You can’t bite the hand that feeds you: The commercial and contractual relations between the four large South African food retailers and their SME suppliers

Marlese von Broembsen

Abstract

This paper interrogates the assumption that small and medium enterprises’ access to domestic value chains is associated with labour-intensive growth of these enterprises. It asks whether, and to what extent, institutional-contractual (legal) dimensions of the supply relationship may act as a dominant or overriding barrier to entry, sustainability and growth. The paper argues that the majority of suppliers are structurally coerced to pursue what the global value chain literature refers to as ‘production upgrading’, namely capturing more value through more automated production, as opposed to ‘functional upgrading’, which would involve building the capacity of their workers. This finding suggests that supermarkets’ procurement practices, rather than so-called inflexible labour laws, undermine the job creation potential of SMEs in the sector. Moreover, ‘social upgrading’ (passing down increased value appropriation to workers) is structurally precluded by the dual pressures that suppliers face – the insecurity of contract (their products are liable to be de-listed at any time) and the pressures on their production costs as supermarkets pass their costs and risks to suppliers through ‘rebate commissions’. The paper argues that the rise of private production and hygiene standards, enforced by some of the supermarkets, determine who is included and excluded from participating in food value chains. The cost implications of meeting these standards, and of the compliance checks, mean that informal, emerging businesses are effectively excluded from participating in these chains. The paper argues for the regulation of contracts between retailers and small suppliers, and for soft-law governance mechanisms such as an ombud, duties of disclosure and transparency, and representation of suppliers on policy-making bodies.

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1. Introduction

One of the National Development Plan (NDP)’s key objectives is to lower unemployment from twenty five to six percent, by 2030. In the short-to-medium term, states the NDP, approximately 90 per cent of the to-be-created semi- and low-skilled jobs are most likely to be created by ‘small and expanding firms’ that service the domestic market (NDP 2012:118). To facilitate growth that is inclusive of these job-creating small enterprises, the NDP proposes several measures: supply-side support to small enterprises (such as access to credit and entrepreneurial education); regulatory reform to reduce ‘the cost of doing business’; and access to domestic value chains.

The NDP places significant emphasis on the necessity of securing small business access to domestic value chains to facilitate ‘market entry in a highly concentrated environment’ (p.129). The retail sector is singled out, and retailers will be ‘encouraged’ to preferentially procure from small business, and to ‘develop’ suppliers in specific regions, ‘in support of regional industrialization objectives’ (p.152). To date, legislative interventions to ‘encourage’ preferential procurement from small businesses include the Competition Act (1998), the Preferential Procurement Framework Act (2000) and the Revised Preferential Procurement Regulations (2011), and the Broad-Based Black Economic Empowerment Act (2003) and regulations.

Within retail, the NDP identifies agro-processing ‘as a key sector for employment growth and entry for SMMEs’ (p.144). Agro-processing includes food and beverage manufacturing, as well as supplying inputs to food manufacturers, such as ‘packaging, containers and preservatives’ (Tschirley 2008). Tregenna’s (2008) analysis of Labour Force and October Household Surveys shows that the food industry holds relatively greater job creation potential than other retail sectors.

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1 This research would not have been possible without the 34 people who agreed to be interviewed, who gave of their time and generously shared information on their relationships with retailers. They remain anonymous for fear of being delisted, but they know who they are. I dedicate this working paper to them as I was inspired by the interviews, their entrepreneurialism and their commitment to their employees, and in the hope that their courage to speak out will have implications for the entire sector. I also thank Martin Kidd for his contribution to the paper in the form of the descriptive statistics, and Frederick Fourie and an anonymous reviewer for their detailed and very helpful comments on an earlier draft.
As both the NDP and Philip (2010) underline, however, the production of commodity foodstuffs is highly concentrated among a few large suppliers. While small and sometimes informal suppliers participate in non-value add commodities, such as fresh produce, most mass-consumed goods (including basic foodstuffs, clothing, and household detergents) are produced by large suppliers; and often supply chains are vertically integrated, as big retailers create their own brands and private labels. The considerable volumes produced mean that suppliers can cut their margins per unit, which ‘tends to squeeze out even medium-sized competitors, let alone small producers’ (Philip 2010:15). In 2005, Mather conducted a survey of small and medium enterprises in Gauteng in the agro-processing sector; only four of the 30 firms surveyed were able to supply supermarkets.

Therefore, this study adopts an even narrower focus. Its concern is a sub-segment of the retail food sector, i.e. domestic food value chains that target high-income consumers but which are not dominated by large suppliers – thus allowing the possibility of (formal or informal) small- and medium-enterprise suppliers to participate in the value chain. The relevant foodstuffs (including beverages) are high value-added goods such as pre-prepared foods; home-made pastas, spices, confectionary, oils, etc.

**Research questions**

The study seeks to interrogate the assumption that small and medium enterprise access to domestic value chains is associated with labour-intensive growth of these enterprises. Rather than considering, for example, labour-market or economic dynamics that may affect such small or medium food suppliers and their consequent employment decisions, the question is whether and to what extent institutional-contractual (legal) dimensions of the supply relationship may act as a dominant or overriding barrier to entry, sustainability and growth. Specifically, the study set out to explore the following questions:

- Are contracts between suppliers and retailers standardised contracts negotiated individually with each supplier, or unilaterally determined by an individual retailer? And are the retailers’ contracts different for black-owned suppliers (for which the retailers earn B-BBEE points) than for white-owned suppliers?
- The global value chain literature suggests that there are four different strategies available to firms to ‘upgrade’ their production in order to capture more value in the chain. Do the terms of the supply agreements make some upgrading strategies more possible, or attractive, than others?
- If firms ‘upgrade’ successfully and increase their sales to the retailers, what are the implications, if any, for workers and for informal-sector suppliers? Are more workers employed? Do casual and part-time workers benefit from ‘social upgrading’ improved

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2 See also Louw et al (2008); Cutts and Kirsten (2006); and Mather (2005).
3 This study was conducted for Trade and Industrial Policy Strategies (TIPS).
4 In order preserve anonymity of the suppliers, who fear a backlash from retailers, I am deliberately vague and general about products.
terms/conditions of employment (e.g. do they become full-time and/or permanent employees and/or do their wages and benefits improve) – a scenario suggested by an earlier case study (Von Broembsen 2016)? Do these supplier businesses facilitate their expansion by sourcing from smaller, often informal businesses, thereby enabling smaller firm growth and employment creation?

The paper is based on interviews with 26 small and medium suppliers and an analysis of their supply agreements with the four big food retailers: Woolworths, Pick n Pay, Spar and Shoprite Checkers (‘the retailers’). More information is provided in section 3 below.

The paper is structured as follows. Section 2 contextualises the discussion with a brief description of the political economy relevant to the food retail sector in South Africa. Section 3 presents the research methodology and the profiles of the suppliers interviewed. Section 4 discusses the survey findings, and outlines the contractual terms between suppliers and supermarkets in some detail. Section 5 introduces the reader to Global Value Chain Analysis, the literature that engages with global value chains that has a policy-orientated focus, which I use as lens to analyse (i) the contractual terms between the supermarkets and the ‘own brand’ suppliers, (ii) the implications of these terms for the suppliers’ growth and job creation potential, and (iii) the growing practice of supermarkets to require compliance with private production standards, in addition to public standards, and the implications of thereof for new market entrants. Section 6 outlines key findings and section 7 concludes with legal and policy recommendations.

2. The ‘supermarketisation’ of the food retail sector: the political economy of food retail

This term ‘supermarketisation’ describes the ‘ongoing, even accelerating, process that will soon see supermarkets as the dominant food suppliers around the world’ (Traill 2006). Supermarkets are cornering an increasingly greater share of the market in emerging markets; South Africa is no exception. Moreover, South African supermarkets are penetrating other countries’ markets. Estimates of their aggregate share of the South African food retail market differ. Weatherspoon (2003) suggests that the total market share of the four big South African supermarkets in 2002 approximated 60 per cent share of total food retail, whereas Louw (2008) suggests that by 2006, the supermarkets had appropriated a far more substantial share of the market—93.8 per cent. If both these figures are accurate, the supermarkets have managed to increase their market share by 33.8 per cent in a mere five years. The Competition Commission (2015) estimates that supermarkets capture 90% of the South African food market.

