The Brattle Group

The effects on consumers of discrimination in Brand management

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1. INTRODUCTION AND EXECUTIVE SUMMARY

The *Draft Bill of Measures to Improve the Function of the Food Chain* of 19 October 2012 ("Draft Bill") concludes that the existence of imbalances in bargaining power between retail companies and manufacturers in Spain generates a lack of transparency in pricing and enables the promotion of potentially unfair and anti-competitive commercial practices. The ultimate consequence of these practices is the distortion of effective competition across the entire agro-food sector, with the subsequent adverse effects for the end consumer.

The Draft Bill proposes a mixed model whereby food supply contracts and abusive commercial practice would be regulated, with self-regulation by the industry on matters of commercial relationships between agro-food sector operators and of administrative control, with the goal of improving efficiency and competition and reducing the current imbalance in the commercial relationship between producers, manufacturers and retailers of food and beverages in Spain. Among other commercial practices, the Draft Bill specifically addresses brand management of food products by retailers, both their own store brands (private labels or PLs) and those of manufacturers and competitors (manufacturer brands, or MBs). The press release published by the Ministry of Agriculture, Food and Environment on 19 September 2012 summarising the Draft Bill, indicated that brand management should be performed *"based on criteria of transparency, fairness, and non-discrimination, avoiding practices that alter free and fair competition between brands"*.

In this context, PROMARCA has commissioned a report from *The Brattle Group* to evaluate the effects on consumer welfare of discriminatory Brand management by retail chains. Specifically, the report analyses the exclusionary effect that discrimination of PLs and MBs has on manufacturer brands, and the consequences of this exclusion for price levels, variety of choice, and innovation and quality, with adverse consequences for the consumer.

Retail distribution of basic consumer goods in Spain has undergone a profound transformation in recent years. The gradual increase in the level of concentration in the sector, retailer vertical integration processes upstream, and the development of private labels (PLs), also known as store brands, have all significantly modified the traditional relationship between producers/manufacturers and retailers. The "double agent" role of the retailer, on one hand a distributor of manufacturer brands (MBs), and on the other, a direct competitor of these same brands with their own PLs, has generated concern in the government and competition authorities in Spain, and also in Europe, due to the potential for exclusion and for the reduction in effective competition in consumer goods retail that these practices can cause, with the subsequent harm to the final consumer.

Retail chains control the price and merchandising both of their own products and those of their competitors. As retailers, their stronger market power grants them increased bargaining power over manufacturers and allows them to achieve better commercial terms. As competitors, they are able to bend competition in the market in favour of their own brands. Retail chains have the incentive to favour their PLs against MBs both in terms of relative price, and other practices such as shelf location or bans on promotions and special offers. This has an exclusionary effect on competitors, who will lose market presence or even be expelled from the market.

This report provides empirical evidence that the growing market power of retail chains and their double role as distributors and competitors are allowing them to apply margins, pricing and marketing policies that are discriminatory and that situate their own PLs in a position of competitive advantage over MBs and generate the exclusion of MBs from the market.

For the product sample analysed, we verified that while the average retail margin for MBs is 33%, the retail margin for PLs is under 8%, i.e., a difference of over 25 percentage points. In this sample, the margin applied to MBs is between 2 and 18 times higher than that applied to PLs. This, together with the fact that in general, MB products are more high range and involve higher production costs than PLs, means that the price of MBs in the product sample is almost 70% higher than PL prices.

These policies have a negative impact on consumers because they cause price increases (of both PLs and MBs), reduce the variety of products available, and negatively affect product innovation and quality.

We estimate that the elimination of discriminatory practices, assuming that retailers would set MB margins equivalent to those currently applied to PLs, could reduce the price of MBs between 4% and 40%, depending on the product (on average, around 20%). Assuming, conservatively, that PL prices were to remain the same, the reduction in MB prices as a result of the elimination of discrimination in Brand management, could cause the difference in price between PLs and MBs, in the product sample analysed, to drop by approximately 50%.

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2. THE DRAFT BILL IN THE CONTEXT OF THE MARKET

2.1 MARKET STRUCTURE AND COMPETITION PROBLEMS

In recent years, retailing in Spain as undergone a profound transformation. Firstly, the supermarket format (especially the large supermarket) has grown in relevance in the context of the buying habits of Spanish consumers. This is particularly evident in the food retail sector (which represented about 19% of total retail space in 2010), where the supermarket has become the food retail format with the largest market share in purchase volume (57%) and in sales volume (47%) in Spain.[1]

Secondly, there has been a gradual increase of concentration in the retail industry. Currently, the food retail sector in Spain has an oligopolistic structure, with 5 major retailers (Mercadona, Grupo Carrefour, Grupo Eroski, Grupo Auchan, and Dia), with an extremely strong presence both in terms of sales space (with approximately 52% of total sales space, in sq.m. in 2010) and of sales of food products (representing around 64% of revenues in the sector in 2010).[2] In some regions there are clear indications of significant market power (or dominant position) of certain retail chains. This is the case of Mercadona in Valencia (39.8% market share in terms of sales volume) and Andalucía (36.3%) and Eroski in the Basque Country (42.7%).[3]

Thirdly, the penetration of PLs in market share of daily consumer goods continued to grow in 2011, reaching a share of approximately 34.5%.[4]

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[1] Source: Ministry of Industry, Tourism and Commerce (MITYC). Boletín de Información Comercial Española (ICE), July 2010 and August 2011

[2] Authors' own, based on data from Kantar Worldpanel (a prestigious international firm specialised in the analysis of consumer behaviour in the mass consumer goods sector) relative to sales of food products (i.e. packaged food and beverages and non-perishable fresh foods). Effective 2011 Dia no longer belongs to Grupo Carrefour, and for this reason the figure for 2010 separates the two entities.

