

The Brattle Group

Competitive Assessment of the Spanish Food Supply Chain

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1. INTRODUCTION AND SUMMARY

1.1 THE CONTEXT OF THE REPORT

Retail distribution of basic consumer goods in Spain has undergone a significant transformation in recent decades. First, the traditional store format has been replaced by a new format in which supermarkets (specifically, medium and large supermarkets) have acquired increasing prominence. Second, the level of concentration of retail distribution in Spain has grown significantly, together with two additional factors that have facilitated the progressive increase in buying power of retailers: on one hand, the process of vertical integration and the development of retailer own brands (ROBs) have converted retailers into double agents, who are now both clients and direct competitors relative to brand manufacturers in the retail market. Retailers selling their own brand in their respective stores compete directly with manufacturers in terms of sales volumes and the placement and availability of products on store shelves. On the other hand, there has been growth in the formation of retail buying groups.

The increase in bargaining power and market power of retailers in relation to other actors in the value chain (producers and consumers) and the fundamental alteration of the relationship between producers and retailers, from a business partner relationship to one of direct competition, have generated concern among Spanish and European competition authorities. This is primarily due to the potential effect of exclusion and the reduction in effective competition in the distribution of basic consumer goods that these practices could generate, with the resulting damage to the end consumer. Specifically, the analysis has focused on evaluating the extent to which the increase in retailer bargaining power and market power, and the growth in the penetration of ROBs – distorting the incentive for retailers, who are retailers and competitors at the same time - may impact effective competition between producers and retailers.

Traditionally, European competition authorities, including the Spanish Competition Authority (*Comisión Nacional de Competencia*, or “CNC”), have been reticent in the application of competition laws, article 101 of the Treaty on the Functioning of the European Union (“TFEU”) relative to B2B agreements and practices that may limit competition (and article 1 of Law 15/2007, *Ley de Defensa de la Competencia*, or “LDC”) and article 102 relative to abuse of dominant position (and article 2 of the LDC) when limiting (or eliminating) the exercise of discriminatory practices with an excluding effect by retail companies in the food sector. On one hand, competition authorities have not analysed the framework of article 101 of the TFEU in depth, and specifically, the rules applicable to horizontal and vertical agreements and the consequences of the fact that retailers with own brands are at the same

time “real or potential” competitors as well as retailers of manufacturers. Secondly, competition authorities believe that it is improbable that retailers hold a “dominant position”, concluding, among other considerations, that the market share at the national level does not exceed the “safe harbour” threshold of 40%. Similarly scarce, or non-existent, are procedures relative to acts of unfair competition (article 3 of LDC) and of discrimination and abuse of economic dependency (Law 29/2009 of 30 December, modifying Law 3/1991, *Ley de Competencia Desleal*, or “LCD”).

However, recent studies and analyses performed in Spain, United Kingdom, France, and Finland on competition in the food retail market (and in basic consumer retail in general) in their respective countries, represent a new focus in the analysis of the behaviour of retail companies, and also define potential solutions to encourage effective competition in these markets. With specific regard to the Spanish market, a recent report by the CNC¹ indicates that the introduction of ROBs in the food retail sector could generate incentives for retailers to apply discriminatory practices to benefit their own brands in detriment of manufacturer brands (“MBs”). These discriminatory practices include the imposition of higher sales margins (estimated as the final sales price minus the wholesale transfer price) for MBs than for ROB products. Other frequent discriminatory practices include de-listing (or refusal to list) of manufacturers in favour of their own brand, the refusal to accept manufacturer promotions (including price reductions) when an ROB alternative exists for the same product, and the strategic positioning of ROBs on the shelves. In the medium and long term these discriminatory practices with excluding effects may reduce inter-brand competition (between manufacturers) and limit, or in some cases eliminate, the incentive for manufacturers to innovate and invest, forcing manufacturers out of business, even when their products are demanded by the consumer. The CNC 2011 report recognizes that, ultimately, a reduction in effective competition will damage consumer welfare.