5 Shoprite has established branches in over 15 African countries and in India (Weatherspoon 2003). Pick n Pay and Woolworths have opened branches in Africa, and in Australia. Spar, a Dutch company, operates more than 20 000 franchises all over the world.

6 Weatherspoon (2003) relied on data collected by AC Nielsen; and interviews with Raymond Ackerman
The literature differs on the relative market share of each retailer. Some authors state that Pick n Pay captures more market share than Shoprite Checkers, others argue the opposite.\(^7\) Indisputably, Shoprite/Checkers and Pick n Pay together garner the lion’s share of the market—anywhere between 24 to 40 per cent each. Louw (2008), who bases his estimates on data collected by the Bureau of Market Research, compares 2004 with 2007 market shares, as shown in Table 1.

**Table 1: A disaggregation of the food retail in South Africa**

<table>
<thead>
<tr>
<th>Supermarket</th>
<th>2004</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pick ‘Pay</td>
<td>35.2</td>
<td>24.1</td>
</tr>
<tr>
<td>Shoprite Checkers</td>
<td>27.8</td>
<td>25.1</td>
</tr>
<tr>
<td>Woolworths</td>
<td>7.1</td>
<td>11.4</td>
</tr>
<tr>
<td>Spar</td>
<td>26.2</td>
<td>13</td>
</tr>
<tr>
<td>MassMart and Cash and Carry</td>
<td>3.6</td>
<td>26.4</td>
</tr>
</tbody>
</table>

The retailers service different markets. Shoprite targets low-income consumers, whereas Checkers serves the higher-income market. Spar and Pick n Pay target both, whereas Woolworths only targets high-income consumers. Pick n Pay competes with Shoprite Checkers for the mass market, and with Woolworths for the upper income market (Mather 2008).

As is the case in Africa generally, the middle class in South Africa is a growing segment of the consumer population (Tustin 2006). Tschirley et al (2015) suggest that the growth of the middle class in Africa outstrips the general population growth by 20 per cent. The implication of more middle class consumers for food retail is not only that surplus income means luxury foods are in demand, but also that their diets change. The middle class eats fewer vegetables and buys more protein and highly processed foods (Reardon 2003; Tschirley et al 2015). This trend is exacerbated by urbanisation and by greater market participation by women, as their having less time to prepare food, means a greater expenditure on prepared foods (Traill 2006). Tschirley et al (2015) conclude that this trajectory—the increase in middle class and correlative demand for processed food—potentially has positive spin-offs for economic growth and employment:

> The productivity and employment consequences of the processing sector in Africa should pass from a niche theme to a mainstream policy issue and receive consequent research emphasis (644).

The structure of supermarkets’ procurement system is an area that requires more research. In recent years, two of the retailers have moved from a regional to a central procurement system, which has significant cost implications for suppliers that don’t have a powerful brand. Whereas, previously, suppliers negotiated with a regional buyer and delivered goods to different regions or even locally, procurement is now centralised. Buyers in Johannesburg make procurement decisions for the whole country.

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\(^7\) See Weatherspoon (2003); Tustin (2006); Bienaber (2007), Louw (2008); Mather (2005).
Another aspect of the structure of this procurement model is that all deliveries at Pick n Pay (which is a key market for small suppliers) take place in the same place on a first-come, first-serve basis. Small suppliers sometimes spend hours in the receiving depot queue—‘you might only have a couple of boxes, but have to wait in the queue behind big trucks delivering mass orders … because Pick n Pay has no incentive to make it efficient’. In relative terms this implies a larger cost for a small supplier.

3. Research methodology and the profile of firms interviewed

A total of 26 suppliers were interviewed. Interviewees were identified in three ways. I had access to a database of about 80 small suppliers in the Western Cape. I e-mailed most people on the database and interviewed those who responded and were willing to be interviewed. Additional interviewees were identified using two other methods—snowballing (suppliers introducing me to other suppliers); and identifying products on supermarkets’ shelves and cold-calling the suppliers. Businesses that supply more than one supermarket were privileged over those that supply only one.

In addition, I interviewed two senior executives from two of the supermarkets, an ex-buyer of a supermarket (now a consultant to SME suppliers), a packaging company, and a driver for one of the suppliers. All the business interviewed are located in the Western Cape. Interviews with two additional firms were conducted to pilot the questionnaire. While their responses are not included in the descriptive statistics, their views are captured in the narrative. A total of 33 interviews were therefore conducted.

Interviews with suppliers were conducted using a semi-structured questionnaire. The questionnaire was supplemented by open questions, and I took extensive notes for each one to three hour interview. While the sample is relatively small, the findings are uniform and statistically significant. The Centre for Statistical Analyses at the University of Stellenbosch generated the descriptive statistics that were collected by means of the semi-structured questionnaire.8

As shown in figure 1, the sample included firms defined (by statute) as small (i.e. between five and 50 employees) and firms defined as medium-sized (50–200 employees). Of the 26 firms, two had been in existence for 1-3 years; three for 3-5 years; and eight for 5-10 years; thirteen were more than 10 years old. All are formal businesses, but the majority started informally, operating from kitchens, garages and barns on farms.

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8 Professor Martin Kidd produced all the figures included in this paper.
The firms’ annual turnover is reflected in Figure 2. Three firms elected not to disclose their turnover—one of these has a strong independent brand, one is a small, independent supplier, and one supplies Woolworths’ private label. Eight firms, a little under a third of the sample, have an annual turnover of more than R20 million. One of these firms is a WW private supplier. The other seven supply WW under their own label. More than half the firms have an annual turnover of under R10 million. Of these firms, three have a turnover of less than one million rand. None of these three are black-owned firms. (The number of employees, relative to size, and disaggregated according to skilled and unskilled, is discussed in section 5.)

For all the suppliers, the South African supermarkets were by far the biggest share of their market. While 44 per cent supplied directly to end-customers, through for example internet sales, and 30 per cent exported their products, suppliers agreed that once a business reaches a certain size, it
is imperative to access the big, domestic supermarkets. Moreover, while some are exporting, none felt that the export market could substitute for domestic supermarkets.

As shown in Figure 3, 23 firms supply Pick n Pay, 21 supply Spar; 15 supply Shoprite/Checkers, and 8 supply Woolworths. Many firms supply more than one retailer, but it should be noted that in sampling decisions, firms that supply more than one retailer were privileged over firms that supply only one supplier. Most often when a supplier supplies only one retailer, it supplies only Spar. Firms that only supply Spar are most often more informal than firms that supply other retailers. As Woolworths’ products are mostly private label products, it was more difficult to identify its suppliers.

(Several interviewees also supply The Food Lovers’ Market. I established anecdotally that its procurement terms are similar to those reported for the other retailers). None supply Massmart/Cash and Carry, as these retailers are targeted as low-income shoppers.

![Figure 3: Number/percentage of suppliers interviewed per retailer.](image)

Each supplier manufactures a range of product lines. For example, a supplier may produce 20 different spices, and each would constitute a different product line, or the supplier may produce different colours of the same product (thus not different product lines), different forms of the same product (such as olives, olive oil, olive tapenade etc.). The average number of product lines is 48. In one case, the manufacturer produces only three product lines, but this is an outlier.

4. Results of the survey: An analysis of the supply contracts

Interviewees report that Spar is an important entry point to test the market, because its procurement is partly de-centralised. This has three distinct advantages for suppliers. First, the supplier does not have to produce in large amounts to supply stores across the country. Instead, she/he need produce only enough for the local store, (or for a couple of stores if contracting with Spar Western Cape). Second, he/she can deliver goods directly to the store. This saves considerable
time, for small suppliers that have to wait in the queue with the corporate suppliers to deliver goods to Pick n Pay, which can take several hours. Third, the terms of the contract are usually more favourable to the supplier that with other retailers.

