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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE AND THE COMMITTEE OF THE REGIONS**

A better functioning food supply chain in Europe

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1. INTRODUCTION

Over the past couple of years, prices along the food supply chain have fluctuated widely. From mid-2007 to mid-2008, agricultural commodity prices rose sharply, which resulted in increased consumer food prices and higher inflation levels overall. Since then, prices of many commodities have come down to levels comparable to or even lower than those reached before the start of the price surge. However, consumer food prices continued to increase and only started declining in May 2009 raising concerns about the functioning of the food supply chain. These changes have caused considerable hardship for agricultural producers and imply that consumers are not getting a fair deal.

The food supply chain connects three important sectors of the European economy – agriculture, the food processing industry and the distribution sectors – that together make more than 5% of European value-added and 7% of employment. Moreover, its performance has direct consequences for all European citizens, since food represents 16% of European households' expenditures. The functioning of the food supply chain takes on increased importance in the path towards recovery from the current economic and financial crisis. High food consumer prices are a source of concern because they put pressure on household incomes in particular now at a time when an increase in consumption is needed. They are particularly hard on the most vulnerable households who spend a considerably greater proportion of their income on food. In the longer run, a better functioning food supply chain is crucial for consumers and for ensuring a sustainable distribution of value added along the chain, thus contributing towards raising its overall competitiveness. Improvements are needed urgently to avoid an escalation of consumer food prices as the recovery sets in.

The Commission has been following developments in food prices as part of a market monitoring exercise launched within the context of the November 2007 Single Market Review¹ which aims to provide policy remedies to identified causes of malfunctioning. In December 2008, the Commission published an interim report on "Food prices in Europe" and set out a roadmap identifying the key directions for policy actions². This Communication presents concrete policy initiatives along the lines of the roadmap and thus concludes the market monitoring exercise on the food supply chain³.

¹ Commission Staff Working Document on "Implementing the new methodology for product market and sector monitoring" SEC(2007) 1517, accompanying the Communication from the Commission on "A single market for 21st century in Europe" – COM(2007) 724.

² Communication from the Commission on "Food Prices in Europe" – COM(2008) 821 and its accompanying Staff Working Documents.

³ The technical analysis on which this Communication is based is published in a series of six accompanying Staff Working Documents.

This Communication is organised as follows. Section 2 describes the link between agricultural commodity prices and changes in consumer food prices. Section 3 identifies the main challenges faced by the food supply chain and presents a number of policy initiatives aimed at overcoming them. Section 4 presents the next steps the Commission will take to implement these initiatives and Section 5 concludes.

2. RECENT PRICE DEVELOPMENTS

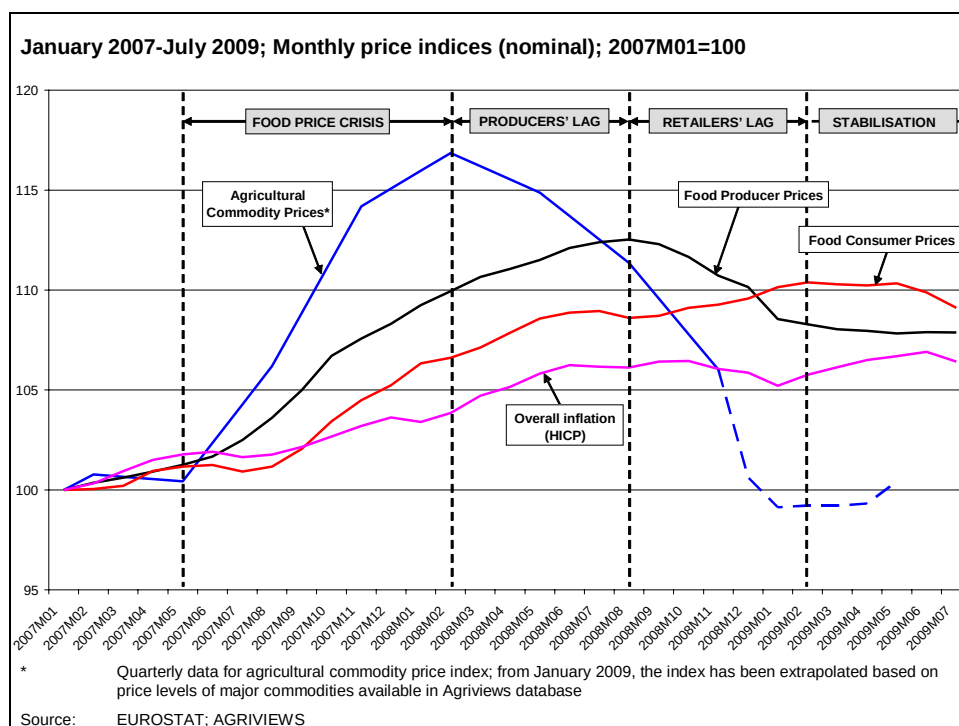
During the second half of 2007 and early 2008, agricultural commodities prices rose rapidly⁴. As a consequence, food producer prices and consumer food prices started to increase as well, albeit at a slower rate. This can be explained by the fact that agricultural commodities make up only a small proportion of the overall production costs of food⁵ and the observation that, in the most competitive markets, food processors and distributors absorbed part of the price increase.

