How the relative bargaining power of Australian agricultural value chain actors affects trading practices – and thus the efficient operation of these markets

Bargaining and market power imbalances[1] have long been a source of angst for participants in Australian agricultural supply chains and an ongoing concern for policy-makers. The exercise (and often misuse) of power by leading firms who are able to coordinate the entire value chains is a distinctive characteristic of present-day agricultural markets, and is generally held to result in reduced trade and the loss of social welfare due to continuing erosion of the agricultural share of the total value added in the food system (Sorrentino et al., 2018).

The perception of monopsonistic behaviour by supermarkets is one of the enduring tensions in the Australian agri-food supply chain. Competition policy in Australia has, to this point, not been successful in dispelling these perceptions. Suppliers of perishable agricultural goods (i.e. farmers and processors) remain concerned that, due to the market power of the large food retailers, they are forced to shoulder a disproportionate share of the continual downward price pressure on food.

Competition policy is unambiguous in dealing with monopolistic behaviour; indeed, the primary focus of competition policy (and regulators) is on dealing with this type of market manipulation. The ACCC's stated purpose of ***making markets work for consumers, now and in the future*** makes it clear that successful competition policy should protect consumers by ensuring that competitive markets deliver accessible prices. We are all consumers, so this goal undoubtedly delivers benefits to all of us.

However, a relentless focus on competition policy which primarily seeks consumer benefit[2] may not be delivering a net benefit to society, due to a failure to adequately address the inequitable distribution of value along supply chains.

While the ACCC has the ability to perform market studies in the process of enabling one of its roles of **supporting fair markets,** the focus of this role is on functional aspects of market operation. It is assumed that if the market is functioning it will be relatively pure, meaning that value is distributed fairly.

Some of the theory associated with this assumption is described in Freebairn (2018), which concluded that the opportunity for monopsony pricing from supermarkets to farmers is minimal. Freebairn's modelling to support this finding is premised on the assumption that ***if supermarkets set farm prices below the opportunity costs of variable inputs required for additional farm production, farmers will withdraw production and the supermarkets will lose a vital input.*** This fundamental piece of economic theory was the underpinning justification to a significant finding in the ACCC Dairy inquiry of 2018. The study found that $1 dollar a litre milk prices at the supermarket were not leading to unfair farm-gate prices for milk supply because supply contracts between processors and supermarkets allowed for pass-through pricing; that is, if processors need to pay more

[1] Bargaining power allows one party to obtain a concession from another by threatening to impose a cost or withdraw a benefit if the concession is not granted. Market power is the ability of a dominant organisation to raise and maintain price above the level that would prevail under competition. While both bargaining and market power may result in lower prices or surplus transfers, a key difference is that exertion of market power always reduces trade level (compared to perfect competition), while this conclusion is not necessarily true in the case of bargaining power (Sorrentino, Russo, and Cacchiarelli 2018).
[2] For example, the 2014 review of Australian competition laws chaired by Prof. Ian Harper noted that competition policy should "make markets work in the long-term interests of consumers", creating the impression that consumer benefit is paramount regardless of cost; i.e. that the misuse of market power by dominant market participants is acceptable as long as the consumer benefits by cheaper prices.

to obtain milk from farmers the cost can be passed on through the contract they have with supermarkets. Pure market theory assumes that if processors are paying unsustainably low prices then farmers would not supply milk and processors would need to lift prices to obtain supply. Therefore, by focusing on the functional aspect of the market (in this case pass-through pricing), it is assumed that fair distribution of value will occur.

There are two main issues with this assumption – ***that the market is efficient and always balances itself*** – which go to the heart of whether the net benefit to society is being delivered in Australian agricultural value chains.

The first issue is whether it is realistic that farmers will simply withhold supply or switch production to alternative products if prices received are suboptimal. In many cases, large investments are made in supply chains and production infrastructure which is specifically tailored towards efficiently producing one commodity. Any opportunity to switch to alternative production could result in stranded assets, significant re-investment and associated opportunity costs. Additionally, processors' contracts are typically shorter than the life-span of the specialised sunk assets required by farmers to supply the processors' demands, leading to the 'holdup' problem. That is, anticipating that processors will exploit short-run supply inelasticities (exacerbated by perishability and limited selling outlets), farmers underinvest in specialised resources relative to the social optimum (Mérel and Sexton 2017).

In the case of Australian dairy, farmers are beholden to the bargaining power of processors in an almost monopsonistic environment and have little choice but to sell short-term at market-inefficient prices, hoping for a long-term turnaround, or go out of business. Inefficient businesses being aggregated into larger (more productive) enterprises is an expected function of competition; however, another unique attribute of agriculture is that the social fabric and community constructs of the sector have been built on the small family holding. In this context, the gradual loss of family farms is another source of tension emanating from the application of competition policy.

There is also a behavioural element in farming production which should not be discounted in relating competition policy to market behaviour. Farmers tend to be risk-averse in choosing commodities for production, and often "stick with what they know"; i.e. they produce what they have always produced with price (demand) having diminished influence on supply.

These factors are significant barriers to the practical ability of farmers to manage supply based on 'market' price.

The second issue is the impact of the relentless productivity gain required on-farm in order to realise profit from the prices received upstream. While total factor productivity (TFP) has been growing in Australian agriculture, albeit slowly, almost all the gain has been achieved through reduction in input indexes. Farmers are becoming more efficient with inputs, including land and - importantly - labour. At a theoretical level this is competition policy in action, delivering better results for consumers through vigorous competitive markets. However, at a practical level theses productivity gains translate to under-priced labour markets and significant stressors on sustainable land management. The net benefit to society is degraded and the risks of regional and environmental decline are enhanced.

