EXPERT TUITION

Economics Questions By Topic:

Monopsony (3.4.6)

A-Level Edexcel Theme 3

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Table Of Contents

SECTION A

Write your answers in the spaces provided.

1 In August 2009 the Competition Commission published a Groceries Supply Code of Practice. Large supermarket chains were paying very low prices to some suppliers. Which type of market power does this suggest the large supermarket chains have?

(1)

A Monopsony

B Monopolistic competitive

C Perfectly competitive

D Natural monopoly

E Competitive monopoly

Answer

Explanation

(3)

(Total for Question 1 = 4 marks)

END OF SECTION A

SECTION B

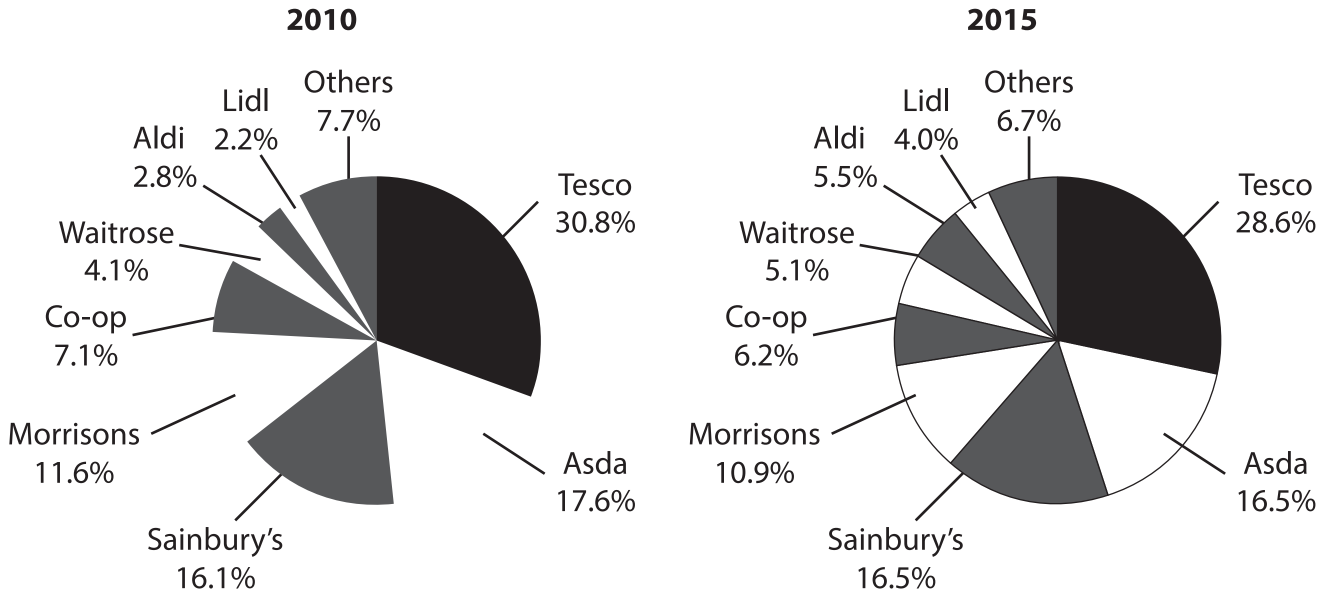
Read all extracts/figures before answering.

Write your answers in the spaces provided.

