

The Brattle Group

COMPETITIVE ASSESMENT OF THE SPANISH FOOD SUPPLY CHAIN

Report Presentation

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Aims of the Report

- A. Evaluate the **level of market power** on the Spanish food supply chain
- B. Analyse the existence of **empirical evidence on the application of discriminatory margins** by retail companies in favour of retailer own brands (“ROBs”) and to the detriment of manufacturer brands (“MB”)
- C. Evaluate the **effect on end-prices and innovation** caused by the increased concentration in the retail sector and the growing prominence of ROBs
- D. Identify **proposals to promote effective competition** in the Spanish distribution market

Main Conclusions (i)

A. MARKET POWER AND PENETRATION OF RETAILER OWN BRANDS

Retailer market power has increased in the last decade

- ◆ Evidence of **High Market Power (or Dominant Position)** in the retail market
 - Mercadona: **Valencia** (39.8% market share) and **Andalucía** (36.3%)
 - Eroski: **País Vasco** (42.7%)
- ◆ Possible existence of **significantly stronger dominant positions at the local level in Valencia, Andalucía and País Vasco** (dominant positions at the local level in other regions cannot be ruled out)
- ◆ The **increase in the economic dependence of manufacturers relative to retailers** does not allow us to rule out the existence of distortion of effective competition in the wholesale supply market

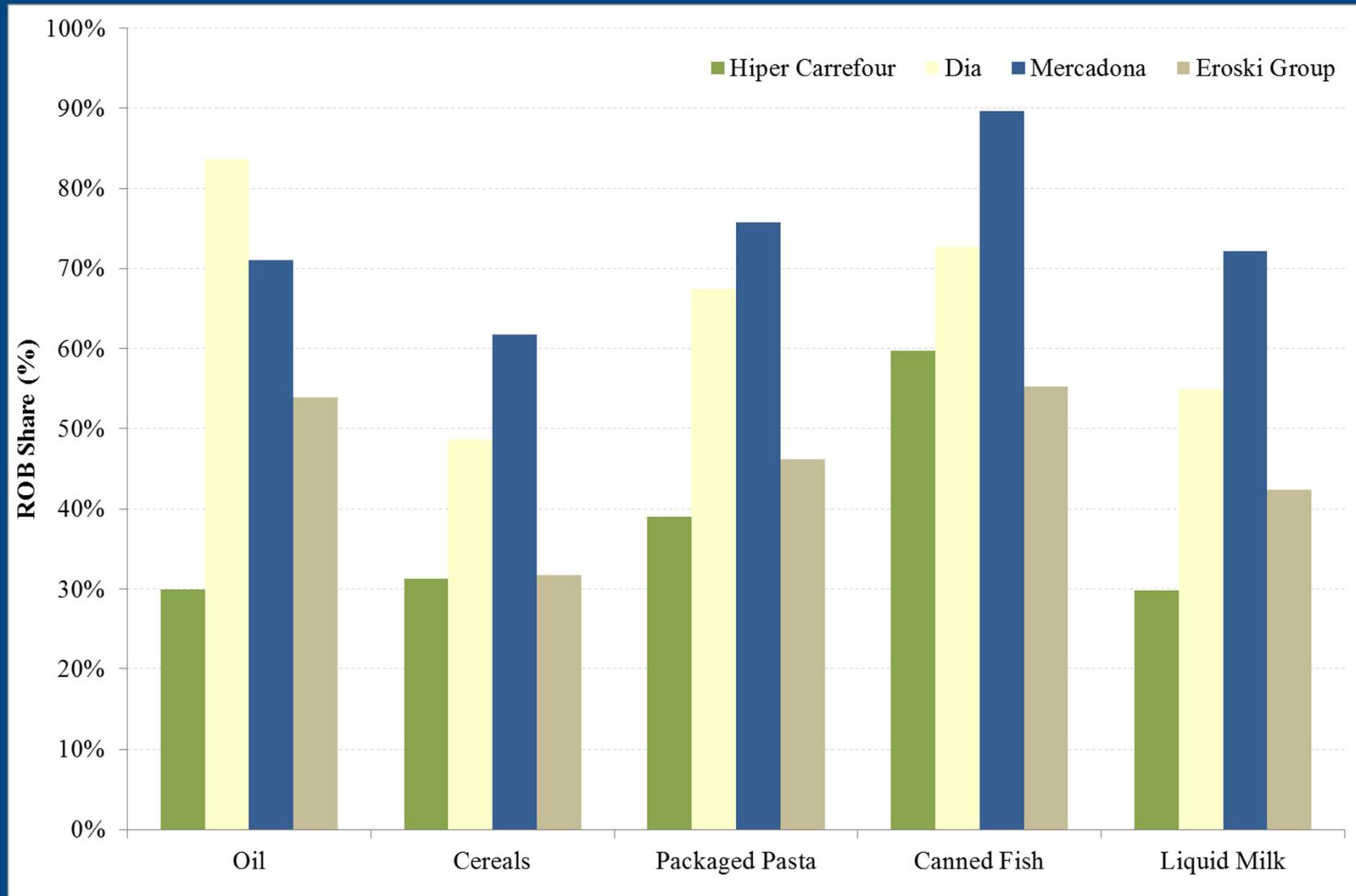
ROB penetration keeps on growing (34.5% market share in 2011)

