

# MEAT AND LIVESTOCK COMMISSION

## SUBMISSION TO THE COMPETITION COMMISSION MARKET INVESTIGATION INTO THE SUPPLY OF GROCERIES BY RETAILERS IN THE UNITED KINGDOM

The Meat and Livestock Commission (MLC) is an executive Non Departmental Public Body set up under the 1967 Agriculture Act. Its remit is to work with the British meat and livestock industry (cattle, sheep and pigs) to improve its efficiency and competitive position; and to maintain and stimulate markets for red meat at home and British meat abroad, with due regard for the consumer.

### Executive Summary

- The Meat and Livestock Commission (MLC) welcomes the Competition Commission's market investigation into the supply of groceries by retailers in the UK, and also believes that the position and effect of the dominance of own brands within the grocery chain is an area the Competition Commission might usefully include in its referral given the potential for a distortion of competition.
- The livestock industry comprises over 150,000 primary producers and over 300 abattoirs.
- The oligopolistic structure of the retail sector has raised concerns in the red meat chain given the livestock industry's heavy dependence on multiple retailers for sales to consumers.
- Of particular concern in the red meat sector is the dominance of multiple retailers' own brands, which confer the status of manufacturer-by-proxy on retailers.
- The effect on the red meat chain of the distortions to the market caused by own brand dominance and the promotional mechanisms employed by multiple retailers is felt throughout the supply chain
- Own labels increase the 'gatekeeping' role of retailers which may distort competition by increasing barriers to entry, reducing innovation and thereby restricting choice.
- Own brands allow retailers to place greater downward price pressure on their suppliers. This may benefit consumers if waste is being removed from the supply chain, but serious concerns are now apparent over whether perpetual 'auction pricing' is harming reinvestment within the supply chain, particularly since energy costs are rising.

- Promotional mechanisms such as 'special purchases' and the use of invoice discounting on suppliers calls into question the risk:reward balance and whether market power is being abused.
- Concerns have also been raised over the weak market position of livestock farmers who, as weak sellers and against a changing policy background (notably the removal of production subsidies), may leave the industry.
- The effect of the industry dropping below a critical mass would result in an unsustainable industry and, in turn, harm government's vision for sustainable development.

## Introduction

1. The production end of the red meat industry comprises around 150,000 primary producers (livestock farmers) and slightly under 300 abattoirs, (see Appendix I for a profile of the red meat industry).
2. Most livestock farmers have limited direct contact with the final consumer since their immediate customers are the main meat processors and manufacturers. Most producers are under-equipped to promote their products directly to consumers, or to develop new export market opportunities. Being comparatively weak in the marketing chain, most red meat producers are largely price-takers. In general, most producers add little direct value to the primary product.
3. The sector is heavily dependent on multiple retailers for sales to consumers: around 75% of retail beef sales, 65% of retail lamb sales, 75% of retail pork sales, over 80% of retail bacon sales and 85% of processed meat product sales are through multiple retailers.
4. As confirmed by the Competition Commission in 2000 and more recently by Lloyd *et al.*<sup>1</sup> red meat producers face an oligopolistic retail structure, under which classical economics suggests that abnormal profits are made not at the expense of the consumer but at the expense of the supply chain. Although the Competition Commission concluded in 2000 that there was no discernible abuse of market power vis-à-vis consumers, the study by Lloyd in 2004 showed that under retail oligopoly conditions, a demand shift (in this case due to the BSE food scare) led to farm-gate farm prices falling substantially more than retail prices, confirming that the concern in relation to the impact of market power on upstream suppliers was warranted.
5. In its report of February 2004, London Economics<sup>2</sup> investigated the concentration ratios (CRs) for UK and European food retail markets. This revealed that the UK was not out of step with other European countries in terms of the concentration of its food retail sector. The same report also calculated the associated Herfindahl index for these countries. Again, the UK does not appear significantly out of line.

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<sup>1</sup> Tim Lloyd, Steve McCorriston, Wyn Morgan and Tony Rayner, 'Price Transmission in Imperfectly Vertical Markets', University of Nottingham, 2004.

<sup>2</sup> 'An investigation of the determinants of farm-retail price spreads'. London Economics, February 2004.

