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Study on territorial supply constraints in the EU retail sector: A critical review

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Executive Summary

Following its Communication on a "European retail sector fit for the 21st century" of April 2018, the European Commission published in November 2020 a "Study on territorial supply constraints in the EU retail sector" (the Study), which was prepared by Valdani Vicari & Associati and London Economics at the request of Directorate-General for Internal Market, Industry, Entrepreneurship and SMEs (DG GROW). The Study assumes that Territorial Supply Constraints ("TSCs") are "*barriers imposed by private operators (suppliers) in the supply chain, which can affect retailers or wholesalers*" and "*may impede or limit the retailers' or wholesalers' ability to source goods in other EU countries than the one they are based in, and/or prevent them from distributing (i.e. reselling) goods to other EU countries than the one in which they are based.*"[1] It purports to show not only that TSCs or "TSC-related practices" are used widely by manufacturers in the European retail sector, but also that consumers are harmed by them.

On behalf of the European Brands Association (AIM), we have critically reviewed the Study and found that it suffers from fundamental flaws in its information basis (starting with the definition of TSCs) and in its analysis of the prevalence and the impact of TSCs on consumers. For these reasons, its results are unreliable, and no policy conclusion can be drawn from them.

To begin with, when attempting to define (and then apply) the notion of TSCs, the Study makes no serious effort to exclude from their scope manufacturers' benign commercial practices that may simply be a natural response to various factors falling outside their control, such as heterogeneous consumer preferences, manufacturing and trade costs, and national labelling, packaging, and recycling regulations. The Study also does not appear to recognise the brand manufacturers' commercial freedom and discretion to organise their business in the way that they deem to be appropriate.

On the contrary, the Study further expands the already bloated range of manufacturer practices under scrutiny by adding to alleged TSCs what it calls "TSC-related practices", which are practices, such as the differentiation of products in terms of content/composition or packaging, that, while not constituting TSCs in themselves, may – so the Study claims – make TSCs possible.

Having failed to establish a solid definitional foundation for TSCs, it is not surprising that the Study finds that "*actual evidence on TSCs […] is far from conclusive*"[2] and "*no hard or documentary evidence [on TSCs] is available*".[3] Nor is the survey and interview evidence presented in the Study any more insightful.

Indeed, in addition to neglecting the possibly justifiable reasons for the observed manufacturer practices, the presented evidence is not representative of the EU retail sector as a whole and focuses instead – by design or non-response – on countries, product categories and customers that overstate exposure to alleged TSCs. Indeed, the Study itself appears to recognise this

1 See the Study, p. 19f.

2 See the Study, p. 44.

3 See the Study, p. 107.

weakness when its states that "*the prevalence of TSCs is more limited than what the survey and interview results suggest.*"[4]

The Study's analysis of the impact of TSCs on prices and consumer expenditures is equally undermined by data problems, as well as conceptual and methodological flaws. Its fundamental conceptual flaw consists in turning what should have been a key objective of the analysis (namely, to investigate how and to what extent alleged TSCs may influence wholesale prices) into the maintained assumption that a given part of the variation in wholesale prices observed across Member States is due to the existence of TSCs. This assumption ignores the vast range of factors, including local cost and demand conditions and bespoke bilateral commercial negotiations between manufacturers and retailers, which lead to cross-country differences in wholesale prices. To see how untenable this assumption is, and ultimately how little the observed variation in retail prices may have to do with TSCs, it is sufficient to note that the Study documents the very same cross-country retail price patterns for both branded manufacturers' products and retailers' private label products. Now, private labels are fully under the control of retailers, meaning that their cross-country retail price dispersion cannot possibly be attributed to the existence of TSCs.

Evading the key question to investigate, the analysis then contents itself with the more modest objective of exploring the extent to which wholesale prices are passed on into retail prices. If there is no or limited passing-on of wholesale prices into retail prices, then TSCs will likewise have no or limited effect on consumers. As a result, even if TSCs were shown to exist, an effect of TSCs on consumers could not be simply assumed.