Question 2

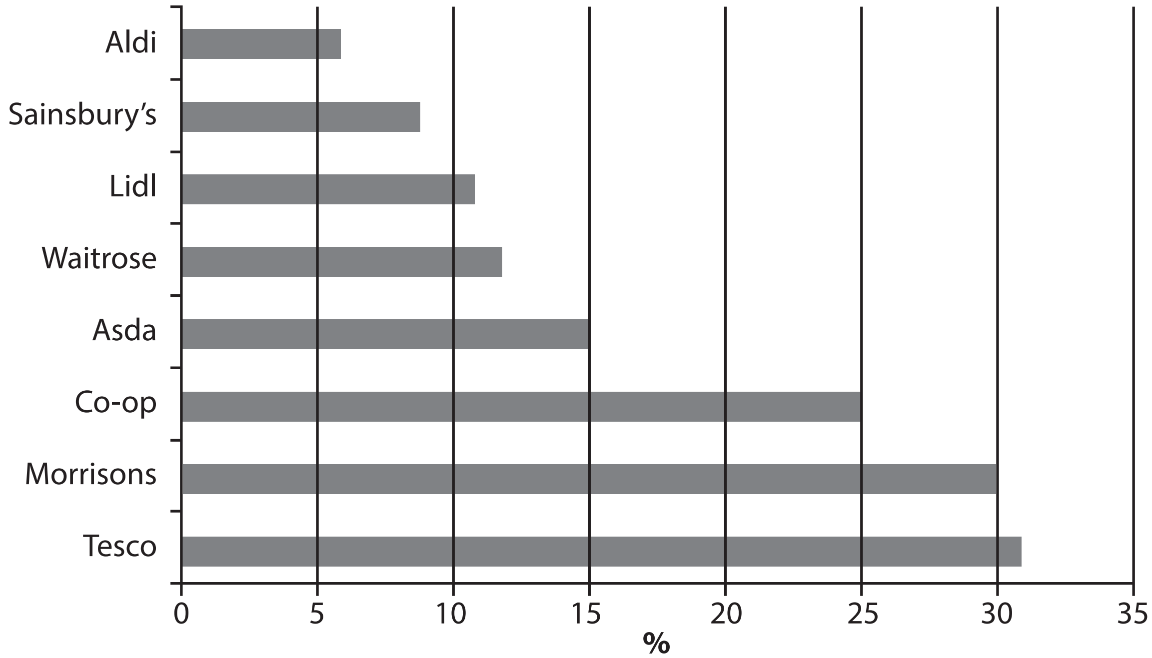
Supermarket price war, food waste and possible mergers

Figure 1: Market shares by total revenue in the UK supermarket sector, 2010 and 2015



(Source: Kantar worldpanel, http://www.kantarworldpanel.com/en/grocery-market-share/great-britain/snapshot/11.10.15/)

Figure 2: Proportion of food suppliers reporting that the following supermarkets fail to meet the Groceries Code of Conduct, 2015.



(Source: YouGov poll of more than 1100 food suppliers to supermarkets. Reported in The Times, 23 June 2015)

Extract A

Supermarket price war puts pressure on their food suppliers

The number of food suppliers (to supermarkets) struggling to remain in business has increased by more than 50% over the past year as supermarkets engage in an intense price war. It has never been tougher for the UK's food suppliers according to a study by accountants Begbies Traynor. It blames aggressive price-cutting by the supermarkets and delays in payments to food suppliers as the main causes of the difficulties. Further problems include food suppliers being forced to pay excessive amounts for packaging specified by supermarkets and funding in-store promotions. Almost 90% of struggling food suppliers are small and medium-sized businesses.

The price war has contributed to food prices paid by consumers falling by 1.7% over the past two years.

The market shares of the big four supermarkets – Tesco, Asda, Sainsbury's and Morrisons – are under pressure as shopping habits change. Many consumers are switching from one main weekly shop to shopping more frequently at local discount stores such as Aldi and Lidl or purchasing goods online from other grocery retailers.

The big four supermarkets have responded by putting more pressure on their suppliers despite an investigation by the Groceries Code Adjudicator (GCA). The GCA has the power to fine supermarkets up to 1% of their annual sales revenue if they break the Groceries Code of Conduct. A YouGov study found considerable differences between the supermarkets in meeting the Code with Aldi performing well but Tesco badly. Despite the Groceries Code, many food suppliers are reluctant to complain for fear of losing contracts with the supermarkets.