## European Food Retail Concentration Measures, 2001 - 2002

	C1	C3	C4	C5	HI
Austria	31.0%	73.6%	82.9%	87.4%	0.21
Belgium	25.3%	63.2%	72.3%	80.7%	0.16
France	21.6%	47.6%	57.2%	66.2%	0.11
Germany	26.3%	58.0%	69.1%	77.7%	0.15
Ireland	31.6%	67.5%	80.5%	89.9%	0.20
Italy	19.4%	52.9%	64.9%	72.7%	0.12
Netherlands	40.8%	70.7%	76.1%	80.1%	0.23
Portugal	26.0%	56.4%	67.1%	76.7%	0.15
Spain	30.9%	56.3%	65.9%	74.0%	0.15
UK	23.8%	53.0%	62.9%	68.4%	0.12
Average	27.7%	59.9%	69.9%	77.4%	0.16

Source: London Economics

6. One area that the London Economics study did not examine, but which is highly pertinent to any analysis of the UK grocery market, is the role of own label sales in the sales mix of multiple retailers. The table below provides a picture of the market structure of the UK multiple retail sector in respect of own/private label food sales by main categories, including data on sales of red meat sales for the year ended February 2006. It shows that retailers' own label shares in meat are considerably higher than for total food. Readily available comparable data for other countries is limited. However, what data is available indicates that the share of own label in total meat sales is around 23% in France.

### Top 5 Retailers' Shares by Value of Own/Private Label Food (year to February 2006)

%	Ambient groceries	Fresh and chilled	Frozen	TOTAL FOOD
Tesco	34.5	71.5 of which red meat: 82.9	47.0	55.9
J Sainsbury	36.5	72.4 of which red meat: 82.2	46.3	58.5
Asda	34.1	71.2 of which red meat: 85.8	53.6	55.2
Morrisons	27.6	68.3 of which red meat: 84.2	38.6	50.4
Somerfield Group	17.4	61.8 of which red meat: 80.1	27.5	39.7

Source: TNS Worldpanel

For comparison, the own label shares of the total market for other grocery categories are set out below:

Packet breakfast cereals	23.9%
Hot beverages	17.3%
Canned goods	41.0%
Confectionary	14.4%
Soft drinks	33.0%
Dairy products	46.1%
<b>Red meat</b>	<b>69.3%</b>

### **Own Brand Power**

7. When factored into the UK grocery market structure, the position of own brands reveals a situation of vertical integration with little associated managerial and financial responsibility, where the multiple retailers are able to exert significant levels of market power through their status as manufacturers-by-proxy. (Retailers who own manufacturing assets themselves are in the minority). The areas where this power can be exerted include:

#### *Retailers as Gatekeepers*

8. As own labels remove the link between producers/manufacturers and consumers, retailers of own brands - who do not own their own manufacturing assets - are able to switch suppliers with no loss of consumer goodwill. While retailers will always act as 'gatekeeper' to some extent given the *spatial monopolies*<sup>3</sup> they operate in-store, this role is significantly enhanced when it comes to own brand products. Manufacturers clearly have the ability to launch their own brands, but will require either a large promotional budget and/or retailer acceptance to attain retailer listing.
9. Large promotional budgets allow manufacturers to highlight the existence of their brands direct to consumers, build goodwill and thus encourage retailers to list their products. Continued promotional activity and advertising is thereafter often necessary to encourage sales and maintain listing. Breakfast cereals is often cited as a category having a high advertising:sales value ratio. It is also an area where manufacturers' brands have a sizeable share of retail sales.<sup>4</sup>
10. Retailer acceptance may occur because brands fulfil a particular niche that the retailer does not wish to service via its own brand offering. One must here distinguish between those 'manufacturer brands' that are exclusive to one particular retailer and those brands which are available through a variety of outlets. The former are usually known as tertiary brands and are exclusive to one retailer. These tertiary brands

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<sup>3</sup> Once customers have entered the store they are 'captive' by virtue of consumer inertia and the retailer may exercise spatial monopoly power.

<sup>4</sup> See above.

may be designed specifically to sell products a retailer does not wish to sell under its own label. A common example in the red meat sector is pig meat products produced under animal welfare conditions that would be illegal in the UK.

