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Session III - Competition Issues in the Groceries Sector: Focus on Conduct

-- Contribution from El Salvador --

23-24 September 2015, Montego Bay, Jamaica

The attached document from El Salvador is circulated to the Latin American Competition Forum FOR DISCUSSION under Session III at its forthcoming meeting to be held on 23-24 September 2015 in Jamaica.

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Session III - Competition Issues in the Groceries Sector: Focus on Conduct

COMPETITION IN RETAIL DISTRIBUTION IN EL SALVADOR

-- CONTRIBUTION FROM EL SALVADOR* --

1. Introduction and background

1. In retail distribution people and organisations act as intermediaries and make manufactured products, or products imported by other agents, available to consumers. Therefore, the relationship between large volume suppliers and producers (upstream) with retail distributors (downstream) is crucial as it represents the access channel to the end client.

2. In El Salvador, there are two channels in retail distribution, one traditional, the other modern. The traditional channel includes municipal markets, wholesalers¹ and neighbourhood shops. The modern channel includes large supermarkets found across the country like Walmart, Súper Selectos and Pricemart, and other smaller, regionally based supermarkets.

3. The modern and traditional sectors serve different segments of consumers because of differences in price, conditions of hygiene and storage, and other aspects like the level of perceived security, opening hours, etc. The modern channel in El Salvador is led by two business groups: Grupo Calleja S.A de C.V. and Operadora del Sur, S.A de C.V. Both groups have various supermarket formats targeting different segments of consumers. There are also smaller groups like Pricemart S.A. de C.V, El Baratillo, La Alameda, Super Talpa and others.

* This document was written by the Competition Authority of El Salvador (*Superintendencia de Competencia*), in August 2015.

¹ Wholesale transactions involve business operators selling to retailers, industry, businesses, organisations or other wholesalers, not the end consumer. They act as intermediaries in the purchase/sale of a product. (UNSTATS, 2002). Likewise, Walmart acknowledges the role of large supermarkets in defining marketing strategies in the sector.

4. Grupo Calleja is currently the only significant chain of supermarkets in the national capital with 91 outlets of various formats, including *Súper Selectos* or *Selectos Market* that are examples of the increasing concentration in the sector. In the 1990s Grupo Calleja expanded significantly, gradually acquiring national supermarket chains El Sol (4 outlets), Todo por menos (14 outlets), Multimart (one outlet) and La Tapachulteca (13 outlets). The purchase of the second of these companies marked the Group's expansion beyond the capital (San Salvador) where it had traditionally operated.

5. Operadora del Sur is the legal entity under which Walmart from Mexico and Central America operates in El Salvador. Walmart has been present in El Salvador since 2005 and currently has 90 sales outlets in four different formats: Despensa Familiar, Despensa de Don Juan, Maxi Despensa and Walmart Supercenter. The company's strategy is based on offering lower prices than its competitors. Walmart also reflects the significant role of large supermarkets in defining marketing strategies in the sector.

2. Competition Authority and retail distribution

2.1 General aspects

6. The most significant changes in the control of retail distribution took place before the Ley de Competencia² (LC) competition law came into force in El Salvador, and therefore these mergers³ were not subject to the scrutiny of any competition analysis. When the competition authority (SC) first began taking action it received applications for the authorisation of mergers from various operators in retail distribution. The applications were declared inadmissible and withdrawn⁴ on the basis of the terms specified in articles 31 to 36 of the LC.

7. Given the importance of healthy levels of competition in markets relating to the security of food sources and the significance of the proportion of household spending on food in El Salvador⁵, an analysis of the competition conditions in retail distribution in El Salvador was considered necessary. The study aimed to identify the commercial practices associated with market strength, negotiating strength or dominant position among competitors in the sector. The study also included the impact of own brands, discrimination in the allocation of shelf space, and distribution and supply activities relating to a limited set of products.

8. Supermarkets provide a point of supply rather than one-off articles. They are able to market a wide range of products, whereas other retail distributors are limited by their sales infrastructure in the range of articles they can sell (i.e. liquid fuel retailers). In order to simplify the study and make it easier to conduct, the quantity of products studied was limited to a basket of goods. This included: (i) basic foods, (ii) groceries, (iii) dairy products, (iv) vegetables, (v) toilet and household cleaning products, (vii) meats

² The Law of Competition was approved by Legislative Decree Number 528, issued on the twenty-sixth of November two thousand and four, and published in Official Bulletin Number 240, volume 365 on the twenty-third of December of the same year, coming into force on 1 January 2006.

