

Circulation: Dairy Members of NFU Cymru

Date: June 2020

Ref: DJ

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Dairy Contract Regulation: Q&A

This briefing has been prepared as a guide and an informative tool aimed at answering key questions regarding NFU Cymru position on Welsh Government and Defra's consultation on dairy contracts' reform which has just been announced. (24/06/20)

Background:

For most dairy farmers, their contract to sell milk is the single most important piece of paper they have for their business and shapes the relationship with their milk buyer. Unfair milk contracts have been an area of concern for the dairy sector for many years. A significant proportion of the calls NFU Cymru dairy team receives are from farmers with issues which ultimately relate back to their milk contract. In 2018, following an industry wide review of the Groceries Code Adjudicator, it was found that there is an uneven distribution of power within the dairy sector, which led Defra to announce that they would launch a consultation on contract regulation aimed at improving fairness in the dairy supply chain. NFU Cymru is supportive of this approach and will be providing a response to the consultation which has been carefully developed over the last few years.

What's wrong with contracts now?

Contracts are critical to determining the business relationship that exists between farmers and milk buyers. However, most milk contracts in their current form do not create mutually balanced business relationships between buyers and sellers and often rights and obligations are heavily biased in favour of buyers.

At times of pressure, when the market is low or a business unstable, purchasers have the ability, through purchaser's discretion, to change contracts terms and pricing mechanisms, even to introduce retrospective penalties and price cuts without negotiation. A headline milk price is of no value whatsoever if a buyer has the sole right to change it at will.

The recent Covid19 crisis has seen many of these scenarios play out. Farmers were hit with price cuts at no notice, unilateral implementation of A/B quotas, a lack of transparency over pricing and delayed payments. Farmers in the dairy supply chain ultimately bore a disproportionate amount of the cost of CV19 as others sought to rapidly pass risk down the chain at breakneck speed.

NFU Cymru wants to see freely negotiated and flexible contracts which are tailored to the needs of both buyers and farmers. Fairer contracts should increase transparency and trust, to the benefit of both, and mean that any changes need to be mutually agreed.

What about the VCOP?

The Dairy Industry Code of Practice for Contractual Relations (VCOP) was agreed and introduced in 2012 to remove conflict and divisiveness from the relationship between producers and purchases. Whilst it did bring about several changes and improvements, the Code has been ineffective at preventing bad practice, especially at times of market volatility, with many purchasers not signing up



to all aspects of the Code and others completely ignoring it. It also included exemptions, for instance in the case of Co-operatives. Attempts to review and improve the Code, such as the Fergusson Review in 2014, have failed through a lack of interest from individual parties and the supply chain. NFU Cymru have long felt that the Code has had its day and it is now time to go one step further to ensure a fair supply chain. Regulation is one way to achieve this.

What is the consultation proposing?

Overview by Government

This consultation is in response to concerns raised that primary producers, including dairy farmers, tend to occupy positions of relative market weakness in the food supply chain. Consensus among agricultural producers in the UK is that unequal bargaining power with processors and retailers can expose farmers to unfair treatment, with the potential to undermine equitable price transmission along the chain. Several other nations have introduced regulations to stabilise markets and address systemic imbalances. In the European Union, thirteen member states including France and Spain have introduced laws on compulsory written milk contracts between farmers and processors. The Scottish Government recently published their analysis of the dairy supply chain and application of Mandatory Written Contracts (MWC) across the European Union, to evaluate the impact of the contracts where they have been adopted. Further afield, the Australian government has recently introduced a mandatory dairy code of conduct.

In 2012 a voluntary code of best practice on contractual relationships in the dairy sector was agreed by industry. It set out minimum standards of good practice for contracts between producers and purchasers. A consultation and impact assessment regarding mandatory written contracts were undertaken the same year, as part of an assessment of the implementation of the EU Dairy Package. Separate consultations were also carried out by the Scottish, Welsh and Northern Ireland (NI) Governments. The results showed a preference for allowing enough time for the voluntary code to take effect. The right to review the situation of contractual relationships was reserved, and if necessary, to reconsider the introduction of legislation on contracts if, after a reasonable period, the desired changes had not been achieved by the industry.