11. Retailers may also decide to stock new-to-market brands because they allow a retailer to meet the needs of a niche group of its customers (eg kosher products) or products that it wishes to trial before introducing own brand versions (eg regional products).
12. In both cases, by acting as gatekeeper the retailer introduces barriers to entry, in terms of access to shelf space and/or a requirement for increased promotional investment. These barriers are increased in each instance by the power of own label because shelf space for manufacturers' brands is limited and because launching a new brand requires it to compete against the retailer-brand advertising that due to its corporate nature promotes all of a retailer's products, and not just single lines or categories.
13. Own brands may therefore restrict choice and constrain the development of new brands either totally, or beyond a 'tipping-point' where niche becomes mainstream and it becomes attractive for a retailer to launch an own brand version. Once an own brand is launched, shelf space constraints may prevent more than a handful of manufacturers having access to consumers through the multiple retail sector. As a result, levels of innovation may be lower in markets where own brands have a monopolistic position.

#### *Price Establishment*

15. Own brand retailers, as manufacturers-by-proxy, are in a privileged position in the supply chain, able to ascertain costs within the supply chain and drive these costs out. In the short term this may benefit consumers as retailers demand greater efficiencies from their supply chains.
16. However, this dominant position may be abused if retailers seek to reduce prices on an ongoing basis (via perpetual 'auction pricing') as part of their strategy to respond to competitive pressures within the retail sector (eg the strategy of Every Day Low Pricing – EDLP), without an understanding of whether and to what extent further efficiency savings can be made by the chain, and where any savings 'stick' in the chain.
17. In the short term it is highly likely that manufacturers will seek to maintain business even if the price a retailer is willing to pay falls below the level that provides a sustainable return on capital. In such circumstances, income for reinvestment is unlikely to be available and supply chains will become unsustainable.

18. An added problem may arise when input costs - over which the manufacturer has little or no control - increase. Energy is a current example where manufacturers have to accept increased input costs, but retailers may shy away from having to pay higher prices.
19. This situation may be exacerbated in industries where there is over-capacity such as in the red meat processing sector. Here processors seek to maintain throughput in order to cover fixed costs. They therefore are often tied to supplying low margin contracts, and have to seek to purchase raw materials (livestock in this example) at a reduced price as costs are passed back to producers rather than up through the chain to consumers. Given the weak position of individual livestock farmers, the market price is therefore not established through classical supply and demand equations.
20. It is worth noting that margins have been driven so low in the abattoir and processing sectors as to make it unattractive to general investors, and the sector remains predominantly in the hands of private companies. The list of quoted companies exiting the sector in recent years includes Hilldown Holdings, Unigate and Northern Foods.
21. Such a scenario reveals distortions in competition that are unlikely to be in the best longer-term interests of consumers. This is because supply chains operating in such abnormal markets are inherently unstable and unsustainable.
22. This is an important point for red meat supply chains as they seek to address the objectives of sustainable development, which are enshrined in government policy. A food economy characterised by the three pillars of sustainable development envisages delivery of the following eight key principles<sup>5</sup>:
  - Produce safe, healthy products in response to market demands, and to ensure that all consumers have access to nutritious food, and to accurate information about food products;
  - Support the viability and diversity of rural and urban economies and communities;
  - Enable viable livelihoods to be made from sustainable land management, both through the market and through payments for public benefits;
  - Respect and operate within the biological limits of natural resources (especially soil, water and biodiversity);

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<sup>5</sup> Food Industry Sustainability Strategy, Consultation Document, paragraph 1.1.14. Defra, 4 April 2005.

- Achieve consistently high standards of environmental performance by reducing energy consumption, minimising resource inputs, and using renewable energy wherever possible;
  - Ensure a safe and hygienic working environment and high social welfare and training for all employees involved in the food chain;
  - Achieve consistently high standards of animal health and welfare;
  - Sustain the resource available for growing food and supplying other public benefits over time, except where alternative land uses are essential to meet other needs of society.
23. Without a functioning market framework that allows efficient producers to generate sufficient income for reinvestment, the food supply chain will not be in a position to fully adopt these key principles.

#### *Own Brand Promotional Mechanisms*

24. Businesses develop brands to differentiate their products within the market in order to optimise their returns. Brand owners would normally promote their products, taking both the risk and achieving reward.
25. The situation is atypical for own brands, where product manufacturers are required to participate in promotional activities using a variety of mechanisms. Some of these practices were highlighted in the Competition Commission's report of 2000, but there are a number of own brand promotional mechanisms that have raised concerns within the grocery supply chain.
26. The use of 'special purchase' price promotions is a tactic increasingly used to drive sales. Multiple retailers typically tender for a quantity of product to be sold under their own label (or under a tertiary brand), buying from the cheapest supplier. Clearly, the operation of such tenders allows competitive forces to operate to the benefit of consumers on each occasion the special purchase is operated. However, multiple retailers increasing and regular use of this mechanism in effect means a perpetual downward auction is put in place. As 'special purchases' become a significant component of total sales, the net effect is to increase instability within the marketplace as suppliers' need to maintain throughput encourages them to discount.
27. In the pork and bacon sector the use of 'special purchases' under tertiary brands are often sourced from systems that do not meet UK regulatory requirements for animal welfare. This ties back to the issue of the key principles of sustainability in the sector.

