NextGen Group Response To Interim Report

Food & Grocery Code of Conduct 2024 Review

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NextGen have reviewed the interim report and provided industry insight around areas that we believe are critical to consider in a future version of the Code.

NextGen, as the primary Grocery Code consultants in Australia and New Zealand are able to aggregate Code insights through engagements with suppliers across multiple retailers and multiple categories. We are able to quickly identify systemic retailer behaviours through these engagements. We have shared these insights in our original and this subsequent submission.

We welcome the opportunity to further engage with Dr Emerson and the Treasury Secretariat to explore the further strengthening of the Code.

Threshold for inclusion

The recommendation for inclusion is $5bn. NextGen suggests Dr Emerson considers $1bn. The UK Code specifies GBP1Bn (circa $2bn) as the threshold for compliance to Code. The UK market is circa 3x larger than the Australian market.

In South Australia Drakes are a large competitor to Coles and Woolworths. For many small suppliers in SA, Drakes would represent the majority of their sales. Whilst there is limited evidence that Drakes misuse their market power, it would remain relevant for suppliers in SA to be awarded the same protections as their counterparts in other states.

Ritchies IGA, as the other independent retailer would also exceed $1bn in revenue. As with Drakes, many small suppliers are heavily reliant on their relationship with Ritchies and deserve the same protections as supplies selling to the larger retailers.

Dr Emerson asserts that Metcash's obligations as a wholesaler extend to their customers (the above independent retail groups) is incorrect. The obligations dealing with in-store activity of the independent retailers are excluded from the Grocery Code wholesale provisions. They are also different legal entities with no 'command and control' structure allowing Metcash to materially influence the actions of the buyers within those independent retailers and their interactions with suppliers.

There is compelling evidence that other retailers selling considerable quantities of grocery products should then also be considered against the suggested lower threshold:

- Costco
    - Whilst positioning themselves as a 'club retailer' – they clearly sell significant quantities of groceries to the general public.
    - They have broadly the same commercial arrangements with the local supply base, purchase from local farmers etc.
    - It would be appropriate that their supplier relationships are subject to the same Grocery Code rigours as other retailers.
- Bunnings
    - Over the past 5 years, Bunnings has progressively increased their range of grocery products now including significant offers in pet, cleaning, laundry and greenlife.
    - Total sales of grocery products in Bunnings is estimated at circa $2bn
    - There is significant and compelling evidence of poor buyer behaviours in Bunnings; behaviours reminiscent of the Coles and Woolworths behaviours that were in part the trigger for the initial introduction of the Grocery Code in Australia.
- Amazon
    - Whilst grocery sales through Amazon Australia are unknown, there is a clearly stated global strategy to dramatically increase their share of the grocery market.
    - Buyer behaviour is anecdotally poor currently, with many examples of disadvantages contracts, variation to contract and supplier's being placed under duress.
    - A future provision allowing for inclusion of Amazon would be wholly appropriate and facilitated through reducing the threshold of entry to $1bn.
- Chemist Warehouse

- The imminent merger of Chemist Warehouse and Sigma will place the merged entity as the clear number one retailer in the Australian pharmacy market with a circa 26% share. The nearest competitor (EBOS) enjoys a 10% market share.
- A significant number of grocery products are sold in Chemist Warehouse – likely in excess of $1bn.
- There is already a material power imbalance between retailer and supplier, this increases as the two largest pharmacy retailers merge.

It is unusual for NextGen to agree with either of the major retailer's media positions, however in this instance we would tend to agree with Mr Banducci's position that Woolworths major competitors should be subject to the same Grocery Code rigours as they are.

Mandatory vs Voluntary Prescribed

We understand Dr Emerson's position on a mandatory Code and recognise that this is no longer a discussion point.

We would like to reference the following three points:

- The legal framework (mandatory vs voluntary) will have little or no impact on a supplier's appetite for raising a complaint. The fear of retribution remains and is potentially exacerbated due to the likelihood of being requested or forced to present their position in a court of law.
- Due to the scale of the potential fines, it is highly likely that any retailer being prosecuted would leverage every avenue to avoid prosecution. This would inevitably lead to long drawn-out legal cases with inevitable appeals. The likelihood of poor retailer behaviour being punished inside of a year is extremely unlikely. The impact on a supplier providing evidence over such an extended period would be an enormous disincentive to complain.
- The fines proposed under a mandatory code would likely have a detrimental impact on foreign supermarkets looking at launching in Australia. The fines would be by far the harshest in the world (where Codes exist). They could be seen as a barrier to entry for new players.