³ For example, the entry of Walmart into the domestic market through the purchase of various local operators.

⁴ Cases SC-001-S/C/NR-2012; SC-037-S/C/NR-2012, among others. These can be found on <http://www.sc.gob.sv/Widget/InformacionWebAll.php?Id=9>.

⁵ On average, spending on food represents 46% of total spending. Own calculations, based on the Survey of Households for proposals (EHPM), of 2013.

and (viii) toiletries and personal hygiene products. These products were named “regular consumption products” because of their importance and high turnover⁶.

2.2 *Study of retail distribution market*

9. A competition study began in 2013 to consider levels of competition in the retail distribution of regular consumer products in El Salvador. Information was gathered from a variety of business operators: upstream suppliers (producers of shop brands, importers, multi-product wholesale marketers, among others), stall vendors from municipal markets, representatives from the two main supermarket chains, and from supermarkets operating on a smaller scale in a smaller geographical area. To varying degrees⁷ information was obtained from all these operators (by conducting personal interviews and making requests for information, etc.) in order to define the activity of retail distribution and plot the type of relationships between the main participants in this activity.

10. Establishing relevant markets is always a demanding task when analysing competition in the food retail sector⁸ because of the varied format of retail establishments within one geographical area and the large quantity of products they distribute, among other factors. The market in El Salvador is no exception. The distinctive features of the economy in El Salvador are the prevalence of the informal sector and the large inflow of consumers into purchasing areas other than supermarkets. Municipal markets and neighbourhood shops (equivalent to ‘pulperías’ further south in Latin America) coexist permanently with supermarkets, both in terms of the space they occupy and the type of goods they market.

11. Despite the fact that these businesses exist side by side, the information gathered for the study from interviews with suppliers, various retailers, and wholesalers shows that vendors in municipal markets and neighbourhood shops (traditional channel) belong to a product dimension that is different from the dimension formed by supermarkets (modern channel), regardless of their format⁹. The differences are based on their method of supply, the assets with which they operate, the range of articles available to the public at any given time, and other features that determine that neither group is replaceable by the other.

12. The geographical aspect of retail distribution is approached from different perspectives in the literature: by administrative area, concentric circles of influence of varying radiuses, simultaneous lead times, number of blocks, among others¹⁰. In El Salvador, the geographical area was established as the entire country, given that the main supermarket chains and municipal markets operate the length and breadth of the nation, not just in major cities. Likewise, price levels at various points of sale (in both the traditional and the modern channel) are similar throughout the country, and given that upstream operators who supply all retail operators are able to market their products across the country, the various types of

⁶ In the case of El Salvador, by focusing efforts on these products (and consequently on the agents who provide this type of article) the group informing the study were able to give an account of the problems in retail distribution in the country from a similar perspective and provide consistent and valid statements. We believe that adopting a similar approach in studies conducted by this organisation and other competition authorities in the future will make a positive contribution to the tasks of investigation and analysis.

⁷ One of the major chains operating in the country refused to provide information relating to its business for the purpose of this study.

⁸ Castañeda (2012) y (Gómez, Lobo y González, 2007).

⁹ No evidence was found to indicate that in the case of El Salvador, the size of the product display area should be taken into account in order to distinguish the type of product (“supply services”) offered by the different supermarkets.

¹⁰ (2012) and (Gómez, Lobo and González, 2007).

retailers distribute a very similar variety of PCP. These factors reinforce the idea that the relevant geographical area is the entire country.

13. Despite being a small country, there are regions in El Salvador with large variations in income and population density, among other factors, which might encourage the retail operators to establish policies to suit these characteristics. This may lead to multiple competition conditions, depending on the region in question, which may lead to practices like price discrimination, as indicated by some of the business operators who were interviewed.

14. In order to validate this hypothesis the prices of certain products¹¹ were noted for three specific regions (Historic Centre of San Salvador, Old Cuscatlán and Soyapango)¹² that vary in both population density, average incomes and number of retail establishments. A statistical procedure called *Analysis of Variance* was carried out with the information gathered. The objective was to identify whether the average price of a basket is statistically different in outlets of the same format located in the different geographical areas selected (on the same specified date). The results did not reveal any statistically significant evidence to conclude that discrepancy exists in average price levels in sales outlets of the same operator in different regions. This supports the hypothesis that these retailers operate similar policies throughout the country.