In 2016 a formal call for evidence was launched to explore the case for extending the remit of the Grocery Code Adjudicator (GCA). The role of the GCA is to make sure that the largest domestic retailers treat their direct suppliers fairly and lawfully by enforcing and monitoring compliance with the Groceries Supply Code of Practice (the Code). The GCA is recognised as an exemplary modern regulator with an international reputation. It is helping to strengthen relationships in the supply chain for the benefit of consumers, retailers and other food businesses.

This process revealed stakeholder evidence of poor contractual relations in the dairy sector. A small number of respondents highlighted the challenge posed by variations to specifications or contract terms, especially if imposed at short notice. Others raised the difficulties producers face in trying to terminate their contracts within a reasonable period, if significant changes are made to prices or contract terms. This evidence suggests a potential pattern of unfair or unclear terms and conditions in contracts between producers and processors, that could limit the ability of farmers to budget effectively, manage price volatility and run profitable businesses. This evidence suggests that the voluntary code is not having the desired impact in terms of improving supply-chain relations.

The UK Government's response to the Groceries Code Adjudicator Call for Evidence (published on 16 February 2018), included a commitment to consult on the introduction of mandatory written contracts using powers in EU legislation. As the UK has left the European Union, we are instead now



seeking new domestic powers to introduce any legislation. The use of domestic powers will allow us to be considerate of the specific nature of the UK dairy sector, although the broad principles of the EU legislation will likely still prove relevant.

The recent COVID-19 pandemic has further highlighted the difficulties sometimes faced by dairy farmers, most notably in relation to sudden price changes. Whilst the problems experienced by the sector were wider than those related exclusively to contractual practice; we would encourage respondents to submit their views on which contractual measures, if any, would improve the resilience of the dairy industry should similar situations arise in the future.

This is a UK wide consultation, undertaken by DEFRA with the agreement of the Devolved Administrations. We recognise that there are significant differences between the dairy supply chains in Great Britain and Northern Ireland. Great Britain's dairy sector is internally well-integrated and operates across internal borders. In Northern Ireland there is a highly integrated cross border supply chain with the Republic of Ireland (RoI). RoI dairy co-operatives own approximately 60% of the processing capacity in Northern Ireland and it is estimated that approximately 35% of milk produced in Northern Ireland is transported to RoI for processing.

Whilst most of the milk produced in Great Britain is sold within the domestic market, Northern Ireland has an export orientated market meaning that the Northern Ireland dairy supply chain is much more dependent on returns from the global commodity markets. The structure of the processing sector also varies across the UK, with a higher prevalence of co-operatives operating in Northern Ireland.

The questions in the consultation are in the document that accompanies this Briefing

What is the NFU Cymru position:

The NFU Cymru is supportive of the introduction of mandatory minimum contract terms for dairy contracts and feel it should apply between all purchaser and farmer relationships to:

1. Balance the risk within dairy supply chains, specifically on price and volume
2. Eliminate unfair trading practises and one-sided contract terms
3. Place dairy farmers in a strong position to develop professional sustainable relationships with their buyer.

NFU Cymru believes regulation should provide farmers and buyers with choices about the types of contracts they want to use to best suit the production needs of the farming business and the market needs of the processor.

What does it cover?

The NFU Cymru Dairy Board have been considering this topic for many years and have taken the time to develop a position following discussions with dairy farmer members, farming unions, individual milk buyers, key industry stakeholders and legal advisers. The position covers 10 key areas of contract regulation:

1. Pricing mechanism

We want to rebalance the risk between farmers and processors, so that there is a **greater sharing of risk** along the supply chain. Discretionary pricing (whereby a processor can unilaterally vary the price at their choosing) should be ended and prices should be transparent and have a clear mechanism which is objective and verifiable. At present, discretionary pricing, in different forms, is almost ubiquitous, and allows for much of the risk in markets and



supply chains to be placed on to the farmer, which we believe is unsustainable. We also believe that **discretionary pricing does not deliver a true market price** as it creates a culture of 'follow the leader' especially with price drops. When farmers are tied into long term contracts, the market forces cannot operate effectively thus creating imbalances. Ultimately, **price should be market focussed**. We do not believe that we should move away from market forces. Bonuses and deductions can be acceptable; however, they must be made clear and not unilaterally varied subsequently.

