AUSTRALIAN FOOD & GROCERY COUNCIL

AFGC SUBMISSION

ACCC Supermarkets Inquiry 2024-25

Interim report response

OCTOBER 2024

PREFACE

The Australian Food and Grocery Council (AFGC) is the leading national organisation representing Australia's food, beverage and grocery manufacturing sector.

With an annual turnover in the 2022-23 financial year of $162 billion, Australia's food and grocery manufacturing sector makes a substantial contribution to the Australian economy and is vital to the nation's future prosperity. Each business in the sector has contributed towards an industry-wide $4.2 billion capital investment in 2022-23.

Food, beverage and grocery manufacturing together forms Australia's largest manufacturing sector, representing over 32 per cent of total manufacturing turnover in Australia. The industry makes a large contribution to rural and regional Australia economies, with almost 40 per cent of its 281,000 employees being in rural and regional Australia.

It is essential to the economic and social development of Australia, and particularly rural and regional Australia, that the magnitude, significance and contribution of this industry is recognised and factored into the Government's economic, industrial and trade policies.

The industry has a clear view, outlined in *Sustaining Australia: Food and Grocery Manufacturing 2030,* of its role in the expansion of domestic manufacturing, jobs growth, higher exports and enhancing the sovereign capability of the entire sector.

This submission has been prepared by the AFGC, drawing on consultation with our members. It is important to note that each member has their own experiences and views, which may differ from those expressed in this submission.

OVERVIEW

The Australian Food and Grocery Council (AFGC) welcomes the opportunity to respond to the Australian Competition and Consumer Commission (ACCC) Supermarkets Inquiry 2024-25 Interim Report, August 2024.

As the peak body representing Australia's food, beverage and grocery suppliers, including domestic manufacturers and importers, the AFGC has a deep understanding and unique insights into the operations and commercial trading relationships of food and grocery suppliers and their supermarket (retailer) customers.

Given cost of living pressures, the awareness of the public and the attention by politicians, the ACCC is understandably focused on the price of food and groceries as a component of overall inflation in the Australian economy. It is, however, important to bear in mind that the pressure consumers are feeling with respect to food and grocery prices reflects the broader hardship they are facing as a result of interest rate rises, energy cost increases and other drivers of inflation.

As this submission will show, the food and grocery supply chain has been, and remains, under enormous strain from unprecedented cost increases following COVID supply chain disruptions, adverse weather events and geopolitical tensions. In addition, the increased costs of energy and labour are having a significant bearing on manufacturing, as are government regulation and the costs associated with the sector's transition to a circular economy and clean energy. These factors continue to drive supply side inflation for food and grocery products.

To mitigate the impact to consumers, manufacturers have adopted cost saving measures where they can. However, the ability for manufacturers to cut costs has been constrained by the fact that a lot of efficiency measures were adopted in the pre-COVID years. As one supplier put it – they have already cut the fat and now risk cutting into the bone. Any longer-term measures to increase the use of technology and automation to mitigate manufacturing costs require supportive government policies. In addition to increases in wholesale costs from manufacturers, retailers have their own cost and profit considerations.

In addition to highlighting the cost pressures on manufacturing, this submission outlines the challenges faced by Australia's food, beverage and grocery manufacturers in selling into one of the world's most concentrated supermarket sectors. The characteristics of this market have put downward pressure on the profitability of Australia's food, beverage and grocery suppliers for an extended period, which has undermined reinvestment in this critical sector.

Further attention is given to issues resulting from the vertical integration and horizontal expansion of Australia's major supermarkets. This development sees food and grocery suppliers engaging with supermarket-owned or -controlled entities at multiple points across the extended supply chain, raising a number of competition-related issues. The AFGC welcomes the Interim Report's focus on expanding supermarket ecosystems, and considers that associated issues should be a priority focus of the ACCC's Final Report.

We also support further examination of the implications of information asymmetry between supermarkets and their suppliers, given the impact on food and grocery suppliers' ability to negotiate commercial arrangements and broader market outcomes.

Finally, the AFGC applauds the ACCC's focus on the allocation of risk and reward along the food and grocery supply chain in the Interim Report. Towards this end, and to counterbalance certain practices that can contribute to the disproportionate allocation of risk, we recommend a re-examination of the protections provided under the Food and Grocery Code of Conduct (the Code).

AFGC RESPONSE

This submission responds to specific key issues identified by the ACCC in Box 1.1 of the Interim Report.

SUPERMARKET PRICE SETTING PRACTICES

How product prices have changed over time

While attention has understandably focused on changes in product prices since the onset of inflationary conditions, the AFGC considers that a sole focus on post-2022 price developments is an incomplete story. In order to fully understand the rapid increase in prices in recent years, it is important to appreciate developments in the years prior to the pandemic.

Manufacturers are always looking for ways to mitigate or absorb rising costs. As in any sector of the economy, manufacturers are not able to mitigate or absorb all cost increases. Hence, there is a need to pass some costs on to retail customers in order to remain profitable, and continue to invest and employ over time. Over the decade since 2014, intense price competition between retailers limited the ability of manufacturers to recoup rising input costs, reducing the sector’s profitability and resulting in stagnating investment in capital equipment, research and development. The Interim Report highlights that monopsony power and market failures can harm dynamic efficiency, impacting firms’ investment in innovation and process improvements. Industry level data suggests that retailers’ market power and asymmetric bargaining position have negatively impacted the food manufacturing sector’s dynamic efficiency.

