FOOD AND DRINK INDUSTRY IRELAND

Ibec

Brexit – the exceptional case for state aid supports for the food and drink sector

Introduction & Summary

The UK vote to leave the EU is a fracture of the single market and it is the first time a country has left. The vote is also the largest and most immediate challenge facing the Irish agri-food and drink sector. The accession process for new members of the Union is structured and in a similar way, departure needs to be structured, take place over a period of years and affected economies and sectors supported.

The principle underpinning EU state aids rules is that efficient operation of the single market is undermined by Government interventions except for clearly defined circumstances such as market failures. However Article 107 of the Treaty states that the Commission "*may declare compatible with the common market aid 'to remedy a serious disturbance in the economy of a Member State*". Brexit is not just a single market phenomenon. It is a fracture and thus a serious disturbance to the Irish economy…..hence a different approach required to remedy this disturbance.

In Ireland the food and drink sector now faces a serious economic disturbance as a result of this fracture. A detailed analysis of the impact on the food and drink sector is undertaken in this report. What is clearly demonstrated by that analysis is the unique position and importance of the Irish food and drink sector in the overall Irish economy. In particular:

- Extensive regional impact of the food and drink sector and economic weakness of those regions (when measured by GDP per capital (PPP))
- Majority of Irish economy expenditure in the Irish economy and high employment multiplier
- Exclusive outlet for farmer/SME output and value addition and thus importance for farming incomes

means that the fracture to the single market and its deep and unique impact on the food and drink sector in Ireland have an economy wide impact.

Accordingly exceptional policy responses continue to be required and these should include a general block exemption for state aid supports for the Irish food and drink sector in order to maintain and sustain economic activity and jobs and the scope of the supports should not be restricted to SMEs. These state aid supports should be targeted as follows:

- **Enterprise Stabilisation** – Short term measures to allow the Irish Government to introduce enterprise stabilisation measures
- **Investment in Competitiveness** – Medium term measures to allow the Irish Government to introduce investment aids to support Irish food and drink companies invest in enabling technology, plant renewal and expansion, refinancing, market development and innovation to regain competitiveness following single market fracture
- **Diversification** – Trade support measures including export trade financing and export credit guarantees to support the continued development of international export markets

Background

The UK vote on Brexit has pushed the Euro-Sterling exchange rate which is key for Irish companies in the agri-food and drink sector from an average of 0.73p in 2015 to a new level in the range of 0.90p. Most analysts expect that if the UK economy weakens over the coming years there is a growing possibility the exchange rate could reach parity. Currency risk is a factor that Irish food and drink exporters have had to deal with for our nearest and largest market for a number of decades. However the rapid and recent change in currency value is different and more serious than that experienced during the major depreciation of sterling in the late 2000s. The current change is structural not cyclical. There are also many fundamental changes to the economic and business environment. These are outlined in **Appendix 1** and the net effect of all this is that revenue is down 25% across a range of products with no price inflation compensation and no ability to absorb it at processor level.

Exposure of the Irish Agri-food sector

The UK is our largest trading partner for food and drink. Ireland is the UK's largest supplier of food and drink. 41% of food and drink exports go to the UK (€4.4bn). This includes:

- 56% of total meat exports
- 30% of dairy exports (including 60% of cheese exports)
- 70% of prepared consumer foods (PCF) exports
- 32% of alcohol exports (including almost 50% of beer and over 80% of cider)

But the deeply entwined trading relationship is about more that exports. The aggregate transaction values between ROI and UK equate to €9bn. This comprises:

• Exports to UK	€4.4bn
• Imports from UK	€3.5bn
• Cross border	€1bn plus

On average 45 % of Irish Agrifood and drink output is traded/impacted by UK/Sterling. This compares with an EU average 9% (Agra Europe)

Impact

An analysis of the historical exchange rate and agri-food and drink export relationship shows that a 1% weakness in sterling results in a 0.7% drop in Irish exports to the UK. If sterling was to weaken further towards the £0.90 mark, this would translate to losses of over €700 million in food exports and about 7,500 Irish jobs. The propensity for cross border shopping increases with weakening sterling causing a loss of revenue to the exchequer as consumers head North to purchase their shopping with the relative cost of alcohol (due to weak currency and high domestic excise on alcohol) in particular a key driver.

