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28 February 2011

Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

By email to: economics.sen@aph.gov.au

Dear Sir/Madame,

Senate Economic References Committee: Inquiry into the impacts of supermarket price decisions on the dairy industry

We attach our submission to the above inquiry.

Yours sincerely,

Ken Henrick

Chief Executive Officer

S U B M I S S I O N

to the
Senate Economics References Committee
inquiry into

The impacts of supermarket price decisions on the dairy industry

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Introduction

The report of the Senate Economics References Committee inquiry into dairy pricing, *Milking it for all it's worth - competition and pricing in the Australian dairy industry*, (May 2010) raised many significant issues which impinge on the integrity of competition regulation in general and competition in the dairy supply chain in particular.

That Committee recommended, among other things:

Recommendation 1

The Committee recommends that the Government requests that the National Competition Tribunal reviews the effectiveness of section 46 of the Trade Practices Act in preventing price discrimination and considers reinstating anti-price discrimination provisions, particularly to protect those parties participating in industries dominated by multinational corporations.

That recommendation identified two fundamental weaknesses in Australian competition law: the weakness of the section 46 prohibition on misuse of market power and the absence of a specific prohibition on anti-competitive price discrimination.

An important third deficiency is the unwillingness or inability - at any rate, the failure - of the competition regulator to apply the law.

Anti-competitive price discrimination

It is important to understand the history of Australia's prohibition on anti-competitive price discrimination and the false grounds on which it was repealed.

Anti-competitive price discrimination occurs when a supplier sells equivalent volumes of identical product to one or more customers at one price and to other customers at higher prices, thus discriminating against them and making it impossible for them to compete on price.

Australia and New Zealand are the only two OECD countries which do not currently have specific prohibitions on anti-competitive price discrimination.

New Zealand, in s27 of the *Commerce Act*, has a general prohibition on contracts, arrangements, or understandings substantially lessening competition (similar to Australia's s45); but the New Zealand legislation (s36B) also provides that purpose may be inferred from any conduct which takes advantage of market power. Australia has no similar provision.

The United States of America has had a prohibition on anti-competitive price discrimination, the *Robinson-Patman Act,* since 1934.

Section 2(a) of the Robinson-Patman Act[1] says:

> *That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality...where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit or such discrimination or with customers of either of them.*

The 1957 *Treaty of Rome*, which established the European Common Market, included such a prohibition.

These other jurisdictions have appreciated that the long-term result of anti-competitive price discrimination is monopoly and have taken determined action to prevent that from occurring.

Australia had a prohibition on anti-competitive price discrimination, the former section 49, which was part of the *Trade Practices Act 1974* (now the *Competition and Consumer Act*) from its inception until the section was repealed in 1995 on the recommendation of the Hilmer Committee.

Until repealed, s49 read in part:

49(1) [Prohibited Conduct] *A corporation shall not, in trade or commerce, discriminate between purchasers of goods of like grade and quality in relation to:*

(a) The prices charged for goods

[1] Ibid., p. 11

(b) Any discounts, allowances, rebates or credits given or allowed in relation to the supply of goods;
(c) The provision of services in respect of the goods; or
(d) The making of payments for services provided in respect of the goods;

If the discrimination is of such magnitude or is of such a recurring or systematic character that it has or is likely to have the effect of substantially lessening competition in a market for goods, being a market in which the corporation supplies, or those persons supply, goods....

The rest of the section provided limited exemptions and defences.

Within two years of the passage of the *Trade Practices Act 1974*, vested interests were already arguing for repeal of s49, before any case had been taken to court under that section. The Swanson Committee recommended in 1976 that s49 be repealed on the basis that s46 (misuse of market power) would do the job.

Three years later the Blunt Committee repeated the recommendation, offering the same rationale.

Fraser governments rejected both recommendations.

In 1993, the Hilmer Committee again recommended repeal of s49 on exactly the same rationale.