Figure 1 – Input and output prices for Australia's total manufacturing industry

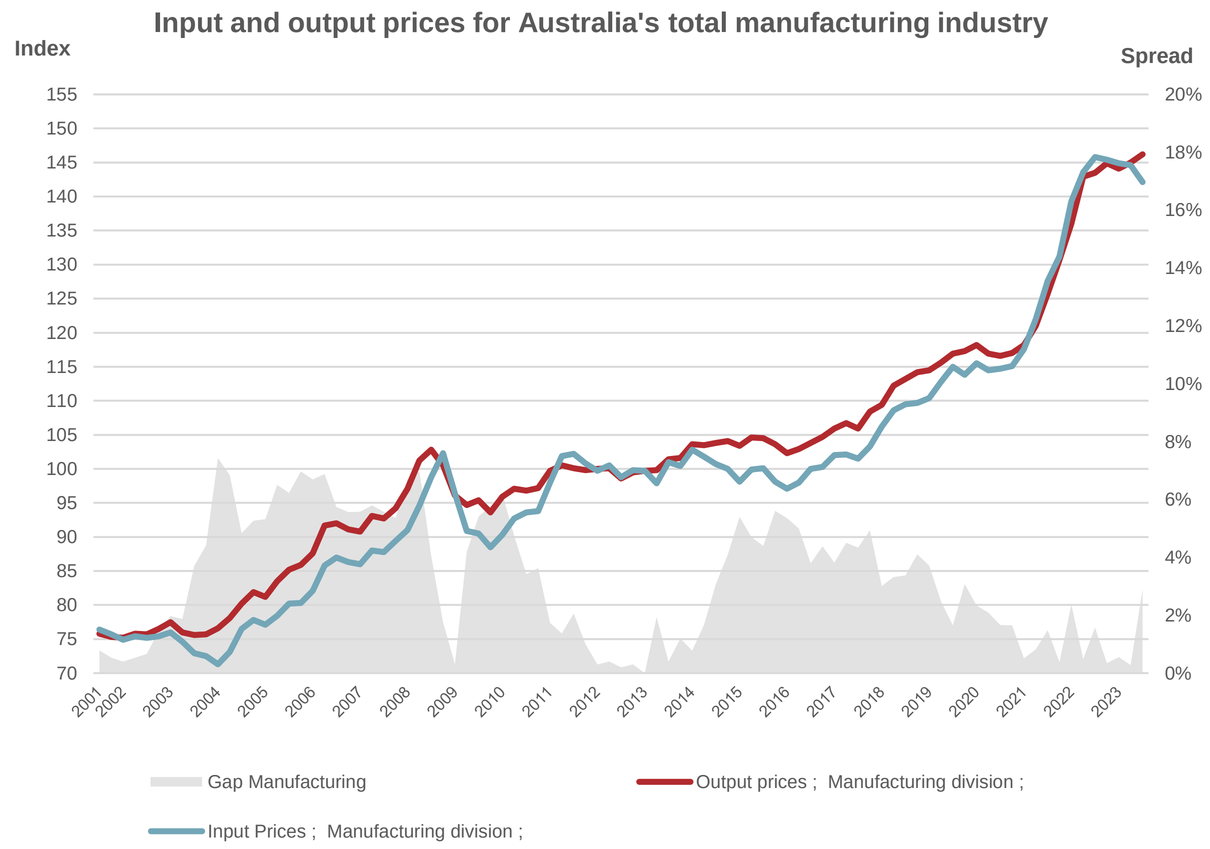
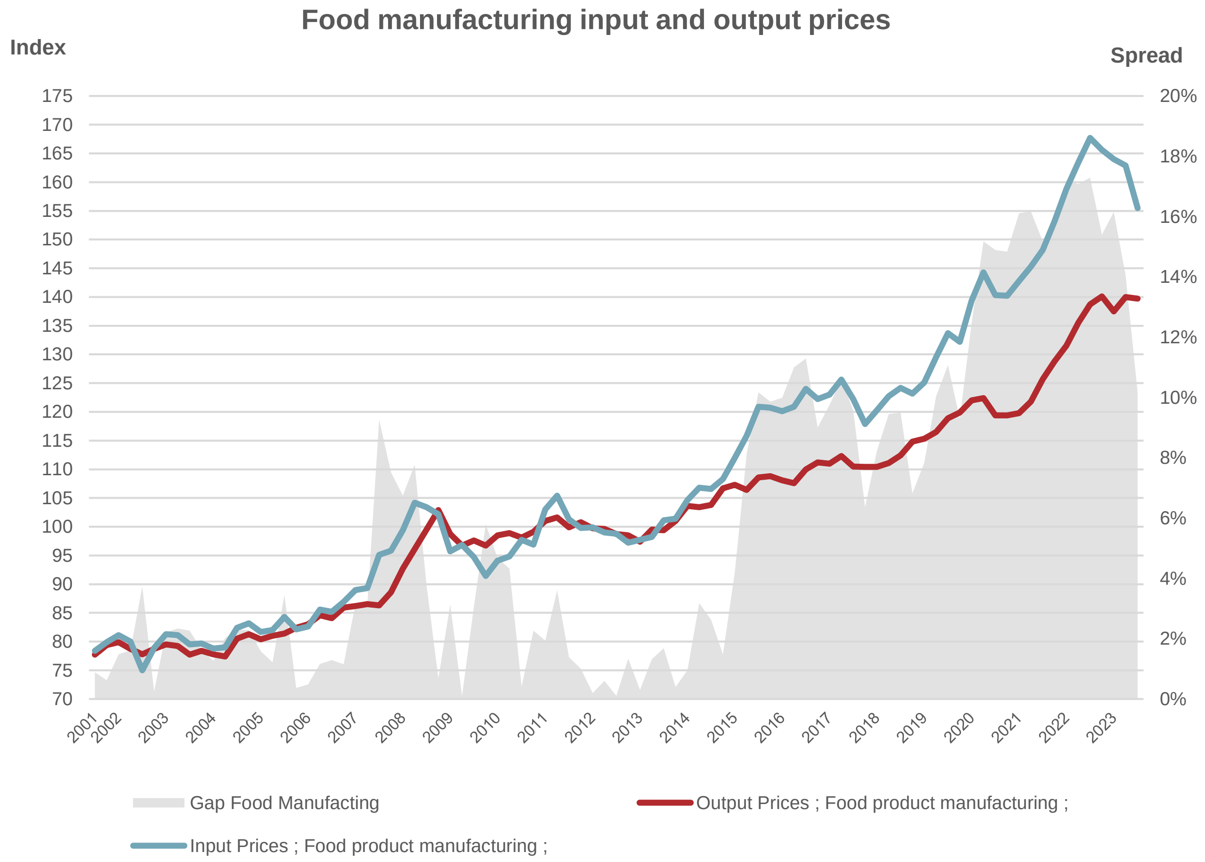


Figure 1 shows that the general manufacturing sector (including machinery and equipment, petroleum, coal, chemicals, metal products, furniture, textiles, leather, clothing and footwear, wood, pulp and paper products) has been able to respond to rising input prices by increasing the output (wholesale) prices for which their goods are sold. However, this has not been the experience of food manufacturers.[1] Instead, the past decade has seen suppliers' input costs rising at a greater rate than the output (wholesale) prices they have received for their goods. Figure 2 shows that from 2014, input costs to food manufacturing (such as agricultural commodities, transport and energy prices) rose at double the rate of output prices. During this period, suppliers cut costs, automated processes, absorbed cost increases and innovated to remain competitive, but their capacity to do so was not unlimited. The consequence was declining profitability and investment stagnation. And although the gap between input and output prices has narrowed slightly since, food manufacturers' input prices remained 20 per cent above their output prices between June 2020 and June 2023.

[1] Note data were not available for non-food groceries or non-alcoholic beverages.

Figure 2 – Food manufacturing input and output prices



The very low level of wholesale price increases in the years prior to 2020 contributed to low prices for consumers, with food CPI only increasing by a yearly average of 1.6 per cent over the period 2011-2021. However, this coincided with greatly reduced supplier profitability. According to the Australian Bureau of Statistics (ABS), sector-wide profits fell from $8 billion to just above $5 billion between 2010 to 2019, remained flat over the next three years, with a further 7.2 per cent fall reported in 2022-23. The fall in profitability has resulted in stagnating investment which negatively impacts the long-term dynamic and productive efficiency of the sector.

Food and grocery supply chains are complex networks involving various actors across different stages, from raw material supply to finished products. To meet the diverse needs of Australian consumers, the fast-moving consumer goods (FMCG) sector relies on both domestic and international inputs. This exposes suppliers to risks from disruptions both at home and abroad, impacting operations and financial stability.

Natural disasters like cyclones, floods, and bushfires can cause widespread disruptions. The 2019-20 bushfires and recent floods damaged crops and infrastructure, exposing the sector's financial vulnerability to such shocks. The 2022 floods, for example, disrupted agricultural supplies beyond affected areas, leading to price spikes and higher consumer costs.

