

**CRESC Public Interest Report**

**BRINGING HOME  
THE BACON:  
from trader  
mentalities to  
industrial policy**

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# BRINGING HOME THE BACON: from trader mentalities to industrial policy<sup>1</sup>

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## Preface and Disclaimer: About This Report

This is a public interest report based on independent research into the pig meat supply chain from the Economic and Social Research Council (ESRC) funded Centre for Research on Socio Cultural Change (CRESC) at the University of Manchester. Karel Williams led an intensive six-month research project in the first half of 2012 and the project's full time researcher was Andrew Bowman. This specific project was co-funded by the ESRC and a meat processor, VION UK who considered there to be a need for an independent, non-partisan academic review of the supply meat chain, and an exploration of alternative models that might better suit the changing environment. The CRESC researchers are solely responsible for the contents of the final report but they have benefited from supermarket, processor and producer comments on a draft of the report.

The report utilises a variety of empirical sources, primarily drawing upon publicly available information in the form of published company accounts, official statistics, media coverage, reports produced by relevant government organisations and trade associations, and other academic studies. In addition, we conducted interviews with representatives from a variety of different organisations relevant to the study, including major supermarkets, food processors, producer associations, government departments and trade unions, as well as organisations representing the pig meat industry in the United States, the Netherlands and Denmark. The interviews were tested and triangulated against other sources. Many interviewees requested confidentiality to protect commercial interests, and so the report does not quote from or name individual interviewees.

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<sup>1</sup> A free copy available to download from <http://www.cresc.ac.uk/publications/bringing-home-the-bacon-from-trader-mentalities-to-industrial-policy>

Beyond this, we would make two supplementary points about our relation with our sponsor VION and about the multi-disciplinary team which produced the report. In both cases, we wish to record our appreciation of their support of and commitment to the project.

Firstly, within VION, we are grateful to Steve Francis for initially championing the report and to members of his team for generously giving us their time. We have drawn on their knowledge of the supply chain but have also carefully avoided discussing company specific issues with VION managers, and we avoided discussion of issues where their view point might compromise the independence of our research. Secondly, we reiterate that this research is co-sponsored by but completely independent of the VION Food Group. Researchers did not obtain confidential information from the VION Food Group. So, for example, the case studies of the costs of supermarket practices and the profitability of processor firms are assembled entirely from publicly available sources, which have been referenced in the text. The description of supply chain relations in the report applies to the whole sector rather than the VION Food Group specifically. Additionally, we stress that responsibility for the policy recommendations in the final section of the report rests entirely with the researchers. The recommendations are not reflective of the corporate position of the VION Food Group nor of individuals within it.

The CRESC centre continues to facilitate and support interdisciplinary research in a way that is unique. Karel Williams and Andrew Bowman took primary responsibility for research design and drafting but a team of senior researchers from diverse backgrounds closely supported them. The team has in different combinations now worked together on a variety of related projects on the on-going financial crisis and on industrial policy choices, where CRESC outputs include a working paper on rebalancing the economy and a public interest report on train building. Julie Froud originally worked as an agricultural economist; Sukhdev Johal is an accounting expert who has run a small business; Adam Leaver has a background in politics and labour studies; John Law moved into sociology from science and technology studies. The dialogue within a diverse team drives the imagination of this report.

This co-investment was one amongst a series of pilot projects funded by the ESRC and we hope the results of this project encourage the ESRC to invest more in new kinds of research, which are radically interdisciplinary and involve knowledge exchange with the private sector.

## Executive summary

- As policy makers seek to rebalance the economy away from financial services and towards manufacturing industry, the concern with developing high tech export sectors needs to be balanced by a focus on defending ‘mundane’ everyday activities in which the UK has an opportunity to reduce its import dependence. The pig meat supply chain is one such example.
- The pig meat supply chain is going through a prolonged and unresolved crisis. The size of the national pig herd has declined by around 50 per cent over the past decade while over a similar period the UK has gone from 80 per cent self-sufficiency in pig meat to less than 50 per cent self-sufficiency. This worsens the UK’s trade deficit and diminishes UK employment.
- This is a classic example of UK failure in tradable goods against North European competitors. The UK’s growing volume of pig meat imports do not come from low wage Eastern Europe or Asia, but from Northern European countries where wages are higher and the workforce less flexible. In Denmark and the Netherlands, which provide over 50 per cent of the UK’s bacon, wages in meat processing are nearly double those in the UK.
- The UK supply chain crisis was occasioned in the late 1990s by a combination of stricter animal welfare laws, a strong pound and animal disease outbreaks. The crisis continues and cannot be resolved because of what we call “opportunistic dealing” right along the chain which undermines efficiency and create a dysfunctional, adversarial food supply chain.
- As British pig producers and processors lost out in the 2000s, British supermarkets succeeded in delivering shareholder value and low prices to consumers. The two outcomes are interconnected because supermarket success depends on their ability to squeeze lower prices from processors and producers along the chain.
- The major supermarkets have a ‘trader mentality’ whereby relationships with suppliers are short-term and subject to change so that supermarkets can extract more value from other actors. Their methods include flexible ‘supply agreements’ instead of contracts, playing suppliers off against one another in an oversupplied market and funding promotional activity largely through processor contributions.
- The opportunistic practices of the big supermarkets encourage and enforce imitation by other actors up and down the chain but supermarkets are the only ones powerful enough to make a financial success of it.

- Pig producers and processors struggle to sell their products at a profit and utilise their production capacity. This discourages productive investment and entrenches the UK pig industry's disadvantage compared to foreign competitors. It also encourages a worsening of pay and conditions for the workforce, and undermines job security.
- This system is economically unnecessary because there is a better way, which delivers on broader economic and social objectives. The more integrated and consolidated national models of the Danish and Dutch pig industry or the profitable in-house UK processing operations of Morrisons represent the alternative, which uses a higher proportion of British meat compared to the other major supermarkets.
- The Morrisons model aligns the interests of firm, supply chain and society. Morrisons runs its vertically integrated processing plants at full capacity and proves the benefits of plant loading with demand stabilised. The firm increases margins, reduces transaction costs and controls quality. Society gains through reduced import dependence, stable employment and the capacity to address animal welfare and climate change.
- The big three supermarkets cannot choose a better way as long as they are locked into their present business model through the demands of the stock market and their own mentality and practices. Therefore, much depends on whether government can and will play a constructive role in persuading firms to change their business models.
- Government has so far failed to recognise the pathology and dysfunction of the pig meat supply chain because the relevant ministries and agencies refuse to intervene in what they see as beneficial competition. UK government policy interventions have hitherto involved a series of unsuccessful voluntary initiatives and attempts to perfect the market.
- Large changes in behaviour and improvements in supply chain performance depend on ownership change and reorganisation. First, government should encourage vertical integration of supermarkets with processors by targeted tax breaks for retailers which increase their manufacturing value added. Second, horizontal integration of producers should be encouraged by support for the creation of co-operatives and assistance to those seeking to leave the industry.
- Government should also increase the powers of the Grocery Code Adjudicator to enforce contracts that give food manufacturers the stability and assurance they need to improve their productivity and lower costs; and restrict many forms of supermarket promotion which are both harmful to supermarket suppliers and misleading to the consumer.

## Policy Recommendations

### Creating Incentives

1. We recommend that *fiscal concessions* (including corporation tax rates lower than the current 24%) *should be offered to all firms in grocery retail with a chain connection to priority sectors such as the UK pig industry.*
2. We propose that these should be linked to *firm level delivery of the crucial economic objective* of increased UK value added. This would effectively encourage integration of processing, as the retail grocery market is mature and not growing; while merger between the big four chains is quite rightly blocked by the competition authorities.
3. We recommend a national debate about whether large national supermarket chains are necessary and specifically about what would be lost and gained if Tesco, Asda and Sainsbury's were split up into regional chains (e.g. Tesco North and Tesco South or Sainsbury East and West)

### Regulating for longer-term chain balance

4. We recommend that the government should move beyond its current 'code of good practice and adjudicator' model for regulating retailer-supplier relations.
5. We recommend that The Grocery Code Adjudicator regulator should secure better practice by reserve powers to enforce model contracts and minimum contract lengths, as well as discouraging, through strong punitive and investigative powers, variations in terms of supply without retailers providing notice and compensation.
6. We recommend that the grocery regulator should immediately curb price-based promotions for staple products which should be phased out with in a period of one year.

### Securing horizontal integration

7. We recommend that government should provide expertise and financial support to create a few large producer co-operatives; one or more of those supported should be encouraged to move into processing as a way of aligning interests and balancing profits at different points in the chain.
8. We recommend that the government sets up a pig meat producer board charged with developing an indicative plan for (a) the physical configuration of an intensive

pig meat production sector which balanced cost competitiveness and higher standards of welfare and (b) the financial investment in new facilities required and how major players like the big new producer retailers could be persuaded to make the investment.

9. We recommend that the pig meat producer board separately defend small traditional framers under an artisan programme whose aim would be to raise quality, increase farm processing and expand the distribution channels available to small-scale producers.
10. We recommend that the government require the four major supermarket chains to set aside dedicated counter space for accredited local and regional artisan suppliers employing less than ten workers. This is because existing channels such as farmers markets do not connect with the mass weekly shop.

### **Aligning interests and redistributing knowledge**

11. We recommend that government should financially support and intellectually encourage an innovative technical and business education, within each region from FE College to university management school. The curriculum should be designed so that senior managers within and beyond the sector can understand the diversity of possible business models; and all managers develop the skills and competences needed to manage supply chain relations in a different and less adversarial way.
12. We recommend a producer board levy which would be directly applied to sustaining one research active, university centre of excellence in meat trade applied economics

### **Encouraging action by civil society**

13. We recommend that civil social organisations and trade unions should campaign for changes in supply change conditions alongside government policy initiatives.

## Introduction

This is a report about pig meat production and retailing, which raises much larger issues about Britain's dysfunctional manufacturing supply chains and its decline in industrial capacity. The report seeks a broad audience, aiming to refocus public attention and redefine policy issues in two ways. Firstly, the report seeks to shift attention away from the transient success and failure of retail supermarkets in winning market share and profits and towards the supply chain behaviour of supermarkets, processors and producers. Secondly, the report seeks to shift the focus in discussions of rebalancing the economy through industrial policy away from high tech sectors of the future towards what we call 'mundane activities' and everyday necessities which are crucial to trade and security and have the potential to generate high levels of regionally distributed employment.<sup>2</sup>

Through the case of pig meat production, the report highlights the waste and harm caused to British manufacturing supply chains by opportunist dealing. The report focuses specifically upon the activities of the 'big three' supermarkets (Tesco, Asda and Sainsbury's) and their relations with the meat processing firms that supply them. More positively, the report shows there is a different and better form of supply chain organisation where vertical integration alongside horizontal cooperation and consolidation could lower costs, align incentives and balance power.

Put another way, what we want to do is start a debate about the consequences of the mentalities and practices which supermarkets, processors and farmers share. The current high profile issue for business journalists and investment analysts is the stumbling performance of Tesco, our largest and most successful supermarket chain, which has moved through profits warning to promises of improvement. However, few have noticed that Britain's fourth largest supermarket chain, Morrisons, is profitably expanding a non-standard business model focused on in-house value added and vertical integration along the chain of meat production and other fresh produce. Instead of an investor debate about this quarter's profits, we want to start a political debate about business models and their supply chain consequences. This report shows that the 'Morrisons model' of chain integration is more desirable both economically and socially, and if widely applied can help deliver a rebalanced economy.

Supermarkets may have delivered shareholder value and low prices for consumers at the final point in the supply chain, but the success of the supermarkets depends on practices that impose less visible costs elsewhere. With overall demand in the grocery sector rising very slowly in recent times, the leading supermarkets have sought to preserve their grocery profits through a zero-sum game for market share played against other retailers. Besides

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<sup>2</sup> For a more detailed definition of the 'mundane activities' concept, see the appendix.

simple expansion of floor space and coverage, market share is won and lost through various forms of value engineering and discounting, which usually entail squeezing suppliers for lower prices through short-term imposition of terms and demands for rebates. Supermarkets thereby become more value extractors than value creators, using their market power to take margin from others along their supply chain.

This has very little to do with the iron laws of economics but much more to do with a set of cultural preferences and business practices which are led by the supermarkets but ubiquitous right along the chain. Actors in the pig meat supply chain for the major supermarkets operate with what we call a 'trader mentality'. The trader mentality is manifested in pervasive short-termism, fixation upon undercutting competitors and an instinctively adversarial approach to transactions where the trader envisages his activity as part of a zero sum game with many moves. The most powerful actors, the major supermarkets who seek supplier relationships that can be renegotiated if better opportunities arise, set practices right across the chain. Suppliers then adapt similar behaviour traits in order to survive and few have long-term partnerships based on trust and mutual interest.<sup>3</sup>

The outcome for the pig industry has been a fragmented, adversarial and disorganised supply chain in which relationships are short-term and confidence and trust are low: short term can mean many things and in this case, it means relations which are much too short and uncertain to sustain producer and processor investment. The industry is hampered by pathological competition occurring both vertically within the supply chain and horizontally between similar firms, leading to a destructive form of behaviour which we call 'opportunistic dealing'. This denotes the use of any means available to secure lower buying prices from suppliers whether by tapping into new sources of cheap imports, playing different suppliers off against one another, or engineering advantageous supply agreements. Opportunistic practices work through a combination of ingenuity and the exploitation of favourable power imbalances where they arise.<sup>4</sup>

Within this frame, the major supermarket chains use their position of power in a market defined by oversupply to extract margin from processors through continual re-negotiation of supply agreements. As profit margins move up the chain to the supermarkets, the burdens of risk (e.g. grain price fluctuations) and adjustment (e.g. factory closures, and the churning of orders) are passed upstream to meat processors and subsequently, to pig meat producers (farmers). The financial outcome is disputed but major processors struggle to break-even on mass-market items, and some producers lose considerable amounts of

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<sup>3</sup> This conceptualization draws from Taylor, D.H. (2006), 'Strategic considerations in the development of lean agri-food supply chains: a case study of the UK pork sector', *Supply Chain Management*, Vol. 11 No. 3, pp. 271-80. For a fuller definition and explanation of the concept, see appendix.

<sup>4</sup> For a fuller definition and explanation of the concept, see appendix.

money on each pig while those processors and producers who are doing better can never be secure enough to plan investment.

So why does this division of profits matter? Department of Environment Food and Rural Affairs (DEFRA) policy makers, civil servants and politicians of all main parties, fail to recognise the problem because the official mentality frames the processes described above as healthy competition without any gross market failure that would justify intervention. This report raises two concerns about this framing. First, opportunist practices incur costs which do not figure in the supermarket accounts as, for example, the churning of orders between suppliers routinely undermines capacity utilisation and occasionally requires the quite pointless closing of one factory and the opening of another. Second, with demand uncertain, the incentive to invest in long-term productivity enhancements is diminished in favour of short-term trading strategies. This locks Britain into high cost production of pig meat because no sensible British farmer or processor would invest in large-scale production or could organise vertical integration on the Danish model.

Pig meat (like most other agricultural commodities) is a tradable good and the UK is failing in pork and bacon production and processing. This is a variant on the old story of British industrial decline because in pig meat the UK is losing out to high-wage northern European producers and processors, rather than low wage outsourcing destinations in the Asia. When more than 60% of our bacon is imported, that adds to the UK's balance of payments deficit in traded goods – which at £99.68 billion in 2011 is the largest in recent history – and raises issues about food security.<sup>5</sup> Pig production and processing is a (small but significant) part of our largest manufacturing sector. As the UK Government Department of Environment, Food and Rural Affairs (2012) notes,

*Food and farming is very important to the UK economy, with the whole food chain contributing £88 billion per annum (i.e. 7% of GDP) and 3.7 million jobs. The food and drink sector is the UK's largest manufacturing sector by Gross Value Added (£23.4bn) and employment (379,000). It offers employment across the skills range from basic processing skills to food scientists, technologists and cutting edge engineers.<sup>6</sup>*

The pig industry is both a bellwether for the meat industry in general, and a 'foot-fall generator' in supermarkets (a heavily promoted item used to lure customers from one retailer to another) meaning it has disproportionate significance in food retail. So 'Bringing Home the Bacon' is relevant to the current debate about the need to rebalance the economy through new kinds of industrial policy. Rebalancing is commonly understood to require an expansion of manufacturing, a reduction in the trade deficit, and a lessened

<sup>5</sup> Agriculture and Horticulture Development Board (2010), *A Pocketful of Meat Facts 2010*. Kenilworth, p. 40. Office for National Statistics (2012), ONS, Balance of Payments quarterly, First Release. March 2012 (<http://www.ons.gov.uk/ons/datasets-and-tables/data-selector.html?cid=BOKI&dataset=pnbp&table-id=E>.)

<sup>6</sup> DEFRA, Food Industry, Supply Chains (<http://www.defra.gov.uk/food-farm/food/food-industry/>)

economic dependence on financial services and household and government debt. The debate has encouraged an interest in re-examining the discredited practice of ‘industrial policy’ delivered by an interventionist state, and many have focused upon identifying favoured high-tech ‘sectors of the future’ in which Britain could become a world-leading exporter (e.g. nanotechnology, renewable energy, or digital technology).<sup>7</sup>

Such initiatives are welcome, but we would highlight in addition the potential for economic renewal from the re-organisation of more ‘mundane economic activities’. In this usage, the term mundane is not pejorative but descriptive, denoting those economic structures and activities necessary to social existence and reproduction for everyone in society regardless of income and social position. The mundane includes infrastructure like broadband provision, necessary utility services like water or electricity and the weekly food supply. It can be the basis for reducing imports and redressing the UK’s trade imbalance, increasing employment, job security and distributing profitable value adding activity across the UK’s regions. Thus, the reorganisation of mundane activities through new forms of government policy intervention is a key area of economic opportunity.

The pig meat case examined here suggests that everyday mass consumed, imported items could be produced domestically for the same cost to the consumer, but with substantial benefits to the wider UK economy. The reorganisation of meat supply chains is not a template for manufacturing revival, but it is important exactly because it forces us to think about sector specific interventions instead of the generic policies favoured in much existing debate.<sup>8</sup> Food production and processing is additionally significant because not only is it the UK’s largest manufacturing sector, but also because it has almost unique potential to create value added in the UK’s hard-pressed de-industrialised and rural regions.

There is a better way available if the supermarkets adapt their business models. They could be encouraged by a more engaged, sector-specific industrial policy using fiscal levers to vertically integrate and thereby quite literally take ownership of the supply chain problems they are creating. The increased power of the vertically integrated supermarkets should then be balanced by horizontal integration through producer co-operatives. Using the example of Morrisons, which has been pursuing a strategy of vertical integration for their meat supply, we argue that changes which benefit the processors and producers need not disadvantage supermarkets. Tesco’s recent troubles reflect wider issues in grocery retail that have been partially hidden by food price inflation. In our view, the dominant business

<sup>7</sup> Department for Business, Innovation and Skills (2012), *UK Trade Performance Across Markets and Sectors* BIS Economics Paper No. 17, (2010), *Manufacturing in the UK* BIS Economics Paper No. 10b, HM Government (2009), CBI (2012), *A Vision for Rebalancing the Economy: A new approach to growth*, Unite the Union (2011), *Manufacturing UK: 2020 Vision*, Mazzucato, M (2011), *The Entrepreneurial State* Demos, Glenie, A and Straw, W (2012), *The Third Wave of Globalization*(IPPR), New Economics Foundation (2012), *Good Jobs for Non-Graduates*

<sup>8</sup> CRESC (2011), *Rebalancing the Economy (Or Buyer’s Remorse)* Working Paper no. 87

models are in any case reaching their limits because they struggle to deliver growth and profits to keep the shareholders and the stock market happy. Thus, there is the potential for significant benefits for a wide range of groups.

## Part 1: The agreed facts and recrimination about decline

In adversarial supply chains, as in dysfunctional families, there are always competing accounts of who is to blame and how. So maybe it is best to begin with the generally agreed and indisputable facts about the pig industry. These are sobering because the recent history of the UK pig industry is one of crisis and decline. For over a decade pig producers (and processors) have struggled to earn a profit while watching European competitors capture market share.

**Exhibit 1: UK consumption of pig meat 1990-2010 (000s tonnes)<sup>9</sup>**

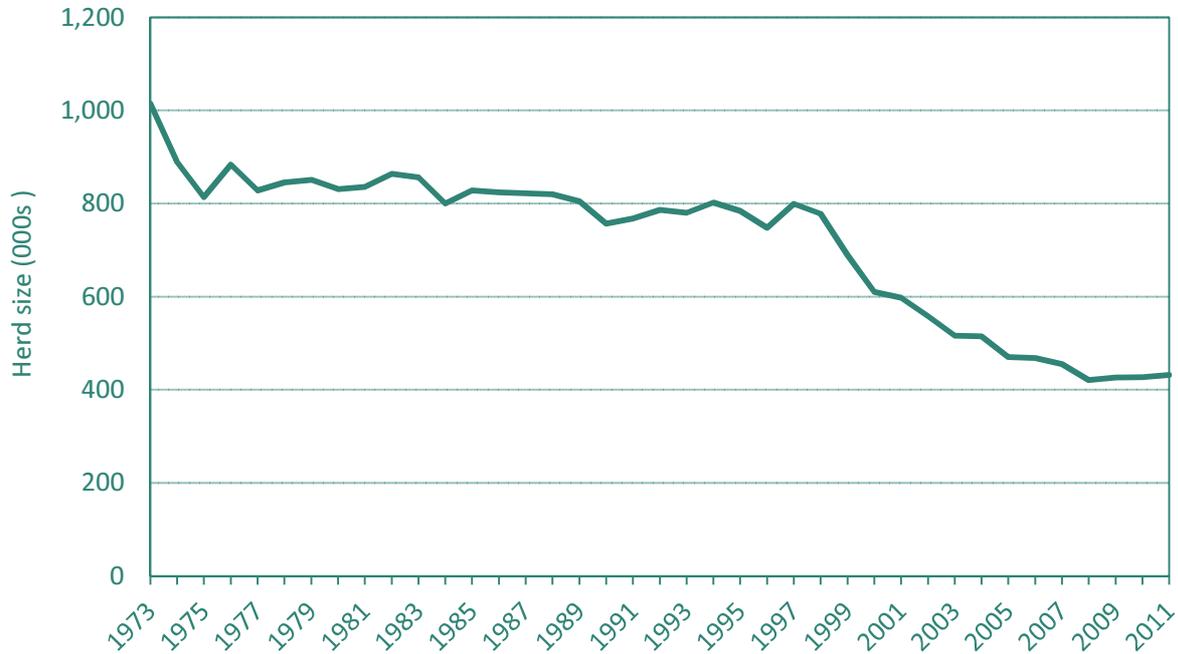


The crisis has nothing to do with the popularity of pork, bacon and sausages which are “value” meat products for British consumers. The total market value of pig meat produced for the UK in 2011 was, according to BPEX figures, over £8 billion. Both the volume and the value of pig meat consumption have been rising steadily over the past two decades prior to the fall in consumption taking place with the onset of recession (exhibit 1). At the same time though as exhibit 2 shows, the size of the UK pig herd and the UK’s overall self-sufficiency has dropped precipitously. In summary, the UK went from over 80% self-sufficiency in pig

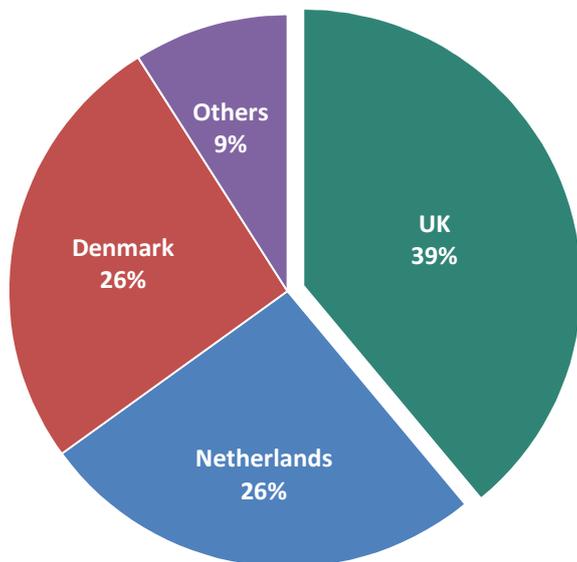
<sup>9</sup> BPEX

meat in the late-1990s to less than 50% in 2008, with a related fall in the number of breeding pigs from around 800,000 in the mid-1990s to less than 450,000 in 2010.<sup>10</sup>

**Exhibit 2: UK female pig breeding herd<sup>11</sup>**



**Exhibit 3: Source of UK bacon consumption in 2010<sup>12</sup>**



In some product categories, the story is worse: in 2009, for example, British producers accounted for less than 40% of the UK bacon market (exhibit 3).<sup>13</sup> As exhibit 4 shows, the deficit in UK pig production is matched by oversupply at the EU level. Although the UK's pig meat exports have increased by over 50% between 2005 and 2011, as exhibit 5 shows, this is from a very low base and still pales in comparison

<sup>10</sup> BPEX / DEFRA, UK Pig Breeding Herd

<sup>11</sup> DEFRA. Note: June census date.

<sup>12</sup> AHDB / DEFRA / HM Revenue and Customs.

