

Grocery market

**Proposed decision to make a
market investigation reference**

March 2006

OFT838

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EXECUTIVE SUMMARY

The OFT is minded to refer the market for the supply of groceries by retailers in the UK to the Competition Commission (CC) for a market investigation.

Our decision takes into account new evidence that we have collected on market developments and features of the market that might prevent, restrict or distort competition and harm consumers.

This evidence suggests that the grocery market is evolving rapidly. The four largest supermarkets (Asda, Morrisons, Sainsbury's and Tesco) have consolidated their share of total food retailing since 2000, and supermarkets (particularly Tesco and Sainsbury's) have moved into the convenience store sector, competing directly with smaller chains and independent stores. The size of the convenience retailing sector has grown overall (by value), partly driven by changes in consumers' shopping patterns. Entry to the sector by some supermarkets has contributed to this growth, but symbol groups (e.g. Spar, Costcutter) have also gained market share. The total number of convenience stores has fallen slightly over the last five years, and within this the number of independent stores has continued to fall, although sales per store have risen.

Overall, we believe that consumers have benefited from competition between the supermarkets and their expansion into the convenience store sector, through falling prices, and an apparent increase in choice and improving quality. However, in some locations consumers have a more limited choice of outlets, and concerns have also been raised over the impact of the decline of independent retailers on the overall choice and range available in the convenience retailing sector.

We have identified a number of features of the market that, when considered against the context of increased consolidation and the move of the supermarkets into the convenience store sector, could be reasonably suspected to distort competition and, in the case of some of the features, harm consumers.

- The planning system creates barriers to entry, primarily for new large format stores. There are reasonable grounds to suspect that, as a result,

the big supermarkets are able to use land holdings to reinforce their market position. We have found evidence of significant land banks and the use of restrictive covenants on sites sold by the big supermarkets.

- There is evidence to suggest that the buyer power of the big supermarkets has increased since 2000, with some evidence that the differential between prices to large supermarkets compared with those to wholesalers and buying groups has risen. Against the background of greater concentration within the market, there may be grounds to suspect that this buyer power could harm consumer choice by undermining the viability of alternative business models including wholesale distribution to the convenience store sector.
- Aspects of the supermarkets pricing behaviour – below-cost selling and price flexing – provide reasonable grounds for suspecting that competition is being distorted, but we cannot conclude, on the basis of the evidence we have collected, that consumers are harmed.
- Developments in the convenience store sector such as the entry of some of the big supermarkets, both by acquisition and new entry, and the growth of symbol groups appear to have contributed to lower prices to consumers but this may have been at the expense of choice of store at a local level.

In view of the size and importance of the market and the breadth of concerns that have been raised, we believe that a market investigation by the CC would be the most appropriate way of resolving the above issues and, if necessary, imposing remedies.

1 INTRODUCTION

- 1.1 This paper sets out the findings of our investigation into the UK grocery market, following the withdrawal of our decision not to refer the market to the CC before the Competition Appeal Tribunal (CAT) on 1 November 2005. This followed the appeal to the CAT by the Association of Convenience Stores (ACS). The paper reconsiders arguments made by the ACS in relation to various concerns about the role of supermarkets in the supply of groceries, specifically the 'Big Four', namely Asda Stores Limited & Asda Group Limited (Asda), Wm Morrison Supermarkets plc (Morrison's), J Sainsbury plc (Sainsbury's) and Tesco plc (Tesco).
- 1.2 The paper summarises the evidence which we have received from supermarkets, wholesalers, buying groups and suppliers in the course of our investigation, and which we have drawn together from public sources.
- 1.3 Under section 131 of the Enterprise Act 2002 (EA02), the OFT may make a market investigation reference to the CC where it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom. Section 131(2) states that a feature of the market is to be construed as a reference to:
- (a) the structure of the market concerned or any aspect of that structure;
 - (b) any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned; or
 - (c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

- 1.4 This does not mean that the OFT is obliged to make a reference in relation to every market which it believes meets the threshold set out in section 131. Rather, the OFT has a discretion whether to make a reference.
- 1.5 In guidance published in March 2003¹ the OFT said that it would make references to the CC only when the reference test set out in section 131 of the Act and, in its view, each of the following criteria, have been met:
- it would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT;
 - it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference;
 - the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it;
 - there is a reasonable chance that appropriate remedies will be available.²
- 1.6 This paper sets out our view on the features of the grocery market in the UK that we believe may prevent, restrict or distort competition, and on how the criteria set out in our guidance apply to them.

¹ OFT 511 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act'.