[3] Significant market power at the regional level in Valencia, Andalucía and Basque Country suggests the probable existence of even more significant positions of dominance of the regional leaders in some provinces and/or towns in these regions.

[4] Nielsen yearbook 2012. Data correspond to packaged food, household goods and beauty products.

The increased market concentration in the retail sector, the process of vertical integration of retailers upstream, and the development of PLs, have all significantly altered the traditional relationship between producers/manufacturers and retailers. The "double agent" role of the retailer, on one hand a mere distributor of manufacturer brands (MBs), and on the other, a direct competitor of these same brands with their own PLs, has generated concern in the government and competition authorities in Spain, and also in Europe, due to the potential for exclusion and for a reduction in effective competition in consumer goods retail that these practices can generate, with the subsequent harm to the final consumer.

The Brattle Group's "Analysis of Competition in the Spanish Retail Market", presented in April 2012, studied the evolution of effective competition in the retail market in Spain, and pointed out that continuous reinforcement of the economic dependence of Spanish manufacturers/producers on retailers with higher market power in the wholesale supply market (especially Mercadona with a market share of 27% in 2011) suggests the need to supervise this market to prevent the distortion of effective competition, which would reduce the incentive for manufacturers to innovate and invest, and would also reduce or eliminate the incentive for powerful retailers to transfer improved commercial terms obtained from manufacturers to the end consumer.[5]

2.2 MEASURES PROPOSED IN THE DRAFT BILL

The *Draft Bill of Measures to Improve the Function of the Food Chain* of 19 October 2012 ("Draft Bill") concludes that the existence of imbalances in bargaining power between retail companies and manufacturers in Spain is generating a lack of transparency in pricing and enables the promotion of potentially unfair and anti-competitive commercial practices. The ultimate consequence of these practices is the distortion of effective competition across the entire agro-food sector, with the subsequent adverse effects for the end consumer.

The Draft Bill proposes a mixed model whereby food supply contracts and abusive commercial practice would be regulated, while the industry would self-regulate in matters of commercial relationships between agro-food sector operators and of administrative control, with the final aim of improving efficiency and competition and reducing the current imbalance in the commercial relationship between producers, manufacturers and retailers of food and beverages in Spain.

The Draft Bill establishes three main groups of measures. The first group addresses the regulation of food supply contracts and abusive commercial practices, making it obligatory to formalise agreements in writing, and for the key elements of the agreements to be subject to agreement by the parties. Certain commercial practices are prohibited, such as unilateral modifications to contracts and unscheduled commercial payments; other practices are regulated, such as the supply of sensitive commercial information, electronic auctions or brand management. The second group of measures proposes self-regulation of the commercial relationships between producers, manufacturers and retail chains. For this purpose, measures include the creation of a Code of Best Practice for Food Contracts, featuring an arbitration system to solve disputes and a national Register of operators committed to adhering to the Code. Lastly, the third package of measures proposes a system of administrative control that includes a system of penalties, classified into types of infringement and the corresponding penalty (the sanctioning authority would be the Ministry of Agriculture, Food and the Environment), together with the creation of a Food Chain Observatory

[5] See report by *The Brattle Group*: "Analysis of Competition in the Spanish Retail Market", April 2012, *("Brattle Report")*.

(replacing the Price Observatory) responsible for monitoring the function of the food chain and food prices.

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2.3 PRINCIPLE OF NON-DISCRIMINATION IN BRAND MANAGEMENT

Among the potentially abusive commercial practices cited in the first group of measures, the Draft Bill performs a specific analysis of the management of food brands.[6] In this context, the Ministry, in its press release dated 19 October 2012, established that brand management *"must be based on transparency, fairness and non-discrimination, preventing practices that alter free and fair competition between brands*".[7]

As demonstrated in Section 3 below, the most frequent discriminatory practices applied by retail chains include imposing retail margins (estimated as the difference between the final sale price to the end consumer and the wholesale transfer price) that are higher for MBs than for PLs. We present empirical evidence that this type of practice exists in Spain. However, other discriminatory practices, equally frequent, include de-listing (or refusal to list) of a manufacturer, the refusal to accept manufacturer promotions, including price cuts, 2-for-1 sales, etc., and the strategic positioning of products on shelves to benefit private labels.

Section 4 evaluates the effect on the final consumer (in terms of price, quality and innovation in the agro food sector) of discriminatory practices in brand management by retail chains.

3. EMPIRICAL EVIDENCE OF DISCRIMINATION IN BRAND MANAGEMENT

In the last decade, retail chains in Spain have increased their market power, and subsequently their negotiating power relative to their suppliers. In parallel, retailers have introduced store brands (private labels, or PLs), thus assuming parallel roles of retailer and competitor: on one hand, retailers act as intermediaries between manufacturers and consumers; and on the other, they compete against brand manufacturers with their own PLs.