(Source: adapted from 'Supermarket price war takes toll on UK food suppliers'. Rupert Jones, The Guardian, 20th July 2015)

Extract B

Food waste in the supply chain

A report from the British Retail Consortium reveals that supermarkets are directly responsible for around 0.2 million tonnes of food waste every year. This is due to the expiry of use-by-dates and poor handling of stock.

However, 4.1 million tonnes of food waste occurs annually in the food supply chain before it even reaches the supermarkets, indicating the existence of information gaps. The supermarkets are cooperating with food suppliers and farmers to try to reduce this waste. This involves improving forecasts for supply and demand of food and increasing the reliability of transportation and storage.

Consumers, the final stage of the supply chain, waste a further 7 million tonnes of food each year. This suggests irrational behaviour. Supermarkets are also working with consumers to reduce the waste by providing advice on how to store and use leftover food. The development of packaging designs to keep food fresher for longer is one of the innovations under way to reduce waste.

(Source: adapted from 'Supermarkets tally up food waste bill'. Will Nicholls, in Businessgreen, 19th January 2015. http://www.businessgreen.com/bg/news/2390792/supermarkets-tally-up-food-waste-bill)

Extract C

Proposed merger activity in the supermarket sector

Analysts at Société Générale, an investment bank, have recommended a merger between Sainsbury's and Morrisons. They claim it would lead to increased economies of scale and market power for the combined business. Such a merger between the third and fourth largest supermarkets in Britain would have been unrealistic a few years ago due to concerns of its impact in reducing competition. However, the chances of getting permission from the Competition and Markets Authority have increased following the growth of Aldi and Lidl. Giant mergers have been approved in other sectors such as Lloyds-HBOS (banking) and British Telecom-EE (telecommunications).

The suggested merger would have its challenges. There is considerable overlap between the locations of the stores and the enlarged company would require the rationalisation and co-ordination of hundreds of thousands of employees. A new expensive IT system is likely to be required and the underlying difficult market trends would remain in the food retailing industry.

(Source: adapted from 'Tesco-bury and AS-Morrisons. Could Britain's supermarkets be about to merge?' Graham Ruddick, in The Telegraph, 16th December, 2015. http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/11699724/Tesco-burys-and-AS-Morrisons.-Could-Britains-supermarkets-be-about-to-merge.html)

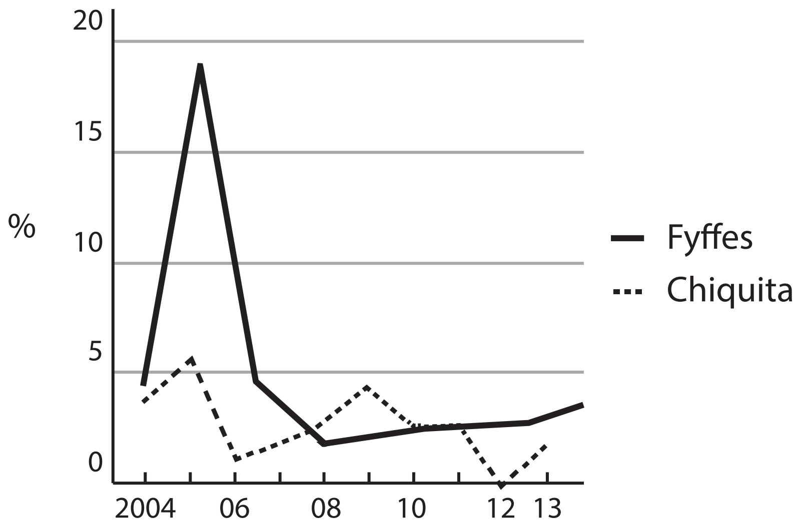
2 With reference to Figure 2 and Extract A, discuss the possible impact of supermarket monopsony power on both food suppliers and consumers.