²OFT 511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.1

- 1.7 Under section 169 of the EA02, where the OFT is proposing to make a decision on a reference to the CC it must first consult, so far as practicable, any person on whose interests the reference is likely to have a substantial impact. This paper sets out our proposed decision and invites comments by 6 April 2006. Comments should be sent to:

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Markets and Policy Initiatives Division 4
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Fleetbank House
2 - 6 Salisbury Square,
London
EC4Y 8JX

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2 MARKET DEFINITION

2.1 In making a reference to the CC, the OFT's guidance says that we must give 'some consideration to the definition of the relevant market', but 'the effects on competition of some features may be clear enough that firm conclusions on the definition of the relevant market by the OFT are unnecessary'.³

2.2 The OFT and the CC have considered the relevant economic definition of the market (or markets) for grocery retailing on several occasions in recent years. The CC has identified two interrelated markets for the supply of groceries to final consumers in the UK:⁴

- the retail market for 'one-stop shopping'; and
- the retail market for 'secondary shopping' (including convenience shopping).

2.3 The CC's 2000 report⁵ (at paragraph 2.26) defined 'one-stop shopping' as 'the shop for the bulk of a household's weekly grocery needs, carried out in a single trip and under one roof'. This is distinguished by the CC from other forms of shopping, characterised as 'secondary shopping', which typically involves the greater use of other types of grocery store, a different product mix and a lower average basket spend.

2.4 It is important to distinguish these broad types of shopping from the separate classification of grocery retail stores. The CC has typically classified stores into three categories:

- one-stop shops: over 1,400 square metres (15,000 square feet);

³ OFT 511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 4.8

⁴ In particular the CC's 2000 report on Supermarkets made under the monopoly provisions of the Fair Trading Act 1973 (Cm 4842), the 2003 merger report on Safeway plc (Cm 5950), and the 2005 merger report on Somerfield plc and Wm Morrison Supermarkets plc (ISBN 0-11-7035963).

⁵ See footnote 2

- mid-range stores: between 280 and 1,400 square metres (3,000 and 15,000 square feet); and
- convenience stores: less than 280 square metres (3,000 square feet).

2.5 It appears that grocery stores of very different sizes can exercise a degree of competitive constraint on one another. This clearly depends on local conditions but the evidence illustrates some general features across all local areas. 'Secondary shopping' takes place at large 'one-stop shopping' supermarket stores, but also takes place at medium-sized high street stores (whether operated by the Big Four or by other chains, such as Waitrose and Somerfield) and from convenience stores (an increasing number of which are operated by a major supermarket multiple). A consumer wishing to purchase a basket of everyday groceries will often enjoy a choice of a variety of stores from which to do so, including a large supermarket, the home delivery services operated by a number of supermarket groups, a number of medium-sized stores, and a number of convenience stores (whether independent or part of a larger group). The consumer will make that choice based on weighing a number of factors which are likely to include considerations such as convenience, price and loyalty to a particular store.

2.6 We are aware of criticism of the 'two markets' approach from a number of groups. For example, the recent All-Party Parliamentary Small Shops Group (APPSSG) stated that 'the lines between 'top up' shopping and 'one-stop' shopping have become increasingly blurred with the presence of large retailers in both markets taking advantage of central buying'.⁶ In practice, recent merger decisions have acknowledged the links between the two markets discussed above, and to that extent we believe that the criticisms of the approach are misplaced. In particular, the fact that one type of retailer starts to supply in hitherto different markets does not necessarily result in those markets being regarded as merged into one.

⁶ All-Party Parliamentary Small Shops Group, *High Street Britain: 2015*, February 2006, page 73

Nevertheless, these are issues that any CC investigation may wish to reconsider.

- 2.7 For the purposes of this investigation and our proposed decision on a market investigation reference, we have used the CC's product market definitions as the starting point. However, we have kept in mind the importance of considering the linkages between these markets, particularly when analysing the growth of the Big Four into smaller format stores. Where we refer to 'the market' in general terms in the document, we mean the market(s) for grocery sales to final consumers in the UK, covering both one-stop shopping and secondary shopping.
- 2.8 In addition to the definition of the relevant product market, there is also a question of the relevant geographical market(s) in consulting on a reference. The CC's 2000 report concluded that 'Taking the evidence as a whole, our view is that the ambit of consumers' search for groceries is essentially local'.⁷ The analysis of mergers involving grocery retailing since the 2000 report has developed a detailed methodology using 'isochrones' based on average drive times between stores. For the purposes of this investigation, we have assumed that market power could, theoretically at least, be exercised at a local as well as at a national level, although national competition clearly constrains the degree to which firms can operate in any locality unconstrained by competition. We are proposing to refer the whole UK market because the features we have identified apply to most local areas and, in the case of buyer power, affects more national upstream markets such as wholesaling.
- 2.9 We emphasise that these comments only give an overview of the possible relevant economic markets. A central task for the CC in any investigation would be to come to its own view of the appropriate market definition(s).

