MARKET POWER AND CONTRACTUAL RELATIONS BETWEEN MILK PROCESSORS AND RETAILERS IN THE HUNGARIAN DAIRY SECTOR

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ABSTRACT

The dairy sector is one of the most significant and problematic branch of the Hungarian food industry. Significant, because the whole dairy sector gives employment for many workers compared with other fields of the agri–food industry and on the other hand the produced milk products represents considerable amount of added value. Problematic branch, because numerous earlier studies make proved that the dairy sector has an asymmetric way of price transmission.

We have made scientific investigation in connection with theoretical and practical approaches towards marketing channel of milk and dairy products with special emphasis in coordination mechanisms in 2005–2007. Behalf of this investigation we have carried out such an empirical experiment, which focused on the contracts between milk producers and dairy processors, as well as between processors and retailers.

We have collected information about the same topics from both parts in connection with general statistical data, general and content parts of the contractual relations, bargain power, relations with partners, obtaining information, and applied marketing and logistics strategies.

As results of these semi-structured interviews we have found very interesting and strange aspects of unbalanced market power, which were supported our basic hypothesis, according to the processors are in a vulnerable, inferior situation compared to retailers. However, an increased economy of scale might improve processors' bargain power against retailers, who try to decrease prices. A good example at increased concentration is represented by *producer organisations and associations* as well (e.g. Alföldi Tej Kft.), which are present *on higher levels within the chain* (processing, export).

Key words: dairy sector, contractual relations, milk processors, retailers, non-price character financial parameters

1. INTRODUCTION

Dairy industry is one of the most significant branches of the Hungarian food industry with a proximately share of 10% from the production of the whole food industry in current prices in past years. Milk processing is placed second among the 18 food branches. 70% of milk produced is processed into dairy products in Hungary.

Concentration process currently taking place in EU can be detected in Hungary as well. Development of the market power is rather unbalanced which can be conducted back to the fragmented milk producers facing with concentrated processors and retailers. Nevertheless, the players of the sector have to compete with the increasing share of imported, significantly lowered priced milk and dairy products in streaming into retail chains (LEHOTA, 2004).

Market structure of Hungarian dairy sector developed recently can be characterised as an oligopolistic one according to shares from trade. Increase in concentration of processing can be described, firstly by recruitment of producers' organisations, secondly by increasing competition among processors and thirdly by depressed prices set by retail chains, as well as by the demand of economies of scale of production and processing (JUHÁSZ, 2005). Building up bargaining power against retail chains aiming to increasing of prices can be also supported by improvement of economies of scale. Our research question is the following: are Hungarian processors able to fight efficiently against over liberalized retail trade? According to our empirical research aiming to analyse the upper part (e.g. processors and retail chains) of the market channel of milk and dairy products, the answer is no, since the valid contracts among them, as well as the system of price setting mechanism show different picture. Unfortunately, like in case of producers, willingness to co-operate is not popular among processors either; hence beneficiaries of present situation are the retail chains. Only very big, mostly foreign companies that have especially large capitalization can build up countervailing power against them (LAKNER – HAJDU, 2002).

2. AIMS AND METHODS

Our surveys conducted at the end of 2007 and the beginning of 2008 aimed at analysing the upper levels within the chain. We have conducted an empiric survey with the primary objective of generally mapping the processes between huge retail chains and their suppliers of milk and dairy products.

To fulfil the research aims we used an appropriate qualitative instrument, which called the system of half structured interviews. To collect the detailed information and to reveal deeper relations we have made personal appointments with the directors of the Hungarian milk processor firms (~50%) and managers of the retailer chains.

Already during the preparation of the interviews (phone calls to make appointments) processors seemed to have highly positive attitude to researches and to set an appointment was easier and faster. In cases of retail chains there is a strict regulation of who can provide information on a specific field, however processors did not seem to consider these rules. Another interesting finding was that while a managing director of a processing firm was aware of all the information we needed, in the retail sector we had to contact several persons in different departments in order to obtain exact information and entirely map the retail chain.

During the selection we tried to interview both the biggest and smallest processors in many regions in the country.

Besides the general statistical evaluation of the examined processors and retail chains, we inquired about the general characteristics and contents of the contracts among them, the bargain power and partner relationship, the difficulties of information gathering and finally about the marketing and logistics strategies they use.

The facts mentioned bellows are collected on semi-structured interviews, but because they asked for anonym we can not specify the exact firms and leaders.

