Submission to the Senate Economics Committee Inquiry into the impacts of supermarket price decisions on the dairy industry. by Dee Margetts

In your 2008/09 Committee Inquiry into Competition and Pricing in the Australian Dairy Industry there was considerable evidence that the market power of the major supermarket chains was creating serious problems for the dairy supply sector, especially for those dairy suppliers (and producers) who were required to supply homebrand milk and dairy products at very low costs to the major supermarket chains.

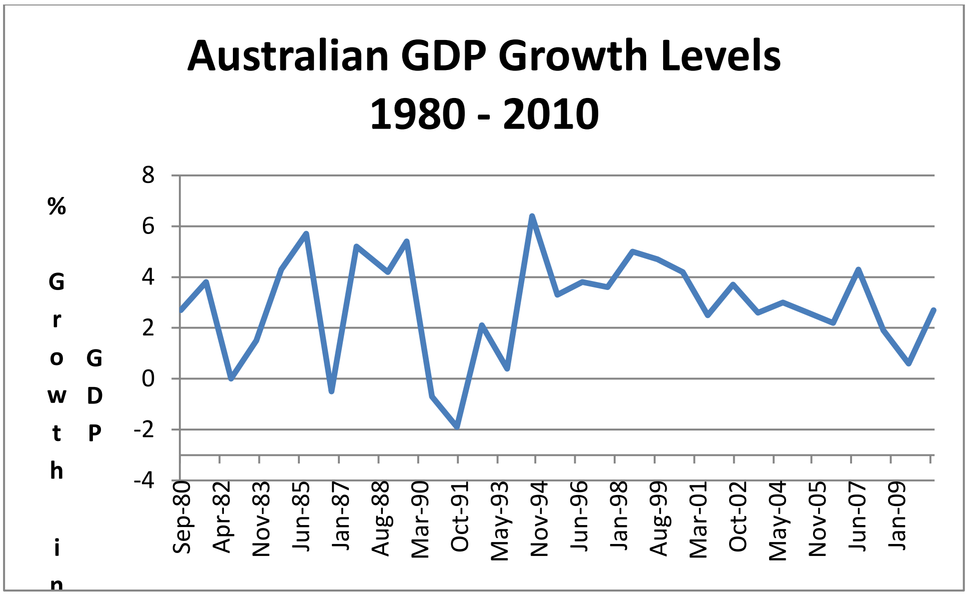
In my 2009 submission to the Senate Economics Committee Dairy Inquiry, I presented the theoretical background and impacts of National Competition Policy (NCP) on the Australian Dairy Industry.

In your Dairy Inquiry hearing in Perth in early 2010, I referred then to the fact that, in association with my PhD research on the impacts of National Competition Policy on the Australian Dairy industry I had also been developing a "Retail Case Study" and would be happy to provide the Senate Economics Committee with its relevant details once the academic journal article on my retail case study had been accepted for publication. At the time, I provided examples of concerns regarding retail market power abuse from the bodies representing Australia's grocery supply sector to the ACCC Grocery price Inquiry which were largely ignored by the ACCC. I have recently been advised that an article on my Australia's Retail Case Study will be published in the June2011 edition of the Journal of Australian Political Economy.

Before I briefly summarise some of the findings of this Study, it has come to my attention that in re-reading the Productivity Commission's 2005 "Review of National Competition Policy Reform's" Terms of Reference, that inquiry did not ask for an assessment of the positive and negative impacts of NCP, but simply to consider the *"...extent of the benefits the reform program has delivered to date and to inform an assessment of the most worthwhile completion related reforms which could apply beyond the current NCP arrangements*" (PC 2005 p iv). That is, the Terms of Reference for that inquiry, did not ask for an assessment of the impacts on National Competition Policy (NCP), and there was no mention of the wish to assess which negative impacts required NCP reforms to be changed.

In their report, the Productivity Commission (PC) claimed that NCP had *"... delivered substantial benefits to the community which overall had greatly outweighed the costs*", and one of their major assumed "benefits" they claimed was a "productivity surge" that they said had "underpinned 13 years of continuous economic growth" (PC 2005 p xii). But as can be seen in the graph below, Australia's GDP growth had dropped down to -1.9% in 1991 and then grew to 6.4% in 1994 (the year before NCP was introduced) but from 1995, Australia's GDP growth figures began falling. When they refer to "continuous economic growth", the 13 years they were referring to was from 1991 to 2004, but it is clear that they were trying to sound much more positive than reality. They didn't mention that the GDP "growth" levels were falling after NCP was introduced.

They did even however, state on a number of occasions that their own "modelling" in 1995 had said that "*Australia's level of real GDP state on a number of occasions would be 5.5 per cent higher once* *the productivity gains, price rebalancing and other changes associated with the reforms had been fully worked their way through the economy*" (PC 2005 xviii). Even though that clearly did not occur!



Source: ABS 5206.0

The PC report, in effect, made every effort to make NCP seem as positive as possible and their only sets of recommendations were a further micro-economic national reform agenda.