Since the second quarter of 2008, prices of agricultural commodities have been plummeting. Contrary to agricultural commodity prices, food producer prices continued to rise until the fourth quarter of 2008, while consumer food prices did not come down until recently. Moreover, the rates of decline in producer and consumer food prices are rather low when compared to the drop in agricultural commodity prices – see Figure 1. The reaction of food processors and distributors to a decrease in agricultural commodity prices has been both slower and weaker than their reaction to their increase of 2007. This discrepancy has negative consequences for the food supply chain as it prevents consumers from benefitting from lower prices and curtails the recovery of agricultural commodity prices by reducing the demand for food products.

⁴ Developments in agricultural commodity prices have been detailed in the 2008 Communication on "Food prices in Europe".

⁵ Raw agricultural products represent a declining share in the consumer price of food products.

Figure 1: Recent price developments along the food supply chain, EU-27



The discrepancies observed between commodity and consumer food price developments, together with the asymmetric response of food prices to commodity price fluctuations, relate in part to structural weaknesses in the system, such as the number of intermediaries operating along the chain and the competitive structure at certain steps of the chain. Moreover, pervasive inequalities in the bargaining power between contracting parties contribute towards reducing both the speed and magnitude of price transmission along the chain and offer an explanation for its asymmetry. In addition, the slow transmission of price changes delays necessary adjustments and helps prolong market inefficiencies at each step of the chain. Such inefficiencies can exacerbate price volatility in agricultural commodity markets. Therefore, the Commission considers that the recent price developments should give a sense of urgency to the implementation of concrete policy initiatives along the directions identified in the December 2008 roadmap.

3. OVERCOMING MAJOR CHALLENGES FACED BY THE EUROPEAN FOOD SUPPLY CHAIN

The food supply chain connects important and diverse sectors of the European economy that are essential for economic, social and environmental welfare as well as for the health of European citizens. On several dimensions, the chain performs well: it delivers high-quality food products at affordable prices to European consumers, it ensures the safety and traceability of food products and it can pride itself on the ample supply of highly competitive, innovative and traditional products, both within and outside the EU. However, the overall competitiveness of the chain and its economic growth have underperformed the overall EU economy since 1995⁶, sectors of the food supply chain are facing increased competition from

⁶ Average value-added growth of the food supply chain sectors has been 2% lower per year than average growth in the EU since 1995.

international actors and recent food price developments have pointed out a lack of resilience to shocks in agricultural prices.