Given the export intensity of the sector it is likely that there will be substantial impacts for both employment and household income in predominantly rural communities as a result of the relative weakened Sterling.

This loss of jobs equates to a cost of €150 million/annum to the state in lost revenue and social welfare -doing nothing costs!

The preference should be to use the money to support/keep jobs and enable industry to survive the transition. Time is needed to adjust to the new currency range /competitiveness challenge.

In the short term the objective must be to put in place mitigating measures to help companies manage their businesses through the on-going uncertainty caused by the currency shift and the exit negotiations. The focus must be on maintaining markets in the UK, developing other markets as well as ensuring that in the domestic market, companies remain competitive against imports and the threat of cross-border shopping.

An immediate Brexit Response

Industry is focussed on improving cost competitiveness, maintaining existing markets and diversifying markets.

Some of this is achievable through internal company measures and national policy responses including currency exposure, cost cutting, promotional supports and risk management.

However state aid restrictions impact on the ability of the Irish states to address critical stabilisation support measures and strategic transformation initiatives.

Enabling strategic supports

The UK vote to leave the EU is a fracture of the single market and it is the first time a country has left. The vote is also the largest and most immediate challenge facing the Irish agri-food sector.

The accession process for new members of the Union is structured and in a similar way, departure needs to be structured, take place over a period of years and affected economies and sectors supported.

The principle underpinning EU state aids rules is that efficient operation of the single market is undermined by Government interventions except for clearly defined circumstances such as market failures. However Article 107 of the Treaty (Article 87 of the previous Treaty) states that the Commission "*may declare compatible with the common market aid 'to remedy a serious disturbance in the economy of a Member State"*.

Brexit is not just a single market phenomenon. It is a fracture and thus a serious disturbance to the Irish economy…..hence a different approach required to remedy this disturbance.

Irish food and drink and the wider Irish economy

The Irish food and drink sector occupies a unique position in the Irish economy. It's €10.8bn of exports account for 10% of goods exports. However it accounts for half of the direct expenditure (payroll, Irish materials and Irish services) by the entire manufacturing sector in the Irish economy. This reflects the deep linkages of the sector to the wider economy with the sector having an output multiplier of 2.15[1]. . In addition farmer SME /growth is the driver for the investment requirement of processors which are the gateway for agricultural products to value added markets.

The principle of systemic importance of regional actors is acknowledged by the European Commission in its Communication *Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty* where it notes "the exit of an undertaking with an important systemic role in a particular region or sector would have potential negative consequences"[2]

This is particularly applicable when 80% of food and drink manufacturing employment is outside Dublin and a clear demonstration that regional economies across Ireland have a strong reliance on the sector. As we show later in this paper these regions in which the sector is primarily located are economically disadvantaged relative to the EU average

Characteristics of the Irish food and drink sector

The Irish food and drink sector is characterised as a high capital cost sector with relatively low margins over time .The primary processing sector for example in both meat and dairy processing would show a 1-2 % net margin over time (Census of Industrial Production – CSO).

The main barrier to developing a higher margin sector stems from Irelands unique seasonality dependent production (high proportion of commodity products) and a very small domestic market relative to the scale of production by a multiple of about ten to one giving rise to an usually large dependence on exports- mainly commodity related products. This set of circumstances places the Irish food industry in category equivalent to New Zealand in terms of export dependence but burdened by an EU high cost of living and cost of production structure.

This combination of high entry levels of capital investment and low returns requires medium to long term financing facilities that are currently not available in the Irish economy. This is exacerbated by overall lack of credit in the Irish economy (see next graph). This lack of suitable finance restricts both the capability of existing processors to expand production capacity and acts as a barrier to entry for new companies into the sector.