Table 2: Retail Market Concentration (sales value, 2011)

Retail Group	Market Share (%)								
	Andalucía	Cataluña	Castilla-León	Com. De Madrid	Com. Valenciana	Galicia	País Vasco		
Mercadona	[1]	IMRF	36.3	23.8	23.9	25.0	39.8	12.1	1.2
Carrefour Group	[2]	IMRF	12.1	11.4	12.4	14.7	14.9	7.9	11.5
<i>Hiper Carrefour</i>	[3]	IMRF	11.3	10.0	11.6	13.5	14.6	7.4	10.8
<i>Dia</i>	[4]	IMRF							
<i>Rest of Group Carrefour</i>	[5]	max([2]-[3]-[4];0)	0.8	1.3	0.8	1.2	0.3	0.5	0.8
Eroski Group	[6]	IMRF	2.9	13.4	7.0	4.2	2.1	20.5	42.7
<i>Eroski Supers</i>	[7]	IMRF	1.6	0.6	4.8	1.6	0.3	19.1	22.7
<i>Hiper Eroski</i>	[8]	IMRF	1.1	1.8	2.1	1.1	1.8	1.4	20.0
<i>Caprabo</i>	[9]	IMRF	0.0	11.0	0.0	1.5	0.0	0.0	0.0
<i>Rest of Eroski Group</i>	[10]	max([7]-[8]-[9];0)	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Dia*	[11]	IMRF	10.3	8.7	13.9	9.0	6.1	8.7	8.3
Auchan Group	[12]	IMRF	3.3	4.6	4.8	9.8	3.0	7.9	9.9
<i>Alcampo</i>	[13]	IMRF	3.3	3.5	1.1	8.7	2.9	7.9	2.1
<i>Simply Market</i>	[14]	IMRF	0.0	1.1	3.6	1.1	0.1	0.0	7.7
<i>Rest of Auchan Group</i>	[15]	max([12]-[13]-[14];0)	0.0	0.0	0.1	0.0	0.0	0.0	0.1
Lidl	[16]	IMRF	6.3	5.6	3.4	4.5	4.7	4.0	5.8
El Corte Inglés Group	[17]	IMRF	2.6	2.4	2.7	5.7	1.6	2.3	1.2
<i>Hipercor</i>	[18]	IMRF	1.5	1.0	0.8	3.3	0.7	1.0	0.0
<i>Rest of El Corte Inglés Group</i>	[19]	max([17]-[18];0)	1.1	1.5	1.9	2.4	1.0	1.3	1.2
Consum Cooperativa	[20]	IMRF	0.0	3.5	0.0	0.0	14.0	0.0	0.0
Ahorramas	[21]	IMRF	0.0	0.0	0.0	10.1	0.0	0.0	0.0
Gadisa	[22]	IMRF	0.0	0.0	2.1	0.0	0.0	16.0	0.0
El Arbol	[23]	IMRF	0.2	0.0	6.2	0.0	0.0	0.3	0.0
Aldi	[24]	IMRF	0.8	1.2	0.9	0.7	1.9	0.0	0.0
Rest of Retail Groups	[25]	See Notes	25.2	25.3	22.7	16.4	11.8	20.2	19.4
Total	[26]	See Notes	100	100	100	100	100	100	100
HHI (by Retail Group)	[27]	See Notes	1643	1030	1054	1192	2084	1051	2163
CR4	[28]	See Notes	65.0	57.3	57.1	59.6	74.9	57.4	72.4

