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Competition in the Food Supply Chain – Contribution from Hungary

- Session IV -

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More documentation related to this discussion can be found at: oe.cd/gfc24.

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Competition in the Food Supply Chain

- Contribution from Hungary -

1. Introduction

1. This contribution summarises the recent experience of the Hungarian Competition Authority (Gazdasági Versenyhivatal – GVH) with food supply chains. First, some data are presented to show the concentration levels and trends at different stages of the Hungarian food supply chain (Section 2). Section 3 then discusses the specific legal framework of agricultural markets, which is also relevant for competition law enforcement. Section 4 summarises the main findings of recent enforcement actions of the GVH in relation to food supply chains.

2. Concentration in Hungarian food supply chains

2. The GVH in cooperation with the Hungarian National Bank has recently published the Competition Statistics Database (https://gvh.hu/en/gvh/competition_culture_development/gvhmnb-competition-statistics-database/gvhmnb-competition-statistics-database). This panel database contains close to 100 indicators at up to 4-digit NACE (Nomenclature of Economic Activities) activity level for the Hungarian economy between 2003 and 2021 on an annual basis. The database has been compiled on the basis of individual balance sheets and profit and loss accounts of enterprises operating in the given NACE category. This database can provide a comprehensive overview of industries classified by economic activities. As many of the variables relate to concentration measures, it is possible to examine the concentration levels and trends of the Hungarian food supply chain.

3. One way to measure concentration in industries is to examine the market share of the largest companies. The Competition Statistics Database contains CR3, CR5 and CR10 ratios calculated based on net revenue and asset value. Another way is to calculate the Herfindahl–Hirschman index, which takes into account all firms by summing the squares of their market shares. Figure 1 shows the CR10 index, while Figure 2 shows the Herfindahl–Hirschman index for the three stages of the food supply chain.

Figure 2.1. CR10 ratio based on net sales for the three main stages of the food supply chain in Hungary (%)

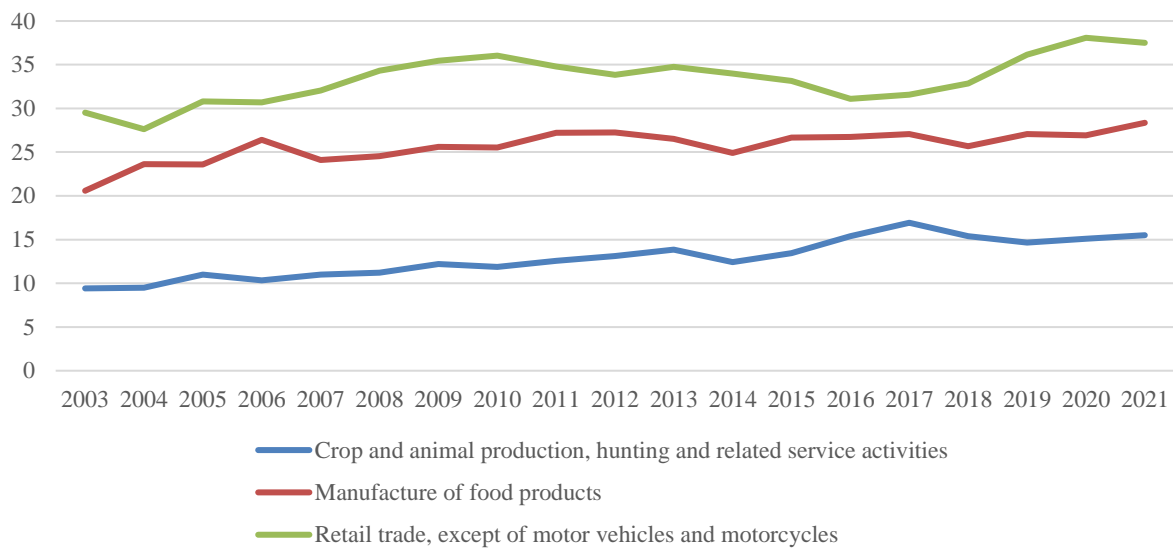
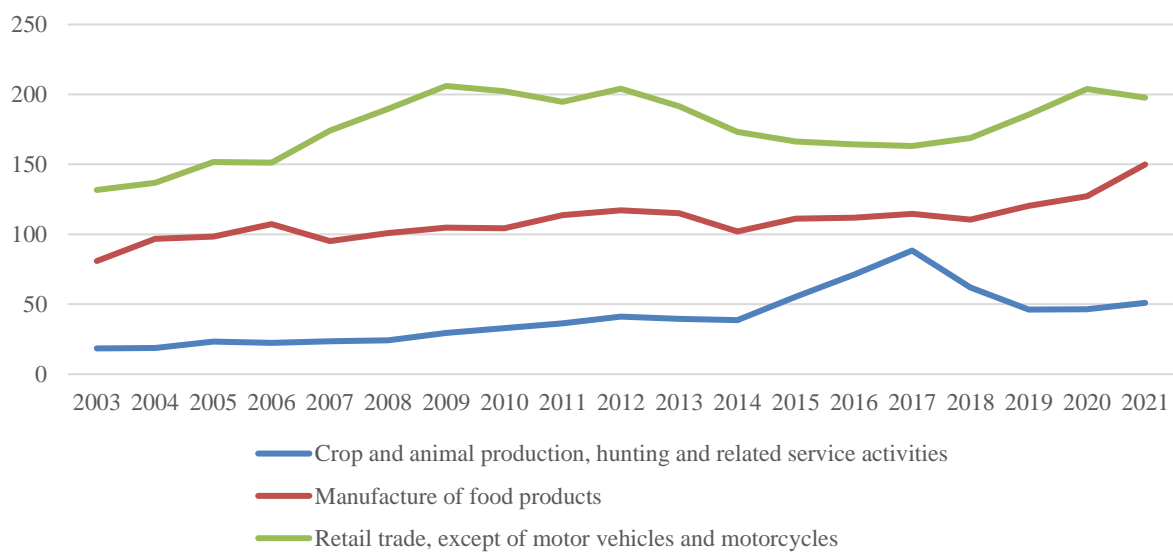