The Commission has been working with stakeholders to improve its understanding of the major challenges faced by the chain and to define relevant and concrete policy actions in line with the December 2008 roadmap. While the food supply chain is very heterogeneous and challenges faced by stakeholders differ between sub-sectors and Member States, three cross-cutting priorities relevant to the whole chain have been identified: (1) promote sustainable and market-based relationships between stakeholders in the food supply chain; (2) increase transparency along the chain to encourage competition and improve its resilience to price volatility; and (3) foster the integration and competitiveness of the European food supply chain across Member States.

3.1. Promote sustainable and market-based relationships between stakeholders in the food supply chain

The food supply chain is characterised by the wide diversity of actors it connects: farmers, food processors, traders, wholesalers and retailers. Both very large companies and small and medium-size enterprises are simultaneously active, either as competitors, suppliers or customers. These relationships are often fraught with difficulties which hold back the full potential of the chain. A key lesson stemming from analyses into this matter, carried out involving stakeholders and National Competition Authorities, is the necessity to draw a clear distinction between concerns about potentially unfair trading practices – related to the imbalances in bargaining power of contracting parties – and concerns about anti-competitive practices.

3.1.1. Bargaining power and potentially unfair trading practices

Within the food supply chain, significant imbalances in bargaining power between contracting parties are a common occurrence and this issue was flagged as a serious concern by stakeholders. This asymmetry in bargaining power may lead to unfair trading practices, as larger and more powerful actors seek to impose contractual arrangements to their advantage, either through better prices or through improved terms and conditions. Such practices may occur at every link of the chain and include, for example, late payments, unilateral changes in contracts, ad-hoc changes to contractual terms, upfront payments as entry fees to negotiations... Within non-processed food supply chains, small farms and cooperatives often deal with larger buyers, be they producers, wholesalers or retailers. Within processed food supply chains, on the one hand small food processors are contracting with usually large retailers that are often their only channel for accessing the market. On the other hand, large multinational food producers may also have important bargaining power as they offer branded products that retailers cannot do without.

Contractual imbalances associated with unequal bargaining power have a negative impact on the competitiveness of the food supply chain as smaller but efficient actors may be obliged to operate under reduced profitability, limiting their ability and incentives to invest in improved product quality and innovation of production processes. A better awareness of contractual rights and stronger action against unfair contractual practices could contribute to preventing these drawbacks since actors with limited bargaining power suffer from a lack of information on their rights. Moreover, they may hesitate to contest contract clauses for fear of losing the contract altogether.

There is thus a need to better understand, and examine in depth, contractual practices and their link to asymmetries in bargaining power within the food supply chain since, depending on each individual situation, they might lead to unfair and inefficient outcomes.

3.1.2. Market power and potentially anti-competitive practices

The ability of suppliers and/or buyers to exercise their market power in a manner that distorts competition to the detriment of consumers depends primarily on the type of supply chain and on local market conditions. Since food markets are most often national or local in scope, the Commission has worked closely with National Competition Authorities on food related issues in the framework of the European Competition Network (ECN).

As a result, National Competition Authorities have granted due priority to case by case investigations, as well as to broader inquiries regarding food markets. These actions, taken together, have considerably improved the understanding of the functioning of this crucial sector of the economy. In addition, certain investigations have led to the finding of a significant number of serious infringements, such as cartels and resale price maintenance cases. These infringements were swiftly remedied through cease-and-desist orders, accompanied where appropriate by substantial fines.

In accordance with its Communication of December 2008⁷, the Commission has also examined the relevance of certain commercial practices both in terms of their likelihood to arise and their ability to raise competition concerns within the relevant food supply chains. In addition to classic cartels and resale price maintenance, other practices were deemed to deserve special attention by Competition Authorities, such as joint commercialization agreements, tying and bundling, joint purchasing agreements (buying alliances) and the increasing use of private labels. For such practices a careful balancing of efficiency enhancing and potentially anti-competitive effects is needed. No sweeping generalisation can be made and National Competition Authorities concur that a case-by-case analysis based on the specificities of local market conditions is necessary in order to establish the existence of a possible competitive harm.