These floods also exposed vulnerabilities in critical infrastructure, particularly the east-west rail corridor, which was unusable for several weeks. This forced supplies to be rerouted by road and coastal shipping, resulting in significant transport cost increases for suppliers. Such cost increases were typically absorbed by suppliers.

Similarly, suppliers face disruptions from international sources. For example, geopolitical instability in the Middle East and from the Russia-Ukraine conflict have led to price shocks in key commodities and fuel, and disrupted international freight routes, increasing import costs.

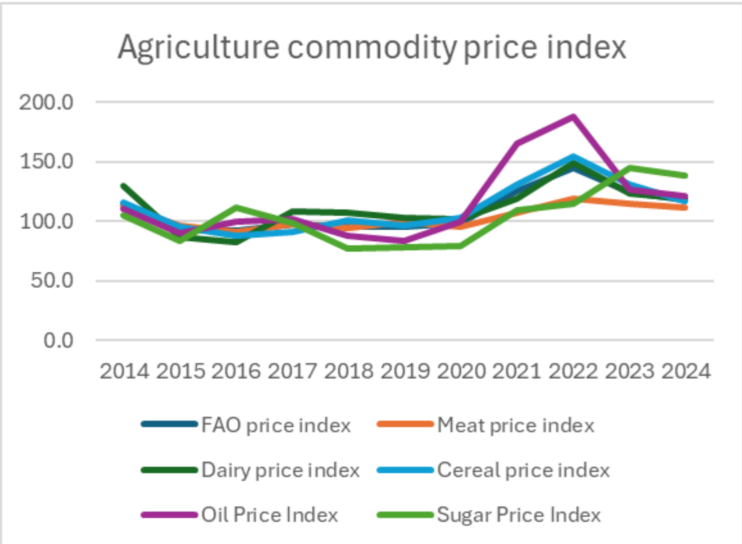
Increased input costs post-2020

With the introduction of pandemic-related restrictions from March 2020, suppliers cooperated closely with supermarkets to ensure minimal disruptions to the provision of household essentials to the Australian population. In this environment of crisis, very few suppliers sought to increase their wholesale prices. However, the ensuing circumstances – including the emergence of inflation, weather related impacts and geopolitical disruptions – saw rapid and unprecedented increases in suppliers' input costs.

Agricultural commodities

Primary commodities form the single largest input to food, beverage and grocery production and any variation in the price has a direct impact on the cost of the total product. As Figure 3 demonstrates, most key agricultural commodities experienced significant price spikes between 2020 and 2022. Despite some recent stabilisation in prices, all remain at a higher level than pre-2020.

Figure 3 – Agriculture commodity price index, 2014-24



The Food and Agriculture Organisation commodity index for the period 2020-23 was 24.5 per cent higher than the 5-year average price from 2014-2019, with certain commodities such as cocoa experiencing year-on-year increases of up to 234 per cent. Table 1 below highlights increases for key agricultural commodities.

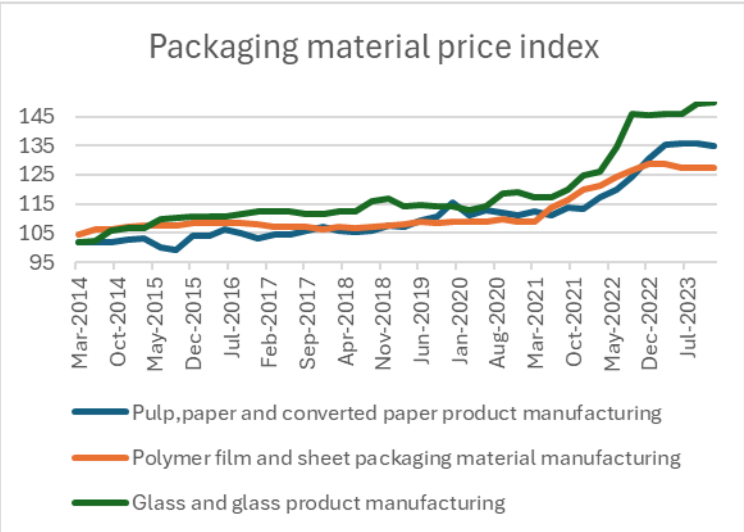
Table 1– Key agricultural commodity price increases

	Per cent increase (2020-23 average vs 2014-19 average)
FAO agriculture commodity index	24.5
Meat price index	11.0
Dairy price index	19.2
Cereals price index	29.8
Oil price index	46.6
Sugar price index	26.9

Packaging material

Four principal material categories – metals, glass, cardboard/paper and plastic – are used by food, beverage and grocery manufacturers for product packaging and logistics. Packaging costs have risen significantly since 2020, as indicated in Figure 4 below, due to a combination of energy, raw material and supply chain influences.

Figure 4 – Packaging material price index, 2014-24



Australian manufacturers rely on both imported and locally sourced packaging. It can be difficult to switch between packaging manufacturers as packaging may be specific to equipment and is typically tailored to the needs of the product. Table 2 below highlights price increases for common packaging materials.

Table 2– Key packaging component price increases

	Per cent increase (2020-23 average vs 2014-19 average)
Polymer film and packaging material	10.9
Paper and corrugated board	14.8
Glass	17.6

Freight and logistics

Rising fuel prices, sporadic supply issues (ad blue, diesel), driver shortages, and tight warehouse capacity (particularly in chilled) have increased the costs of distribution in recent years. Coupled with the increasing cost of international freight (containers, air freight and sea freight), this has added to cost pressure on the industry as illustrated in Figure 5 and Table 3.