Once it is established that there is a market for the product, growth beyond a certain size inevitably means that that suppliers need another retailer besides Spar. Shoprite/Checkers is a favourite, because its shelf prices are lower than the other retailers (which means products move more quickly off the shelves) and it assists with labelling and other advice. Additionally, unlike the other supermarkets, Spar does not require compliance with food and health safety standards over and above public standards. According to interviewees, the downside of Shoprite/Checkers is that its primary target is a lower-income market; for high-value, niche products, the market within the Checkers/Shoprite group has a ceiling. Woolworths is difficult to contract with, because most of its products are private label. Pick n Pay is therefore a critical market for emerging suppliers, which lends Pick n Pay additional market power.

As mentioned previously, a supplier’s experience depends on whether it is (a) a strong independent brand; (b) a supplier for Woolworths Private label; or (c) a supplier without a powerful brand. Most interviewees fall into the latter category, which includes suppliers with a substantial turnover. A supplier without a powerful brand is essentially competing for space on the supermarket’s shelf, where it competes with other small suppliers and with large listed companies. Suppliers pay an ‘incentive fee’ to retailers, to ‘incentivise’ supermarkets to stock their products (which is discussed in more detail below). These suppliers are presented with ‘trading terms’ and unless the supplier has a very good relationship with the buyer, the terms are pretty much non-negotiable.

In conformity with global practice among supermarkets, retailers divide products into categories and appoint a major corporate supplier as ‘category captain’ (Towill 2005). Thus while the buyer decides which products will be stocked, one supplier is elevated to a powerful position to manage the shelf and store access of its competitors. The category captain works with the supermarket to plan the lay-out of the shelf, decides which brand goes where, how much of each brand should be stocked, and which brands should be promoted. Several studies (Abratt and Godgfrey 1990’ Towill 2005) show that shelf position—eye-level being the prize spot—influences consumer decisions. Interviewees attest to the power of the category captains—whose own products are in competition with theirs—to make decisions on where their products should be placed, and how much of their product should be stocked. They argue that if too little of a product is stocked, consumers are less likely to buy it, which compromises the growth of the business. As two interviewees note,
There is no place for growth because one cannot generate the volumes one needs. Unless you are a big brand, your bargaining power is limited. You are blacklisted if you take issue with buyers [on purchasing or shelf placement decisions].

If you take issue with a buyer you get blacklisted [your product will be boycotted], so you need to remain grateful for whatever shelf space you can get. They know it and you know it.

Woolworths stocks its own private label, as well as well-known brands, and some smaller brands. The experience of suppliers for the Woolworths’ private label is markedly different to that of the suppliers with their own brands. Suppliers for Woolworths’ private label experience the relationship as a partnership. Woolworths assigns a food technologist to work with individual suppliers to help them improve recipes and to gain the technological know-how to improve products. Woolworths is not selling shelving space to these suppliers. Rather, it is engaged in manufacturing high-value products. Suppliers with their own brands are competing for shelf space, and their contractual terms and experiences are similar across all the retailers.

Retailers use two legal mechanisms to govern their suppliers: contracts and standards. In this section, I analyse the contracts. The contracts, or “trading terms” typically outline the basis on which every order is placed. The parties agree on a price for each product, and the supermarket’s mark-up on that product. Few suppliers take issue with this part of the agreement. In addition to a price mark-up (known as a ‘back-end margin’), all three supermarkets (with the exception for Spar franchisees) charge a “front end margin”, known as a ‘rebate commission’—which is a percentage of every order—a mechanism by which they transfer their costs, and risks, to suppliers. Table 2 shows the rebate commissions charged by the four supermarkets.

<table>
<thead>
<tr>
<th>Supermarket</th>
<th>Number of suppliers</th>
<th>Minimum Rebate Percentage</th>
<th>Maximum Rebate Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pick n Pay</td>
<td>23</td>
<td>9,79</td>
<td>17</td>
</tr>
<tr>
<td>Woolworths</td>
<td>8</td>
<td>8,99</td>
<td>16,75</td>
</tr>
<tr>
<td>Spar</td>
<td>18</td>
<td>2,97</td>
<td>12</td>
</tr>
<tr>
<td>Shoprite Checkers</td>
<td>15</td>
<td>8,9</td>
<td>20</td>
</tr>
</tbody>
</table>

Rebate percentages vary significantly, not among retailers, but among suppliers. Every retailer charges a rebate commission, and there is no discernible, or at least transparent pattern as to why some suppliers pay a high rebate percentage, others a small rebate percentage, and in a few cases no rebate commission is charged. All except two suppliers (mistakenly) thought that the supermarket’s rebate percentage is fixed and applies to uniformly to all suppliers. The degree of information asymmetry attributable to non-transparent procurement practices, and the fact that supermarkets ban suppliers from sharing their trading terms with others suggests that some state intervention is warranted—by the Competition Commission and by the Legislature.
The mean rebate percentage levied by Pick n Pay is 9.8 per cent of the value of the order; Woolworths is 9 per cent; Spar is 3 per cent and Shoprite Checkers is 9 per cent. The range is extraordinary. The maximum rebates levied by retailers are as follows: 20 percent (Shoprite/Checkers); 17 per cent (Pick n Pay); 16.75 per cent (Woolworths) and 12 per cent (Spar). For each retailer, there is at least one supplier which is not charged a rebate at all. Only in the case of Spar is there a structural explanation. Only 50 per cent of Spar suppliers are charged a rebate commission. Many, though by no means all, suppliers who are not charged a rebate are ones that contract directly with franchisees, who do not charge a rebate commission. This is a significant finding that warrants further research, since the sustainability of Spar’s business model suggests that arguments (by other supermarkets) that rebate commissions are necessary to sustain a supermarket would appear unfounded. And, the fact that some businesses pay an rebate commission, and others (with similar products) do not, gives the former a significant competitive advantage.

The largest component of the rebate commission is an ‘incentive fee’, which is a fee that the supplier pays to the retailer for the privilege of his/her goods being stocked by the retailer. Other components include an advertising fee (without reciprocal obligations on the part of retailers to advertise the producers’ products), a settlement fee (to pay the supplier within 30 days), and a ‘swell allowance’ (for retailers to assume the risk of over-ordering and breakage). In addition to the rebate commission, most Pick n Pay suppliers have to contribute to Pick n Pay’s costs of building or refurbishing their stores.

In the section that follows, I disaggregate the rebate commission, and explain each element. Thereafter, I discuss additional costs levied that are not part of the rebate commission. In some ways, the distribution among these items is misleading, since Woolworths may require a bigger incentive fee, but carry all the risk, whereas Pick n Pay may charge a smaller incentive fee, but nearly always includes a swell allowance in exchange for the supplier carrying the risk. The discussion aims, therefore, to explore the distribution of risk and value between suppliers and retailers, rather than focusing on comparing percentages. The section focuses primarily on Pick n Pay’s practices, for the following reasons: First, 23 of the interviewees supply Pick n Pay, so we have the most data for Pick n Pay. Second, as mentioned, Pick n Pay is a significant market for suppliers in this sector. Last, Pick n Pay’s ‘terms of trade’ are more onerous than those of any of the other supermarkets.

In 2012, under the leadership of ex-Tesco MD, Pick n Pay de-listed its suppliers and concluded new trading terms (with some suppliers) that are more advantageous to Pick n Pay. The supermarket moved from a regional procurement system (where buyers in each region had the authority to negotiate agreements with suppliers) to a centralised system, where decisions are made centrally by a committee. Buyers are now located in Johannesburg. Under the new regime, in the case of small suppliers (under R20 million annual business with Pick n Pay), contract terms are no longer negotiated. Instead, suppliers are simply issued ‘trading terms’. The trading terms is a
standard document and Pick and Pay unilaterally decides which terms apply to each supplier and the amounts charged.