1.2 PRINCIPAL OBJECTIVES

This report analyses the combined effects of the special commercial relationship (at the horizontal and vertical levels) between manufacturers and retailers, and the increased market power of retailers in Spain in the last several years. The report aims to analyse the real or potential impact when certain retailers with their own label are also real and/or potential competitors of brand manufacturers, inasmuch as they are either owners of the production facilities where ROB products are manufactured; or linked, with increasing exclusivity (in terms of duration and degree of exclusivity) with certain

¹ CNC, “Report on relationships between manufacturers and retailers in the food sector” October 2011 (hereinafter, “CNC 2011 Report”).

suppliers; or simply have an established ROB that allows them to apply pressure on manufacturers. The report analyses this situation in the context of the growth in market power of retailers vis-à-vis manufacturers, which limits the channels of alternative distribution for manufacturers.

Although emphasis has been placed on studying the change in the manufacturer/retailer relationship caused by the introduction of ROB, less attention has been paid to the empirical evaluation of the ultimate effect of the introduction of ROBs and increased retailer market and bargaining power on price, quality, and choice of the products acquired by the consumer. This report aims to cover, at least in part, the scarce attention dedicated to evaluate the final effect on consumers of the profound changes taking place in the retail market in Spain.

With this aim PROMARCA commissioned *The Brattle Group (Brattle)* to perform a competitive analysis of the relationships between manufacturers and retailers in both the wholesale and the retail market for basic consumer goods in Spain, including an estimate of potential economic damage to final consumers (in terms of price and innovation) that may arise from the growth in the bargaining power of retailers, and the process of concentration of this market. PROMARCA also asked *Brattle* to assess the existence of empirical evidence that demonstrates the application of discriminatory margins by vertically integrated retailers upstream, in favour of their own brands and in detriment of manufacturer brands.

The objective of this report is threefold. Firstly, to evaluate market power (and degree of dominance) in the Spanish retail and wholesale basic consumer goods markets, with special emphasis on the food distribution market, taking into account the competitive structure of the market, and, in particular, the following factors: (a) market position of the leading company in each market versus its competitors; (b) the existence of barriers to entry (and to expansion); (c) the bargaining power of retail distribution participants in each of the analysed markets. Secondly, to evaluate the effect on final consumers (in terms of price, commercial margins, and innovation) of the increased concentration in the retail sector in Spain, and of the growing prominence of ROBs in recent years. Thirdly, to discuss and evaluate the proposals for reform contained in the CNC 2011 Report and, where appropriate, to propose the development of complementary measures to promote effective competition in the Spanish distribution market.

1.3 MAIN CONCLUSIONS

Evaluation of Market Power and Dominance

Using regional data (by Autonomous Community) we have assessed market power and degree of dominance in the retail and wholesale markets for basic consumer goods in Spain, and also in the food retail sub-sector. Although the geographical market of reference in retail is local in nature, requiring a more local context for a competitive analysis, the regional level represents a reasonable context for dominance analysis, allowing identification of regions with a high market power where dominant positions may exist (of one or more operators) at a more local level. The principal conclusions are summarised below:

- (1) Evidence exists to suggest that Mercadona may have a dominant position in the retail market in Valencia and Andalucía, and Grupo Eroski in the País Vasco. The factors on which this statement are based are (a) high level of concentration (individual or collective) of the retail market in these three regions; (b) existence of entry (and/or growth) barriers; (c) reduction in competitive pressure relative to the leaders in these markets by the second operator, Grupo Carrefour, following the separation of Grupo Dia in 2011; and (d) limited purchasing power of the final consumer;
- (2) Significant market power at the regional level in Valencia, Andalucía, and the País Vasco suggest the probability of even greater dominance of the regional leaders in certain provinces and/or cities in these regions;
- (3) Although the level of concentration (individual and/or collective) in the retail market is moderate in the remainder of the regions analysed (Castilla y León, Galicia, Cataluña and Madrid) the existence, or emergence in the near future, of dominant positions at the local level in certain provinces and/or cities in these regions cannot be ruled out;
- (4) The continuous reinforcement of the economic dependence of manufacturers/suppliers in Spain relative to the most powerful retailer in the wholesale supply market (Mercadona, with a market share of 27%) suggests the need to monitor this market to prevent distortion of effective competition, which would limit the incentive for manufacturers to innovate and invest, and would reduce (or eliminate) the incentive for retailers with market power to reflect improved trade conditions obtained from manufacturers in the final sales price. The weakening of competitive pressure by the second operator, Grupo Carrefour, following separation from Dia en 2011, and the existence of significant barriers to entry, or growth, in the wholesale market, do not allow us to rule out the existence of distortion of effective competition in the wholesale supply market.

