

Economic Impact of Retail Alliances in Upstream Operators in the Food Supply Chain

Professor Steve McCorriston
University of Exeter
England, UK

Addressing the Potential Upstream Impacts: Working Framework

- Agricultural suppliers and SMEs are weak participants in the food chain and are faced with increasingly concentrated downstream (particularly retail) sectors.**
- Concerns that competition issues in the food sector mainly impact on procurement**
- Competition issues in the food sector also impact on the price transmission process**
- Potential concerns with Retail Alliances:**

Overview: Addressing the Potential Upstream Impacts

▶ Context

- concentration at retail stage in food sector

- aims of retail alliances

▶ Background

- concerns relating to agricultural suppliers (and SMEs) in the food chain

- aspects of 'weakness' and 'fairness'

▶ Market power in the food sector:

- Concerns and actions relating to market power in procurement particularly unfair trading practices

- Price transmission

▶ Conclusions?

Some Background: Results from an OECD Survey

Countries	Food price increase	Food price volatility	Price transmission along the chain Unfair trading practices	Declining terms of trade for farmers	Other
Australia			+	+	
Belgium		+	+		+
Canada	+		+		
Chile			+	+	
Czech Republic	+				
Denmark	+		+		+
Estonia			+	+	+
European Union	+	+	+		
France	+	+		+	
Indonesia	+		+	+	
Israel	+		+		
Italy	+	+	+	+	
Latvia			+		
Lithuania	+				+
Netherlands			+	+	+
New Zealand			+		
Poland		+	+		+
Portugal			+	+	
Slovenia			+		
South Africa	+		+		
Switzerland	+	+	+		
Turkey	+	+	+	+	
United Kingdom	+			+	+

- “..transparency along the food chain was identified as a top priority”

Retail Alliances

- ▶ Obtain better acquisition prices and give them more negotiating power in procurement
- ▶ Compete with established retail chains
- ▶ Efficiency benefits through sharing information and expertise
- ▶ Coordinate over provision of private brands
- ▶ Create partnerships in entering new markets

Addressing Competition Issues in the Food Chain

- ▶ ECN Report on Competition Enforcement in the Food Chain (2012)
- ▶ DG Comp on Retail Competition and Innovation
- ▶ ECB Retail Market Structure and Prices
 - Downstream concentration associated with lower consumer prices
 - Concentration in procurement associated with lower consumer prices

Addressing a wider range of concerns about the functioning of the food chain across EU Member States