(12)

(Total for Question 2 = 12 marks)

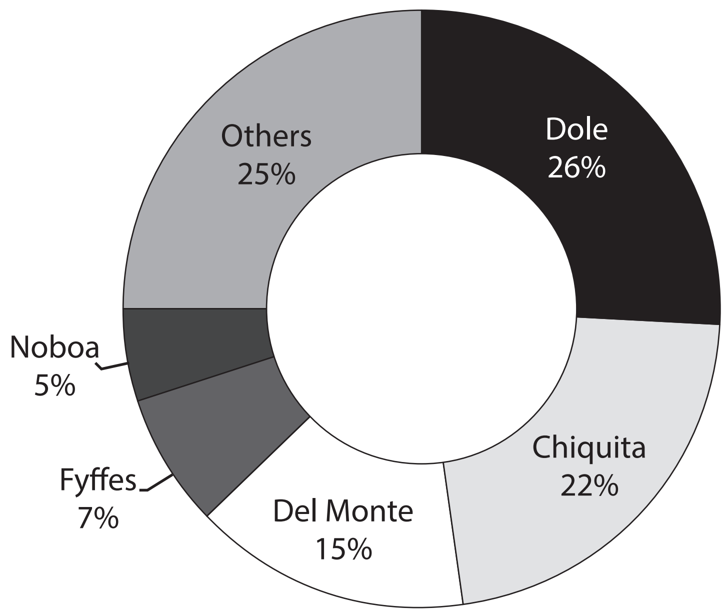
3 Bananas

Figure 1 Fruit importers' profit margins, %



(Source: http://www.ft.com/cms/s/0/8537646e-a85b-11e3-8ce1-00144feab7de.html#axzz3SqiJkq3q)

Figure 2 Global market share of banana distributors (excluding supermarkets)



(Source: http://www.businessweek.com/articles/2014-03-10/
with-chiquita-fyffes-merger-dole-will-no-longer-be-top-banana)

Extract 1 Supermarket pricing makes merger of Chiquita and Fyffes necessary

Bananas have become the biggest fruit on the planet in terms of production volume, as consumers eat ever more of them. Global banana production has doubled since 1990 to 100 million tonnes a year. A deal to create the world's largest banana distributing company was arguably made necessary by the low fresh fruit prices to be found on the shelves of any supermarket. By planning a $1 billion merger, Chiquita of the US and Dublin-based Fyffes are attempting to address a retail price squeeze that is reducing their already low profit margins. Their profit margins have been shrinking: Chiquita's from 3.5% in 2004 to 0% in 2012, and Fyffes' from just under 5% to 3.5% over the same period, say their annual reports.

A banana price war between large supermarkets, which often sell the fruit as a loss leader, has hit profit margins for distributors. Large retailers are also using their purchasing power to force producers and distributors to absorb cost increases, which have been made worse by poor weather and crop diseases. Supermarkets are also increasingly sourcing their bananas directly from producers, damaging distributors' revenues, said Alistair Smith, a campaigner for social and environmental issues relating to the supply of bananas. In the UK, such direct sourcing accounted for more than half of the bananas traded. Smith said "The current low prices are not sustainable for the industry. They are damaging the industry and the people who work in it. The industry has been suffering from overcapacity for the past few years, so a merger of the two major players should resolve some of the volatility in the market."

Announcing the proposed merger, Ed Lonergan, Chiquita's Chief Executive, said: "We have always identified Fyffes as a fantastic partner. The tie up makes particular sense now as the banana market is the most competitive I have ever seen – there are so many players bringing bananas into every port in the world."

A merger is likely to give the combined company more negotiating power with suppliers, although the Fairtrade Foundation warns that the merger would only squeeze banana growers further. The merged company would have combined sales of $4.6 billion. It would distribute about 160 million cases a year in total, compared with 117 million at Del Monte and 110 million at Dole.

Chiquita is the larger company, with annual revenues in excess of $3 billion compared with $1.5 billion at Fyffes. The merged company would have the scale to negotiate better deals with retailers. Chiquita and Fyffes hope to achieve $40 million a year in pre-tax cost savings while gaining share in the melon, pineapple and packaged salads markets. Savings will come from logistics, for example putting more bananas on to fewer boats.

The high profile of these brands makes it likely that regulators will scrutinise the proposed merger as the new company would have almost 30% of the European market.