Retailer commercial practices and their effect on the end consumer and on innovation

The gradual increase in concentration in the retail market observed in Spain in recent years, the marked prominence of ROBs, which has significantly increased retailer negotiating power, and the existence of barriers to entry, all advise reconsideration of the net effects on effective competition in the retail market of upstream vertical integration of certain retailer chains. The reduction of effective intra-brand competition (between retailers), in turn, reduces the potential pro-competition effect of vertical integration in the short term (i.e., the elimination of double margins between two previously independent companies, thereby reducing the final sale price to the consumer) and increases the risk of market exclusion and/or business failure of manufacturers, with the resulting negative effect on consumers in the medium and long term. The evidence in Spain demonstrates that innovation and competition in the food segment and in other consumer product segments are now under threat due to the increased pressure of ROBs and their vertical integration strategy.

The results of the econometric study, performed to determine the effect of market concentration and the introduction of ROBs on consumer prices, allow us to conclude that:

- (1) *The increased market power of retailer chains in Spain does not translate into lower consumer prices.* Moreover, in the case of ROBs, in almost half of the products analysed the price has increased. According to our analysis, retailer chains do not appear to pass on to their customers the lower wholesale prices that they may obtain due to their increased bargaining power with suppliers;
- (2) In general, *ROB prices increase in line with the increased penetration of the ROB;*
- (3) *MB prices also increase in line with the increased penetration of ROBs.* The limited degree of effective competition in the retailer market allows retailer chains to increase manufacturer brand prices with the aim of widening the competitive advantage of their own retailer own brand products;
- (4) In several products, we observed that, *as ROB penetration increases, the price difference between ROBs and MBs decreases.* This is because the price increase of ROBs is generally higher than price increases in MBs when ROB penetration grows.

The report presents empirical evidence that vertically integrated retail chains have the incentive to increase the margin on manufacturers' products versus equivalent ROB products to encourage the consumer to purchase ROB products. This usually occurs in MBs with a loyal client base. This practice places MBs at a competitive disadvantage and distorts competition between MBs and ROBs, because the ability of the MBs to compete is weakened due to the retailer's commercial policies. The

commercial policy of “cross-subsidies” harms consumers who are loyal to a MB when the price of this brand goes up. In the medium and long term, it is logical to think that the growth in retailer bargaining power will result in an increase in the price of ROB products, which will negatively affect ROB consumers. Discriminatory policies may also result in the disappearance of second-tier MBs, and a reduced ability and incentive for manufacturers to innovate.

Evidence suggests that MBs, and not ROBs, are the drivers of innovation and growth of the basic consumer goods sector in Spain. It is therefore important to ensure that effective competition exists between manufacturers, in order to promote innovation and investment in the Spanish food sector. The growing concentration of the retail market, the increase in their bargaining power, and the penetration of their own brands, all limit innovation by manufacturers, and will negatively impact Spanish consumers in the medium and long term.

Proposed reforms to drive effective competition

Despite numerous complaints by consumer goods manufacturers and the apparent recognition on the part of competition authorities, including the CNC, of the existence of distortion of effective competition in the retail market, to date these competition authorities have taken very little action against retailers. The evaluation of dominance and market (and purchasing) power performed in this report indicates that there are signs that in certain regions (País Vasco, Andalucía, and Valencia), the necessary conditions may already exist in the retail market that would justify the enforcement of competition law with respect to practices identified in the CNC 2011 report (dominant position, and discriminatory practices leading to exclusion, article 2 of LDC), and in the wholesale market (distortion of free competition through unfair acts, article 3 of LDC, and discrimination and economic dependence, LCD).