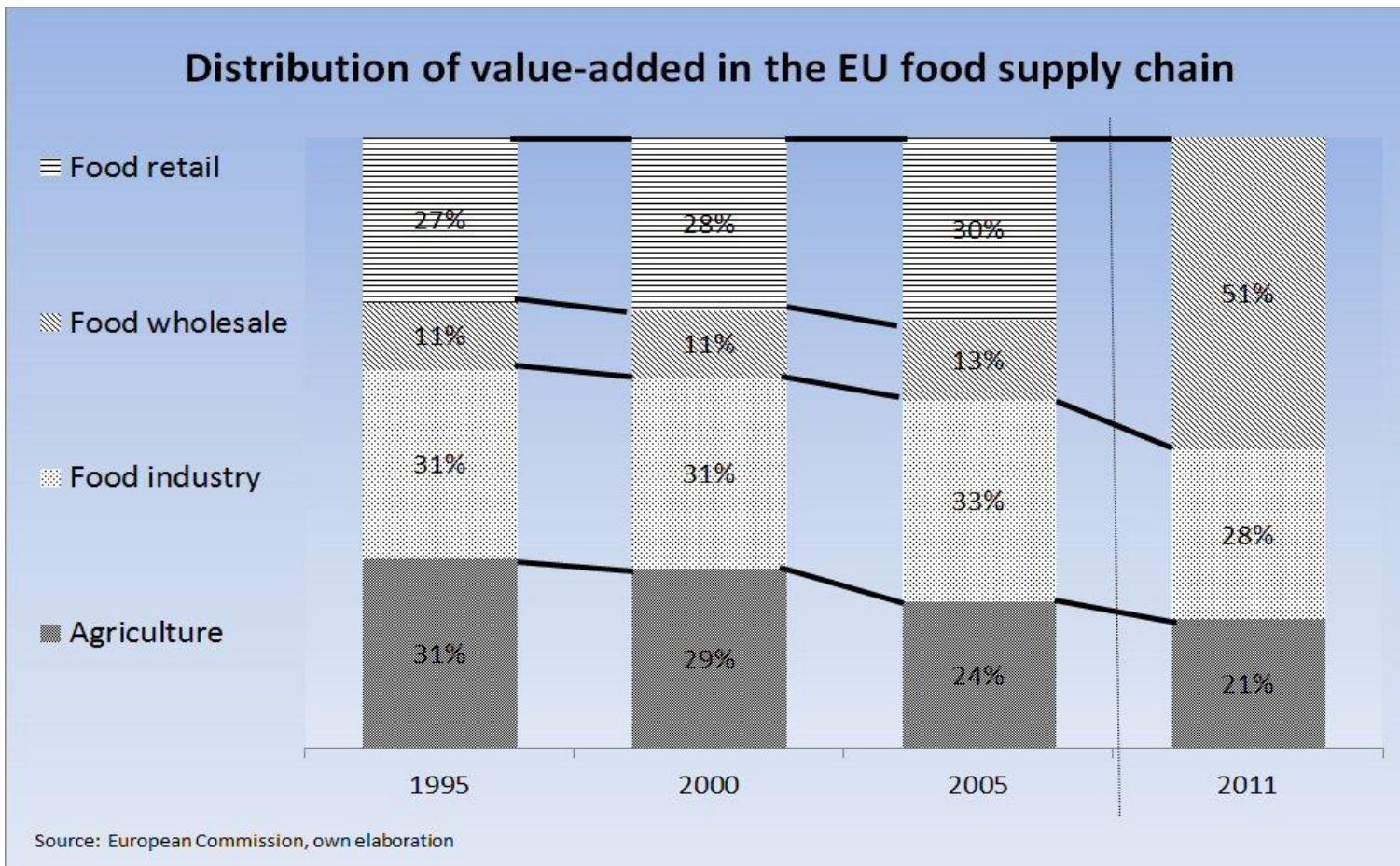
- ▶ High Level Forum for a Better Functioning Food Supply Chain (2010) to investigate issues across the food supply chain
- ▶ Supply Chain Initiative–UTPs in the supply chain
- ▶ Agricultural Markets Task Force, 2016: “Improving Market Outcomes–Enhancing Position of Farmers in the Supply Chain”
- ▶ Food Price Monitoring Tool (complementing Food Price Observatories across several countries)

- ▶ Measuring Agriculture's Share of the Euro Dollar across EU Member States (2019)
- ▶ EU Directive on UTPs, 2019

Range of concerns relating to agriculture in the food chain

- ▶ Low and declining share of the ‘Food Euro’
- ▶ Lack of transparency in the functioning of the food chain and over price formation
- ▶ Increasing concern with unfair trading practices
- ▶ ‘Low’ price transmission from farm to retail reflects these concerns
- ▶ Addressing these issues has brought increasing attention from policy makers noted above