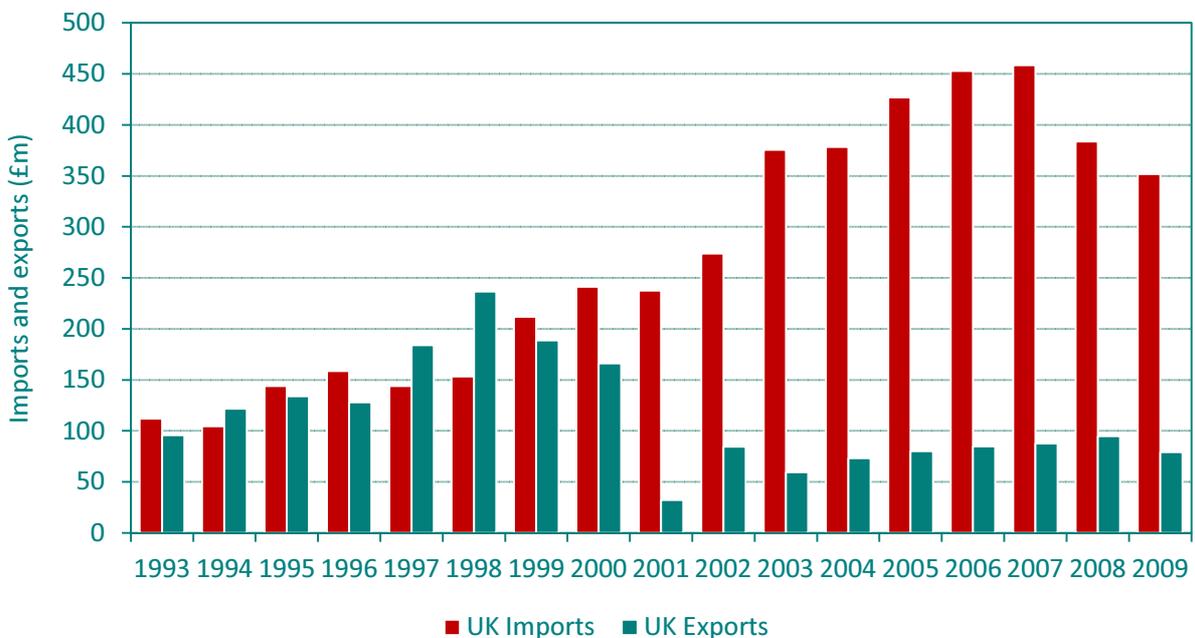
<sup>13</sup> BPEX, *A pocket Full of Meat Facts 2011*

to the levels of imports. As of 2008, only four other EU nations were doing worse than the UK in terms of pig meat self-sufficiency – Bulgaria, Greece, Latvia and Lithuania.<sup>14</sup> Exhibit 6 shows that the UK's main source of imports of bacon and ham are from Denmark and the Netherlands.

**Exhibit 4: UK and EU 27 self-sufficiency in pig meat production<sup>15</sup>**



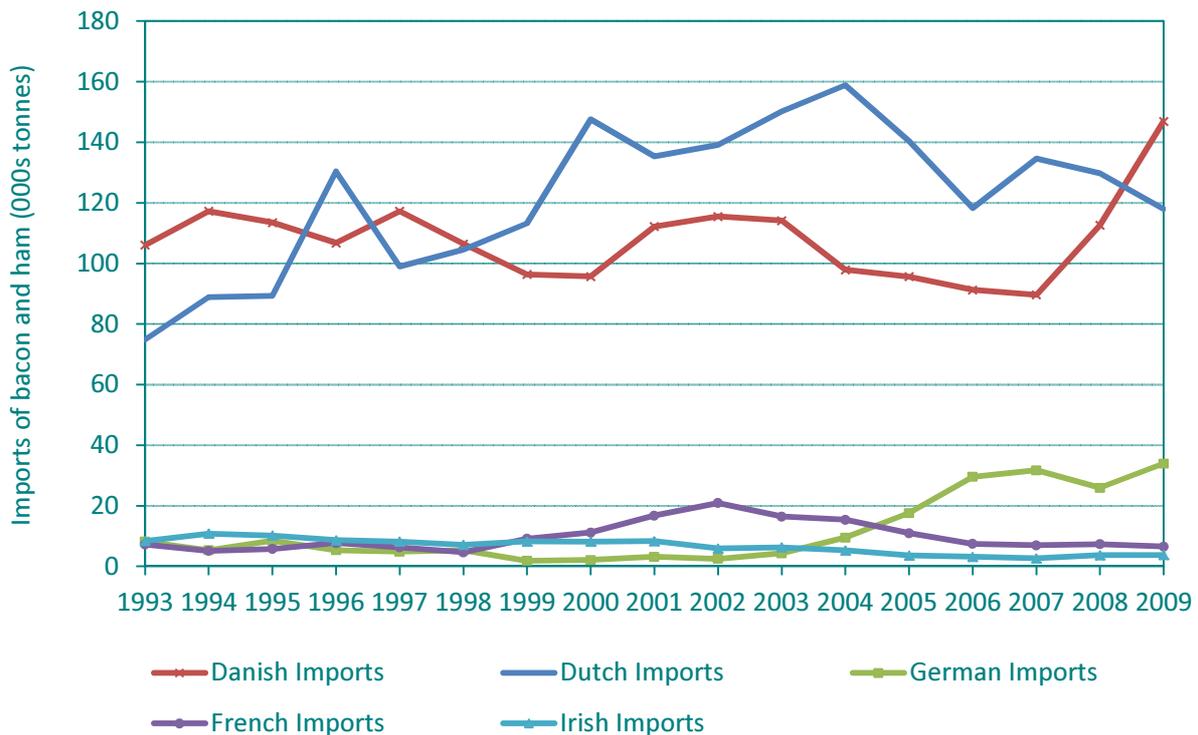
**Exhibit 5: UK pork trade with the EU26<sup>16</sup>**



<sup>14</sup> BPEX, 'EU pig meat self sufficiency' (<http://www.bpex.org.uk/prices-facts-figures/consumption/EUpigmeatself-sufficiency.aspx>)

<sup>15</sup> DEFRA

<sup>16</sup> HM Revenue and Customs

Exhibit 6: UK imports of bacon and ham (000 tonnes)<sup>17</sup>

This is an industry in decline and unsurprisingly, alongside steep falls in output (exhibit 7); levels of gross fixed capital formation (exhibit 8) have been falling steadily. The standard story of globalization has it that nations such as the UK must accept the loss of a good deal of their industry to low-wage competitors in other parts of the world. In this case, however, British producers have lost market share to competitors in other Northern European nations, predominantly the Netherlands and Denmark, whose production costs are lower though their labour costs are significantly higher than the UK. Production costs in the UK have been higher than the EU average for most of the past decade.<sup>18</sup>

What brought this situation of terminal crisis and import dependence about? A few proximate causes are widely agreed upon. In the late 1990s and early 2000s, widespread outbreaks of Foot and Mouth disease and Classical Swine Fever drove many British farmers out of business (exhibit 7). Capacity reduction combined with the appreciation of the pound against European currencies (66-70 pence against the Euro between 2003 and 2007), so that imports became increasingly attractive to retailers and processors. Animal welfare reforms introduced in 1999 banned the use of close-confinement stalls and tethering. BPEX, the pig industry statutory levy claimed this added 6.4 pence per kilo to the cost of production, although animal welfare groups claim the actual impact was closer to 2 pence (to

<sup>17</sup> DEFRA

<sup>18</sup> BPEX,

<http://www.bpex.org.uk/downloads/301365/299415/2009%20Pig%20Cost%20of%20Production%20in%20Selected%20Countries.pdf>

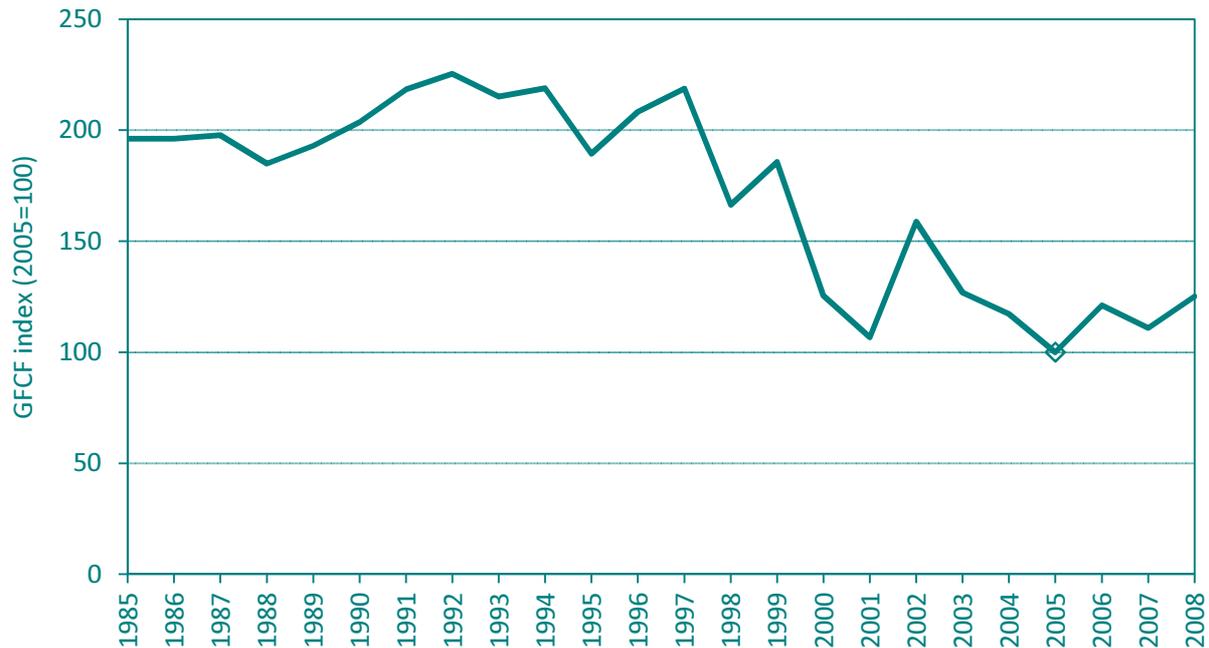
contextualise at the time of writing, the deadweight average pig price (DAPP) is 146.3 pence per kilo, with the average DAPP fluctuating between 110 and 150 pence over the past five years).<sup>19</sup> In any case, the reforms did add significant extra costs to UK producers. Raised standards meant that a substantial proportion of the imported pig meat on sale in Britain was reared below UK legal standards and illegal if UK legal jurisdiction applied. New welfare laws will be introduced across the EU in 2013 and will move EU standards closer to the UK, although doubts remain over whether the rules will be adequately enforced in mainland Europe.<sup>20</sup> Volatile grain prices are the other proximate cause of producers' problems. In 2011 BPEX estimated feed accounted for 77 per cent of the cost of production – small fluctuations in price therefore swing farmers between profit and loss, and in recent times, the fluctuations have been large with the heaviest costs falling on pig producers. Grain price volatility is of course a global problem, affecting Dutch and Danish producers as well. However, as will be explored below, British producers claim that risk distribution within the supply chain means that they feel the effects of these rises more keenly than many overseas competitors.

**Exhibit 7: UK pig farming output**<sup>20</sup>



<sup>19</sup> House of Commons, EFRA Select Committee (2009), *The English Pig Industry*, Note 16, (<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmenvfru/96/9605.htm#note16#note16>)

<sup>20</sup> *Food Manufacture*, 'Retailers should check pork meets EU standards' 4 November 2011, (<http://www.foodmanufacture.co.uk/Sectors/Meat-poultry/Retailers-should-check-pork-meets-EU-standards>)

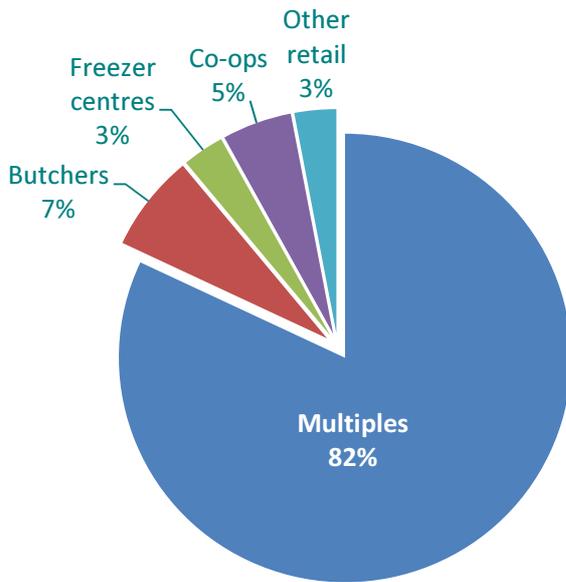
**Exhibit 8: Gross fixed capital formation in UK pig farming<sup>21</sup>**

These factors combined to produce a precipitous decline in output beginning in 2000 which the industry has yet to recover from. Despite this, the government has offered little direct support to the industry beyond subsidies in the immediate aftermath of disease outbreaks. This fits with the long-term policy decision that the production of pigs (like chickens) is of course subject to regulation but on the market so that agricultural policy intervention is not used to sustain domestic or EU production levels. When the result is decline in the UK pig meat industry, the major players all have different narratives about how someone else is to blame.

## 1.2 Blame and alibis

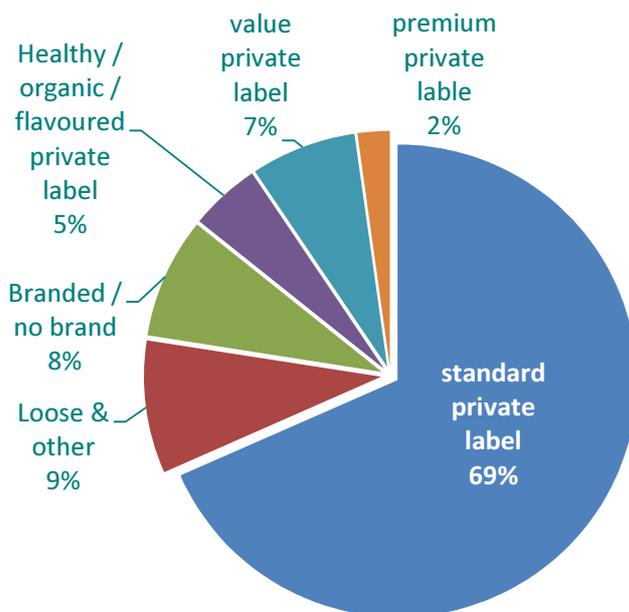
If the facts are agreed, there are fundamental disagreements among different actors over the question of ‘who is to blame? And the only recurrent theme is that the guilty actor is always someone else. Producers and processors compete to tell different stories about their victim status; both blame the conduct of the supermarkets (though, for reasons discussed further below, only producers tend to do so publicly), who in turn cite the alibi that what they deliver for consumers and shareholders justifies their behaviour.

<sup>21</sup> DEFRA

**Exhibit 9: GB retail pork sales by outlet and packaged type<sup>22</sup>**

In the pig producers' narrative, they are the victims, principally at the hands of the supermarkets. Producers have attempted to market British produce in terms of quality and welfare standards so as to justify higher prices. However, producers have little control over marketing. Supermarkets (multiples) dominate pig meat retailing (exhibit 9). As exhibit 10 shows, over two-thirds of pork is sold under retailers 'private labels', or 'own-brand' as they are

more commonly known. Organic and independent branded produce makes up only around one-tenth of meat sold. This combined with oversupply in the EU pig meat market, tips the balance of power in the supply chain substantially in the direction of the supermarkets because it is their brand (not British provenance) which reassures the consumer in the typical three seconds of hesitation over choice of product before the pack goes into the trolley.

**Exhibit 10: Fresh pork sales by retail category<sup>23</sup>**

BPEX, the pig industry's statutory levy, represents producers as farmers who are situated at the bottom of a supply chain hierarchy in which price spreads between the farm gate and the retail cabinet are excessively wide and everybody except the farmer is making money. (see exhibit 11). According to BPEX's own calculations shown in exhibit 12, retailers make large profits of more than £100 per pig; processors make a more modest

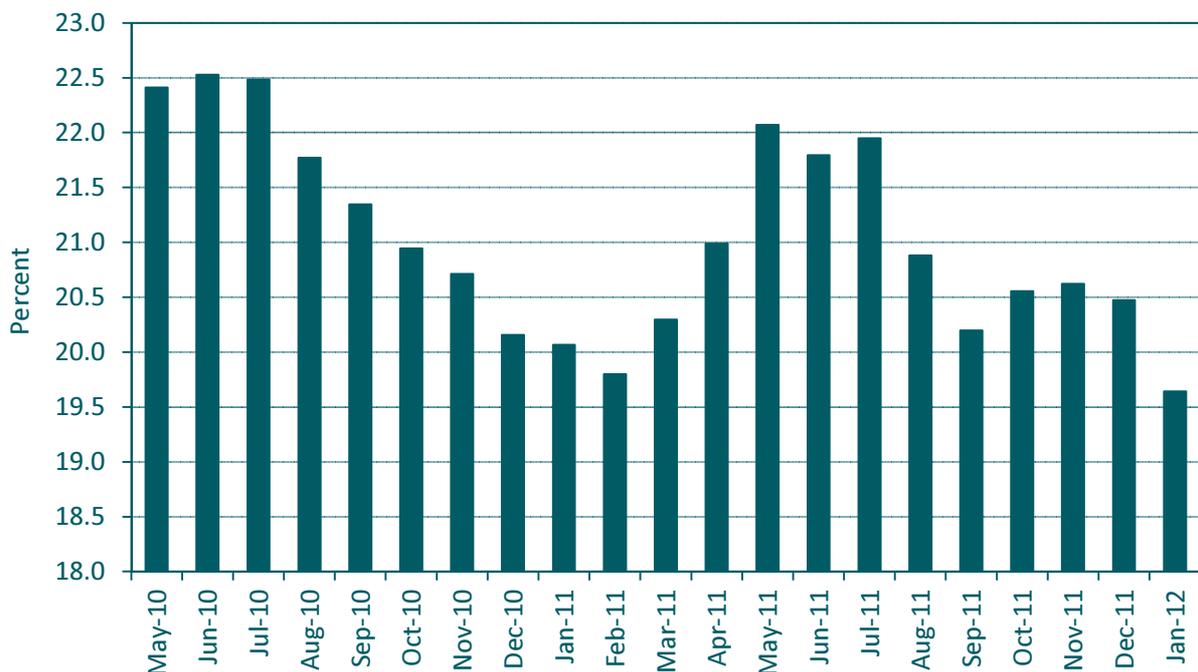
profit of £40 per pig, while farmers fluctuate between slim profits and outright losses

<sup>22</sup> Kantar Worldpanel

<sup>23</sup> (12 weeks to December 2011); Kantar Worldpanel

according to fluctuations in grain prices and competition from imports. These figures are of course internally disputed by others along the chain; one processor told us that the “average processor” made no more than £10 per pig and efficient producers made more. But the figures have been used externally by farmers’ associations who have framed the problem in terms of supermarket corporate social responsibility (CSR), and have persistently lobbied for retailers to pay more for their pig meat and promote British quality assurance schemes such as the Red Tractor label.

**Exhibits 11: Pig farmers’ share of the retail income** (based on average retail pork basket price)<sup>24</sup>



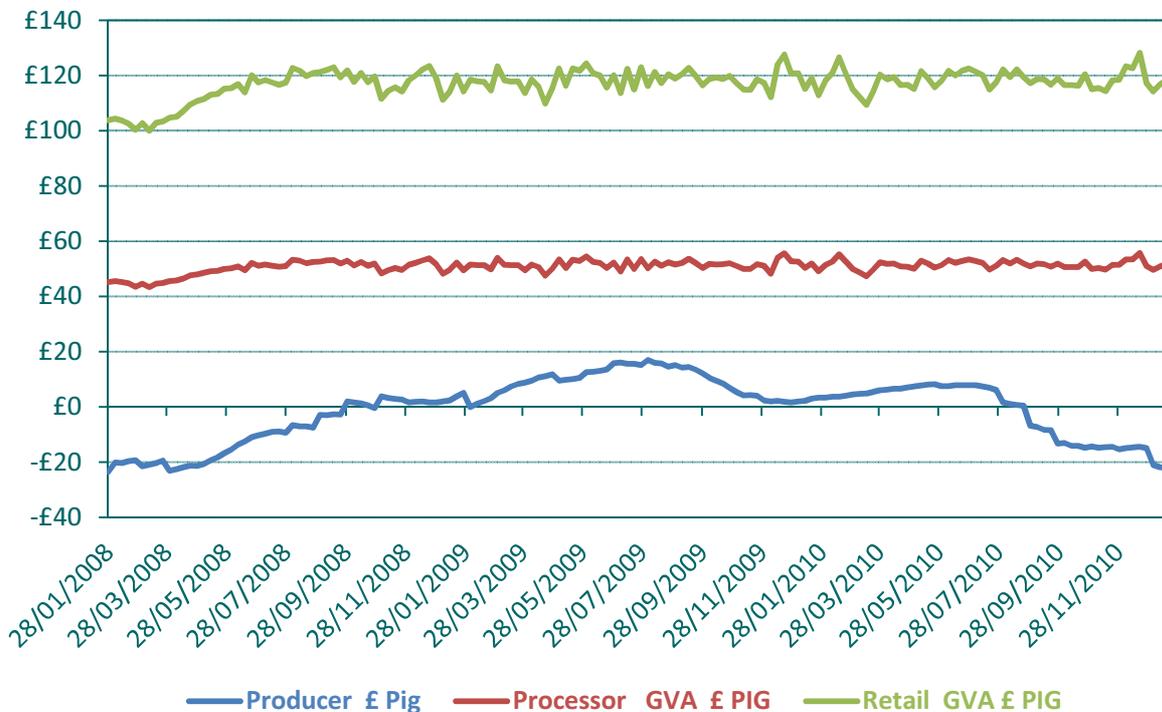
The producers’ case has been pressed through high-profile publicity campaigns which include both informal protests like pickets outside shareholders meetings, direct political pressure through sympathetic MPs, and celebrity appeals such as ‘Jamie [Oliver] Saves Our Bacon’. These actions have forced supermarkets to engage with the issue, but producers are not convinced by supermarket reassurances. In June 2011, the National Pig Association commented that the big three supermarkets had been telling different stories to producers and processors:

*They have told producers in numerous meetings that they will help drive up the price through special promotions and by diverting more of their spend from imported pork to higher-welfare home-produced pork. But they have been telling processors a different story — that they intend to maintain their margins at all cost. Despite their claims to*

<sup>24</sup> BPEX, ‘Farm gate retail price spread’ (<http://www.bpex.org/prices-facts-figures/pricing/FarmGateRetailPriceSpread.aspx>)

support British pork, they have failed to put an extra penny into the supply chain. All of the 15p rise [in the deadweight average pig price] over recent weeks has come from processors, and now abattoirs are losing money, as well as producers.<sup>25</sup>

**Exhibit 12: Average profit margin per pig in the UK<sup>26</sup>**



As well as highlighting the friction between supermarkets and producers, the quote also points to the position of processors as intermediaries passing price increases and reductions down to farmers. Although processors, like producers, place most of the blame for low-prices on the supermarkets and consumers, the processors dispute BPEX's profit calculations in exhibit 12 on the grounds that they present an exaggeratedly positive picture of the processors' situation: they claim (as confirmed by analysis of accounts later in this report) that profits are smaller than represented here than and far from stable.<sup>27</sup> The processor trade association, the British Meat Processing Association argues that the situation for their members is the worst of all: processors have all the problems of the producers because they face supermarket buying-power, but processors have none of the cultural and political capital that 'farmers' can mobilise to defend their interests.

<sup>25</sup> BPEX Weekly, 13 May 2011 (Source: May <http://www.bpex.org.uk/bpexWeekly/BW130511.aspx>)

<sup>26</sup> Source: BPEX, Profitability in the Pig Supply Chain, March 2011. GVA is gross value added

<sup>27</sup> While BPEX titled this exhibit 'profit per pig', our examination of the data indicates that it relates to 'gross value added per pig. Gross value added is the internal value that is added to purchases from which the claims of labour costs, depreciation and profit are satisfied. Therefore, GVA is not pre-tax margin. One processor states that inefficient processors clear £10 pre-tax margin per pig and efficient producers certainly more.

In February 2011, *Food Manufacture* reported that conditions for processors were the worst in living memory and repeated many processor complaints.<sup>28</sup> The profit-squeeze in the sector has led to dramatic consolidation in comparison with farming, where more diversified businesses can switch between activities according to market conditions. A major success for producers in recent years has been new EU labelling directives requiring products to identify their origins. However, for processors who assemble complex products with meats derived from a variety of sources, this has created additional costs.<sup>29</sup> Such pressures have pushed processors to lower the “pork” content of their products, creating a further source of public hostility.<sup>30</sup>

The one thing that producers and processors can agree on is the power of the supermarkets; but the supermarkets have an alibi which serves to deflect otherwise weighty charges. The argument of the supermarkets is that they are using their power for the double purpose of delivering quality, choice and, above all, low prices to generally satisfied consumers and adequate returns to the shareholders. So, for example, when a *Financial Times* investigation in 2005 revealed that the amount of money owed by Tesco to its suppliers had risen by £1.5 billion over five years, the retailer responded saying ‘we are simply working smartly and efficiently for the good of our customers, shareholders and suppliers’.<sup>31</sup> Such claims can carry greater appeal in a time of recession. A study conducted for Morrisons this year found that the poorest 20 per cent of households spend 30 per cent more of their weekly income on food than the UK average.<sup>32</sup> With average household incomes declining, supermarkets can point to their value-engineering capabilities almost as a form of public service. In addition, most supermarkets have responded to criticism by adopting variants of responsible sourcing policy which involves supporting higher welfare producers, some preference for British producers and the use of supply chain ‘partnership’ arrangements.<sup>33</sup> High profile publicity around schemes such as the Ethical Trading Initiative has also deflected criticism over exploitative treatment of overseas suppliers. Pushed further, in private, supermarkets and processors both complain about the inefficiency of British pig production, in which farms tend to be smaller and less efficient than their European

<sup>28</sup> Food Manufacture, ‘Firms face toughest price negotiations in living memory’ 1 February 2011 (<http://www.foodmanufacture.co.uk/Sectors/Meat-poultry/Firms-face-toughest-price-negotiations-in-living-memory>)

<sup>29</sup> Food Manufacture, ‘Europe must keep cool over country of origin labelling’ 22 June 2010 (<http://www.foodmanufacture.co.uk/Sectors/Meat-poultry/Europe-must-keep-cool-over-country-of-origin-labelling>)

<sup>30</sup> Food Manufacture, ‘Cut to the bone’ 9 April 2009 <http://www.foodmanufacture.co.uk/Sectors/Meat-poultry/Cut-to-the-bone>

<sup>31</sup> Financial Times, ‘Tesco defends treatment of suppliers’ 9 December 2005.