Source: Own elaboration, based on data from independent market research firm (IMRF)

Figure 11: ROB Share by Retail Group and Product Category



Main Conclusions (ii)

B. IMPOSITION OF DISCRIMINATORY MARGINS

Retail chains apply higher margins to MBs than to ROBs, to incentivising end-consumers to purchase ROBs

- ◆ In some products, the margin applied to MBs was between 2 and 18 times higher than the margin applied to ROBs
- ◆ This practice distorts competition between MBs and ROBs
- ◆ In the medium and long term, the increasingly stronger bargaining power of retailers may result in:
 - An increase in ROB prices;
 - The disappearance of second-tier MBs; and
 - The reduction in manufacturers' ability and incentive to innovate

Main Conclusions (ii)

B. IMPOSITION OF DISCRIMINATORY MARGINS

Examples

- ◆ ***Extra virgin olive oil (2007-2008)***: the retail margins applied to the wholesale transfer price were approximately 22% in the case of MBs, versus 1% in the case of ROBs
- ◆ ***Milk (2008)***: the retail margins applied to the wholesale transfer price were approximately 48% in the case of MBs, versus 30% in the case of ROBs
- ◆ ***Product F (2011)***: the retail margins applied to the wholesale transfer price of packaging format β in 2011 were approximately 66% in the case of the MBs, versus 18% in the case of the ROBs

Average Retail Margin in MBs and ROBs (%)