28. Another mechanism used by retailers to promote their own brands is to require suppliers to make a contribution through invoice discounting to the retailer's promotional activities. Such charging of over-riders is voluntary in so far as the supplier may decide not to supply the retailer, but otherwise it is compulsory. Such activities imply that the Supermarket Code, where supermarkets may not unreasonably require a supplier predominantly to fund the costs of promotion<sup>6</sup>, may not assist suppliers in the way originally envisaged.
29. In these cases, it is the supplier who must bear the cost of the promotion, usually wholly, in terms of reduced margins. The counter argument is that promotional activities drive sales and therefore suppliers benefit. The question is therefore whether own brand promotional mechanisms distort the risk:reward balance.
30. Another area where distortions may occur is in Buy One Get One Free promotions (BOGOFs). Where a high notional sale price is placed on single items, the transparency of the offer to the consumer is reduced.

### **Long Term Sustainability of the Livestock Industry**

31. As a result of CAP reform, agreed in 2003 and implemented from the beginning of 2005, UK livestock producers - particularly cattle and sheep producers - face a radically altered policy environment, notably through the removal of direct production-linked subsidies (which are only partially offset by receipt of the Single Payment, which is itself subject to mainly environmental 'cross-compliance' conditions). Adapting to CAP reform, together with growing global competition and the prospect of further international trade competition under a yet to be concluded new World Trade Organisation agreement, represent substantial challenges to producers, even the most efficient.
32. An element of government's sustainable development vision is 'a farming sector which is competitive and profitable, diverse and resilient and without reliance on subsidy or protection'.
33. Enterprise costings carried out on behalf of MLC<sup>7</sup> show that, after subsidies are stripped out, not even the most efficient cattle producers and only the top third performing sheep producers in England secured a positive net margin. While there is scope to secure further efficiencies in production, long term sustainability also requires returns from the marketplace that cover production costs and allow for investment.

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<sup>6</sup> Paragraph 14 of the OFT's Supermarket Code.

<sup>7</sup> 'Business Pointers for Livestock Enterprises', English cattle and sheep business costings for 2005/06, published in Farmers Weekly, November 2005.

34. Were competitive pressures - key amongst which are the pressures from multiple retailers down through the supply chain - to drive out significant numbers of producers and volume of production and, in turn, erode the viability of the meat processing and manufacturing sector, this would undermine the overall critical mass of the domestic industry. Recovery from such a position would be most difficult, given the long production cycle (especially of cattle) and the loss of husbandry skills.
35. Over dependence on imported meat, in a world characterised by political uncertainty and increasingly wide-scale impact of animal disease outbreaks, is not *a priori* desirable.
36. A sustained decline in the livestock industry might also be expected to have some undesirable impact on the landscape and diversity of the countryside, and in some instances on the natural environment through changing grazing patterns. These are scenarios that are not well explored, but which policy changes, increasing competitive pressures and public interest considerations call for investigation.
37. Such a longer term overall scenario is not consistent with government's sustainable development vision.

## **Conclusion**

38. The effect on the red meat chain of the distortions to the market caused by own brand dominance and the promotional mechanisms employed by multiple retailers is felt throughout the supply chain. Processors and manufacturers have difficulty in earning sufficient margins for reinvestment and some with high borrowings may find their business models unsustainable during periods of downward price pressures.
39. It is however livestock producers who are arguably most affected by this scenario. This is because of the price-taker position of primary producers. The removal of production-linked subsidies for cattle and sheep producers has made the dominance of a few buyers even more of a concern as they are at a watershed in terms of their decision making.
40. Unless the market price more accurately reflects the removal of subsidy, which artificially benefited the retail sector as the dominant force within the supply chain<sup>8</sup>, livestock production in the UK will decline with knock effects on the abattoir sector; a loss of critical mass is a position not easily reversible. By way of example, the unsubsidised British pig sector has come under severe price pressure and since 1998 the number of breeding pigs has fallen by 45%.