2.3 *Study in retail distribution: a successful case of support between organisations*

15. The experience of conducting this study demonstrates the need for competition authorities to take advantage of the support provided by the efforts and skills of other government departments, whether in terms of technological resources, knowledge or data. Given that one of the major retailers operating in the country refused to respond to the requests for information, it was necessary to resort to a pricing base¹³ drawn up by staff at the *Defensoría del Consumidor* (Organisation for Consumer Protection)¹⁴ and supplied with data from several retail establishments from across the country (including all chains of supermarkets and municipal markets). This made it possible to obtain information on the historic prices of various articles marketed in the sales outlets of the supermarket chain that refused to provide the information requested.

16. A great deal of support was also received from the Department for Information Technology at the Ministry of the Economy in El Salvador which, using the register of property and online geographical reference software, designed a web application for the competition authority with all the retail establishments (municipal markets and supermarkets) in El Salvador. This application allowed an analysis of the radiuses of influence to be completed and information on the density of retail establishments to be obtained¹⁵. This study is an example of successful collaboration between various government departments and shows how tools used in one department can be very helpful in the defence of competition.

¹¹ Large eggs, vegetable oil, beef, tomato paste, white rice, watermelon, powdered milk, flour, deodorant, potatoes, onions, toothpaste and papaya.

¹² For example, average incomes per head in these areas are \$826.86, \$1,329.38 and \$603.29 US dollars, respectively.

¹³ <https://www.google.com.sv/search?q=observatorio+de+precios&oq=observatorio+de+precios&aqs=chrome69i57j0l3.3772j0j1&sourceid=chrome&ie=UTF-8>.

¹⁴ <http://www.defensoria.gob.sv/>.

¹⁵ <http://dtimap.minec.gob.sv/mercadosrelevantes/>.

3. Some aspects specific to retail distribution in El Salvador

3.1 *The relationships between supermarkets and operators upstream*

17. The presence of only two significant chains of supermarkets and the high degree of fragmentation among the providers who supply them give the retail distributors considerable negotiating strength. Similarly, many business operators who supply supermarkets operate on a smaller scale and depend, to a large extent, on the modern channel to market their products. Finally, the commercial relationships between large retailers and suppliers are highly asymmetrical.

18. The type of practices used by supermarkets with regard to their suppliers that take advantage of their negotiating power varies according to the size of each provider (the greater the volume of sales, the better the treatment received), the type of product to be acquired and the degree of dependency of the business operator upstream on distribution through the modern channel. Nevertheless the study revealed some elements in the commercial relationships between large retailers and suppliers that could be problematic. These include: (i) the absence of documents regulating commercial relationships, (ii) excessively long payment periods, (iii) unclear treatment of damaged merchandise, (iv) demands arising from the application of the most-favoured nation clause, (v) joint financing of promotions, (vi) discrimination in the allocation of shelf space and (vii) different treatment in administrative processes according to the size of the providers.

19. Purchasing relationships between supermarkets and providers are ruled by “trust” and “gentlemen’s agreements” despite the existence of legal instruments that provide legal security to both parties¹⁶. The practice of not using documents to regulate commercial relationships between the large retailers and the business operators upstream allows supermarkets to take advantage of their negotiating power, which leads to practices that are potentially damaging for suppliers, like excessive delays in making payments for goods acquired and unjustified requests for the replacement of damaged merchandise.

20. In El Salvador, 97%¹⁷ of the production units are micro, small or medium-size companies and cash flow restrictions are one of their main obstacles to growth (Saavedra, 2010), (Belger, 2010). As a result, the payment periods imposed by retailers on their providers (normally between 30 and 90 days) can make it difficult for a company to expand, or for new providers to begin marketing their products in the modern channel, thereby reducing the possibility of the market becoming dynamic.

21. There is disagreement among suppliers upstream on conditions of responsibility with regard to the replacement of damaged merchandise. Some of the operators interviewed indicated that the supermarkets demand the replacement of articles that are about to expire or are imperfect in any way, despite the fact that these products were received and approved by the retailer at the point of delivery. Retailers tend to make these demands even if the damage to merchandise occurred during the handling of the products by the supermarkets.

¹⁶ The upstream business operators indicate that they do not demand any documentation to cover the risk of retaliations on the part of the retailers, or that they do not do so for fear that the retailers will simply stop acquiring their products.

¹⁷ Ministry of the Economy in El Salvador – Department for Statistics and Censuses, Directory of Economic Units 2011-2012.

22. Controversy surrounding payment periods and the handling of damaged merchandise could be eliminated by the use of a legal instrument known as an “Exchange invoice”¹⁸. Payment periods and other elements must be established in this document, which would provide clarity with regard to cash flow management. The law establishes that acceptance of the exchange invoice by a purchaser implies approval of the product received. Finally, retailers would not be able to demand the replacement of merchandise damaged as a result of actions not attributable to the upstream operators.