This double role allows them to control sale prices and conditions, both of their own products and of their competitors' products. Bigger market power allows them to increase the pressure on manufacturers in order to obtain better buying terms. Additionally, retailers are able to determine sale prices and conditions (shelf positioning, promotions and special offers) both of their own products and those of competing manufacturers.

Retail chains are able to establish the price margins of manufacturers' products in relation to the price and margin of their own PLs. The Brattle Report, dated April 2012, presents empirical evidence that allows us to affirm that retail chains use this ability to favour the PL, to the detriment, ultimately, of consumers.

The Brattle Report analysed retail margins per unit, estimated as the difference between the sale price and the wholesale price between manufacturer and retailer,

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[6] The recent report by the Spanish Competition Commission (CNC) "Report on relationships between manufacturers and retailers in the food sector" dated October 2011, already indicated that the introduction of PLs in the food retail market could encourage retail chains to use discriminatory practices in brand management with exclusionary effects in order to benefit their PLs to the detriment of MBs.

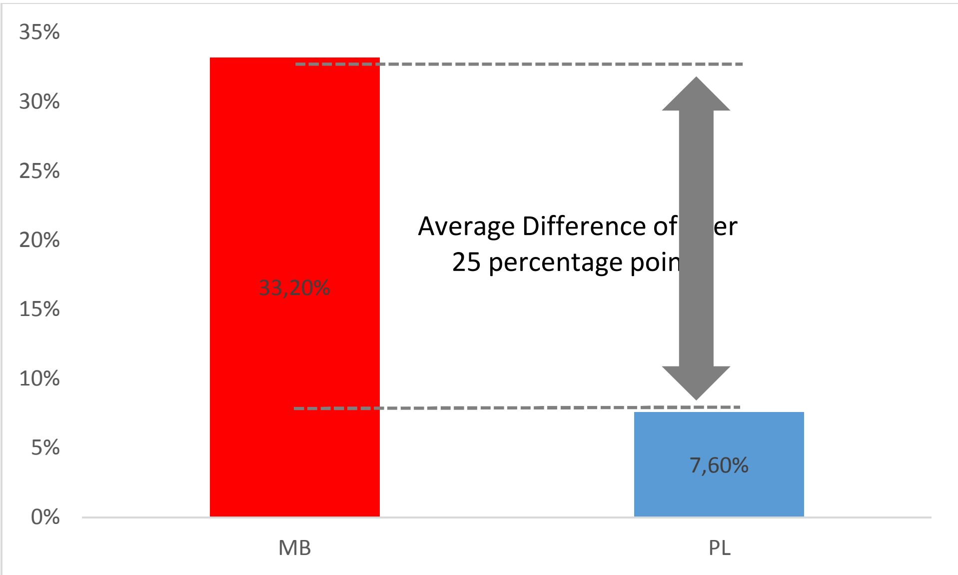
[7] Press release from Ministry of Agriculture, Food and the Environment, *Report on Draft Bill for Measures to Improve the Function of the Food Chain*, 19 October 2012; available at http://www.lamoncloa.gob.es/ConsejodeMinistros/Enlaces/191012-EnlaceCadenaAlimentaria.htm

applied to 12 representative products from 6 categories[8] and concluded that in all products analysed, retailers imposed retail margins per unit between 2 and 18 times higher for MBs than for PLs, for no objective reason.[9] This generates artificially high prices of MBs relative to PLs and their subsequent drop in market presence, or in the final instance, their disappearance. For example:

- In the case of extra virgin olive oil, in 2007-2008 retail margins applied to MBs were approximately 22%, , but only 1% for PLs;
- Margins per unit in the case of regular olive oil in 2007-2008 were likewise low for PLs (1%) and significantly higher for MBs (16%);
- In 2008, retail margins applied to the wholesale price of milk were approximately 48% for MBs, dropping to 30% in the case of PLs;
- In the case of beer, retail margins applied to wholesale prices for 33 cl cans in 2011 were approximately 66% for MBs, and only 18% in the case of PLs.

In the total sample of 12 products, we confirmed that while the average retail margin for MBs was 33%, in the case of PLs it was less than 8%, i.e., a difference of over 25 percentage points (see Figure 1 below). This, together with the fact that in general, MBs are more upmarket with higher production costs than PLs, means that the MB price for the overall sample was nearly 70% higher than the PL price.[10]

Figure 1: Average Retail Margin for MBs and PLs



4. IMPACT ON CONSUMER WELFARE OF DISCRIMINATION IN BRAND MANAGEMENT

This section analyses the exclusionary effect that discrimination in PL and MB Brand management has on MBs and the consequences of exclusion for consumer welfare and, in particular, on price levels, variety of choice, and innovation and quality.

[8] Cocoa powder, biscuits (two types of Marie biscuit), coffee, oil (normal and extra virgin), milk (whole, semi-skimmed and skimmed) and beer (33 cl and 1 litre)

[9] See *The Brattle Report*, Table 7, page 69 (reproduced in Annex 1 to this paper) for further details on this analysis.

[10] See Table 2 in Annex 1 for more details on this analysis.