4.1 Incentive fee

An incentive fee is a fee paid to a supermarket to ‘incentivise’ it to stock your product. Pick n Pay charges a median incentive fee of 5.8 per cent, up to a maximum of 8 per cent (in this study). This fee is paid to Pick n Pay for the privilege of having the stock on the shelf. It does not create any rights for the products to remain on the shelf until they have been sold, or to keep the product until its sell-by-date, and it does not protect the suppliers from their products being de-listed (take the product off the list of products ordered) at any time. As described by a distributor (someone who is an agent for suppliers’ goods)

If a product is not performing in certain stores, Pick n Pay can de-list you in all stores. One of the most frustrating aspects is that they de-list products without informing you. The next time you visit the store, there are items that you have to take back, otherwise they will not place any more orders with you. If it were still on the shelf, you could save the products for re-selling, but in most cases it is just removed and dumped into the ‘return bins’ with broken items. It is normally in such a mess that you cannot save anything and it is your loss.

4.2 Swell allowance

In terms of contract law, risk passes to the buyer when the seller delivers the item. Of the retailers, only Woolworths consistently (although the sample is small) assumes all the risk upon delivery. Risks include breakage of goods in the stores; customer returns; over-ordering by the supermarket, and any damage to the products after their delivery. Presumably, Woolworths builds these risks into the incentive fee. Shoprite Checkers charges a “swell allowance”– usually between 5 and 8 per cent, although in once case zero—for it to assume all the risk.

Spar appears to negotiate risk. Sometimes Spar assumes the risk, sometimes the supplier, and sometimes it is shared. If Spar assumes the risk, it does not charge a ‘swell allowance’ for its assumption risk.

Pick n Pay does not assume the risk. Suppliers could choose whether to pay a ‘swell allowance’—usually two per cent—for Pick n Pay to assume the risk. One supplier related how Pick n Pay had placed additional orders for stock over two religious festivals. The supplier incurred significant expense to increase production to meet the order. At the end of the period, Pick n Pay returned stock that was not sold, and which was now past its sell-by-date. Interviewees reported that Pick n Pay will not place any more orders until the supplier has reimbursed Pick n Pay for the returned stock, and Pick n Pay refuses to offset the amount owed by the supplier against amounts Pick n Pay owes the supplier for its other products lines. Since 2012, a swell allowance is most often included automatically as part of the rebate commission. It appears that the swell allowance covers all risk, except over-ordering. Interviewees report that often excess stock is
handled carelessly and damaged in the process. The cost implications for a business are enormous.

While one might argue that Pick n Pay’s mean rebate commission is only 0.8 per cent higher than Woolworth’s, the important issue is the subversion of the normal rules of the contract of sale. Pick n Pay would presumably argue that it is not concluding a sale agreement, but is contracting for the consignment of goods.

Given the proclivity of food retailers globally to pass on risks and costs to their suppliers (UK Competition Commission 2006), it is likely that other retailers will follow Pick n Pay’s example in the future.

4.3. Settlement fee

The literature is replete with the cash flow implications for SMEs when retailers withhold payment. All four supermarkets charge a ‘cash settlement fee’, which is a fee that the supplier pays for earlier payment. For Spar and Shoprite/Checkers, the ‘cash settlement’ entitles the supplier to be paid within 30 days. Both retailers usually charge a settlement fee of 2.5 per cent. Woolworths’ settlement fee is between 3.5 per cent and 4.75 per cent. For both Pick n Pay and Woolworths, the usual payment period is 30 days, but several suppliers enjoy more favourable terms. Most suppliers pay a 2.5 settlement fee and one pays 3 per cent. Four suppliers do not pay any cash settlement fee. Three suppliers pay 1 or 1.5.

We tested for a correlation between the amount paid as a settlement fee and the payment period, and there is a correlation, but it is not not statistically significant. Of the 20 suppliers whose settlement fee was verifiable, 11 enjoy more favourable terms: one supplier is paid within 21 days, six within fourteen or fifteen days, and three within seven days. In fact, in one instance, the supplier is paid within seven days, and does not pay a rebate commission at all. There is no discernible reason—such as being a new business or a black-owned supplier—for the supplier to enjoy more favourable terms relative to other suppliers.

4.4. Advertising fee

Both Shoprite/Checkers and Pick n Pay levy an ‘advertising allowance’. Again, there appears to be no criteria to determine who is charged an allowance, or how much. Nor does it appear that a high ‘advertising allowance’ is offset by a lower charge on another component of the rebate commission. Suppliers report that the allowance translates into a certain number of advertisements in Shoprite/Checkers’ broadsheets. For Pick n Pay suppliers, the obligation to pay an ‘advertising allowance’ does not translate into a right to advertising. Pick n Pay argues that the allowance contributes toward advertising the Pick n Pay brand.

In addition to the advertising allowance, suppliers may pay to have their products advertised in Pick n Pay’s broadsheets. Different suppliers are charged different amounts. The amount charged
does not appear to relate to the size of the advertisement, or to the turnover of the business. More than one supplier reported that he/she entered into an agreement with Pick n Pay to advertise a product(s) in its broadsheet and paid the agreed fee upfront. Pick n Pay oversold the advertising space, did not advertise the products in subsequent broadsheets, and did not reimburse the producer. Suppliers felt unable to challenge the practice as they feared being ‘blacklisted’ and their products ‘de-listed’ i.e. no longer stocked by the supermarket.

Woolworths sometimes charges an ‘advertising allowance’; a ‘branding integrity’ allowance; or a ‘marketing levy’. These categories appeared on the supply agreements, but none of the suppliers I interviewed paid these costs. Spar does not levy any fee.

In addition to the rebate commission, Pick n Pay charges some suppliers additional costs, which include the following:

- Payment for stores: Some suppliers are required to contribute an amount (usually R 1500) to Pick n Pay to refurbish existing stores or to build, or purchase, new stores. Theoretically these amounts are charged for stores in which the suppliers’ products are stocked, but suppliers reported that they have been levied for stores that do not stock their products. Some suppliers have never been asked to contribute.

- A ‘strike clause’: Some ‘terms of trade’ include a penalty which is triggered if a supplier fails to deliver a certain percentage—usually 95%—of the products Pick n Pay orders over a year. The strike clause ensures continual supply of products. Suppliers complain that Pick n Pay is unwilling to take into account the reasons for non-delivery, such as its own refrigeration facilities being compromised during the year under review, or seasonality of products. The legal basis for Pick n Pay’s claim is interesting: the clause assumes a contract of sale (for a year) and penalises the supplier for failure to deliver—a classic breach of contract provision. Yet, the supplier has no basis on which to claim specific performance—that the supermarket has to take delivery of an order and pay according to agreed terms—as Pick n Pay claims that it is contracting afresh for each order it places over the same period, namely a year.

- Promotions: Some suppliers report that they refuse to promote their products. Others report that they have no choice, and that Pick n Pay decides unilaterally whether a product will be promoted (such as offering two for the price of one or offering a discount), and the promotion costs are borne by the supplier.

As the value chain literature has rich insights into how retailers use standards, and the implications of standards on SMEs, I turn first to analyse the above findings in the light of the global value chain literature, and then having introduced the literature, discuss how the retailers apply standards. Thereafter, I discuss the suppliers’ perspective on the effect of standards for the growth of their businesses, and on new suppliers’ prospects of accessing these food value chains.
5. **An analysis of the supply contracts and the implications for “upgrading” and job creation.**

This section of the paper analyses the survey data. First, drawing on global value chain analysis, I discuss the power relations in different types of chains as reflected in the supply agreements. Second, I reflect on the implications thereof for the upgrading strategies available to suppliers, and consequently for job creation. Last, I consider the legal mechanisms, other than contracts, that supermarkets use to govern their suppliers, namely food and safety standards. I argue that Spar and Checkers-Shoprite have a different philosophy to Pick n Pay and Woolworths, which has significant implications for the ability of new businesses to participate in food value chains.

### 5.1 Differentiating among chains: the implications

With its policy orientation, global value chain (GVC) analysis provides a useful lens to analyse the data. GVC analysis scholars are concerned with understanding how value is distributed in global value chains, how lead firms (in this case supermarkets) exercise their power to govern other firms in the chain (‘governance’) and the strategies available to firms to appropriate a greater share of the value of the product, or to increase their market share (‘upgrading’).