⁷ 'Supermarkets', Competition Commission 2000, paragraph 2.47

3 MARKET STRUCTURE

- 3.1 Before analysing specific features of the market that could distort competition and harm consumers, the next two chapters set out background information on market structure and the impact on consumers. This is important both to set the context for the discussion of market features, and because analysis of the market and consumer outcomes can give some high-level indication of whether there might be competition concerns. This section focuses on the structure of the grocery retailing sector, and changes which have occurred since the CC report in 2000. Much of the analysis is based on publicly available information, although in some cases we have also drawn on comments and data provided directly by supermarkets and other retailers.
- 3.2 There are three broad trends in market structure to which attention has been drawn in relation to concerns about competition in the market:
- first, that national market concentration in the grocery sector is growing, and is relatively high in comparison with other countries;
 - second, that some supermarket operators have moved into the convenience store sector; and
 - third, that market concentration at a local level limits the choice available to consumers in some areas.
- 3.3 The following sections look at the evidence behind each of these claims in the context of wider market developments.

Structure of the grocery retailing sector

- 3.4 Taking a high-level overview of the grocery retailing sector, total sales through UK grocery outlets were around £120 billion in 2005, a 4.2 per cent increase on 2004.⁸ Of this, around £95 billion comprised grocery

⁸ IGD (August 2005), *Grocery Retailing*, page 3

sales, with the remainder representing sales of non-grocery items. Groceries now account for nearly half of all retail sales, and around 13 per cent of all household spending.⁹

3.5 Total sales through grocery outlets can be broken down by type of store. The IGD estimates that around £88 billion (or nearly 75 per cent) of sales occurred in stores larger than 280 square metres – i.e. stores classified by the CC as either one-stop shops or mid-sized stores. Figures given to us by the supermarkets as part of our enquiry suggest that just over 2,000 of these stores are supermarkets (i.e. greater than 1,400 square metres), of which around 1,700 are operated by the Big Four. This compares with a total of more than 50,000 convenience stores, which between them account for the remaining £32 billion of sales through grocery outlets (see figures below).

3.6 At the individual firm level, it is clear from observation that there is a wide variety of different types of grocery retail operator. For the purposes of our investigation, we have chosen to distinguish between the following categories of operator:

- 'Big Four' supermarket chains – i.e. Tesco, Asda, Sainsbury's and Morrisons; each of these operators has an overall market share of greater than 10 per cent and a broad national presence;¹⁰
- 'Other supermarkets' – including such firms as Somerfield, Waitrose and Marks & Spencer: we also count the 'discount stores' such as Aldi, Lidl and Netto in this category;
- 'Symbol groups' – we define these loosely as multi-store chains where there is a single fascia, but where ownership can be fragmented: examples include Musgrave, which operates the Budgens and Londis fascias, and Spar UK;

⁹IGD (August 2005), *Grocery Retailing*, page 11

¹⁰ For comparison, the next largest chain at a national level is Somerfield, with a market share of around 6 per cent based on TNS till roll data.

- 'Co-ops' – i.e. co-operative stores, acting in a similar way to symbol groups; and
- 'Independents' – stores which are independently owned and are not operated under a wider 'symbol'.

3.7 These categories mask significant differences between types of supermarket operator. Even within the Big Four, there are clearly differences in the nature of the branding and offer to the consumer. Within the 'other supermarkets' sector, the differences are even more stark, contrasting the offering of firms such as Waitrose and Marks & Spencer with stores such as Aldi, Lidl and Netto.

3.8 The supply chain which serves the retailers is similarly diverse. Suppliers range from small local firms to large multi-nationals. For the larger supermarkets, most of the wholesaling and distribution of produce is carried out 'in-house'. However, for smaller retailers the picture is more complicated. A number of wholesalers (such as Palmer & Harvey McLane and Booker) serve many smaller retailers. There are also buying groups (e.g. Spar and Costcutter) which negotiate collectively with suppliers on behalf of smaller stores. Some of these buying groups often operate branded retail fascias at the retail level.