23. The country’s small size and the intensive publication of promotional campaigns in various media by the major supermarkets make it easy to monitor the activity of competitors. Retailers can use this input to estimate the price at which upstream business operators supply rival chains¹⁹. Similarly, supermarkets can check which brands are participating in the promotional campaigns of other supermarkets and therefore demand conditions from their providers similar to those granted to the competition, which is known as the *‘most-favoured nation clause’*. This practice discourages the smallest suppliers from taking part in promotions and offering special sales conditions to promote their products because these programs expose the suppliers’ willingness to reduce costs. They also present financial costs that are difficult to sustain.

24. The most important asset of a supermarket is its shelf display space. This is the means by which upstream suppliers reach the end consumer. Therefore the criteria used to assign this space are fundamental to the commercial dynamics of retail distribution. The upstream providers state that the allocation of shelf space is based on the market share of each brand in its product category, its sales history, and additional investments in the purchase of space and promotions. The latter creates significant difficulties for new products entering the market because of their lack of sales history. Access to the market and the ability to display product in the modern channel depend on the result of negotiations with supermarkets.

25. Finally, suppliers indicate that supermarkets treat them differently according to various characteristics like order size and scale of the operation of the provider. As a result, small suppliers maintained that preference is given to receiving orders of goods from larger suppliers. This is the case even when there are other business operators waiting for their products to be received who have invested more time in dispatching their products.

3.2 *Own brands*

26. In El Salvador the main supermarket chains increasingly market their own brands in a varied range of products. The literature indicates that the effects of introducing own brand products are ambiguous, Bunte (2011) and Whelan (2008). On the one hand, options for consumers increase, but as the products are generally cheaper, they weaken brands that are not market leaders. They can also expel weaker brands from the market and reduce the range of options for the consumer. In addition, own brands are likely to be more successful in product lines where there is little or no added value (i.e. commodities) and less successful in market segments where confidence in the producer is very important (i.e. personal care products, dairy products, etc.) (Quelch, 1996).

¹⁸ Special Rules applicable to the Exchange Invoice available at <http://www.asamblea.gob.sv/eparlamento/indice-legislativo/buscador-de-documentos-legislativos/regimen-especial-de-las-facturas-cambiarias-y-recibos-de-las-mismas>.

¹⁹ Once again, the small size of the country and the market mean that upstream suppliers do business with the main supermarket chains permanently and without distinction.

27. In El Salvador a brief exercise was conducted using the prices of various market-leading products and their own brand rival products in one of the major supermarket chains in the country. For this sample of items, the observation was made that own brand items, as indicated in the literature, were strong in commodities (toilet paper, rice) but weaker in products with a high added value, like dairy products or vegetable oil.

28. Another important consideration is that supermarkets supply themselves with own brand products by importing goods, making their own goods (implying an emerging growth in backward vertical integrations) or by acquiring products manufactured and labelled by third parties, who in many cases also supply other brands. In general, products marketed under own brand labels are lower in price compared to items from third party brands. As previously indicated, upstream business operators are concerned about supermarkets' preference for assigning shelf space to own brand products to the detriment of competitor items in the same product category when the decision is not based on commercial reasons, like inventory turnover or historic level of sales.

4. Conclusions and final impressions

29. Retail distribution in El Salvador is highly concentrated in two supermarket chains. Nevertheless, the main concerns regarding competition in retail distribution do not lie in the behaviour of supermarkets towards end consumers, given that there is intense competition between the two major chains in the market. This fact is confirmed by constant promotions and the opening of new sales outlets by both chains. Similarly, there has been no evidence of the dividing up of markets, agreements or price discrimination, or similar practices. The main concerns are based on the approach taken by major retailers towards their suppliers and the advantage taken of their negotiating power, which can disproportionately weaken upstream business agents.

30. Therefore, the main challenge relating to competition in the sector of retail distribution in El Salvador is to foster the entry of new retail chains in the country, or failing that, to design alternative marketing channels to reduce suppliers' dependency on the major retailers. It is also necessary to promote the use of legal instruments (like contracts or exchange invoices) that provide legally secure commercial agreements between retailers and suppliers. Finally, it is also necessary to work together with other government bodies to promote good practices in this business sector and to seek to establish standards for commercial relationships between supermarkets and suppliers in order to reduce the asymmetric nature of negotiations and the risk of abusive practices by major retailers.

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