Scholars distinguish between different kinds of chains, three of which have relevance for this study. First, ‘hierarchical chains’ refer to vertically integrated production processes where the lead firm (in this case the supermarket) controls production because it owns the subsidiaries. Second, ‘market value chains’ describes exchanges between retailers and suppliers that are based on demand and supply, and which are governed by an arms-length contract. This ‘governance structure’ is common where the products are basic, product specifications are straightforward, and the transaction needs little buyer input (Gereffi et al 2005). As a result, according to theory, the ‘central governance mechanism’ is price, which is usually set by suppliers, and as the transaction costs for a supplier to switch buyers, and vice versa, is relatively low, and the bargaining power between retailers and suppliers is evenly distributed. In the South African context, however, the distribution of bargaining power in arms-length contracts between retailers and suppliers is relatively equal not because either party can easily find another supplier or buyer, but because neither the supermarket, nor the supplier, can do without the other. One of the interviewees with a strong brand name falls into this category. Its ‘trading terms’ reflect the symmetrical bargaining power between it and the supermarkets, and product prices and rebate commissions are actually negotiated.

In between ‘hierarchical’ and ‘arms-length’ chains lie various configurations, distinguishable in terms of the different distributions of bargaining power. Woolworths’ private label can be described as ‘quasi hierarchical’ (Humphrey and Schmidz 2008) or “relational” (Gereffi et al 2005) in that Woolworths exercises considerable control over production processes, almost as if the supplier were a subsidiary. The transaction costs for Woolworths to change suppliers are high, since it invests significant time in each producer, sometimes provides financial assistance to
bring production facilities up to its standards, and transfers production know-how to its suppliers. Woolworths is accordingly committed to long-term relationships with its private label suppliers, and their experience of how trading terms are negotiated, and of the relationship with Woolworths, is much like a partnership—which is very different to the experience of own-brand name suppliers.

According to global value chain analysis scholars, the relationship between the supermarkets and the suppliers without a strong brand presence would an arms-length one, in that the transaction costs for switching should be low (since neither invests much in the other), and the ‘governance mechanism’ is price, which is decided by the supplier (Gereffi et al 2005). In South Africa, however, and not unlike in other countries, the concentration of market power among supermarkets means that supermarkets dictate the terms. Given Pick n Pay’s unique market position—as one of the two largest retailers, and relative to Shoprite/Checkers, its concentration on middle class consumers—it enjoys almost monopsony market power in relation to small suppliers. Pick n Pay renews its ‘trading terms’ annually and these are presented as if they constitute a standard form contract, although as shown in section 4, the terms of these contracts differ markedly between suppliers. The ‘terms of trade’ does not constitute a contract, according to Pick n Pay, it merely reflects the terms on which Pick n Pay trades with suppliers for that year. Each time Pick n Pay places an order, a new contract—the terms of which are reflected in the ‘terms of trade’—is concluded. This means that suppliers’ products can be ‘delisted’ at any time without Pick n Pay committing breach of contract.

It is no different for black-owned enterprises. The firms I interviewed started off as informal (as is the case for most white-owned interviewees) and their participation in the value chain was facilitated by the ‘transformation’ initiative within Pick n Pay (that provides them with the necessary technical and financial support), but the ‘terms of trade’ are concluded with the buyer. Compliance for B-BBBE scorecard purposes only assesses the percentage of procurement relative to their turnover that retailers spend on black-owned enterprises, and does not assess the terms on which black-owned enterprises participate. This means that there is no incentive for the terms to be equitable, or more favourable than extended to white-owned suppliers (von Broembsen 2016).

This section has analysed the one legal mechanism by which supermarkets govern their supply chains—contracts—the other is through the applications of food and safety standards, which I discuss below.

5.2 Food and safety standards

Three government departments—the Department of Health (DOH), Department of Agriculture, Forestry and Fisheries (DAFF) and Department of Trade and Industry (DTI)—are responsible for developing and enforcing food safety in South Africa. Six Acts and regulations promulgated

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9 Sturgeon (2009) later acknowledged that these descriptions of chains are ‘ideal types’
in terms of the Act govern the production, manufacture, transport and labelling of food manufacture (Siphugu 2011). These include:

- The Foodstuffs, Cosmetics and Disinfectants Act, 1972 (Act No. 54 of 1972), which governs the manufacture, sale and importation of foodstuffs, cosmetics and disinfectants. It controls what goes into foods, rather than regulating the hygiene of food preparation, and is administered by the Directorate: Food Control of the Department of Health and enforced by local authorities (Siphugu 2011).

- The Health Act, 1977 (Act 63 of 1977) and a raft of regulations is enforced by local authorities in their areas of jurisdiction. The Act and regulations includes hygiene specifications relating to foodstuffs, both in general and specific to different sectors.

- The International Health Regulations Act, 1974 (Act 28 of 1974)


- The Standards Act, 1993 (Act 29 of 1993) is administered by the SABS and regulates canned meat and fish products, and frozen seafood.

The internationally recognised Hazard Analysis Critical Control Point (HACCP) system has been gazetted as part of the Foodstuffs, Cosmetics and Disinfectants Act. This legislation covers 12 sectors and their categories of food-handling enterprises, including food preparation and catering (from caterers to restaurants) and street-vended foods, but no sector is as yet legally obliged to introduce HACCP (Fuller 2007). Different government agencies are responsible for the different sectors and enforcement of the legislation: New labelling and advertising of foodstuffs regulations (R146 of 2010) have been in effect since March 2012. Different government agencies are responsible for enforcing these regulations.

Suppliers reported that Spar and Shoprite/Checkers require compliance with the legislation discussed above, and suppliers have to provide a certificate of compliance from the Department of Health, or a certificate that shows compliance with either HACCP or Woolworths’ audits. Suppliers reported that Shoprite Checkers’ labelling experts provided suppliers with significant report to comply with the new labelling regulations.

Woolworths and Pick n Pay require additional audits. It appears that Woolworths differentiates between its private label suppliers and own-brand suppliers. Private label suppliers reported that Woolworths requires progressive compliance over three years, assists suppliers to meet compliance, and bears the costs of the annual audits after the first audit. Suppliers who supply Woolworths under their own label carry the cost of the annual audit in some cases, in other cases not. Pick n Pay requires compliance with the international standard, HACCP. Suppliers who supply both Pick n Pay and Woolworths report that Pick n Pay is unwilling to accept compliance with Woolworths’ audit, despite Woolworths’ standard, in their view, being more onerous than HACCP. Suppliers to Woolworths and Pick n Pay therefore have to bear the costs of two different audits to comply with HACCP and with Woolworths’ standards.
Compliance with HACCP is costly. First, suppliers have to pay certified compliance auditors to assess what needs to be done and to draft a compliance plan. HACCP specifications often involve renovations, such as installation of an air-locked bathroom, basins with taps that can be manipulated with feet and elbows, rather than hands, perspex rather than glass windows, and special tiles. Second, suppliers have to pay a compliance auditor to audit the factory. Compliance fees range between R 5000-8000.

Suppliers feel strongly that government should regulate the application of private standards, such as HACCP, in three respects:

- They argue that government standards provide adequate protection to consumers. Should retailers require additional compliance with private standards, whether HACCP or otherwise, emerging businesses should be granted a statutory three year progressive compliance period (which follows Woolworths’ practice with its private label suppliers).
- Suppliers should not have to bear the costs of two different private standards.
- Suppliers should be able to choose the company responsible for the audit if it bears the cost. Suppliers reported that Shoprite Checkers providers suppliers with a list of accredited auditors, which means auditors are subject to market forces. By contrast, it is mandatory for Pick n Pay suppliers to use Intek. Suppliers felt that Intek is not transparent about its prices, and that it subtly threatens to ‘fail’ ‘difficult’ suppliers. One supplier reported that historically, Intek was part of Pick n Pay’s in-house auditing department.