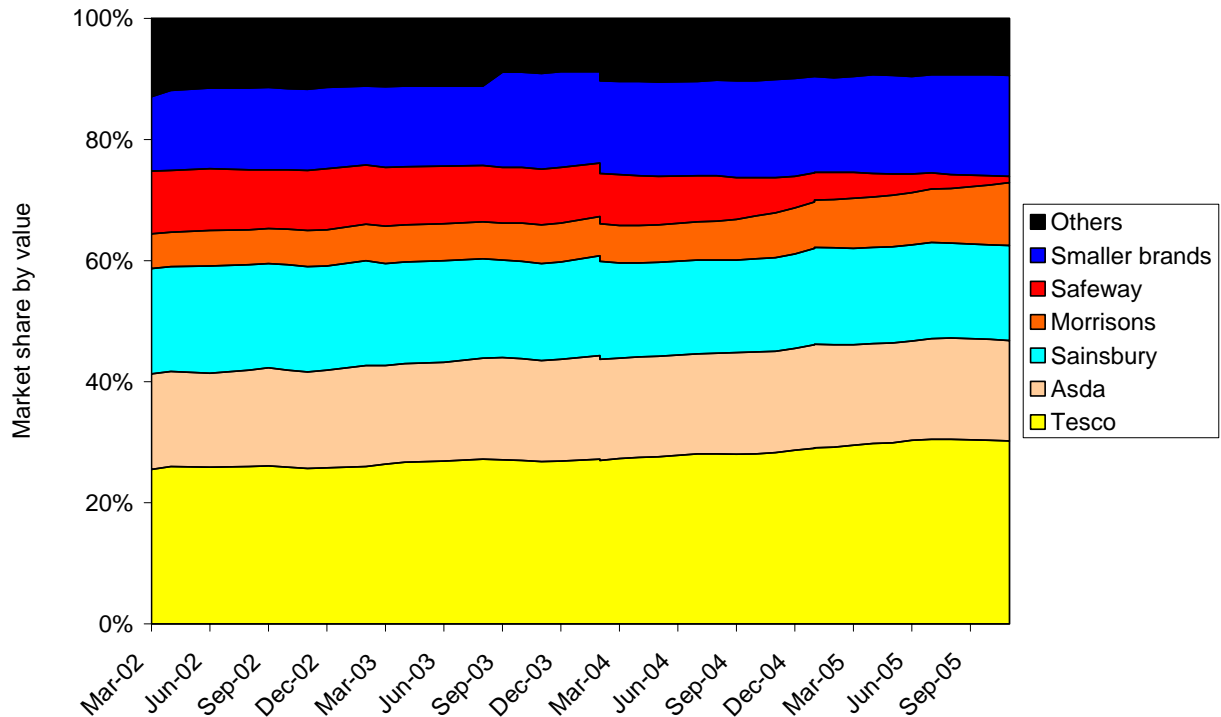
National market concentration

3.9 Figure 3.1 below illustrates the movement in total grocery sales by different types of retailers since 2002.¹¹ It suggests that the national market share of the largest supermarkets (five supermarkets in 2002 and four in 2005 following the acquisition of Safeway by Morrisons) has stayed roughly constant at around 75 per cent by value of the grocery market. This, allied with the growth in market share of Tesco, the market leader, means that concentration has increased. In the remainder of the market, smaller brands, including symbol groups (e.g. Spar, Costcutter),

¹¹ In terms of the economic markets described in Chapter 2, this covers both one-stop shopping and secondary shopping, but does give a useful overview of changes in the sector.

have also expanded, while others (notably independents) have lost market share.¹²

Figure 3.1: Grocery national market shares by value 2002 - 2005



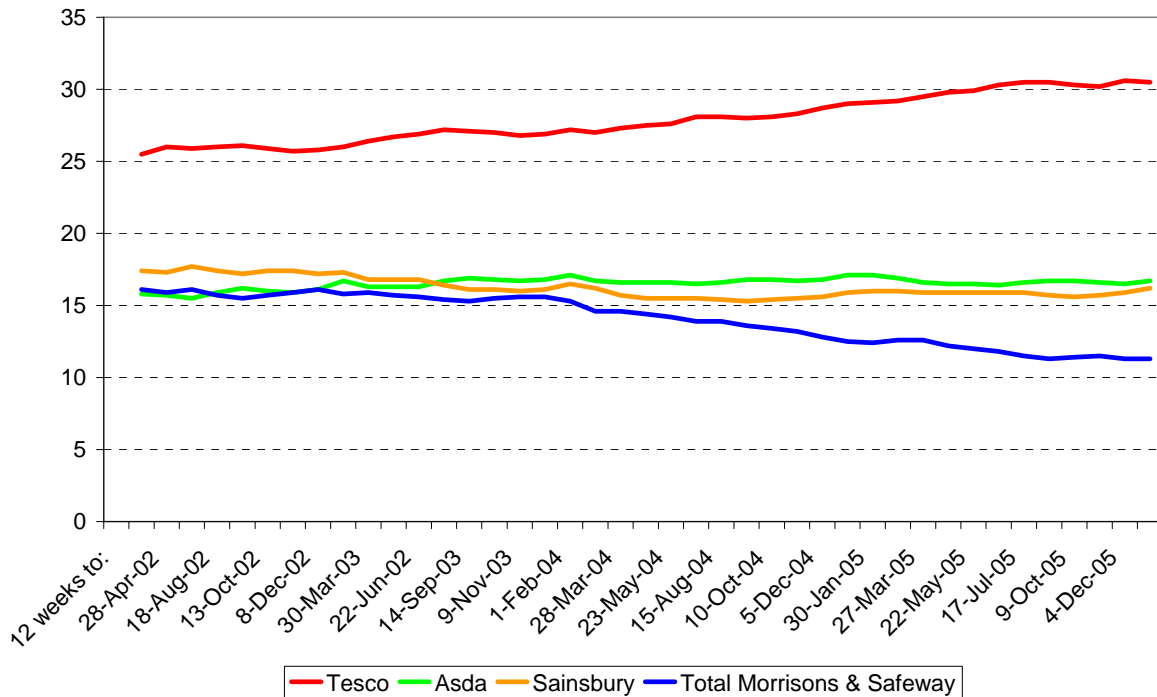
Source: TNS data, till roll

3.10 Figure 3.2 below shows the estimated market shares for the Big Four, combining Morrisons and Safeway. This suggests that Tesco has increased its market share from around 25 per cent in 2002 to more than 30 per cent at the end of 2005 (according to TNS). Of the other Big Four supermarkets, Asda had a 16.5 per cent share, Sainsbury's 15.9 per cent and Morrisons 11.3 per cent at the end of 2005. Tesco now appears to