Figure 2.2. Herfindahl–Hirschman index based on net sales for the three main stages of the food supply chain in Hungary



4. In general, it can be observed that the farming level is the least concentrated and the retail level is the most concentrated, with the processing level in between. In addition, concentration is increasing over time on the basis of both measures, indicating that the food supply chain in Hungary has also become more concentrated over the decades. Concentration levels are not alarmingly high, but it should be noted that the figures are very aggregated (2-digit NACE level) and do not represent relevant markets in terms of competition policy.

3. Specific legal frameworks for agricultural products

5. Agricultural markets are special in many ways. There is a specific regulatory framework for agricultural products, justified by the fact that agricultural producers play a key role in providing citizens with sufficient and nutritious food.

6. Competition in agricultural markets is influenced by EU and national regulations. A notable example is the possibility to form recognised interbranch organisations. These interbranch organisations can legally collect various data and provide a platform for market players to cooperate. In addition, national and European subsidies (as part of the Common Agricultural Policy) have a significant impact on product prices and the incentives for market players. These regulations and subsidies are specific to agricultural products, which makes this market and the whole food supply chain unique compared to other product markets.

7. Furthermore, Section 93/A of the Hungarian Competition Act allows for agreements and concerted practices between agricultural companies if “competition is not distorted, restricted or prevented stemming from the agreement referred to in Section 11 in excess of what is considered necessary for making an economically justified, reasonable profit, and other actors of the market in question are not excluded from making such profit.” The conditions for exemption are assessed by the minister in charge of the agricultural sector. The exemption is effective as of September 1, 2015. This legislation makes cartel enforcement in agricultural markets less effective.

8. This legislative restriction of the GVH’s enforcement powers in relation to agricultural products is in line with the legal provisions on the market conduct of market players with significant market power (SMP) as set out in Section 7(6) of Act CLXIV of 2005 on Trade. According to this provision, as of 1 August 2012, the GVH is not entitled to investigate SMP behaviour in the food sector, as this is primarily the responsibility of the National Food Chain Safety Office, which is also responsible for investigating unfair trading practices (UTP) in the food sector. This provision is without prejudice to the investigation of abuse of a dominant position in relation to food and non-food products according to national rules, in which case the enforcement of competition law takes prevail over the enforcement of UTP and food-related enforcement by the National Food Chain Safety Office.

9. Special rules apply to beers and soft drinks sold in HORECA units according to Section 7/B of Act CLXIV of 2005 on Trade since December 2020. According to the legislation, HORECA units cannot enter into agreements that result in that more than 80 per cent of their annual beer purchases coming from the same producer. In addition, HORECA units are required to stock at least two different producers’ products for each beer and soft drink category. To date, the GVH has conducted five investigations into breaches of these rules. In the case of non-alcoholic beverages, the reviewing court referred the case to the Constitutional Court, which declared the soft drink-related provisions as unconstitutional. For the time being, therefore, these rules apply only to beers.