4.1 DISCRIMINATION IN BRAND MANAGEMENT CAUSES PRICE INCREASES

Exclusionary discrimination practices in Brand management by retail chains do not translate into benefits for the end consumer in terms of price. Growth in market power of retail chains and increased penetration of PLs do not translate into lower prices for the end consumer.[11]

The discrimination of margins by retailers in favour of their PLs has an exclusionary effect because it artificially increases the price of the MB, reduces its market share and, in the final instance, can cause the exit of the MB from the market (either because of de-listing or reduction in sales). Through the discrimination of margins, retailers are able to increase the penetration of their PL while at the same time they obtain profit from the higher margins applied to the MBs. However, the low margins of PLs are not sustainable in the medium term and, as we will show below, these will tend to rise in parallel with the rise in the retailer's market power and the increased penetration of the PL.

The increased level of penetration of PLs and the growth in market share of retail chains causes overall price increases, both in PLs and MBs. The current low prices of PLs are aimed at increasing penetration, but as penetration grows, prices also grow. In order to maintain the market share of PLs, retailers also raise the price of the MB. Further, the higher buying power of retailers, which allows them to force wholesale prices down, gives retailers more power in the end market but does not translate into lower prices for the consumer.[12]

MB prices rise as PL penetration grows

Retail chains increase the price of MBs as their PLs gain market share, in order to be able to increase the PL price without losing share[13] and to maintain the impression that the PL is cheaper. [14] According to the analysis, the increased penetration of PLs causes price increases in 10 of the 15 products analysed (oil, cereals, beers, cocoa powder, toothpaste, dishwasher detergent, milk, pasta, canned fish and sodas) and price reductions in only 3 products (coffee, chocolate and detergents).[15] For example,

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[11] The data presented here have been taken from *The Brattle Report* of April 2012, which analysed information on sales volumes, sales value and sales prices (quarterly) by retail chain for 15 common consumer products (oil, instant coffee, chocolate, cocoa powder, sweet biscuits, breakfast cereals, canned fish, liquid milk, sodas, beers, detergents, dishwasher detergent, shower gel and toothpaste). For each product, the average quarterly price of the PL and the three leading MBs were measured in the 7 largest retail chains in Spain, in 7 regions (Andalucía, Cataluña, Castilla-León, Madrid, Valencia, Galicia, and Basque Country). The period of analysis was Q1 2001 to Q4 2011. The data necessary for the analysis were obtained from Kantar Worldpanel.

[12] *The Brattle Report* analyses the effects of the increased market share of retail chains and the growth in PL penetration on PL and MB prices. This paper reproduces the results of the second of these effects. Relative to the former, the Brattle Report concludes that in 11 of the 15 products analysed, MB prices do not fall in parallel with increased concentration in the retail market. For the majority of products analysed, the increase in market power of the retail chain causes higher prices in PLs prices (7 out of 15 products) or has no effect on the PL price (7 out of 15 products). This means that the higher bargaining power of retail chains does not translate into lower prices for the final consumer. For more details see The Brattle Report, pages 59-61.

[13] Strategies of this kind have been widely analysed in economic literature. See, e.g. the seminal article by Steven C. Salop and David T. Scheffman (1983), Raising Rivals' Costs, *The American Economic Review*, Vol. 73, No. 2, Papers and Proceedings of the Ninety-Fifth Annual Meeting of the American Economic Association (May, 1983), pages 267-271.

[14] This is coherent with the results of Wedel, M. and J. Zhang, (2004), "Analyzing Brand Competition Across Subcategories," *Journal of Marketing Research*, 41 (November), pages 448-456, which also prove that this effect does not only occur in a single category, but that cross effects exist between categories. Evidence of the positive effect of PL penetration on MB prices is also shown in Ward, M.B., Shimshack, J. P., Perloff, J. M., & Harris, J. M. (2002). "Effects of the private-label Invasion in Food Industries," *American Journal of Agricultural Economics*, Vol. 84(4), pages 961-973.

[15] See *The Brattle Report*, Table 6, page 62 (reproduced in Annex 1 of this paper) for further detail

a 10% growth in PL penetration in causes an increase of over 5% in MB prices in the canned fish category, 4% in toothpaste, and 3% in dishwasher detergent.[16]

Retail chains do not transfer to their clients the competitive pressure that the growing presence of PLs exercises on MB manufacturers. MB manufacturers are forced to lower their margins in order to compete with PLs, but the end prices are higher, meaning that revenues are transferred from the manufacturer and the end consumer to the retailer.

This strategy has an exclusionary effect on MBs because, on one hand the manufacturer's margins are smaller and their products are less profitable, and on the other, their sales are lower because of the increase in the final sale price. The strategy seeks to exclude or limit the presence of the MB in the market.