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<sup>8</sup> OECD calculations have shown that ancillary industries extract around one-third of the benefit of direct farm subsidies (OECD 2003). The oligopoly structure of the retail sector in the UK in effect makes it an ancillary industry.

41. This will have a direct effect on sustainability and on consumer choice, and is a situation which will have been reached not because consumers are not purchasing red meat or that the UK production exceeds consumption<sup>9</sup>.
42. The Meat and Livestock Commission welcomes the Competition Commission market investigation. It also believes any investigation should examine potential abuses of market power within the supply chain and should include an analysis of the position and effect of the dominance of own brands within the grocery chain as a mechanism by which competition may be distorted, consumer choice limited and innovation dampened.

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<sup>9</sup> In 2004 the UK was 68% self-sufficient in beef, 84% in lamb, and 49% in pork and pork products.

## Appendix I. Profile of the Red Meat Industry

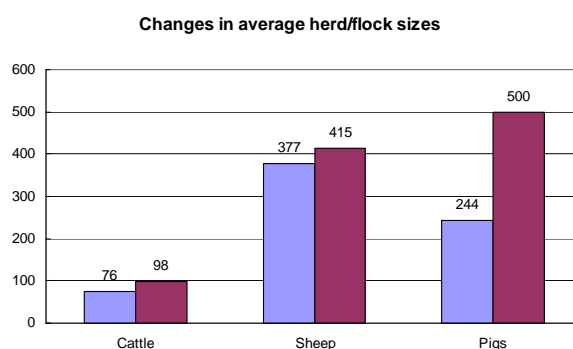
### *Farm Sector*

The value of UK beef, lamb and pig meat production totalled £4 billion in 2004, 23% of the total value of output from British farms. The livestock supply chain is complex; MLC research indicates that there are around 350,000 separate supply chains in the British red meat industry.

Of the total agricultural land area of the UK (18.4m ha), 60% is grazed by livestock.

There are around 280,000 agricultural holdings in the UK, of which 151,000 keep cattle, sheep and pigs, many of which are mixed holdings (mainly cattle and sheep since pig producers tend to be more specialist). 107,000 holdings keep cattle (beef and dairy), of which around 80,000 keep beef cattle. There are 87,000 holdings with sheep and 10,100 with pigs.

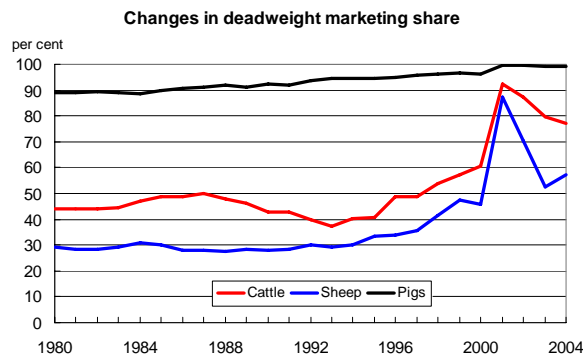
Economies of scale, combined with continual cost price pressures, have led to a sharp reduction in the number of holdings and an increase in average herd/flock sizes. This trend had been most pronounced in the pig sector, because pig farmers had not received production-linked support payments and were generally most exposed to market pressures. It has been least pronounced in the sheep industry, in which there are large numbers of hill farmers who have few alternative enterprises and for whom a large proportion of their incomes have been derived from subsidies. However, the ending of production-linked subsidies could lead to a more marked impact in the cattle and sheep sectors in the future.



Animals are either sold at an auction market (liveweight marketing), where buyers working for meat plants purchase the animals, or sold directly to the abattoir (deadweight marketing). At one time, the majority of animals were sold liveweight.

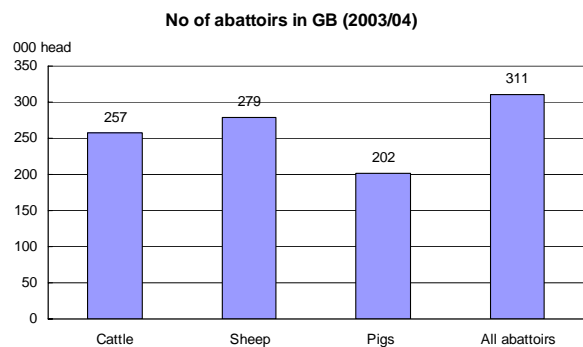
Since 1980, the number of livestock markets in Great Britain has declined at an annual average rate of 3%. As a result of the 2001 foot and mouth disease outbreak, many never reopened, and today there are estimated to be only just over 100 operating in Great Britain.