Hilmer went even further, with an ideological statement[2] specifically disparaging the interests of small business and revealing he was influenced by unvalidated theories[3] on competition:

> *The prohibition against price discrimination prevents the sale of like goods to different persons at different prices, where such discrimination substantially lessens competition. The provision is contrary to the objective of economic efficiency and has not been of assistance to small business. The Committee does not believe that it is the role of the competitive conduct rules to protect any particular sector of society, and does not believe*

[2] *National Competition Policy: Report by the Independent Committee of Inquiry, August 1993, p. 74.*
[3] op. cit., footnote, p. 2, reveals Hilmer's thinking as influenced by a number of theorists.

> *that the competition rules should be used to achieve objectives contrary to economic efficiency.*

[Our emphasis].

In Hilmer's own words, prevention of a substantial lessening of competition would be "contrary to the objective of economic efficiency". The corollary to Hilmer's logic is that a substantial lessening of competition would promote economic efficiency. And, presumably, that monopoly would be most efficient of all.

Given the hyper-concentration of the grocery industry in the hands of Woolworths and Coles, whose combined market share increased from about 50 per cent in 1995 to about 80 per cent of grocery sales today, that part of Australia's economy, at least, must now be highly efficient.

Swanson, Blunt and Hilmer each argued that s49 needed to be repealed. Yet s49 had no effect if market participants were not engaged in anti-competitive conduct in relation to pricing. Of course, s49 also assumed a diligent regulator prepared to take cases where evidence of anti-competitive price discrimination was available.

Hilmer's series of unsubstantiated assertions became the basis for the repeal of s49 in 1995 by the Keating government.

Hilmer added:[4]

> *The Committee considers that price discrimination generally enhances economic efficiency, except in cases which may be dealt with by s.45 (anti-competitive agreements) or s.46 (misuse of market power). To the extent that s.49 has had any effect it seems to have been to diminish price competition. The Committee does not consider that competition policy should be distorted to provide special protection to any interest group, including small business, particularly where this is potentially to the detriment of the welfare of the community as a whole.*

[4] Ibid., pp79-80.

To the extent that s49 had "had any effect" *it had not been used as the basis for a single prosecution by the regulator from 1974 to 1995*, so could not in any way have diminished price competition. Section 49 "diminished price competition" only in the sense that those without an anti-competitive pricing advantage were unable to compete on equal terms.

The mediocrity of Hilmer's thinking is obvious. Around the world, prohibitions on anti-competitive price discrimination are in place ***not to protect small business, but to protect the competitive process.***

In the Australian context, the absence of a s49-style prohibition hurts not only small businesses, but large businesses which supply the world's most powerful grocery duopoly and are unable to resist the duopoly's demands for anti-competitive pricing advantages.

That is why, since the deregulation of the Australian dairy industry in 2000, the supermarket chains' private label milk has consistently been priced substantially and continuously below proprietary branded milk.

It is important to note that anti-competitive price discrimination prohibitions in other jurisdictions provide that both supplier and customer are liable where such conduct occurs.

In that context, an anti-competitive price discrimination provision can be seen as a shield for the supplier, helping the supplier to resist the demands of a customer with greater market power.

Taking the Australian dairy industry as a case in point, dairy processors and farmers would not be in the parlous position they are at present if the processors had been able to resist the demands of the major supermarket chains for substantial pricing advantages for their private label brands. Regardless of the fact that contracts are let on the basis of tenders, dairy processors are well aware of the pricing levels which the major supermarket chains will accept and have no practical option but to meet those demands.

Why was s49 repealed?

Hilmer's denial of any support for small business had the effect of promoting the interests of some big businesses.

A search of the Westfield Group website reveals that Professor Fred Hilmer has been a director of that company since 1991.

One might well wonder why repeal of s49 was given such priority by three separate inquiries when no cases had ever been taken by the Trade Practices Commission.

The answer might well lie in the fact that s49 included an "effects" test, rather than the "purpose" test in s46. "Purpose" tests are notoriously difficult to satisfy unless one has strong evidence from a whiste-blower or a "smoking gun" document. Repealing s49 and obliging a regulator to rely on s46, for example, probably weakened the prohibition seriously, but we'll never know since the regulators were and remain dormant on these issues.

