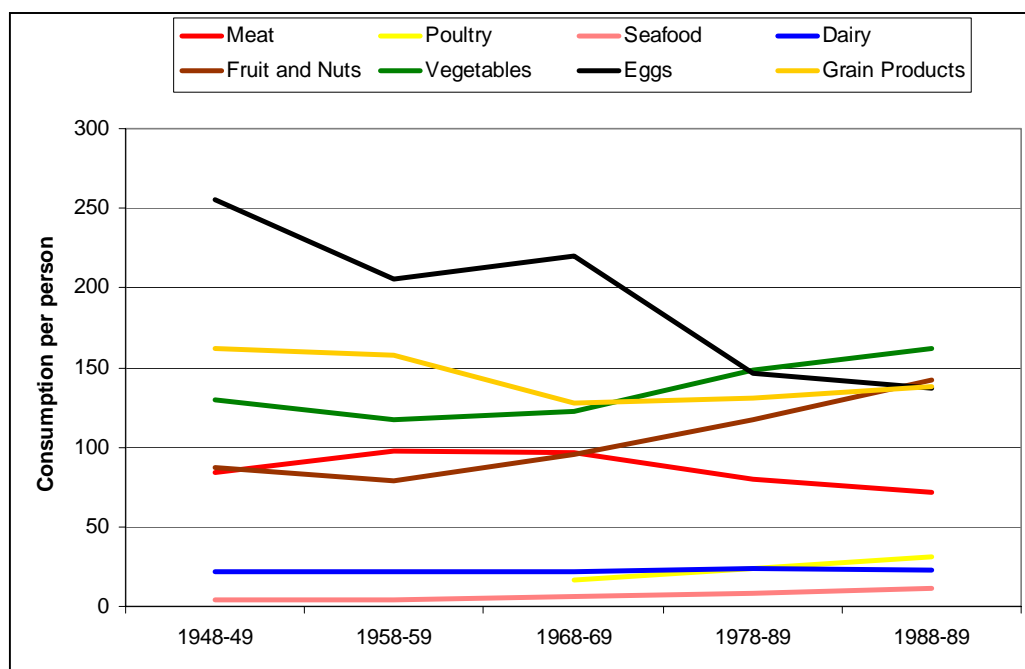
Consumer Preference

While growth in food spending has been modest, preferences for different types of food have been changing. According to Short, Chester & Berry⁴ consumption has shifted away from meat, eggs, grains and sugar, and increased for poultry, seafood, and fresh fruit and vegetables. Consumption of dairy products has remained relatively stable since 1948-49.

The trend suggests that consumers may be including a higher proportion of high value foodstuffs in their diets, such as seafood, and fresh fruit and vegetables. Health conscious consumers are perhaps increasingly demanding 'healthy' foods. Figure 2 shows changing Australian preferences for food over the second half of the twentieth century. There has been a decrease in consumption of eggs and meat products with a corresponding increase in vegetables, fruit and nuts, and to a lesser extent chicken and seafood.

⁴ Short, Chester & Berry 2006, *Australian Food Industry: Performance and Competitiveness*, ABARE Research Report 06.23 Prepared for the Australian Government Department of Agriculture, Fisheries and Forestry, Canberra. pg 11.

Figure 2: Apparent per person consumption of selected foods



Source: ABS (Australian Bureau of Statistics) 2000, *Apparent Consumption of Foodstuffs*, cat. no. 4306.0, Canberra.

Q.10 What have been the major changes to the structure of grocery wholesaling in Australia over the past 5 to 10 years

With the increased dominance of retail companies together with the drive for vertical integration there has been a reduction in the ‘middle man’, and a blurring of the edges between wholesale and retail. This is particularly evident in the fresh fruit and vegetable business. In this case the Horticultural code of conduct has attempted to redefine the different sectors of the supply chain to provide clarity to sellers.

Q.17 Identify each of the steps in the supply chain from supplier to retailer

A *food supply chain* is a network of food-related business enterprises through which food products move from production through consumption, including pre-production and post consumption activities. Appendix 1 outlines the grocery supply chain and some of the specific industry chains within the grocery chain.

Problems encountered by primary producers in supply chains

The structure of the grocery supply chain being characterised by a large number of producers, a smaller number of manufacturers and wholesalers and an even smaller number of retailers gives way to an imbalance of power. This market power gives rise to and is further reinforced by access to market information. Improving transparency and market information would allow all participants in the supply chain to make better decisions and better allocate resources.

Recommendation 1

Improve price transparency in agricultural markets by Codes of Conduct or legislation

Q.18 The activity or value added in each step

Farmers have traditionally produced and sold the raw commodity. As farmers have seen advantages in becoming more vertically integrated to derive benefits from the supply chain they have branched out into various activities. Some examples of how farmers have integrated into the supply chain include:

- Farmer cooperatives in the dairy industry to process and sell milk,
- Cooperatives in the fruit industry setting up packing houses
- Farmers markets where farmers have a direct link with the customer

Q.19 The businesses or business types that undertake each activity

The Australian Farm Institute report⁵ provides a comprehensive analysis of the current structure of farming businesses. In 1994-95 approximately 99 percent of Australian farmers owned (or leased from the state) the land they operated and most farm businesses were family farms. The predominant business structures in farming are individuals (63 percent) with partnerships the second most common structure (27 percent) followed by trusts (6 percent) and companies (4 percent).

In some industries the collective power of individuals have led to the establishment of cooperatives, marketing groups and pack houses. This is particularly common in the dairy and horticulture industries. However cooperatives have limitations and when they are placed in direct competition with companies they are limited by their access to capital and therefore constrained in their ability to invest in capital and achieve economies of scale or scope to produce further benefits for their members.

Q.20 The pricing structure in each step (price per unit, price mark-up, etc.)

An important issue in all agricultural commodity markets is the lack of price disclosure throughout the market chain. This is also one of the key findings of the Whitehall and Associates report⁶. There is either no, or very little information available to suppliers of price and volume movements of produce through the chain. Farmers are aware of what they receive for the product and then the price at which it appears on the retail shelf. Often there are large differences that are not identifiable.

The pricing structure is best demonstrated using selected commodity case studies as follows.