The vast majority of pigs are sold deadweight.



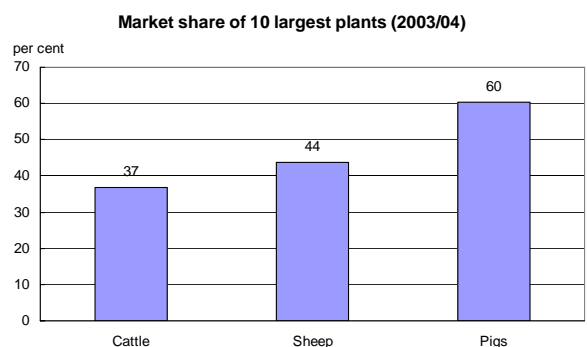
### Abattoir Sector

The abattoir sector is characterised by over-capacity and low margins. Consequently there has been a sharp decline in numbers, a trend exacerbated in the 1990s by new EU hygiene regulations, which forced many abattoirs to upgrade their plants or leave the industry.



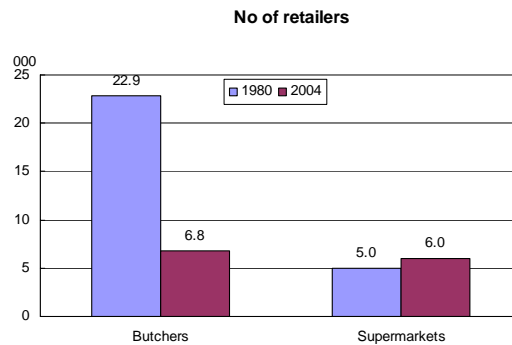
The number of abattoirs in Great Britain declined from 1,000 in 1985/86 to 297 in 2004/05 (246 abattoirs killing cattle, 267 abattoirs killing sheep and 189 abattoirs killing pigs), which indicates that the majority of these abattoirs are multi-species operations.

A small number of abattoirs account for the majority of slaughterings, as economic pressures have forced many small- and medium-sized abattoirs out of business.



## Retail Sector

At the retail end of the meat industry, social factors have been particularly important, notably changes in consumers' shopping patterns with a strong move towards single-stop shopping as food buyers seek to minimise the time spent shopping. The move by consumers away from independent butchers has led to a dramatic fall in their number in Great Britain.



While the number of supermarkets has not increased greatly, the average size of supermarkets is now much larger. Larger town centre stores have replaced first-generation supermarkets and there has also been the development of out-of-town superstores. A further development has been the increasing share of the large chains in multiple retailer sales.

## Employment in the meat sector

533,000 people worked on farms in the UK (the farmer, family and paid labour) in 2003. Of this total, 348,000 (65%) worked on farms keeping cattle, sheep or pigs. Over time, direct farm employment has declined, and there has also been a decline in the share of the total accounted for by paid labour. In some sectors shortages of skilled labour are proving a barrier to expansion.

<b>Employment in the meat sector, 2003</b>	
	<b>000</b>
Farms	348
Abattoirs	17
Meat processing	74
Animal by products	1
Butchers	37
<b>Total</b>	<b>477</b>

In addition to direct farm employment, there is also a considerable amount of employment in ancillary sectors. These are either downstream sectors that are responsible for getting the product to the consumers' plate or upstream sectors that provide inputs into the animal production process. Total employment that can be attributed to red meat production is almost 500,000. However this excludes businesses such as animal feed companies, haulage companies, veterinary surgeons, pharmaceutical companies, and the meat counters of multiple retailers. If employees associated with the meat sector in

these businesses are included, total employment is estimated at around 700,000.

### *Regional distribution*

The geographical distribution of pig production tends to be complementary to cattle and sheep production. In other words where there are more pigs there are fewer cattle and sheep. Most pigs are produced in the eastern and lowland parts of England, often associated with arable farms. Cattle and sheep are found more in the Western half of England and in hill/upland areas.

Consequently, British pig production is much more concentrated in England than are cattle or sheep. In December 2005, 80% of pigs on farms in the UK were in England, compared with 47% of sheep and 55% of cattle.

Livestock production is relatively more important on Scottish and Welsh farms than on English farms. The value of finished livestock in 2004 accounted for 17% of total output in England compared with 48% in Wales and 38% in Scotland.

MLC  
June 2006