(Source: adapted from http://www.ft.com/cms/s/0/c8463dac-a86f-11e3-b50f-00144feab7de.html#axzz3BffD7L9c March 10, 2014 and http://www.ft.com/cms/s/0/43b73338-a825-11e3-a946-00144feab7de.html#axzz3BffD7L9c and 'Bananas: the right split' in the Lex column 14 March 2014)

(a) With reference to Extract 1, explain **one** condition necessary for the existence of monopsony power.

(4)

(b) Evaluate the likely effects of supermarkets' monopsony power on banana **distributors**.

(8)

(Total for Question 3 = 12 marks)

4 Egg farming, egg distribution, food manufacturing and supermarkets

Extract 1 A letter from a chicken farmer

Our problems started four years ago when the big egg packaging and distribution firms merged, purchasing nearly 70% of the eggs produced. I lost £40 000 last year and I could see the profits of Noble Foods [the UK's biggest egg distributor] increasing. There was no competition anymore and prices paid to egg farmers stayed low, while everything else, like the cost of chicken feed, was going up. New EU regulations preventing the housing of hens in conventional 'battery' cages have meant installing new cages, costing over £14 per hen. Many egg farmers like me are unable to absorb the costs of buying the new cages and some egg farmers have left the industry. 750 000 hens have been slaughtered across the UK.

Extract 2 The egg distribution business - profile of Noble Foods Limited

Noble Foods, the UK's largest egg packaging and distribution business, operates 160 vehicles from seven sites, 365 days a year, employing over 150 full-time drivers in temperature controlled vehicles. Eggs are collected from over 325 individual farm producers located throughout the UK and transferred to a packing centre, where they are sorted and boxed for delivery to customers. Pre-tax profits at Noble Foods increased by £1.4 million in 2011.

(Source: © 2011 Noble Foods Ltd)

Extract 3 Increased costs of eggs for food manufacture

Eggs – both in liquid and powdered form – are used in a variety of food products from biscuits and cakes to pasta and mayonnaise. The reduced supply of eggs, caused by the new EU regulations, is damaging the profits of some food manufacturers. Several of them are closing down their production lines because they cannot afford the soaring cost of eggs from distribution firms. However, they cannot raise their prices because supermarkets refuse to pass on any increase to consumers.

Extract 4 British farmers forced to pay the cost of supermarket price wars

Farmers say they are being forced out of business by the unfair buying practices of supermarkets. Discounts such as "buy one get one free" are not a generous gift from the supermarket. There is public ignorance of how supermarkets buy produce and the system that allows them to offer lower prices while increasing their profits. Tesco's profits were above £3.5bn for the first time last year and Sainsbury's rose by nearly 13%. These results are achieved largely by getting suppliers to reduce their prices or not pass farmers' cost increases through to the supermarkets. Most sectors of British farming, from eggs to fruit, vegetables and pork, have had reduced prices paid for their produce in the past year, despite record increases in costs.

(Sources 1, 3 and 4: adapted from © The Guardian 2 July 2011, © The Observer and © Parliamentary copyright 2011)

Figure 1 Egg types in the EU

Types of eggs produced in EU	**Minimum cage requirements per hen**	**Market share in UK, 2012 forecast**
Hens in conventional cages, 'battery'	550cm^2	Banned January 2012 under new EU regulations
'Caged' hens in EU-compliant cages	750cm^2 and a minimum height of 45cm with nest area, perching space and a scratching area	49%
Barn eggs	1110cm^2 free to move in large indoor area	4%
Free range eggs	As barn, with daytime access to open air pen, 4m^2	44%
Organic free range eggs	As free range, plus organic food (no artificial growth enhancers)	3%

Figure 2 UK egg market information 2011

Egg production	9 691 million eggs
Egg consumption	11 512 million eggs (32 million per day)
Consumers of eggs in the UK	
Retail (supermarkets etc.)	47%
Food Manufacturers	25%
Foodservice (hotels, restaurants)	28%

(Sources for Figure 1 and Figure 2: permission to reproduce granted by the British Egg Information Service, www.britegg.co.uk and © European Union, http://eur-lex.europa.eu/)

4 Using the information provided, explain the market power enjoyed by egg packaging and distributing firms, such as Noble Foods, when buying eggs from chicken farmers.