Compliance costs have the effect of excluding new market entrants (Gereffi and Lee 2012) and more seriously, ‘in some areas there are signs that standards certification, as one element of industrial competence of suppliers, has helped to promote cut throat market-based transactions as supermarkets use reverse internet auctions to choose the cheapest of standards compliant suppliers, and push inventories, costs and risks further down the chain’ (Navdi 2015: 332). Supermarkets assert that compliance with these private standards are necessary for consumer protection. Yet, Spar’s products comply with public standards, and consumers are safe. One supplier put me in touch with a someone who had supplied Pick n Pay with baked goods for twelve years. The new HACCP requirements meant she could not afford to continue supplying Pick n Pay. From a policy perspective, this is a critical area for more research. Dolan and Humphrey’s observation is apt. They argue that standards are ‘a function of relative power’. UK Supermarkets can demand compliance from African suppliers, for example, but not from Spanish suppliers. Yet, they continue to stock Spanish products, which undermines their justification that these private standards are applied for the protection of consumers. (Dolan and Humphrey 2000:158).

5.3 Analysing the job creation potential of SMEs in food value chains

In the introduction to this paper, I noted the NDP’s faith in SMEs in the agro-processing sector to create jobs. A previous case study (Von Broembsen 2016) suggested that SME suppliers employ both permanent employees and informal/atypical labour (casual, seasonal, part-time).
And, in the case study, when the supplier’s business grew, atypical workers were made permanent employees. One of the objectives of this study was to determine the implications of firm growth for workers. Figure 4 shows the number of people employed by the firms interviewed.

Figure 4: Number of Employees

Ten firms employ between 21 and 60 employees, excluding the owner. Four firms employ between 11 and 20 workers; four fewer than 10, and four over 60 workers. Typically firms that employ fewer than ten people were either highly automated, or outsourced their production and added value by packaging the products.

A significant finding was that none of the firms employed casual, seasonal or temporary workers. All employees were full-time, permanent workers. Initially I tried to categorise employees by level of education, but this proved too complex, as many employers weren’t sure of their employees’ educational attainment. Instead, I distinguished between employees with any post-school training, and those who had no post-school training of any kind. Employees with a drivers licence, therefore, or who have basic book keeping skills, were categorised as skilled. On average, suppliers employed approximately 34 unskilled employees, and the maximum number of employees was 285. These numbers reflect only the employees involved in manufacturing, and not those employed to farm the produces. These numbers underestimate the number of unskilled employees as two of the interviewees are distributors, and they are structured in one of two ways. Either they buy the finished products from suppliers and assume responsibility only for packaging, or the producer acts as an agent for small suppliers, who do not have the infrastructure to distribute their products to retailers. These distributors would typically only have one or two employees, and typically distribute stock for up to 40 suppliers and up to 800 product lines. The number of employees responsible for making the products is therefore not captured by their employee data. The distributors are included in the study because despite representing several suppliers, and despite large product lines, they are treated no differently to other suppliers, and the retailers still unilaterally determine the terms of their supply agreements.
Firms generate significantly more unskilled than skilled jobs. The average number of skilled employees is 5, and the firm with the most skilled employees has 26. And there is a statistically significant correlation between turnover and the number of jobs created.

Global Value Chain literature refers to strategies that countries and firms deploy to appropriate a greater share of the market, and/or share of a product’s value as “economic upgrading”. Humphrey and Schmitz (2000) identify four different economic upgrading strategies. Product upgrading involves firms producing a different, more complex product; production upgrading involves improving the efficiency of the production process, often by improving technology; functional upgrading involves building the capacity and skills of workers to assume more sophisticated functions; and chain upgrading refers to firms transitioning into a different industry. The creation of jobs and increased worker rights (including security of tenure as workers and increased wages) is known as “social upgrading”.

Only two of the suppliers interviewed envisaged that growth of their enterprise would translate into employing more people. Most indicated that they would invest in automation rather than employing more people (the exception was packaging—a function that cannot be performed by a machine). Only one cited inflexible labour laws as the reason for not employing more people. My analysis, based on interviews with 33 people over a three month period, and supplemented by informal conversations with several business owners who have previously supplied the four retailers, is that the cumulative effect of the risks that the suppliers bear—from insecurity of contract, to over-ordering and unpredictable actions by the retailer or the category captains—mean that suppliers are predisposed to pursuing ‘production upgrading’ through automation, rather than ‘functional upgrading’, which would involve building the capacity of their workers.

6. Key findings

The key findings of the study are the following. First, the opportunities for enterprise growth are highly circumscribed by the supplier’s power, relative to the supermarkets’. The type of value chain a supplier participates in has significant implications for the terms of its supply agreements; the upgrading strategies available to it; and the extent to which its growth is likely to translate into creating additional employment. Three types of value chains are identifiable in this study, characterised by different power relations:

i. Strong independent brands: chains where suppliers have strong brands, and the bargaining power between supermarkets and suppliers is therefore roughly equal.

ii. Supplier for Woolworths Private label: Where the supplier supplies for the Woolworths (WW)’s private label and WW has made considerable investment in the suppliers’ production processes, the transaction costs for WW to change to another supplier would therefore be considerable. The terms of the contract reflects the mutual investment of the parties; and

iii. Supplier without a powerful brand (the position of most, even relatively large suppliers). The bargaining power between suppliers and supermarkets is markedly asymmetrical, as
high niche food retail is concentrated in the hands of only 5 retailers—the four mentioned, and an emerging retailer, The Food Lovers’ Market. The contractual terms reflect the parties’ asymmetrical power. In some cases, the contracts reflect an abuse of market power, which might contravene the Competition Act. Black-owned suppliers’ terms are no more (or less) generous than their white counterparts.

One exception to this third category is Spar. Spar operates as a franchise, and therefore has a less centralised procurement model. Each store-owner is entitled to procure a percentage of goods directly from local producers. These supply agreements, between store-owners and suppliers, reflect this more equal relationship. Possibly the reason for a more equal supply agreement is that the relationship between the store owner and the supplier is a personal one than between corporate retailers and small suppliers, and franchisees seek to differentiate their stores from competitors by stocking interesting, local products.

Second, for the third category of suppliers—the majority—this survey finds that the terms of their supply agreements are such that they are structurally coerced to pursue what the value chain literature refers to as ‘production upgrading’, namely capturing more value through more automated production, as opposed to ‘functional upgrading’, which would involve building the capacity of their workers (or at least notionally, hiring more skilled workers). This finding suggests that supermarkets’ procurement practices rather than so-called inflexible labour laws undermine the job creation potential of SMEs in the sector. Moreover, ‘social upgrading’ (passing down increased value appropriation to workers) is structurally precluded by the dual pressures that suppliers face—the insecurity of contract (their products are liable to be de-listed at any time) and the pressures on their production costs as supermarkets pass their costs and risks to suppliers through ‘rebate commissions’.

Third, the rise of private production and hygiene standards, enforced by some of the supermarkets, determine who is included, and excluded, from participating in food value chains. Most of the suppliers that I interviewed, started producing foodstuffs informally from a kitchen or garage. Many started by supplying their local Spar, which enabled them to test the market for their product before incurring unnecessary production costs. They graduated to supplying Pick n Pay. All four supermarkets historically required compliance with public health and safety standards. In recent years, Woolworths and Pick ‘n Pay, and to a lesser extent Shoprite Checkers and Spar, require strict compliance with stringent private production and hygiene standards. The cost implications of meeting these standards, and of the compliance checks, means that informal, emerging businesses are effectively excluded from participating in these chains. All interviewees favoured a mandatory period of grace for start-up businesses to attain gradual compliance.

10 See Bienaber and Vermeulen (2007), which describes Spar’s local procurement practices in rural areas in the Eastern Cape.
7. Conclusion: Legal and policy analysis

This study is small and does not claim to be representative, but the findings are uniform and mirror the report of the UK Competition Commission (now the Competition and Markets Authority) on its investigation into UK supermarkets’ procurement practices. The UK Commission identified the following ten ‘widespread’ practices among supermarkets in relation to suppliers (Towill 2005:427).