<sup>32</sup> Morrisons (2012) ‘Poorest budgets eaten up by food’ (<http://www.morrisons.co.uk/Corporate/Media-centre/Corporate-news/poorest-budgets-eaten-up-by-food/>)

<sup>33</sup> British Retail Consortium, ‘Retailers: partners in the supply chain’ ([http://www.brc.org.uk/brc\\_policy\\_content.asp?iCat=46&iSubCat=657&spolicy=Food&sSubPolicy=Grocery+Supply+Chain](http://www.brc.org.uk/brc_policy_content.asp?iCat=46&iSubCat=657&spolicy=Food&sSubPolicy=Grocery+Supply+Chain))

competitors so that British producers struggle to deliver the high volume and low price combination required for the mass market.

## Part 2.1: Business practices –opportunistic dealing

The blame game gives exaggerated public expression to relations between actors that can be found elsewhere because power inequalities, dependence and differences in cultural resources are commonplace along many other chains. The most distinctive characteristic of the ‘pigs to pork’ chain is not the power relations that divide producers, processors and supermarkets but the characteristic practices which unite them (in varying degree and with varying amounts of power).

**Exhibits 13: Retailer’s market share of pig meat sales and proportion British sourced<sup>34</sup>**

Retailer		Market share pork	Market share Bacon	Market share sausages	Market share Ham	% Share of UK pigs slaughtered per week
Morrisons	Share (%)	14.7	12.5	11.3	12.4	20.0
	British (%)	(90)	(19)	(56)	(30)	
Waitrose	Share (%)	4.0	3.5	4.9	4.0	5.0
	British (%)	(100)	(100)	(90)	(90)	
M&S	Share (%)	1.1	4.4	2.8	3.1	5.0
	British (%)	(100)	(90)	(100)	(90)	
Co-op	Share (%)	5.2	6.4	5.6	6.0	10.5
	British (%)	(100)	(86)	(90)	(90)	
Sainsbury’s	Share (%)	15.1	14.6	14.0	16.3	16.0
	British (%)	(70)	(21)	(30)	(25)	
Asda	Share (%)	15.7	15.2	14.6	16.1	2.0
	British (%)	(55)	(15)	(30)	(10)	
Tesco	Share (%)	26.5	24.0	29.2 / 29.6	29.6	6.0
	British (%)	(67)	(18)	(52)	(25)	

We term this behaviour opportunistic dealing: by this we mean the actors have short term trader mentalities and behave so as to extract maximum value from transactions with other supply chain actors; opportunistic advantage from the current or next transaction is the

<sup>34</sup> BPEX, Source, Kantar World Panel moving annual total 52 weeks to December 2011

main focus so that actors have a point concept of value as something that can be cashed out; the stream of value and future options for the industry and other players are irrelevant; opportunism is performed by avoiding fixed commitments on price and quantity in a world where tomorrow is a new day and exit is somebody else's solution to financial distress. Our description of how opportunist practices plays in the pig meat industry is based on interviews with a variety of industry figures, triangulated with existing supply chain studies and assorted secondary literature.

**Exhibit 14: Retailers business model for pig meat**

Retailer	% Share of UK pigs slaughtered per week	Most commonly used operating model
Morrisons	20.0	Fully Integrated supply chain model
Waitrose	5.0	Long term (25 years+) dedicated whole pig supply via Dalehead, a subsidiary of Tulip UK
M&S	5.0	Longer Term partnership built via breeding of a higher welfare Pig. Whole pig strategy
Co-op	10.5	Longer Term partnership built via breeding of a higher welfare Pig. Contracts based on volume not price.
Sainsbury's	16.0	Medium term (2-3 year) contracts available, but no fixed price and volume or reference price. Retailers able to renegotiate the terms. Movements in the DAPP can allow suppliers to enter negotiations, but it serves only as an invitation to conversation.
Asda	2.0	Short Term (12-18 month) agreements in place to supply core volume. No fixed price or volume. Some pricing linked to DAPP movements (mostly pork), however generally retailers are able to renegotiate terms at any point and serve 12 weeks notice. Promotional volume negotiated on a rolling 3-4 weeks basis, 4-6 months in advance
Tesco	6.0	Promotional volume (50-60% of category) based on a rolling 6-month tender process. Core volume agreements available on a 12 monthly basis as part of joint business planning. No fixed price or volume. Some pricing linked to DAPP movements, however generally retailers are able to renegotiate terms at any point and serve 12 weeks' notice.

We do not know whether the supermarkets are more transactionalist than other actors in the chain, but they are more frequently criticised for their practices because, as we argue below, the supply chain empowers opportunist supermarket buyers incentivised to secure

supply and extract the most profitable deal. It is therefore crucially important to note that, because such behaviours are organisationally embedded, dealing is a continuum and, whilst all supermarkets use buyers to pressure suppliers, some supermarkets are more transactionalist than others. This point is made in exhibits 13 and 14 below which ranks supermarkets according to whether they seek or avoid contractual commitment.

Four supermarkets (Morrisons, Waitrose, M&S, and the Co-op) all make some regular commitment to pork producers in terms of price and quantity associated with a preference for British suppliers. It is equally clear that such practices are not driven by market position and premium pricing because two of the four firms are Morrisons and the Co-op competing in the mass market. However, based on the table below, the three biggest supermarkets (Tesco, Sainsbury and Asda) with a combined pork and pig product market share of more than 50% could fairly be described as commitment-averse.

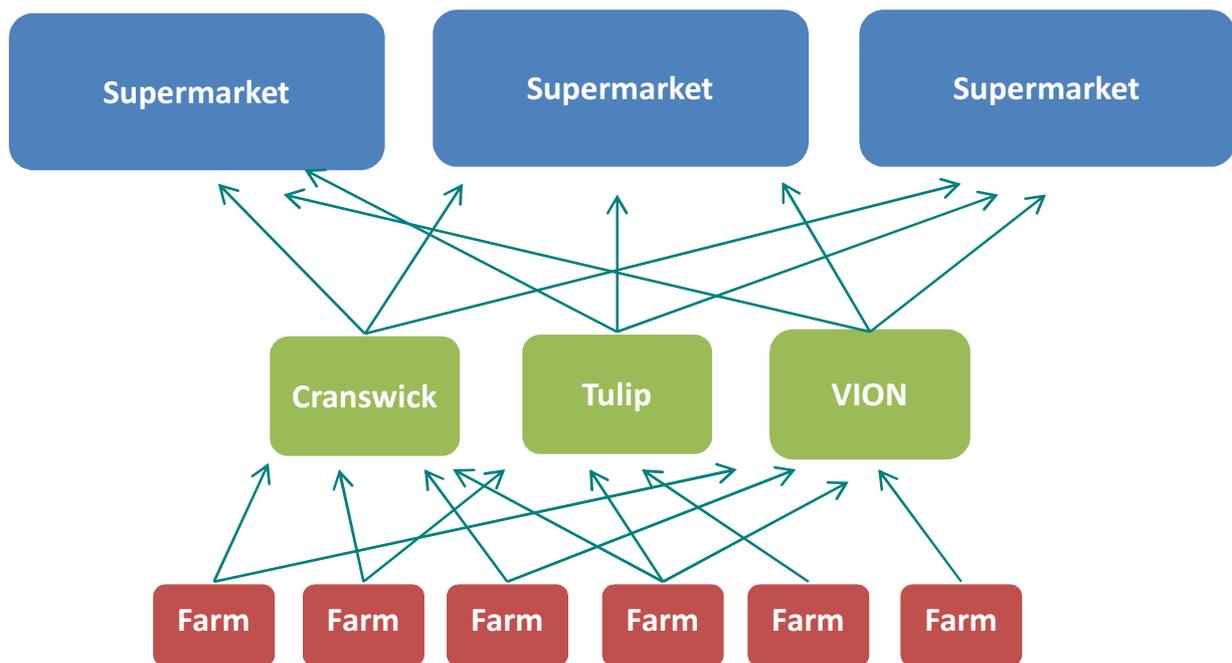
So, if the dominant retailers are opportunist, how does this play along the chain? To understand the consequences, we must explain how physical operations and marketing structure the possibilities for action amongst others in the chain. The process that ends with pig meat in the retailer's chiller cabinet pivots around disassembly of the carcass and the perishability of the product. Producers (farmers) create a complex product with a lead-time of around 40 weeks. After slaughter, this is then rapidly disassembled into a range of basic materials ('primal cuts') in less than a day at the primary processing stage in abattoirs. At the secondary stage of processing and packaging, two to three days the product is re-assembled into complex consumer items which must be sold quickly. Transactionalist supermarkets do not buy whole pigs from producers and then employ processors on sub-contract to do the slicing and packaging; instead, transactionalist supermarkets, like the big three in the UK, buy individual cuts of pork and sliced meats from processors and, in competition with other supermarkets for market share, press those processors for lower prices on a variety of final product lines which are delivered to their regional distribution centres.

Supermarkets derive their power from the fact that they are gatekeepers to consumers who buy their own brand meat (power that is reinforced by over-supply and excess capacity amongst processors and producers). Surveys suggest that less than one third of consumers 'shop around' different stores for meat purchases. As already mentioned, the vast majority of meat sold in the UK is sold under supermarkets' own-brands. The public holds these in high-regard because only 11% of consumers considered meat from independent butchers to be better quality than supermarket meat.<sup>35</sup> Thus, processors supply products *to the market* but they are unable to *make a market* independently for new products (except in the case of niche premium product lines like Cranswick's Jamie Oliver sausages). This power allows

<sup>35</sup> Kantar data, January 2012

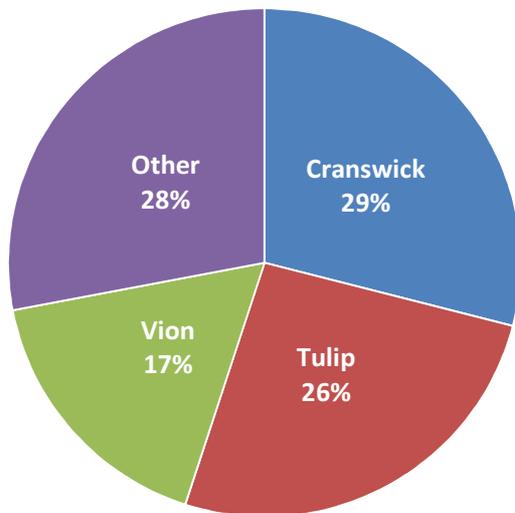
supermarkets to pass risks and costs downwards to processors, who in turn attempt to pass them down to producers, while extracting value upwards. Under these conditions, supermarket behaviour therefore structures the wider set of behaviours and relations within the chain.

**Exhibit 15: Example of the vertical, multiple relationships between supermarkets, processors and farmers**



Supermarkets place pressure upon their suppliers in the most elementary fashion by threatening to move to other suppliers. Suppliers have bargaining power in products for which there is limited supply, meaning high-value produce such as outdoor-bred pigs which are primarily bought under contract through well-integrated chains, or for popular branded produce which the supermarket has no choice but to stock. For standard products, commodity status and over-supply limits bargaining power. Supermarkets do not drive down their buying prices by playing an open market for two reasons. First actual change of suppliers is disruptive because products are made according to strict codes of practice given concerns over animal welfare, food safety and appearance; Second, supermarket own-brand pig meat is sourced largely from three giant processors (Tulip, Cranswick and VION) who have 75% of the pork processing market because processing is even more concentrated than retail (see exhibit 16 below).<sup>36</sup>

<sup>36</sup> It should be noted that this is by no means a complete monopoly. In certain categories the major processors occasionally lose share to smaller processors (for example Sainsbury's gets much of its bacon from Direct Table) while in sausages the market is more diversified.

**Exhibit 16: Market share of pork processors<sup>37</sup>**

Instead, teams of supermarket buyers operate primarily through (renegotiable) supply agreements with individual processors for particular product lines. These are not contracts in the conventional sense: firstly, they do not run for a defined length of time, but operate for indefinite (or alternatively, temporary) periods. Secondly, they guarantee neither prices nor volume for the processors which makes plant loading or any kind of forward planning very difficult. The agreements are

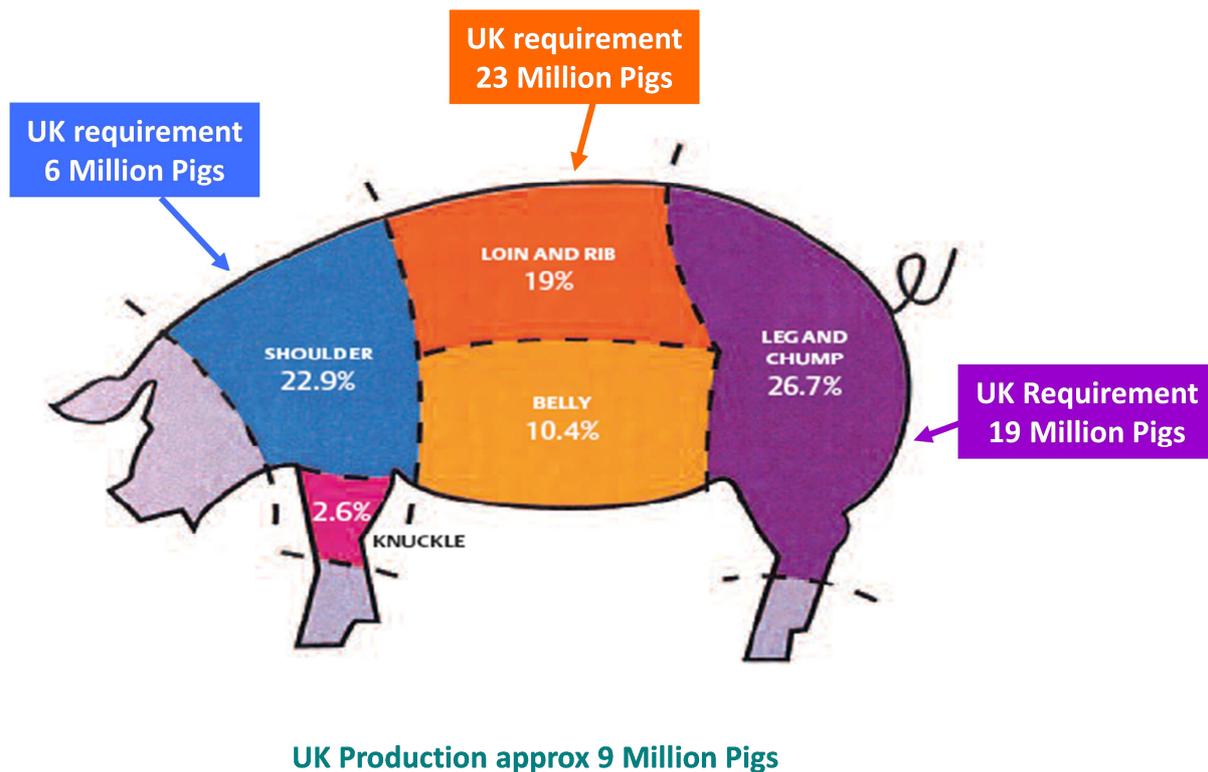
continually renegotiated – other studies and our own interviews with suppliers suggest on a monthly basis – as supermarkets press processors for lower prices. Some of the supply contract is routinely held back for tendering by other suppliers and main order switching finally taking place when exhausted processors are no longer willing or able to deliver on the latest demands.<sup>38</sup>

Supermarkets can inspect processor facilities at short notice, and, even without inspections, supermarkets know their suppliers' buying price (the market price for slaughtered pigs) and their selling price so they can accurately calculate processor margins and demand concessions accordingly. Thus, category management relationships are continual struggles around accounting disclosure and transparency which both undermine trust and create incentives for accounting manipulations and secrecy.<sup>39</sup> Major supermarkets also sell a substantial proportion (recent Kantar data suggests that as much as 40%) of their pig meat under promotions. Promotions can function as a means whereby processors clear out excess produce, but they also form an additional source of pressure to lower prices. Finally, supermarkets make demands for over-riders (cash payments to protect their margins and assist in marketing activities) through ad-hoc negotiations, referred to as 'promotional allowances'.

<sup>37</sup> Kantar data, February 2012

<sup>38</sup> Food Chain Centre (2006), *Applying Lean Thinking to the Red Meat Industry* (Available at <http://www.foodchaincentre.com/cir.asp?type=3&subtype=63&cir=317>), Taylor, D.H. (2006), 'Strategic considerations in the development of lean agri-food supply chains: a case study of the UK pork sector', *Supply Chain Management*, Vol. 11 No. 3, pp. 271-80.

<sup>39</sup> Free, C (2008), 'Walking the talk? Supply chain accounting and trust among UK supermarkets and suppliers', *Accounting, Organizations and Society*, 33, 629-662.

**Exhibit 17: UK market demand for different types of cuts 2011<sup>40</sup>**

Why do the three major pig meat processors, stay in the business if they face such pressures? Tulip and VION<sup>41</sup> are both able to disregard short-term profitability to an extent: they do have significant UK pig farming interests but cannot be considered as standalone profit centres when they serve as a route for their Danish and Dutch parent companies' products into the UK market and the co-operative business model of their parent companies enables a more long term view. Cranswick, the other major pig meat processor, is a quoted PLC with a history of acquisition which complicates like-for-like performance comparisons and is using its own branded products as a means of controlling product specification and margins.<sup>42</sup> In a situation similar to that found in other studies of supermarket suppliers

<sup>40</sup> BPEX

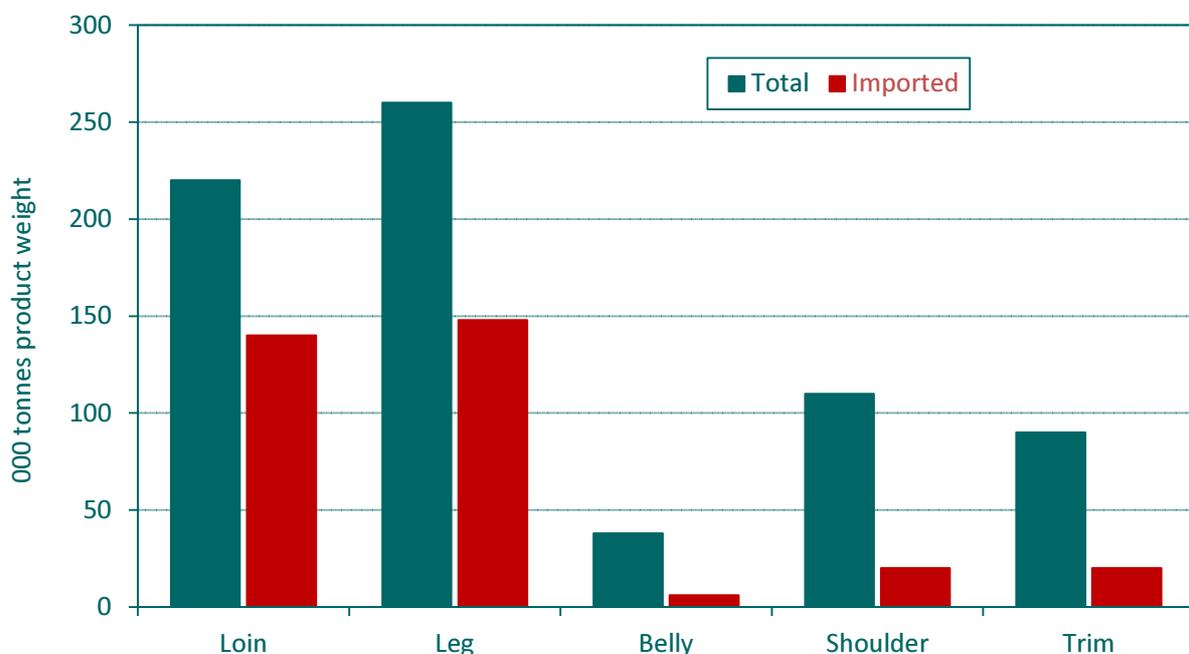
<sup>41</sup> VION UK is the British subsidiary of VION NV, Europe's largest meat processor owned by Zuidelijke Land-en Tuinbouworganisatie, a major Dutch farming co-operative. As well as pig meat, VION UK also processes beef, lamb and chicken. Following the takeover of Grampian Country Foods Group in 2008, VION became the UK's largest meat processor. Tulip is a subsidiary of the Danish Crown group, Europe's largest pork producer which is owned by the Danish farming co-operative Leverandørselskabet Danish Crown Amba. Tulip established itself in the UK in 2002, and proceeded to acquire a number of large meat processing firms through its 2003 takeover of the Flagship Food Group and of George Adams and Sons Ltd in 2007. Both Tulip and VION operate as private companies functioning as routes for exports from their owners in Denmark and the Netherlands.

<sup>42</sup> Cranswick was formed in the 1970s as a co-operative venture between producers to buy feed. It subsequently transferred into meat processing and in the 1990s acquired a stock market listing – today it is the only one of the major processors which operates as a PLC. Like the others though it has been extremely active in acquiring other meat processors, taking over Continental Fine Foods (2001), Perkins Chilled Foods (2005), Delico (2006), and Bowes of Norfolk (2010). Cranswick is a competitor in the mass market but differs from

where supply base rationalisation has resulted in a small number of ‘super middlemen’, the three major pig meat processors then compete to be ‘the last man standing’ in a given product line, acting as category managers – an intermediary between the supermarket and the rest of the supply chain which shoulders the burden of ensuring security of supply and product quality. As in other meat products, processor profit margins are routinely sacrificed for turnover, exclusivity and market share.<sup>43</sup>

For both producers and processors, who must by necessity deal with a whole pig, the major problem is matching supply to demand. The aim in the processing industry is to achieve what is known as a good ‘carcass balance’ so that all parts of the pig are sold profitably while the processor secures full plant capacity utilization. Some cuts, such as loins, are in far greater demand than other cuts so that there can be simultaneous over-supply and undersupply of various products from the one pig (See exhibit 17 and exhibit 18 below).

**Exhibit 18: UK supply/demand imbalances for different pig cuts<sup>44</sup>**



Against this background of supermarket dealing, processors are then forced into opportunist practices because of the instability of demand and the nature of the disassembly task. Processors must engage in heavily discounted distress selling as inventories build up, with various forms of processed meat providing a means to clear the market of unwanted cuts (as shown in exhibit 17 above and exhibit 18, this is predominantly belly, shoulder and trim). And processors will also source their products opportunistically –

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Tulip and VION in providing a wider range of high mark-up branded products and high value added manufactured goods (e.g. sandwiches and cooked meats).

<sup>43</sup> Hingley, MK (2005), ‘Power imbalance in UK agri-food supply channels: learning to live with the supermarkets?’, *Journal of Marketing Management*, 21(1-2), 63-88.

<sup>44</sup> BPEX

by either extracting margin from UK producers or finding cheaper products from the wider EU market.

**Exhibit 19: Supermarket weekly pig meat purchasing requirements<sup>45</sup>**

Retailer	Pig-equivalent in loins bought per week	UK pigs bought per week
Tesco	50,000	9,400
Asda	40,000	3,400
Sainsbury's	38,000	26,200
Morrisons	36,500	31,500
Co-op	19,800	16,800
M&S	7,900	7,900
Waitrose	7,900	7,900

In sum, processor profitability depends heavily upon sourcing from and selling in an array of sites and markets according to the advantages offered by short-term fluctuations in price and demand. Consequently, skill in dealing rather than operations management or strategy is the prize asset amongst management in processor firms.

The situation is similar upstream. UK producers stand apart from their European counterparts in their lukewarm commitment to the formation of farming co-operatives, generally preferring to operate on a more individualistic basis and competing with other farmers when opportunities arise. Other studies have found that farmers commonly decide when to sell their animals based on the spot market price, with the prioritization of short-term profitability (at the expense of others) generally proving irresistible. Improvements to productivity tend to happen in secret to maintain a competitive edge, and collaborations tend to take place where one party believes it would gain the upper hand.<sup>46</sup>

Looked at in terms of the whole supply chain, opportunist practices mean that co-operation, long-term planning and productivity enhancing investments are, as a 2008 Competition Commission report puts it, in the supermarkets 'overshadowed by the short-term necessity of extracting the best possible terms and conditions from suppliers so as to compete effectively with other grocery retailers.'<sup>47</sup> A House of Commons Select Committee concluded in 2009 that a significant element of the English pig industry's lack of

<sup>45</sup> Pig equivalent loin numbers are estimates.

<sup>46</sup> Food Chain Centre (2006), *Applying Lean Thinking to the Red Meat Industry* (Available at <http://www.foodchaincentre.com/cir.asp?type=3&subtype=63&cir=317>), Taylor, D.H. (2006), 'Strategic considerations in the development of lean agri-food supply chains: a case study of the UK pork sector', *Supply Chain Management*, Vol. 11 No. 3, pp. 271-80

<sup>47</sup> Competition Commission (2008), *The Supply of Groceries in the UK: Market Investigation* (Available at [http://www.competition-commission.org.uk/rep\\_pub/reports/2008/fulltext/538.pdf](http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538.pdf)), p. 165.

competitiveness stemmed from supply chain instability and the underuse of long term cost of production contracts.<sup>48</sup> Cranfield University researchers, for example, have claimed that meat processors are 30 – 40 years behind other manufacturing sectors in terms of levels of automation.<sup>49</sup> The Food Chain Centre meanwhile have estimated that carcass imbalances can cost processors up to 3% of sales – which under their tight margins can have major consequences. To understand the broader impact of opportunist practices on the supply chain and wider society, it is necessary to illustrate the problem with a direct case study.