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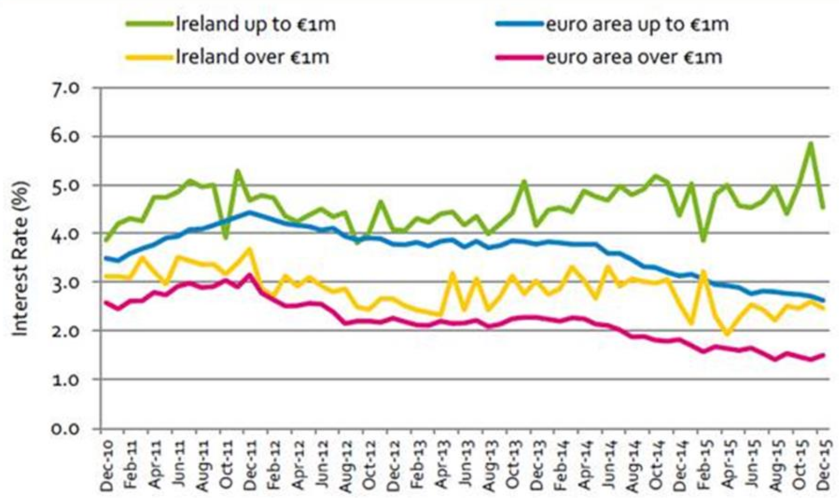
[1] Sharing the Harvest, FDII 2012

[2] Communication from the Commission — Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty; Article 44 (c)

Figure 38: Interest rates for non-financial corporations (new businesses) by loan size, 2010- 2015



Looking at the same data in time series from 2010 to 2015, it is clear that not only are interest rates in Ireland above average for loans of up to €1 million and for loans over €1 million, Irish rates have been noticeably more volatile than euro area rates. Irish and euro area interest rates diverged further in 2014 and 2015.

Source: European Central Bank

The EU recognised this challenging environment (in effect a market failure) in the past[3] through the provision of processing grants for both Annex 1 and non-annex 1 (processed) sectors of the Agri industry.

Food and Drink Industry Ireland in this submission outlines the unique and very challenging circumstances that Ireland finds itself in at present. Moreover, by European standards, the food and drink sector is a disproportionately large part of the economy. Measures to facilitate the stimulation of growth in the food and drink sector, including state aid supports, will have a hugely beneficial effect on the wider economy.

In addition to having a very significant linked employment and Irish economy expenditure function, the sector is also important in terms of food security, ensuring population nutrition, utilising the output of the agricultural sector and thus underpinning the wider rural economy.

Its complex supply chain from farm to fork is both remarkably sensitive and resilient at the same time. Moreover as a result of the combination of innovation and cost competitiveness measures there is a greater capability in production/processing of value added materials.

These typically fall outside the scope of agricultural products listed in Annex 1 of the Treaty and thus are not covered EC guidelines for state aid in the agriculture sector.

As mentioned above the economic profile of the sector is different to other manufacturing sectors – it is a stable industry with significant growth potential but low margins aside from some of the strong drinks consumer brands. The net effect of this low long term return and high capital cost is that financing for investment and expansion purposes is not as readily available as for other sectors. This absence of commercial finance even in non-recessionary times has meant that over time specific state resourced banking facilities were created State support has less of a market distorting effect than would be the case where the state is competing with commercial finance providers   Thus in the case of food and drink, special

[3] European Agricultural Fund for Guidance and Guarantee (FEOGA)

consideration needs to be given to the appropriateness of a general block exemption rather than simply relying on a completely horizontal approach to regional aid.

Over the following pages this submission will highlight by means of an economic analysis a number of issues which are unique either to Ireland or to the food sector. If addressed through a general block exemption, economic activity and employment in the Irish economy can be maintained in the face of severe economic disruption.

