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Contractualisation and Contractual Relations

This briefing has been submitted by the National Farmers Union, who represent over 55,000 farmer and grower members across England and Wales. It details answers to questions posed by the Agri-Markets Task Force.

1. Contractualisation

Question 1

Is the current balance between mandatory and voluntary contracts for specific sectors/products as laid down in the CMO Regulation appropriate? Is there a need to consider mandatory contracts for additional sectors/products? If so, what is the justification (e.g. specificity, organisation/structure of the sector, geographical considerations)?

It's worth noting at the outset that in English law, where there's a buyer and a seller, and an offer and an acceptance, a contract exists; it may not be a written contract but it is (in the main) enforceable in law. There are only limited exceptions where contracts must be in writing; otherwise, in English law, a verbal contract is as binding as a written one. The problem with verbal contracts, of course, is proving what the agreed terms were; whereas with written contracts, it is much easier after the event to see (and if necessary to prove) what the agreed terms were.

All of this makes the terms 'mandatory' and 'voluntary' contracts rather redundant because in English law where a farmer sells and someone else buys, there will always be a contract. Unless, of course, a 'mandatory' contract in this context means that the type of contract and its terms are specific and dictated and must be used (e.g. where the exact contract to be used is prescribed in legislation); and a 'voluntary' contract in this context means that a specific contract is available but its use is not compulsory. If that is the meaning of these terms in this context, then a drive for such 'mandatory' or 'voluntary' contracts is not something that the NFU would support. Whilst we want to see fairer and better contracts for farmers, and we believe that there are steps that could be taken to ensure fairer and better contracts, we also believe that farmers should be able to choose from a range of contract options; farmers should be able to select a contract with a risk and reward profile that meets their individual business needs. We do not want to see prescriptive and inflexible contracts that must be used and which do not meet the needs of some farming businesses.

We would not, however, object to provisions which make written contracts mandatory in all sectors; written contracts enable farmers to see in advance the terms on which they will sell their produce. Written contracts also give farmers a reference point against which to measure the buyer's performance, and an enforcement mechanism where the buyer breaches the contract terms. These contracts would be most appropriate for post farm-gate transactions between a farmer and a buyer of his produce. A buyer in this respect is defined as an individual or entity which intends to process the farmers produce for onward sale, or where the entity intends to retail or wholesale that produce.

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Question 2

Are the terms of the current framework for Contractualisation (i.e. Articles 148 (milk) and 168 (general) CMO) sufficient? Should additional provisions, be envisaged? If so, which? Do contract conditions always have to be symmetrical for parties or could differentiated rules e.g. for termination of contracts, cater for different risk profiles and vulnerabilities?

The current framework is not sufficient to ensure better and fairer contracts for farmers. The framework provides that Member States may require written contracts, and whilst the framework sets out what such contracts are to cover, it provides no mechanism for ensuring that the actual terms are fair. For example, the framework says that if written contracts are required, the contract should set out "details regarding payment periods and procedures" but the framework takes no steps to ensure that the payment periods and procedures are fair; a contract saying that a farmer will get paid a year after delivery would be compliant with the framework but patently unfair.

Additional provisions should be considered. We would suggest that provisions are brought in which provide a 'safety net' for farmers – a set of contract terms which will be implied into all contracts for the sale by farmers of agricultural products. This approach is used in English law to protect consumers who might otherwise be in a position of inequality of bargaining power vis-à-vis sellers, just as farmers often are vis-à-vis buyers of agricultural produce. It must not be possible for buyers to exclude such implied terms. The terms could afford farmers a basic level of contractual protection; for example, it could be an implied term in every contact that the terms of the contract cannot be varied without the written agreement of both parties. As mentioned above, this would apply to post farm-gate transactions between a farmer and a buyer of his produce. A buyer in this respect is defined as an individual or entity which intends to process the farmers produce for onward sale, or where the entity intends to retail or wholesale that produce. Such a safety net could help prevent some of the worst behaviours that we see, to the benefit of all players in the supply chain, and to the benefit of consumers. Further, such an approach does not preclude freedom of contract, so farmers and buyers are free to agree contractual arrangements that suit their business needs, subject to the 'safety net' provided by the implied terms. In addition, as the resulting contracts are not prescriptive and do not involve set prices or collective bargaining, there should be very little impact upon competition. Finally, in English law, enforcement of the implied terms would be relatively simple – a buyer breaching an implied term could be sued in Court for damages for breach of contract.

Contracts do not have to be symmetrical, although symmetry of rights and obligations will be a strong indicator of a fair and balanced contract. However, it is important that there is a degree of freedom of contract to allow farmers to select a contract that matches their risk (and therefore reward) appetite. Too often at the moment, however, the contracts that farmers have with their sellers put all of the risk, and very little of the reward, onto the farmer. A 'safety net' of implied terms could help to protect farmers from some of the worst behaviours of buyers in terms of risk-shifting.