In a similar manner to making positive statements about the overall economy, they endeavoured to make positive statements about the impacts of NCP major policy changes in a range of industry sectors which had been targeted by NCP and related "reforms", including the dairy industry. Regarding the dairy industry they claimed there had been significant price reductions:

"*The average retail price of drinking milk has fallen by 5 per cent in real terms since full deregulation in 2000, despite the imposition of an 11 cents a litre levy to fund an assistance package for dairy farmers*" (PC 2005 p xix).

However, my research into the dairy industry found that the average retail milk prices dropped in the year following Australia's farmgate deregulation but then began to climb again at a rate higher than Australia's CPI index, and after the removal of the statutory marketing arrangement, Australia's farmgate and retail milk prices became disconnected (Margetts 2007 p 64).

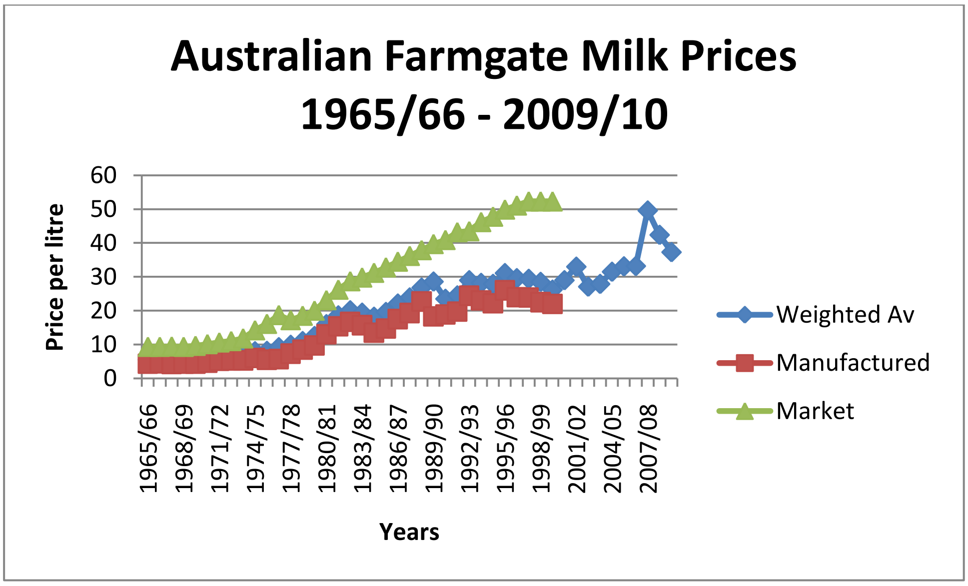
They also stated that:

> Employment in dairy farming had fallen
> The National Competition Council had concluded that total dairy farm income across Australia had risen and they quoted the NCC as stating that" the gross farm income is about $300 million per annum better off...compared to the year prior to deregulation..." (Quoted from the NCC submission, 2004d p 6).

The Milk Industry Liaison Committee were quoted as saying that the NCP's "gift to the major retail chains for milk was $1.13 billion and farmers, workers and consumers were $1,879 billion poorer each year (quoted from MILC sub DR 169 p 10)

However, data from Dairy Australia shows that the farmgate prices for market milk producers dropped considerable after their statutory marketing authorities were abolished as part of National Competition Policy in 2000 and even though market milk producers' average production costs were greater than producers of milk for manufacturing (because they had to produce daily milk all year round, including during droughts etc and could not simply produce high amounts seasonally as would producers of milk for manufacturing) but their farmgate prices became artificially linked to what were called "international milk prices" even though at the time of farmgate deregulation, Australia's farmgate prices for manufacturing milk were some of the lowest in the world for dairy exporters. And as I explained in my submission to your former dairy industry inquiry, the retail milk prices became disconnected to the farmgate prices (Margetts 2007).

As can be seen from the graph below, Australia's average farmgate milk prices continued to remain quite low in real terms (until there was a temporary rise in international dairy prices in 2007/08).



Source: Dairy Australia

My research into the impacts of NCP on Australia's retail sector has shown that National Competition Policy was not based on classical market theory, but corporate-based "contestability" theory (Margetts 2011). The removal of the Prices Discrimination Section from the Trade Practices Act was based on the Baumol et al support of corporate market dominance. However, my research has shown that this theory has been the focus of much critique for many years and had rarely if ever been proven to exist in situations of connection to corporate market dominance (Margetts 2011).

While classical market theory acknowledges the need to avoid the negative impacts of market dominance, the Baumol et al "contestability" theory supports corporate market dominance providing the market is considered capable of enabling the entry of competitors, even if it is not happening!

Largely because "contestability" was rarely tested, it was astounding to see therefore, that due to the Hilmer report recommendations, all of Australia's legislation was required to be reviewed to force it to be applied to "contestability" rather than market theory, and unless it could be successfully argued that the legislation/regulations were both in the public interest AND "contestable" they were likely to be made more vulnerable to corporate market dominance.