The Economic Case for State Aid Exemptions for the Irish food and drink industry

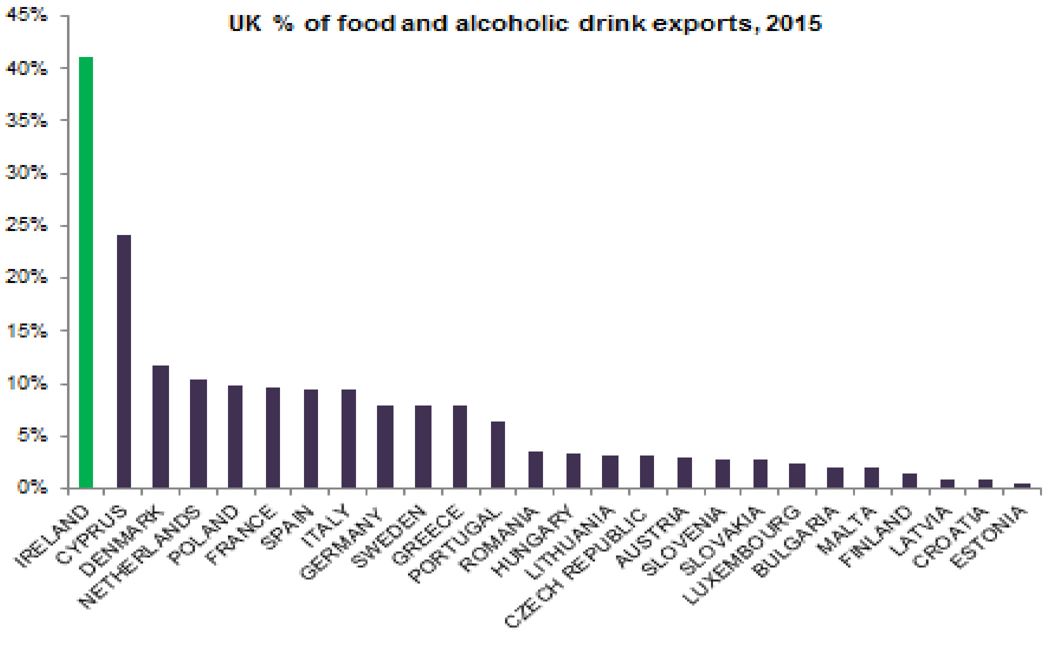
In this section we look at the economic case for State aid exemptions for the Irish food industry. These include:

1. Irish food and drink exports are more exposed to the UK than any other European sector across a large number of categories
2. The importance of the manufacturing sector for incomes in supplier sectors such as agriculture
3. The industry is mainly based in regions which are weak by European comparison

Industry exposure levels

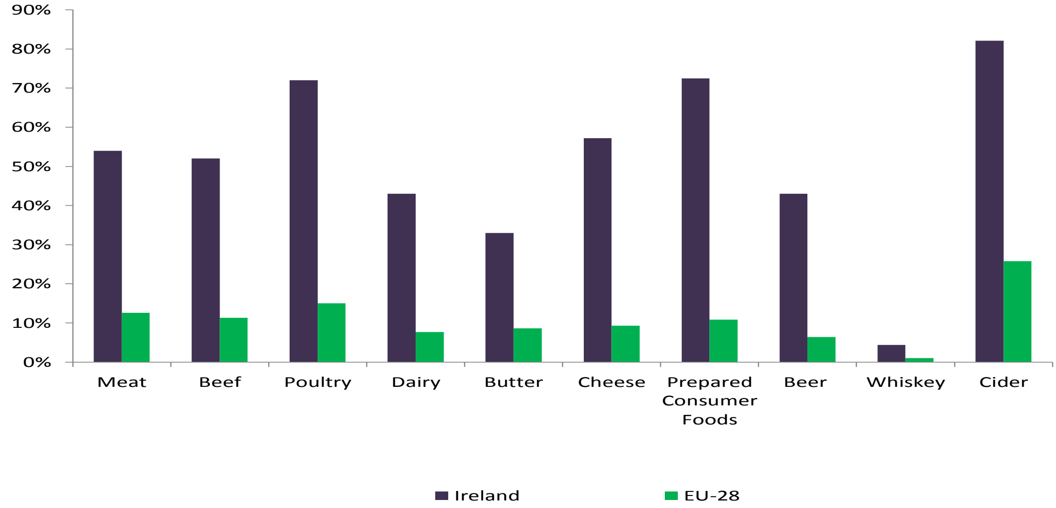
The exposure of Ireland's agri-food and drink industry to Brexit is much greater than any other European country. In fact, it is over three times greater than that of any other EU15 country and 11.7 percentage points higher than any other country in the EU28.

Figure 1: UK % of food and drink exports, 2015



This differs across subsectors, the Irish Prepared Consumer Foods, Meat, Dairy and Beverage industries are particularly exposed. Within meat for example 71.5% of poultry exports go to the UK and 52% of beef.