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Question 3

Is there merit in extending the sugar system comprising compulsory individual delivery contracts and collective written agreements within the trade to all or some sectors?

In any relationship where one is selling to a single large buyer (i.e. British Sugar) any framework that provides greater contractual certainty is a valuable option to have.

For example, with the current arrangement, Sugarbeet growers in the UK have a contract with British Sugar to grow a certain amount of Sugarbeet per year. Not only does this ensure British Sugar can fill its factories with c. 7m-8m beet and produce its EU quota (and beet for industrial use), the grower knows in advance it will have a market for his or her produce. Even with quotas going in 2017, a similar framework would certainly be valuable for the certainty of a guaranteed market.

In England the sugar system works well where farmers face a monopoly buyer. The system may be equally appropriate in other such situations; however please see our comments above about freedom of contract.

Question 4

To what extent is the effective organisation of a sector (e.g. through POs/cooperatives) essential to inducing more constructive/empathetic trading relationships within the supply chain? Would there be an interest in having such organisations negotiate certain risk and profit sharing mechanisms which the different operators in the food supply chain integrate into individual delivery contracts? Could this improve the distribution of the value added in the chain?

Effective organisation can help to address the fundamental issue here, which is the inequality of bargaining power for farmers. However, PO or cooperative membership may not be appropriate for every farmer, and so steps should be taken to rebalance bargaining power for individual farmers by providing them with a 'safety net' of implied terms (see question 2). Where POs do exist, they should have the ability to negotiate contract terms with buyers.

Question 5

Should Member States play a more active role in promoting/recognizing POs/IBOs and tailoring their statues accordingly?

We would like to see Member States playing a more active role in promoting POs. It would be especially useful if funding could be made available to help farmers with the set-up of POs (for example, to enable the farmers to take professional advice on the PO set-up, and to enable farmers to pay for skills training for PO representatives taking part in contractual negotiations).

Question 6

How can contract compliance and enforcement be successfully achieved/ensured? To what extent is a functioning futures market considered essential to a successful system of contractualisation?

Contract compliance is easily enforced in England by bringing a breach of contract claim, although the legal costs of bringing such a claim, and the risk of adverse legal costs being awarded against a claimant if the claim is lost, can often be prohibitive. Any framework that seeks to address contractualisation in agriculture could ensure contract compliance and enforcement by providing that Member States must ensure that farmers have access to an adequate and affordable remedy for any breaches of contract terms by buyers.

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A futures market is a valuable risk management tool, and could also help to widen the choice of contracts made available by buyers to farmers (because risks can be hedged); however, a futures market is not essential to a system of contractualisation.

Question 7

Is it considered that producer organisations, associations of producer organisations, cooperatives or IBOs can play a specific role in drawing-up and promoting the use of standard forms of contracts and contract terms and publishing certain types of contract information?

POs (etc.) should be able to negotiate contract terms for their members, and they could promote such contracts, but they should not be able to dictate contract terms to farmers who are not their members (i.e. POs can promote best practice but must not compel non-members to use their contracts) as such an approach could stifle competition.

2. Contractual Relations

Question 1

Distribution of value added: Is the value added fairly distributed between the different operators along the food chain and have these shares changed significantly over recent years? Is the price transmission from the producer to the consumer satisfactory?

It is difficult to establish how value is distributed across the supply chain. These figures are not published in the public domain and retailer financial annual reports do not suggest any commercially sensitive information. However we do know that the retail sector, in the UK, operates within a very small percentage margin. Typically, operating profit margins are from 3-5%. This therefore means UK retailers are in a constant battle on price and efficiency to ensure they retain their profit margins, without increasing the price for the consumer. More recently we have seen the rise of discount supermarkets (Lidl and Aldi), competing with the big four supermarkets (Tesco, Morrisons, Sainsburys and ASDA), by offering a lower retail price. As a result discount supermarkets have rapidly increased their market share. In response to this, the big four supermarkets have taken action, by attempting to match the discounted retail price. A number of supply chains will have seen a knock on effect of this price war, through the price they get paid, where the cost ultimately is passed down the supply chain; however this isn't necessarily the case for all supply chains.

Over recent years, UK retailers have built sustainable supply chain structures into their business models. Visibility of future supply and sustainability of the agri-market was a key concern for retailers. Tesco, the UK's largest retailer, was one of the first retailers to respond to this concern, and so developed their sustainable dairy group (TSDG). TSDG is a group of aligned dairy farmers who are paid using an independent cost tracker model. This is based on the farmers' annual costs being submitted to an independent consultancy, which analyses the data. From this information Tesco and the TSDG farmers can then agree upon a fair price for the milk.