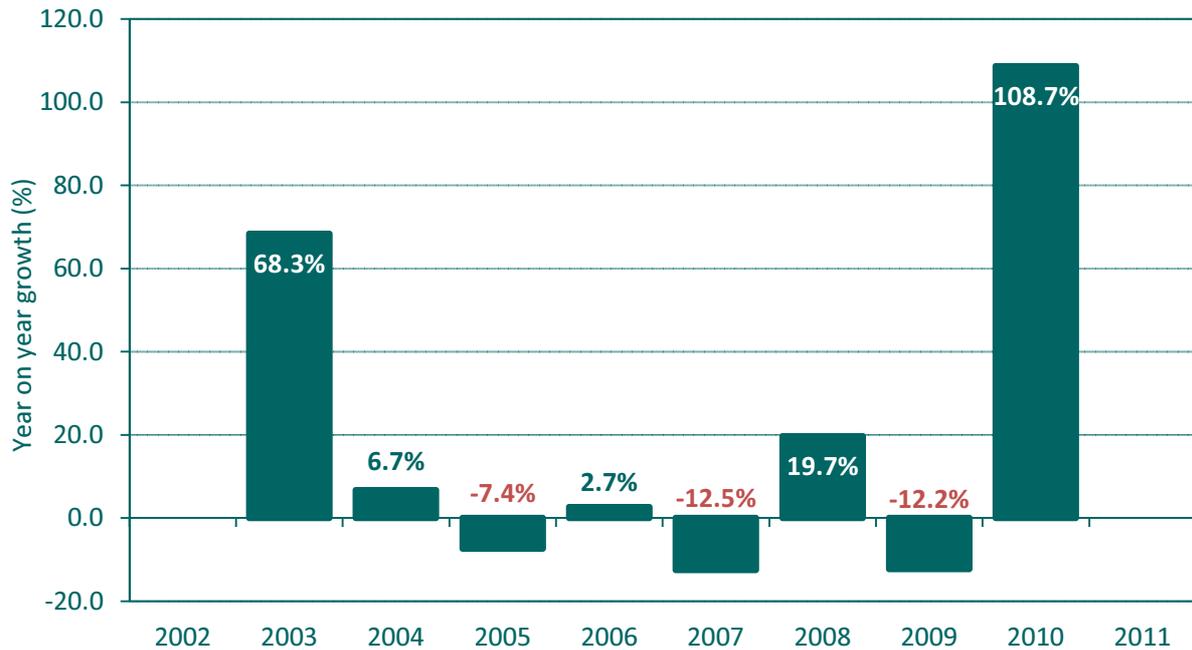
## 2.2 Opportunist practices and chain disruption: a case study

The supposed success of the supermarkets illustrates the power of the point concept of value: the proof of their success is their ability to deliver value for shareholders and low prices for consumers. From a chain point of view, the issues are much more complex because there are serious questions about the impact of supermarket practices on other supply chain actors and the ability of supermarkets to pass costs onto the wider society. None of this shows up in supermarket financial accounts for shareholders, nor is it taken into consideration when assessing everyday low prices for consumers. This is where opportunist practices impose invisible high costs. Whenever retailers move volume from one supplier to another, workers have to be hired and fired, plants opened and closed, and equipment bought and scrapped. As well as the loss of capital invested by processors and their upstream suppliers, the social repercussions can be considerable as many processing plants are based in rural areas or regions with high existing levels of unemployment.

The case study below covers restructuring at VION Food UK Limited (hereafter VION UK) after it had acquired Grampian Country Foods whose pre-merger condition meant some change was inevitable. Before the merger Grampian was an industry player with more excess capacity, higher costs, more exposure to imported materials, more exposure to retailers with high ratios of promotional activities and imported pig meat. VION was selected for case study because it is the big player with the most recent change and represents supply chain dynamics in heightened form. The case story below is entirely told from publicly available sources (principally VION Food UK Limited company accounts and media reports) not internal or confidential sources; to maintain the independence of our research, the story was pieced together without interviewing VION UK managers about this restructuring and without access to internal documents.

<sup>48</sup> House of Commons, Environment, Food and Rural Affairs Select Committee (2009), *The English Pig Industry* (available at <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmenvfru/96/96.pdf>), p. 9.

<sup>49</sup> Food Manufacture, 'Chop and change: meat and poultry processing focus' 6 November 2010, (<http://www.foodmanufacture.co.uk/Sectors/Meat-poultry/Chop-and-change-Meat-and-poultry-processing-focus>). Overall equipment effectiveness was found to be low (26-40% compared to world class performance of 85%), poorly designed, inefficient and unreliable.

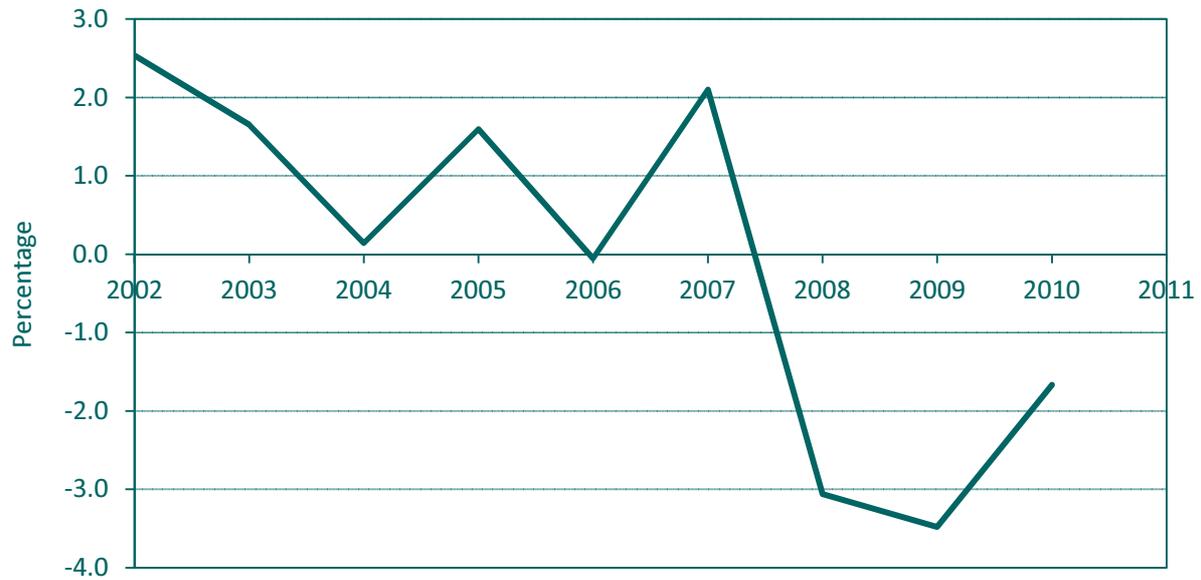
**Exhibit 20: Analysis of VION Food UK annual real sales growth 2002-2010<sup>50</sup>**

We did subsequently interview trade unionists from USDAW and Unite about the industrial relations consequences of industry wide difficulties about plant loading because, under such conditions, where management cannot offer secure employment in the medium term, it is extraordinarily difficult to maintain harmonious industrial relations.

The context can be established by considering VION UK's financial accounts before and after the takeover of Grampian Foods. The first part of the story is about how low prices undermined stable profitability. The driver is a pattern of saw tooth fluctuations in year on year turnover and similarly dramatic fluctuations in profitability) depending on which supermarkets are being supplied (Exhibit 20 and 21). In VION UK's case, a dramatic increase in turnover is attributable to the takeover of Grampian Foods in 2008, but otherwise the loss or gain of supermarket supply agreements account for the fluctuations. The story is broadly that when supply agreements are lost (as in 2005, 2007 and 2009) turnover and throughput collapse and the firm makes no pre-tax profit or incurs losses.

This financial performance reflects plant level difficulties inside VION UK as the firm struggles to load plants and offer continuity of employment. The press reports below cover restructuring at VION UK's Winsford, Malton, Haverhill and Scunthorpe plants. The second part of the story is about how dealing creates social disruption which has no clear economic efficiency rationale.

<sup>50</sup> Fame, BvDep

**Exhibit 21: VION Food UK Limited's pre-tax return on sales<sup>51</sup>**

The history of the Winsford plant is instructive. VION UK acquired the Winsford meat-processing site when they purchased Grampian Country Food Group in 2008. It was built in 2005 as one of three packing factories from which Asda would source its own-label fresh pork. The factory was an all-new state of the art plant which cost £25m to set up, and created 400 new jobs. At the time, a senior Asda manager was quoted in the press as saying: 'This gives us the confidence we need to be really certain of the future growth of our meat business.'<sup>52</sup> Indicating problems with the supply agreement, VION UK shed 94 of its 400 Winsford employees in 2010, and in February 2012 sold the facility to Morrisons, the one major supermarket with an integrated business model which was seeking to expand its processing operations. The Winsford plant was saved and its employees have a more secure future under the vertically integrated Morrisons model in which demand is guaranteed. But other VION UK plants have not been so lucky because the big three supermarket chains favour opportunist practices. Moreover, the struggle for market share amongst processors, both established and newcomers is fought out by undercutting competitors.

In this case, the connection between cheap imports and factory closures is quite direct and can again be illustrated from VION. In 2009, VION UK announced 820 redundancies in response to over-capacity in the UK meat-processing sector.<sup>53</sup> In 2011 a further 180 jobs were cut at its Scunthorpe bacon plant. Meanwhile, Asda switched suppliers to Forza AW, a new entrant to the processing sector which had set up new processing facilities in

<sup>51</sup> Source: Fame, BvDep.

<sup>52</sup> The Grocer, 'Three prongs for Asda red meat' 22 January 2005

(<http://www.thegrocer.co.uk/companies/three-prongs-for-asda-red-meat/99439.article>)

<sup>53</sup> BBC, 'Food firm VION cutting 820 jobs' 20 January 2009 (<http://news.bbc.co.uk/1/hi/business/7839638.stm>)

Bradford.<sup>54</sup> Having been blamed for the job losses at VION's Scunthorpe plant, Asda claimed in its defence that Forza AW's new operations would create 350-400 new jobs.<sup>55</sup> The net job loss may be negligible but the disruption for the established workforce was of course considerable.

Across the processing sector, these kinds of changes lead to industry wide problems about industrial relations which we describe below. The difficulties for the workforce are not confined simply to factory closures. As supermarkets put pressure on their suppliers, so suppliers tend to put pressure on their workforce pay and conditions as a means of maintaining their supply agreements. Union representation is extensive across the meat processing industry, but just like their employers, trade unions in processing firms lack bargaining power. Union representatives interviewed for this study described a 'never ending race to the bottom' of worsening pay and conditions which was not producing a competitive, stable industry. The cause, they claimed, was pressure from supermarkets, who as well as pressing for lower buying prices, would adjust orders at short notice necessitating either longer and more frequent shifts or the dumping of unwanted produce. Processor firm managers primarily looked to the workforce to bear the burden of adjustments. The result was below inflation pay rises, and pressure towards irregular working patterns matched to the unpredictable fluctuations in supermarket orders. Both developments have encouraged firms to recruit a growing number of agency workers. The trade unions suggest that commonly 15-30% of the workforce is under informal contracts, with as many as 70% from agencies in some workplaces. Agency workers were described as both heavily exploited and also a contributor to workplace tensions, in being used to lower general wage levels. Claims made by trade unionists over the deterioration of working conditions within the meat processing industry are confirmed by a 2008 Equality and Human Rights Commission (EHRC) report which investigated the growing dependence of processor firms on an informal labour force in response to competitive pressures.<sup>56</sup> The report

*found evidence of widespread poor treatment of agency workers, particularly migrant and pregnant workers, both by agencies and in the meat processing factories. Some amount to breaches of the law and licensing standards – such as coercing workers to do*

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<sup>54</sup> *The Grocer*, 'VION forced to slash jobs after Asda contract loss' 06 November 2010 (<http://www.thegrocer.co.uk/fmcg/VION-forced-to-slash-jobs-after-asda-contract-loss/213781.article>), *The Meat trades Journal*, 'Chasing the big cheese' 19 March 2010 ([http://www.meatinfo.co.uk/news/fullstory.php/aid/10349/Chasing\\_the\\_big\\_cheese.html](http://www.meatinfo.co.uk/news/fullstory.php/aid/10349/Chasing_the_big_cheese.html)), VION Food Group, 'Press release: VION Announces Re-structuring of its Abattoir and Cooked Meats Operations' 19 January 2009 (<http://www.VIONfood.co.uk/en/media-centre/press-releases/post/VION-announces-re-structuring-of-its-abattoir-and-cooked-meats-operations/show.html>)

<sup>55</sup> *This is Scunthorpe*, 'Asda defends decision to end VION contract' 05 November 2010 (<http://www.thisisscunthorpe.co.uk/Store-defence-finish-contract/story-11184931-detail/story.html>)

<sup>56</sup> Equality and Human Rights Commission (2008), *Inquiry into Recruitment and Employment in the Meat and Poultry Processing Sector*

*double shifts when they are tired or ill. Others are a clear affront to respect and dignity.*<sup>57</sup>

Over-capacity within the meat processing industry undermines conventional trade union bargaining activity. A factory failing to accept management's relay of the demands of a supermarket buyer understands the work could go to other firms or indeed to other plants within the same firm. There have been several instances of major strike action taking place in the factories of major meat processing firms in recent years, most recently at VION UK's Cambuslang processing plant in February 2012 over pay and conditions. A spokesperson for Unite explained the action at the time saying 'You can't keep asking workers year on year to accept attacks on their terms and conditions – they are going to fight back and rightly so'.<sup>58</sup> However, further planned strike action in March 2012 was suspended after Sainsbury's suddenly ended its contract with the plant.<sup>59</sup> The continual 'fear factor' of losing business to other processing factories with excess capacity means that the processing workforce is generally accommodating and union strategy generally effectively focuses on preserving job security, with officials in a 'fire fighting' role responding to the threat of factory closures rather than acting as an upholder of standards. This level of pressure on the workforce, and the accumulating industrial relations problems are in nobody's interest. Over the longer term, the industry will become less productive because it is left with a low skilled, transient and poorly motivated workforce, which has implications for competitiveness with the highly skilled (and considerably better paid) Dutch and Danish meat industries and also, as the EHRC report makes clear, implications for food hygiene.

### 2.3 Drivers of Opportunist Practices

Opportunist practices are pervasive because the supermarkets and their processors are caught in a kind of prisoner's dilemma: many parties recognise the dysfunction of such opportunistic dealing, but are unwilling to break from it when it promises to achieve short-term gains at the expense of trading partners and competitors. Moreover, in the case of the big supermarkets, the drivers of opportunist practices are two forms of **pathological competition** built into the supermarket business model as they struggle to attract consumers and shareholders.

Supermarket buyers then become the agents of misery for processors because, according to our industry sources, buyers (who are predominantly young and keen to use the post as a stepping-stone to promotion) are placed under enormous pressure to maintain gross margins sometimes as high as 40-50%. The exact nature of face-to-face negotiations

<sup>57</sup> Ibid, 1.

<sup>58</sup> Unite the Union, 'Unite meat workers to take strike action at VION foods', 17 February 2012 (<http://www.unitescotland.org/2012/02/17/unite-meatworkers-to-take-strike-action-at-VION-foods/>)

<sup>59</sup> *Food Manufacture*, 'VION strikes delayed after Sainsbury's contract loss', 09 March 2012 (<http://www.foodmanufacture.co.uk/Business-News/VION-strikes-delayed-after-Sainsbury-s-contract-loss>)

between buyers and suppliers remains confidential, but on occasions, information surfaces which sheds light on the nature of these invisible relationships. For example, internal documents obtained by The Telegraph from a major food manufacturer in 2008 show that suppliers are briefing their staff to expect a range of complex psychological tactics to be levelled against them, including frequent recourse to threats of de-listing.<sup>60</sup>

**Exhibit 22: Supermarket financial winners and losers post-Christmas 2012<sup>61</sup>**

	Retailer's performance against competitors					
	Tesco	Asda	Sainsbury's	Morrisons	Waitrose	M&S
Tesco		£18m	£3m	£2m	£7m	-£1m
Asda	-£18m		-£11m	-£9m	-£1m	-£2m
Sainsbury's	-£3m	£11m		£5m	-£2m	£1m
Morrisons	-£2m	£9m	-£5m		-£1m	-£2m
Waitrose	-£7m	£1m	£2m	£1m		-£2m
M&S	£1m	£2m	-£1m	£2m	£2m	
Net gain or loss	-£29m	£41m	£12m	£1m	£5m	-£6m

The first driver of opportunist practices is the form of competition for consumers. Because the UK grocery market is mature and not increasing significantly in size (and overseas expansion and non-food lines are not an easy supplement), the UK supermarkets engage in competition for market share. Within this game, the successful supermarket chain wins share by persuading a relatively small number of switchable, floating customers to shop in its stores. Exhibit 22 (taken from Kantar Worldpanel's post-Christmas 2012 analysis of the retail sector) illustrates the zero-sum game played by the supermarket chains where chain x's gains are mirrored by chain y's losses.

Being one of the single most expensive items in the average weekly shop, meat is treated as a footfall driver – heavily promoted in order to entice new customers – in the zero sum game where sales growth is obtained by snatching market share from competitors: this is achieved through price cuts or promotions, both of which squeeze suppliers' margins. The rationale for this supermarket behaviour is that it delivers lower prices and thereby serves the consumer. More accurately, it serves a model of the consumer as *homo economicus*, but consumer preferences are actually considerably more complex.

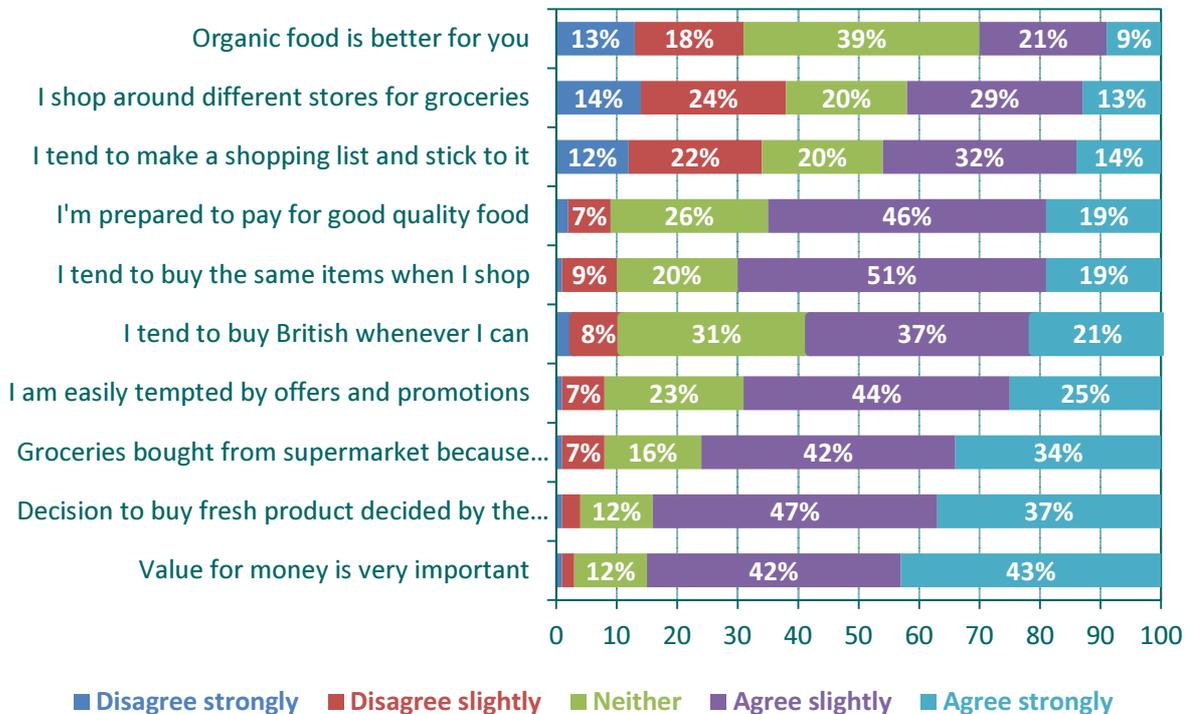
Surveys routinely point to price as the most important motivational factor deciding purchases, and price inflation combined with wage stagnation is likely to entrench this.<sup>62</sup>

<sup>60</sup> The Telegraph 'Supermarkets and suppliers: Inside the price war' 27 April 2008

<sup>61</sup> Kantar Worldpanel, 4 weeks to 25 December 2011. Asda excludes Netto.

But survey results also show a significant proportion of consumers (commonly 40-60%, certainly more than a wealthy niche) stating they would be willing to pay more to support local jobs or the national economy.<sup>63</sup>

**Exhibit 23: Analysis of consumer preferences (February 2012)<sup>64</sup>**



In any case, the ‘price war’ is partly a phoney one when the price of a basket of goods across different supermarkets is relatively stable and most consumers through habit or convenience return to shop at the same store. Supermarkets compete as much in terms of floor space, location and marketing as in price reductions, and the squeezing of suppliers has as much to do with increasing profit margins as with delivering cheaper goods.

The second driver is the imperative to create shareholder value whereby all companies should deliver financially (regardless of sector or position), so supermarkets must fight to satisfy shareholders as well as customers. In an article for *The Times* in September 2010, Terry Leahy of Tesco bemoaned the short termism forced upon him by investors. “Many”, he said, “don’t want to get under the skin of the business or don’t have the patience for long-term value creation.” Management, he explained, was constantly chasing short-term profits for fair-weather investors: “In the 13 years I’ve been CEO, the entire market capitalisation of Tesco has been traded more than 15 times, and that is low compared with most FTSE companies.” The recent fall in Tesco’s share price (including a 16% drop in one

<sup>62</sup> Quaestor, January 2012, ONS in Kantar, Feb 2012, IFS, *The Impact Of Austerity Measures On Households With Children*, January 2012.

<sup>63</sup> IGD *Home or Away – The role of provenance* July 2008

<sup>64</sup> Quaestor

day in January, which wiped £4.8bn off its market capitalisation) shows that the market judges the success of a supermarket or any other kind of mass retailer by its ability to deliver profit for shareholders in the short term. Successful value extraction from the supply chain thus becomes imperative, both because it directly buttresses supermarket profitability and indirectly provides the means for competition for share (even if it jeopardises the chain). In the business press, Tesco's failure to hold and win share was widely attributed to its half-hearted 'Big Price Drop' campaign, which cut prices across 3,000 products in late 2011; and the (unconsidered) implication was that Tesco should be more demanding of its suppliers in 2012. Taken together, these factors inhibit measures which would create a more stable and productive supply chain.

### Part 3: Policy response and the official mentality

*DEFRA has made a commitment in our Business Plan to support and develop British farming and encourage sustainable food production by looking at the competitiveness and resilience of the whole food chain ... to foster a competitive, vibrant, diverse and sustainable industry which produces food to high standards of quality, safety and animal welfare and which is responsive to consumer needs.*<sup>65</sup>

As the above quotation shows, the relevant government ministry (DEFRA) is publicly committed to a better world for food producers and processors. Successive governments can hardly avoid these issues on pigs to pork because the agreed facts show that the chain is both unsustainable and uncompetitive. The issues have been pushed up the agenda by political pressure from the National Pig Association (the trade association for commercial producers) about the cost burden of Britain's higher animal welfare laws. A series of government reports indicate awareness and anxiety about chain problems in pigs to pork. But a variety of government policy initiatives have been conspicuously unsuccessful and this, we would argue, is because of the official mentality which only sanctions intervention to make the market work better.

#### 3.1 'Lean' supply chains

In the period since the 1999 raising of animal welfare standards, the first major initiative came out of the government's 2002 Policy Commission for the Future of Farming and Food.<sup>66</sup> This highlighted the red meat industry as "the most urgent case for action", stating that the "the long supply chain is one of the reasons why competitiveness is slipping".<sup>67</sup> This led to the establishment of the Food Chain Centre (FCC) quango, which undertook research

<sup>65</sup> <http://www.defra.gov.uk/food-farm/food/food-industry/>

<sup>66</sup> Policy Commission on the Future of Farming and Food (2002), *The Future of Farming and Food* (Available at <http://image.guardian.co.uk/sys-files/Guardian/documents/2002/01/29/foodreport.pdf>)

<sup>67</sup> *Ibid.* 42

that highlighted problems arising from supply chain fragmentation and a pervasive short-term “trading mentality”. The project finished in 2007 with a report recommending the application of ‘lean thinking’ – a set of techniques for organizing production derived from automobile industry process improvement in the 1980s.<sup>68</sup> Lean solutions revolved around eliminating waste in the form of supply chain losses and time spent in non-value adding activity. This, the FCC said, could be achieved through ‘horizontal co-operation’ in farmer-supplier associations and ‘vertical co-operation’ in retailer-supplier demand management agreements – long-term contracts which allowed selected suppliers to implement sophisticated flow systems and minimise waste.<sup>69</sup>

The impact of the initiative is hard to ascertain (because there was no evaluation of outcomes). But our discussions with industry representatives suggest uptake was limited. The implicit assumption was that business behaviour would change if actors had evidence of a better way of organising production (without substantial involvement of government). The initiative never considered critiques of lean production which argued that the benefits of lean techniques in auto assembly depended on high and stable levels of demand and capacity utilisation; the implication of such critiques was that lean would never work in pig processing where the key success conditions were absent.<sup>70</sup> As we understand it, lean was not tried because entrenched power-imbalances scuppered collaboration as retailers still sought to pass price and input volatility risks downwards.<sup>71</sup>

<sup>68</sup> Food Chain Centre (2006), *Applying Lean Thinking to the Red Meat Industry* (Available at <http://www.foodchaincentre.com/cir.asp?type=3&subtype=63&cir=317>). Womack and Jones are cited frequently throughout the meat industry studies, but in particular Womack, J., Jones, D. and Roos, D. (1990), *The Machine that Changed the World*, Rawson Associates (New York, NY). This built upon earlier studies of vertical integration in meat supply chains, see Fearn, A. (1998), ‘The evolution of partnerships in the meat supply chain: insights from the British beef industry’, *Supply Chain Management*, Vol. 3 No. 4, pp. 214-31, Fearn, A. (2000), ‘Building effective partnerships in the meat supply chain: lessons from the UK’, *Canadian Journal of Agricultural Economics*, Vol. 46 No. 4, pp. 491-518. Hornibrook, S.A. and Fearn, A. (2001), ‘Managing perceived risk-multi-tier case study of a UK retail beef supply chain’, *Journal of Chain and Network Science*, Vol. 1 No. 2, pp. 87-100. Palmer, M. (1996), ‘Building effective alliances in the meat supply chain: lessons from the UK’, *Supply Chain Management*, Vol. 1 No. 3, pp. 9-11.