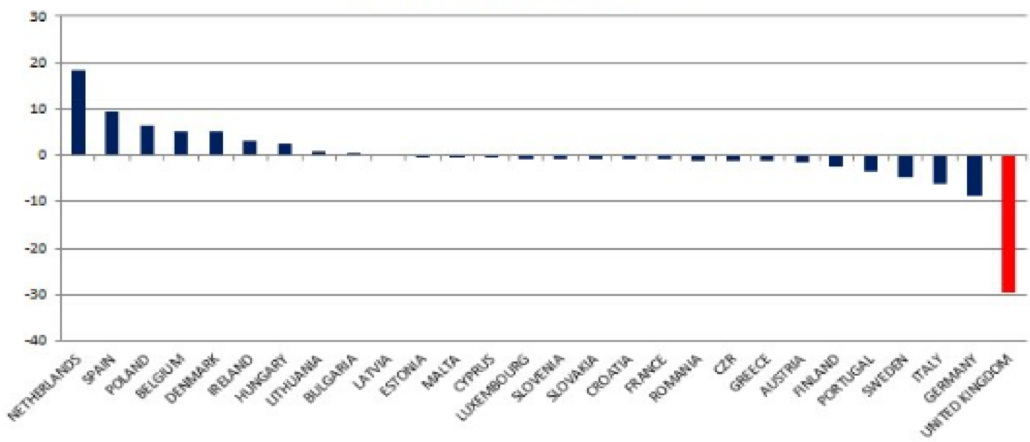
Figure 2: UK % of exports by subsector



When it comes to the dairy side 43.2% of exports go directly to the UK including 60% of cheese. Again, this is in the region of 5 times higher than the European average. For prepared consumer foods 70% go directly to the UK, over six times the European average Within alcoholic beverages beer with almost 50% of exports going to the UK and cider at over 80% of exports are particularly exposed. From these figures we can see that the Irish food and drink industry categories are between four and six times more exposed than the average EU country to Brexit. Another aspect of export exposure is the extent of exports as a percentage of overall output – e.g. beef exports 90% of output, dairy exports over 80% of output.

It is clear that the Irish food industry is in a position of extreme exposure to trade losses associated with Brexit. Diversification to other EU markets will also be difficult and take some time given the unique UK trade deficit in food (Figure 3), the integration of the UK and Ireland retail supply chains and common taste factors.

Figure 3: Food trade deficit/surplus €bn, 2015



In the following sections we outline its importance to rural communities which rely on the Irish food and drink sector on more detail.

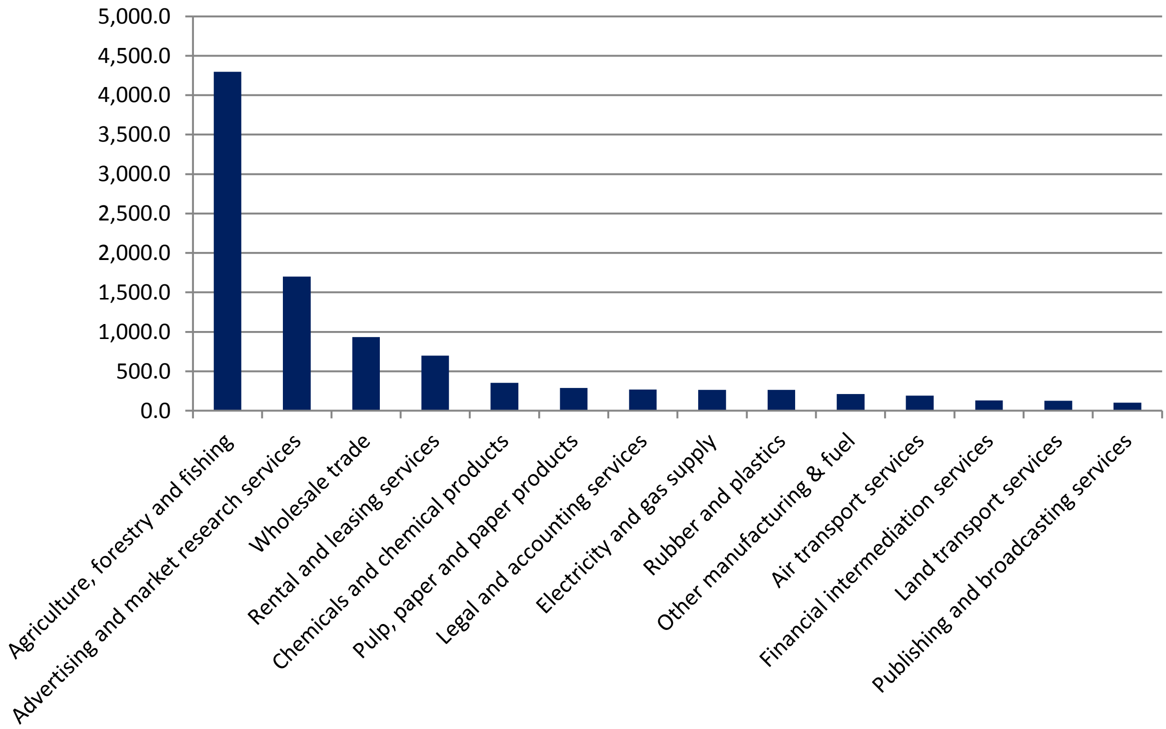
Importance of the sector to agri-incomes