⁷ Communication from the Commission on "Food Prices in Europe" – COM(2008) 821.

In order to promote sustainable and market-based relationships between stakeholders of the food supply chain, the Commission:

1. considers that action is needed to eliminate unfair contractual practices between business actors all along the food supply chain.

1.1. The Commission will work with Member States to put contractual relations on a more secure footing so that contracting parties will be able to reap the full benefits from the single market while retaining their freedom to contract. This will entail:

- **an exchange of information on contractual practices**, including a clarification of contractual rights and of the legality and fairness of commonly used contract clauses;
- **the launch of awareness campaigns** to inform stakeholders of their contractual rights and potentially illegal or unfair practices;
- **an exchange of best practices on notification of contractual practices** (e.g. Ombudsmen, actions by enforcement authorities, collective actions);

1.2. At the Community level, on the basis of the information gathered in this context, the Commission will:

- **work together with the food supply chain stakeholders to prepare sets of standard contracts**, whose use would be voluntary, taking into account the diversity of the food supply chain;
- **assess unfair contractual practices in the Internal Market and propose any necessary Community measures to address such practices.**

2. will work with the European Competition Network (ECN) to develop a common approach to relevant competition issues⁸ aiming at a sustained exchange of information, a swift identification of problematic cases and an efficient allocation of tasks among each member. In this context, the Commission proposes to create, where necessary, joint working teams within the ECN dedicated to the analysis of specific practices and markets which may be critical for the functioning of the food supply chain. This enhanced cooperation will contribute to better detect endemic problems specific to food markets and promptly coordinate future actions.

⁸

It must be noted that impact of vertical relationships between operators in the chain on competition come under the scope of the existing rules applicable to vertical agreements – Commission Regulation (EC) No 2790/1999 of 22 December 1999 and associated Commission Guidelines on Vertical Restraints, currently under review.

3.2. Increase transparency along the food supply chain to encourage competition and improve its resilience to price volatility

Markets along the food supply chain suffer from a lack of price transparency and predictability. Upfront in the chain, derivatives are an important tool to cope with the observed volatility of agricultural commodity prices. It is essential to ensure that derivatives keep serving their initial purpose of price discovery and hedging. The issue of how to tackle "excessive speculation" on commodity markets is debated globally. In this respect, it is necessary to improve the overall transparency and oversight in the EU for derivatives on agricultural commodities – including over the counter markets. In particular, a better overview of the activity of different types of market participants is needed.

Moreover, the roadmap proposed the creation of a European food prices monitoring tool to increase price transparency in downstream markets of the chain. Today, the Commission publishes a first version of such a tool⁹, putting together data collected by Eurostat and National Statistical Institutes. It is structured along two dimensions:

- Tracking consumer price levels of comparable food products across Member States to assess price dispersion and integration of the retail internal market for food – see Section 3.3.;
- Tracking price developments in Member States at each step of the chain – agricultural commodity, producer and consumer food prices – for a selection of specific products, such as milk, cheese or pork.

The monitoring tool thus provides valuable information on price levels and developments all along the food supply chain and shows the price evolution by product and Member State, taking into account the diversity of the chain. It provides visibility on food price evolution in each country and will contribute to increasing pressure on stakeholders to speed up price transmission. The tool will be further developed in order to improve the link between food consumer, producer and agricultural commodity prices and to increase the coverage of products monitored.

While consumer surveys conducted in the framework of the Second Consumer Markets Scoreboard¹⁰ show a general satisfaction with the services offered by food retailers, they also reveal a relative lack of satisfaction on the comparability of food prices between different retailers. It is thus desirable to further develop price comparison tools (such as websites or smart phones that can be used in store to scan and compare products) for food products, following the examples of a number of such successful services across Europe. The development and use of such websites can send a powerful signal to citizens that governments are taking concrete steps to help them save on their daily or weekly shopping. It would contribute to increasing the intensity of competition at the retail level in local markets as well as upstream along the food supply chain. At the same time the Commission is aware of the need to ensure that any information divulged to consumers is of high quality. The identification of key success factors for such price comparison services based on existing experience would be of considerable help for the further development of such tools.