3. MARKET POWER AND CONTRACTUAL RELATIONS

3.1. Mapping the marketing channel of milk and dairy products

Completing our empirical research from the previous years (POPOVICS, 2007A,B, 2008; SZABÓ G. G.– BÁRDOS, 2005A,B, 2006, 2007) *we aimed the upper stage of the dairy sector in 2007 and 2008.*

A number of papers deal with description and examination the marketing channel of milk and dairy products (FERTŐ ET. AL. 2005 AND 2007; HOCKMANN – VŐNEKI, 2007; KŐNIG – MAJOR, 2006; VÁGÓ, 2008; VARGA ET. AL., 2007). Naturally, we assembled a part of the questionnaire based on these bibliographies dealing with marketing channels of milk and dairy products.

Significant proportion of the milk produced is sold through *wholesalers* or *directly to hypermarkets* or *domestic supermarket chains*. A slightly smaller amount is sold to small shops and specialty products (e. g. cheese, organic products) go to export. We must note that the direct selling to institutions, hotels, canteens and restaurants (HORECA) is also important and can reach 20-40 % in case of some producers.

The import of usually low quality products (containing high amount of whey, a by-product of the dairy industry) produced by French and German processors for the third world but sold in Hungary is a great burden to every producer, since these low-priced products have price decreasing effect. Processors consider this as misleading the consumer, since the nutritional value in these products is far from the original product that consumers would actually buy. Most of the consumers are highly price-sensitive and they tend to choose a products if it is 10 Ft cheaper. This price is categorized as dumping price and is used by wholesalers and retailers to force drastic price decrease.

3.2. Characteristics of contractual relationships

One is the so called *annual or perhaps a few-year-long frame contract*, which contain general conditions and stipulations. The term of these contracts is usually defined, contain no exact prices and only the assortment of the product to be supplied is given, from which the difference can reach 10 % in a year. There is a so called *secondary contract* as well, which is usually *shorter* and its term ranges between 1 to 6 months according to market conditions. These contracts contain the agreements on the exact supply details: amount to be supplied, days and date of delivery and terms of payment which is usually 30 days. These *contracts are completed by the list containing products to be supplied and the actual purchase price.*

As regards the *non-price character financial statements* in the contract processors list 10 categories (different kind of bonuses, marketing contribution, campaign contribution, listing prize, shelf prize, price reduction, logistical contribution, developmental bonus, shop opening bonus, coordinating prize, organizing prize, and so on), which retail chains specify in the contract and they regularly pay accordingly. According to some processors, these fees, bonuses and contributions are equally important details of a contract with the date and signature. The average consumer has no idea how big the share of these financial conditions is, and in this aspect the domestic chains fell into close line with big hypermarkets. These parameters are stipulated usually by retailers and they do not do business with a processor who is not willing to meet their financial parameters. We can say that today these parameters are commonly used and they are *considered as some kind of marketing costs that are not connected directly to the product but they provide background information on selling and promotion*. This non-regulated issue puts *processors into an absolutely vulnerable position.* (In 2007, the MKIK Institution for Economic and Business Analysis ordered by the Hungarian Competition Authority has conducted a wide-scale survey titled "Relation between big-volume retail chains and their processors", in which they list 81 pretences of contributions based on in-depth interviews and questionnaires) (MKIK GAZDASÁG ÉS VÁLLALKOZÁSELEMZŐ INTÉZET, 2007).

Asymmetric power distribution is represented by the *issue of sanctions* as well if there is a (partial) default of the contract, since these sanctions are practiced in one direction, i.e. retailers can exercise the right of out listing and payment of penalty and lower prices. True, considering the upper there are few problems arising from default of the contract, since processors at all cost strive to meet the stipulations stated in the contract. *The other way round*, if the wholesaler fails to pay, the *only measure the producer can take is to terminate the contract*. However, it happens only in exceptional case, since in this case only after a long legal procedure would producers get the payment for their goods, entering a different marketing chain is difficult and the product being perishable there is no possibility to store or retain the product. One way of achieving a longer storage is processing into powder but these type of firms have been closed down in Hungary. The other way is producing UHT milk, but in case of fresh products long-time storage is impossible.

We have to mention that *millions have been lost on exported products in 2007.* Therefore, in foreign trade it is common to pay in advance for the product, especially in the case of special food items, such as cheese, organic products, etc. Besides the upper statements, the export of goods is also supported by the fact that while processors in the domestic market are price-takers, in the export markets (e.g. Italy) they have more bargaining power, since they sell no bulk products but individually produced premium items with higher added value.