2. Relationships and Farmer representation

We believe that **relationships are crucial** to the improved working between farmers and processors. The rise of co-operatives and farmer groups in the UK has seen greater farmer collaboration which has massively improved relationships. But for those without a good relationship, it can be extremely challenging and creates a David against Goliath situation. We feel that any changes to contract terms e.g. price mechanism, penalties or bonuses **should be agreed between the parties**, and there is a huge role for **Producer Organisations, Co-ops and farmer groups**.

3. Exclusivity and volume

A key mechanism for developing more sustainable contracts is the structure which allows for farmers to supply more than one business. Almost all contracts are currently exclusive, which means you must send every single litre to the processor you are contracted with. We believe that **farmers should be able to choose between exclusive and non-exclusive contracts** so that there is flexibility for farmers to **adapt and take advantage of different markets**. In recent times we have seen processors with issues over volume either restricting volumes or changing payment schedules to heavily penalise overproduction which may limit expansion or productivity gains. We are aware that some may prefer exclusive terms, and where this is the case then this should remain an option. For a Co-op or a Producer Organisation, this is choice for them, but we believe that this should be choice. Pricing mechanisms and volumes should logically be mutually managed by farmers and processors.

4. Elimination of unilateral changes and one-sided contract terms

Many contracts feature terms which allow the processor to make changes to contracts without the agreement of the farmer or without consultation. For example, a payment schedule may be changed overnight so that the farmer gets paid for a different profile. Many contracts also feature one sided term, such as farmers must keep supplying a business in administration or circumvention clauses which allow processors to ignore other contract clauses 'if the board deems necessary'. These types of clauses exist in almost every single contract. They may very rarely or never be used, but sometimes can be used in times of severe pressure, thus pushing the risk on to the farmer. We believe that **these kinds of clauses should be removed from all contracts** and terms need to be agreed jointly by the farmer or their representatives.

5. Consequences of breach

A mandatory code is only effective if there are measures in place to ensure it is being followed, and clear consequences for any breaches. We believe that a structure like that of the Grocery Code Adjudicator should be in place to oversee the regulation. There is potentially a role for a structure such as an inter-branch organisation (IBO), made up of processor and farmer representatives, which is used in other countries to enforce mandatory codes. If any party is found to be in breach of the code, **there should be appropriate levels**



of consequence (i.e. financial penalties) so that it deters any actions which may be against the code.

What are the benefits?

For Farmers, we believe it would bring:

- Greater clarity and transparency to milk contracts
- A professional, two-way and sustainable relationship with their milk buyer
- Create a fairer balance in the rights and obligations between the producer and the purchaser
- Reduce producer vulnerability by bringing transparency, certainty and trust to milk price mechanisms
- Eliminate unfair trading practises and one-sided contract terms

For milk buyers, we believe it would:

- Help instil confidence and foster long-term, trusting relationships with producers, this is vital to secure supply
- Contract reform has the potential to reduce volatility by creating more stable trading terms for both farmers and milk buyers
- Buyers can be more specific about their milk requirement needs and farmers can manage and match production to demand more efficiently to maximise their contract's potential
- Buyers and farmers can agree more innovative contractual terms based on need and requirement

Why is NFU Cymru concentrating on dairy contracts?

Contract regulation is just one of many areas NFU Cymru is working on for our dairy farmer members. NFU Cymru dairy board vision covers three key areas including:

1. Building better, fairer supply chain relationships
2. Building an improved business environment whilst ensuring farm competitiveness
3. Promoting the best of Welsh milk and milk products

Contract regulation sits under the first commitment. Around 30% of queries and complaints NFU receives nationally from dairy members relate back to the wording of their contract. NFU Cymru can and does provide a first port of call for dairy farmers who have queries about their contracts, and we advise members to contact NFU Call First if they have an issue on 0370 845 8458

Do NFU Cymru want there be exemptions to the regulations?