¹² One of the big supermarkets provided us with alternative figures for market shares, based on TNS retail tracker information (which includes grocery sales in non-grocers). This puts the market share of the Big Four at around 58 per cent in 2000, 60 per cent in 2002, and around 65 per cent now.

have nearly twice the market share (in overall grocery retailing) of its nearest competitor.

Figure 3.2: Market shares by value of the Big Four



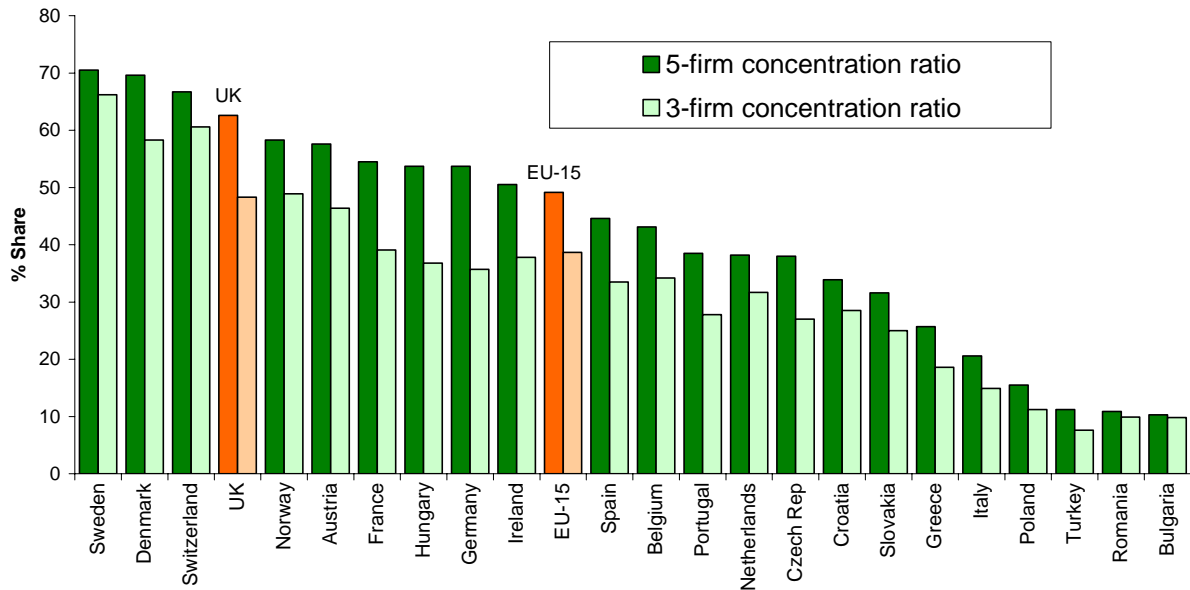
Source: TNS data, till roll

3.11 Among the smaller retailers, Somerfield and Waitrose appear to have made significant gains over the last three years (Somerfield mainly through acquisition of former Safeway stores). Aldi, Netto and Lidl now together have just over a 5 per cent market share by value, representing modest growth over the past five years.

3.12 Figures produced by the IGD suggest that the UK has one of the more concentrated grocery retail sectors in Europe, as measured by the market share of the three or five largest firms. Figure 3.3 below indicates that

the top five UK grocery retailers account for 63 per cent¹³ of the total grocery market.

Figure 3.3: Market shares of the largest retailers in European grocery markets, 2004



Source: IGD European Grocery Retailing 2005. Shares based on all grocery retailing formats.

3.13 Care needs to be taken in interpreting these figures, given differences in the way the sector has developed, the role of the planning regime, and the impact of different consumer demands in different countries.¹⁴ Nevertheless, we simply observe that on some measures of market concentration, the UK market appears to be relatively highly concentrated. This is something that may be worth exploring further.

¹³ Note that this figure and the 75 per cent figure noted in paragraph 3.7 are not directly comparable as the definition of groceries may be differently defined in arriving at both sets of figures.

¹⁴ One of the supermarkets gave us alternative figures (Planet Retail 2005, Grocery Retail Banner Sales) suggesting that the UK grocery sector is in fact less concentrated than average.