<sup>69</sup> Further analysis of the lean thinking approach to meat supply chains can be found in Zokaei, K. and Simons, D. (2006), ‘Value chain analysis in consumer focus improvement’, *The International Journal of Logistics Management*, Vol. 17 No. 2, pp. 141-62, Simons, D. and Zokaei, K. (2005), ‘Application of lean paradigm in red meat processing’, *British Food Journal*, Vol. 107 No. 4, pp. 192-211, Taylor, D.H. (2006), ‘Strategic considerations in the development of lean agri-food supply chains: a case study of the UK pork sector’, *Supply Chain Management*, Vol. 11 No. 3, pp. 271-80, Simons, D., Francis, M., Boulakis, M. and Fearn, A. (2003), ‘Identifying the determinants of value in the UK red meat industry: a value chain analysis approach’, *Journal of Chain and Network Science*, Vol. 3 No. 2.

<sup>70</sup> Important critiques of lean production in the automobile were not acknowledged, e.g. Williams *et al* (1992), ‘Against Lean Production’, *Economy and Society*, 21: 3, 321-354.

<sup>71</sup> Cox, A. Chicksand, D. Palmer M. (2007) ‘Stairways to heaven or treadmills to oblivION?: Creating sustainable strategies in red meat supply chains’, *British Food Journal*, Vol. 109 (9), pp.689 – 720, and EFPF (2010) ‘Unlocking the commercial benefits of integration’, [http://www.effp.com/knowledge-bank/our-view/OurView\\_6.aspx](http://www.effp.com/knowledge-bank/our-view/OurView_6.aspx)

### 3.2 Punishing abuses of power

In 2008 the Competition Commission's report *The supply of groceries in the UK* claimed supermarkets were able to 'transfer excessive risk and unexpected costs' to food suppliers through the exercise of buying power in the supply chain – in particular through retrospective adjustments to the terms of supply.<sup>72</sup> The uncertainty this created for suppliers, the report stated, was holding back investment in production and processing and through this harming the long-term consumer interest.

The Grocery Supply Code of Practice (GSCOP) was subsequently developed to 'ensure that suppliers do not have costs imposed on them unexpectedly or unfairly by retailers'.<sup>73</sup> The Groceries Code, as it is now referred to, applies only to retailers with turnover greater than £1bn, and targets retrospective adjustments to supply agreements, delayed payments to suppliers and other such abuses. It officially came into force in February 2010, but there is still ambiguity surrounding its enforcement. With retailers failing to agree on a voluntary enforcer, the government decided to establish a Groceries Code Adjudicator (GCA) in the department for Business Innovation and Skills, funded by a levy on supermarkets. The adjudicator can act as an arbitrator, an investigator, and an imposer of financial penalties.<sup>74</sup> The draft bill was published in May 2011, and remained stuck at this stage until May 2012, leading to criticism of DEFRA Minister Caroline Spellman by opposition MPs, who claimed the government was delaying the bill and ignoring the plight of farmers struggling to cope with supermarket discounting drives. At the time of writing, the Bill has just begun its course through parliament, with ambiguity surrounding the extent of its ability to arbitrate, investigate and punish.<sup>75</sup>

Producers doubt the adequacy of the GCA's powers, and argue it addresses effects rather than causes. Certainly, the structural power imbalances and business models which maintain negative and harmful buyer practices are neglected in favour of an attempt to 'perfect the market' according to micro-economic ideals of fairness, transparency and the rule of law. The neglect is deliberate because ultimately it appears to be the official view that, as the Competition Commission enquiry puts it, 'Grocery retailers' buyer power is of benefit to consumers since part of the lower supplier prices arising from this buyer power will be passed on to consumers in the form of lower retail prices.'<sup>76</sup> The BIS GCA consultation similarly concludes that, '[t]he Government supports the view that the GCA

<sup>72</sup> Competition Commission (2008), *The Supply of Groceries in the UK: Market Investigation* (Available at [http://www.competition-commission.org.uk/rep\\_pub/reports/2008/fulltext/538.pdf](http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538.pdf))

<sup>73</sup> Competition Commission (2009), News Release: Commission Publishes Code of Practice Order (Available at [http://www.competition-commission.org.uk/press\\_rel/2009/feb/pdf/08-09.pdf](http://www.competition-commission.org.uk/press_rel/2009/feb/pdf/08-09.pdf))

<sup>74</sup> Department for Business, innovation and Skills (2011), *Draft Groceries Code Adjudicator Bill* (Available at <http://www.official-documents.gov.uk/document/cm80/8080/8080.pdf>)

<sup>75</sup> Groceries Code Adjudicator Bill [HL], 10 May 2012

(<http://www.publications.parliament.uk/pa/bills/lbill/2012-2013/0002/2013002.pdf>)

<sup>76</sup> *The Supply of Groceries in the UK*, p. 12.

should have the overriding objective to work in the long term interest of consumers [meaning lower retail prices]. The GCA should not facilitate or encourage coordination among suppliers and retailers.<sup>77</sup>

### 3.3 Transparency and communication

The third major initiative followed the 2009 EFRA Select Committee report *The English Pig Industry*.<sup>78</sup> The Committee identified a lack of communication and transparency as a major cause of problems in the supply chain and recommended that

*DEFRA must use its leverage to bring together the key elements of the pig meat supply chain to address the problems that threaten the sustainability of the English pig meat industry ... with goodwill and encouragement, we believe many of these [problems] could be resolved.*<sup>79</sup>

However, the parameters of action were set such that new initiatives should be industry-led with government acting only as a facilitator of round table discussions. In their testimony, DEFRA officials stated, '[T]he pig sector's long term sustainability will continue to depend on its ability to compete successfully upon market principles' and that it was not government's role to 'dictate what should happen between producers and the retailers'.<sup>80</sup> The outcome was limited intervention through the establishment of DEFRA's Pig Meat Supply Chain Task Force, which operated for 12 months in 2009-10, bringing together industry representatives to engage in working groups directed toward industry problems.

A follow up report, *New Ways of Working towards a Resilient Pork Supply Chain* (2009), identified the scale of the problem.<sup>81</sup> The problem was closing the productivity gap with EU competitors: for example, Denmark and the Netherlands were estimated to be 15-20% more productive. This would require serious capital investment in farms and factories contingent upon increased supply chain stability. However, intervention was based on the assumption that vertical integration of the kind found in Denmark and the Netherlands would not be possible in the UK. So the Task Force's proposal was for the formation of voluntary 'Supply Chain Partnerships', in which supply chain actors collaborated for mutual

<sup>77</sup>Department for Business, innovation and Skills (2010), *Taking forward the establishment of a body to monitor and enforce compliance with the groceries supply code of practice (GSCOP): The Groceries Code Adjudicator* (Available at <http://www.bis.gov.uk/assets/biscore/business-law/docs/competition-matters/10-1011-groceries-supply-code-practice-government-response>), p. 6.

<sup>78</sup>House of Commons, Environment, Food and Rural Affairs Select Committee (2009), *The English Pig Industry* (available at <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmenvfru/96/96.pdf>)

<sup>79</sup>Ibid. p. 39.

<sup>80</sup>House of Commons, Environment, Food and Rural Affairs Select Committee (2009), *The English Pig Industry* (available at <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmenvfru/96/96.pdf>).p. 119 and 129

<sup>81</sup>DEFRA / BPEX / EFPF (2009), *New ways of working towards a resilient pork supply chain* (Available at <http://archive.defra.gov.uk/foodfarm/farmanimal/pigs/task-force/documents/effp.pdf>)

benefit.<sup>82</sup> The one tangible positive outcome was new agreements about labelling standards on provenance and about the enforcement of environmental regulations. As regards the Partnerships, the results were modest and piecemeal at best not least because ‘partnership’ is an ambiguous term, and most supermarkets can claim to pursue them in some form. As grain prices spiked in the summer of 2010 it was decidedly back to business as usual, with producers and processors complaining publicly about supermarkets’ unwillingness to share risks.

### 3.4 Official mentality

The fourth set of official reports we consider do not relate directly to pig meat supply chains, but provide a window into current government and civil service thinking on food systems. The first is the Government Office for Science’s 2011 report the *Future of Food and Farming* (2011).<sup>83</sup> More than the immediate economic problems of the industry, the report highlighted the longer-term issues of food security and sustainability. The supplementary report *Developments in the Global Food Supply Chain* (2011) drew attention to the problems posed by supermarket business models:

‘[C]ommercial pressures mean that key actors in the supply chain are focused on short and medium term perspectives. This will leave them unprepared for the major global challenges discussed by the project.’<sup>84</sup>

The report highlights the extent to which official thinking on even the largest food system problems is shaped by orthodox neoclassical economics. For example, the report’s assertion is that ‘food security is best served by fair and fully functioning markets and not by policies to promote self-sufficiency’.<sup>85</sup> Government’s role is to correct market failures, not to shape new markets, ‘the development of new metrics of sustainability, strong direction setting and a consensus for action amongst diverse actors.’<sup>86</sup>

Upon entering office, the Coalition government initiated a Farming Regulation Task Force in July 2010 with the aim of reducing ‘red tape’ around the industry. The initial recommendations of the task force, published in May 2011, included 220 measures to

<sup>82</sup>Pig Meat Supply Chain Taskforce (2010), *Report of the Pig Meat Supply Chain Task Force* (Available at <http://archive.defra.gov.uk/foodfarm/farmanimal/pigs/task-force/documents/100201-final-report.pdf>), DEFRA / BPEX / EFP (2009), *New ways of working towards a resilient pork supply chain* (Available at <http://archive.defra.gov.uk/foodfarm/farmanimal/pigs/task-force/documents/effp.pdf>)

<sup>83</sup> Government Office for Science, *The Future of Food and Farming: Challenges and choices for global sustainability* (Available at <http://www.bis.gov.uk/assets/bispartners/foresight/docs/food-and-farming/11-546-future-of-food-and-farming-report.pdf>)

<sup>84</sup> Government Office for Science, *Developments in the Global Food Supply Chain: Summary of Workshops and Key Messages* (Available at <http://www.bis.gov.uk/assets/bispartners/foresight/docs/food-and-farming/workshops/11-606-w2-developments-global-food-supply-chain>) p. 2.

<sup>85</sup> *The Future of Food and Farming*, p.19.

<sup>86</sup> *Ibid.* p. 101.

reduce regulatory burdens on food producers.<sup>87</sup> DEFRA immediately accepted 159, and are working towards devising measures to implement a further 31, making de-regulation a priority for the department.<sup>88</sup> Although the report does not directly concern supply chain relations, like the *Future of Food and Farming*, it illustrates that the growing interest in active industrial policy is not shared amongst key figures in government and within ministries where preferences remain broadly orientated towards the structural reform common sense of the past 30 years. A number of intellectual obstacles will therefore have to be overcome before more meaningful measures are taken.

The solutions prescribed by government so far have been constrained by an official mentality that is framed by the idea that orthodox micro-economics is the key to chain management and a better macro world: perfect the market by punishing the worst abusers of buyer power, set better standards, and facilitate better communication and transparency. Additional government intervention cannot be conceived of beyond clumsy (and illegal) direct subsidies to pick winners, or protectionist measures to prop up losers, and the assumption is that relevant expertise can (and indeed should) only exist amongst market actors rather than government officials.

#### Part 4: A better way for sector and firm

The story so far is that most industry actors, just like politicians and civil servants cannot think of what a different supply chain in pigs to pork would look like and how production and processing could be reorganised. Opportunist practices are routine for actors with trader mentalities; the official mentality limits government intervention for change because policy must be what makes the market work better. If management and governmental cultures are interlocked, it is important to insist that there is a better way to organise production which can deliver lower costs and balanced profitability across the chain. And this alternative is not hypothetical like 'lean' because it is practically realised in the vertically integrated and cooperative organisation of the Danish and Dutch national industries and in the Morrison's supply chain which serves Britain's fourth largest supermarket. In this section, we use these examples to explain the better way which, as the Morrisons case shows, does not have to wait for a comprehensive reorganisation of the whole industry.

<sup>87</sup> Independent Farming Regulation Task Force (2011), *Striking a balance: reducing burdens; increasing responsibility; earning recognition* (<http://www.defra.gov.uk/publications/files/pb13527-farm-reg-task-report.pdf>)

<sup>88</sup> DEFRA (2012) 'Government Response to the Farming Regulation Task Force' (<http://www.defra.gov.uk/publications/files/pb13717-farmregulationtaskforce-response.pdf>)

## 4.1 Successful national industries

If we are looking for successful national chains in pigs to pork, the most obvious comparators are Denmark and the Netherlands, the two main sources of UK pork imports. The two national models are not exactly the same because Denmark is more integrated and the Dutch system involves independent farmer owned co-ops which invest in processor firms.<sup>89</sup> Both produce export success. Total Danish pig meat production in 2010 was around 1.974m tonnes (as compared to 760,000 tonnes in the UK), with more than 80% of this going to exports. This is striking because neither Denmark nor the Netherlands have any natural advantages in terms of climate or land resources, nor any economic advantage in terms of lower costs of labour, nor – if we set animal welfare standards aside – a dramatically less onerous regulatory system. Indeed the Danes and the Dutch have the disadvantage of hourly labour costs which are twice as high as in Britain; and yet, as exhibit 24 shows, their labour cost per kg is at or near the British level.

### Exhibit 24: A comparison of labour costs<sup>90</sup>

	UK	Denmark	Netherlands
Labour cost/hour (£)	9.98	19.12	18.39
Labour cost/kg (p)	13.85	13.99	13.02

How do the Danes turn structural disadvantage into competitive success? The first and most striking difference with the UK is the scale of the Danish pig industry's operations which are consolidated around larger production units. According to the Danish Agriculture and Food Council, there were approximately 5,000 Danish pig farms in Denmark as of 2010 with around 13.2 million pigs and around 15,000 people involved at the primary production phase. By way of contrast, the UK in 2010 had more than 10,000 farms, 4.4 million pigs and some 4,000 people involved in primary production. Therefore, the UK has twice as many farms, rearing one-third the number of pigs with one quarter the number of employees. The exit of farmers since the late 1990s is not redressing the scale problem: as exhibit 25 shows, there is no trend towards consolidation because UK herd sizes are in fact on average getting slightly smaller.

<sup>89</sup> Although the ownership models are different in this manner, the effects are comparable in that they align interests along the chain.

<sup>90</sup> Source: InterPIG and BPEX

**Exhibit 25: Average size of the UK's pig breeding herd<sup>91</sup>**

The second main factor behind Danish success is their industrial organisation which combines extensive vertical integration with co-operative ownership structures in production and a small number of major actors in processing. Pig farmer co-operatives have been in existence in Denmark since 1887, and by the mid-twentieth Century around 50 were in operation. Today around 90% of throughput is channelled through two farmer owned co-operatives, Danish Crown and Tican, which both operate their own selling, processing and distribution companies (with the Danish Crown accounting for around 90% of this throughput). Danish Crown owns Tulip, and Tican owns Direct Table, both major processors with international operations – including in the UK – and own-label branded products which are marketed internationally. All rendering is carried out through a joint venture, Daka, in which Danish Crown, Tican and a number of other meat industry companies are shareholders. The Danish Agriculture and Food Council provide information and support to all actors in the supply chain.<sup>92</sup>

The Danish system is not one of adversaries engaged in opportunist practices; instead, the Danish system works by cross-holdings which align interests. Producers sell their produce to processors and exporters in which they are already shareholders, receiving dividends as compensation for the periods in which they receive lower prices.<sup>93</sup> Despite over-capacity in the pig meat market, through co-operatives, farmers retain a much greater level of bargaining power with buyers. The aligned and co-operative organisation enables a better

<sup>91</sup> DEFRA

<sup>92</sup> KG Grunert *et al* (2005), 'Market orientation of value chains: A conceptual framework based on four case studies from the food industry', *European Journal of Marketing* 39:5-6, pp. 434

<sup>93</sup> Interview with Danish Agriculture and Food Council, March 2012, JE Hobbs, WA Kerr and KK Klein (1998), 'Creating international competitiveness through supply chain management: Danish pork', in *Supply Chain Management*, 3, 2, pp. 68-78

distribution of risk around the chain, ensures that production volume can be better matched to demand, and provides the opportunity to plan and pool resources. As a consequence, the Danish industry is better able to exploit economies of scale, gain access to credit, make capital investments and fund R&D. Processing is large-scale and highly capital intensive, and in contrast to the competitive secrecy about process improvement in the UK system, automation in Denmark is based on data shared throughout the whole chain. A small but highly trained labour force has been formed through government sponsored apprenticeships and specialist technical colleges.

This not only saves costs but also creates the capacity to improve product quality and make complex made-to-order products in less time. Danish producers have, for example, created an 'England Pig' suited to production of British style bacon rashers and raised according to the higher welfare standards expected by UK consumers.<sup>94</sup> According to Grunert *et al* (2005), for the major UK supermarkets, 'the high degree of vertical integration in the Danish pork sector is viewed as an advantage, ensuring stable supplies, homogeneous quality, and generally consistent implementation of changes when required.'<sup>95</sup>

## 4.2 The Morrisons model

It is unrealistic to propose the transplant of national industrial models because Britain cannot easily become Denmark. Hence the importance of the Morrisons case which shows that it is possible within the UK to behave as a socially responsible vertically integrated processor, source more British produce, and do so while competing on price in the mass market with the 'big three' major supermarkets. It is hardly surprising that Marks and Spencer or Waitrose can sustain relations of commitment with producers and processors because they have the advantage of market positioning and premium pricing. The importance of Morrisons is that it shows how vertical integration can reduce costs and increase profits for retailers competing in the mass market.

Other retailers do operate with dedicated supply chains for the entire product in the case of Waitrose, and Marks and Spencer, or for premium lines in the case of Sainsbury's on their *Taste the Difference* range, and Tesco on their *Finest* range. In all these cases, the processing factories are not directly owned and the retailer's commitment to suppliers could be read as a kind of buyer's adaptation to special circumstances; the costs of switching are much higher for premium quality, bespoke products bought by more demanding customers who wish to see certification for higher welfare and environmental standards, and take a keener interest in the origins of the product.

<sup>94</sup> KG Grunert *et al* (2005), 'Market orientation of value chains: A conceptual framework based on four case studies from the food industry', *European Journal of Marketing* 39:5-6, pp. 433-434

<sup>95</sup> *Ibid*, p. 435

Morrisons represents a different case because it directly owns processing facilities (including abattoirs) as a way of ensuring supply and delivering quality at a low price. The policy is organisationally embedded in the firm whose management board includes a 'group manufacturing director'. Ken Morrison, who built the chain from small beginnings in Bradford, determined the integrated design. As a patriarch and autocrat, Morrison employed his three eldest children in the business, refused to have non-executive directors on the board and was fined for ignoring rules on insider share dealing. Ken Morrison had executive control from age 26 in 1956 for the next 50 years and his decisions were unquestioned (until integration problems and profits warnings after the 2004 acquisition of Safeway).

It is not surprising that Ken Morrison, who started in provisions on Bradford market and whose daughter was the poultry buyer, felt at ease with vertical integration which gave him quality control; nor that Ken Morrison was committed to adding more value by prep in store with the 'market street' aisle of fresh foods. But what is really striking is what has happened since 2006 in the period when Morrisons has been headed by two outsider CEOs - Marc Bolland and Dalton Philips - whose jobs were to deliver shareholder value through profitable expansion. Bolland retained the directly owned processing plants and Philips is investing heavily in expanding these operations.

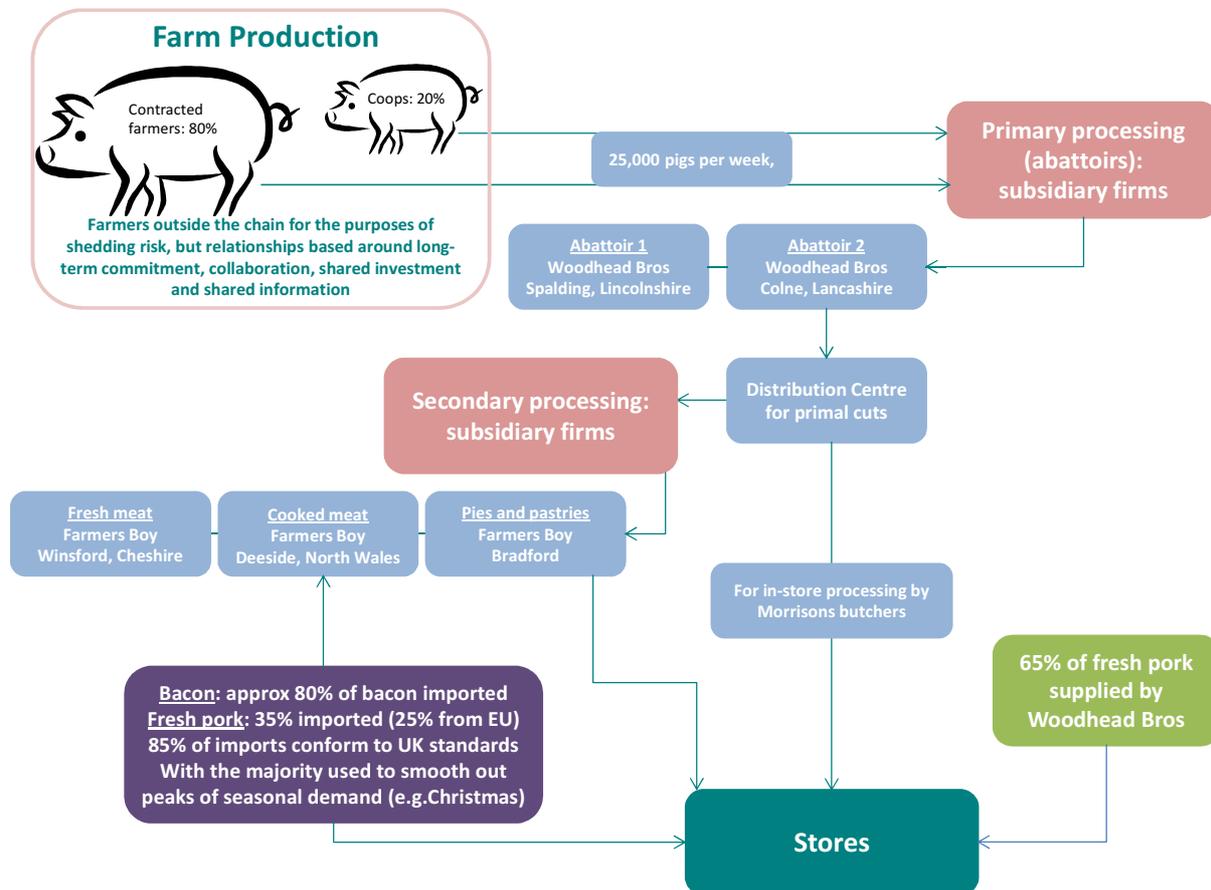
A significant proportion of Morrisons' fresh produce is provided through directly owned subsidiaries in its own vertically integrated supply chain. This does not include farmer/producers but incorporates all aspects of food processing which feeds its centralised, in-house distribution network (see exhibit 26). As exhibit 19 showed, in consequence, Morrisons as fourth largest chain sells more British pig meat than any of the 'big three' supermarkets.

In recent years, Morrisons' management has been investing heavily in acquiring more processing capacity by expanding their existing plants, buying up plants from other processors, and acquiring processing firms. The aim is to expand the number of company-processed products offered. In consequence, Morrisons is already the second largest fresh food manufacturer in the country and soon will be first if the current expansion continues. It currently employs over 7,000 people in food processing and has pledged to invest over £200m in expanding its manufacturing operations by 2013.

Following on from major acquisitions, such as that of the packed vegetable producer Simply Fresh in 2010, in 2012 Morrisons has made significant purchases of meat processing plants in Winsford from VION UK and in Deeside from Cranswick, as well as a fish processing plant in Grimsby; and it has also announced a further £21m to be spent on expanding capacity at

its Colne abattoir.<sup>96</sup> By 2015, it claims it will be the single largest buyer of produce from British farmers, although its share of the retail market is significantly smaller than that of Tesco and Asda.