Avocado supply chain pricing

The pricing structure for avocados depends on the time of year. During peak supply:

- The farmer will receive 30-35 cents per avocado
- The packer/marketer receives 50 - 60 cents per avocado, from which a service fee of approx 20 - 25c per avocado is deducted before paying the growers. Of this approximately 5c is profit to the packer/marketer.
- An agent/merchant may take 10 – 20 cents per avocado. The exact amount is unknown as there is no transparency at the point of transaction to the retailer.
- The retailer would usually sell for \$1 – 1.50 per avocado.

Potato supply chain pricing

⁵ Synapse Research & Consulting & Bob Hudson Consulting 2005 *Australian Farm sector Demography: Analysis of Current Trends and Future Farm Policy Implications*, Australian Farm Institute, Surrey Hills, Australia

⁶ Spencer, S. 2004, *Price Determination in the Australian Food Industry: A Report*, Australian Government Department of Agriculture, Fisheries and Forestry, Canberra.

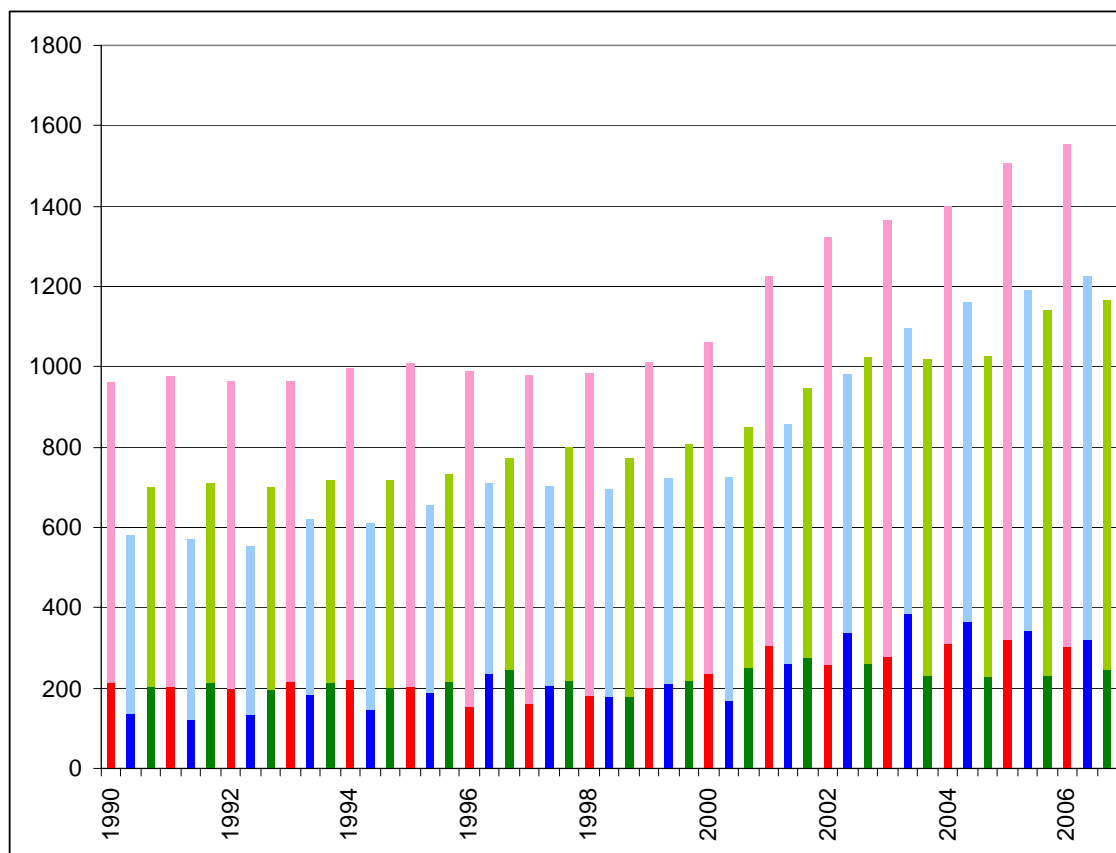
- The growers sell potatoes at 30 cents/kg
- It is estimated that agents/merchants work on 2 cents/kg however the rate is rarely disclosed. A lot of produce bypasses the agent/merchant and goes directly to the pack house.
- The price received by the pack house from the retailer is unknown
- Potatoes retail for \$3/kg at the supermarket.
- Transport costs are minimal at 6.5 cents/kg

Q.21 The proportion of the final retail price of the product accounted for by each part of the supply chain

While the margins vary widely from industry to industry, the Whitehall and Associates study shows producers receive on average between 20 percent to 30 percent of the retail dollar. ABARE collects information on the average retail price of beef, lamb and pork. It also collects information on the average saleyard price of beef, lamb and pork. This information for the last 16 years is graphically represented in Figure 3. Red and pink bars represent the saleyard and retail prices for beef in cents per kilogram, Blue and light blue bars represent saleyard and retail prices for lamb and green and light green represent saleyard and retail prices respectively for pork.

Figure 3 demonstrates that saleyard prices are approximately 20 to 30 percent of the retail prices. Since 2000 retail prices have increased substantially while the saleyard prices have only increased by a marginal amount. From 2003 the saleyard prices for lamb and pork actually started to decrease while retail prices continued to rise. Similarly saleyard prices for beef have decreased from 2005 while retail prices have continued to increase. Unfortunately corporate confidentiality prevents further breakdown of the supply chain.

Figure 3 Australian Average retail and saleyard Prices for Beef, Lamb and Pork



In the Chicken meat industry the Association has obtained information that estimates the proportion of retail price, the poultry meat contract growers receive. The retail price for chickens is approximately 384 cents per kilogram of dressed frozen chicken. The Chicken farmers in equivalent kilograms dressed frozen chicken receive approximately 30 cents per kilogram as a growing fee representing about 7.9 percent of the retail price.

In the turkey industry current retail prices are about \$8 per kilogram for a whole bird. The current growing fee is approximately \$1.17 per kilogram equating to about 14 percent of the retail price.