PL prices also increase as their penetration grows

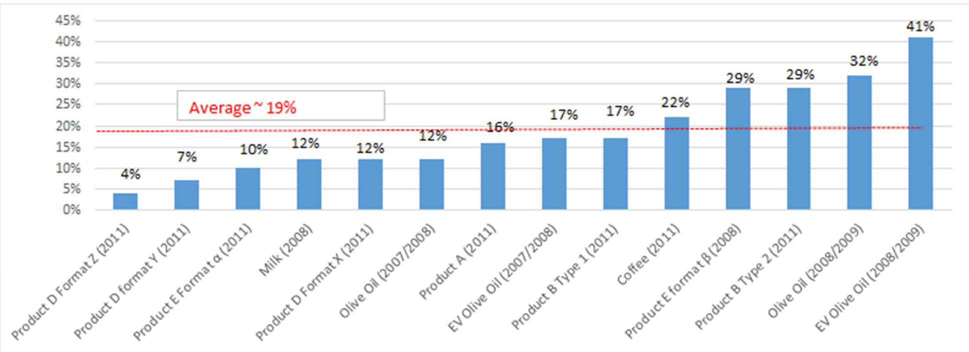
In the long term, the low price of PLs is not sustainable. In fact, data indicate that as penetration of PLs increases, so does their price. The higher market power of PLs translates into a rise in prices. Additionally, with the loss of relevance of MBs, average margins will drop and will probably be insufficient to cover fixed costs. In a balanced context, the price of PLs would be higher. The growing market power of retail chains would allow them to increase their prices profitably.

As *The Brattle Report* shows, as PLs increase their market penetration, their price also increases. This occurs in 11 out of 15 products analysed (oil, coffee, beer, chocolate, toothpaste, detergents, biscuits, shower gel, dishwasher detergent, canned fish and sodas).[17] For example, a 10% increase in PL penetration is linked to a price increase of the PL of over 6% for chocolate and sodas, and over 5% for shower gel and dishwasher detergent. [18]

The absence of discrimination in Brand management lowers prices

We estimate that the elimination of discriminatory practices, assuming that retailers would set MB margins equivalent to those currently applied to PLs, could reduce the price of MBs between 4% and 40%, depending on the product, and on average, 20% (see Figure 2, below).[19]

Figure 2: Potential Price Reduction in the Absence of Discriminatory Practices



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16 See *The Brattle Report*, pages 62-63

17 See *The Brattle Report*, Table 6, page 62 (reproduced in Table 3, Annex 1 of this paper) for further details

18 See *The Brattle Report*, page 63

19 For further detail see Table 2 in Annex 1

Assuming, conservatively, that PL prices were to remain the same, the reduction in MB prices as a result of the elimination of discrimination in Brand management, could cause the difference in price between PLs and MBs, in the product sample analysed, to drop by approximately 50%, from the current 70% to 36% in the absence of margin discrimination. [20]

4.2 DISCRIMINATION IN BRAND MANAGEMENT LOWERS VARIETY, QUALITY AND INNOVATION

The evidence suggests that it is MBs, and not PLs, that drie innovation and growth in the mass consumer sector in Spain. According to a study by ESADE's Brand Institute[21], 80% of new product launches in Spain in 2008 corresponded to MBs. The growing concentration in the retail market, retailers' higher bargaining power and the penetration of PLs all reduce product variety, limit innovation by manufacturers, and reduce the quality of products, with the subsequent negative effect for the end consumer in the medium and long term.

The policy of excluding brands reduces variety and quality

The policy of exclusionary discrimination followed by retail chains causes a reduction in the variety and quality of products, either due to the artificial increase in price of MBs and the reduction of manufacturers' margins which generate lower sales and profitability [22] or simple because of the arbitrary de-listing of the MB. The reduction in product variety was demonstrated in a recent study for the European Commission that analyses the number of products introduced in a year.[23] For example, of more than 1,000 products launched in 7 European countries in the category of fruits, vegetables and packaged derivatives, only 32 launches took place in Spain compared with more than 500 in Italy or France. This proportion is repeated systematically in all categories and the trend in negative between 2005 and 2009. The European Commission report indicates that the probable cause is the growth in the market share of discount stores and other commercial formats selling a limited variety of products[24].

The disappearance of brands reduces innovation in the food and beverage sector

The exclusion of MBs has a negative effect on the food sector in Spain. Evolution of R+D spend in the food and beverage sector in Spain (with a high penetration of PLs) is far below the average in other European countries.[25] At the national level, while R+D

[20] *Ibid.*

[21] ESADE Brand Institute study (2010), *Economic and Social Impact of Manufacturer Brands in Mass Consumer Markets in Spain*, page 20

[22] European Commission (2009), "Competition in the food supply chain", document accompanying the Communication of the Commission to the Council, the European Parliament and the European Economic and Social Committee and the Regions Committee – *Improving the Function of the Food Chain in Europe*, Brussels {COM (2009) 591}, p.18.

[23] European Commission study (2011), *The Impact of Private Labels on the Competitiveness of the European Food Supply Chain*, prepared for DG Enterprise and Industry by Landbouw-Economisch Instituut (LEI).

[24] See Daskalova, V., (2012), "Private labels (Own Brands) in the Grocery Sector: Competition Concerns and Treatment in EU Competition Law," Tilburg Law and Economics Centre, Discussion Paper 2012-002, p. 17.

[25] R+D expenditure in the food and beverage sector grew spectacularly in Germany between 2002 and 2007 (almost 80%). In France and United Kingdom, growth was close to 20%, and in 8 small European countries, average growth was 40%. On the contrary, in Spain growth in R+D spend in the food and beverage sector over the same period was 12%. See EC study (2011), *The Impact of Private Labels on the Competitiveness of the European Food Supply Chain*, prepared for DG Enterprise and Industry by LEI, page 92.

spend in food and beverages from 1994 to 2009 grew 1% per year, spend across all sectors grew by 11%.[26]

Empirical evidence exists to demonstrate that PL manufacturers invest significantly less in R+D than MB manufacturers. According to estimates published by the ESADE Brand Institute, 89% of R+D spend in the food, beverage and chemical products sectors corresponded to MB manufacturers.[27] According to a Kantar Worldpanel study[28] it is the leading brands that drive innovation and growth in the mass consumer market in Spain. The study identifies the 30 labels that are most innovative and that generate most consumer growth in Spain, none of which are store brands, or PLs. Additionally, the study indicates that the categories growing the most in Spain (in terms of value and volume) are precisely those featuring more innovation.