In their grocery prices inquiry, the ACCC chose to avoid assessing the impacts of National Competition Policy. This is significant as there is considerable corporate market dominance in Australia's retail grocery sector (and the ACCC chose to accept those levels of dominance without properly assessing the impacts of their oligopolistic market power on Australia's grocery supply sector since 1995).

As NCP was based on contestability theory rather than normal market theory, the very least that the ACCC should have done was to assess whether the basic pre-conditions of contestability theory existed in Australia's retail grocery sector. But they did not. **My research into their own data, however, shows that the three basic pre-conditions of contestability do not exist in Australia's retail grocery sector.** (Margetts 2011)

I explained that those preconditions are as follows:

- a perfectly contestable market must have free entry and costless market exit;
- contestable market prices must not be greater than marginal costs; and
- incumbent firms in contestable markets must have zero or negative economic profit (never above normal) (Margetts 2011.

It is important to note also that the US corporate market supporters such as Baumol et al, who were the major promoters of contestability theory, did not explain or admit the impacts of oligopolistic market dominance on the retail supply sector. They did, however, assume that the costs would be reduced and consumers would benefit.

It should be noted that while "contestability" had been the basis of NCP rather than classical market theory, it is clear that the Productivity Commission has not ceased to promote corporate market dominance and market deregulation (while they kept calling it "competition"). In their 2005 "Review of National Competition Policy Reforms, the PC recommended that:

"*In retail infrastructure markets, once effective competition has been established, regulatory constraints on prices should be removed*..." (PC 2005 p L).

This indicates that even if they considered that deregulation should occur, proper assessment of "effective competition" should have been undertaken. But, as their view of "effective competition" was corporate-based contestability theory, what most people would consider to be assessment of "effective competition" did not happen before they placed extra pressure on deregulation.

It is also important to remember that in their Grocery Price Inquiry, ACCC chose to ignore/disagree with the majority of representative primary producer organisations who advised them in their submissions that there was a growing gap between farmgate and retail prices.

The data I obtained from the Australian Beef Association shows that this gap increased after the introduction of NCP. But it was not just the Australian Beef Association who had stated in their submission that there was a growing gap between farmgate and retail prices. The majority of Australia's primary producers' representative groups also stated that the gaps in farmgate and retail prices were continuing to grow as retail prices continued to rise (Margetts 2011). The ACCC gave very little opportunity for confidential submissions to their grocery prices inquiry and they chose not to conduct any confidential surveys of Australia's grocery supply sector to check the range of serious issues on the supply sector which were mentioned in their issues paper.

It was also explained how highly questionable it was for the National Competition Council, when Graeme Samuel was President of the NCC, to put so much pressure on all of the States and Territories for trading hours deregulation, when there had been the removal of the Prices Discrimination Provision of the Trade Practices Act, and the range of other policy changes which enabled the market power of the major supermarket chains to continue to grow, including their ability in the late 1990s to use Australian Workplace Agreements to avoid paying overtime for those employees working out of normal working hours. This range of major policy changes provided greater financial benefits for the major supermarket chains over their small business retail competitors and suppliers. The removal of the Statutory Marketing Arrangements for major primary production sectors gave them much more power over the grocery supply sector and evidence has been shown that it is essential to properly investigate how much Australia's grocery supply sector has been and continues to be seriously damaged (Margetts 2011).

From the dairy perspective, as NCP provided a means by which the major supermarket chains (MSCs) were able to increase their market power, the removal of the Statutory Marketing Arrangements had a much more negative effect on dairy producers than it would have had if Competition Policy was actually based on competitive market theory, rather than "contestability theory" which supported corporate market dominance.

The Impacts on Challenge Dairy

It would be useful if your committee could inquire what caused the destruction of WA's Challenge Dairy Cooperative. In particular, it would be necessary to find out whether they were required to supply home brand dairy products to major supermarket chains and if so, whether the supply prices by dominant supermarket chains helped cause their financial disaster.

The current milk price war

In some ways, it could be suggested that one reason the major supermarket chains are conducting a milk price war is that their average dairy retail prices had been growing at a higher rate than dairy farmgate prices, so it's possible they wished to make retail prices drop. As market dominators, they have the ability to increase or drop prices of their sales items, at the expense of their suppliers. Their market power (and overall profit margins) enables them to be able to drop retail prices of some items considerably. The vast majority of such price ”specials” have been at the expense of suppliers, due to the oligopolistic market power of the major supermarket chains.

Because the retail milk prices have been largely disconnected to the costs of milk production in Australia, the recently introduced milk price war appears to be strongly linked to retail grocery market dominance of the major supermarket chains.

Even if Coles and Woolworths have not been dropping their prices to dairy suppliers, the dairy industry is under considerable cost pressure during seasons of drought (in Western Australia) and major floods in other states, and the fact that the major supermarket chains can announce such substantial price cuts and claim that those prices will remain low means that the lack of market support for the impact of dairy farmers during droughts and floods is outrageous. However, most seriously, their milk price war has put considerable pressure on retail competitors and the combined impacts on dairy producers and dairy manufacturers are unacceptable.

If the Committee wishes to meet with me to ask more questions regarding my retail case study publication, I would be happy to provide further information and respond to questions.

References

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