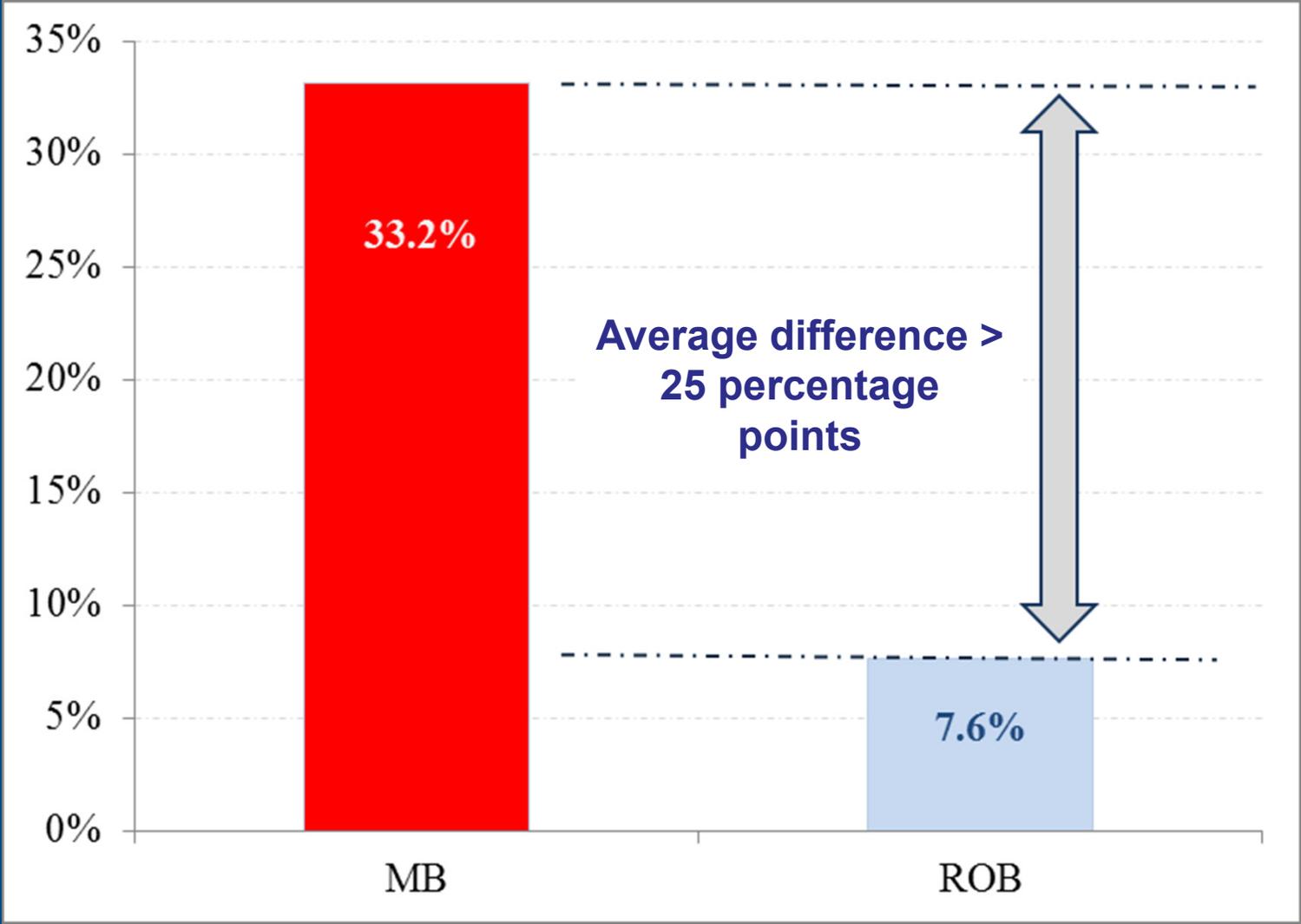


Table 7: Comparison of Sales Prices and Margins for MBs & ROBs

Product		Year	Brand Type	Transfer Price	RRP excl. VAT	Margin per Unit	
				(Index)	(Index)	(Index)	(%)
				[A]	[B]	[C]	[D]
				See Note	See Notes	[B]-[A]	[C]/[A]
Product A	[1]	2011	MB	100	125	25	25%
			ROB	44	46	2	5%
Product B Type 1	[2]	2011	MB	100	132	32	32%
			ROB	80	88	8	10%
Product B Type 2	[3]	2011	MB	100	155	55	55%
			ROB	82	89	8	10%
Product C	[4]	2011	MB	100	137	37	37%
			ROB	59	64	4	7%
Product D Format X	[5]	2011	MB	100	114	14	14%
			ROB	76	76	0	0%
Product D Format Y	[6]	2011	MB	100	115	15	15%
			ROB	71	76	5	7%
Product D Format Z	[7]	2011	MB	100	115	15	15%
			ROB	68	75	7	10%
Product E Format α	[8]	2011	MB	100	149	49	49%
			ROB	73	99	25	34%
Product E Format β	[9]	2011	MB	100	166	66	66%
			ROB	93	110	17	18%
Extra Virgin Olive Oil	[10]	2007-2008	MB	100	122	22	22%
			ROB	84	85	1	1%
		2008-2009	MB	100	137	37	37%
			ROB	83	67	-16	-19%
Olive Oil	[11]	2007-2008	MB	100	116	16	16%
			ROB	83	85	2	2%
		2008-2009	MB	100	134	34	34%
			ROB	86	79	-8	-9%
Milk	[12]	2008	MB	100	148	48	48%
			ROB	79	103	24	30%