This report proposes the application of measures additional to those proposed by the CNC 2011 Report, which seek to restore the balance, in terms of bargaining power, between retailers and manufacturers, to lower the barriers to entry and growth, and ultimately, to resolve (or at least mitigate) the issue of distortion of effective competition in the retail market. The principal measures include:

- (1) *Enforcement of competition law to the practices identified by the CNC*, in cases when there are clear indications that the circumstances requiring enforcement, and specifically, dominance and economic dependence, exist. Competition authorities should reconsider the enforcement of competition law in order to limit practices that represent the imposition of discriminatory actions that have an excluding effect on MBs, and prevent manufacturers

from “independently determining the policies to be adopted in the internal market and the terms and conditions they propose to offer their clients”. Competition law should also be applied to limit retailers from accessing confidential, sensitive information belonging to manufacturers that could be used to benefit ROBs, ultimately damaging effective competition in the retail market and reducing consumer welfare.

- (2) *Regulation of the recommendations proposed by the CNC, notably:*
- a. *Establishment of a set of regulations that create a basic framework for the relationship between manufacturers and retailers, mandatory for all operators in the retail market regardless of their market share, e.g. the obligation to establish written contracts, reasonable notice in the event of modifications, definition of the information that manufacturers must provide to retailers for the correct marketing of their products, and the prohibition of unilateral and retroactive changes;*
 - b. *Draw up mandatory regulations for operators exceeding a given share of the wholesale and/or retail market at the local level, to restore the balance in bargaining power between manufacturers and retailers, e.g. the elimination of preferred client clauses in contracts, prohibition of unscheduled commercial payments not foreseen in the contract, and the regular supply of information by retailers to government authorities to allow proper monitoring of the market;*
 - c. *Limitation of the exchange of sensitive information relative to price, cost structures, formats, and future strategies between manufacturers and retailers;*
 - d. *Creation of an independent control body to monitor the evolution of the market, resolve disputes between manufacturers and retailers, with the powers to take actions ex officio;*
 - e. *Establishment of obligations to guarantee that retailers perform category management in accordance with pre-determined criteria in a proportionate, objective, and non-discriminatory manner.*
- (3) Other measures aimed at limiting market power, such as the *establishment of obligations relative to structural disinvestment* in areas with serious competition problems, based on *ex-post* analyses of the competitive situation; and the *establishment of limitations to retail expansion based on the status of competition at the local level*, through the implementation of a “pro-competitive license”.

1.4 THE STRUCTURE OF THE REPORT

The report is divided into three Sections. Section 1 analyses the structure of the distribution market (wholesale and retail) in Spain, including a definition of each market and an evaluation of dominance in the food retail market.

Section 2 performs a quantitative analysis of the evolution of prices (and commercial margins) in Spain in the last three years and their link to the growth in concentration in the Spanish distribution sector and the increasing prominence of ROBs. An innovative aspect of this report is the attempt to illustrate the possible range of damage to consumers as a result of increased concentration in the distribution market and the growing importance of ROBs. In this section we present an estimate of the potential damage to end consumers (in terms of price increases) as a result of the application of discriminatory margins imposed by supermarkets on MBs, compared with the margins applied to the sale of ROBs. Lastly, this Section also evaluates the possible negative effect of the strong expansion of ROBs on choice and innovation.

Section 3 presents a critical assessment from the viewpoint of competition policy and the promotion of economic efficiency of the remedies and proposals contained in the CNC 2011 Report. This Section proposes a series of measures additional to those proposed by CNC, which seek to promote effective competition in the distribution market by reducing the level of concentration and market power of retailers, and the lowering of barriers to entry and expansion. Given the difficulty associated with solving the problems identified exclusively by means of ex-post measures, we propose a series of complementary measures to competition law, with the aim of protecting end consumers from potential indiscriminate increases in current or future prices (and/or reduction in product innovation and quality).

Annexes 1 to 6 of the Report complement the information contained in the main body of the report. It is worth noting Annex 3, which presents a theoretical discussion of the relationship between indices of concentration commonly used by authorities on competition and market power (and dominance). Annexes 4 and 5 include an analysis of dominance in the retail and wholesale supply markets for daily consumer products (packaged food, drinks, non-perishable fresh products, cleaning and beauty products). Annex 6 presents the methodology (econometric analysis) used to analyse the relationship between observed prices and the evolution in the degree of concentration in the distribution sector in Spain, and the growing prominence of ROBs. Lastly, Annex 7 contains a brief biography of the authors of the report.