4 Buying Power in Grocery Supply Markets

Increasingly, Australian farmers sell their produce into markets that are dominated by a small number of very large-scale corporations. Individual farmers have very little ability to negotiate fair contractual arrangements, as their customers often have significant resources and use these to their advantage.

These issues are of particular concern for farmers involved in agricultural enterprises such as horticulture, dairy and poultry (for meat and eggs) which are producing highly perishable goods. The short life span of the product limits the growers ability to withhold product and source the best market, often they are driven by the ability to sell their product quickly.

Q. 46 Are large grocery wholesalers or retailers able to acquire products from suppliers at lower prices or on better terms than smaller wholesalers or retailers? Does this differ by product type?

Horticultural Industries

MSCs dictate the price that they will pay to agents, wholesalers and growers. For Asian vegetables and herbs, this price is set at a constant rate throughout the year. Smaller green grocers do not have the buying power or back up finance to be able to manipulate the market against supply and demand and must pay the market fluctuation at the time.

However, smaller retailers are finding a niche by providing produce that is fresh, since it doesn't sit in distribution centres, but comes either directly from the local grower or from the market floor. The prices paid to growers are better and those offered to the consumer are either the same or less than the MSC.

Q.47 Do grocery wholesalers or retailers with buying power pass on the lower prices they can achieve from suppliers to retailers and consumers?

A number of members conveyed comments on wholesaler retailer relationships to the Association. Some of these are included below:

"Wholesaler or retailers with buying power do not pass on lower prices to retailers or consumers. MSCs are obtaining their Asian vegetables/herbs from growers at a set price through out the year, however when produce is scarce, and wholesale market floor price rises, they usually raise the price to the consumers. The mark ups by retailers can be over 400 percent. For example English spinach has been seen to have been bought by an MSC for \$0.70 a bunch, then retailed at \$3.70."

"MSCs don't usually pass on lower prices, unless they are running a special. Then they expect the grower to reduce his price. They also expect a reduction on price if buying in large volumes but I do not see them pass this onto their customers".

Q.48 Do suppliers incur lower unit costs in supplying larger wholesalers or retailers? What are the sources of these costs savings (bulk sales, purchase guarantees, etc.)? Are these reflected at the retail level?

In horticulture industries growers supplying the MSCs actually have higher input costs, as they have to adhere to far more stringent quality assurance protocols. The MSC growers are also liable for the costs of order cancellations, even though the product had been delivered to the agent/wholesaler a few days before. The condemnation rate by the MSCs is therefore higher than the smaller green grocer. These negatives can on occasion offset the gains made by bypassing the agent/merchant.

Q.52 Are there other forms of behaviour or conduct by supermarkets in their dealings with producers or suppliers that may indicate market power?

There is a degree of implied market power that runs within the grocery supply chain that although it may not be directly visible, it still plays a part in returns and arrangements. For example, in the dairy industry the fresh milk market in NSW is dominated by two processors. At the time of deregulation these processors competed with each other to achieve contracts for generic milk with the retailers. A contract with the major retailer provides volume of through put and also allows them to sell their higher margin branded milk. In competing for the retail contracts processors reduced their prices to a point that they could not provide sufficient returns to farmers for supplying the milk. While this would appear beneficial for the customer the rationalisation in the industry has now meant that prices have had to increase to levels higher than in the regulated market as processors now compete for milk from farmers.

5 Factors Influencing the Pricing of Inputs Along the Supply Chain for Standard Grocery Items

Q. 66 *What are the major influences on the prices you receive for your produce? How are your prices determined? What proportion of the retail price of the product do you receive?*

As price takers, the most influential factor in determining the price received for produce is the level of produce available on the market. Farmers have little ability to set the price to reflect the cost of production or any intended rate of return. As they are selling a commodity the price received will be dependent on whether the buyer can get it from somewhere else cheaper.

Some industries where there are specialised requirements, specialised growers or limited markets are developing contractual relationships where the grower is able to identify a cost of production and factor this into contractual negotiations. However these are still tenuous and require an open negotiation process where both parties are willing to participate.

Q.67 *Have the prices you receive for your produce changed over the past 1 to 3 years? What have been the major reasons for any changes in the prices you receive? Have your costs of production changed over the past 1 to 3 years? Have the prices you receive for your produce changed by more or less than your cost of production? Please provide details?*

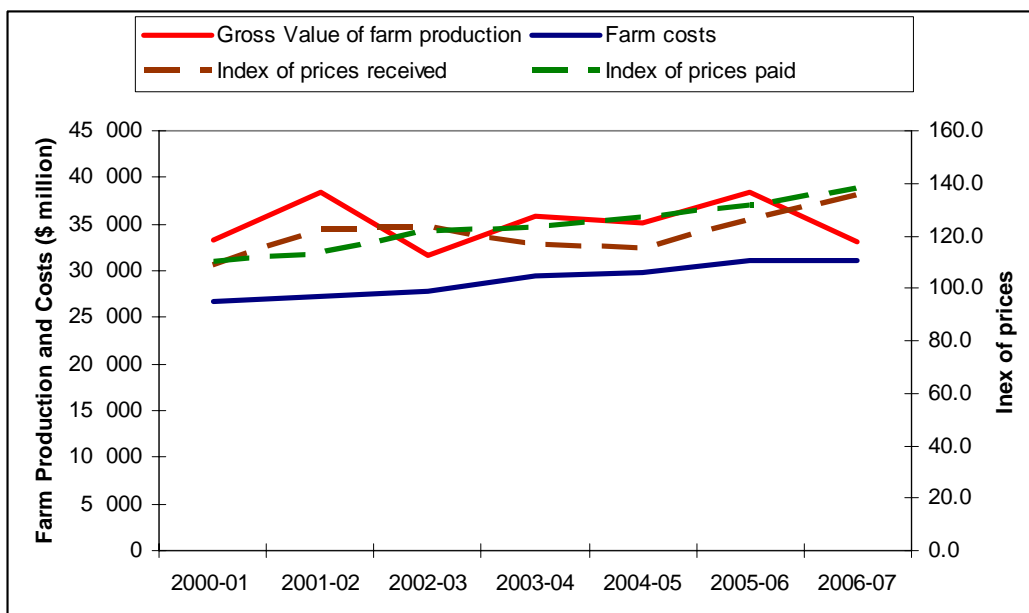
Figure 4 illustrates the total gross value of farm production and farm costs for Australian farms over the period 2001 to 2007. As the graph illustrates the value of production has fluctuated due the drought and resulting changes in production. On the other hand costs have followed a steady increasing trend. The index of prices paid and prices received illustrated in Figure 4 shows that for the period between 2002/03 and 2004/05 prices paid grew at a faster rate than prices received resulting in a declining terms of trade. In the period since 2004/05 prices received have started to increase again and since 2005/06 they have been increasing at a faster rate than the index of prices paid.