4. Competition investigations in the food supply chain

10. The special regulations and subsidies introduced in Section 3 also affect competition in agricultural supply chains and the enforcement activities of the GVH. In recent years, the GVH has carried out three sectoral inquiries in the food supply chains with the aim of understanding the market situation and price transmission along the supply chains. In addition, several mergers have been carried out at all levels of the food supply

chains, but in principle all of them have been approved without commitments. There are currently three ongoing antitrust cases against beverage companies (one abuse of dominance and two RPM cases). No other relevant competition cases relating to the food supply chain have been closed by the GVH in recent years.

11. This section summarises the main findings of the recent sectoral inquiries into the food supply chain. Two of the sectoral inquiries were so-called accelerated sectoral inquiries, which means that the GVH had a maximum of 90 days to complete the analysis. Therefore, these accelerated sectoral inquiries had a narrow focus on price transmission and costs along the supply chains.

4.1. Sectoral inquiry of the beverage procurement of HORECA units

12. In October 2020, the GVH launched a sectoral inquiry to investigate the beverage procurement practices of HORECA units and beverage manufacturers/distributors. The sectoral inquiry was preceded by several complaints from microbreweries that they were unable to enter the HORECA market due to the widespread use of exclusivity agreements by large beer producers. In addition, the GVH wanted to investigate the market and consumer impact of a new legislation¹ requiring HORECA units to stock products from at least two different manufacturers for beer and soft drinks (see Section 3 for details).

13. The sectoral inquiry confirmed that large beverage distributors offer HORECA units various subsidies and discounts which contribute to their viability, but these arrangements can also lock in HORECA units and make it difficult for smaller outlets to enter the market. On the other hand, these subsidies have enabled many HORECA units to cover the investment costs of opening the unit and to achieve financially sustainable operation. The Hungarian HORECA sector is therefore heavily dependent on these subsidies. From the consumer's point of view, the larger number of HORECA units results in a wider choice of locations and more competition between locations for consumers, which is clearly beneficial for consumers.

14. Overall, the GVH would consider it important to achieve a balance between maintaining the efficiency gains of the subsidies, while minimising the foreclosure effects and allowing new companies to enter the market with new products. The consumer survey carried out as part of the sectoral inquiry shows that consumers are generally satisfied with the selection of beverages on offer in HORECA units. This is also the case for the beer selection, with even consumers who prefer microbrewed beers indicating that the craft beer range of HORECA units is good.

15. Based on the findings of the sectoral inquiry, the GVH did not find any evidence of potential consumer harm resulting from the commercial practices of large beverage producers. The GVH also recommended that the legislator evaluate and review the above-mentioned regulations requiring HORECA units to stock at least two manufacturers' beverages. In particular, the GVH pointed out that the regulation imposes significant costs on HORECA units, which are already in a difficult situation due to the lock-down measures related to Covid19 and rising energy costs.

16. In addition, the sectoral inquiry drew the attention of the GVH to some potentially illegal practices among soft drink distributors and retailers, resulting in two RPM cases.

¹ Section 7/B of Act CLXIV of 2005 on Trade

4.2. Accelerated sectoral inquiry into the Hungarian market for milk and dairy products

17. In response to the very substantial food inflation in Hungary at the end of 2022, and reacting to societal expectations, the GVH launched two accelerated sectoral inquiries in January and February 2023, investigating the milk and dairy and preserved food markets, respectively.

18. The dairy sector was chosen as a candidate market because price inflation in this market was very high, reaching almost 80% at the end of 2022. The scope of the investigation covered domestic dairy farmers, domestic milk processors, competition from imported dairy products, as well as retailers and producers and importers of plant-based dairy alternatives (mainly plant-based drinks and yoghurts).

19. Market concentration at farm level (CR10: 27–29%) is much lower than at processing level (CR10: 86–87%), where there are about 10 significant domestic players. These processors produce both branded and private label products for retailers. The market share of private label products is not negligible and their penetration is generally increasing. On the retail side, the number of significant companies is similar to that of the processors (CR10: 80–83%), although some local retailers operate in a franchise model and these chains have a significant combined market presence.

20. For dairy farmers, the costs of feed, medicines and energy increased substantially after 2021. For processors, the main cost element is raw milk, the price of which more than doubled over the period, in addition to the increase in energy prices. The retail sector has been affected not only by rising wholesale food and energy prices, but also by some government legislation. Government decrees introduced an additional retail tax² and retail price caps³ for eight products. As only consumer prices were capped, but not wholesale prices, the loss had to be absorbed by retailers alone.