- Suppliers are threatened with de-listing if they refuse to reduce their prices;
- Suppliers have to ‘offer better terms’ to enable the retailers to compete on price with other retailers;
- Suppliers have to reduce their price in exchange for listing more products, or for large orders;
- Retailers discriminate among suppliers when applying credit periods;
- Suppliers are required to finance the building of new stores;
- Suppliers are required to use ‘designated hauliers and materials vendors’;
- Suppliers have to pay for ‘product wastage’;
- Suppliers are ‘requested’ to make donations to the retailers’ favourite charities;
- Suppliers have to provide ‘retrospective discounts’ if these are requested; and
- Suppliers have to pay for special promotions.

The South African Competition Commission is presently investigating the food retail sector. Its terms of reference, published as in Government Gazette no 500 of 2015, states that it is investigating the concentration of food retail in the hands of four retailers, and the barriers to new retailers entering the market. Its recommendations will hopefully address the structure of the market, including supermarkets’ ‘pricing practices’, such as rebate commissions.

This paper has described the supermarkets’ procurement practices. I have argued that their procurement practices contribute to SMEs favouring capital over labour-intensive growth strategies. Additionally, their procurement practices (in particular Pick n Pay and Woolworths’ practice of demanding compliance with private standards) restrict access by new suppliers, in particular informal suppliers (and the vast majority of suppliers in the own-brand category started as informal businesses) to agri-food value chains.

The survey started with a set of questions that sought to understand the relationship between suppliers and the four food retailers that dominate the South African market. Specifically the research sought to understand:

- Whether contracts are in fact negotiated, as orthodox contract law theory presupposes, or whether these are a type of standard form contract, that is drawn up by the more powerful party, namely supermarkets. And, given B-BBEE legislative imperatives and incentives, is there a difference in contractual terms between white and black-owned suppliers?
• The implications of the contractual terms for new entrants, firm growth, and for employment creation.

The study found that for suppliers that produce their own brands—the majority of suppliers—with the exception of Spar, the terms of their contracts are unilaterally decided by the supermarket, and are different for different suppliers. And black-owned suppliers’ contractual terms do not benefit from more favourable terms than white-owned suppliers. B-BBEE regulations measure retailers’ compliance with B-BBEE incentivised procurement from black-owned enterprises in terms of their total procurement spend, without regard to the terms of black-owned suppliers’ participation in value chains. This enables supermarkets to claw back their procurement spend through rebate commissions, with impunity.

The data shows that increased turnover leads to more jobs. However, longitudinal research might show that this trend will be undermined (particularly for newer firms) as the anecdotal evidence suggests, by (a) the recent trends by supermarkets to move away from a regional, relational model of buyers getting to know products and suppliers and negotiating contracts through a centralised procurement system; (b) insecurity of contract; and (c) supermarkets requiring suppliers to comply with private (as opposed to public) standards.

The study found that none of the businesses employed people on a casual basis, that there were few instances in which workers’ skills were upgraded to assume more complex functions, and that none sourced from informal businesses. With the social interests at stake, I argue for policy interventions in three areas. First, the state should regulate the contracts between supermarkets and small suppliers, as it does in other relations marked by unequal power relations—such as contracts between retailers and consumers, employers and employees, and franchisors and franchisees. I discuss three possible ways to do so, below.

Second, the emergence of private standards as a means of regulating suppliers, has significant chilling effects on new entrants. As international studies show, demanding compliance with these standards has less to do with protection of the consumer, and more to do with power relations, which serves to exclude new market entrants. The paper made a case for regulating how these private standards may be enforced, including making provision for gradual compliance over a 3-5 year period, and ensuring that uncompetitive practices, such as insisting on the SMEs using particular audit firms, are eliminated. Third, the question of rebate commissions—as a means for retailers to pass down costs and risks to their suppliers—have to come under scrutiny.

Pick n Pay’s egregious contract terms might violate Competition Law, but do not violate contract law since, by their signatures, suppliers are supposed to have exercised their free will and agreed to the terms. The research shows, however, that the imbalance of power between retailers and suppliers mean that suppliers are essentially coerced into signing these ‘terms of trade’ which are unilaterally decided on by supermarkets, if they want to participate in the competition for shelf space. I explore different policy responses below—the first being to regulate the contracts
between supermarkets and retailers, and the second to adopt a soft law approach to governing supermarkets.

7.1 A duty of good faith in contract law

Legal theorists argue that parties ‘bargain in the shadow of the law’. Supermarkets bargain knowing that their contracts are ‘legal’ and would be enforced by courts even if unfair to suppliers. The reason for this assurance is that South African contract law is premised on the notion that contracts reflect the will of the parties. Courts have argued that contracts have to be enforced, even if unfair, because we should be free ‘to regulate our own affairs, even to our own detriment’ (Kruger 2011:712), and moreover, courts must enforce contracts to facilitate certainty in the commercial and social world, otherwise ‘all trade would be impossible’. The fact that the courts will enforce the contracts irrespective of whether the terms are unfair, or whether the agreement is the outcome of unequal bargaining power, means that supermarkets’ power is unchecked, as it is legitimated by law.

Since 2007, the Constitutional Court’s jurisprudence on contract law has taken a different turn. In a landmark 2007 judgment, Barkhuizen the court applied the foundational values of the constitution—freedom, dignity and equality—to determine whether a clause in a contract between an insurer and an insured was valid. The majority held that, ‘the Constitution requires the court to employ its values to achieve a balance that strikes down the unacceptable excesses of freedom of contract (my italics) while permitting individuals the dignity and autonomy of regulating their own lives’ (par 12). The court reasoned that in cases where the bargaining power is unequal, constitutional principles are likely to ‘trump’ the principle of pacta sunt servanda. This decision was followed by a decision in 2013, in which the court again invoked the Constitution to find a clause in the agreement that provided for a home-owner to lose her property and two years of down-payments because she defaulted on two instalments, invalid. While South African courts have always had recourse to public policy to scrutinize egregious contract terms, or contracts that offend public morality, several commentators have argued that through this jurisprudence the court is developing a more substantive, positive duty of good faith. Sutherland (2009) suggests that the Constitutional Court’s decision in the Barkhuizen case could be interpreted to mean that a ‘one-sided promotion of personal interests … constitutes a breach of the duty to act in good faith.’ Other cases have continued to apply orthodox contract theory, and the law will take decades to develop if left to the courts.

Many European civil law countries have incorporated a duty of good faith in their laws of contract. And Israel has codified its common law of contract to include a duty of faith, which would be a high road for South African policy makers, and would promote the NDP’s goal to realise inclusive growth.

11 Sasfin (Pty) Ltd v Beukes 1989 1 SA 1 (A).
12 Barkhuizen v Napier 2007 5 SA 323 (CC)
A duty of good faith means that parties’ freedom of contract—in the case of all contracts (not only supply agreements)—is constrained by a duty to act in good faith. In German and Israeli law, a duty of good faith has been interpreted to mean that ‘each bargaining party [has] to take account of the other party's interests as well as his own’ (Whittaker and Zimmerman 2000:63). A duty of good faith regulates how parties contract, acting as a ‘fairness’ procedural restraint on unchecked power. It has been operationalized in three ways: (a) as an interpretative aid (when a contractual clause might be interpreted in two or more ways, the judge chooses the one that reflects good faith); (b) as an implicit term in the contract as a duty to be ‘loyal, to protect, to cooperate, and to inform’; (c) to ‘prevent abuse of a right’ by playing a limiting or correcting role (McQueen 1999).

Applying the principles of good faith to supply agreements might have the following implications:14 First, whereas a contract is usually only recognized when agreement is reached, a duty of good faith has been extended to pre-contractual negotiations, to include duties of disclosure and liability for ending negotiations in bad faith (McQueen 1999). A pre-contract duty of good faith could address the asymmetrical bargaining power in the supermarket/supplier relationship in important ways. For example, if a supermarket seeks product sensitive disclosure in pre-contractual negotiation, breaks off negotiations and produces substantially the same product within a specified period, it would amount to a breach of good faith. Apart from some high profile cases where suppliers aver that Woolworths ‘stole’ their idea, several people I interviewed reported that Woolworths had ‘stolen’ their own product ideas, or ideas of other suppliers. They provided me with the contact details of these suppliers, for verification purposes. A supplier could currently sue on the basis of an unlawful action (delict), but the elements required to establish delictual liability are significantly more difficult to prove than proving a breach of good faith.