### Exhibit 26: The Morrison Supply Chain



How does the vertically integrated model work in meat processing? A wholly owned subsidiary Neerock Limited t/a Woodhead Brothers buys all of Morrisons' fresh pork and beef directly from a supplier network of 1,700 farmers, or from live auction. Nine livestock buyers work 'in the field' in contact with farmers. Andrew Thornbur, Morrisons' meat manufacturing director, explains

*We are looking to make use of every bit of the carcass. Everything which is not sold as fresh meat goes to our Farmers Boy factory in Bradford to be used in manufacturing food products ... This way, we have no waste, we do not need to sell any of the carcass*

<sup>96</sup> *Meat Trades Journal*, 'Morrisons buys out Cranswick at Farmers' Boy' 30 March 2012 ([http://www.meatinfo.co.uk/news/fullstory.php/aid/13849/Morrisons\\_buys\\_out\\_Cranswick\\_at\\_Farmers\\_Boy.html](http://www.meatinfo.co.uk/news/fullstory.php/aid/13849/Morrisons_buys_out_Cranswick_at_Farmers_Boy.html)), *Food Manufacture*, 'Morrisons buys meat processing plant from VION' 01 February 2012, (<http://www.foodmanufacture.co.uk/Manufacturing/Morrisons-buys-meat-processing-plant-from-VION>)

*on elsewhere, and we are ensuring full traceability for our customers. Woodhead buy 3,000 cattle every week and we will sell 99.9 per cent of these ourselves.*<sup>97</sup>

Through ‘Supply Chain Development Groups’, Morrisons brings together farmers, manufacturers and retail buyers to undertake planning on how to reduce costs and improve quality. Although farmers are not fully integrated into the Morrisons pig meat supply chain, the trading relations are long-term and based around high levels of trust, as well as investment. According to Martyn Fletcher, Morrisons’ Director of Manufacturing

*We always pay a fair price, we have supported farmers when times have been tough and we ask them not to be greedy when things are better. We can take some volatility out of the market and allow farmers to plan and invest in their businesses.*<sup>98</sup>

In its investor relations material, Morrisons publicly represents their integrated supply chain as a source of competitive advantage. The 2011 annual report for example, states:

*It’s a unique supply chain set-up that works for us in a number of ways. First of all, because we buy direct from farmers, we know exactly what we’re buying and where it comes from. By cutting out the middle man, we can save money and pass on those savings to our customers. And by running our own processing plants, we can keep control of quality throughout every stage of the production process.*<sup>99</sup>

In our view, supermarket-led vertical integration also has cost advantages at the processing stage which come from high and consistent plant loading (in an industry where independent processors have a cost penalty arising from poor capacity utilisation). Capacity utilisation is high at Morrison’s processing plants in meat or veg because it is geared directly to the fairly predictable volume of the category which Morrisons stores will sell each week. Cost recovery is good because Morrisons can plan to use the whole of the pig meat carcass in its own operations with surplus cuts processed into sausages, pies or used in ready meals. Both return on capital metrics and the continuity of workforce employment benefits from this commitment, as compared to independent suppliers where fluctuations in turnover drive factory closures, distress sales of recently installed plant and workforce redundancies, Morrisons are able to expand and purchase facilities, make heavy capital investment and hire and train workers in the knowledge that their supply has a guaranteed market. The investments represent a risk because they are long-term commitments which Morrisons cannot easily reverse; but the risk is limited in categories like meat where Morrison’s weekly throughput is unlikely to decline.

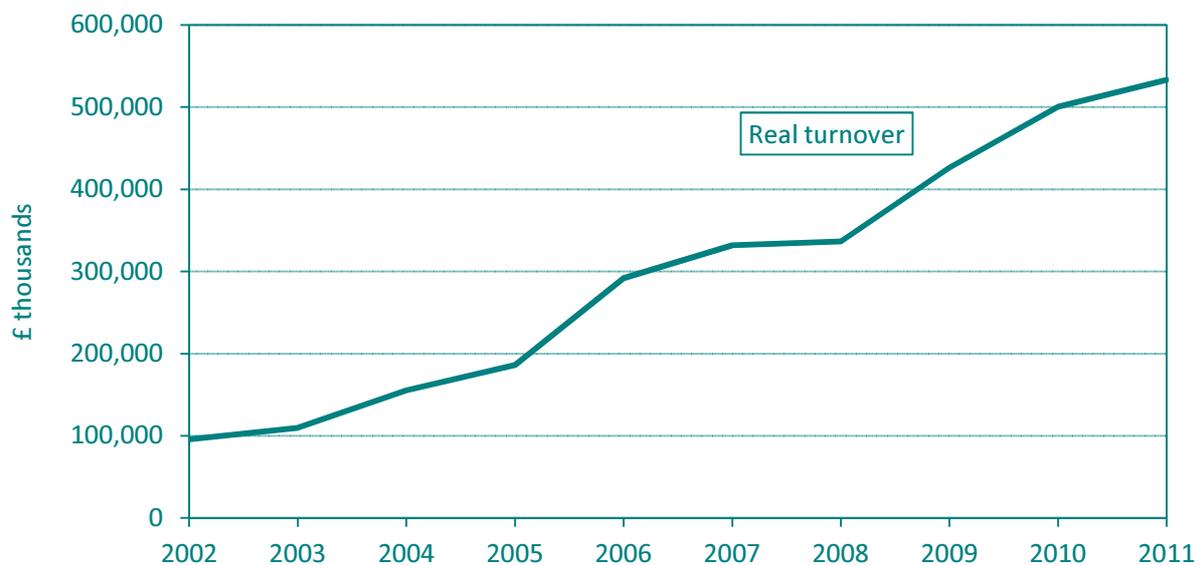
<sup>97</sup> Farmers Guardian, ‘Opening of Spalding abattoir: Morrison’s back British industry’ 22 May 2009 (<http://www.farmersguardian.com/opening-of-spalding-abattoir-morrison%92s-back-british-industry/25198.article>).

<sup>98</sup> Ibid

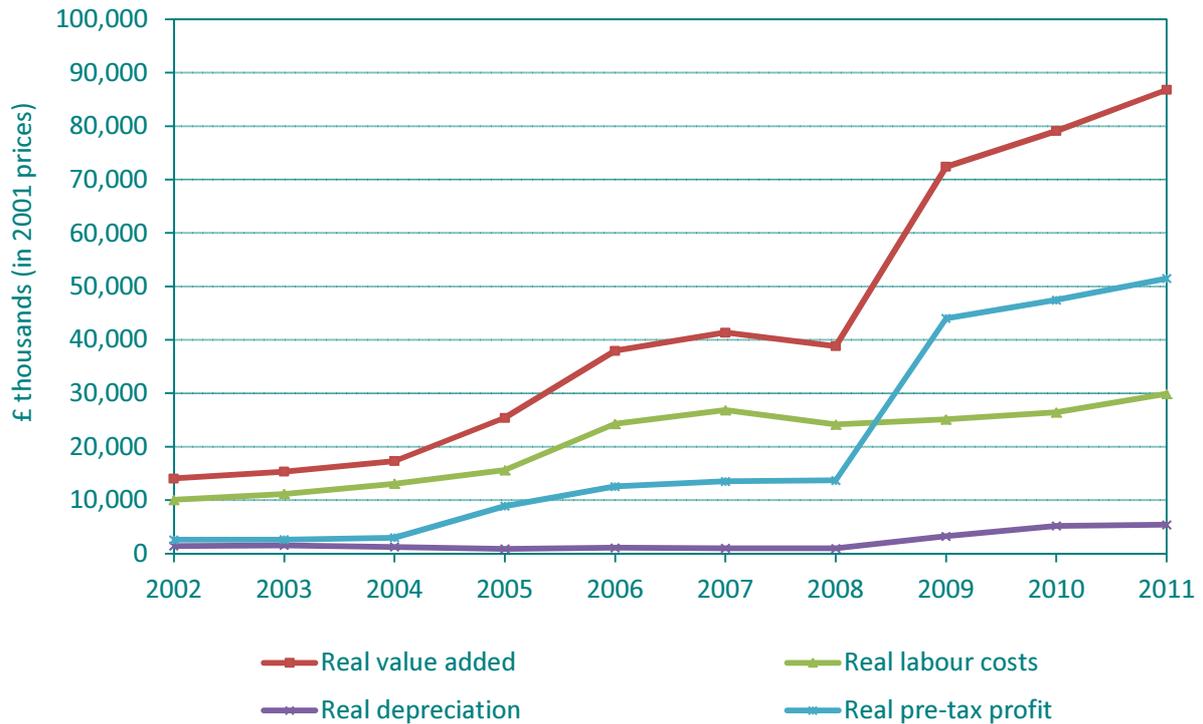
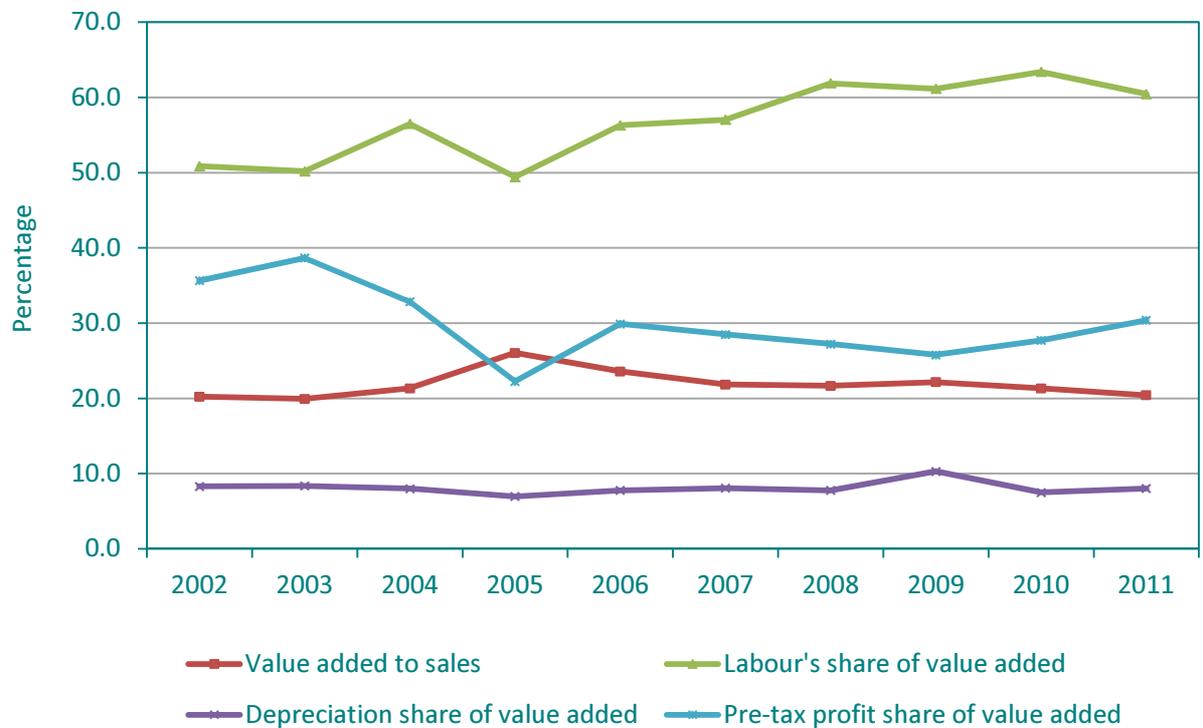
<sup>99</sup> Morrisons Annual Report, 2011, p. 9-11.

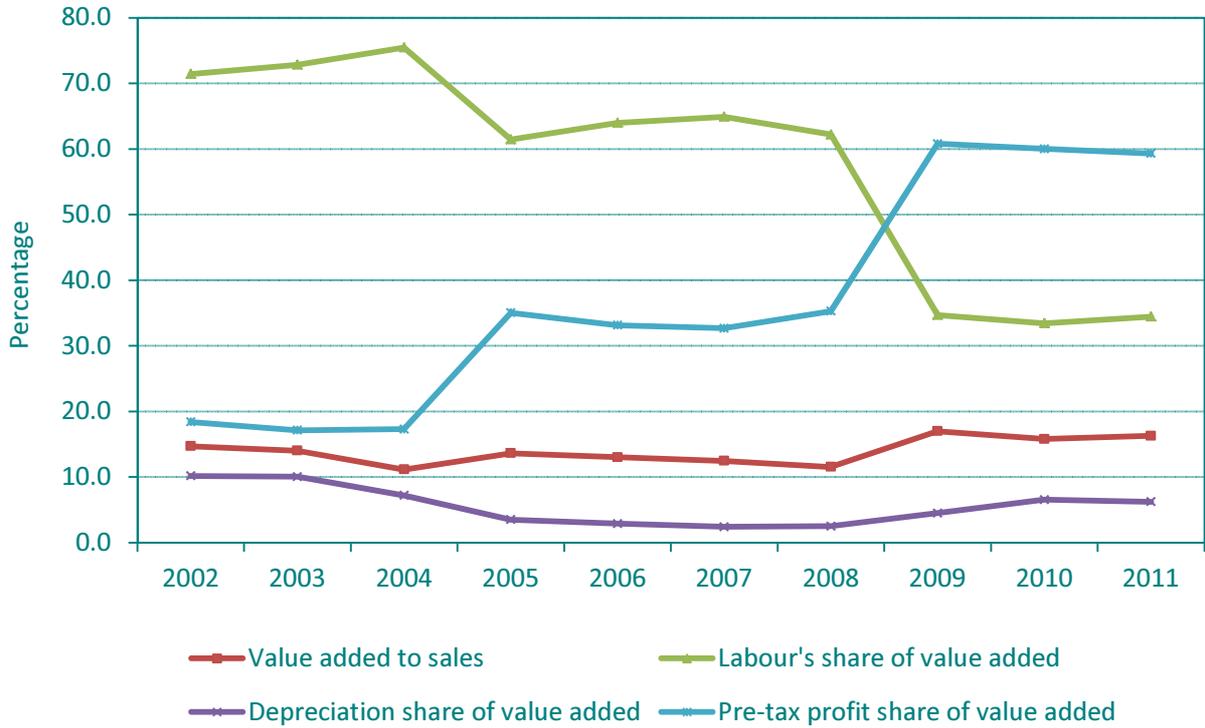
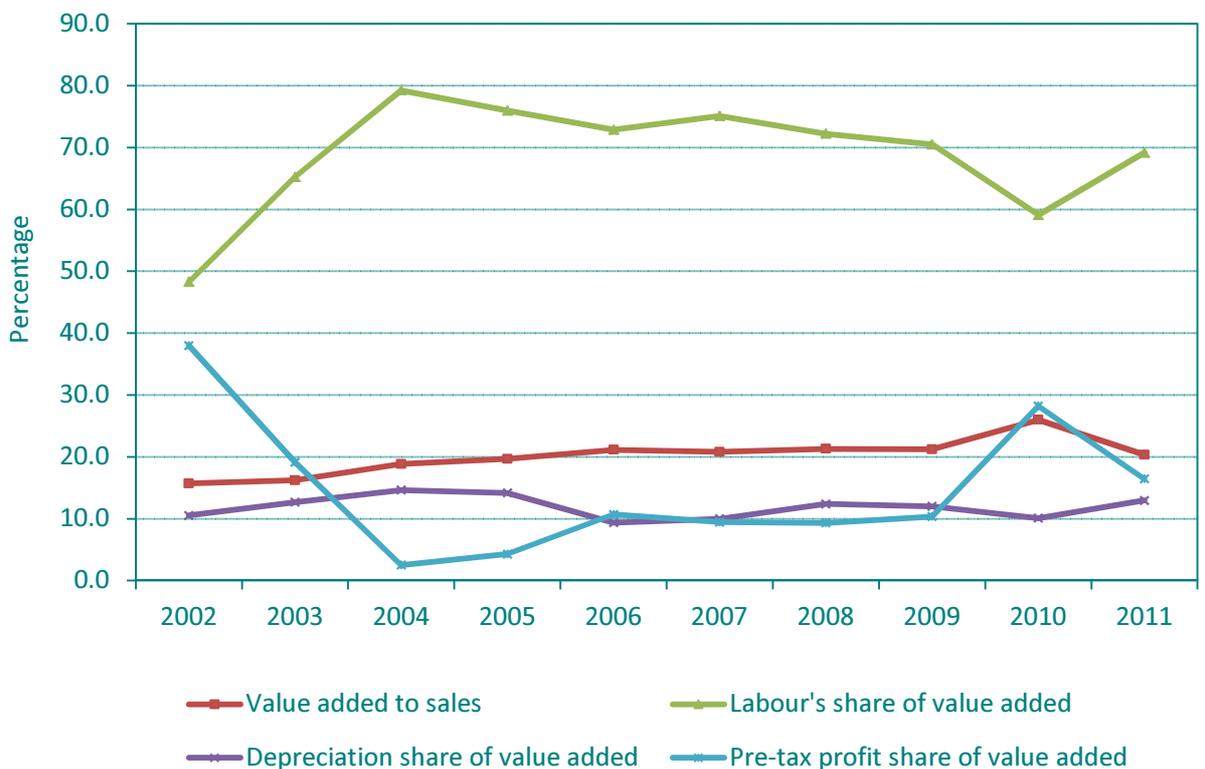
Meanwhile, from the publicly available evidence, the investment in processing is highly profitable. Like other supermarkets and retail chains, Morrisons is very reluctant to present disaggregated financial results which give a window into the relative profitability of different lines and activities: just like Marks and Spencer which, in its glory days, never separately disclosed the margins on food and clothing. Nevertheless, it is possible to analyse the accounts of Neerock Limited, which trades as Woodhead Brothers and is the subsidiary company which operates as Morrisons' meat supplier. This is effectively the integrated meat processing division of Morrisons, and, under current audit rules, Neerock should report as if it were a standalone operation without any manipulation of results by parent company transfer pricing decisions. It is therefore reasonably fair to compare the financial results of VION, Tulip and Cranswick with those of Neerock. As the data shows, the three independent meat processors have weak financial results while Neerock has favourable ratios and higher profits which allow it to reinvest from a position of strength.

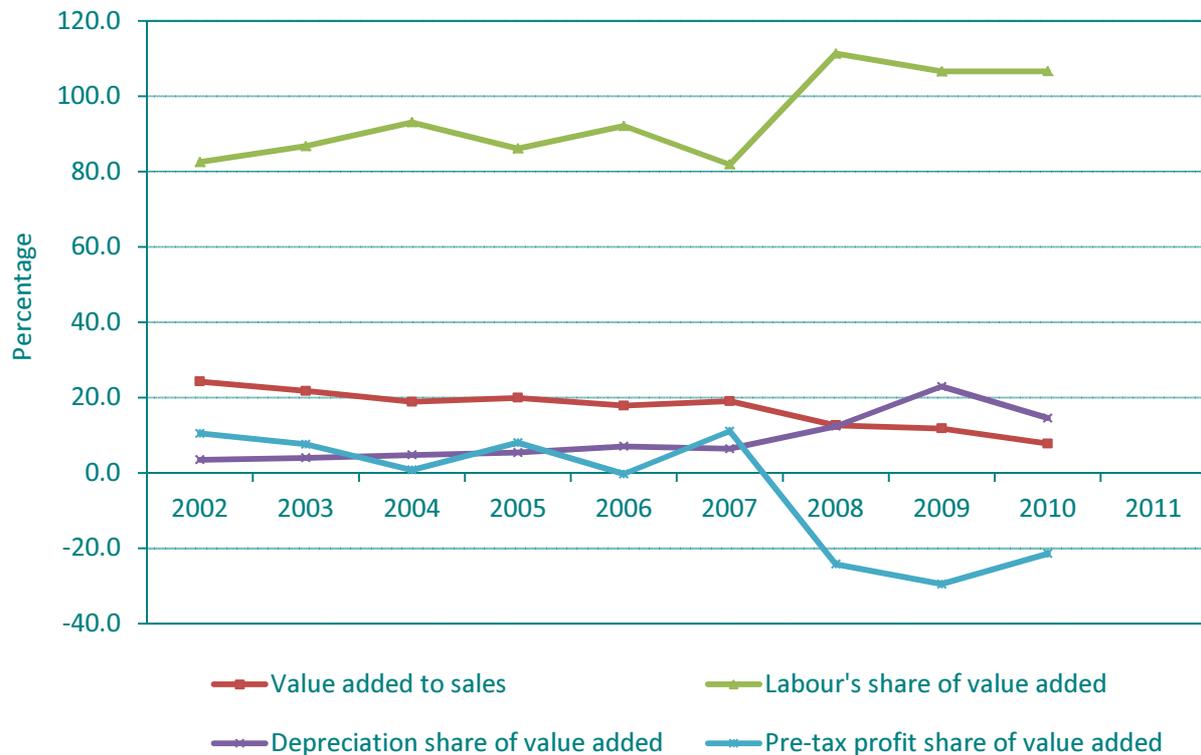
**Exhibits 27: Neerock Limited turnover (in 2011 prices)<sup>100</sup>**



<sup>100</sup> Source: Fame, BvDep

Exhibits 28: Neerock Limited value added analysis (in 2011 prices)<sup>98</sup>Exhibit 29: Cranswick PLC – value added comparison of UK based pig processors<sup>101</sup><sup>101</sup> Fame, BvDep.

**Exhibit 30: Neerock Limited – value added comparison of UK based pig processors<sup>99</sup>****Exhibit 31: Tulip Limited – value added comparison of UK based pig processors<sup>89</sup>**

**Exhibit 32: VION Food UK Limited – value added comparison of UK based pig processors**<sup>89</sup>

The contrast in financial performance against Tulip and VION (and to a lesser extent Cranswick) is stark and starts from different patterns of turnover growth and fluctuation. Neerock shows a steady growth of turnover from £95m to £533m between year 2002 and year 2011 which allows capacity to expand in line with demand. Turnover trends in the other three major processors are complicated by acquisition but the general pattern is one of saw tooth fluctuation as supermarket contracts are won or lost. What immediately sets Neerock apart from the three independent meat processors is its far higher profit share of overall value added – some 60% in 2010 as compared to 20% in VION, less than 20% in Tulip and 30% in Cranswick. The corollary is that two of the three majors (VION and Tulip) have problems with high labour share of value added, which in VION UK's case is at or above the high level of 80%. Thanks to a portfolio of its own branded products, Cranswick does better with a creditable labour share of around 50-60% which leaves room for healthy profit margins which are about as good as it gets for an independent producer supplying the supermarkets. But, this is trumped by Neerock whose labour share of value added falls from a normal 70% in the early 2000s to 35% in recent years.

How can Neerock be turning in hugely superior financial results from the same mundane activity? The declining labour share of value added for Neerock is not a result of falling wages because average wages are similar across the different firms, nor the result of greater spending on fixed capital because Neerock's depreciation share of value added is lower than

some of the other three. Rather, as the company moves along a trajectory of expansion with high levels of capacity utilisation. Neerock is paying sector average wages but throwing off a cash surplus (after labour costs) in a way that we would ordinarily associate with an Asian low wage producer on a trajectory of rapid expansion. In other words, what makes the difference for Neerock is not that it is able to gain dramatic advantages over its competitors through heavy investments in new technologies, nor by accessing far cheaper sources of labour, rather it achieves its higher profits because it is able to run its plants at their maximum capacity with demand guaranteed in the integrated supply chain. The other processors meanwhile suffer because fluctuations in supermarket orders mean their plants and equipment are not as well utilised.

Morrisons starts from a structural disadvantage because, as the fourth largest chain, it lacks scale and has an unusual portfolio of stores (northern supermarkets and almost no convenience stores). This is partly compensated by in-house processing which is extremely profitable, though not large enough to deliver consistently the shareholder value that would protect the firm from activist shareholders. Over the past three years from 2009 to 2012, Neerock's return on sales is 9.8% and its return on capital employed is 48%, so it is both building cash reserves and making a healthy contribution to Morrisons: in 2011, Neerock accounted for 3.2% of turnover and 5.9% of pre-tax profit.

Nevertheless, without any huge increase in floor space, Morrison's has enjoyed strong growth in turnover and maintained margins of around 5% on sales for the past four years so that, by 2011, Morrisons had pre-tax profits of £51 million on shareholder equity of £136 million.

**Exhibit 33: Morrison's performance, stores and selling area**<sup>102</sup>

	2006	2007	2008	2009	2010	2011
Sales (£m)	12,115	12,462	12,969	14,528	15,410	16,479
Total turnover growth (%)	-0.01	2.86	4.07	12.02	6.07	6.94
Operating Profit Margin (%)	-2.58	2.96	4.72	4.51	5.57	5.3
Number of stores	-	375	382	425	439	475
Sales Area (sq. m)	-	1,006,790	1,034,103	1,102,480	1,139,084	1,198,820

<sup>102</sup> Source: IGD

This retail success rests on the strength of Morrisons' offering in groceries where Morrisons have pledged to maintain a consistent price-led volume strategy and an overall basket price competitive with Tesco and Asda. For staple items, it aims to be the cheapest in the country. This challenges and disproves the assumption that the system of opportunist practices, pitting producers and processors against one another, is the only way for retailers to operate if they want to deliver cheap products to consumers and profits for the stock market.

The full benefits to the company can be listed as follows:

- **The reduction of transaction costs and duplication of services:** layers of both middle and senior management are removed, information and administrative functions merged and transport and distribution systems rationalised.
- **Capture and control of margins:** rather than fighting chain adversaries for profit, Morrisons is able to control and cross-subsidise as necessary between processing and retail; currently, profitable processing is being used to defend a retailing operation which would otherwise be at a considerable disadvantage to the more extensive scale and geographical distribution of the big three supermarkets.
- **Balancing supply and demand:** demand is guaranteed and carcass balance is achieved through internal connection and negotiation. Morrisons' stores, for example, sell bone marrow which is waste for other producers, while sausages and pies are made from trim and unwanted cuts by Morrisons' other meat processing firm, Farmer's Boy.
- **Supply security from dedicated facilities:** commitment gives the ability to plan for the long term and (maybe) innovate in the short term. By owning the suppliers and aligning incentives, new product ideas can be implemented more quickly and with less complicated bartering negotiations and tendering than would be the case when sourcing products externally. The guarantee of long-term commitment from the parent company means that subsidiaries can invest with a longer timeframe than vulnerable independent processors who must anticipate that their relationships with supermarkets being short term.