There are three reasons why investment is lower in PL R+D. Firstly, the PLstrategy of producing different product categories limits their ability to develop an R+D culture and infrastructure specialised for each product category. Because the business of brand manfacturers is usually limited to a smaller number of product lines, their capacity for innovation is greater.[29] Secondly, because PLs are sold exclusively in the retailer's own distribution channels, their ability to reach a critical mass of clients for the allocation of fixed R+D investment costs is much lower. The capacity and incentive of MBs is greater in the case of global brands with potential access to a greater number and variety of end consumers, since they are present in a larger number of stores. Thirdly, PL margins and the margins of PL suppliers are generally lower than MBs, and therefore their ability and incentive to innovate is also lower.

The growth in market power in the retail sector, and the higher penetration of private labels, results in a reduction in R+D, and therefore in innovation, in the medium and long term.[30] The increase in the penetration of PLs could, in principle, represent an incentive for MBs to innovate in order to differentiate themselves from PLs and to make their products more attractive to consumers.[31] However, there are several issues that limit that incentive. Firstly, the increased buying power of the retailer represents lower manufacturer margins and consequently, the ability of manufactures to increase R+D spend. Even when the manufacturer is able to fund innovation, the growing power of the retailer allows the retailer to take ownership of the profits generated by the innovation. Therefore, the incentive to innovate diminishes.[32]

Secondly, for certain products, copycat practices and the privileged access by retailers to sensitive confidential information about MBs, allow retailers to "copy" onto their own

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[26] In 2009 R+D spend in the food and beverage sector was 1.1 times greater than in 1994 (or 597M euros), while R+D spend in all sectors in the same year was almost 5 times (4.7) the levels of 1994 (or 3,728M euros). Own data based on SEPI - ESEE (Corporate Strategy Survey). Average of companies with more than 200 employees.

[27] ESADE Brand Institute study (2010), *Impacto Económico y Social de las Marcas de Fabricante en Mercados de Gran Consumo en España*, p. 21; (press kit available at http://www.esade.edu/itemsweb/content/produccion/4002763.pdf).

[28] Kantar Worldpanel presentation, *Breakfasts with Consumers 2012,* 13 February 2012.

[29] See article by T. Condon, "Brand new: Wal-Mart's Foray into Private Labels," New York University Stern Business, Winter 2002

[30] CNC report, "*Informe Sobre las Relaciones entre Fabricantes y Distribuidores en el Sector Alimentario*", October 2011, already recognised that in the medium and long term these discriminatory and exclusionary practices could reduce inter-brand competition (between manufacturers) by limiting, and in some cases eliminating, the incentive for manufacturers to innovate and invest, forcing them to leave the market even when their products were in demand by consumers, especially when the competition between retailers is scarce. The CNC report recognised that in the final instance a reduction in effective competition would adversely affect the welfare of the end consumer.

[31] See Steiner, Robert L. (2004), "The Nature and Benefits of National Brand/Private Label Competition," *Review of Industrial Organization,* Vol. 24 (2), pp. 105-127.

[32] See Inderst, R., y N. Mazzarotto, (2008), "Buyer Power in Distribution," in *Issues in Competition Law and Policy* (ABA Antitrust Section Handbook), ed. W. D. Collins

Brand the innovation introduced by the MB, reducing the incentive for manufacturers to innovate and invest.

Thirdly, MB commercial strategy is, in the final instance, in the hands of the retailer, who may or may not accept the introduction of a new product (and thus obstruct distribution), decide on its price relative to its own PL, or simply launch an equivalent product at the same time, taking advantage of the manufacturer's R+D work. It is a fact that access to the market for innovations in Spain is limited[33]. Therefore, profitability of innovation in the medium-long term is not guaranteed, due to the retailer strategy which lowers the incentive for manufacturers to innovate.

Lastly, the strategy to increase innovation as a response to higher PL penetration is only feasible for leading brands with loyal clients, in categories where it is possible to sufficiently differentiate the product. Second-tier brands, less able to differentiate, are easy targets for elimination, through de-listing, copying, or pricing that make them unattractive in comparison with PLs. [34]

Therefore, the increased market power of retailers and their control of MB commercial strategy (in their double role as distributor and competitor) mean that a potential increase in innovation is not sustainable in the medium term because it is difficult for manufacturers to realise a return on their investment[35] It is therefore probable that, as a result of the higher penetration of PLs, innovation and the number of new references will fall.