Changes in cost of production over time

Farm costs show a gradual increase over time. Figure 5 illustrates the main farm cash costs for a broadacre farm in NSW over the period from 2000 to 2006. The large increase in costs between 2005 and 2006 is due to a compounding effect of increased costs across the board together with the higher oil prices leading to a large fuel component. It is important to note that recent increases in prices for fertilisers and chemicals, which by some reports have doubled in the last 12 months, are not included in the latest ABARE figures.

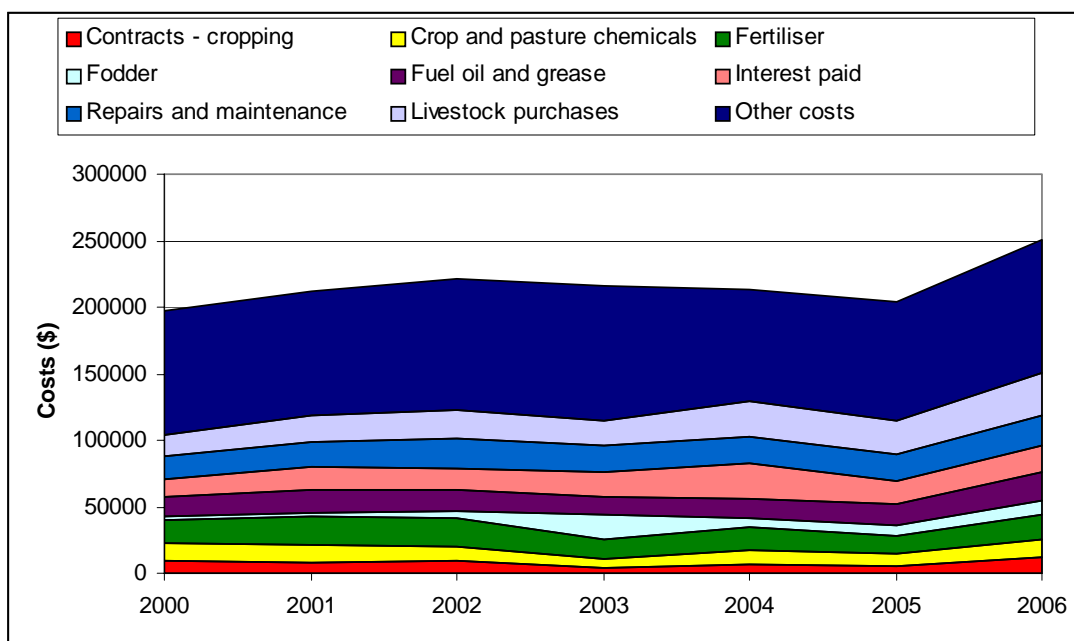
The prices received by intensive industry producers have changed little in the last decade, and in that time the cost of production has increased by at least 35 percent. ABARE figures reveal that the long-term trend in the farm terms of trade index (the ratio of the prices received by farmers to the prices paid by farmers for their input costs) is clearly downward – declining 55 percent between 1989/90 and 2004/05.

Figure 4 Australian Farm Production, Costs, Prices Paid and Received



Source: ABARE Commodity Statistics 2007

Figure 5 NSW Broadacre farm cast costs



Source: ABARE farm surveys data

The Association obtain from a poultry grower member actual cost of production and prices received. These are contained in Appendix 2. This information is sensitive and should be regarded as confidential.

Q.68 To whom do you sell your produce? What supply arrangements do you have with the buyers of your produce? Do you sell any of your produce to the MSCs? If so, what options do you have if you decided not to sell to the MSCs (other grocery retailers or wholesalers, food processors, exports, etc?)

There are a multitude of different supply arrangements in the agricultural produce chain. These include saleyard auction operations for the sale of livestock, direct sales between buyers and sellers, arranged marketing arrangements with grain, cooperative arrangements, and wholesalers or agent arrangements.

As buyers seek to secure longer term prices and supply commitments there is evidence of increasing use of contracts between producers and buyers. These are especially evident in the poultry meat and dairy industries where processors are attempting to secure more consistent supply levels at required quality and prices.

Poultry Grower

A poultry grower is contracted solely to one processing company to provide a poultry growing service. As the grower does not own the poultry, there is no other supply arrangement with any other party. The contracts with a processor are for terms up to 5 years or as short as one batch of poultry, however, the processor can loan a grower to another processor.

The contract can be terminated where fault is proven within 7 days of the fault not being rectified or where no fault exists a grower must give 7 months notice to exit the contract. The contracts stipulate the obligations of both parties to supply inputs and management and growing facility standards. The contracts also detail the payment terms and variation to payment based on efficiency (feed use and mortality) and can detail the way price is negotiated.

Horticulture Producers

Apple sales are through wholesale markets or through marketing groups direct to supermarkets and operate without supply arrangements.

The Potato industry operates under similar wholesale markets or marketing groups without contracted supply arrangements securing sales to agents or pack houses.

At present there are no direct supply arrangements, for Asian vegetables, however the MSCs may be negotiating some for selected products (e.g. Bok Choy).

Citrus do have a processing option under a contract and also an export market however the export market suffers from extended transfer of ownership until point of sale similar to that with the retailers which allows buyers to cancel orders after delivery.