When a retailer is quick to agree to something, i.e. moving from voluntary to mandated, would suggest they see greater benefit than detriment to their businesses. Both retailers have very quickly and vocally agreed to a mandated position – that should warrant further discussion.

Dispute resolution arrangements

The Code currently provides for mediation, arbitration and review by an independent Code Arbiter. To date there have been very limited complaints (6 since 2021). The mechanism for complaining is not at fault, the perception that there will be retribution is at the heart of the lack of complaints.

Positioning the current Independent Arbiters as Mediators we believe is mis-guided. Dr Emerson suggests that they *have a deep knowledge of the systems and practices of the supermarket that engaged them*. That is simply not the case evidenced by only 6 cases having been brought to all

4 Arbiters in the past 3 years. That has not allowed sufficient exposure for the Arbiters on the diversity of different Code issues and category nuances. None of the Arbiters have a background in the Grocery industry, they have all been, or are, practicing lawyers. Whilst they have a clear understanding of law, their commercial grocery experience is limited.

Whilst we recognise the constraints that the current constitution and associated laws place on the proposed solution, we believe that Dr Emerson should continue exploring further options. We do not believe the proposed solution will see any change in the supplier's appetite to 'put their head above the parapet'.

A solution that would allow a suitably qualified independent expert to evaluate systemic behaviours and mandate changes to processes and behaviours within the grocers would be ideal. If they then also had the ability to conduct investigations into alleged behaviours, independent of any one supplier's issues they could also be granted the ability to reverse decisions and award compensation (similar to the existing options available to the Arbiters).

The key element missing from the current solution is the ability for an individual to investigate the retailer's behaviours without a supplier publicly coming forward and complaining.

The fact that the current Arbiters are on the retailer's payroll is a further significant barrier to acceptance. The New Zealand model with an appointed commissioner, funded by government, has had significantly greater engagement with suppliers in the first 6 months of their Grocery Code than the Australian Arbiters or their predecessors the Code Compliance Officers since 2015. That alone is compelling evidence that the AU model is not fit for purpose.

We support Dr Emerson's proposal to introduce an anonymous complaints line similar to the NZ Grocery Commission and that used by the ACCC for cartel whistleblower reporting (accc-cartels.whispli.com).

The challenge will be around who can do something with that information? The currently proposed solution would have anonymous complaints being submitted to the ACCC. The likelihood of the ACCC investigating a retailer based on one or two specific complaints is highly unlikely. The likelihood of the ACCC investigating a retailer without bringing evidence from named suppliers to the courts is also highly unlikely.

We are sure that the information gathered would be compelling – we are unsure how it will be leveraged to create behaviour change within the retailers. How will a small supplier who is being materially mistreated seek support from the ACCC within a reasonable time frame? The ACCC is simply not resourced to be able to manage these scenarios. By way of reference the Commerce Commission in NZ have appointed 26 full time, government funded, personnel to monitor and police the NZ Code.

Additional protections against retribution

In NextGen's opinion, no amount of 'prohibition against retribution' written into version 3 of Code will overcome the supplier's deep-rooted fear of complaining. They simply will not believe that the retailer will not find a way around the rules and create issues for the supplier in the future.

The only way of accessing supplier feedback on retailer's behaviour is through an anonymous mechanic.

There is no framework that Dr Emerson, or government, can put in place that will remove the fear of retribution for suppliers when between 25% and 50% of their sales may be represented by one retailer. The risk is simply too great.