Figure 5 – Freight and warehousing index, 2014-24

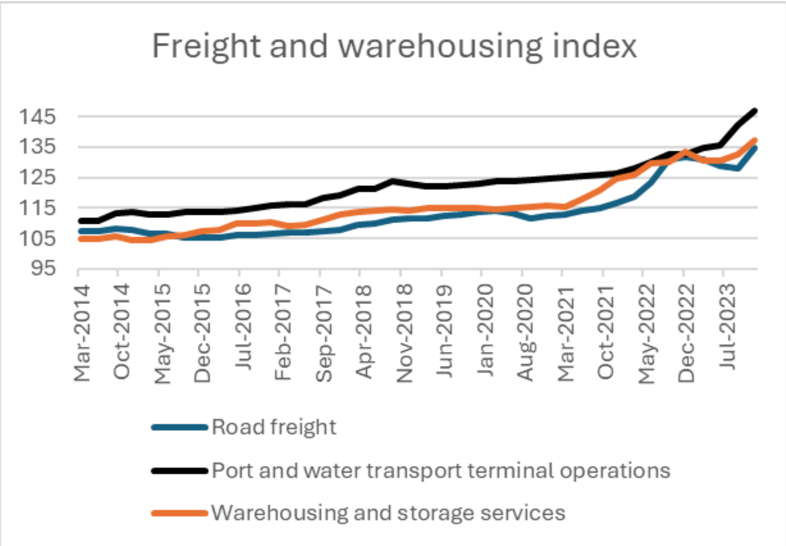


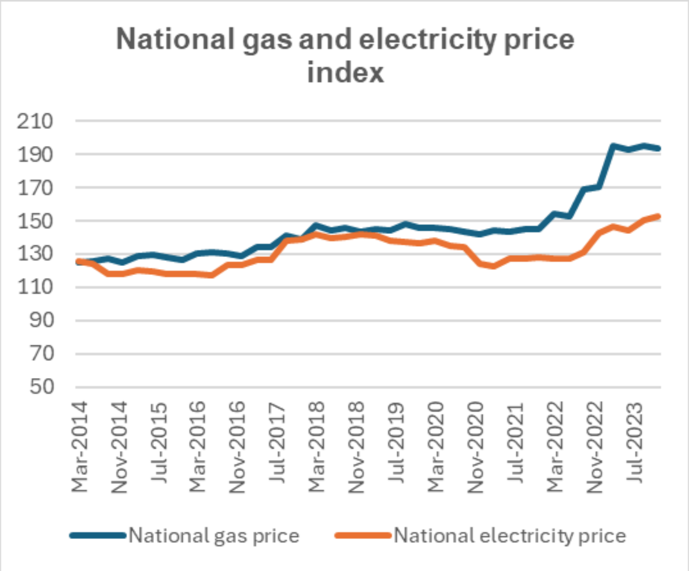
Table 3 – Freight and logistics price increases

	Per cent increase (2020-23 average vs 2014-19 average)
Road freight index	11.8
Rail freight index	16.7
Water Freight	15.3
Warehousing and storage services	13.1

Energy

Food, beverage and grocery manufacturing is highly energy intensive. Significant increases in energy costs, and challenges regarding reliability of supply and getting contracts from energy suppliers have raised the cost of production throughout the food and grocery manufacturing process.

Figure 6 – National gas and electricity price index, 2014-24



The inability, over the preceding decade, of suppliers to reliably secure wholesale price increases for their products is important context. Before heading into the COVID-era escalation in costs, suppliers had generally not taken price increases for many years. With the spike in supplier input prices across the board, many were unable to absorb the level of costs coming through without risking the viability of their manufacturing operations and jobs. As a result, suppliers had no alternative but to pass on a proportion of their cost increases, in many situations negotiating a wholesale price increase with supermarkets for the first time in over a decade.

The combination of wholesale and retail cost pressures has led to an average annual rate of consumer inflation for food of 4.4 per cent from 2020-2023. This compares to an average annual rate of consumer inflation for food of only 1.6 per cent during the decade prior to 2020.[2] The AFGC contends that the suppression of wholesale prices during the years prior to 2020 not only caused pressure for suppliers, but was also only of benefit for consumers in the short term. By exacerbating the cost pressure faced by suppliers over an extended period, many suppliers were poorly positioned to absorb a rapid increase in costs such as emerged after 2020. This created conditions for the rapid increase in prices that has been seen.

However, for many suppliers the increases in their wholesale prices achieved since 2022 has only enabled them to cover a portion of their increased operating costs. Hence, industry profitability has continued to decline, with a reduction of 7.2 per cent experienced in the 2022-23 financial year.[3]

It is also worth noting that while consumer prices for food have increased in Australia, they have not risen to the same extent as in overseas markets. According to ABS data, Australian food prices increased

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[2] Australian Bureau of Statistics, Consumer Price Index – Food and non-alcoholic beverages, average annual inflation from 2009-2023: https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/consumer-price-index-australia/latest-release

[3] See the AFGC's latest State of the Industry report: https://www.afgc.org.au/industry-resources/state-of-the-industry-2

approximately 18 per cent between December 2019 and December 2023, which is a considerably lower rate of increase compared to the UK (30 per cent), Europe (26 per cent), US (25 per cent), New Zealand (25 per cent) and Canada (23 per cent).[4]

Differences between prices paid by consumers and prices charged by suppliers

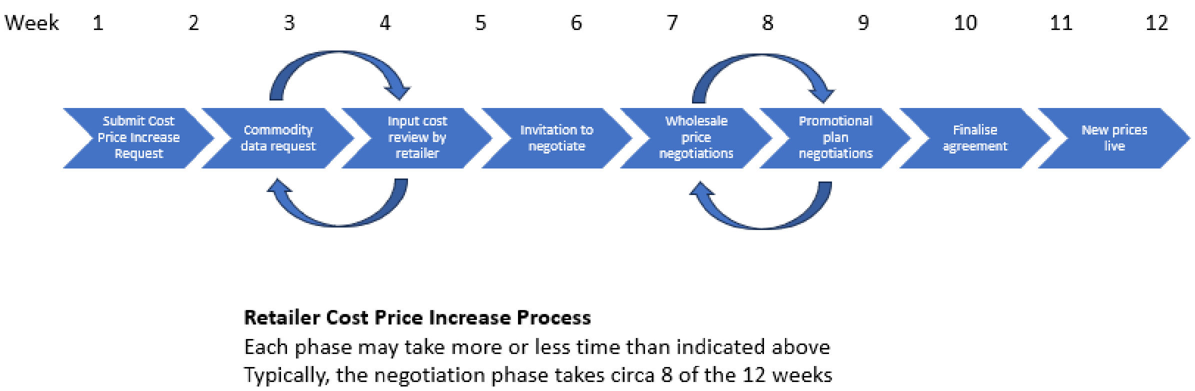
Pricing mechanics within the Australian food and grocery sector are complex, but fundamentally driven by the retail market. Supermarkets use their buyer power to exert influence over the cost price increase process, through which wholesale prices are agreed. It is not as straightforward as suppliers 'owning' wholesale prices and retailers 'owning' retail prices – instead the major retailers actively interrogate the supplier's wholesale prices, and influence other key financial elements at the centre of the supplier-retailer commercial relationship:

- *retail price* – under the full control of the supermarket
- *wholesale price* – determined by the supplier, but significantly influenced by the supermarket through the cost price increase process (see below)
- *investment* – although this ultimately requires the agreement of the suppliers, the supermarket influences how, when and which supplier products can be promoted and often requests other forms of investment from suppliers, including margin support payments.

Cost price increase

Any supplier seeking to increase the wholesale price for their goods, to recoup a portion of increased input costs, must navigate a price increase process that is controlled by the supermarket, who can ultimately accept or reject a supplier's proposed price.

Figure 7 – Retailer cost price increase process



As Figure 7 shows, the cost price increase process is lengthy and typically takes at least three months. During price negotiations, the supermarket generally continues to order at the 'old' price. Suppliers, meanwhile, can only start to recover their increased costs upon conclusion of the negotiation process. In a

[4] Office for National Statistics UK Consumer Price Inflation; US Bureau of Labor Statistics Consumer Price Index; Eurostat Harmonised Index of Consumers Prices; Stats NZ, Consumer Price Index; Statistics Canada Consumer Price Index.

rapidly inflationary environment, such as in recent years, this is challenging for suppliers as their costs rise far quicker than their wholesale prices.

In many cases, suppliers face extensive questioning from supermarkets, who have been known to ask suppliers to justify why the price increase is necessary, and request potentially sensitive information, such as invoices, to assess which input costs have gone up and by how much. However, suppliers are concerned about revealing cost information to supermarkets due to several risks. On one hand, it allows retailers to leverage operational information from a supplier's competitor during negotiations, information which cannot be verified, potentially leading to sub-optimal decision making. On the other hand, if a retailer competes in the same category with their private label, it could give them insight into the supplier's manufacturing processes or intellectual property. This reinforces concerns over information asymmetries in the sector, where retailers have more visibility into suppliers' operations, giving them an advantage in negotiations and further skewing the power dynamic.