6 Impediments to Efficient Pricing of Inputs Along the Supply Chain

Q.73 *Is there evidence of market power in the supply of grocery products to retailers or wholesalers? Please identify specifically which grocery products and explain the sources of market power?*

The size of the consumer market accessed through the major retailers definitely leads processors, wholesalers and manufacturers to try compete for access to those retailers and therefore drive price and quality back down through the supply chain. Simply by providing a tender process it forces suppliers to compete to obtain the shelf space rather than product availability and price being determined by the production process. However, it is very difficult to show evidence of unconscionable conduct as it relates to parties along the supply chain or misuse of market power as it relates to parties at the same level of the supply chain.

Recommendation 2

Amend the *Trade Practices Act* to expand the definition of unconscionable conduct to include unilateral contract variation and commercial retaliation

Aggressive pricing is most evident in regard to the supply of the supermarkets' generic ("own brand") lines. According to a *Financial Review* article, these now represent some 11 percent of all supermarket stock and their aim is to increase this to 50 percent to cater for the consumers' preference for price over brand loyalty. In some cases the generic produce is identical to the branded label (e.g., milk and eggs) and in other cases there is a quality differential. Supermarkets are able to obtain a particularly low supply price for its generic produce by the commercial attraction to suppliers of:

- (i) being able to supply a large volume of produce over an agreed period; and
- (ii) being able to access supermarket shelf space for branded products. Such access is available only to suppliers who also supply the produce for the generic label. For example, a supermarket will not stock the branded milk of a company unless the company also supplies, at lower price, milk for generic marketing. Such access to valuable, and limited, shelf space is critical to the intermediaries' commerce.

A number of activities exist which demonstrate a unilateral approach to demand supply arrangements in agriculture. These include:

- The processor knows the cost of production of the growers because the processors either own their own farms or they request prices from growers.
- Processors will only offer the equivalent of a national Consumer Price Index rise and not consider variations because of production cost increases.
- Processor servicemen routinely visit farms during each growing cycle to obtain production information. Farmers can't access production information from processors. Increasingly within contractual arrangements confidentiality clauses are inserted to prevent farmers talking to other farmers. This limits the ability of collective bargaining groups.
- Under some arrangements, contracts may authorise processors or other agents to audit grower's premises to determine if they are meeting suitable standards. This arrangements is not often reciprocated.
- In the horticulture industry, supermarkets have been known to order produce and then cancel the order, often a couple of days after the product has been consigned to the packing house or delivered to the warehouse.
- Horticulture products can be condemned by the MSC several days after delivery and the grower might not be notified for a number of weeks after delivery.

- In horticulture, supermarkets have been known to reject specifically packaged produce. The farmer then has had to repackage the product, at his expense, to be able to place his product on the open market, in attempt to recover his losses.
- In the case of citrus, the fruit ownership is not transferred until just before the consumer purchases it. Some growers deliver fruit but do not know for a few weeks what the sale price is. If price drops after a higher price was negotiated at the point of ordering the retailer simply cancels the order.
- In the apple industry supermarkets use verbal agreements and can gouge prices by placing an order at one price 2 weeks ahead of delivery and offer a spot price upon delivery if the market has dropped.

Recommendation 3

That a legally binding Retail Code of Conduct be developed

Q 79. How has the sale of private-label or generic products by grocery retailers changed in recent times? Has this change had any impact on the level of competition along the grocery supply chain?

The introduction of generic brands has taken away one of the marketing advantages that allowed differentiation between very similar products. This is common in commodity like products such as flour, milk, eggs.

The Dairy industry is one of the key industries where the dominance of generic private label products is clearly evident. The mix of a highly perishable commodity product with high constant demand makes it very difficult to differentiate and therefore very easy to compete on price rather than quality characteristics. This is perfectly suited to the fresh milk market.

It is understood that processors must first win the generic contract in order to gain shelf space for their own label in the fresh whole milk category. The shelving arrangement then places the labelled product next to the generic brand, albeit usually in a position slightly out of the line of sight. When two products are exactly the same (in many cases they come out of the same factory) apart from the label the consumer will usually chose the product that is \$1.18 per litre rather than the \$1.88 per litre product.

It is also understood that contracts to supply generic labelled products are very tight with very few opportunities to vary any arrangements through the life of a contract which could be three years. This in turn places limitations on the processors to vary their conditions back to farmers. The only opportunities processors have is to vary the pricing of their own label milk which in turn increases the disparity between generic brand and the labelled product.

In addition to the generic branding of products the contracts for the supply of these products has also changed. In the dairy industry the original contracts were regionally based. Now the contracts are national which in the dairy industry has effectively limited the competition to the two main processors who concentrate on producing fresh milk and can serve the whole market. These processors now must subcontract milk from other sources if they cannot make the required volumes.

There are some issues with labelling that create misinformation in the market place. The use of the term natural and its true meaning may not be completely know by consumers and may be confused with other labels that have different characteristics.

Recommendation 4

Secure the use of safeguard provisions and accurate and effective country of origin labelling on imports of agricultural products (subject to review by all commodity areas).

7 Horticulture Code of Conduct

Q.81 What has been the impact (if any) of the Code on market behaviour along the supply chain for horticultural products?

Depending on the produce sold there have been variable impacts by the Code on market behaviour. Asian vegetables/herbs at the Sydney markets do not appear to have seen any impact. In other fruit and vegetables the effect has been very minimal as only some agents/merchants introduced agreements (and some of those were non compliant). The growers feel that without enforcement of the Code there can be no change in behaviour.

The Association knows that some growers have not secured written agreements. However it is likely that this is not a result of lack of awareness or understanding, or a perception that the Code cannot deliver benefits if followed in good faith or enforced. Rather it is likely that these growers know of first hand incidents where growers have been asked to sign backdated contracts, have been boycotted by traders who seek to negotiate new contracts or who complain to the ACCC. The first priority of growers is to preserve income by continued trading with less favourable terms than having no income at all. Moreover, it is likely that the reports of failure of the Code are driving non compliance from both the grower and trader sectors.

A February 2008 survey of horticulture producers of the Association showed that 79 percent had a trading relationship which required an agreement. However, 32 percent had not discussed the matter with the agent/merchant, 21 percent were trading without an agreement and 58 percent did not know if their agreement was compliant with the Code (sample size 24).