The examples provided in the interim report (Box 2) are high level examples of blatant retribution and likely to be seen for what they are. In reality, retribution is far more subtle and difficult to differentiate from every day commercial decisions that a retailer might make in the course of running their business. Examples:

- A nominal reduction in promotional slots – e.g. from 12 a year to 8
- Limited supplier access to the more attractive or effective promotional mechanics
- Lower engagement with new product submissions from the supplier
- Artificially increased support for the supplier's competitors
- Slightly less space on shelf – e.g. only a 10% reduction
- Etc

The above examples could be defended as the right commercial decision whilst being easily disguised and are indeed retribution. Unless an Arbiter or investigator had a robust understanding of the commercial practices within the retailer's management of categories, they would never be able to identify the retribution.

The current Arbiters have limited commercial acumen to be able to identify the underlying commercial behaviours that are leveraged punitively or as retribution.

Good faith

The question has been asked if Good Faith provisions should be applied to suppliers. There is currently a provision in clause 6B (h) that allows a retailer to consider if the supplier has acted in Good Faith.

Expanding this further would likely cause issues:

- What legal vessel would be available to make suppliers subject to Code provisions?
    - Who would prosecute a supplier for a breach of Good Faith under the Code?
- If a supplier were deemed to not have acted in Good Faith, would this then allow the retailer to do the same?
    - This would likely lead to the 'weaponisation' of Good Faith as it would always be in the retailer's interest to establish that the supplier has not acted in Good Faith subsequently exempting them from the Good Faith provisions.
    - Any complaint by the supplier would likely then be a 'two part' investigation – did the supplier act in Good Faith and then the actual complaint. A further disincentive for a supplier to raise a complaint.

The Code was introduced to address the very real power imbalance between retailer's and suppliers. There are very few, if any suppliers, that would be deemed to have a greater balance of power in a negotiation than the retailer. There are multiple examples of the retailers acting punitively towards many of the top 20 suppliers.

Buyer incentives

In Box 1 the interim report correctly indicates two dynamics – a) the category managers (buyers) are incentivised in a way that likely facilitates poor Code behaviour and b) the senior management are often at arm's length from the activities their teams initiate to achieve their targets (i.e. plausible deniability).

The math is very straightforward – each year the category manager is targeted on increasing the direct profitability (or gross margin) of their category. They must either increase prices to shoppers or reduce what is paid to suppliers.

Over the past 2 years we have seen the major retailers do both. With the increased focus on 'price gouging' with multiple enquiries in play, it is highly likely that retailers will not be able to continue with this practice. As a result, the only alternative for a category manager to improve their category profitability it to increase pressure on the suppliers.

The current Coles 'Supplier Collaboration' initiative is strong evidence of the retailer seeking incremental investment from the supplier to facilitate this position. At no point do any of the major retailers indicate that they will reduce their category margins to facilitate lower shopper prices. The investment is always sought from the supplier.

In the recent Senate enquiry both retailers denied the above dynamics where prevalent in their organisations.

Recommendation – publish the KPI's that the buying team are targeted against. There will then be a degree of transparency around the decision-making process. It is unlikely that the incentives will change as we operate in an open market Western economy and the retailers have a requirement to meet their shareholders expectations – which by definition means they must seek to increase their profit and returns year on year. Visibility will allow a correlation between KPIs, actions and the Code.

Strengthening obligations

There are several obligations under the current Code that allow retailers to agree with suppliers that they contract out of their obligations. Due to the systemic power imbalances between suppliers and retailers, it is common that suppliers believe they have little choice but to agree to the opt out requests by retailers.

NextGen believes that simplifying the Code and removing the opt out provisions on some elements of the Code will provide further clarity. We recommend the removal of the following opt out or opt in provisions:

- Payments for waste after the retailer has accepted the products.
    - This is currently open to significant interpretation by the retailers and suppliers have little ability to reject claims.
    - Current provisions within supplier's terms are often representative of waste levels decades ago when supply chains were dramatically less sophisticated or were the product of negotiations under duress with the retailer. It is not