⁹ Available at <http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/data/database>
¹⁰ The Consumer Markets Scoreboard, Second Edition, 2009.

In order to increase transparency in the food supply chain, the Commission:

- 3. will make proposals to improve the oversight and overall transparency of agricultural commodity derivatives markets** in the context of the overall approach on derivatives¹¹ and the review of the Directive for Markets in Financial Instruments (MiFID):
 - 3.1. appropriate transparency and reporting requirements should be extended to all agricultural commodity derivatives, including those traded over-the-counter;
 - 3.2. these obligations should be complemented by the introduction of position reporting obligations by categories of traders to be defined at EU-level. This would enable regulators to have an overview of the positions taken by the different types of traders;
 - 3.3. the possibility of enabling regulators to set position limits to counter disproportionate price movements or concentrations of speculative positions¹² will be carefully assessed, with a view to ensuring the efficient functioning of those markets;
- 4. publishes today the first edition of the European Food Prices Monitoring tool and commits itself to examining ways of developing it further** in order to cover a greater number of food products and chains, starting from the Summer of 2010. This would require the cooperation of National Statistical Institutes. The Commission consequently calls on National Statistical Institutes to collect the necessary data;
- 5. recommends that all Member States have web-based and easily accessible food retail price comparison services.** The Commission will work with Member States to ensure an exchange of best practices and experiences in this field.

3.3. Foster the integration and competitiveness of the European food supply chain across Member States

3.3.1. Integration of the food supply chain

As already pointed out in the Communication on "Food prices in Europe", the food supply chain is highly fragmented between EU Member States. The information collected for the European food prices monitoring tool confirms important cross-country differences both in terms of price levels and price developments. While intra-EU price dispersions for food and non-alcoholic beverages have been declining overall, significant differences in price dispersion across different products remain, as illustrated in Figure 2, based on an experimental prices' collection¹³. The price dispersion of some basic products such as sugar or

¹¹ As outlined in COM(2009) 563 on "Ensuring efficient, safe and sound derivatives markets: future policy actions".

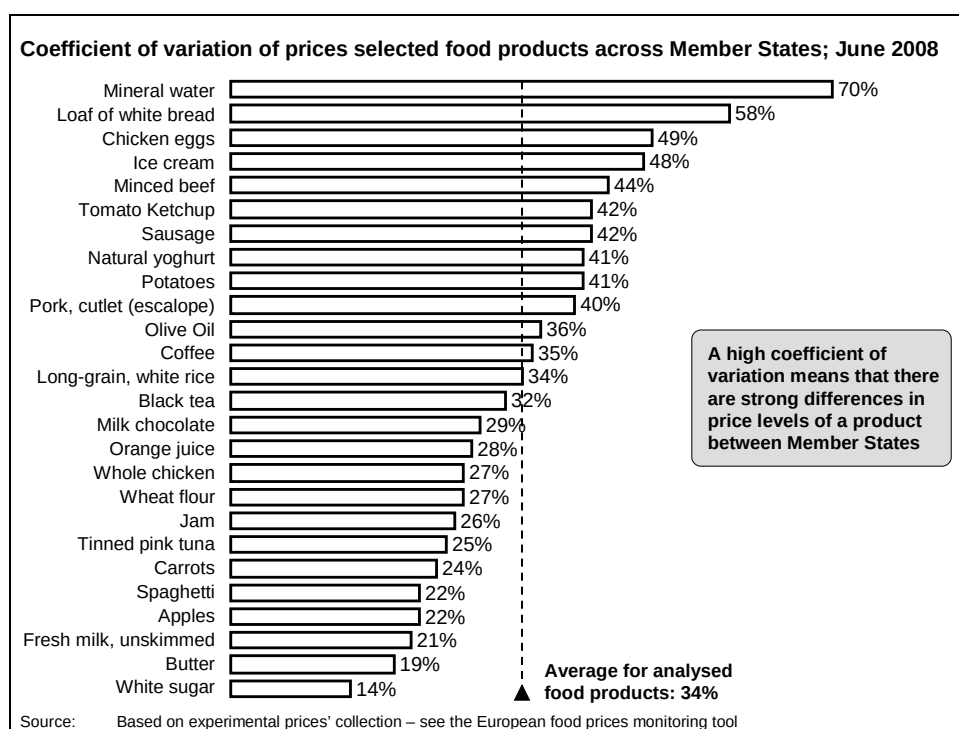
¹² Speculative position limits are limits on how many open derivatives contracts specific categories of traders can hold.