Source:

[1] to [9]: Information obtained by *Brattle* by means of direct conversations with companies and associations in the sector

[10], [11]: Food Price Observatory, MARM, Study of the Value Chain and Price Formation for Olive Oil, January 2010 and June 2011

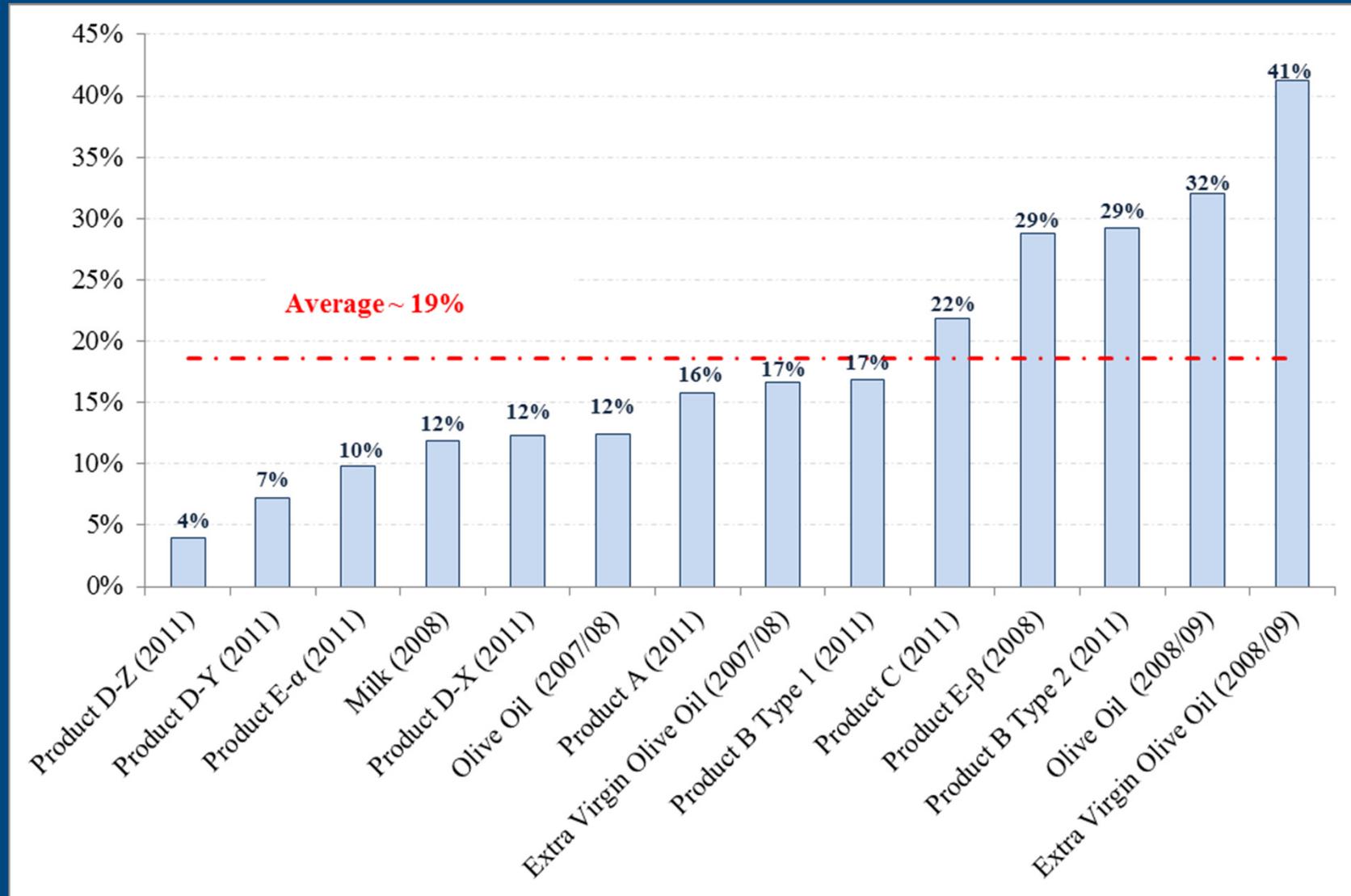
[12]: Food Price Observatory, MARM, Study of the Value Chain and Price Formation for Packaged Liquid Milk, April 2009