Even this exploration of the extent of the passing-on of wholesale into retail prices, however, is unsatisfactory, as it is marred by an array of serious data and methodological problems. The Study's description of its data and methodology lacks clarity and consistency. Despite the resulting obstacles to fully replicate the Study's analysis, four main issues can be identified in its empirical implementation.

- First, the econometric analysis uses data that suffer from a poor coverage of products and Member States. The so-called "product-level analysis" appears to be based on the prices of only a few dozen individual products, most of which are observed in only two distinct Member States at a time. Because it is self-evident that results would change considerably if the analysis had been conducted on a comprehensive account of products in all Member States, the Study's analysis cannot reasonably inform any policy decisions.
- Second, there is a massive discrepancy in the coverage of the retail and wholesale price data. Indeed, while the retail data cover market-level outcomes, the wholesale data cover only up to five retailers, thereby greatly exaggerating their potential role in explaining market-wide phenomena.
- Third, both the construction and interpretation of the variables used to capture wholesale prices in the econometric analysis are inconsistent and misleading. By confusing the concepts of pass-through elasticity and pass-through rate, the Study mistakenly concludes that its results are in line with the results of the cited economic literature whereas they wrongly yield implausibly large figures, which are much larger than in the extant economic literature.

[4] See the Study, p. 102, fn. 146.

- Fourth, the level of aggregation in the Study's data cannot accurately account for the impact of retail market competition on prices.

On this basis, the Study's estimates of the impact of TSCs on retail prices are arbitrary and cannot be used to derive the impact of TSCs on consumer expenditures. In particular, the Study takes its estimate of the impact of TSCs on retail prices and multiplies it by a measure of consumer expenditures in the Member States and for the product groups included in its dataset to derive a measure of the consumer savings that the removal of TSCs would generate.

In doing so, the Study effectively assumes that, after the removal of TSCs, wholesale prices would collapse to the level of the Member State exhibiting the lowest wholesale prices. However, this assumption is in sharp contrast with both economic theory and common sense: if a low-price Member State started to experience an increase in demand due to customers redirecting their purchases, prices in that Member State would increase. This assumption is also bound to grossly exaggerate any consumer savings by overstating the savings of consumers located in high-price Member States and ignoring the higher expenditures of consumers located in low-price Member States.

The Study's main result is that the removal of TSCs could lead to consumer savings of €14.1bn (or 3.5%) on their purchases of "bread and cereals", "other food", "alcoholic beverages" and "non-alcoholic beverages" in 16 Member States for which the Study's authors had retailer purchase price information.[5] However, this baseline estimate is subject to considerable uncertainty given the very wide 90% confidence interval preventing the Study from ruling out that such savings may account for as little as 3.5% (€0.5bn) of the mid-point estimate. Indeed, the consumer savings are so imprecisely estimated that, even if one ignored all the shortcomings and flaws in arriving at the final estimate, it would clearly not be possible to draw any reliable conclusions about the effects of eliminating TSCs given such considerable degree of uncertainty.

This estimate must be dismissed in any event because, to derive it the Study (i) erroneously assumes that, after the removal of TSCs, wholesale prices would collapse to the level of the Member State exhibiting the lowest wholesale price, (ii) then takes this erroneous estimate of counterfactual wholesale prices and multiplies it with an erroneously estimated pass-on elasticity, leading to an erroneous estimate of counterfactual retail prices, and (iii) finally multiplies the erroneous estimate of counterfactual retail prices by total consumer spending. The Study's main result is therefore based entirely on a combination of unrealistic assumptions and erroneous estimations. Such an approach necessarily yields an incorrect result.

For all these reasons, we conclude that the Study suffers from fundamental flaws in its conceptual design, information basis and empirical methodology to analyse the prevalence and impact of alleged TSCs. The results that the Study arrives at are therefore unreliable and no policy conclusion should be drawn from them.

[5] See the Study, p. 89f.