3.14 Overall then, the evidence suggests that national market concentration has increased slightly in recent years. Perhaps as significant has been the shift in the relative market shares *within* certain categories of operator, for example between the Big Four. In relation to international comparators, there is some evidence to suggest that the UK may be relatively concentrated, although we have not attempted to investigate this in detail. However, higher concentration is not in itself necessarily a competition problem if it has arisen as a result of higher levels of competition or greater efficiency.

Structure and growth of the convenience retailing sector

3.15 A second focus of recent concern has been the expansion of some of the Big Four into the convenience store sector: in 2000 they had between them 54 convenience stores in the UK but by 2005 they had 1,306¹⁵.

3.16 Sales in convenience stores (i.e. below 280 square metres) represent around 20 per cent of total grocery retail sales in the UK.¹⁶ The convenience store share of the overall grocery retail market has increased over the last five years. The convenience store sector has grown by 31 per cent over the last five years compared with 24 per cent for all food retailing.¹⁷ The IGD forecasts that convenience stores' share of the total grocery retail market is likely to continue to rise, increasing from 20 per cent to nearly 24 per cent by 2010.¹⁸

3.17 Part of this growth appears to be a response to changing consumer demands – for example changing work patterns leading consumers to place a higher value on convenience relative to cost. The IGD has commented that well-stocked convenience stores are ideally placed to meet consumer needs for top-up and 'on-the-move' shopping. According

¹⁵ Source: data provided by the Big Four in the course of our investigation

¹⁶ IGD (August 2005), *Grocery Retailing*, page 19

¹⁷ Mintel (December 2005), *Convenience Retailing*

¹⁸ IGD (August 2005), *Grocery Retailing*, page 191

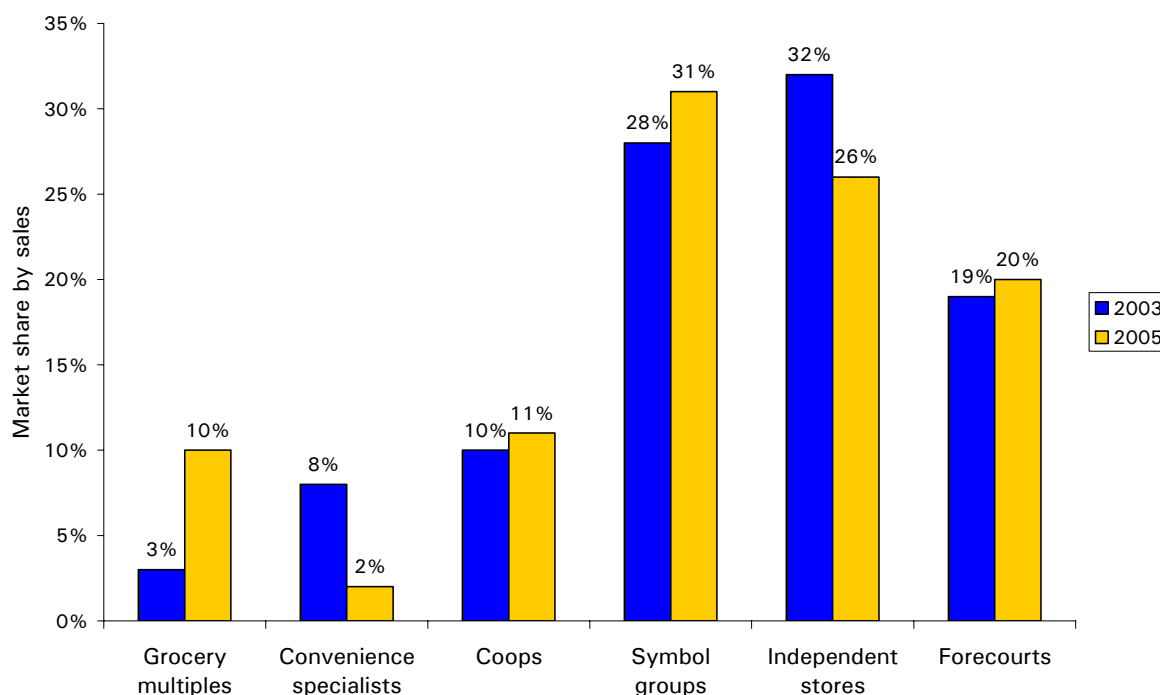
to Mintel, 'the convenience store sector has been growing at a substantial pace in recent years. Industry estimates suggest that, in 2004, growth in sales was 5-7 per cent, one of the most buoyant sectors of food retailing'.¹⁹ The overall picture therefore suggests healthy growth for the convenience store sector, facilitated by growing consumer demand.

3.18 Nevertheless, concerns have been raised about the rapid growth of the Big Four's share of the convenience store sector and the impact that this has had on independent retailers in that sector. Figure 3.4 below shows the change in value of sales through convenience stores over the last two years.²⁰ This shows significant growth in the sector for the grocery multiples (almost entirely driven by expansion of Tesco and Sainsbury's) – from 3 per cent in 2003 to 10 per cent in 2005. However, it is notable that co-ops and symbol groups have also expanded. The losers have been convenience specialists such as greengrocers and fishmongers (down 6 per cent) and independent stores (down 8 per cent).