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5. CONCLUSIONS

In the last decade a concentration process has occurred in the retail sector that given a lot of market power to a small number of companies in the sector. In parallel, through vertical integration and/or the creation of store brands, retailers have gone from being mere distributors to also being competitors of the products they distribute. This has placed them in a privileged position to control the sale and relative pricing of PLs and MBs inside their stores. At the same time, increased concentration in the sector reduces competitive pressure between stores and allows retail chains greater control of their price policies. Retailers have used this increased market power and their double role as distributor and competitor to favour their own PLs to the detriment of MBs and ultimately, to the detriment of consumers. Specifically, this report provides evidence that retailers establish discriminatory margins between PLs and MBs in order to favour PL penetration. As PL penetration increases, retailers raise PL prices since low margins are not sustainable in the medium term, and also the prices of MBs in order to maintain the competitive position of their own brands.

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[33] A new product launch in Spain achieves average distribution of 24% of points of sale in the first year, vs. 38% in Germany, 44% in UK or 56% in France. n nuevo lanzamiento alcanza en España una distribución media del 24% de los puntos de venta durante el primer año frente al 38% en Alemania, el 44% en el Reino Unido o el 56% en Francia. IRI Symphony (2006), Estudio Lanzamientos Europeos 2006. Ver presentación Launch Track, Tracking de un nuevo producto en tiempo real disponible en: http://symphonyiri.es/NoticiasyEventos/EventosyWebinars/EventosyWebinarsDetail/tabid/251/ItemID/1022/View/Details/Default.aspx.

[34] See Richards, Timothy J. & Hamilton, Stephen F. & Patterson, Paul M. (2010), "Spatial Competition and Private Labels," *Journal of Agricultural and Resource Economics*, Western Agricultural Economics Association, vol. 35(2), p. 103.

[35] Per the conclusions of Richards, Timothy J. & Hamilton, Stephen F. & Patterson, Paul M., (2010), "Spatial Competition and Private Labels," *Journal of Agricultural and Resource Economics*, Western Agricultural Economics Association, vol. 35(2), the rationality of the response by MB manufacturers (in the face of growing penetration of PLs) by means of the creation of new differentiated products is not obvious, since the new products may gain market share but their margins may not be sufficient to cover the cost of developing the product.

The discrimination in the establishment of margins and prices has an exclusionary effect on MBs that is harmful for the consumer. Specifically, the effects of discriminatory Brand management on consumer welfare are threefold:

1. **Increase of PL and MB price**: the establishment of higher margins for MBs artificially increase their price. As PL penetration increases, retailers raise the price of both PLs and MBs, to the detriment of the consumer.

2. **Reduction in variety:** the artificial price increase of MBs, the reduction in manufacturer margins, or the de-listing of MBs, reduce the variety of products in the market, limiting consumer choice.

3**. Negative effects on innovation and quality**: the progressive expulsion of MBs from the market translates into a reduction in innovation and the incentive to innovate. The evolution of spend in R+D in the food sector in Spain is lower than that in the principal European countries. Lower manufacturer margins, barriers to retailing of product innovations, and arbitrary de-listing of brands, reduce the incentive to innovate for MB manufacturers, who are the group that dedicate most efforts to R+D.

6. RECOMMENDATIONS

In order to reduce the harmful effect on consumers of discrimination in Brand management, it is necessary to implement mechanisms that limit discriminatory practices, so that Brand management is based on transparency, fairness and non-discrimination, avoiding practices that alter free and fair competition between PLs and MBs. The Draft Bill of measures to improve the function of the food chain contains measures in this direction, such as limitation of the supply of sensitive commercial information, the establishment of a Best Practice Code for food contracts; and the creation of a Food Observatory. However, in order to guarantee the development of free and fair competition between brands, we propose the adoption of two additional measures.

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1. First, we propose to complement the limitation on the supply of sensitive information by **expressly prohibiting the supply of certain information relative to the individual intentions of corporations in terms of their future actions** relative to strategic variables such as price, cost structure, future promotions, new formats, etc. This limitation would be in line with European Guidelines on horizontal cooperation[36] which prohibit the exchange of information on future strategy and establish limits on the exchange of other types of information.

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2. Secondly, we suggest the establishment of **FRAND (fair, reasonable and non-discriminatory) obligations**, in the spirit of the Draft Bill and mentioned in the press release announcing said Draft Bill on 19 October 2012, to guarantee that MBs and PLs are marketed in a context that is fair, reasonable and non-discriminatory. These obligations would require the retailer to perform category management following pre-determined criteria and in a manner that is proportional, transparent, objective and non-discriminatory (e.g., with regard to the establishment of retail prices and retail margins). In the event of dispute, these requirements would be verified by the Food Chain Observatory.

[36] Guidelines on the applicability of article 101 of the Treaty on the Functioning of the European Union to horizontal cooperation agreements (Official Daily Bulletin C 11 de 14.1.2001].