In the view of growers, they understand that the Code in its present form does not deliver the balance of market power that growers envisaged. However, ironically and more fundamental for the success of the Code, growers believe it may be delivering terms that are 'transparently and clearly' unfair which is a disincentive for growers to persist in negotiating their rights under the Code. This disincentive can only be overcome through enforcement by the ACCC of the Code.

Q.82 What would be the impact on market behaviour along the supply chain for horticultural products if retailers and other major buyers were also included in the Code?

While growers' relationship with agents/merchants is the most problematic area, supermarkets are not guilt free. They offer no written contracts, only 'growing agreements', and produce specifications are not available for all produce lines leaving ambiguity and scope for dispute. Importantly over 50 percent of their produce is sourced direct from growers, and is increasing. For these reasons Association supports retailer's inclusion within the Code.

The Code must bring the whole horticulture supply chain under the one system (to include wholesalers, retailers, processors and exporters). While retailers argue that they abide by the voluntary Retail Industry Grocery Code of Conduct; growers fear going to the Ombudsman for fear of commercial retaliation.

Not only do small growers fear the abuse of market power by agents and merchants but they also fear the disappearance of a range of buyers from the market. Consolidation in the wholesale market to increasingly dominant but few agents, merchants and retailers will drive down growers' prices for fresh produce.

The risks to be avoided are in tying the supply chain in too much regulation making compliance costs too expensive which will invariably be passed back to growers or to encourage traders to circumvent the regulation or indeed squeeze out the competition entirely, in order to increase their margin. Including retailers in an enforced code will share regulatory costs across the wholesale sector.

Q,83 *Would such inclusion improve the effectiveness of the Code?*

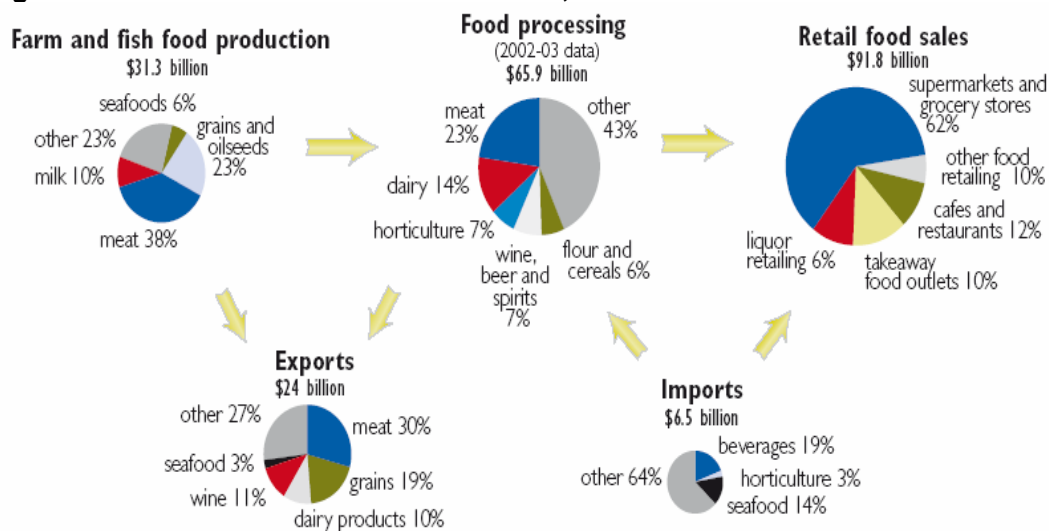
Including retailers and other major buyers in the Code would greatly improve the effectiveness of the code. Amending the Code regulation to include all cooperative like or produce pooling structures, which are registered with the Australian Taxation Office, under the definition of a 'grower' will focus the transparency back on the relationships which exercise market power against the growers' interests. The Horticulture Code currently sweeps pack houses, cooperatives and other marketing organisations up within the definition of a 'trader' which then excludes the relationship between the cooperative and the trader from regulation.

To ensure a successful Code, the Association also proposes spot checks of transactions by the ACCC in all Central Markets. The checks would cover the existence and validity of agreements. Repeat offences from a particular trader might trigger an investigation into all previous transactions if considered 'reasonable cause' under Section 155 of the *Trade Practices Act*.

Annexure 1 - Understanding the Grocery Supply Chain

The Australian food industry encompasses many sectors, from the producers of the raw materials used in food through export, import and processing sectors to sales to domestic consumers. Figure 4 shows the major components of the food supply chain in terms of value.

Figure 4: Value Chain For Food In Australia, 2004-2005



Source : DAFF 2006¹

There were around 130 000 farm businesses in Australia in 2003-04 (ABS 2005), most of which were small to medium size family farms. The gross value of primary food production was around \$31 billion in 2004-05.

The Australian food processing sector comprises around 3,400 firms, of which the largest twenty account for nearly half of industry turnover (DAFF 2005⁷). Food and beverage manufacturing was Australia's largest manufacturing industry in 2002-03 (the latest year for which data are available). It generated sales and service income of nearly \$66 billion, accounting for around 22 percent of the total value for Australian manufacturing (DAFF 2006⁸). The sector is also a significant employer, particularly in many regional areas.

Supermarkets are the major outlet for food and liquor sales, capturing a 62 per cent share of the domestic market in 2004-05. There are five major supermarket chains in Australia and a large number of smaller independent retailers. In 2003-04, the dominant supermarket chains, Coles and Woolworths, accounted for an estimated 51 per cent of food, liquor and grocery sales. Retail food and liquor turnover in Australia was estimated to be around \$92 billion in 2004-05, which is around 46 per cent of total retail turnover.

⁷ DAFF (Department of Agriculture, Fisheries and Forestry) 2005, *Australian Agriculture and Food Sector Stocktake*, Canberra, March.

⁸ DAFF (Department of Agriculture, Fisheries and Forestry) 2006, *Australian Food Statistics 2005*, Canberra.

Food manufacturing

This sector, like primary production, has been consolidating, but on a larger scale, with the largest 50 food processing companies in Australia accounting for almost three quarters of total industry revenue in 2003 cited by Short et al⁹.

According to AFFA¹⁰ it is common for one or two of the largest suppliers to share over 50 per cent of the domestic market for a particular product.