¹⁹ Mintel (December 2005), *Convenience Retailing*

²⁰ Mintel (December 2005), *Convenience Retailing*

Figure 3.4: Market shares by value of sales in the convenience store sector



3.19 Similar trends are evident in data summarised in Table 3.5 below showing the number of convenience stores in the UK.²¹

Table 3.5: Numbers of convenience stores in the UK

Type of store	2001	2005
Co-operatives	1,297	2,321
Convenience multiples (including Big Four's outlets)	2,756	2,379
Affiliated independents	7,175	12,400
Unaffiliated independents	34,250	26,873
Petrol forecourts where groceries are sold	9,367	8,112
Total	54,845	52,085

²¹ Based on information provided by the ACS, in turn based on research by William Reed Publishing.

- 3.20 These figures suggest a significant fall in the number of unaffiliated independents. This is offset to some extent by an increase in the number of affiliated independents, reflecting the increasing success of symbol groups as shown in Figure 3.4 above. However, the figures still record a net loss of around 2,760 stores between 2001 and 2005. Government data show that retail sales through small food retailers grew by just 8 per cent at current prices between 2000 and 2005, compared with 27 per cent growth for large retailers.²²
- 3.21 Looking just at convenience stores (i.e. excluding convenience sales through larger supermarkets), it is clear that the sector is disaggregated, and that the Big Four's share remains relatively low at around 10 per cent. Figures from the Verdict Neighbourhood Retailing study suggest that Spar is the largest player in the sector with 9.7 per cent: Tesco is the second largest with an 8.2 per cent share.
- 3.22 As noted in Chapter 2, convenience retailing is also carried out in larger format stores including supermarkets, so shares of supply should also, arguably, include convenience sales through supermarkets. The difficulty is in estimating what proportion of a supermarket's sales represents convenience shopping. The ACS has estimated that the turnover of the Big Four and other supermarket operators from convenience retailing in their stores above 280 square metres was £18 billion in 2004.²³ On this basis, it estimates that all grocery multiples have around 50 per cent of the convenience retailing sector.
- 3.23 In summary, the evidence confirms that the share of the convenience sector of the market, both in terms of all convenience retailing sales and sales through convenience stores taken by the Big Four, has increased. However, the convenience store sector of the grocery market has grown and is growing in size which, arguably, is a factor in encouraging new entry and expansion for the benefit of consumers.

²² Mintel (December 2005), *Convenience Retailing*

²³ In the 31 May 2005 Europe Economics report commissioned by the ACS for its response to our 22 March 2005 report on the supermarkets code of practice and other issues

Concentration in local areas

- 3.24 A final issue relating to market structure is around alleged local market concentration in some areas. There have been claims of supermarkets having high local market shares – e.g. Inverness, Bicester, Milton Keynes, Twickenham, Southall and Hemel Hempstead. For these areas, the APPSSG report²⁴ quotes CACI data, indicating that Tesco's share of supply in groceries is over 40 per cent in these areas. CACI's grocery catchment analysis in fact suggests that, out of 1,452 postal areas in Great Britain there are 104 where Tesco has more than a 50 per cent share by the number of stores.²⁵
- 3.25 We have not attempted a full analysis of concentration in local areas. One of the Big Four pointed out to us that a proper analysis would have to be based on isochrones, rather than post code areas (which we accept are only a crude approximation to a true economic local market). One of the Big Four's data suggest over 80 per cent of consumers in Great Britain can reach three or more different one-stop shop fascias within 15 minutes. If mid-range stores are included, then around 93 per cent of customers have access to three or more operators within 15 minutes drive time. The same supermarket has acknowledged that there has been a slight reduction in the level of choice since 2000 due to the CC-approved acquisition of Safeway by Morrisons.
- 3.26 Another of the Big Four put alternative information to us based on relevant local markets being delineated by an approximate 10 minute drive time in urban areas and 15 minute drive time in rural areas. On this basis, 53 per cent of consumers have access to fewer than three fascias in their local area (i.e. 47 per cent of customers have access to three or more operators in their local area).

²⁴ See footnote 4

²⁵ CACI study, UK Dominant Grocers, 2005

- 3.27 Of course, in any analysis of competition in local areas, account would have to be taken of the strength of the chains of substitution between areas such that consumers on the edge of one area might be tempted to shop in an adjacent area. In the time available we have not attempted to carry out an analysis of chains of substitution.
- 3.28 In order to provide an outline picture, and to help with some of the later analysis of features of the market that might be distorting competition, we asked the Big Four to list all of their current stores along with postcode locations. We reiterate that this (i) is not being used to indicate local markets and (ii) does not record store ownership by other retailers outside the Big Four (so we have no way of working out accurate local market shares from these data). The data indicate that across the 1,596 postcode areas identified in the UK, around a quarter had no large stores owned by the Big Four and around half had one store owned by the Big Four. The remaining quarter of post code areas had two or more big stores owned by the Big Four.