The CSO's most recent I-O tables show that secondary Irish food production has output of €22.42 billion per annum. Adjusted by the 17.6% turnover growth in the sector between 2012 and 2015 it is likely that total industry output is in excess of €26 billion today. Of this 70% or €18 billion per year is spent on intermediate consumption in other sectors of the economy. A further 9.3% or €2.1 billion is spent on compensation of employees in the sector, around 25% of value added.

Purchases from the agricultural sector made up 39.7% of total ex-industry intermediate consumption of the food and beverage production sector in 2012. On the other hand the €4.3 billion of intermediate purchases made by food and drinks producers from the Agriculture sector in 2012 made up 94% of the total external product flows from the agricultural sector.

This level of purchasing is the main facilitator of farm incomes and investment across the board. Loss of market share in the UK and squeezed margins will eventually be appreciated materially by the primary processing sector, depressing farm incomes and reducing primary investment.

Figure 4: Extra-industry intermediate consumption by secondary Irish food and beverage producers



Regional economies and reliance on the sector

In the previous sections we showed that the Irish industry is more exposed than its European counterparts. We also demonstrated the importance of the food processing sector for on-farm incomes and output. In this section, we show that the sector is also primarily located in regions which are economically disadvantaged relative to the EU average. Table 1 shows the placement of Irish regions in a European context at NUTS3 level. It also shows their relative reliance on the agrifood sector.

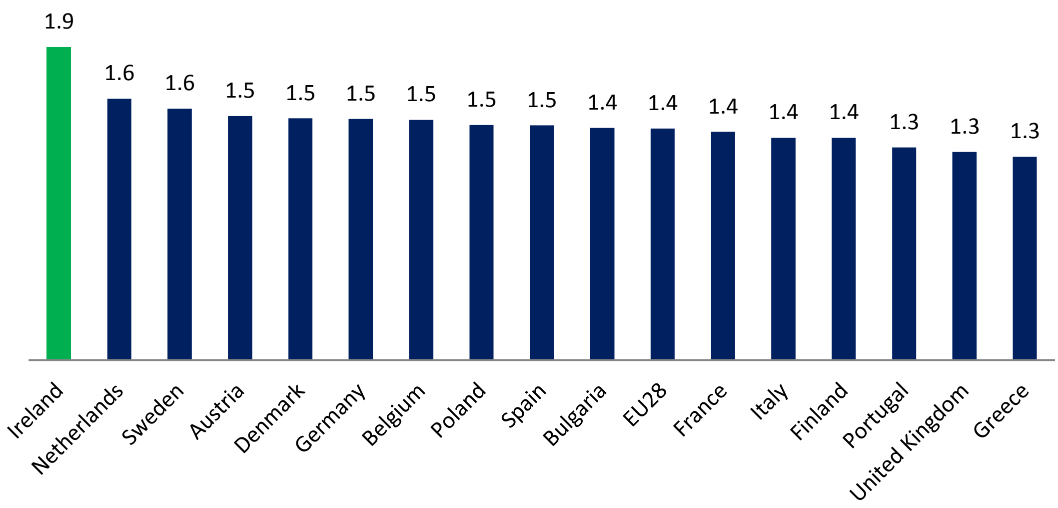
Two points are clear from this data. Firstly, over half of the overall Irish Agri-food and drink sector (primary & secondary activities) is located in regions in the bottom 60% of NUTS3 EU regions as measured by GDP per capita (PPP). Secondly, half of employment in the sector is in the 4 NUTS3 regions with GDP per capita PPP below the EU average. The sector accounts for 9.7% of total employment in the sector in each of those four weakest regions.