The supply of food and groceries is a competitive market, with product substitutability and supplier competition keeping wholesale prices in check. Suppliers are also constrained by the fact that if they set a recommended retail price too high, and consumer demand falls, their factory throughput diminishes, and they are unable to recoup fixed costs. In addition, supermarkets control product ranging and can introduce competing brands, including private label, if they have concerns regarding insufficient supplier competition or high supplier pricing.

While the price increase process determines the wholesale price, suppliers do not ultimately receive the full wholesale price for the goods they sell to supermarkets. This is because the grocery supply agreements[5] between suppliers and supermarkets typically contain a wide range of deductions made by the latter.

The price received by suppliers can be expressed as:

Net price = Wholesale price – (fixed deductions + variable deductions + additional deductions)

The wholesale price is therefore not representative of the actual payments received by suppliers for their goods. The range of deductions from supplier invoices is wide, and the impact is a considerably lower payment to suppliers than that which might be inferred from the wholesale price.

Suppliers generally provide the same wholesale price to all supermarkets, however the final payment they receive varies according to the trading terms they have with each of their customers.

Promotional pricing activity, including the frequency of promotions

Promotions are a key element of pricing within the Australian food and grocery sector. For supermarkets, promotions are a vital pillar of consumer marketing strategies. For many suppliers, the increased sales

[5] The coverall term used in the Food and Grocery Code of Conduct to refer to any agreement between a retailer and a supplier (other than a wholesaler), or between a wholesaler and a supplier, that relates to the supply of groceries to or for the purposes of a supermarket business (whether or not the agreement is the principal agreement between them relating to the supply of groceries). It includes any document comprising the agreement or made, from time to time, under the agreement.

volume from promotions is essential to drive growth and maintain ranging within supermarkets. Promotions are also important in driving volume for suppliers to help allay the significant fixed costs of manufacturing. For consumers they provide price point value and engagement. The importance of promotions to a supermarket's value offering to consumers has only grown during the current cost of living crisis, with supermarkets emphasising consumers' increasing focus on value and discernment regarding price. In this environment, consumers are more inclined to purchase items on promotion than under 'normal' circumstances.

Promotions are negotiated and agreed on a case-by-case basis with suppliers. However, the typical commercial structure of a promotion is for suppliers to:

- fund between 50 and 100 per cent of the price discount
- pay the supermarket for promotional display space
- pay the supermarket for inclusion in catalogue
- provide in-store merchandising and incentives.

Suppliers can benefit from the increased sales volume associated with promotions. Although there is a broad range of promotional configurations, typically a supplier will fund between 50 and 100 per cent of the promotion. In cases where a supplier is funding the entirety of the promotion, they will receive less for every item sold, while the supermarket would receive the same amount as for when the item is sold at full price. In such circumstances, the supermarket can maintain or grow their gross profit margin while also benefiting from increased sales volume, whereas benefits for the supplier are more contingent.

More recently supermarket practices have sought to make the supplier responsible for price competition within the retail market, over which they have no control. The AFGC has concerns that practices, such as below, negatively impact on the market's natural competitive process.

- *clashing* – more recently, supermarkets have required suppliers to provide assurances that a promotion does not 'clash' in the market prior to, during and after the promotional period. This limits the supplier's ability to promote their product in another supermarket, dampening industry price competitiveness.
- *competitor promotion* – while a promotional plan is typically negotiated between the parties, there are examples of suppliers having a promotion imposed on their business following a supermarket realising its price is higher than one of its competitors. In such cases, supermarkets might seek financial support from the supplier to compensate for a promotional activity of their competitor. Suppliers often feel compelled to accede.

CONSUMER EXPERIENCE

Consumer concerns raised regarding shrinkflation

The AFGC acknowledges consumer concerns regarding the phenomenon commonly known as 'shrinkflation' – whereby product sizes are reduced without a corresponding reduction in the shelf price. Shrinkflation, or price pack architecture, reflects the difficult decisions a supplier must make in the face of considerable increases in input costs, as outlined above. As discussed, suppliers mitigate cost increases to the extent possible and where not, they have the hard decision of either reducing pack or product size, reducing quality, ceasing production of the product, or moving production offshore to a lower cost market.

In these circumstances, the reduction of product sizes is the least worst option available to suppliers and allows the consumer to still enjoy the product while minimising the additional price paid.

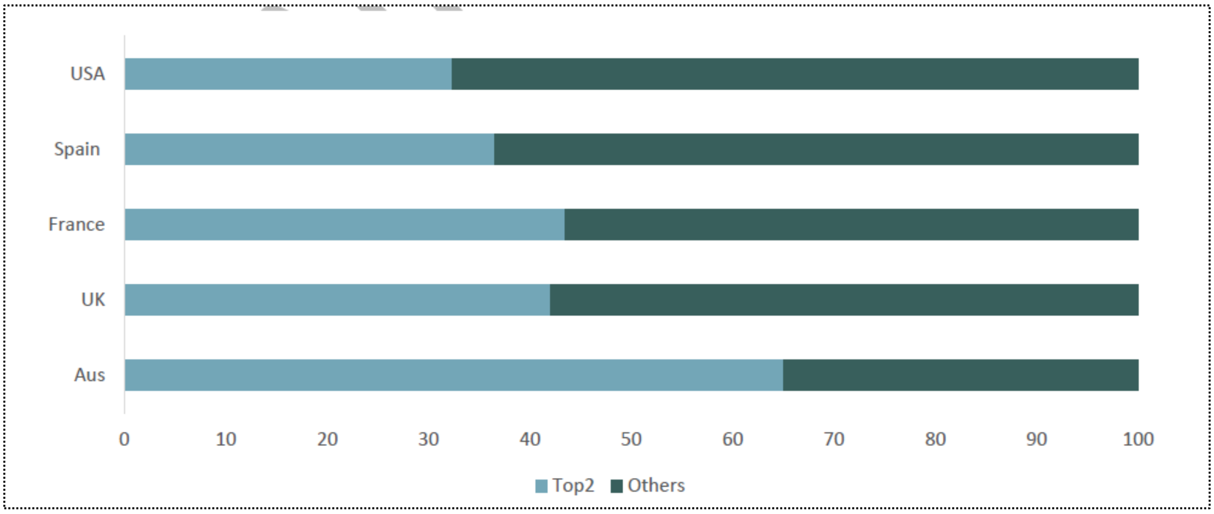
The current Unit Pricing Code, a mandatory industry code under the *Competition and Consumer Act 2010*, establishes the rules for which supermarkets must display unit prices and shows how much a product costs using a standard unit of measurement.