Agriculture's role in the value chain

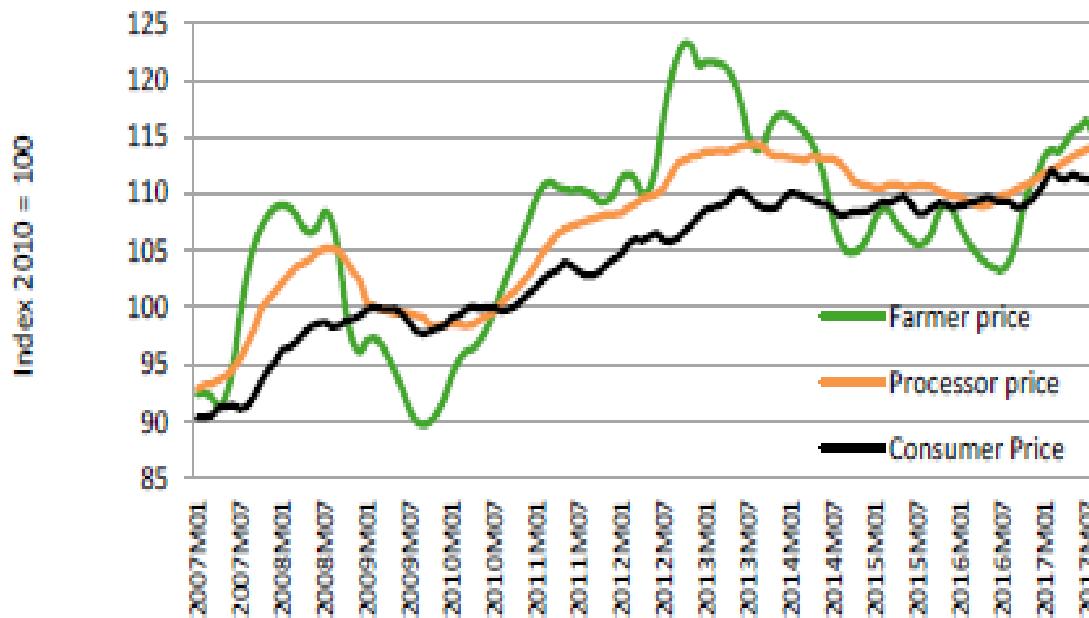


Role of SMEs in the Food Chain

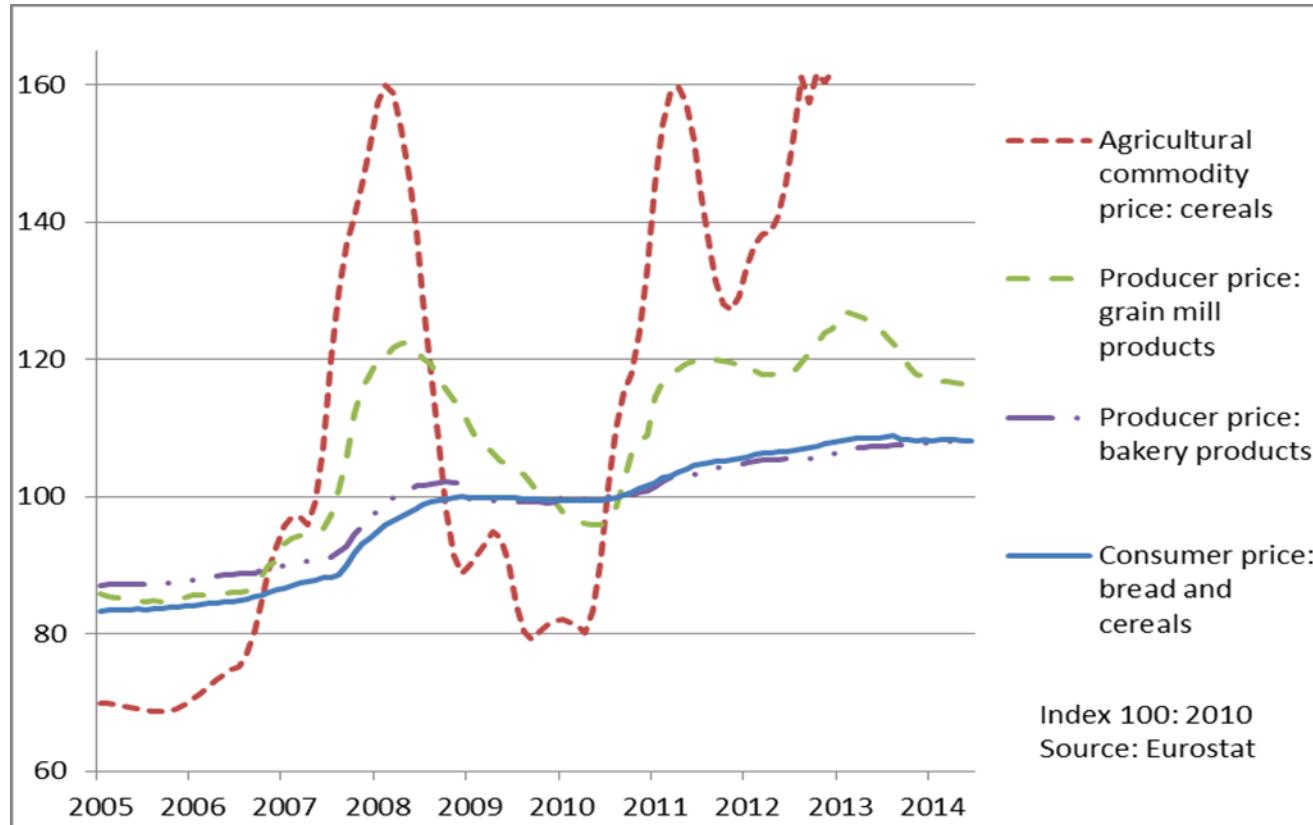
- ▶ In UK food sector: SMEs account for 97% of businesses; 28% of employment; 19% of turnover
- ▶ In Europe food and drink sector: 99% of businesses; 50% of turnover; 63% of employment