(4)

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(Total for Question 4 = 4 marks)

5 Food manufacturing and retailing

Extract 1 Northern Foods struggles to meet supermarket power

Food manufacturing is a brutal industry. A fresh burst of commodity inflation has raised input costs and the buying power of the big supermarkets makes it hard for food manufacturing firms to pass these extra costs on. The grocers' influence is a benefit to consumers: though dominated by a handful of big chains, Britain's retailing industry is competitive, and the margins squeezed from manufacturers are shared with shoppers. That buyer power is not such a blessing for suppliers, who struggle to hold on to any cost savings they make. Multinational firms, such as Nestlé or Unilever, possess the strength and the famous brands to fight back. Small suppliers seem powerless.

Northern Foods isn't small (it has almost 9,500 employees) and owns some sizeable brands, such as Fox's Biscuits; but the core of its business is supplying prepared foods to which supermarkets then attach their own labels. The firm led the way in chilled prepared meals, partnering with Marks & Spencer (M&S) in the 1980s. But as others caught up, Northern Foods found itself struggling against retailers who could quickly change suppliers if they wanted to pay less.

Northern Foods' response to its declining fortunes and slumping share price was to seek a merger. In November 2010 there was a proposed merger with Greencore, a Dublin-based food manufacturer. It would have yielded the merged company £40m a year, around 2% of joint sales, through cost and tax savings, and better terms with its own suppliers. Behind the push for a merger was a belief that a bigger, more diversified firm would not be so easily bullied by retailers.

Yet it is far from clear that Northern Foods' main problem is insufficient scale. Other food manufacturers have thrived despite pressures on profit margins. Cranswick, a supplier of upmarket pork products to supermarkets, has a bigger stockmarket value than Northern Foods' with less than half the staff. Its revenues and share price have grown quickly in the past decade, as have those of Kerry Group, an Irish firm supplying the upmarket City Kitchen line of prepared meals for Tesco. The firm works closely with retailers to provide good service and improved products and is very disciplined in controlling costs.

The key to a good bargaining position for food manufacturing firms, it seems, is to make it costly for retailers to change suppliers. The more reliable the supply, the better the goods and the more tailored the service, the harder it is for retailers to switch. This requires constant effort: a firm that stands still is a target for the cost-cutting chains.

(Source: adapted from © *The Economist* Newspaper, 10 February 2011)

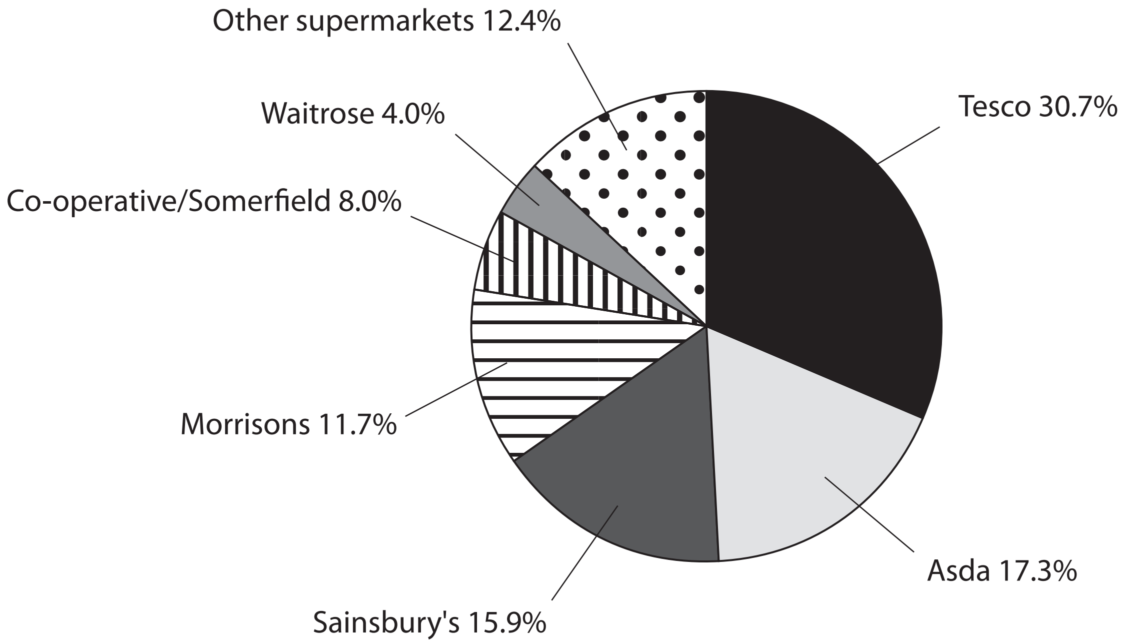
Extract 2 Tesco pushes into northern California