The integrated chain has already enabled Morrisons to respond faster to consumer demands. For example, in 2010 as scandals surrounding animal cruelty in abattoirs resurfaced, Morrisons was capable of taking the immediate step of installing CCTV in all its abattoirs.<sup>103</sup> Interviews with trade unionist representatives suggest that while Morrisons'

<sup>103</sup> BBC 'Morrisons installs CCTV in its abattoirs' 19 November 2010 (<http://www.bbc.co.uk/news/uk-england-bradford-west-yorkshire-11800357>).

processor firms place similar pressures upon their workforces to other processors (e.g. increasing use of agency staff, downward pressures on wages and conditions) industrial relations are overall more harmonious. The added stability of employment is likely to be one factor here, but in comparison to the antagonistic relations in other firms, we were told that Morrisons' management had 'embraced the trade unions' and through consultative committees were enabling worker representatives to play a role in decision making at various levels of the firm. In both these cases, it is perhaps not so much the case that Morrisons is inherently a more socially and environmentally responsible retailer, but rather that its integrated supply chain model allows it to be. The added control over the chain, the alignment of interests and the added margin gained gives it the *latitude* to take more ethical approaches to the way it does business, and to take a more long term perspective on the value of its workforce.

Any transition to the Morrisons model would in some ways be back to the future for the big three supermarkets. In past decades, many of the UK's major retailers owned some production and processing facilities, but have since abandoned them to focus on their core business of retailing whilst shifting supply chain risks elsewhere. Why don't the others follow this model? It is perhaps the consequences of a combination of the prisoners' dilemma outlined in section 2.2 and 2.3 above, engrained habits and competencies, and shareholder pressures which have encouraged conservative strategy in the larger chains. Opportunist practices entail an optimistic self-reinforcing logic whereby poor results in one deal can always be compensated for by better results in the next one. With market conditions volatile and market actors diverse, the expectation of getting a better deal next time around through a refinement of strategy is strong. A switch to an integrated supply chain model meanwhile would require a large amount of long-term investment, which could take long periods of time to pay off and in the meantime lead to a considerable worsening of the quarterly earnings ratios which stock market analysts use to form judgements on the health of the company. Making the shift to a better model will require more active government intervention and a shift in culture and priorities for supermarket managements.

## Part 5: What can we learn from the pig meat industry?

Size isn't everything and that surely is the point about the significance of pig meat. Pig meat is a relatively small subsector which will not in itself be a lever for changing the macro economy. Moreover, most of us outside the sub-sector will not be greatly affected in any direct way if production and processing continue in decline and distress. But pig meat is part of the economically important red meat sector, which in turn is part of food production and processing, a major employer and strategic driver of UK success and failure in tradable goods activities and balance of payments. Furthermore, if no one sector is representative

and provides a generic template for innovative new industrial policy, pig meat is symptomatic and provides a window onto larger issues about frames, practices and success measures in food production, processing and retail. Pig meat therefore provides an opportunity to discuss what an engaged, new and sector-specific industrial policy might look like.

### 5.1 The significance of the pig meat sub-sector

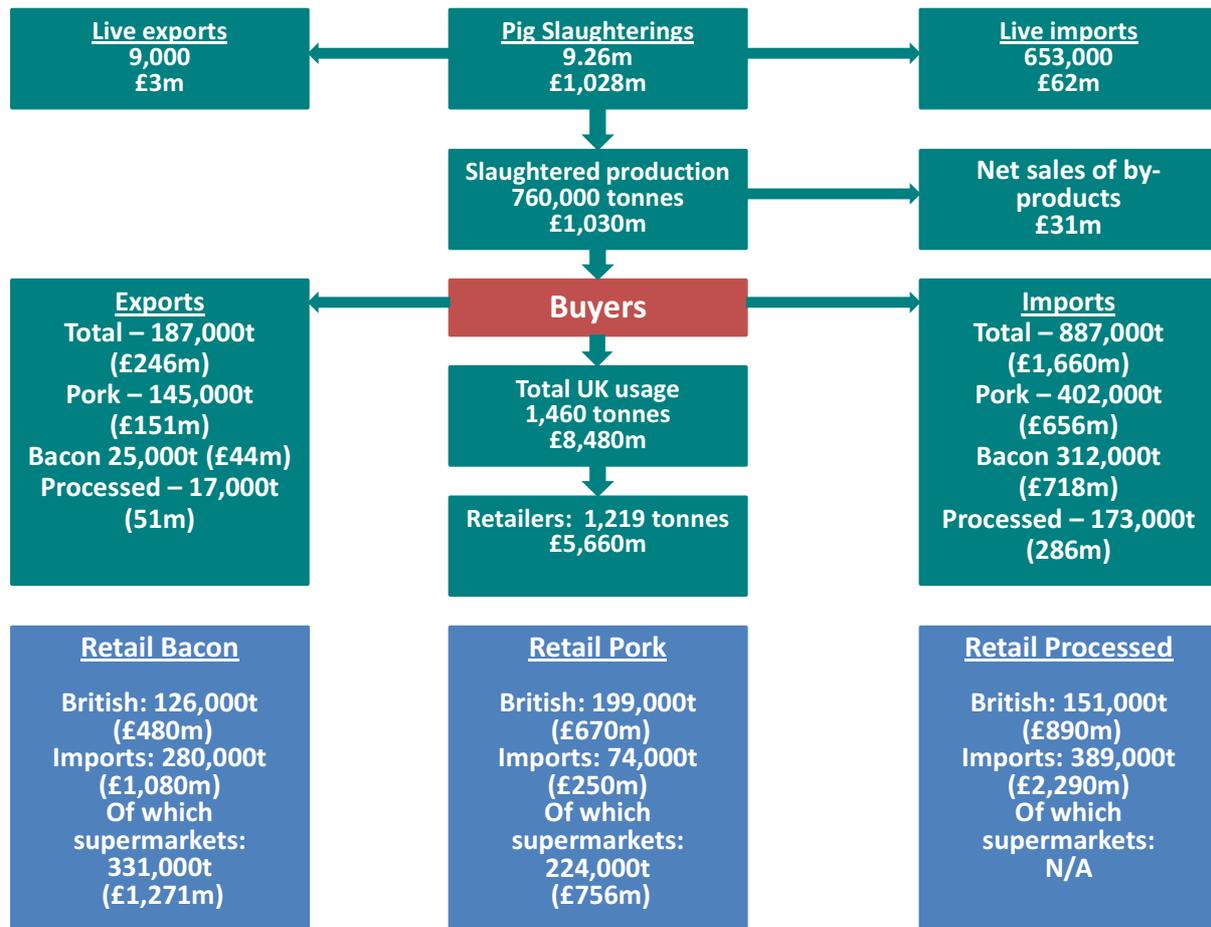
How large is the pig meat sub-sector? The answer depends on the measure that is used. If we include retailing, its ‘contribution’ to the economy runs into hundreds of millions of pounds and its value added is one billion pounds. If we exclude retailing then the numbers employed in pig meat production and processing are in the tens of thousands. A recent study commissioned by the Agriculture and Horticulture Development Board calculated the ‘contribution’, that is the net economic value, of the English pig meat industry.<sup>104</sup> Taking pigs alone, and combining farming and allied industries (inputs, retail, processing) it calculated a net contribution to the economy of £197.3m, and a net contribution to employment of £107.6m.

BPEX market value data are different (see exhibit 34.) So too are economic value added calculations (see exhibit 35) which make assumptions about how resources employed by the industry would be redeployed in the absence of a pig meat sector<sup>105</sup>. A standard value added calculation (exhibit 36) gives much larger totals: including retail the figure is £950 million with just under £400 million in production and processing.

Employment figures give a different view of the size of the sub-sector. As exhibit 33 shows, employment is modest outside retail. During 2010-11, some 280,000 were employed in the sector according to Matrix estimates, but this total included no fewer than 216,000 retail workers whose jobs were sustained by pig meat related activity; pig meat production and processing directly employed no more than 65,000 workers. Retail employment at local points of sale is required whatever the size of the pig meat sub-sector. It is also true that secondary processing (like slicing and packing bacon) is likely to be carried out near final consumption with or without imports. Employment of 65,000 isn’t negligible but, even if half as many again were employed in a revitalised more self-sufficient economy, the lesson is that the pig meat sub-sector is and will be relatively small as a generator of employment. But, the pig meat subsector *is* significant in two other ways: first, it is nested within the much larger red meat sector within food processing; and second, because the mentalities, practices and business models of pig meat are symptomatic of larger problems.

<sup>104</sup> Marsh *et al*, *The real value of English red meat*, March 2012

<sup>105</sup> For example, would the proportion of the sub-sector labour force finding new employment be more or less than the standard re-employment rate, as calculated by the ONS.

Exhibit 34: The pig meat market quantified (2011)<sup>106</sup>Exhibit 35: Economic value generated by the English pig industry 2010/11<sup>107</sup>

Sector	Economic value generated
Pig Farming	£72.5m
Pre-farming and farming inputs	£56.6m
Processing and wholesale	£360.7m
Retail	£564.1m
<b>Total</b>	<b>£951.5m</b>

<sup>106</sup> BPEX<sup>107</sup> Matrix estimates based on DEFRA

**Exhibit 36: Employment in the English pig industry 2010/11<sup>108</sup>**

Sector	Employment generated
Pig Farming	6,784
Pre-farming and farming inputs	4,423
Processing and wholesale	52,093
Retail	216,361
Total	279,661

First, then, by any standards, the red meat sector is significant. If pigs are combined with sheep and cattle, DEFRA estimates that the gross economic value to be just short of £5 billion (five times the size of pig meat). Matrix estimates that total employment (including retail) to be 868,762. Most of this is in retail, but as context it is worth remembering that food processing in census of production terms (i.e. the manufacturing activity excluding farming/ production) employs some 400,000 in the UK, or around 1 in 5 of all those engaged in manufacturing. And the success of the food-processing sector in substituting for imports or increasing exports is important for trade performance because in 2011 food and drink accounted for £17 billion of the UK's deficit on visible trade. Food production and processing – and changes in the sector – have huge significance for UK trade performance and job creation.

Second, the pig meat sub-sector is also significant because the trader mentalities, opportunist practices and business models analysed in earlier sections of this report are similar in other food processing sub sectors. Of course, industrial policy also needs to engage with specifics: even within red meat, pig production is distinctive because it is intensive rather than extensive.<sup>109</sup> Even so, with appropriate caution it is accurate to say that the problems overlap and it is possible to apply supply chain lessons learned from pig meat production to other sectors.

## 5.2 The importance of 'mundane' sectors to new industrial policy

What are the lessons of this report's analysis? The government acknowledges supply chain problems in sub sectors such as pig meat, but successive government policies have had a limited impact. The fundamental problem has been how the official mentality frames legitimate state intervention in strictly market terms. *The object is always to make the*

<sup>108</sup> Source: Matrix estimates based on DEFRA, ADHD and HMRC trade data.

<sup>109</sup> Pig production creates by far the largest gross income per hectare per year of any of the red meats: £2,018 compared to £89 for sheep, £135 for beef cattle and £66 for crops (Matrix, 14).

*market work better.* Competition is therefore assumed to be desirable. The difficulty is that policy makers have not understood that the *form* of that competition is a significant part of the supply chain problem. Voluntary initiatives resting on goodwill and trust have failed because of the commitment of the big three supermarkets to opportunist practices. Interventions have also failed because they have not tackled the imbalance in power relations between retailers and suppliers. Finally, policy makers have also been reluctant to challenge the alibi of shareholder value driven retailers when the latter point to the social value of low prices.

The government's failure to engage actively with the problems of pigs to pork (and other food supply chains) has been part of a more general 30-year retreat from active sectoral policies for creating and redistributing employment and output. Such policies survived into the 1980s with successes like North Sea oil procurement, but increasingly the emphasis in the UK was on structural reform through low business and personal taxes and flexible labour markets. These generic policies have had disappointing results. Even though the underlying constraints were identified at the time in the early 1980s,<sup>110</sup> government interventions have never addressed the pervasive problems of demand composition, industrial organisation and management culture which have limited British success in tradable goods. Neither have they properly addressed regional disparities, where the only legitimate form of intervention has been infrastructural improvement and training; and most of the infrastructural spending is in the South East.<sup>111</sup>

The recession which began in 2008 exposed the structural weakness of the non-financial private sector economy. For instance, it has become clear more than half the extra jobs under New Labour were publicly funded,<sup>112</sup> and the hugely depressive force of a £87 billion visible trade deficit by 2007 was countered by the boost to consumption of housing equity withdrawal which itself depended on an unsustainable rise in house prices. Against this background, front bench politicians led by Peter Mandelson (2009) rediscovered a role for industrial policy, which they had long discredited by invoking the failure of 'picking winners' (for instance supporting British Leyland.)

In 2008 and 2009, the desire to 'rebalance' the economy suddenly became a matter of political consensus, and industrial policy was overloaded with worthy but previously neglected aims in need of urgent attention. The UK needed to

- *reduce its trade deficit* (most thought via export success);

<sup>110</sup> Williams, K., Williams, J. and Thomas, D. (1983), *Why are the British Bad at Manufacturing?* London: Routledge and Kegan Paul

<sup>111</sup> In practice, London and the South East have claimed the lion's share of capital expenditure on transport improvement.

<sup>112</sup> Froud J, Johal S, Law J, Leaver A, Williams K (2011), *Rebalancing the Economy (Or Buyer's Remorse)*. CRESC working paper no. 87 (<http://www.cresc.ac.uk/publications/rebalancing-the-economy-or-buyers-remorse>)

- foster economic activity by *increasing private output* rather than trading coupons or cashing out on rising asset prices;
- create *private sector jobs*, particularly in the de-industrialised regions recently dependent on publicly funded employment

More radical observers added that the UK needed to lay the foundations for an economy that was

- *ecologically sustainable* and
- *resilient* in the face of international economic and political volatility.

These larger objectives are all relevant to UK food production and processing.<sup>113</sup>

It is doubtful whether any new policy or suite of policies could deliver quickly on all these aims, but let us make three general points that are particularly relevant to the food industry.

- Debates about industrial policy have usually been about hopes and aspirations. For instance Labour's Shadow Business Secretary, Chuka Umunna, has talked of 'picking sectors' for export success through industry councils, an investment bank, and reinvented regional development agencies.<sup>114</sup> Against this, policy debate and initiative remains fixed on properly functioning markets, low tax regimes, and a flexible labour force, with little focus on *sectoral* obstacles to industrial innovation.
- Similarly, and as part of this, there has been little attention to sectorally specific levers for engineering beneficial industrial or supply chain change in practices and business models.. The BIS web site talks up company and sector success stories and lists policy initiatives across many sectors but does not explain how tax rebates or large scale funding can be mobilised for fixing specific sectoral problems or indeed how government would plan anything contentious. The long-standing emphasis at BIS is on a business friendly approach and sector working parties, which are dominated by big corporates and trade associations. This format is ill adapted to the design and disbursement of inducements, as demonstrated by the debacle of the car scrappage scheme which was of more benefit to Korean importers than British assembly plants.
- Finally, the fixation has been on chosen sectors of the future which have predominantly been either in new technology areas, such as green energy, or transformational

<sup>113</sup>EFFP (2011), 'This time it's different' <http://www.effp.com/knowledge-bank/our-view/ThisTimeItsDifferent.aspx> EFFP (2011), 'The new sustainability agenda' <http://www.effp.com/knowledge-bank/our-view/3ps.aspx> EFFP (2010), 'Food GB: stepping up to the plate', [http://www.effp.com/knowledge-bank/our-view/OurView\\_8.aspx](http://www.effp.com/knowledge-bank/our-view/OurView_8.aspx)

<sup>114</sup> *The Observer*, 'Chuka Umunna: 'The market is not able to provide direction' 06 May 2012

technologies, such as vehicles in an era of high-energy prices and global warming. Little attention has been paid to more mundane sectors – such as the food industry- and the UK’s decaying public and private infrastructure is only now getting attention because government is looking for grand projects to combat permanent recession.

There are several problems with the current approach. First, there is a strong case for saying that it is simply too optimistic. Can Britain (which lacks corporate champions, SME supply chain strengths, and hampered by a point concept of value) achieve success in sectors of the future, like green energy, against Japan or Germany? This is simply uncertain. Second, and as we have just hinted, the policy neglects the promise of interventions aimed at import substitution in mundane but important activities such as food processing (It is useful to remember that in terms of employment, this is the largest surviving manufacturing sector, and probably purchases more machinery than any other sector). *Our suggestion is that such mundane and half-forgotten sectors can play a crucial role in managing the trade deficit, generating new employment and economic value, and ensuring food security.*

This is why the argument about the pig industry is so important. Yes, it is small. Yes, sectors differ so it cannot act as a generic template for industrial policy. And yes, the success of any intervention also depends on the environment created by more general fiscal and monetary policies.<sup>115</sup> Nevertheless, it points to the *kinds* of interventions and new instruments needed to secure industrial success.

### 5.3 From point measures of value to a chain definition of success

So what needs to change?

The starting point has to be the need for a shift to *a chain definition of success*. In the pig-to-pork sector, the supply chain business model shared by supermarkets, processors and producers needs to change. As we have seen, all participants are traders who hope to recover their costs by opportunistic dealing. All use a point measure of value. In a world of unequal power, this business model has worked for the supermarkets precisely *because* it has not worked for processors and producers. Supermarkets have extracted value for shareholders and customers, but have done this by undermining profitability upstream. The result has been the decline of the pig industry, with cheaper imports taking an ever-larger market share

A long chain definition of success would balance private profitability at different points in farm, factory and supermarket *along the chain* by curbing opportunist practices. The public and the national economy would also benefit because operating efficiency which would

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<sup>115</sup> More generally, there is clear need to restrain the financial sector, while the current policy combination of tight fiscal and loose monetary policy (with no restraint on disruption arising from long chain international finance) is undesirable and indeed fatal to industrial policy.

secure greater *competitiveness*; increasing pig production and processing would contribute to UK national income; it would create *secure employment*; and it would bring UK *trade benefits*.

So how can opportunist business practices be restrained?

Let us begin by discussing two broad options: the standard one of regulation and our preferred policy lever of ownership change (backed by regulation). One possibility is regulation. It would be possible to insist on long term contracts between retailers, processors, and producers. But we are pessimistic about this. It would, we suggest, be frustrated by embedded trader mentalities which would divert the powerful supermarkets into capturing value in new contractual ways. Any attempt to countermand this this would require cumbersome utility-style regulation with rules about caps, floors and indexing across a sector which awkwardly does not produce a homogeneous utility type output.

For this reason, we favour a second and more radical policy option: *We recommend that ownership structures should be changed so that the interests of retailers and processors are aligned through common ownership, while producer interests are safeguarded through creating countervailing power in producer coops.* Our proposal thus is for a double reform of the pigs meat chain. We would like to see both

- *more vertical integration between supermarket retailers and processors;*
- *and more horizontal integration between producers*

So where to start?

The obvious starting point is with the *supermarkets and promotion of the Morrisons model.* The supermarkets are the most powerful actors in the supply chain. They have the capacity to shape the actions of processors and the untapped potential to take responsibility for supply chain management. Increasing the level of vertical integration between supermarkets and their suppliers would internalise wasteful conflicts and generate efficiency gains to be distributed by supermarkets as dividends and lower prices. Efficiencies would be considerable. Transaction costs would fall, and carcass balance and capacity utilization would be more easily managed: as Morrisons shows, this is a viable way of organising the production chain.<sup>116</sup>

At the same time, this vertical integration would need to be accompanied by a balancing increase in horizontal integration between producers re-organised on cooperative lines on

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<sup>116</sup> Note, for Morrisons, that it is vulnerable to demands for short-term shareholder value in the absence of supportive industrial policy. It also is troubling that the company is unable to communicate its different business model to its consumers.

the Danish and Dutch model. In the first instance, this would be needed to protect producers from increased retailer power. In the longer run it would also help focus policy debate on the need for large scale investment in low cost production, as well as what to do about small producers and animal welfare concerns that can be too easily be sacrificed in market processes (which in the UK case are not currently producing a competitive intensive sector).

Before we turn to developing these proposals in more detail, we would add a brief comment on how and why ownership matters. We are not convinced that some forms of ownership are generally superior to others. We would not, for example, wish to rank coops, private equity and public companies in some definite order in terms of superior financial results or social responsibility. The effects of the ownership form are necessarily very variable because they depend on conjunctural contexts, business models and sectoral dynamics: so that, for example, turning retail banks into coops would achieve very little if the high street business model of free current accounts and cross selling persisted.

But changes in ownership are a hugely neglected social lever for securing large and initially rapid changes in business mentality and practices in a sector like pig meat and a country like the UK. In this country, much has been wasted by trader opportunism as actors maximise point value and refuse to take responsibility for consequences outside their firm. Vertical integration, here via the extension of retail ownership into processing, can then be a way of internalising and aligning interests which are otherwise external and adversarial, while horizontal integration can be a way of creating an opposing external interest and power which is the other means of securing balance along the chain. Finally, such changes of ownership do not make regulation redundant. In our view, regulation to ensure balance within the chain is still necessary because large owners cannot be trusted always to choose responsible business models.

## Part 6. Policy Recommendations

The general approach we have developed argues that.

- *Industrial success crucially depends on chain rather than point value definitions of success.*
- *Industrial policy needs to encourage alignment of interests alongside countervailing powers and the business cultures appropriate to these.*

- What this will mean in practice will depend on the specifics of the sub-sector in question, so *policy in practice will need to focus on specifics like the business model with the aim of changing mentalities and practices.*
- There is considerable virtue in focusing on ‘mundane’ sectors and subsectors, and attending to import substitution as well (or instead of) high-tech export sectors.

And in the context of the pig to pork sub-sector, we argued above for greater vertical and horizontal integration and briefly sketched out how this might be achieved. In this section, we detail our policy recommendations for the sector and explain what ownership change and regulation entails.

### 6.1 Creating incentives for chain thinking

Supermarkets’ incentives to change their behaviours have hitherto come from a combination of four factors: changing consumer preferences; competition with other retailers for market share; stock market demands for greater short-term profitability; and regulatory interventions, for instance to do with disease control and animal welfare.

- ***We recommend that **fiscal concessions (including corporation tax rates lower than the current 24%) should be offered to all firms in grocery retail with a chain connection to priority sectors such as the UK pig industry.*****
- ***We propose that these should be linked to **firm level delivery of the crucial economic objective of increased UK value added. This would effectively encourage integration of processing, as the retail grocery market is mature and not growing; while merger between the big four chains is quite rightly blocked by the competition authorities.*****

So long as the supermarkets are collectively delivering low prices and shareholder returns they will be incapable of generating the supply chain changes required. But if the Morrisons model is a better way, how do we encourage it? As we have noted, successive governments have tried to promote economic activity through lower rates of corporation tax for all companies regardless of sector or strategy. By contrast, our approach is sectoral specific.

In pig meat, and other agricultural supply chains, a selective tax rebate for output increase would be a focused way of encouraging retailers to take ownership of processors on the Morrisons model (thereby aligning interests that are currently in conflict). Alongside cuts in corporation tax, reductions in national insurance contributions for employers could also be offered for hiring or retaining staff in priority sectors.

In the UK, it is relatively easy for the government to monitor sales and purchases and to calculate the proportion of value added obtained organically or by acquisition. In the case, of the supermarkets, concessions on corporation tax related to sector-specific targets for

value added growth would be a powerful incentive because, as exhibit 37 shows, in the past decade from 2002-11, the big four supermarkets have all been responsible corporate citizens, eschewed tax avoidance, and paid tax on profits at a rate of 20-30%.

**Exhibit 37: Analysis of supermarket's profits, tax and tax rates**<sup>117</sup>

	Tesco			Sainsbury's			Asda			Morrisons		
	Pre-tax profit	Tax	Effective tax rate	Pre-tax profit	Tax	Effective tax rate	Pre-tax profit	Tax	Effective tax rate	Pre-tax profit	Tax	Effective tax rate
	£m	£m	%	£m	£m	%	£m	£m	%	£m	£m	%
2002	1,201	371	30.9	571	200	35.0	314	111	35.4	243	88	36.2
2003	1,361	415	30.5	667	206	30.9	328	68	20.7	277	94	33.9
2004	1,600	498	31.1	610	206	33.8	274	68	24.8	320	122	38.1
2005	1,962	593	30.2	15	50	333.3	388	5	1.3	297	91	30.6
2006	2,235	649	29.0	104	46	44.2	388	131	33.8	313	63	20.1
2007	2,653	772	29.1	477	153	32.1	342	36	10.5	369	121	32.8
2008	2,803	673	24.0	479	150	31.3	497	59	11.9	612	58	9.5
2009	2,954	788	26.7	466	177	38.0	571	126	22.1	655	195	29.8
2010	3,176	840	26.4	733	148	20.2	492	163	33.1	858	260	30.3
2011	3,535	864	24.4	827	187	22.6				874	242	27.7
Avg 2002-2011	23,480	6,463	27.5	4,949	1,523	30.8	3,594	767	21.3	4,818	1,334	27.7

They would therefore be influenced by the promise of a rate of corporation tax rate as low as 10% for a limited number of years in return for a specific increase in value added through vertical integration on the Morrisons model. (The concession would be temporary because efficiency gains from chain management should increase profit quite quickly). The adjustment in sourcing would not damage consumers or retail margins because at the margin British supply (already at heavily discounted prices close to import parity) would be available to displace imports with little material impact. Neither would it be illegal under EEC or WTO rules, since it is not intended to subsidise or capture activity but to align supply chain incentives to deliver economic efficiency and social objectives.