IBIS World cited by Short et al highlight that the revenue shares held by the largest 50 firms vary considerably across the different segments, ranging from 7 percent for seafood to 94 percent for milk and cream processing. Industry segments, in which these large firms had 75 percent or more of revenue, in 2003, were fruit and vegetable manufacturing, poultry processing, wine manufacturing, spirit manufacturing, bread manufacturing, sugar manufacturing, soft drink, cordial and syrup manufacturing, beer and malt manufacturing, confectionary manufacturing, and milk and cream processing. Foreign owned companies make up almost half of the largest 50 firms, producing 47 percent of domestic revenue.

The chairman of the Australian Competition and Consumer Commission (ACCC) Fels¹¹ in 2000 described how consolidation followed deregulation in areas such as the dairy industry. He also pointed out; however, the importance of food processors' key customers wanting to deal with as few suppliers as possible, which, among other benefits, may lead to improved product quality:

According to Fels, consolidated processors provide retailers with lower transaction costs, more significant volume discounts, improved brand recognition and promotions, improved service and product support, uniformity in store layout and stock, and greater control/accountability regarding supply chains and product quality. In these circumstances, processors and distributors see advantages to establishing a presence in multiple state markets such that they can provide national coverage to these retailers.

However the restructure and consolidation in the wholesale, retail and manufacturing sectors in the value chain has put a lot of pressure on the other suppliers in the food value chain as demonstrated in Figure 7. It can be seen that primary production sector has borne the brunt of the pressures from the imports, manufacturing, wholesale, retail and the food service sectors.

Industry Supply Chains

The characteristics of supply chains vary significantly, sometimes even for the same food source. The supply chain for rump steak, for example, is simpler than that for salami. Other products may have more complex supply chains, involving more points at which food safety hazards can develop— for example, the National Risk Validation Project applies the highest risk ratings to 'raw ready to eat seafood' businesses, given the potential for multiplication of harmful organisms at any point of the supply chain (FSA & MEC 2002¹²).

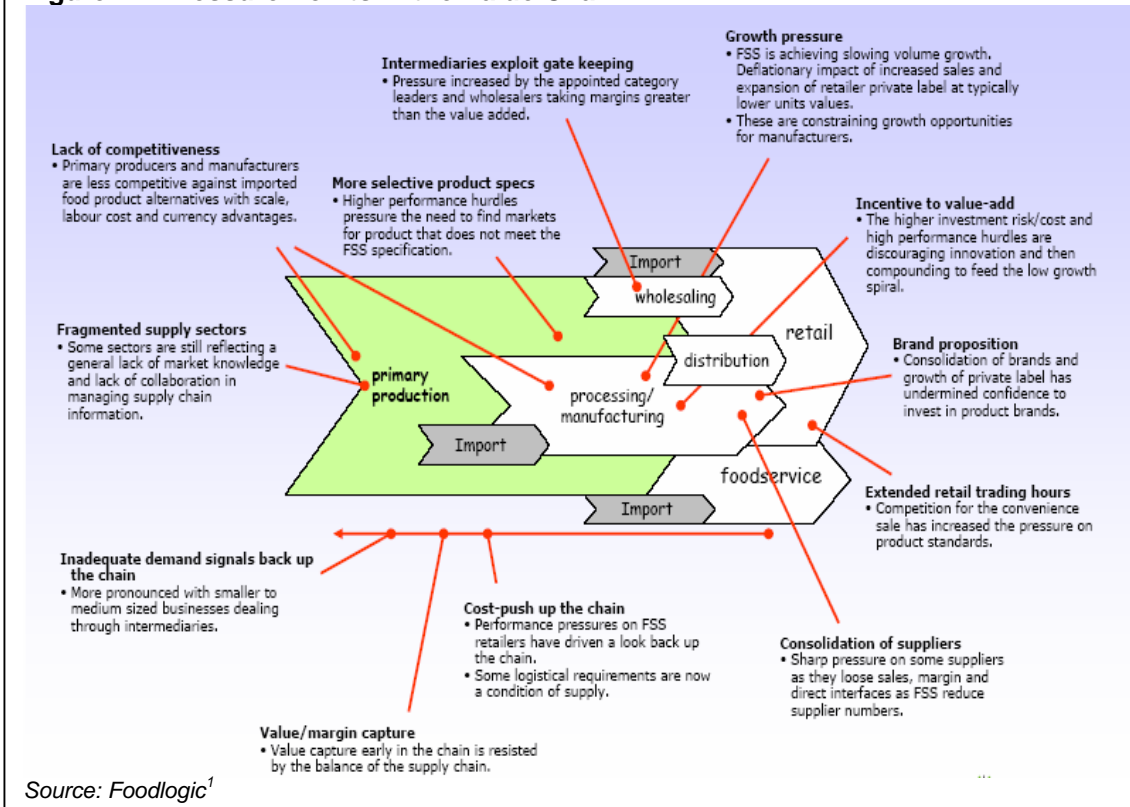
⁹ IBIS World 2003, cited in Short, Chester & Berry 2006, *Australian Food Industry: Performance and Competitiveness*, ABARE Research Report 06.23 Prepared for the Australian Government Department of Agriculture, Fisheries and Forestry, Canberra. pg 19-21.

¹⁰ AFFA (Department of AGRICULTURE, Fisheries and Forestry-Australia) 2002, *National Food Industry Strategy, an Action for the Australian Food Industry*, Canberra pg 9.

¹¹ Fels 2000, 'Trade Practices Act and the food sector', in ABARE (Australian Bureau of Agricultural and Resource Economics) 2000, *Outlook 2000*, Proceedings of the National OUTLOOK Conference, Canberra, 29 February-2 March, vol. 5, *Additional Papers*, ABARE, Canberra. Pg 153

¹² FSA (Food Science Australia) & MEC (Minter Ellison Consulting) 2002, *National risk validation Project*, Report to the Commonwealth Department of Health and Ageing and NSW Department of Health, Canberra.