It is important to note that when s49 was repealed, the Parliament did so on the basis of Hilmer's advice that sections 45 or 46 would do the job. *The Parliament did not express the view that anti-competitive price discrimination was acceptable conduct.*

From 1974 until today, neither the former Trade Practices Commission nor the Australian Competition and Consumer Commission has taken a single case to court under the former s49 or s45 or s46 in relation to anti-competitive price discrimination.

Conduct which every other OECD member state has prohibited apparently has never come to the attention of Australia's competition regulators. Or it has, but they have failed to act in 37 years.

In 1981, a private case, *JCool&Son v. O'Brien Glass Industries*, was taken to the Federal Court of Australia.[5] Justice Keely found that both s49

[5] FCA 95 (13 July 1981).

and s47 of the *Trade Practices Act* had been breached. It is important to note that s49 was an effective piece of legislation, later repealed without valid reason.

On 24 February 2011, the following astonishing exchange took place at a Senate estimates committee hearing.

Senator Milne had asked the ACCC chairman whether s46 was adequate for dealing with anti-competitive price discrimination, given that the section had been weakened by the High Court's decision in the Boral case and whether there was an issue of anti-competitive price discrimination in selling private label and proprietary branded milk at different prices.

SENATOR MILNE*: So can you tell me, is it price discrimination when different price are charged for the same product in different packaging?*

MR SAMUEL: *Well no its not. When you talk of price discrimination, then you refer to Boral senator, I think that we need to clarify. The price discrimination issue as you described within the provisions of the Trade Practices Act were repealed back in 1995 or thereabouts as a result of the Hilmer competition policy report.*

And there is nothing to prevent retailers selling products that might look similar or might be of a similar content at different prices. Of course we are aware, as I am sure you are, that the difference in price between a generic brand and a home branded products and that the branded product are very much related to the marketing elements of the branded product. When you refer to Boral, of course we are referring much more to issues of predatory pricing and the misuse of market power...

Mr Samuel may have misunderstood the general thrust of the question, but did not qualify or elaborate on his statement that s49 had been repealed. He did not directly answer Senator Milne's question about the adequacy of s46 in dealing with anti-competitive price discrimination.

Mr Samuel continued with further commentary, then said:

> *It is also appropriate just to note that there is our grocery inquiry indicated in its significant chapter the whole dairy and milk processing chain, there are several steps in the processing chain from the dairy farmer right through to the supermarket shelf and perhaps it is just worth reflecting back on that chapter in the grocery inquiry as to the various elements of that chain that can impact upon the price of milk at the retail level and equally at the pricing level that the farmer receives at the farm gate area.*

SENATOR MILNE: *And that's precisely the concern of course that this is becoming a more and more a make or break issue for the farmers because the farm gate price is being driven lower and lower to unsustainable levels and being sold below the cost of production for them. So could I ask you in terms of the Competition and Consumer Act, is it adequate to deal with the issues that are being faced by the farmers at the moment when it comes to issues like predatory pricing, when it comes to issue like anti-price discrimination. Have we got an adequate act?*

MR SAMUEL: *Well when it comes to issues of predatory pricing we have of course got two provision of section 46 including the now infamous Birdsville amendment. And I'd have to say to you to that that amendment is, on any analysis is subject to ultimate testing in the courts, goes a long way to covering issues of potential predatory pricing...*

He concluded his response to Senator Milne with the following statement:

MR SAMUEL: *Well I think I have indicated that the legislation in the context of predatory pricing we think is very, very thorough indeed.*

While again ignoring the issue of whether the prohibitions against anti-competitive price control were adequate, Mr Samuel did not point out that under that "very, very thorough indeed" legislation, the ACCC has received hundreds of allegations of predatory pricing under s46(1AA) but has not taken a single case to court.

Nor did he point out that the ACCC had advised the government in 2008 to amend that section - effectively to undo the amendment.

It seems also that, to Mr Samuel's mind, the repeal of s49 was absolute - he is apparently unaware that s49 was repealed on the basis that

sections 45 and 46 would catch such conduct, not because that conduct had become acceptable.

Anti-competitive price discrimination is now rife in Australia, thanks to nearly 37 years of regulatory inaction. The dairy industry provides a keystone example.

Can s45 and s46 catch anti-competitive price discrimination?