In 2007 Tesco began its move into the United States by opening a chain of small-format grocery stores on the West Coast of the United States (Arizona, California and Nevada) under the brand name Fresh & Easy. Tesco has now begun its expansion into northern California, with the opening of its first two stores in the San Francisco Bay area, indicating the continued expansion of its loss-making US venture under new group chief executive Philip Clarke. A further 10 standard stores are set to open by April 2011. Fresh & Easy, which has more than 160 stores, is to open about two stores a week this year. The initial planned capital expenditure was up to £250 million per year. One of the key decisions for Mr Clarke will be deciding whether to continue with the Fresh & Easy chain, which made a loss of £165m last year, but is expected to break even by 2013, and turn losses into profits by 2015.

Tesco is planning to extend Fresh & Easy into smaller sized stores with the aim of attracting customers from larger out of town stores owned by competitors. Opening the northern California stores demonstrates that Mr Clarke is pushing ahead with expansion, despite the highly unusual decision last October to close 13 loss-making stores, primarily in Arizona and Nevada. These states have been hit by the US housing market downturn, shrinking populations, the high percentage of house repossessions and high unemployment rates.

(Source: adapted from © The Financial Times Limited, 3 March 2011)

Figure 1 UK supermarket market shares by revenue, 2009



(Source: © Kantar Worldpanel)

Extract 3   Tesco's purchase of 77 One Stop stores angers rivals

One Stop, a chain of 598 convenience stores in the UK, was bought by Tesco in 2002 as part of its £377m acquisition of T&S Stores. Tesco has been forced to defend itself against allegations of high prices – despite its general claims that its huge scale means consumers benefit from the retailer offering the same prices nationwide. A spokesperson for Tesco said "The ranges are quite different in One Stop. It is a separate business with a different supply chain and a separate business model with stores that are typically smaller than those running under the Tesco Express name". In clearing the original merger, the OFT said "Tesco has said that the transaction will bring consumer benefits as its Express store prices are lower than those of One Stop." There are currently 1,183 Tesco Express stores, and Tesco controls 3.5% of the convenience store market. Tesco is the world's third largest retailer by revenue, after Walmart and Carrefour, and the second largest after Walmart by profit.

(Source: adapted from © Guardian News & Media Ltd 2010 16 December 2010)

5 Using examples from the Extracts, assess the degree of **monopsony** power in the groceries market.

(12)

END OF SECTION B **(Total for Question 5 = 12 marks)**

SECTION C

Write your answers in the spaces provided.

6 'Amazon.com, the giant online retailer, has too much power.' It uses its market power to put a squeeze on publishers, in effect driving down the prices it pays for books. If a publisher refuses, Amazon may take action by 'delaying their delivery, raising their prices, and steering customers to other publishers'.

(Source adapted from: https://www.nytimes.com)

Evaluate the likely costs of a monopsony operating in a market such as book retailing.

(25)

END OF SECTION C **(Total for Question 6 = 25 marks)**