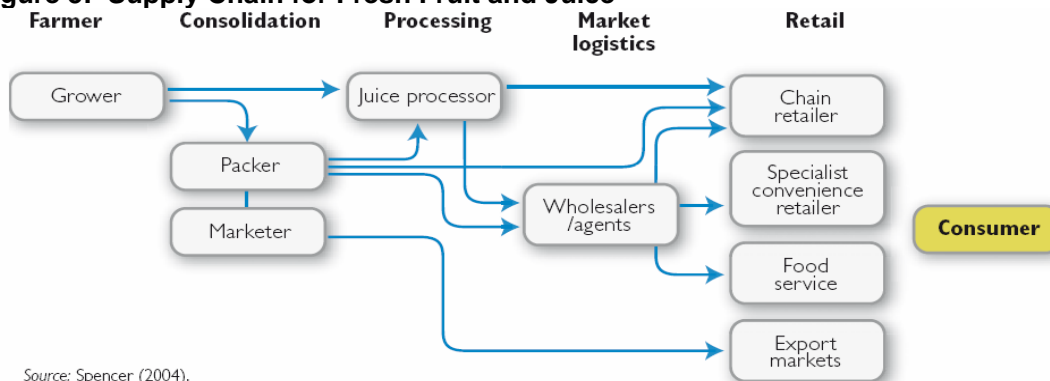
Figure 7: Pressure Points in the Value Chain



Fruit and Juice Supply Chain

The orange farmer grows and harvests oranges, and enters into agreements with packers, who sort, grade and store packed oranges. Packers store oranges for a short period and coordinate transport for further movement. Oranges that are to be transformed to fruit juice are supplied to juice processors, who provide wholesalers, chain retailers or export markets with packaged orange juice products. Oranges that are to be consumed fresh in domestic markets are passed on to wholesalers or to chain retailers directly. Fresh oranges for export markets (United States, South East Asia, Japan and New Zealand) go through export marketers. Domestic orange growers also compete with expanding orange and orange juice concentrate imports (particularly from South America). A typical Fruit and Juice supply chain is illustrated in Figure 5.

Figure 5: Supply Chain for Fresh Fruit and Juice



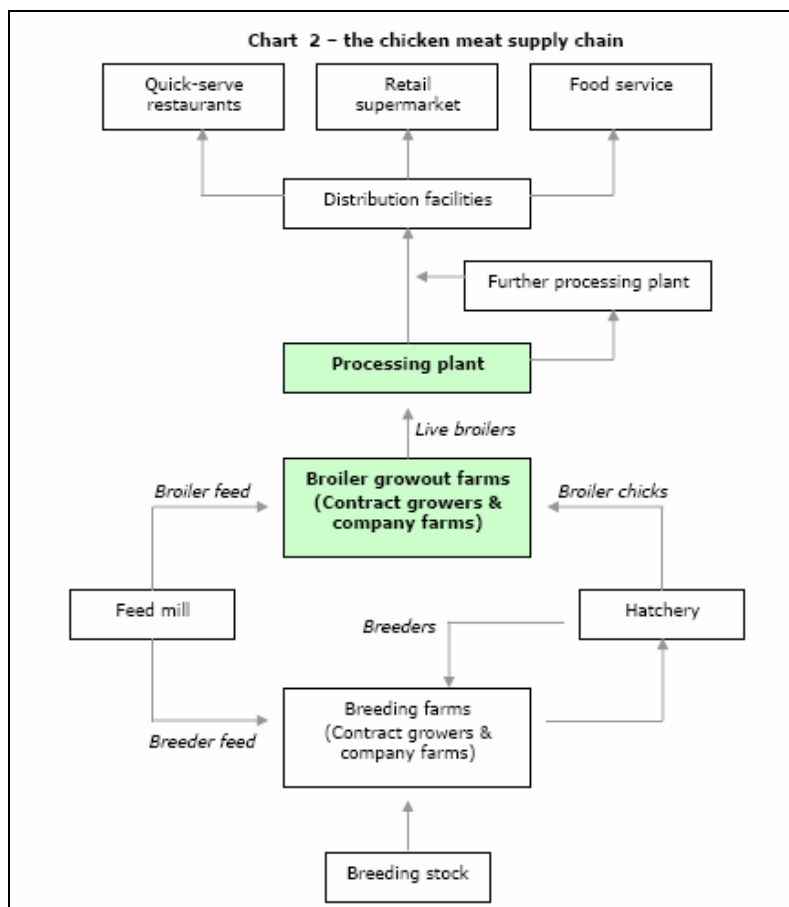
Livestock Supply Chain

Meat processing can involve several stages, depending on the product. Processing rump steak, for example, involves the abattoir and the boning facility. For salami, processing includes further stages that involve other meat and nonmeat inputs. Meat processors supply a range of sectors, including other food manufacturers, chain retailers, cafés and restaurants, and export markets. Increasing vertical integration in the meat supply chain, however, has reduced the separate role of meat wholesalers. A typical livestock supply chain is illustrated in Figure 6.

Poultry Meat Supply Chain

The poultry meat industry is vertically integrated with processing companies owning feed mills, breeding farms, hatcheries, some growing farms, processing plants and some wholesale/retail outlets. Two of these companies also own the rights to the poultry genetics within Australia. The majority of poultry growing out farms are owned by small farming families. Two exceptions are corporate owned enterprises. Both these growing sectors are contracted to the processing companies. Therefore there are limited numbers of business entities within the path to the retailer, namely the processing companies, contracted transporters (birds and inputs), contracted growers and the food and retail sectors. Processing companies provide inputs to contracted growers who grow birds to slaughter weight by those processing companies who deliver a finished product to retail and food sectors (Figure 8)

Figure 8: Poultry Meat Supply Chain



Source: The Government of NSW, October 2004, Review of NSW Poultry Industry Legislation October 2004 Final Report, prepared by Ridge Partners.

The processing company owns the chicks (once chicks are purchased if the company does not own the genetics), feed, veterinary advice and bird medications which are all provided to the contract growers free of charge, i.e., the processing company retains ownership of the inputs throughout the primary production phase. Contract growers are paid on either a per bird basis or a per growing area basis (square metre).

Horticulture Supply Chain

The supply chain varies between and within horticulture commodities (Figure 9). Some examples below have been chosen from Asian vegetables/herbs, avocados, apples and potatoes as growers have indicated these are some of the commodities with significant supply chain issues.

Figure 9: Horticultural Industry Supply Chain