It is these factors, which often may be masked in a market study, that most often lead to tension and dissatisfaction in agri-food supply chains. Technical determinations which find no impact of bargaining power imbalance in farm supply chains do not necessarily account for externalities such as the low wages paid by suppliers or the degradation of land and water resultant from farmers continuing to supply product at the available prices.

What needs to change to correct this?

The imbalance of power between farmers and highly concentrated downstream market participants (such as retailers and processors) is already being addressed in some overseas jurisdictions. Some measures designed to prevent abuse of market and/or bargaining power used in the EU and US include mandatory reporting of stocks and use of the Herfindahl-Hirschman Index to calculate the degree of concentration. In 2018, the European Commission (EC) recognised the imbalance of bargaining power and developed a Directive to protect weaker suppliers of food and agricultural goods (i.e. farmers & farmer organisations) from stronger buyers and reduce unfair trading practices. The directive prohibits 16 unfair practices which are differentiated as 'black' and 'grey' practices, as outlined in Table 1.

Table 1: Unfair trading practices prohibited in the EC Directive

Black Practices: *prohibited whatever the circumstances*	**Grey Practices:** *considered unfair, but allowed subject to unambiguous agreement beforehand*
1. Payment later than 30 days for perishable agricultural and food products 2. Payment later than 60 days for other agri-food products 3. Short-notice cancellation of perishable agri-food products 4. Unilateral contract changes by the buyer 5. Payments not related to a specific transaction 6. Risk of loss and deterioration transferred to the supplier 7. Refusal of a written confirmation of a supply agreement by the buyer, despite request of the supplier 8. Misuse of trade secrets by the buyer 9. Commercial retaliation by the buyer 10. Transferring the costs of examining customer complaints to the supplier	11. Return of unsold products 12. Payment of the supplier for stocking, display and listing 13. Payment of the supplier for promotion 14. Payment of the supplier for marketing 15. Payment of the supplier for advertising 16. Payment of the supplier for staff of the buyer, fitting out premises

Source: (European Commission 2019)

Member states are required to designate an enforcement authority who will hold the power to act on and investigate a complaint, impose fines if found in breach and publicly publish decisions with the aim that these actions will provide a dissuasive effect. Measures will also be in place to ensure smaller suppliers have opportunities to lodge a complaint without fear of commercial retaliation as well as cooperation and coordination between each member state and the EC. Transposing of the Directive into national law is required by EC member states by April 2021, with the requirement to apply it six months after this date.

Many of the provisions in the EC directive are similar to those found in industry codes in Australia, and emphasise the principle that transparency and consistency in contract arrangements make it less likely that market power imbalance will lead to unfair practice. These provisions recognise that competition measures need to balance the requirement to protect consumers' interests with the need to ensure fair distribution of value through the supply chain. Importantly, a fundamental assumption remains that if farmers continue to supply then a fair farm-gate price is being achieved. This assumption needs to be challenged.

Competition regulators need to be enabled to continually monitor whether fair distribution of value that delivers a net benefit to society through a triple bottom line impact is being achieved. In many cases, and particularly in some agricultural markets, a reliance on functional markets delivering this result is naïve.

For instance, negative impact on the natural capital that agriculture relies on, cannot yet be corrected by market action as natural capital markets are either immature or non-existent. These markets are developing and it is likely in the future that opportunity cost of natural capital will become part of the consideration in cost of production to determine fair farm gate price, however currently natural capital decline is a feature of agricultural production. A feature which competition policy has no capability to address, unless a monitoring function is introduced which allows for the determination of fair price which includes the assessment of natural capital value.

Labour costs are another area where market dynamics are not necessarily delivering a result which society would consider to be equitable. Once again, in order to continually improve productivity, agricultural sectors reliant on significant labour inputs are restricted in their ability to improve labour conditions or are forced to adopt new practices and technologies which remove labour inputs altogether. The net benefit of competition measures is reduced, particularly for regional communities, as wages remain stagnant and there is a flight of labour away from the regions seeking job opportunities.

Australian policy is characterised by a reluctance to intervene, and often leans heavily on neo-classical economic arguments that government intervention should be minimised to improve the competitiveness and efficiency of markets. In contrast, economist Joseph Stiglitz has noted that almost all markets could be improved with government intervention in methods that dovetail neatly with distinctive issues in agricultural supply chains, e.g. by correcting unequal access to information, reducing negative externalities or encouraging positive externalities. The concept of countervailing power[3] is of particular interest to policymakers, in which public support of the farm sector and collective actions might mitigate the effects of downstream market power without the need to impose new regulations on the processing and retailing industries (Bonanno, et al. 2018).

Bargaining power imbalances are clearly evident in Australian agri-food value chains. Existing regulation addresses these imbalances by *focusing on the functional aspects of markets* and ensuring that transparent and consistent practices are adopted between buyers and sellers. While these measures may well correct technical deficiencies in market structures, they do not necessarily provide the ability to correct a significant source of tension: namely, inequitable distribution of value throughout the supply chain. As long as it is assumed that a technical focus on delivering perfect markets will deliver fair prices to all participants, this situation is likely to continue.

The ACCC already recognises the unique aspects of agricultural markets, indicated by the appointment of an Agricultural Commissioner and the development of several industry codes for the sector.

Recognition of the specific characteristics of agricultural markets needs to be extended to an ongoing function of ***monitoring how trading practices deliver a balance of net social (economic) welfare and consumer benefit***. It should not be assumed that the process of correcting imbalances in bargaining power will deliver the outcome of creating efficient markets without additional intervention.

[3] Countervailing power is the ability to balance another firm's power, specifically where "weak" firms that are exposed to the power of "strong" firms.

References

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