Table 1: Irish regions in context

	Nominal GDP rank (of 1331 NUTS3 regions)	Purchasing power rank (of 1331 NUTS3 regions)	Decile (ppp)	% at work agri-food and beverages sector (primary occupation)	% of employment in the sector
Dublin	33	33	10	1.4%	5.9%
South-West	88	99	10	9.1%	19.2%
Mid-West	287	325	8	9.7%	11.1%
West	356	409	7	9.4%	13.0%
South-East	542	606	6	11.4%	16.7%
Mid-East	596	670	5	5.9%	10.0%
Border	694	774	5	10.6%	15.7%
Midlands	892	990	3	10.1%	8.4%

The Mid-East, Border and Midlands regions are all in the bottom 50% of European regions when it comes to GDP per capita adjusted for purchasing power. The South East is in the lowest 60% with Dublin and the South-West in the top 10% of regions in the block. These regions are also more reliant on agri-food and drink as a sector with over 10% of workers in both the Border and Midlands regions employed in the sector.

Figure 5: Ratio of GDP to Actual individual consumption



Finally it is worth noting that GDP per capita may be a misleading figure to use in an Irish context due to the well noted impact of multinational companies on Irish national accounts. Actual individual consumption which Eurostat has noted as a "more useful for comparing the relative welfare of consumers across various countries" in Ireland is much lower in comparison to GDP than among other EU states. Although figures for AIC are not available at a regional level the figures above should be adjusted downward by a factor of up to 26% in order to reflect the relative welfare of consumers. If this was applied across regions then these four regions would each have AIC per capita of less than 75% of the EU average (the cut off for EU state aid rules). The Border would have little over 62% and the Midlands little of 52% of EU average AIC per capita.

Remedies to economic disturbance in the Irish food and drink sector

In 2009 the Commission in a Communication noted that the "*current global crisis requires exceptional policy responses*[4]" and cited Article 87(3)(b) of the Treaty that the Commission "*may declare compatible with the common market aid 'to remedy a serious disturbance in the economy of a Member State'. In this context, the Court of First Instance of the European Communities has ruled that the disturbance must affect the whole of the economy of the Member State concerned, and not merely that of one of its regions or parts of its territory. This, moreover, is in line with the need to interpret strictly any derogating provision such as Article 87(3)(b) of the Treaty*". This was the basis for the introduction by the Commission of the Temporary Framework in 2008 which amongst other things allowed for an increase in de minimus levels, state backed credit insurance etc.

The Commission produced a staff working paper[5] in Oct 2011 which noted "*The Temporary Framework of aid to the real economy complemented the framework put in place to allow a swift and coordinated response during the crisis. Whilst its take-up has been limited, it has been a useful safety net allowing for an emergency response during the crisis. Whilst its take-up has been limited, it has been a useful safety net allowing for an emergency response tailored to tackling the difficulties arising from financial turmoil*"

In Ireland the food and drink sector now faces a serious economic disturbance as outlined by the analysis in the previous chapter. What was also demonstrated by that analysis is the unique position and importance of the Irish food and drink sector in the overall Irish economy. In particular:

- Extensive regional impact of the food and drink sector and economic weakness of those regions (when measured by GDP per capital (PPP))
- Majority of Irish economy expenditure in the Irish economy and high employment multiplier
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means that the fracture to the single market and its deep and unique impact on the food and drink sector in Ireland have an economy wide impact. Accordingly exceptional policy responses continue to be required and these should include a general block exemption for state aid supports for the Irish food and drink sector in order to maintain and sustain economic activity and jobs. The scope of the support should not be restricted to SMEs – see **Appendix 2**.