Elimination of Discriminatory Practices (i)

Based on the products analysed, and assuming that retail chains apply margins to MBs equivalent to those currently applied to their ROBs, the elimination of discriminatory practices:

- ◆ *could reduce the price of MBs by between 4% and 41%*
- ◆ *could reduce the price difference between ROBs and MBs by nearly 48%*

Elimination of Discriminatory Practices (ii)



Main Conclusions (iii)

C. EFFECTS ON PRICE

Data analysed

- ◆ Sales volumes, sales value and prices (quarterly) of 15 of the most representative products of the consumer basket
- ◆ For each product, price analysis has been performed on the ROB and the three principal MBs in the 7 largest retail chains in Spain
- ◆ Period of analysis: From Q1 2008 to Q4 2011
- ◆ 7 regions: Andalucía, Cataluña, Castilla y León, Madrid, Valencia, Galicia and País Vasco
- ◆ Data provided by a prestigious international company specialised in the analysis of consumer behaviour in the consumer products sector

Main Conclusions (iii)

C. EFFECTS ON PRICE

The growth in market power of retail chains and the increasing penetration of ROBs does not translate into lower prices for the end consumer

- ◆ The increasing bargaining power of distribution chains (relative to food suppliers) has a null effect on MB prices, but a positive (or null) effect on ROM prices
- ◆ Both, ROB and MB prices increase as the level of penetration of ROB products grows
- ◆ However, the larger the level of ROB penetration, the smaller the relative price difference between ROBs and MBs (due to higher relative increases of ROB prices relative to MB prices)

Main Conclusions (iii)

C. EFFECTS ON PRICE

Examples

- ◆ A 10% growth in ROB penetration caused a price increase in the MB of 5.5% for canned fish, 4.0% for toothpaste, and 3.0% for dishwasher detergent
- ◆ A 10% growth in ROB penetration is associated with a price increase of over 6% for ROB chocolate and soft drinks, and over 5% for ROB shower gel and dishwasher detergent
- ◆ A 10% growth in ROB penetration provokes a reduction of the price difference MBs and ROBs of about 5% in the case of chocolate and instant coffee, and of nearly 13% in the case of detergent

Table 5: Impact of Increasing Market Share of Retailer Chains on MB and ROB Prices

	MB Price	ROB Price
Beer	0	+
Biscuits	0	+
Canned Fish	0	0
Cereals	0	-
Chocolate	-	0
Cocoa Cream	-	+
Coffee	0	0
Detergents	+	0
Dishwasher Detergent	-	0
Milk	0	0
Oil	0	+
Pasta	0	+
Shower Gel	0	+
Soft Drinks	0	+
Toothpaste	0	0

Source: Own elaboration, based on data from a independent market research firm. «0» means that market power does not have an effect on the price of the given product; «+» means that the greater the market power, the higher the price; and «-» means that the greater the market power, the lower the price. Level of significance is 95%.