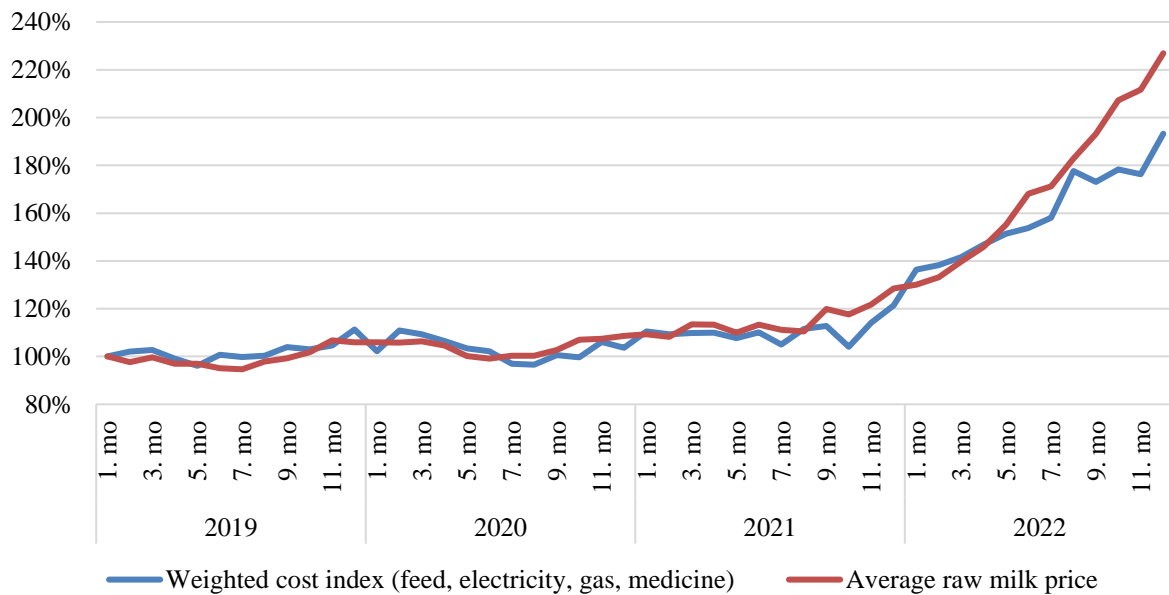
21. The analysis of raw milk prices shows that there is a strong correlation between input prices and raw milk prices (see Figure 3). However, since the second half of 2022, raw milk prices have increased more than the associated cost increases. Raw milk prices increased by 78% on an annual basis, which was the highest price increase among the EU Member States. A key element behind this very substantial price increase was probably the so-called raw milk price forecast published by the Milk Interprofessional Organization and Product Board, a formally recognised interbranch organisation. The Milk Interprofessional Organization and Product Board published quarterly its raw milk price forecast for the next quarter and year. Although it was not mandatory to apply in any contracts, it was actively communicated to farmers and could be used as a reference point in their negotiations. The price forecast was based on a formula that included both historical data and several subjective factors. The former included historical consumer price data as well which, in the opinion of the GVH, were not justifiable as that can lead to a permanent inflation. The latter were agreed by the Presidency of the Milk Interprofessional Organization and Product Board. When reviewing the price forecast, the GVH noted that it almost always predicted a price increase, even in late 2022, early 2023, after the already very substantial price increase, in a time when raw milk prices in the EU started to fall. The GVH advised the Milk Interprofessional Organization and Product Board to stop publishing the price forecast in its current form and to revise the methodology (if they want to publish it in the future). The Milk Interprofessional Organization and Product Board stopped publishing the price

² Government Decree 197/2022 (4 June)

³ Government Decree 6/2022 (14 January)

forecast after the intervention of the GVH. The GVH decided not to launch a formal competition case against the Milk Interprofessional Organization and Product Board as this would have required significant resources and the outcome is questionable under Article 93/A of the Hungarian Competition Act (see Section 2 for details).

Figure 4.1. Monthly evolution of raw milk price and the related costs since 2019 (January 2019 = 100%)



22. The GVH paid particular attention to analysing how the retailers' gross margin (i.e., the difference between the consumer price and the wholesale price) had changed and whether it was in line with the increase in their operating costs. A product-by-product analysis of the composition of gross margins showed that although gross margins themselves increased, so did the costs they were intended to cover. As a result, retailers' net margin (profitability) increased for some products, remained static for others or even turned into a loss for some products.