Other retailers like Sainsburys, The Co-Op, Marks and Spencer's and Waitrose have similar farmer groups in place, being paid on a cost of production model. These are mainly focused on liquid milk supply.

Following the downward fall on farm gate prices in summer 2015, retailers without farmer groups were able to pay a minimum farm gate price through their liquid milk processors. This minimum price was based on the average cost of production for the UK overall. Morrisons also introduced two new products into the market; Milk for Farmers and Cheese for Farmers, where 10p of the retailer price would be paid directly to the farm. The sales figures of these two lines have been very successful and Morrisons are looking at rolling out this concept across other agricultural products in the future.

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However, farm gate prices did not see any significant change from this initiative, as these product contracts sat with a European co-operative and therefore the extra money gained through retail sales, was equally distributed between 12,700 farmers across seven countries, including the 2,700 farmers in the UK.

Due to the range of integrated and non-integrated supply chains along with the category strategy of the retailers we cannot link retail price with farm gate price. Retailers are on some product lines, like liquid milk, selling the product as a loss leader in order to drive footfall into store, typically as part of a short term promotional pricing tactic. Retailers on these occasions are footing the cost of selling below the purchase price. However, whilst these models are paying a fair price back to farm at a time when world prices are at their lowest, this is not a long term sustainable strategy. At the same time, the principle of paying a fair price to farmers is not universal across all agricultural products i.e. meat, lamb, pork etc.

Because there is no link between farm gate prices and retail price in the UK, the price transmission from the producer to the consumer is difficult to determine. However, there is certainly a growing concern from farmers when it comes to the low level of retail pricing. Falling commodity prices have facilitated food price deflation at the consumer level. In turn, this gives rise to an expectation that food is cheap and the concern is that shoppers and retailers expectations of low prices will hamper a recovery in farm gate prices.

Question 2

Unfair Trading Practices: Do Unfair Trading Practises exist in the food chain and is it a common problem?
If yes:
a) To what extent?
b) Are UTPs concentrated at certain stages of the chain?
c) Are UTPs concentrated at certain product categories?
d) Are UTPs limited to certain Member States?

Unfair trading practises are a common problem throughout the whole supply chain. The Grocery Supply Code of Practise (GSCOP) was established to legislate against UTPs in 2008 after a Competition Market investigation highlighted the issue within the retail sector. GSCOP governs the relationship between the top 10 UK retailers with a turnover of over £1 billion and sets out best practice working relationships with retail direct suppliers. The Grocery Code Adjudicator (GCA) was brought in in 2013 to oversee GSCOP and investigate breaches of the code. The GCA also is able to fine the retailer up to 1% of the retailer's turnover if they have been found guilty of breaching GSCOP. However, GSCOP only relates to the retailer's direct suppliers. There is no legislation which prevents any stakeholders within the supply chain from abusing their power over primary producers.

Voluntary codes for commodity sectors set out best practise ways of working in the UK. As these are voluntary, there is no method of auditing or regulating practises, nor is there any assurance to primary producers that they are being followed by the processor in full. The NFU are calling for the role of the GCA to be extended so that sector Voluntary codes are over seen by the adjudicator, giving them more power. The NFU would also like to see these voluntary codes, made compulsory as not all operators within the supply chain sign up to these voluntary principles.

UTPs do happen across all agri-sectors; dairy and livestock (beef and sheep) being the more obvious affected, due to a number of factors; imbalance of buying power within the supply chain and a lack of transparency of market data and market signals from consumer trends. Within the UK, poultry and horticulture generally tend to hold a closer relationship with the retailer, and therefore are more likely to be governed by the GSCOP principles, and therefore the frequency of UTPs is less. This is very much an overview of the sectors. There are of course businesses within these sectors who do not supply direct to retail.

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A most common unfair trading practise within the dairy and livestock sectors is lack of reasonable notice to price changes and specification changes. Within the dairy industry, a number of processors will only give 24 hours' notice to a change in price. This instantly reduces the producer's monthly income by a significant amount and one which he cannot plan for. The ability plan future expenditure is greatly reduced, due to the lack of visibility of farm gate price.