Price developments at different stages of the food chain

Figure 10 - Food supply chain index for EU-28 (2007-2017)



Price developments in the food chain



- ▶ We should expect that prices in the agricultural sector to be more volatile than downstream prices
- ▶ But there is still a concern that the characteristics of the food chain impact on price developments across different stages
- ▶ These are reflected in concerns about price transmission—see later

Market power in the EU food sector

- ▶ High levels of concentration across EU Member States particularly at retail level
- ▶ Concentration at the food manufacturing level
- ▶ How does this impact on the upstream sectors?
 - procurement issues and UTPs
 - price transmission

Concentration in the Food Retail Sector

Figure 8 - Retail concentration ratio (CR5)



Source DG GROW from Euromonitor

Competition in the Food Chain not just about numbers!

Table 5.7

Market share of private labels based on volumes, %

	2003	2009	Change
Switzerland	n/a	54	n/a
United Kingdom	41	48	7
Germany	35	40	5
Belgium	38	40	2
Spain	29	39	10
Austria	n/a	37	n/a
Slovakia	11	37	26
France	28	34	6
Portugal	n/a	34	n/a
Denmark	25	28	3
Hungary	17	28	11
Finland	24	28	4
Czech Rep	13	28	15
Sweden	22	27	5
Netherlands	22	25	3
Poland	7	21	14
Greece	n/a	18	n/a
Italy	14	17	3

Source: PLMA.

More specific concerns have been associated with Unfair Trading Practices

- ▶ UTPs:
- ▶ “practices that deviate from good commercial conduct and are contrary to good faith and fair dealing. They are usually imposed on one trading partner on another. The food supply chain is particularly vulnerable due to large differences in bargaining power”

Unfair Trading Practices

- ▶ UTPs come in a variety of forms
- ▶ May arise for a number of reasons
- ▶ Challenging to establish how widespread they are
- ▶ And yet to establish the specific effects...insights from theory are largely missing

Examples of UTPs

- ▶ Contract terms include unfair clauses
- ▶ Unilaterally terminating a contract with no notice or unjustifiable reasons
- ▶ Contractual sanctions imposed with no justification
- ▶ Non-contractual retrospective unilateral charges
- ▶ Imposing charges to fund a promotion
- ▶ Listing fees
- ▶ etc

UTPs can arise when

- ▶ Limited number of buyers
- ▶ Dependence of suppliers due to technology or know-how
- ▶ Limited information
- ▶ Switching costs
- ▶ Incomplete contracts
- ▶ Lack of contract enforcement

Incidence of UTPs

- ▶ Case studies: are they general?
- ▶ Surveys: coverage?
- ▶ Evidence from complaints to adjudicators: but parties may not be willing to come forward
- ▶ EU Commission published an impact assessment (2018)
- ▶ Recent evidence from JRC survey of the EU dairy sector:

.....98% of farmers surveyed reported at least one UTP

.....most common: “no safeguard if buyer fails to fulfil contract”

- ▶ Taking the lack of evidence on incidence and specifically identifying effects makes the UTP issue a difficult one to pin down with an evidence base but an important issue for future research

Potential Issues

- ▶ Equity in the distribution of rent in the value chain
- ▶ Transfer of risk between stages in the value chain
- ▶ Are UTPs necessarily associated with market power?
- ▶ Are UTPs more likely with increased concentration in procurement?

- ▶ Lack of evidence on these issues
- ▶ ...are they particularly pervasive in the food supply chain given the context set out above?
- ▶ ...does producer 'harm' passed through as benefits to consumers?