23. The analysis also showed that there is no level playing field between dairy products and their plant-based alternatives, with dairy products being favoured. This is partly due to the significant difference in VAT (5% for milk compared to 27% for plant-based drinks). This is unfortunate because plant-based dairy alternatives have a much lower environmental footprint and are also suitable for people with lactose intolerance and milk protein allergy. Therefore, from a social, environmental, and animal welfare perspective, it would be desirable to promote plant-based dairy alternatives and level the playing field. Overall, consumers should be the ones selecting winners in the marketplace, not legislation.

24. The GVH also used an econometric approach to examine the relationship between price changes and potential market power by applying a price transmission analysis (PTA). This model examines the speed and symmetry of price changes followed by input cost changes. Based on academic literature, it is hypothesised that firms with market power are able to quickly pass on cost increases to downstream levels, but are not similarly incentivised to reduce their own output price in the face of falling costs. The model assessed the dynamics of prices at farm, processing and retail levels. It provided a detailed view of the supply chain, particularly as many PTAs in the food sector focus only on retail-farm

dynamics. The analysis showed that it was the processing level that had some market power and was able to pass on cost increases quickly and completely, while also closely following retail price changes. The processing level was also able to prevent its margins from being squeezed by the dairy farm level in the long term. These findings warned the GVH to keep an eye on the concentrated dairy processing industry.

25. Other recommendations of the GVH included the elimination of price caps due to their market-distorting effects; the development of the now operational price monitoring database (<https://arfigyelo.gvh.hu/>, available in Hungarian only), which allows consumers to compare the prices of different food products in different retail outlets; the promotion of environmentally friendly, recyclable packaging; and further efforts to monitor and promote competition in the retail sector.

4.3. Accelerated sectoral inquiry into the Hungarian market for preserved foods

26. The second accelerated sectoral inquiry focused on the market for preserved (canned and deep-frozen) fruits and vegetables. In general, these products are quite heterogeneous and can make an important contribution to a healthy lifestyle, and therefore their price changes are also important from a public health point of view.

27. Given the short timeframe of the accelerated sectoral inquiry, only 12 specific products were selected and their price data analysed. Each of these products has a slightly different supply chain. Similar to the dairy market analysis, each level of the supply chain (farmers, processors, retailers) was contacted to provide information and data. The GVH also collected data from agricultural research institutes.

28. It was clear that the pricing of different products followed different trends. At each level of the supply chain, there were examples of products with increased margins and profit content, as well as products where these figures were decreasing in 2022.

29. At the farmer level, despite ideal conditions for agricultural production, domestic production of vegetables and fruits (the raw materials for the products under investigation) has declined in recent years. The decline can be attributed to both a smaller area under cultivation and lower yields. The latter was particularly pronounced in 2022 due to the severe draught. The decline in cultivation area is due to the fact that vegetables are more exposed to extreme weather conditions and therefore, unlike industrial crops (such as wheat and soya), their yields are more volatile and their cultivation more expensive, making their production risky and less attractive for farmers. If yields, and therefore farmers' incomes, are significantly lower than expected in a given year, farmers may switch to another crop the following year. The underlying trend seems to be that more and more domestic producers prefer to grow crops that offer a more secure and predictable income and require less capital. The decline in supply naturally leads to higher prices, especially when yields are very low – as was the case in 2022. It is important to note that Hungary exports a large amount of these products, so the decline in domestic demand did not limit the processors' pricing ability. On this basis, the GVH recommended measures to promote domestic production of fruits and vegetables and to improve the stability of yields. The GVH proposed increased support for the installation of modern and sustainable irrigation systems to cope with drought, and technical and financial support for the spread of precision agricultural methods.

30. The sharp rise in energy prices as well as the labour shortages also played a significant role in the increase in preserved food prices. The GVH therefore proposed to support investment in energy efficiency and the use of renewable energy sources, as well as support for training in precision agricultural and

improvements in automation, which could address the shortage of labour while increasing productivity at both farm and processing level.

31. The GVH also noted that the gross margin of these products at retail level is between 25% and 35%. The gross margin represents a larger proportion of the consumer price than the GVH experienced for dairy products. On this basis, retailers are generally able to make higher profits on these products, although this is likely to be partly due to the fundamental characteristics of preserved foods, such as lower inventory turnover rate and longer shelf life.

32. Finally, the GVH noted that packaging had also proved to be a substantial cost element at the processing level. On this basis, the GVH proposed to collect and recycle (metal and glass) packaging at the highest possible rates. This would reduce the canneries' dependence on the supply of packaging materials.