RETAIL COMPETITION

The nature and extent of competition between Coles and Woolworths

The combined market share of Australia's top two supermarkets, Coles and Woolworths, stands above most other comparable countries and is surpassed only by New Zealand (see Figure 8). The Herfindahl-Hirschman Index of Concentration, a metric widely used by competition authorities, is estimated at 2302,[6] suggesting considerable market concentration.[7]

Figure 8 – Combined market share of top two supermarket retailers (Sources: Statista, Axios, Kantar)



Effective competition

As the Interim Report acknowledges, the supermarket channel continues to be the dominant means through which Australian consumers purchase food and grocery products. Australia's food and grocery suppliers face the challenge of selling their goods to a concentrated market, with 82 per cent market share held by only four companies (Woolworths, Coles, Aldi and Metcash). The AFGC is concerned that the current market structure, combined with the vertical and horizontal integration of supermarket retailers, as

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6 AFGC estimate, based on Statista retail market share data

7 The AFGC notes that markets with an HHI in excess of 1800 are generally considered to be highly concentrated, and that the ACCC recognises competition concerns in cases where the HHI exceeds 2000 (particularly in merger analysis)

well as the expansion of supermarket ecosystems into multiple related services, have a long-term negative impact on supplier profitability and economic dynamism.

Vertical and horizontal expansion

As noted in the Interim Report, Australia's major supermarkets have vertically and horizontally integrated into various key adjacent industries, including media, data, wholesale food distribution and transportation, with significant potential implications for suppliers. This has often been the result of mergers, acquisitions and internal business growth. As a consequence, supermarkets are not only the principal customers of suppliers, but in many cases also providers of services that suppliers are encouraged to use.

This expansion means that supermarkets not only control a disproportionate share of the retail market but will increasingly be a significant participant in numerous related channels and industries. Increasingly, suppliers find themselves engaging with supermarket-integrated companies or associated businesses at multiple points across the extended supply chain. As a condition of doing business, suppliers are often strongly encouraged to use services controlled by the supermarket which are sometimes at above-market rates, increasing both the costs faced by suppliers and their reliance on supermarkets.

While this ecosystem holds the promise of cost reduction and consumer benefits, it also poses challenges such as heightened barriers to entry and increased market concentration. The AFGC is concerned that the expanded ecosystems can contribute to a consolidation of power across the supply chain with the potential for supermarkets to incorporate adjacent services within their ecosystem into core negotiations. This dynamic pressures suppliers to engage with these integrated entities, without regard to the costs or value of the services provided. Such practices raise concerns about diminishing competition in the provision of these services and potential repercussions on market dynamics.

Another issue arises when vertically integrated supermarkets can use their buyer power in negotiations. Research shows that vertical integration has dual effects on prices. On one hand, the products with eliminated double margins tend to become cheaper to sell, known as the efficiency effect, which is raised in the Interim Report. However, the Interim Report also notes the potential for vertical integration to be harmful "if it allows a firm to leverage a dominant position to reduce competition".[8] Higher relative profit margins, as a result of the efficiency effect, can create an incentive to drive sales to these products. In Australia this is concerning when a vertically integrated firm also holds significant bargaining power in negotiations and hence warrants further investigation by the ACCC.

The AFGC holds particular concerns regarding supermarket-controlled services, including the limited ability to negotiate, lack of transparency of pricing architecture and inadequate ability to assess costs against a competitive market set:

- *channels to market* – along with their core businesses, major supermarkets are also actively targeting other channels to market, including food service, online, workplaces and care facilities. Over the past decade business acquisitions and expansions have demonstrated this key strategy of entering and dominating new channels. The result has been a marked reduction in the supplier

[8] Page 225.

customer base, potentially enabling supermarkets to exert buyer power through seeking to align prices paid for goods, trading terms and margin support from suppliers. This further enhances market concentration. The relative increase in importance of supermarkets to suppliers, the worse the supplier's bargaining position tends to be, as they lack alternative buyers for their products.

- *retail media* – suppliers using retail media, which includes payments from suppliers to cover their products featuring in a supermarket's catalogue or being promoted on e-commerce platforms, is an increasing emphasis of supermarkets when negotiating commercial agreements. While retail media can deliver benefits to suppliers, and ultimately, they can decide whether to purchase those services, many suppliers have reported concerns that they are pressured into using the services at markedly higher than market costs.
- *data* – the major supermarkets steer suppliers towards acquiring data from companies with which they either have strategic partnerships or majority ownership. Again, suppliers can benefit from using retailer data, however as data becomes more central for commercial negotiations, suppliers struggle to validate the value and quality of these services.

GROCERY SUPPLY CHAINS

The Interim Report suggests "supply chains for packaged groceries are typically more straight forward than perishable goods."[9] However, packaged goods' supply chains are notoriously complex. They involve a wide range of actors at different stages, upstream, midstream, and downstream, each playing a role in supplying and transforming raw materials and commodities into finished products.

The shift towards global sourcing has made this even more challenging, as companies must manage varying interdependencies and processes across different partners and countries. In the food manufacturing sector alone, Australia is reliant on imports of specialist ingredients and other food components (food additives, colouring, flavouring, and processing aids) for an extraordinarily diverse range of products. Moreover, other inputs such as packaging, manufacturing plant and equipment, disinfectants, and personal protective equipment are imported and are critical to the manufacture of the wide range of products found on supermarket shelves.

Packaged goods suppliers not only deal with the same complexities and constraints as the primary sectors (such as those selling agricultural or meat products), they also manage additional difficulties and pressures from the subsequent stages of manufacturing and processing those resources obtained from the primary sector.

A recent McKinsey article suggests that the more complex the supply chain, the greater the risk of suffering disruptions that can cause operational and financial impact. This can cause a loss of up to 45 per cent of yearly EBITDA per decade.[10]

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[9] See.page 221.

[10] Reimagining industrial supply chains | McKinsey

Suppliers' ability to effectively negotiate on prices and implications for their ability to make efficient production decisions

The AFGC has provided an overview of suppliers' ability to effectively negotiate cost price increases above. This section focuses on supermarket behaviours that impact suppliers' ability to make efficient operational decisions, and the allocation of risk and reward along the supply chain.

Some characterise the food and grocery sector as dominated by relatively few firms that account for the vast majority of wholesale supply to supermarkets and, therefore, hold significant bargaining power, with potentially harmful outcomes for consumers. However, this characterisation is misleading for the following reasons.

Product substitution and bargaining power

A supplier can have significant market share in a category, but this does not necessarily translate to outsized significant bargaining power due to the number of alternative products available in the market, and a high degree of substitutability. The current cost of living crisis provides a clear example of the relative price elasticity of demand for products, with industry reports showing that consumers are looking for specials, deals, and buying cheaper alternatives (often referred as "trading down").[11] Therefore, even with scale and brand differentiation, companies still face competitive pressures from their relevant market. This relevant market includes all those products that are regarded as interchangeable or substitutable by the consumer based on their characteristics, their prices, and use – potentially spanning multiple categories or several products.

Furthermore, even the largest suppliers face constraints in their bargaining power. While some suppliers may have access to alternative sales channels such as export markets, a significant portion of their domestic sales (potentially upwards of 70 per cent) come through the supermarket channel. As such they cannot afford to walk away from negotiations with supermarkets. The mechanics of negotiations also occur at the category and sub-category level, not at the company level or a global head office – a further constraint on supplier bargaining power.