ANNEX 1
Table 1: Comparison of Prices and Margins per Unit for MB and PL products
(Exact copy of Table 7 in The Brattle Report)

Product		Year	Brand Type	Transfer Price excl VAT (€/L or €/Kg)	Retail Price excl VAT (€/L or €/Kg)	Wholesale Price (Index) [A] See notes	Retail Price excl VAT (Index) [B] See notes	Margin per Unit (Index) [C] [B]-[A]	Margin per Unit % [D] [C]-[A]
Product A	[1]	2011	MB	3,72	4,64	100	125	25	25%
			PL	1,64	1,73	44	46	2	5%
Product B Type 1	[2]	2011	MB	1,27	1,68	100	132	32	32%
			PL	1,02	1,12	80	88	8	10%
Product B Type 2	[3]	2011	MB	1,17	1,81	100	155	55	55%
			PL	0,95	1,05	82	89	8	10%
Product C	[4]	2011	MB	1,7	2,33	100	137	37	37%
			PL	1,01	1,08	59	64	4	7%
Extra virgin olive oil	[5]	2007-2008	MB	3,382	4,119	100	122	22	22%
			PL	2,825	2,867	84	85	1	1%
		2008-2009	MB	3,066	4,203	100	137	37	37%
			PL	2,533	2,041	83	67	-16	-19%
Olive oil	[6]	2007-2008	MB	3,01	3,5	100	116	16	16%
			PL	2,5	2,55	83	85	2	2%
		2008-2009	MB	2,6	3,49	100	134	34	34%
			PL	2,24	2,04	86	79	-8	-9%
Milk	[7]	2008	MB	0,71	1,05	100	148	48	48%
			PL	0,56	0,73	79	103	24	30%
Product D Format X	[8]	2011	MB	0,684	0,78	100	114	14	14%
			PL	0,52	0,52	76	76	0	0%
Product D Format Y	[9]	2011	MB	0,68	0,78	100	115	15	15%
			PL	0,48	0,51	71	76	5	7%
Product D Format Z	[10]	2011	MB	0,68	0,78	100	115	15	15%
			PL	0,46	0,51	68	75	7	10%
Product E Format α	[11]	2011	MB	0,67	0,99	100	149	49	49%
			PL	0,49	0,66	73	99	25	34%
Product E format β	[12]	2011	MB	0,23	0,39	100	166	66	66%
			PL	0,22	0,26	93	110	17	18%

Source:
[1] to [4] and [8] to [12]: Information obtained by *Brattle* via direct conversations with companies and associations in the sector.
[5], [6]: Food Price Observatory, MARM, Value Chain Study and Formation of Olive Oil Prices, January 2010 and June 2011.
[7]: Food Price Observatory, MARM, Value Chain Study and Formation of Packaged Liquid Mil, April 2009.

Table 2: Estimate of the reduction in price of MBs in the absence of discrimination in Brand management

Product		Year	Margin per Unit			RETAIL PRICE (excl VAT)						Reduction in Retail Price (excl VAT)
						With discrimination			Without discrimination			
			MB (%)	PL (%)	Difference % points	MB (Index)	PL (Index)	Difference (%)	MB (Index)	PL (Index)	Difference (%)	Difference (%)
			[A] Table 1	[B] Table 1	[C] [A]-[B]	[D] Table 1	[E] Table 1	[F] [D]-[E]/[E]	[G] 100x(1+[B])	[H] [E]	[I] ([G]-[H])/[H]	[J] ([D]-[G])/[D]
Product A	[1]	2011	25%	5%	20	125	46	169%	105	46	126%	16%
Product B Type 1	[2]	2011	32%	10%	22	132	88	50%	110	88	25%	17%
Product B Type 2	[3]	2011	55%	10%	45	155	89	73%	110	89	23%	29%
Product C	[4]	2011	37%	7%	30	137	64	115%	107	64	68%	22%
Extra virgin olive oil	[5]	2007-2008	22%	1%	20	122	85	44%	101	85	20%	17%
		2008-2009	37%	-19%	57	137	67	106%	81	67	21%	41%
Olive oil	[6]	2007-2008	16%	2%	14	116	85	37%	102	85	20%	12%
		2008-2009	34%	-9%	43	134	79	71%	91	79	16%	32%
Milk	[7]	2008	48%	30%	18	148	103	44%	130	103	27%	12%
Product D format X	[8]	2011	14%	0%	14	114	76	50%	100	76	32%	12%
Product D Format Y	[9]	2011	15%	7%	8	115	76	51%	107	76	40%	7%
Product D Format Z	[10]	2011	15%	10%	5	115	75	53%	110	75	47%	4%
Product E Format α	[11]	2011	49%	34%	15	149	99	51%	134	99	36%	10%
Product E format β	[12]	2011	66%	18%	48	166	110	51%	118	110	7%	29%
MINIMUM			14%	-19%	5	114	46	37%	81	46	7%	4%
AVERAGE			33%	8%	26	133	81	69%	108	81	36%	19%
MAXIMUM			66%	34%	57	166	110	169%	134	110	126%	41%

Table 3: Impact of PL penetration on the price of MBs, on the price of PLs, and on the relative price of MBs over PLs
(Exact copy of Table 6 in the Brattle Report)

	MB Price	PL Price	Relative Price MB over PL
Beer	+	+	-
Biscuits	0	+	-
Canned fish	+	+	+
Cereals	+	0	0
Chocolate	-	+	-
Chocolate spread	+	-	+
Coffee	-	+	-
Detergents	-	+	-
Dishwasher detergent	+	+	-
Milk	+	-	+
Oil	+	+	+
Pasta	+	0	0
Shower gel	0	+	-
Soda beverages	+	+	-
Toothpaste	+	+	0

Source: Authors' own, based on Kantar Worldpanel data. "0" signifies that PL penetration does not effect the price of the product in question; "+" means that the higher the penetration of PLs, the higher the price; and "-"means that the higher the penetration of the PL, the lower the price. Significance level is 95%. For more details see Annex 6 of *The Brattle Report*.