No. NFU Cymru believe any contract regulation should apply to all milk purchasers. All farmers have a supplier/buyer relationship with their purchaser, whether they supply a PLC or a Co-operative. Fair and transparent contracts should be available to all and the points outlined above are relevant to all. Regulation should apply to the supply relationship that a farmer has with their milk buyer and is separate to that of any ownership relationship which may exist (for example as a member of a Co-op).

I have a good relationship with my milk purchaser, I don't want regulation to change that.

NFU Cymru will not support any proposal that it believes will damage the industry or adversely affect those who already have a good working relationship with their milk buyers. Some purchasers are already aligned with much of what the NFU Cymru are calling for and it is not these businesses regulation is targeting. The NFU Cymru position is simply aimed at removing unfair trading practices and one-sided contract terms and placing **all** dairy farmers in a strong position to develop professional sustainable relationships with their milk purchasers.

Do NFU Cymru want all contracts to look the same?

No. The NFU Cymru's position is aimed at ensuring there is a level playing field and minimum standards for all dairy farmers. It is also about offering choice to farmers and processors to develop contracts which suit their respective business needs. Some purchasers are already aligned with much of what the NFU Cymru are calling for, but it is important that all farmers have the same opportunities. Individual purchasers may choose to go above and beyond what is stipulated by regulation, but others will no longer be able to undermine or undercut those who are attempting to work fairly with their suppliers.

Do NFU Cymru want fixed milk prices?

No. Regulation on contracts should not mean that there is a move away from the market. Prices do need to move with and reflect market conditions; this reflection should be objective, verifiable by both farmers and buyers and not subject to manipulation. This will give farmers greater certainty, allowing them to invest in their business with confidence.

Do any other countries regulate contracts?

Yes. 13 European member states have contract regulation under the Common Market Organisation. The UK's exit from the EU should mean that we are not restricted by European legislation. Instead we can design an approach which works best for our dairy industry. Many other countries are looking at regulating contract terms, for example Australia have recently brought in legislation, which is aimed at increasing transparency over price, prohibiting some exclusive contracts, and banning unilateral contract changes.

What if I supply a multi-national dairy company?

As mentioned above, the UK is not the only country looking at improving fairness in the supply chain. In May 2019 we saw the introduction of a new European Directive aimed at banning unfair trading practices in the food supply chain. Those businesses operating in Europe on a multi-national level will have to comply with this directive in any case, which needs to be implemented by all member states by the 1st November 2021. This shows clearly that the direction of travel, globally, is towards stronger, fairer contracts. It is not clear at this time whether the UK will be subject to this regulation, due to the complexities of Brexit. However, all European companies exporting product throughout the Union, including several processors operating in the UK, will need to comply.

Will this cover the entire UK?

Yes, it is highly likely that regulation would cover all four devolved countries of the UK. NFU Cymru have been working closely with our counterparts in Wales, Scotland and Northern Ireland to ensure we have a joined-up response to the consultation that works for farmers across the United Kingdom.

What if I want an exclusive or evergreen contract?

That would still be possible and an individual business choice. NFU Cymru are looking to create options for farmers, not restrict them.

What type of farmer representation/structure does the NFU Cymru want to see?

NFU Cymru are keen to see any structure which improves farmer collaboration, representation which creates a more sustainable relationship, such as PO's, co-op's and democratic farmer representative structures. It is not for NFU Cymru to say which structure is best for businesses, but for farmers and milk buyers to find the structure which works best for their respective businesses.

Are the NFU Cymru pushing Producer Organisations?

NFU Cymru believe that Producer Organisations (POs) play a vital role in helping farmers collaborate and provide a tool by which farmers can improve their negotiating position with milk buyers. Equally, other structures, such as co-ops can be extremely effective. It is ultimately up to groups of farmers whether they feel that a PO would suit their situation, but NFU Cymru certainly see a role for PO's as part of a sustainable, professional relationship between farmer and milk buyer.