Second, a duty of good faith has been used as a reason for declaring contractual terms invalid. It could be argued that rebate commissions breach a duty of good faith on the basis of a ‘one sided promotion of interests’(McQueen 1999:166). Third, it has been used as a means of addressing unforeseen circumstances or hardship. Some terms of trade include a strike clause that penalizes suppliers if they fail to deliver products that have been ordered, irrespective of the reason for non-delivery. A duty of good faith would limit the scope of this clause to cases where the supplier is at fault.

Admittedly, few suppliers would likely take a supermarket to court, given the costs of litigating, the time, and the inevitable risk of being de-listed. However, a duty of good faith in our contract law would mean that the parties bargain in the shadow of different law—where courts would scrutinize agreements and make findings that supermarkets are failing to contract fairly. The two retailers who suppliers accused of the most exploitative behaviour are patronized predominantly by middle class consumers, and the retailers—Woolworths and Pick n Pay—have cultivated public images of being socially responsible corporate citizens. A substantive duty of good faith might

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14 Based on principles outlined by McQueen (1999).
tilt the bargaining power in favour of small suppliers, given that a breach of good faith might be more effectively contested in the court of public opinion.

### 7.1.2 Regulating contracts between retailers and SMEs through legislation

The Consumer Protection Act (68 of 2008) and the National Credit Act (34 of 2005) regulate contracts between consumers and retailers. The definition of consumer includes not only individual, but legal persons, such as companies, as long as their turnover or asset value does not exceed R 2 million. Regulations published on 31 March 2011 in terms of the Consumer Act regulate contracts between franchisors and franchisees, including clear guidelines on the rights of franchisees for advertising fees paid to franchisors.

The legislation and regulations provide for a range of consumer rights, including a right to information; and a institutional enforcement, or ‘dispute resolution’ mechanisms, including a Commission, provincial structures and a Consumer Goods and Services Ombud. The point is that there is precedence for the state to regulate contracts between two different corporate entities, where the one is the seller and the other the buyer and their bargaining power is asymmetrical.

This study has made a case for government to regulate contracts between supermarkets and small suppliers to address practices such as rebate commissions, advertising fees without rights to advertising, coercion to contribute to new stores, unfair strike clauses, requiring compliance with private food hygiene standards, and to include rights to information, duties of transparency on the part of supermarkets, and even rights to collective bargaining to associations of small suppliers. The sector would need to be consulted more broadly, and government would need to protect against unforeseen consequences, such as supermarkets not procuring from small suppliers as a result of such legislation.

### 7.1.3 Regulation through ‘new governance’

Regulatory goals have traditionally been pursued exclusively through statutory enactments, administrative regulation, and judicial enforcement. New forms of regulation are emerging, known as “new governance” (Lobel 2005) that encourage experimentation, employ stakeholder participation to devise solutions, rely on broad framework agreements—such as sector charters—flexible norms and revisable standards; and use benchmarks, indicators and peer review to ensure accountability (Trubeck and Trubeck 2006).

Essentially, the state devolves some of its regulatory power to other actors to negotiate rules between them, or to self-regulate. The UK Competition Commission’s report on grocery retailers has favoured this approach. The UK Competition Commission found that:

> The transfer of excessive risks or unexpected costs by grocery retailers to their suppliers is likely to lessen suppliers’ incentives to invest in new capacity, products and production processes… if unchecked, these practices would ultimately have a detrimental effect on consumers.
The principal manner in which excessive risks or unexpected costs could be transferred from grocery retailers to suppliers was through retailers making retrospective adjustments to the terms of supply. We also concluded that there were circumstances where allocations of risk may be agreed up-front between a retailer and supplier, but that the extent of risk transferred to the supplier was excessive (my italics). We also have concerns regarding the transfer of risk from grocery retailers to suppliers where, as a result, the retailer has less incentive to minimize that risk (2006:15).

The South African study illustrates that supermarkets’ supply chain practices (with the exception of Spar franchisees) transfer ‘excessive risk’— for supermarkets’ over-ordering; damage after delivery (in the absence of a ‘swell allowance’), strike clauses, and in the case of retailers delisting a product, the costs of products that are removed off shelves. The greatest risk faced by Pick n Pay’s suppliers is that each new order constitutes a new contract, and the threat of being ‘delisted’ for even non-commercial reasons (such as questioning decisions) means insecurity of contract limits the suppliers’ incentive to invest in ‘new capacity’ i.e. to create more, or better paid, jobs. At the same time, a ‘strike clause’ that calculates the percentage of goods delivered over an annual period in relation to the total annual orders, allows Pick n Pay to treat multiple contracts as one contract, which transfers excessive, and retrospective risk, and cost, to its suppliers.

The UK Competition Commission instituted two key mechanisms to address these supply chain practices. First, it recommended that the existing ‘Groceries Supply Code of Practice’, which is based on the ‘Supermarkets Code of Practice’ be amended. In particular it recommended a ‘fair-dealing provision’, which is concomitant with the ‘duty of good faith’. An Office of Fair Trading was established, so that it was enforced through administrative law mechanisms rather than through expensive, time-consuming, adversarial litigation. Second, the Commission mandated an institutional mechanism—an Ombud—to resolve issues between suppliers and retailers, with a clear mandate to privilege the ‘complaints and disputes’ of ‘suppliers without market power’ over those from concerning ‘suppliers of major branded products that have market power’ (UK Commission 2006; Towill 2005).

I canvassed ‘soft’ law mechanisms with suppliers – duties of disclosure on the part of supermarkets, access to information rights for suppliers, recourse to an ombud, and representation.

**Representation**

Supermarkets are represented on several public advisory bodies, some of which inform legislative processes, such as the South African Bureau of Standards setting Committee that regulates product standards. They are also represented on the retail committee of the National Empowerment Fund, and serve on NEDLAC. Suppliers are not represented in any of these fora. The supermarkets enjoy access to government thinking and potentially the ‘regulators come to adopt the mindset of the regulated’—a phenomenon Stiglitz (2012: 249) refers to as ‘cognitive capture’. Suppliers

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15 Interview with a Director of one of the retailers in September 2011.
have no voice, or institutionalised spaces, to influence policy or thinking. The vast majority of suppliers favoured representation of supplier organisations at policy-making tables.

**An ombud**

Suppliers supported the idea of an ombud to address their grievances. They are reluctant to use adversarial means, such as litigation, which is both costly and time consuming because, as one supplier puts it, ‘it is self-defeating to bite the hand that feeds you’. An ombud would provide opportunity for associations of suppliers, rather than individual suppliers, to seek resolution to practices that they perceive of as unfair. Given potential publicity, supermarkets would be incentivised to address suppliers’ concerns—and are less likely to engage in reactionary blacklisting—to protect their reputations as good corporate citizens.

**Duties of disclosure/Transparency requirements**

The food retailers are competing with each other, and Woolworths and Pick n Pay in particular, self-project images of being ethical companies. Duties of disclosure and processes whereby a transgression of a duty of good faith becomes reportable in the public domain are examples of how other pressures groups (such as consumers, NGOs, the media and unions and small and business organisations) might contribute to regulating corporate behaviour.

Finally, through the practices described in this paper, and in particular through applying food and safety standards, three of the supermarkets—Pick n Pay, Woolworths and Shoprite Checkers—are effectively determining who gets to enter food supply chains and who is excluded, and if they are allowed to participate in their supply chains, the terms of their participation. Their procurement practices have profound public policy implications—for the viability and growth of small businesses in the food industry, which create jobs for unskilled, unemployed South Africans—practices that will have to be addressed if the NDP’s vision is to be realized.
References


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