The Interim Report seeks to differentiate between a (positive) supermarket bargaining power which counteracts supplier market power in the packaged goods sector, with an economically harmful oligopsony power in fresh produce. The report also says that "while monopsony power allows buyers to acquire products for lower prices, it typically leads to undersupply and *reduced investment by suppliers over time*. Inefficient levels of supply and investment in production will in turn, lead to higher prices and reduced choice or quality for consumers in the long run."[12]

As outlined above, packaged goods suppliers' profit margins have been under pressure which has in turn impacted investment in local manufacturing. Investment is a key driver of innovation and increased productivity. However, food manufacturing investment has not kept pace with sector growth. Over the

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[11] Grocery shoppers are trading down – but that's not all bad for supermarkets - Inside FMCG

[12] ACCC Interim Report, Pg 46. We note the market displays oligopsony power rather than monopsony.

decade prior to 2021-22, the food product manufacturing turnover compound annual growth rate was 3.7 per cent with a 1.0 per cent decline in capital investment. This is real-world evidence of supermarkets' asymmetric bargaining power and its impact on packaged goods suppliers.

Information asymmetries between supermarkets and supplier and the impact on supplier ability to plan, operate, invest and manage risk associated with operating their businesses

Information asymmetry

Packaged good suppliers have similar concerns to fresh produce suppliers when it comes to information asymmetries. They often find themselves in negotiations with supermarkets with considerably less information to optimise their approach and secure favourable outcomes. This represents another major challenge suppliers face from the asymmetric power (including informational power) of the supermarkets.

The impact of information asymmetry is only rising as a consequence of the increased prevalence of retail data in strategic and operational decision making. With their investments in data loyalty programs, data processing organisations and data science capability, the major supermarkets have access to an enormous range of data and insights, which are used to inform negotiations with suppliers. In contrast, suppliers can only access processed data through purchasing it from the supermarket's respective data house. A supplier who does not purchase the processed data sits at a major informational disadvantage in commercial negotiations.

Some other examples of the practical consequences of information asymmetry are:

- *inconsistent shelf layout charges* – suppliers generally bear the costs associated with supermarkets changing the shelf layout as a result of a range review. The AFGC is concerned that this is an unreasonable cost on suppliers and that they face a lack of clarity regarding the cost calculations which range from the proportion of their products being changed in the range review, to their percentage of sales for the category. The supplier has no access to information to assess the 'true' cost of implementing the shelf layout changes.
- *category margin claims* – from time to time, suppliers have received requests from supermarkets to increase the latter's margin on a given product on the grounds that the product falls below the category margin expectations. Notwithstanding the fact that, by definition, some products must always be below the average margin, this practice also demonstrates disadvantages suppliers face from information asymmetry. Ultimately, only the supermarket knows the respective margins of every product within a category. The supplier, who only knows this detail in relation to their own products (and not their competitors within the category), is not able to evaluate the supermarket's margin claims and is thereby at a disadvantage in negotiations.

Uncertainty and risk

Concerns regarding uncertainty and risk are ever-present for suppliers doing business with supermarkets. Suppliers are often party to opaque commercial arrangements, and on occasion the terms of agreement can shift abruptly, denying them the certainty required for commercial planning. This section outlines several contemporary examples of common supermarket behaviour relevant to these themes and demonstrate how supermarkets use their asymmetric power:

- *unreasonable shelf layout charges* – suppliers have received requests for contribution to the cost of changing shelf layouts even when their products have not been affected. While many suppliers who challenge unreasonable requests of this kind have seen the retailer back down, many nevertheless feel compelled to pay so as not to jeopardise the relationship with their supermarket customer.
- *display charges* – suppliers pay to have product displayed at aisle end (gondola) as a way of driving product awareness and purchasing volume, however recent significant increases in these charges with limited corresponding value is a further example of opaque commercial arrangements.
- *unexpected range review costs* – some suppliers, having successfully navigated the range review process and had their products selected, have been presented with contracts to formalise the ranging agreement that included new costs which had not previously been discussed in negotiations.
- *range review criteria* – transparency and certainty for the criteria supermarkets use for ranging decisions are critical to suppliers' decision making. In reality, the criteria are often vague and subject to variation during the range review process. This denies suppliers certainty regarding the criteria against which ranging decisions will ultimately be assessed, leaving them at a disadvantage in negotiations.

These are examples of the challenges faced by suppliers in relation to transparency and certainty of costs and charges levied by supermarkets, leaving suppliers in a position of considerable uncertainty. The AFGC considers that such behaviours can contribute to the lack of certainty, ability to plan, operate, invest and manage risk.

Implications for the Food and Grocery Code of Conduct

In light of the challenges outlined above, the impact of which is a disproportionate allocation of risk upon suppliers, the AFGC recommends a re-examination of the protections provided under the Food and Grocery Code of Conduct (the Code). Below are several examples of practices currently permitted under the Code that influence the allocation of risk and reward along the supply chain. The results can be financial loss, reduced efficiency and an erosion of confidence in commercial relations within the sector.

Promotions

As detailed above, the sector has faced considerable supply chain disruptions over the past few years. This has resulted in difficulties importing raw materials, packaging, processing aids or finished products. In many cases, such interruptions impact the ability to meet demand, particularly when products are scheduled for promotion. Unfortunately, even following supplier advice on the impact of disruptions, the AFGC understands that sometimes supermarkets have gone ahead with promotional plans, the supplier has not been able to deliver (due to the supply disruptions), and as a result the supermarket has threatened or delisted the product's ranging.

New product ranging

Another challenge faced by Australian food and grocery manufacturers managing supply chain complexity can be a lack of commercial certainty, resulting in a need to make significant financial decisions about new products without confirmation they will be ranged. Whether imported or locally manufactured, new products can have significant timelines associated with supply chain management or manufacturing investment. Once the product has been accepted, through the range review process, the supermarket often requires delivery within a shorter timeframe than may be involved in producing or sourcing the product. This can result in the supplier having to make financial decisions and commitments to commence production of the product prior to receiving confirmation it will be accepted by the supermarket. This is further exacerbated by opaque criteria aimed at measuring the success or failure of the new product introduction. For example, the development cycle to bring a new product to market may take multiple years, significant cost, resource and investment by the supplier. Yet it can be delisted within twelve weeks or less for not meeting margin and hurdle rates. An example of the ever-present risk for suppliers doing business with supermarkets.

Range reviews

Prior to commencing a range review, the supermarket must provide the supplier with a list of products to be reviewed. To meet the Code's 'reasonable notice' criteria for delisting, supermarkets initiated a process of highlighting products that do not meet ranging criteria and therefore may be delisted. This practice alerts the supplier to products they should consider as part of the review process and discuss with the supermarket. In reality, a supplier often has their entire product range highlighted as not meeting range review criteria, including products that are market leaders in their categories. This injection of uncertainty into the process provides a further opportunity for a supermarket to renegotiate the commercial criteria of the product and secure more favourable terms for itself.

Range acceptance

Following the range review process, the supermarket will write to the supplier confirming the review outcomes. Supermarkets often use a template email which includes an expectation that by agreeing to the ranging decision, the supplier will not seek a cost price increase until the next range review period, typically 12 months later. This places risk upon the supplier in the face of significant and unforeseen cost increases within this period.