¹³ Price collection conducted by Eurostat for the Consumer Markets Scoreboard and the European food prices monitoring tool.

butter is significantly lower than average; for other consumer products such as mineral water, eggs or ice cream, the price variation is higher than the average dispersion for the food products analysed.

Several national factors, such as differences in average household incomes, preferences in taste, differences in the level of value-added tax or the share of local production, explain some of the observed differences in price levels across countries. However, other factors related to market dynamics and regulatory framework play a role as well. The Commission is engaged in on-going food safety standards harmonisation to further boost cross-border trade in food products. This is of particular relevance in avoiding problems arising from possible emergencies in the food chain originating in a Member State or in a third country. The continued enforcement of the Directive on Unfair Commercial Practices as well as a review of the labelling directive currently underway¹⁴ should also contribute to the increased integration of the food supply chain. Finally, the Commission has taken a number of decisions recently to stop the development of national and regional origin labelling schemes. Moreover it has proposed to develop a new framework for geographical indications, marketing standards and certification schemes in its agricultural product quality policy¹⁵.

Figure 2: Dispersion of price levels for selected products across Member States



Business practices such as constraints on territorial supply or hindrances to parallel trade constitute another key barrier to the integration of EU markets. Stakeholders have reported indications of these practices which are inconsistent with Internal Market principles. A case in point relates to retailers from a given country being “forced” to source locally when dealing with multi-national suppliers, thus raising obstacles to cross-border trade. Such practices are

¹⁴ Proposal for a Regulation of the European Parliament and of the Council on the provision of food information to consumers – COM(2008) 40.

¹⁵ Communication from the Commission on "Agricultural product quality policy" – COM(2009) 234 final.

likely to undermine the functioning of the Internal Market and could negatively affect consumers through higher prices and a narrower selection of products.

In order to remove obstacles and end practices that fragment the Internal Market, the Commission:

- 6. will assess measures to address territorial supply constraints, to the extent that these create economic inefficiencies and contradict Internal Market principles.** The Commission will produce an Impact Assessment based on a detailed study to inform its action by the end of 2010;
- 7. urges the Council and the European Parliament to rapidly adopt the Commission's proposal for the revision of the legislation on labelling rules;**
- 8. will review selected environmental standards and origin labelling schemes that may impede cross-border trade,** with a view to establishing whether the policy objectives of these regulations can be reached with a smaller impact on the integration of the food supply chain; **it will also work with Member States and the industry towards better harmonising the implementation of Community food safety standards.**

3.3.2. Competitiveness of the food supply chain

The agricultural sector is highly fragmented and diverse in terms of size, farm type and socio-economic performance of agricultural enterprises. The current economic crisis is having a very significant impact on the sector by exerting considerable pressure on agricultural prices and income, notably in the dairy and livestock sectors. Although several mechanisms embedded in the CAP have already been implemented to alleviate some of the most negative effects of the crisis, it has reinforced the pressure towards further restructuring the sector.