uncommon that suppliers pay between 1% and 2% of their invoice sales as a waste provision for the retailer.
    - Payment of waste by the supplier removes, or at least dilutes, the incentive for the retailer to mitigate waste. This, among other things, falls short of community expectations around food and packaging waste.
    - Recommendation – prohibit all waste agreements from supplier terms.
- Payments for retailer's activities
    - Whilst the Code endeavours to articulate that a supplier is not 'required' to pay for retailer activities, as articulated above, they often feel that they have no choice and there would be significant consequences if they declined to pay.
    - Whilst the number of examples of payments for activities has declined over the last 5 years creating a simple prohibition would simplify the issues.
    - Where there are legitimate costs associated with promotions e.g. the purchase of in-store media, this could be managed as a provision within the promotion clauses of the Code.
- Unilateral or retrospective variation to agreements
    - We can see no need in the Code to include an opt out clause allowing a retailer to make unilateral or retrospective changes to any agreements
- Requiring suppliers to purchase the retailer's data
    - It is common practice that the retailer sells their transaction and loyalty card data to suppliers. The buyers are set KPI's on supplier spend on the retailer's data sources. For clarity, the sale of data by retailers is a very material profit centre.
    - Non-engagement, or reduced spend on data, could likely lead to negative consequences for suppliers.
    - Recommendation – call out the sale of data specifically within the Code not requiring a supplier to purchase the data as a condition of doing business.

Delisting products

As retailers have become more sophisticated in their understanding of the Code the following dynamics have been observed in regard range reviews:

- Retailers becoming more relaxed in regard having to both set, and then apply without discrimination, the range review criteria.
    - This is contributed to as it is likely that suppliers will not complain and as such the category managers decision will rarely, if ever be challenged.
- Category managers, should they so wish, manipulating category performance or manipulate category data to provide 'genuine commercial reasons' for a delisting.
    - Example – a category manager could reduce the supplier's promotional participation, overall sales and market share drop, a few months later the supplier is challenged with a 'genuine commercial reason' delist for a decline in sales and share.
- The retailers may use data to which the supplier has no access and can hence not validate the genuine commercial reason.
    - The data is either not provided or the supplier would need to purchase the data from the retailer.

    - The only way a supplier could validate that the data was used appropriately would be to engage the external Code Arbiter.
- The published criteria may not be applied without discrimination across brands within the range review:
    - Unless an audit were conducted on the decision making, and criteria used, it is almost impossible for a supplier to establish if due process was followed.
    - There are examples where a supplier's products have been delisted on the grounds of low margin when it is likely that the retailer's private label products operate on a lower margin. On this basis the private label product should have been deleted as well. On the basis the private label product was not delisted would clearly indicate that the criteria were not applied without discrimination.
    - Again, as above, the only way a supplier could seek validation would be to raise a complaint to the external Arbiter.

The best a supplier can hope for is that the category manager has not applied due process correctly and endeavour to challenge the decision on these grounds. If they are brave enough to challenge the decision in the first place.

- In our experience it is extremely rare that a delist decision is reversed by the retailer. This would indicate that either every decision is correct or there is no effective or viable escalation process to challenge decisions.

The Code is currently constructed in an overly complicated way in regard range reviews. Multiple sections apply to review process and a lay person would not easily interpret the overall requirements from reading the Code.

- The Code specifically states that a retailer may set a supplier a profit target. This sits uncomfortably with us as the supplier, under competition law, cannot seek to influence non-promotional retail price points. Retail pricing fundamentally shapes product profitability and is 100% controlled by the retailer hence it being both illogical, and potentially a breach of competition law to hold the supplier accountable for profit targets.
    - We regularly see retailers reduce the price of a product on the grounds of 'wanting to be market competitive' and then holding the supplier directly or indirectly accountable for the reduction in profit delivery for the retailer.

Recommendation – create a new aggregated section within the Code dealing specifically with range reviews. Clarify and simplify the rules and expand the explanatory notes to clearly articulate what is expected of retailers when conducting a range review. Potential to include a written statement for each range review that a named person must confirm that all decisions were Code compliant and an audit of the process was completed – ideally the line manager of the category manager – i.e. make someone visibly and publicly accountable for the work.

Promotions

It is common practice that a supplier must either 'lap' historical promotional investment or increase promotional investment in line with the retailer's expectations. The current Coles 'Supplier Collaboration' initiative is strong evidence of such practice where Coles are allegedly putting significant pressure on suppliers to either match historical investment – often going

back as far as 2018/19 or to match their competitors alleged promotional investment in the category.