What are the drawbacks of encouraging vertical integration? The most obvious is the *size and increase in power of vertically integrated supermarkets*. So how might increasing supermarket power be checked? Our immediate answer (to which we return below) is to

<sup>117</sup> Fame, BvDep

encourage horizontal integration between producers. But what of the size of the supermarkets? Here we offer no firm conclusion, but we believe the question of chain size should be revisited and reviewed, with expert and civil society input, in a much broader frame than in previous OFT or Competition Commission reports.

- **We recommend a national debate about whether large national supermarket chains are necessary and specifically about what would be lost and gained if Tesco, Asda and Sainsbury's were split up into regional chains (e.g. Tesco North and Tesco South or Sainsbury East and West)**

Breaking up the national chains is technically possible and arguably, it is socially desirable. This is partly because it could be used as a lever to support regional and local sourcing (as is done by the Booths regional supermarket chain based in Preston), and this would be further strengthened if some chains had their headquarters in an unfashionable secondary city (as Morrisons already does). The economic costs of breaking up the chains would not be large because they are already organised around regional distribution centres with satellite stores; and the scale penalties would be limited both because vertical integration should drive down costs and a regional Tesco with half the national turnover would still take 5-7p out of every retail pound spent in the UK.

There is of course a dismal post 1979 history of British government design and redesign of private ownership arrangements for (ill-considered) and very narrow economic reasons concerned with competition and monopoly. The landmarks here include the breakup of the tied public house system and vertically integrated brewing; and the separation of rail track and train operating companies under John Major's privatisation so as to prevent the creation of regional train monopolies. However, these precedents should not be allowed to limit thinking, since radical interventions in the rights of private ownership on competition grounds are also widely accepted (think of current negotiations about high street bank chains, or the deregulation of telecommunications and the creation of BT Openreach). There is no reason in principle why much broader issues about social objectives could not be taken into account.

## 6.2 Regulating for longer-term chain balance

As we have noted, whatever the focused tax incentives or changes in ownership, there would be a continuing need for regulation. There would also be a need for a countervailing power to supermarket buyers even if there were seven regional supermarket chains and they had all adopted the Morrisons model. This is because independent producers would still exist. This suggests that regulation to protect the interests of independent producers is now, and will remain a priority, even if regulation is not enough to provide the initial impetus for change.

- **We recommend that the government should move beyond its current ‘code of good practice and adjudicator’ model for regulating retailer-supplier relations.**
- **We recommend that The Grocery Code Adjudicator regulator should secure better practice by reserve powers to enforce model contracts and minimum contract lengths, as well as discouraging, through strong punitive and investigative powers, variations in terms of supply without retailers providing notice and compensation.**

But there is another more urgent issue which requires immediate attention and firm level regulatory intervention. As we have noted, price promotions are a nil-sum game for the retailers and a significant generator of waste because consumers buy more than they need. Since price based promotions are systemic, neither buyers nor supermarket managements can easily avoid these. Any supermarket which unilaterally moves away from this is punished by consumers in lost share<sup>118</sup>. There is a strong efficiency argument for imposing restrictions on retailer promotional activity. The supermarkets will not ask for this because it is their primary tool for short-term market share gains (and stock management); however, at a senior management level the broader market benefits would be recognised.

- **We recommend that the grocery regulator should immediately curb price-based promotions for staple products which should be phased out with in a period of one year.**

### 6.3 Securing horizontal integration

As noted above, increasing vertical integration between retailers and processors needs to be balanced by horizontal integration amongst producers to create countervailing power and give policy makers some levers over problems of production which have an economic and social dimension. The British producers lack power but they also have a problem of economic inefficiency and productivity deficit in a competitive feed conversion activity where the social goal of animal welfare can easily be lost sight of, especially when European competitors are now catching up with previously higher British animal welfare standards

The producers are part of a fragmented sub-scale industry which cannot cope with the intersecting pressures from domestic retail oligopoly and well organised international competitors. They are trapped between market demand on the one hand (most consumers are not prepared to pay for an extensive outdoor-reared pig) and efficient supply side competitors on the other (where the Danish and Dutch industries manage intensive

<sup>118</sup> In the autumn of 2011, all the retailers embarked on a new round of price reductions set off by Tesco. Asda would almost certainly wish to price based on EDLP (every day lowest price), which is more transparent, fits the Wal-Mart ethic and helps to diminish transactional volatility by reducing the volume of promotions. However, they cannot do this quickly or unilaterally.

production more cheaply despite higher labour costs). As a result, many UK producers make losses or producers are forced out of business.

There is a strong case for promoting producer co-ops to increase the collective power of farmers over input and output prices, with the long run aim of turning farmers into contracted producers whose incomes fluctuate but who nevertheless earn something regardless of price trends. We also recommend the creation of a producer board (rather like an old fashioned marketing board but) focused on sector structure and animal welfare; the board would draw on what remains of the specific expertise that once existed in university agricultural economics departments and by levy support the rebuilding of empirically informed, sectorally expert applied economics. The producer board would have two tasks. First, the board would be charged with developing an indicative plan for how the sector might be reorganised around the double priority of cost competitiveness and higher welfare through investment in modern large-scale units. Second, the producer board would at the same time organise marketing coops of small non-intensive producers so that they could tap the demand for local and artisanal food more effectively, probably by reserved counter space for local producers in large supermarket outlets.

- **We recommend that government should provide expertise and financial support to create a few large producer co-operatives; one or more of those supported should be encouraged to move into processing as a way of aligning interests and balancing profits at different points in the chain.**
- **We recommend that the government sets up a pig meat producer board charged with developing an indicative plan for (a) the physical configuration of an intensive pig meat production sector which balanced cost competitiveness and higher standards of welfare and (b) the financial investment in new facilities required and how major players like the big new producer retailers could be persuaded to make the investment.**
- **We recommend that the pig meat producer board separately defend small traditional framers under an artisan programme whose aim would be to raise quality, increase farm processing and expand the distribution channels available to small-scale producers.**
- **We recommend that the government require the four major supermarket chains to set aside dedicated counter space for accredited local and regional artisan suppliers employing less than ten workers. This is because existing channels such as farmers markets do not connect with the mass weekly shop.**

## 6.4 Aligning interests and redistributing knowledge

The double policy of vertical and horizontal integration highlights the need to re-educate actors in the food supply industry from pig farmers to supermarket senior managers and their adjuncts in BIS and other departments. Even if the incentives for vertical integration were agreed, the extent to which industry actors would be able to implement this is uncertain. Industry structures have promoted skills in trading at the expense of technical and manufacturing competence. The civil service has been similarly de-skilled by supply side policy precepts to the point that while it can put out contracts, it has little relevant knowledge to guide, support, and intervenes in specific sectors. The academic expertise of university agricultural economics has been dissipated. This suggests the need for a much more activist role for government in the context of skills, both in the industry, education and in government itself.

- **We recommend that government should financially support and intellectually encourage an innovative technical and business education, within each region from FE College to university management school. The curriculum should be designed so that senior managers within and beyond the sector can understand the diversity of possible business models; and all managers develop the skills and competences needed to manage supply chain relations in a different and less adversarial way.**
- **We recommend a producer board levy which would be directly applied to sustaining one research active, university centre of excellence in meat trade applied economics**

## 6.5 Encouraging action by civil society

Many of the recommendations presented above involve radical change of policy objectives and instruments, tackle entrenched power and will inevitably take some time to get traction amongst the political classes and within government. But action could also usefully start with civil society and trade union campaigns about supply chain conditions. Progressive local authorities such as Enfield Borough Council are already asking the supermarkets what they have done for the local community; other groups could join in and ask what is being done to supply chain workers. Unite has already used the Ethical Trading Initiative for this purpose. Supermarket ethical trading should be as much about workers in the UK as about fair trade overseas and animal welfare.

- **We recommend that civil social organisations and trade unions should campaign for changes in supply chain conditions alongside government policy initiatives.**

## Part 7. Afterword

Our object is not to tip the balance of power in favour of one group at the expense of others. Instead, the agenda of vertical and horizontal integration and new business models represents something close to a win-win proposal. If stakeholder interests are aligned, and this leads to increased economic efficiency, supermarkets will make substantial gains from integration, consumers will benefit, and processors will enjoy more stable and prosperous business conditions.

If these proposals were implemented UK competitiveness would increase. The UK industry would expand and import dependence would be reduced. We are not proposing UK self-sufficiency: Danish and Dutch producers have a long-term role in the supply of British breakfast bacon. But, if British industry is reorganised, the supermarkets could profitably annex the factories of their British processing subsidiaries and their import share of the British bacon market would naturally fall back to mid-1990s levels as British industry increased its competitiveness.

We have developed the argument for the pig meat but envisage the changes in this chain (and the tax incentives offered) could be part of wider meat initiative, appropriately adapted to differentiate between the intensive production of pigs and poultry and the extensive rearing of sheep and beef cattle.

To conclude, we believe that this research highlights both the potential and the difficulty of a new kind of industrial policy which engages with sector specifics and deploys a novel and targeted repertoire of policy instruments. The approach is quite unlike generic structural reforms through labour market flexibilisation and low taxes. Such generic policies appeal because they seem to offer answers that are independent of particular circumstances. But these generic remedies have been tried in the UK for 30 years with relatively little success. The reason for this is that they do not change specific business models in particular sectors, and the dysfunctional supply chains and embedded mentalities and practices that go with these.

To deal with problems of British un-competitiveness and decline it has become clear that we need new and different ways of thinking – and the pigs-to-pork story suggests how we might go about this. We need to focus on supply chains and business models rather than on the point value of opportunistic dealing. But the specifics will always be sectoral. In industrial policy, it is simply not the case that one size fits all.

## Appendix: Concepts of supply chain dynamics and obstacles to economic renewal

This appendix formally defines and brings together concepts which are introduced and used at different points in this report on the pig meat supply chain and will (in more developed form) be used again in further CRESC studies of other supply chains and sectors.

The aim of this appendix on concepts is threefold. First, it aims to show how mentalities, practices and success indicators can all fit together in an assemblage which locks firms into business models that damage the sector and have negative consequences for other firms further along the chain. Second, it aims to understand how this assemblage can produce, at individual firm level, the appearance of purpose, achievement and success while it occludes the collective sectoral outcome which is impasse, retreat and failure. The concepts therefore highlight, third, what has to change if economic renewal through a new kind of industrial policy is to become practical politics and serious business in key sectors of the national economy.

The concepts and the study have this significance because the problems of the pig meat supply chain in the food sector can in variant form, be found in other UK sectors. The chain behind the assembly of cars is, for example, like the chain from dis-assembly of pigs, marked by rising import penetration, adversarial behaviour and structural obstacles to the rebuilding of national and regional supply chains. The success of the big three supermarkets in delivering low prices and shareholder value at the apex of the food supply chain is a misleading indicator just like the success of UK car assembly plants in producing nearly 1.5 million units of output (with limited British content); while the intractable problems in both pig meat and cars relate to mentalities and practices which are pervasive from top to bottom of their respective chains.

The first of our concepts is **‘trader mentality’** which we have adapted from existing supply chain studies,<sup>119</sup> earlier academic discourse and current popular usage of the term, although, as we argue below, we aim to use it in a different and less Manichean way. The term trader mentality is used frequently, disparagingly and without precision in two (rather incongruous) fields of media discussion of high finance and scholarly agrarian history. The most recent high profile usage of the term in finance was in early 2012 when the media reported Hank Greenberg and Paul Volcker’s criticism of the investment bank Goldman Sachs which had since the 1990s deviated from its core business of relationship based investment banking

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<sup>119</sup> In particular Taylor, D.H. (2006), ‘Strategic considerations in the development of lean agri-food supply chains: a case study of the UK pork sector’, *Supply Chain Management*, Vol. 11 No. 3, pp. 271-80.

and instead had become a ‘trading operation’ which had changed the ‘mentality’ inside the firm.<sup>120</sup>

In academic discourse, the term ‘trader mentality’ is classically used in histories of agrarian thought. Here is a quotation from Philip Conford’s work on the organic food movement in early twentieth century Britain:

*As the organic writers saw it, agriculture would never reclaim its rightful position as the basis of Britain's economy while producers and consumers were exploited by middlemen and vested interests. The existing economy was dominated by the ‘trader’ mentality, that is, by people who, themselves unproductive, profited from the exchange and manipulation of goods and money: retailers, shipping and other transport interests, import-export companies, banks and finance houses. If Britain's economy moved towards agricultural self-sufficiency, the influence of traders and dealers would be significantly reduced and they would no longer have the power to deny prosperity to British farmers and health to the British people.*<sup>121</sup>

Old and new usages of the trader mentality term are united by their moral fundamentalism which is embedded in a Manichean world view: trading is inherently dubious because it is unnecessary or speculative and this moral characterisation of trading is part of an attempt to distinguish good and bad actors or virtuous and vicious activities within a chain or sector which should be focused on the primary or the productive. Thus, in the Volcker usage, there is the good primary activity of advisory investment banking from which Goldman has deviated into prop trading; for the ideologues of organic agriculture, the problem is middlemen traders inserting themselves into the supply chain between producers and consumers.

Our usage of trader mentality is different. Generically, trading makes the capitalist world go round as actors seek to make a turn; the trader mentality should not therefore be disparaged as secondary or parasitic; and it can operate across the supply chain amongst producers, processors and retailers. The problem is not the trading mentality per se but its primacy from top to bottom of particular chains regardless of collective consequences. Specifically, in pig meat, the mentality is organisationally embedded and the cultural predisposition toward it is enforced by power relations within and between organisations. Supermarkets are the dominant players and roles closest to dealing (like buyers) always having a status denied to others (like production engineers) who are just support.

<sup>120</sup> J Berman (2012), ‘Ex-AIG CEO: Goldman Got ‘Backdoor Bailout’ During Financial Crisis’ *Huffington Post* 15 March 2012 ([http://www.huffingtonpost.com/2012/03/15/hank-greenberg-goldman-sachs\\_n\\_1349189.html](http://www.huffingtonpost.com/2012/03/15/hank-greenberg-goldman-sachs_n_1349189.html))

<sup>121</sup> P. Conford (2002) ‘Finance versus Farming: Rural reconstruction and Economic Reform, 1894-1955’ *Rural History* 13:2, pp. 226.

In the original 1776 edition of *The Wealth of Nations*, Adam Smith wrote that Britain is ‘a nation that is governed by shopkeepers’ and our report shows how this governance can be a supply chain problem. The trader mentality frames all choices as effectively short-term and fixes upon undercutting competitors through an adversarial approach to transactions where the trader envisages his activity as part of a zero sum game with many moves; as (almost unnoticed) some players quit and others hope to be the last man standing. This framing is set by the most powerful actors, the big three supermarkets who seek supplier relationships that can be renegotiated if better opportunities arise; suppliers right across the chain then adapt similarly opportunistic behaviour in order to survive and few have long term partnerships based on trust and mutual interest.

In general terms, we would characterise big three supermarket sourcing strategies as ‘**opportunist dealing**’. This denotes the use of any and every practice to secure lower buying prices from suppliers, whether by tapping into new sources of cheap imports, playing different suppliers off against one another, or engineering advantageous supply agreements. Supply chain opportunism could be described as a practice of *bricolage* without any long term vision or memory because it works in an endless present through a combination of ingenious use of ‘ready mades’ and the exploitation of favourable power imbalances where they arise.

Opportunist dealing is necessarily unconstructive because its only fixed element is the motivating belief (or illusion) that the next bet can win. But, opportunist dealing is not necessarily destructive because outcomes are relative and depend on specific chain and sector circumstances. From an analytic point of view, we would add several qualifications which are relevant to thinking about how opportunist practices play in food chains and how they might be managed by policy makers:

- (1) The behaviour of ‘opportunist dealing’ is only one of two possible outcomes of the trader mentality which under different conditions can result in ‘**predatory contracting**’ as the trader searches for advantage which is locked in by a long term contract that covers changing circumstances and requirements. Health and education are the classic fields of predatory contracting as private business deals with the state to provide facilities and services in activities like health where there cannot be a market which allows continuous renegotiation. As we note in our discussion of pig meat supply chain policy, where trader mentalities are entrenched, externally imposed or supervised contracting is unlikely to solve the problem. If new UK regulation required longer-term contracts in meat supply (and made no other changes), we would expect the powerful supermarkets to seek locked-in contracting advantage as they pursued the same trading ends by different means. Hence the importance of our proposals for structural reform through vertical integration to align interests and horizontal integration to create countervailing power.

(2) The forms of market competition and the growth trajectory within the sector determine whether or not opportunist practices by the powerful are seriously damaging for disadvantaged actors further along the chain. The results are likely to be most damaging in sectors where concentration in retail or production is combined with intense price competition to supply commoditised nearly identical products. Outcomes will generally be worse if the market is mature and final demand is not growing; and outcomes will be worst if production or process overcapacity hangs over the sector. Hence our concern about the maturity of the groceries market and the end of the retail ‘space race’ (the purchase of real estate and the creation of ever larger stores to increase market share).<sup>122</sup> The prediction is that, with easy growth denied, the big three supermarkets will now resort to increasingly aggressive extraction of value from their suppliers.

Using evidence from the food supply chain, this report argues that the trader mentality and supply chain opportunism are dysfunctional for the sector and disadvantageous for the wider society. The negative consequences of big three supermarket opportunism include undermining the sustainability of the supply chain, entrenching import dependence, limiting the contribution of food manufacturing to the UK economy, lowering product quality and deteriorating industrial relations through pressure on pay and conditions for the workforce. We have also highlighted the possibility of a different and better way, citing Dutch and Danish national meat supply chains and the alternative supply chain strategies pursued in the UK mass market by Morrisons and the Co-op. Supply chain opportunism is what the big three know but it is not economically necessary and we suspect that (for any given store portfolio) it is a less profitable strategy than vertical integration.

This analysis of cost passing and missed opportunity leads to two inter-related questions arising: why are the supermarkets considered such a success and how are they able to deflect criticism by farmer producers and others? Our report highlights the importance of the supermarkets’ discursive alibi that they are delivering low prices for consumers and shareholder value for investors. This alibi is powerful because of widespread social acceptance of the **‘point concept of value’** which in turn reflects a so-far unchallenged and nearly unnoticed shift away from the stream concepts of value which prevailed in earlier and less financialized forms of capitalism.

In the **‘stream concept of value’**, the financial return on investment (or any other kind of fixed commitment) is uncertain in the classical sense (as envisaged by the Chicago School economist Frank Knight) where uncertainty denotes the incalculable and risk denotes the probabilistic. If productive activity and cost recovery ebb and flow unpredictably, as Keynes recognised, the rationale for firm action then has to be ‘animal spirits’ in a world where very little can be reliably assigned an ex ante financial value by calculating ‘the weighted average

<sup>122</sup> *Financial Times*, ‘Retail: Tesco signals end to store space race’ 02 March 2012

of quantitative benefits multiplied by quantitative probabilities'.<sup>123</sup> Action is not only about a lien on the future stream of income but also a renewal of the on-going firm's options, which usually depend on an intact supply chain of complementary capabilities and social overhead expenditure on objects like R&D or training. Within this frame, supportive and co-operative behaviour towards suppliers, customers and the workforce is not a necessity; but short-term value extraction from stakeholders is counter-productive insofar as it narrows options which would be broadened by mutually beneficial relationships and alignments of interest.

Compare and contrast this to the **point concept of value** where the measure of success is the financial value that can be crystallised by an individual (corporate) actor, classically a single quoted firm, at one point in time. This was anticipated from the 1940s in a performative thought experiment with the new portfolio models of evaluating productive investment by using discounting techniques to calculate the present/point value of future income streams. It is more explicit from the 1990s in a financialized activity like private equity, where businesses are bought to be sold and the measure of success is what has been realised at point of sale. It is also pervasive throughout the discourse of shareholder value which focuses almost entirely on the trend of the single firm's earnings and share price in the current quarter or year; and then on whether earnings going forward are predictably stable or increasing thereafter.

In the point concept of value, the 'cash it out' logic of crystallisation does not directly require that economic value must be realised at a point in the near future; but short term, cashing out of gains is always attractive because, once the time value of money perspective is normalised, distant returns are in the present always worth little with a high discount rate. The single firm crystallisation perspective also shifts behaviour towards other chain actors. The firm is still, of course, practically engaged in the co-production of value with other economic actors, but the single firm's point success is increased insofar as value is extracted from other stakeholders as part of a distributional struggle, where value gained by other economic actors represents value lost to oneself. Thus point value is coherent with business mentalities and practices which encourage short term, adversarial relationships with suppliers, customers and the workforce; the extensive use of management accounting for internal allocations and external charging; plus (in quoted firms) a preoccupation with higher share price and good investor relations in a world where wasted or bankrupt suppliers are a way of doing business not a shameful visible offset to success.

When point value is normalised as the measure of success, the delivery of large amounts of shareholder value, as in the case of Apple, can be used to deflect other criticisms which raise questions about chain consequences for suppliers like Foxconn. And any firm like Tesco,

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<sup>123</sup> J.M. Keynes (1936) *The General Theory of Employment, Interest and Money*, p. 161

which delivers low prices to customers plus shareholder value for more than a decade, puts itself entirely beyond criticism; at least until it stumbles on delivering profit when analysts quickly doubt the competence of management and the direction of strategy. Thus, more generally, the point success of the big three supermarkets suppresses any questions about how their firm level success relates to the wasting of food supply chains and the consequences for the wider national economy in which they are embedded.

The concept of **'business model'** brings together the framing mentality, a repertoire of business practices and standard measures of success as a kind of determining apparatus. In our previous work, we proposed a generic definition of business model as that which exists where firm or sector meets the two intersecting basic requirements of financial viability and stakeholder credibility which are mediated by narratives of purpose and achievement.<sup>124</sup> Thus, the organisation must recover its costs (including a surplus or target rate of return in for profit firms) and also meet the expectations of stakeholders whose identity, priority and requirements are variably and socio-politically defined in different times and places. In this formal sense, General Electric and the BBC both have business models though their relevant stakeholders and profit targets are very different.

We would now wish to add some specifics about business model dynamics and trajectory. After analysing the supermarket case, we would argue that a business model is set in motion by trader mentalities, business practices and point measures of success; and this motion is organisationally embedded so that these firms and sectors are set on a path which is not easily changed by anything short of wrenching crisis. This is part of a more general problem of cultural fixity in business. Hence the demand for economic turnaround which typically comes after crisis has called established management practices into question, as well as the disruptive importance of changes of ownership (whether through privatisation or PLC merger and acquisition). Ownership change may not transform financial performance but it provides an opportunity to cancel previous frames and practices "under new management", especially at firm level, when accompanied by a 'selection' of personnel so that the recalcitrant and un-reconciled are excluded from the new management hierarchy.

Firm and industry business models are techno-politically adapted to specific activities. And when considering activity specifics, it is easy to concentrate on glamorous, high tech sectors of the future. Here there is the drama of sudden success and fast moving transitions to failure as with smart phones where, within four years of the iPhone launch, the winners (Apple and Samsung) had made huge profits and the losers (Nokia and RIM) were writing memos about 'burning platforms'. And also, as we have noted in this report, industrial policy is typically focused on high tech materials, products and activities (from graphene

<sup>124</sup> Froud, J, Leaver, A., Phillips, R. and Williams, K. (2008) 'Stressed by choice: a business model analysis of the BBC', *British Journal of Management*, 20 (2), pp. 252-64.

through pharma to renewable energy) which offer the hope that the British could from small beginnings build employment and export success in these areas.

In our view, UK high tech success is unlikely when, as Rosenzweig<sup>125</sup> insists, business success is relative and Britain will be competing against well-resourced German and Japanese competitors with large lead firms able to finance technique and draw on supply chain capabilities. In our view, it would be more sensible to put the main industrial policy emphasis on defending and growing **‘mundane activities’**, like UK food processing which in terms of employment is currently our largest manufacturing sector and which could play a leading role in import substitution. In this usage, the term mundane is not in any way disparaging because our aim is to describe and single out some worthwhile activities.

In common sense usage, the term ‘mundane’ is slippery and deceptive when applied to productive activity. Much production of low-tech products is not mundane insofar as it embodies advanced process technology while many luxury and high tech products appear mundane when production is traced back far enough to the basic components. We aim to sidestep these difficulties by using the term mundane activities to denote those economic structures and activities necessary to social existence and reproduction for everyone in society regardless of income and social position. The FTSE 100 CEO and the unemployed school leaver both require access to certain types of goods on a daily basis. The mundane therefore includes technical infrastructure like broadband provision, necessary twentieth century utility services like water or electricity and weekly food supply.

Grocery supermarkets and the food supply chain are important to the mundane because here we have a high weekly spend on groceries and unusually socially inclusive retail channels. Thus, the average British household spends some £100 every week in a supermarket, with high-income groups spending more and the welfare poor counting every penny. The success of the big four chains depends on their ability to pull in customers from right across the income distribution range in ways which prevent bottom end defection to hard discounters like Aldi and top end defection to Waitrose or Booths. The variation of offers between stores according to local demography and regional tastes is also rather limited because of the national food culture

We would not entirely disparage industrial policy focused on the creation of high-tech, export orientated sectors of the future. But, regionally distributed, mundane activities are probably more important as a means of safeguarding or growing employment and value added. And the message of this report is that such mundane sectors require radical structural intervention which uses ownership to lever changes in the business model. This, this report seeks not only to provide a better understanding of sectoral problems, but also to change the way we think about economic renewal.

<sup>125</sup> Rosenzweig, P. (2007) *The Halo Effect*, Free Press: New York