Downstream concentration and procurement

- ▶ In the standard set-up, farmers obtain lower prices and impacts on the profitability and sustainability of the agricultural sector
- ▶ Merel and Sexton (2017) question this standard approach
- ▶ Their argument is that since downstream firms rely on inputs in the future, they have no interest in ‘unduly’ harming their suppliers

- ▶ Their framework highlights the trade-offs
- ▶ It's a dynamic model:
 - in the short-run, it's the standard mark-down effect
 - but if firms value future supplies, this offsets the static mark-down issue
 - the higher the concentration, the more the downstream firms internalise the externality associated with ensuring supplies in the future

Key insight: higher concentration does not necessarily negatively impact on agriculture

EU Directive (2019)

▶ Prohibited 10 ‘black’ practices

- ▶ ...late payments
- ▶ ...short notice of cancellation
- ▶ ...unilateral contract changes
- ▶ ...payments not related to specific transaction
- ▶ ...risk or loss transferred to supplier
- ▶ ...lack of written contract
- ▶ ...misuse of trade secrets
- ▶ ...commercial retaliation by buyer
- ▶ ...transferring costs of complaint to the supplier

Price Transmission in the Food Chain

- ▶ Not overly surprising that price transmission is ‘low’
- ▶ But concern is that market power in the food sector impacts on the price transmission process and that this contributes to ‘unfairness’
- ▶ Market power in downstream markets and procurement lowers price transmission
- ▶ The specific mechanism behind this means that margins in the food chain can widen as agricultural prices fall

Price transmission elasticity involving an upstream agricultural market with an imperfectly competitive food industry

$$\tau = \frac{s_A (1 + \gamma\sigma)}{(1 + s_A\gamma\sigma) ((1 + \mu) + s_B\gamma\eta)}$$

s_A is the share of the raw agricultural commodity in the food industry cost function

s_B is the share of other inputs

σ is the elasticity of substitution between agricultural and materials inputs

γ is the inverse elasticity of supply of marketing inputs

η is the industry elasticity of demand

μ is the mark-up elasticity that captures the competition effect

$$\tau = \frac{s_A}{(1 + \mu)}$$

Comparing this with a competitive food sector

$$\frac{\tau_c}{\tau} = 1 + \mu$$

$$\mu = \omega \left(\frac{\theta}{n\eta - \theta} \right)$$

ω is the change in the elasticity of the demand function

n is the number of competing firms

θ is the intensity of competition

As competition decreases through n or increases in θ , μ rises,
.....=>price transmission decreases

But can buyer power impact on price transmission?

- ▶ The main mechanism is similar: it is the elasticity of the mark-down (not the mark-up) that matters in this case.
- ▶ Conditional on functional forms, this will depend on the number of firms competing in the procurement market and the intensity of competition in the procurement market
- ▶ In essence, oligopsony power contributes to lower price transmission: i.e. for supply shocks, prices at retail change by less than prices at the farm level

Price transmission and vertical coordination?

- ▶ Take the example of private labels. Increasing feature of retail competition
- ▶ There are off-setting effects here: success of private labels increases market share for main retailers---but reduces the inefficiency associated with double marginalisation.
- ▶ So, price transmission may or may not increase for private labels compared with national brands
- ▶ Evidence is mixed: results from data using Canadian data confirms higher price transmission for private labels; results from data relating to the UK suggests lower price transmission for private labels.

Conclusion: Where does all this take us on the issue relating to retail alliances?

- ▶ Agriculture (and SMEs) are the weakest parts of the food chain and there has been increasing concern in relation to competition in downstream stages in the food chain.
- ▶ This is particularly so with respect to buyer power
- ▶ There is increasing concern with regard to how UTPs impact on upstream suppliers
- ▶ Price transmission and the role of competition also (implicitly) relates to the ‘unfairness’ issue.

- ▶ These issues facing upstream suppliers may tie into the issue relating to retail alliances
- ▶ What are the potential linkages?

...to the extent that retail alliances relate to procurement issues, this exacerbates concerns about the weakest links in the food sector

...to the extent that retail alliances promote competition at the retail stage and efficiency in the food chain, in principle, these effects could go the other way

...similarly, the effect of vertical control is ambiguous