As a matter of what is now a substantial historical record, the answer is no.

No case relating to anti-competitive price discrimination has ever been brought under either section.

The reason is either that sections 45 and 46 are inadequate, or the national regulator has failed in its duty, or both.

Coles supermarkets and $1 a litre drinking milk

The terms of reference for the current inquiry ask "whether such a price reduction is anti-competitive".

National Foods' submission to the 2009 Senate Economic References Committee inquiry into dairy pricing said in part (our emphasis):[6]

> *One of the findings from the ACCC 'Grocery Inquiry' in 2008 was that increased processor costs were generally being reflected in wholesale prices for proprietary branded milk but that,* ***as a result of binding private label supply contracts and the bargaining power of the major supermarket chains, increased costs of production for processors were not being reflected to the same extent in wholesale, or retail, prices for private label milk.***

In other words, the arrangements between the major supermarket chains and the dairy processors for the supply of private label milk are such that the supermarket chains enjoy an on-going anti-competitive pricing advantage not available to other retailers of drinking milk.

[6] National Foods submission to Senate Economic References Committee *Inquiry into competition and pricing in the Australian dairy industry, 22 October 2009, pp 9-10.*

This is a clear example of anti-competitive price discrimination, specifically prohibited in almost every other OECD jurisdiction: dairy processors are supplying drinking milk to two major customers at one price and identical drinking milk to other (smaller) customers at higher prices. In all of those OECD jurisdictions, both the supermarket chain, as customer, and the dairy processor, as supplier, would be liable to prosecution.

Note that economies of scale are not affected by the prohibition on anti-competitive price discrimination. Genuine economies of scale are still available.

Yet, having documented the anti-competitive price discrimination, as National Foods noted in their submission to the 2009 inquiry, the ACCC took no action whatsoever.

National Foods' submission continued:

> *For suppliers of drinking milk like National Foods, these circumstances have resulted in the dual commercial difficulties of:*
>
> *1 being unable to fully recover cost increases on significant volumes of private label fresh milk; and*
>
> *2 an increasing retail price differential between National Foods' brands and major supermarket chains' private labels. This in turn leads to further consumer demand shifts to lower value private label product.*

Dairy processors have two other related difficulties: they need to pay the farmers who supply them with essential milk enough to allow them to stay in business and reinvest in their farms, plant and equipment and herds and provide for their personal needs; they need to get a sufficient return on investment in processing plant and equipment to allow them to stay viable and active in the dairy industry.

Both of those requirements are constrained by the prices the major supermarket chains decide to pay the processors. The supermarket chains are price setters; processors and farmers are price takers. Willingly or not, the dairy processors have entered into anti-competitive price discriminatory arrangements with the big supermarket chains.

To claim that prices are "staying down", as Coles has, is false. As on-farm costs and input costs have already increased significantly in recent years and prices for grain feed, diesel, fertiliser, electricity, water

and the proposed "carbon price" tax will affect farm input costs regardless of whether agriculture is exempted.

As a result the cost of production of milk will continue to increase *substantially*.

Since the only available "discretionary" profit margin available in the supply chain has been in the hands of the major supermarket chains, and since Coles has already committed all or at least most of its available retail profit margin to absorbing its latest discount to $1 a litre, prices must increase again soon or the production of fresh drinking milk by the Australian dairy industry will be at risk.

The $1 a litre price is unsustainable. As costs increase, the temptation for Coles will be to try to grab back margin from dairy processors and that in turn could lead to lower prices being paid to farmers.

The price of milk

There is no single "price" for milk. Prices vary from State to State over time - both farm gate prices and the prices paid to processors.

A column item in *The Australian* on 24 February 2011[7] said Victorian farmers were currently paid around 43 cents a litre "because they are the biggest and most efficient producers".

Dairy farmers supplying National Foods in New South Wales, according to Durie, get closer to 47 cents a litre, but National Foods makes more money from Victorian milk than from NSW milk. National Foods factory price in NSW is about 52 cents a litre.