Table 6: Impact of Penetration of ROBs on MB and ROB Prices

	MB Price	ROB Price	Relative Price MB vs. ROB
Beer	+	+	-
Biscuits	0	+	-
Canned Fish	+	+	+
Cereals	+	0	0
Chocolate	-	+	-
Cocoa Cream	+	-	+
Coffee	-	+	-
Detergents	-	+	-
Dishwasher Detergent	+	+	-
Milk	+	-	+
Oil	+	+	+
Pasta	+	0	0
Shower Gel	0	+	-
Soft Dinks	+	+	-
Toothpaste	+	+	0

Source: Own elaboration, based on data obtained from independent market research firm. «0» means that market power does not have an effect on the price of the given product; «+» means that the greater the market power, the higher the price; and «-» means that the greater the market power, the lower the price. Level of significance is 95%.

Main Conclusions (iv)

D. EFFECTS ON INNOVATION

Evidence suggests that the drivers innovation and growth in the consumer products sector in Spain are the MBs, rather than the ROBs

- ◆ Increased concentration in the retail market, higher retailer bargaining power, and the penetration of ROBs
 - Limit innovation by manufacturers
 - Will negatively impact consumer welfare in the medium and long term

Proposed Reforms (i)

1. ENFORCEMENT OF SPANISH COMPETITION POLICY LAW

- ◆ **Retail Market:** Enforcement of Article 2 of *Ley de Defensa de la Competencia* (“LDC”) to category management practices in retail markets where a dominant position exists (e.g., Andalucía, País Vasco and Valencia)
- ◆ **Wholesale Supply Market:** Enforcement of Article 3 of LDC to the commercial relationships between food supply market participants, characterised by a growing economic dependence of manufacturers on food distribution retailers
- ◆ More specifically, certain ROB practices should be limited (or abolished):
 - Discriminatory practices that have exclusionary effects on MBs
 - Privileged access to manufacturers’ confidential and sensitive

Proposed Reforms (ii)

2. REGULATION OF CNC RECOMMENDATIONS

Mandatory Obligations for all market participants

- Obligation to establish written contracts between manufacturers and retailers
- Establishment of a model contract to serve as a basic framework
- Establishment of reasonable notification periods for modification of supply contract terms
- Limitation of privileged access by the retailer to manufacturers' confidential and sensitive information
- Prohibition of retroactive changes to contracts

Mandatory Obligation for market participants with market power

- Prohibition of certain clauses, such as the “most preferred client” clause
- Regulation of commercial payments and prohibition of retroactive payments
- Obligation to provide information periodically to the public administration to facilitate thorough monitoring of market evolution and the profitability achieved by retailer chains in the different stages of the supply chain

Creation of an Independent Control Body (“Ombudsman”)

- To monitor the evolution of the sector, and
- To solve disputes between manufacturers and retailers
- With the authority to act *ex officio* and powers similar to the CNC

Proposed Reforms (iii)

3. MEASURES AIMED AT CONTROLLING RETAILER INCENTIVES IN THE CONTEXT OF THEIR DOUBLE ROLE AS RETAILER AND MANUFACTURER

- A. First, we propose the limitation in the supply of information by producers of manufacturer brands to retailers, through the establishment of an *express prohibition to supply certain type of information related with the private intentions of companies regarding their future conduct in the context of strategic variables such as pricing, cost structures, future promotions, new formats, etc.*
- B. Second, we suggest the establishment of FRAND type obligations (“Fair, Reasonable and Non-Discriminatory”) for the sale on equal terms of MBs and ROBs, so that the retailer would perform category management in accordance with pre-determined criteria and in a proportionate, objective, and non-discriminatory manner (in relation, for example, with commercial margins, product placement ...)

Proposed Reforms (iv)

4. MEASURES TO LIMIT MARKET POWER

- A. First, the *imposition of mandatory structural divestments in those areas where serious competition problems are identified, based on an ex-post analysis of the competitive situation*

- B. Second, the *imposition of regulatory measures to limit the expansion of retailers based on local competition conditions, through the implementation of a «pro-competitive license» authorization for the establishment of new premises that fosters effective competition*