Delisting

Delisting is the process of removing a product from a supermarket's range following a range review. Suppliers view delisting as a tool that supermarkets can employ to pressure or punish them. According to the Code, a product can be delisted for numerous reasons, including failure to meet quality or quantity requirements, persistent failure to meet delivery requirements, or failure to meet the supermarket's commercial sales or profitably targets. However, the criterion of meeting commercial sales or profitability targets is not transparent and widely open to interpretation. A product's commercial performance is influenced by many factors within the control of the supermarket and outside the control of the supplier, including the product's position on the shelf, pricing architecture, store ranging, assortment, or availability. In practice, the definition of a genuine commercial reason is opaque.

A supermarket's threat to delist can result in commercial detriment for the supplier. While suppliers can recommend a retail price, the supermarkets ultimately control the shelf price. The AFGC is aware of numerous cases in which the supermarkets have raised shelf prices, resulting in a decline in sales, then initiated discussions on delisting the product unless they are provided with further financial support such as increased margin or additional promotions. In such cases, the supplier is commercially harmed by a decision made independently by the supermarket regarding its shelf price.

In circumstances where a product is delisted, a supermarket will also seek financial support from the supplier to clear the stock out of its own system. This can include funding mark downs, product promotions or waste. Under the Code a supplier has the right to have a delisting decision reviewed by the supermarket's senior buyer. However, the AFGC understands that when a supplier seeks clarification from the senior buyer, they are typically provided with identical information as provided at the time of the initial delisting decision. The information typically does not provide sufficient specificity regarding why the product has been delisted.

Hesitation about raising concerns with supermarket chains due to fear of jeopardising their ongoing commercial relationships.

Despite significant changes to the Code's dispute resolution process, steps taken by supermarkets to introduce post-complaint safeguards and the confidentiality requirements of Code Mediators, suppliers continue to cite fear of retribution and lack of trust as major concerns.

The AFGC acknowledges addressing the lack of trust and fear of retribution is difficult and is likely to require a significant degree of cultural change, the implementation of process safeguards and positive messaging from senior supermarket executives through to buyer behaviour when dealing with suppliers. We consider that improving the Code's specific protections to curtail the behaviours outlined above would also contribute to strengthening supplier confidence.

The fear of retribution, whether real or perceived, is a powerful dynamic within the food and grocery sector and exists regardless of the size of the supplier. It is fundamentally a problem caused by an imbalance of market power, and the asymmetry of dependence between suppliers and supermarkets. In the absence of a less concentrated retail market, the fear of retribution will continue to be a major feature of supplier-supermarket relationships and hence must be accounted for in the design of dispute resolution mechanisms.

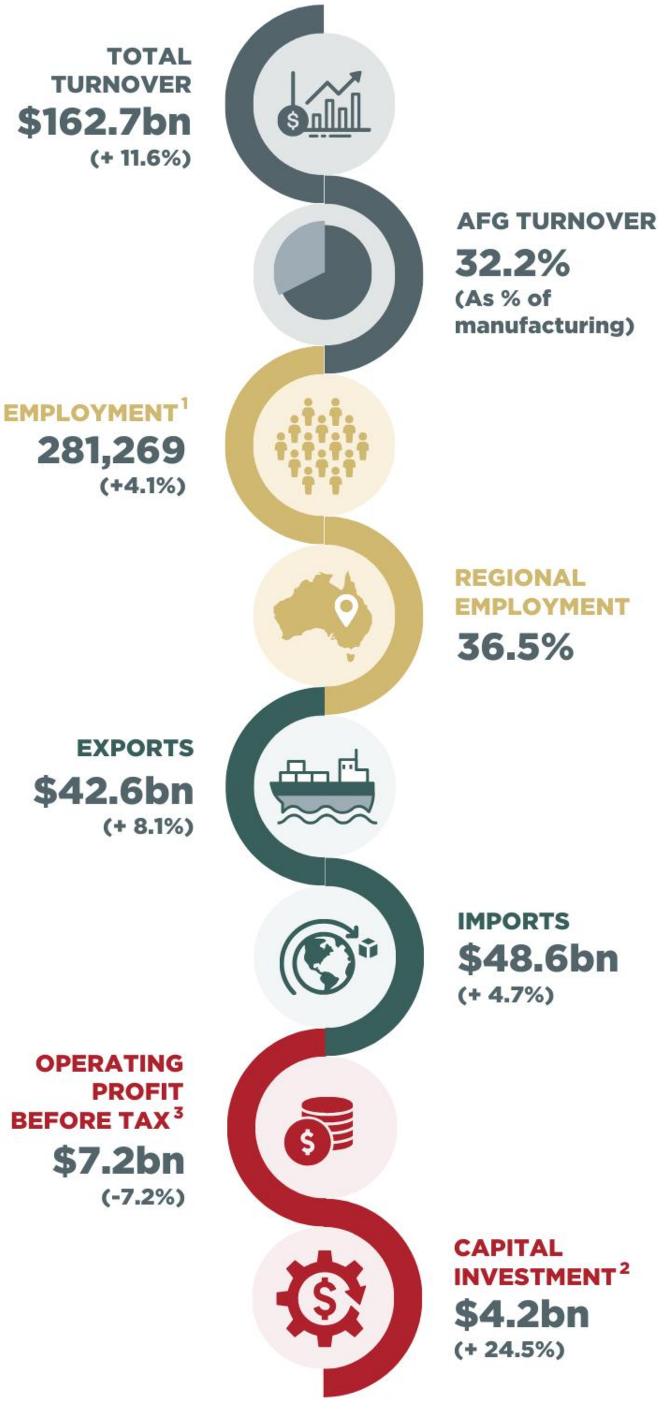
As a general rule, the more escalatory a dispute process is, the less likely a supplier is to utilise it. A supplier advancing a dispute through courts or engaging with the ACCC is extremely unlikely, given the long timelines, high costs and damage to the commercial relationship that would be entailed. Such pathways are viewed by suppliers as a 'nuclear' option, out of recognition of their highly destructive consequences. Conversely, the less escalatory, and thereby less likely to invite retribution, a pathway is, the more likely that suppliers will avail themselves of it.

This fear of retribution from an individual formal complaint has led the AFGC to place more weight on investigating systemic patterns of concerning behaviour, de-identifying those concerns, and discussing them with the relevant retailer. The AFGC has effectively taken this approach to informally working with supermarkets to resolve issues of concern across our membership.

Unfortunately, the 2024 review of the Code has resulted in a more litigious dispute resolution process and has diminished the needs of suppliers, which centre on a process that is quick, low-cost, confidential, does not damage the commercial relationship and provides binding outcomes supported by reparations or compensation. Of significant importance to suppliers is the ability to investigate systemic patterns of behaviour rather than just individual disputes.

The AFGC therefore calls on the ACCC to recommend a strengthening of the Code's specific clauses relating to price negotiations, range reviews and delisting, particularly given they were not considered in the recent review of the Code despite being in the Terms of Reference.

State of Industry
2022-23



The figures on this page exclude the fresh food sector and are based on 2022-23 ABS data.

1: This is total number of employees, head count basis and does not include seasonal employees.
2: Gross fixed capital formation for food, beverage and tobacco manufacturing subsector is taken as indicator of capital investment.
3: For food, beverage and tobacco product manufacturing subsector

AUSTRALIAN FOOD & GROCERY COUNCIL