These state aid supports should be targeted as follows:

- **Enterprise Stabilisation** – Short term measures to allow the Irish Government to introduce enterprise stabilisation measures

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[4] OJ C 14, 21.1.2009, p.4

[5] DG Competition – *The effects of temporary State aid rules adopted in the context of the financial and economic crisis* – Commission Staff Working Paper (October 2011)

- **Investment in Competitiveness –** Medium term measures to allow the Irish Government to introduce investment aids to support Irish food and drink companies invest in enabling technology, plant renewal and expansion, refinancing, market development and innovation to regain competitiveness following single market fracture
- **Diversification –** Trade support measures including export trade financing and export credit guarantees to support the continued development of international export markets

Appendix 1 - Analysis of business conditions 2016 V 2010

Analysis of business conditions 2016 V 2010.		
	2010	**2016**
Brexit means that the current sterling weakness is different from the normal exchange rate cycle and things could get much worse	Monetary policy cycle and economic issues in the UK and Eurozone were the main issues impacting on the exchange rate	Sterling could weaken much further as the full economic consequences of Brexit become clearer
Capacity for Irish exporters to drive efficiencies	From the start of the great recession in 2008, Irish manufacturers and in particular food processors implemented very effective productivity and change strategies through lean and other measures. This greatly improved the overall competitive position of Irish exporters.	Following a number of years on intensive efficiency measures, capital deepening and business transformation, most food processors now have limited opportunities for further productivity gains. This means that the exchange rate movement cannot be offset through business efficiency improvements
Total export values are higher, so losses could be greater	Food exports to the UK in 2010 were €3.4bn	Irish food exports to the UK in 2015 were €4.4bn and the gains made since 2010 could easily be reversed, hence resulting in a greater overall negative impact for the economy.
Pricing strategy of UK retailers	Currency and commodity related import food inflation in 2010 was passed through to UK consumers in the form of higher prices – UK retail food prices increased by over 5% in 2010.	UK retailers have already flagged that they will cut food prices in response to Brexit. UK retail food price inflation is currently negative.
Impact on supply chain policies of UK retailers and food services sector	No real long-term impact as UK buyers see sterling weakness as cyclical	Concerns about a more structural shift in exchange rate relationship, combined with Brexit related trade risks means that UK buyers are planning significant supply chain restructuring - a loss of confidence in Ireland as a competitive supply base will accelerate this
Market Renationalisation	With the exception of beef, origin labelling was voluntary	In UK and other EU states, there is a growing move by some retailers towards domestic sourcing policies for

		meat and dairy. Piloting of mandatory country of origin labelling for meat and dairy ingredients is starting in France and proposed in other states. It has the same objective of favouring domestic production. Mandatory original labelling is also required by EU law for other meat products
UK retail food and drinks sector now more competitive	Market dominated by traditional big four retailers	Strong growth by hard discounters who have doubled their market share to 10% at the expense of larger retailers
Displacement by imports – the Prepared Consumer Foods example	The depreciation of sterling was the main trigger for a fundamental realignment of supply chains in the domestic grocery sector which saw PCF imports rise from €1.96bn in 2006 to €2.35bn in 2010 and to €2.75bn in 2012 – a period of decline in the overall grocery market	The conditions have now been created in supply chains for this realignment to accelerate at the expense of domestic producers

Appendix 2 - Scope of State Aid Supports–small midcaps and innovative midcaps in addition to SMEs

The European Commission has acknowledged[6] that small midcaps and innovative midcaps can face the same market failure as SMEs.

Access to state aid in the Irish food and drink industry should not be evaluated on the size of the company as the profile of different industry sectors in terms of average margins, growth potential, capital requirements, exposure to the UK market etc. are very different. Evaluation should be on the basis of quality of the investment, its expected impact on the economy and on its effect on competition.

Small mid cap and innovative mid cap enterprises form a hugely important part of the Irish food and drink industrial base. Large businesses (over 250) employ over 380,000 people in the Irish economy, over 30% of the Irish workforce. In the food sector 6% of enterprises are classified as large[7] compared with the European average of 1% and almost all are mid-caps. This reflects the strong export orientation of Irish industry combined with a small domestic market but also the scale required to operate successfully on an international basis.

Larger enterprises tended to record higher labour productivity ratios than SMEs due to economies of scale, higher levels of capital intensity and their ability to adopt or develop innovations[8]. Rather than this been seen as a negative in relation to SMEs, it is the case that these larger businesses underpin local and regional economic development by forming important value chains with SMEs (sub-supply, services, logistics etc.).

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[6] http://ec.europa.eu/competition/state_aid/modernisation/risk_finance_guidelines_en.pdf
[7] Census of Industrial Production 2010, Central Statistics Office, Dublin
[8] Business economy – size, class, analysis, Eurostat, March 2011

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