The agro-food industry is a significant contributor to employment and value-added growth among EU manufacturing industries but growth in value-added and labour productivity within the EU food industry is outpaced by that of the United States. At world level, EU food products are losing market share to Brazil, Canada and Australia. The High Level Group on the Competitiveness of the Agro-Food Industry¹⁶ (HLG), following a comprehensive approach, identified the main issues underlying the competitiveness gap of the sector and proposed a set of 30 concrete recommendations addressed to political and economic actors¹⁷. The HLG acknowledged the lack of transparency in price formation mechanisms and the imbalances between actors as major concerns for the food supply chain. In addition, while urging the EU to maintain a high level of food safety and quality standards, the group identified a strong need for an improved innovation framework, targeted actions on the numerous SMEs in the sector and on the performance of the European agro-food industry on world markets.

¹⁶ Commission Decision No 2008/359/EC of 28 April 2008.

¹⁷ Final report, recommendations and roadmap of key initiatives available at:
<http://ec.europa.eu/enterprise/sectors/food/competitiveness/high-level-group/documentation/>

The retail sector faces a competitiveness challenge as well. Even though the sector has been transformed dramatically over the past decade as a result of increased consolidation, the emergence of hard discounters and the introduction of low cost own labelling, European retailers have experienced lower productivity growth than, for example, their US counterparts over the last decade. Among the several factors that have contributed to this productivity gap, which depends also on the different market dynamics, investment in information and telecommunication technologies and in new business processes appear to have played an important role. Some regulatory features may also have impeded productivity growth in the EU retail sector. Restrictive establishment rules have limited the opening of new stores and thereby the diffusion of innovation¹⁸. Crucially, an ambitious implementation of the Services Directive would make a major contribution to the removal of such barriers.

In order to foster the competitiveness of the food supply chain, the Commission will:

- 9. promote and facilitate the restructuring and consolidation of the agricultural sector** both in the context of the Rural Development policy, notably by encouraging the creation of voluntary agricultural producer organisations, and in the broader context of post 2013 Common Agricultural Policy. This will first be examined for the specific situation in the dairy sector by the recently established High Level Expert Group on Milk;
- 10. take action to bring forward the proposals of the High Level Group aiming to improve the competitiveness of the agro-food sector, notably of SMEs, and to foster innovation and exports in the sector.**

4. IMPLEMENTATION OF POLICY INITIATIVES

This Communication sets forth a number of proposals for tackling the challenges identified. The increase in transparency along the food supply chain and the promotion of sustainable and market-based relationships between stakeholders have the potential to facilitate the European recovery and should thus be undertaken with priority before the end of 2010. The other initiatives address structural issues of the chain, with the aim of improving integration and competitiveness in the longer term. They will be complemented by propositions to strengthen the competitiveness of Europe's retail sector in the forthcoming Communication on the Retail Market Monitoring exercise.

The Commission will issue by November 2010 a report on the follow-up to the actions proposed, on the basis of on-going discussions with EU Institutions and relevant stakeholders. To that effect, the Commission plans to broaden the scope and mandate of the existing High Level Group on the Competitiveness of the Agro-Food Industry, as well as its membership.

¹⁸ These issues will be further developed in the forthcoming Communication on the Retail Market Monitoring exercise.

5. CONCLUSION

The rapid rise and fall of agricultural commodity prices and its delayed impact on food prices have raised concerns amongst stakeholders and policy makers about the functioning of the food supply chain. The market monitoring exercise conducted over the past two years has shown that these concerns are justified. The lack of market transparency, inequalities in bargaining power and anti-competitive practices have led to market distortions with negative effects on the competitiveness of the food supply chain as a whole. Similarly, price rigidities have negatively affected the adjustment capacity and innovativeness of all the industries along the supply chain.

Looking into the future, it should not come as a great surprise that agricultural commodity prices may increase again rapidly as the world climbs out of recession. If the identified market malfunctioning is not addressed soon, there is a risk that consumer food prices will increase in turn disproportionately, leading to a drop in purchasing power and consumer confidence, and possibly slowing the emerging recovery of the European economy. It is therefore of the utmost importance to exert constant vigilance in order to identify and remove market distortions that have contributed to the observed asymmetries in price transmission along the food supply chain.