Within the livestock sector, the NFU have heard of a number of beef farmers only being given a few weeks' notice of a specification change, to reduce the weight of the animal. Food processor St Merryn had written to livestock producers informing them of changes to grids, weight deductions and levis. Beef farmers supplying St Merryn were only given two weeks' notice of these significant changes to the terms and conditions of their contract. With these changes and others across the industry resulting in £1.1 million being pulled out of the prime cattle market when comparing February 15 to February 16, according to an AHDB study conducted in 2016. Changes to weight limits which had been capped at 420kg will impact on producers with cattle already in sheds with target weights in mind. Farmers can't alter production systems overnight and cattle will already be overweight as they were targeted at the old spec, therefore losing out seriously on the new specification. Some suggested farmers could have been as much as £65 - £75 worse off per head, which some farmers reporting as much as £300.

This is an unacceptable length of time to give notice for an animal which take 18 months to 2 years to produce. It is a breach of the Voluntary Code of Practice which clearly states farmers require at least 3 months' notice of any changes to terms and conditions. For this reason, the NFU are calling for voluntary codes to be made compulsory and for the Grocery Code Adjudicator to oversee these codes.

The lack of transparency in supply chains makes it difficult to pinpoint where these UTPs originate from; this could be consumer trends driven, commercially driven by a retailer, or supply driven from a processor. It therefore highlights the importance of greater transparency within the supply chain, ensuring primary producers receives adequate market signals to know how and when to produce what the market requires.

These unfair trading practises are not solely related to one specific product category. They happen across all agricultural commodity crops and can originate from anywhere within the supply chain.

<u>Question 3</u>

Functioning of the food supply chain: Can the functioning of the chain be improved by addressing UTPs?
If yes:
a) Via a continuation of development of the existing voluntary initiatives (SCI and its national platforms)?
b) Via a targeted approach where the Member States adopt – and enforce measures adapted to nation/regional challenges (i.e. nation legislation, national enforcement)?
c) Via an EU approach with framework legislation and national enforcement?
d) Via EU legislation, targeting the whole chain and enforcement at EU level?

The Grocery Supply Code of Practice (GSCOP), as mentioned above, has improved trading relationships to those businesses which trade with the 10 major retailers. The latest survey conducted by the YouGov and commissioned by the Grocery Code Adjudicator (GCA), has found that the retail culture has changed to a more collaborative approach and that direct retail suppliers feel they have a greater influence over their terms of supply. This highlights the fact that having a powerful regulator in force has a significant impact in reducing unfair trading practises.

Given the examples within the dairy and livestock sectors, set out above, the NFU are calling for an extension of the GCA remit to oversee the relationships between UK primary producers and their processors.

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Industry Voluntary Codes outline best practise, specific to commodity sectors. These voluntary codes set out expectations to the industry on how fair and transparent relationships should operate between the food chain and the primary producer, i.e. reasonable notice of price changes. The NFU would like to see these voluntary codes become compulsory and for the GCA to oversee their compliance.

We would like to see these codes be made compulsory across all commodity sectors, as unfair trading practises do not specifically relate to the dairy and livestock industry outlined in the examples above.

Currently, GSCOP only governs grocery supply chains. This is defined as food and drink, pet food, cleaning products, toiletries and household goods. The NFU would like to see ornamentals brought under these product categories. The ornamental industry within the UK experiences significant unfair trading practises, through short notice cancellations to orders, lack of transparency in forecasting and an imbalance of buyer power.

The NFU would also wish to see longer term relationships develop across the whole supply chain. Long term relationships with suppliers and primary producers allow businesses to access to capital investment whilst giving confidence for future trading. As a result, supply chain efficiencies can be embedded to gain and more stable trading environment. Information sharing is a key aspect to a closer, more joined up relationship. Being able to communicate key market signals within reasonable timeframes gives the transparency the agricultural industry needs in order to respond to the market/consumer demands.

In addition, the UK exports approximately ¾ of our food and drink to the European Union therefore the NFU would like to see an equivalent of GSCOP and the GCA which sees protection given in other Member States.

<u>Question 4</u>

Is the CAP an appropriate tool to addressing UTPs?

The CAP would not be an appropriate tool to addressing UTPs. Unfair trading is linked to an imbalance of power within the supply chain, where one body forces risk to a smaller body. The CAP does not give primary producers in the UK the negotiating power and transparency with the food supply chain they greatly need. The appeal of a dairy futures market is rooted in its potential to support the UK dairy industry in managing market risk. The ability of highly liquid futures markets to generate pricing data over time can improve market transparency and aid price discovery across the industry. Increased transparency is however regarded as a secondary, longer term benefit which in itself is contingent on the existence of reliable price data for the underlying cash market. The primary focus of this briefing is therefore on the usefulness of a dairy futures market as a hedging tool rather than as a market intelligence tool. This briefing summarises the key features of a dairy futures market and assesses its relevance to market risk management in the UK dairy industry. As such, this briefing highlights some of the more practical issues which require industry attention whilst considering the potential of a dairy futures market.

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