The c*alculation of processor prices is usually according to a mutual agreement,* but in most cases the actual enter into a contract is dependent on the commercial partner and processors hardly have chance to influence the non-price character financial parameters mentioned above.

In most cases processors have the right to supply their preferable *product portfolio* for retailers, but the market demand rapidly reveals which product has justification in the market. Thus, after 2-3 transports it is made clear by the turnover that a product should not have been forced to be sold to consumers.

The *timing of delivery* is influenced by Hungary's EU accession as well, since according to the European regulation night transportation into stores is prohibited. Usually the big supermarket chains specify a given period for transportation, but the centralized sourcing using depots are also present and in this case timing is more flexible. In case the time for delivery is a fix date the logistics strategy would be changed and suppliers would schedule the other transports accordingly.

3.3. Private labels and brands

Objectively, we can state *that neither the usage of private labels nor processor brands increase the bargaining power at the processors*. In case of processor brands an *exception* is the *production of special unique products*, with which the bargaining power might be improved. It is resulted from the fact that consumers are only interested in the highlighted information on the package and the most important factor they check is the price. If the name of the product is in Hungarian (even if it is misspelled) almost everything can be sold, even import products provided that they are cheap enough. The use of private labels has fallen into discredit due to some retailers. In consumers' concern the notion of private labels is linked not to quality but to low price and thrift. The *use of private labels divides consumers into two groups (segments),* it inspires some of them to buy the product because its cheap, while for the group of "conscious" consumers it suggests to buy anything but it.

From the processor point of view, we can only understand the useless role of brand names if the balance of power is mapped, since in this case the system works the other way round... Namely, there is not such a situation that the processor decides or conducts research to get to know the right nutritional value for digestion or realises that strawberry chunks in yogurt are appetizing. Unfortunately, in real life wholesalers are not interested in the nutritional value or desirability of the product; it can even contain 99 % whey. What the wholesaler is only interested in is that he intend to spend HUF 39 on a yogurt, it should have a nice design and be homogeneous. Then production can be launched and if the producer cannot take these conditions he will promptly find another supplier either in the domestic or foreign market.

3.4. The reasons for and the difficulties of changing the commercial partner

Processors *consider the changing of the commercial partner very difficult,* since they only change their established suppliers if serious problems occur or if another partner's offer is much lower than the average market price. However, the latter case requires substantial financial investment on behalves of the suppliers, since it is not common to have a wide price gap. *Pluriactivity is common among processors and they try to be present through various channels,* in case the relationship with one break still could continue production with another. Although processors continuously strive for partner stability, changes still occur, because retailers (having a better offer from a competitor) try to push prices even lower, and this time the processor has to terminate their business. *The number of commercial partners has been clearly increased since our EU accession.* The reasons why a processor chooses a certain commercial partner and not another one are *primarily geographical closeness, personal contacts, current contractual and suitable transport conditions* and not routine, reliability and favourable price, which would also reflects some kind of vulnerability.

The usual *term of contracts with commercial partners is 3 year* and processors emphasized the importance of partner stability, however they added that one who knows the current situation would not rank this first. According to processors, *the reason of terminated contracts is unacceptable bulk prices and the unreliability of the partner*.

4. CONCLUSIONS

As results of the semi-structured interviews some very interesting and notable aspects of the unbalanced market power have been revealed, which supported our basic hypothesis, i.e. processors are in a vulnerable and inferior situation compared to retailers.

Both the parameters of the contract and the system of price agreements confirm the upper statement. Typically most parts of the contracts are heavily influenced by the retailers; moreover the contracts contain a special part, consisting of the so called “non-price character financial parameters” (e.g.: listing fee, various donations, and bonuses). Applying of these parameters both players mentioned as a critical question, retailers tried to cover it, while processors were upset because of it. One thing is sure, that these repayments mean significant additional cost for the processors.

Unfortunately, *like in case of producers*, *willingness to co-operate is not popular among processors either;* hence the beneficiaries of the present situation are the retail chains. Only very big, mostly foreign companies that have especially large capitalization can build up countervailing power against them. However, an increased economy of scale might improve processors' bargain power against retailers, who try to decrease prices. A good example at increased concentration is represented by *producer organisations and associations* as well (e.g. Alföldi Tej Kft.), which are present *on higher levels within the chain* (processing, export). (SZABÓ, G. G. – POPOVICS, 2008).

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