Durie continued:

> *Farm gate prices in NSW and Queensland actually fell by some 10-15 per cent this year while they rose by about the same amount in Victoria.*

[7] "Dairy dust up", John Durie, *The Australian, 24 February 2011, p. 32*

> *As much as Coles would like to divert farmer anger to the processors, it won't work, because the farmer relationship is not with Coles, and the farmers see the supermarkets as the domestic price-setters.*

Because they are. The prices which the major supermarket chains decide to pay the processors - given the market power deriving from their dominance of drinking milk sales - largely determine the profit levels available to the processors and, through them, the profit margin left over for the farmers.

Again, according to Durie,

> *National Foods earns just 1 per cent return on its milk sales, but for the moment at least it earns big margins on branded and flavoured product.*

Branded milk sales are now 50 per cent of total sales[8]. As Coles's unsustainable $1 a litre price for drinking milk has been matched by other retailers, the certain result is that private label milk will win market share.

Dairy Australia has calculated that the discounting will cost Coles and Woolworths close to $75 million in retail margin.[9] But the shift of volume from proprietary brands to private labels will also cause losses for dairy processors and make it virtually impossible for them to offer any substantial relief to farmers, who, as we have noted above, are already facing their own input and operating cost increases.

It is probably true to say that the dairy processors failed to appreciate prior to the deregulation of the milk market in 2000 that the big supermarket chains' private label milk would grab such a large percentage of the drinking milk market, pushing the processors' own

[8] Dairy Australia, *Dairy 2011 Situation and Outlook, February Update, p. 12.*
[9] Ibid.

branded product aside, devaluing those branded products and reducing the returns to the processors from their own branded sales.

The large percentage of drinking milk the processors now sell at low margin under private labels and the reduced sales of branded (higher margin) drinking milk have put both processors and farmers under great pressure.

Since many independent grocery retailers sell mainly branded product, at higher margin to the processors, those individual businesses are effectively forced to cross-subsidise their supermarket chain competitors' lower prices. They are being disadvantaged by anti-competitive pricing discrimination.

Indeed, farmers' submissions to the current inquiry suggest that the farming sector is bearing the brunt of the supermarket chains' determination to grab the great bulk of the gross profit available in the dairy supply chain.

Dairy farmers are exposed to the full force of the greater market power of the processors and the supermarket chains and are effectively defenceless. This raises questions of unconscionable conduct, given the disparity in market power.

How is the price of milk calculated?

The short answer is, we do not know in detail. We do know that prices are effectively set by the major supermarket chains because of their market power.

We do know that the actual price is a combination of a per litre price and trading terms. Trading terms may entail multiple level rebates, discounts, co-operative marketing charges, bonus product, off-invoice allowances and so on. The actual "net net" price paid could be calculated if the details of these arrangements were known.
But the actual prices paid by the chains are impossible to know from the outside.

The ACCC has ample powers under s155 of the *Competition and Consumer Act* "to obtain information, documents and evidence".

The Commission could use those powers to obtain all relevant information, but takes a passive approach to enforcement, rather than actively investigating matters brought to their attention.

And as the national competition regulator, the ACCC should do so.

Indeed, the ACCC used those powers to obtain very substantial quantities of both paper and electronic documents from the major industry participants during the 2008 grocery price inquiry.

However, as one ACCC officer admitted to us after the ACCC's report was released, that vast quantity of documents was not used because the ACCC's staff could not understand them.

Such a statement raises serious questions about the skill sets and experience of ACCC staff.

What else about industry operations across many sectors do they simply not understand?

Are they competent to administer competition law?

At present the ACCC seems too often to look for reasons *not* to act. .

Conclusion

Australian competition law needs reform. A major review of this area of law is overdue.

However, an immediate response to the issues underscored by market dominance and anti-competitive pricing arrangements in the dairy industry should include two elements:

- <u>The immediate reintroduction of a prohibition on anti-competitive price discrimination.</u> Given the context of the *Competition and*

Consumer Act 2010 as it stands, the simplest solution is to reinstate the former s49 in its original form, remembering that in the one case taken it proved to be effective.

- New arrangements to ensure that the Australian Competition and Consumer Commission actually applies the legislation it is supposed to administer. Whether the appointment of a new chairman, due from 1 July 2011, is sufficient to bring about such change remains to be seen.