- Non-compliance to the requests made by retailers as ever would be positioned as 'reduced investment' and as such a 'genuine commercial reason' for potential delist. Whilst much of the incremental investment passes through to lower shopper prices, a material portion is leveraged by the retailer to improve their margins when products are promoted.
- This constant lapping of investment ultimately leads to increased retailer margins and reduced supplier margins, generally for no commercial gain to the supplier as the same pressure is being applied to all suppliers (i.e. a net zero sum game for suppliers).
- Recommendation – make it explicit within the Code that historical promotions are not a yardstick by which future investment is measured. Non-lapping of promotions is not grounds for a genuine commercial reason delist. Further explanatory notes outlining what 'reasonable' funding looks like – i.e. cost and benefit to both parties.

Fresh produce

The Code currently does a nominal job of regulating the fresh produce interaction between retailers and growers. The Horticultural Code seeks to regulate the relationship between grower and agent/wholesaler but does impact on the retailer interaction. The Grocery Code impacts on the direct relationship between a retailer and grower or agent. There is significant opportunity for misunderstanding and confusion between the two Codes.

Primary producers (fruit, vegetables and greenlife) are amongst the most vulnerable in their direct or indirect dealings with supermarkets. Their product is heavily influenced by environmental conditions and is in most cases short shelf life. The actions of the retailer's buying teams have an immediate and often profound impact on the grower's commercial position.

There is significant evidence that actions by the retailers, intended or unintended, create significant commercial loss for growers. This has reached the stage where the security of food supply in Australia is coming into question. When the overall available profit available between growers and retailers is evaluated, the retailers harvest the lions share, in many instances all the profit. This is not sustainable.

Suggested solutions:

- Ensure that the Grocery Code applies through to the final primary producer, regardless of the route to market. Where farmers aggregate their products through an agent, they are as equally impacted by the retailer's actions as the farmer that sells direct to the supermarket.
- Clear and unambiguous contracts with growers. Currently farmers often plant crops against a verbal or 'handshake' agreement with a retailer. There is often no contractual agreement on quantity or price. All the commercial risk is born by the grower.
    - It is currently commercially attractive for the retailer to indicate a volume requirement to multiple growers ahead of their likely needs. The subsequent oversupply of product leads to poor returns for growers who often sell product at cost or below cost to ease the cash flow pressure that planting the crop created.

- Establish a reasonableness test to the criteria and specifications for products set by the retailers. Currently a significant portion of crops are rejected by retailers due to minor growing variances that have no impact on the integrity or useability of the products. The retailers hide behind 'this is what shoppers want' – we believe the retailers have a major role to play in re-educating shoppers around what 'real' fruit and vegetables look like.

The power imbalance between retailers and suppliers is most extreme in Fresh Produce. We urge Dr Emerson to consider to fully explore this imbalance and the social and economic impact of the retailer's buying behaviours. The Code could be materially modified to curb the current behaviours, intended or unintended, of the retailer's buying behaviours.

Summary

Much publicity has been placed on Mandatory vs Voluntary. The optics of 'being firm' with the retailers has made this an attractive option. There has been media association with this position supporting a position that this will have a positive impact on the 'cost of living crisis'. For those not familiar with the Code this may be an easy conclusion to reach. In reality there is likely to be little or no impact on the cost of groceries through moving to a mandated Code.

The focus on the above detracts from the primary issue which is to find ways of establishing and addressing poor retailer/buyer behaviour towards suppliers that does not require a supplier to become visible in the process. As stated, many times above, any process that requires a supplier to become visible in their complaint to the retailer will simply fail. Every year we see systemic initiatives and behaviours from the retailers that could potentially be interpreted as Code breaches.

Changing the remit of the arbiters would likely have a greater impact on compliance than a move to a mandatory code. We would strongly support expanding the arbiters' offices to include individuals with the appropriate commercial skills (i.e. grocery buying/selling experience) to better assist in identifying poor commercial behaviour.

It is all well and good giving the ACCC a bigger stick with which to beat the retailers. Without there being a mechanic by which poor behaviour can be established whilst preserving the anonymity of the complainant, the stick will gather dust.

NextGen Group Pty Ltd

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