The changing offer to consumers in the convenience sector of the grocery market

- 3.29 Mintel's December 2005 report on convenience retailing observed that the sector had undergone a rapid change, 'as two of the big supermarket multiples have made inroads to the sector and more independent operators have decided to go for strength in numbers and join the symbol groups.'²⁶ We can conclude from the report that smaller players in the market, including independent convenience stores, must evolve to meet changing and more exacting consumer demand. The report noted that all the change in the market meant 'improving options for consumers'. It had 'raised the bar, with convenience stores more inclined to offer fresh foods, ready meals, familiar supermarket labels and in-store bakeries. Other issues like store design, promotional programmes and service were also all improving rapidly.' The report said, and we agree, that this poses

²⁶ Mintel (December 2005), *Convenience Retailing*

challenges for the trade, arguably heightening consumer expectations of service, quality and value. Chapter 4 discusses the offer of price, quality, range and service to consumers in the whole grocery market in more detail.

3.30 Overall, we observe that the grocery market is evolving rapidly. This is partly in response to changes in consumer demand (e.g. changing work patterns, demand for convenience, growing expectations about quality, range and service available from shops). However, it has also been accompanied by changes in the structure of the supply side of the market. Key changes have included:

- increase in concentration among the Big Four;
- some of the Big Four have moved into smaller store formats (e.g. Tesco Express and Sainsbury's Local), competing directly alongside smaller supermarkets and independent stores; and
- in particular, symbol groups have gained market share, and increasing numbers of independent convenience stores are joining buying and symbol groups.

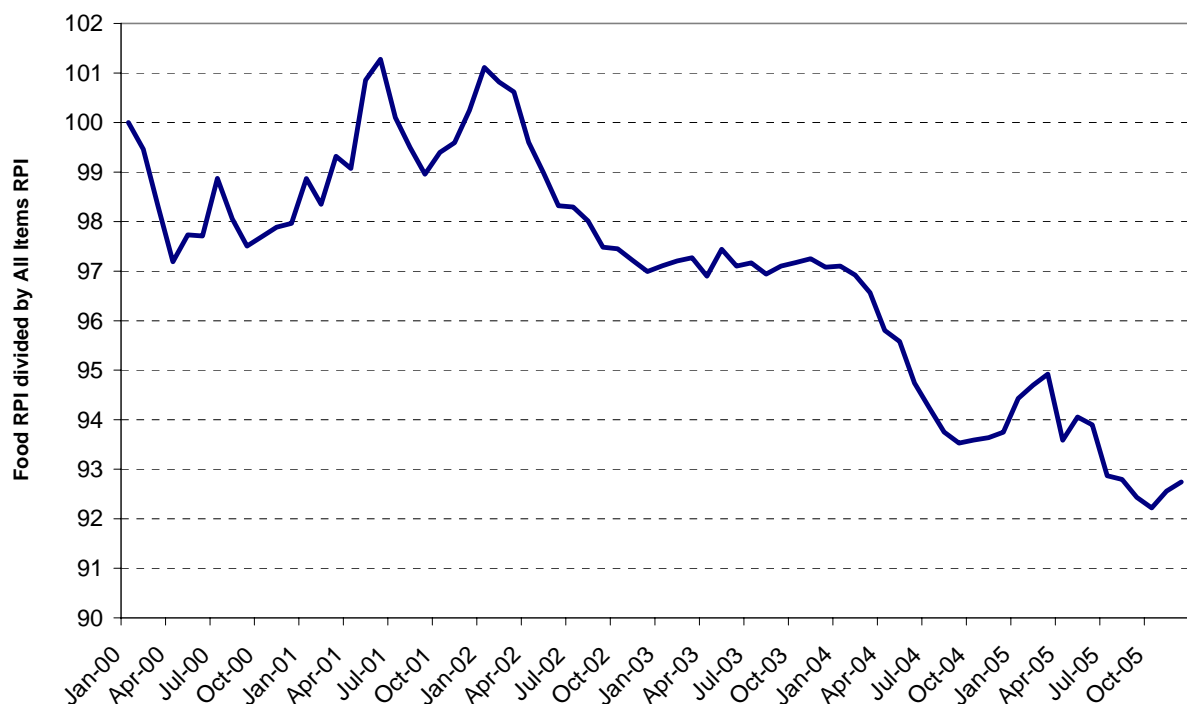
4 OFFERING TO CONSUMERS - PRICE, QUALITY, RANGE AND SERVICE

4.1 Given the market structure outlined in the previous chapter, this chapter considers how consumers have fared as a result of the increase in market share of the Big Four and the move of two of them into the convenience store sector. The offering to consumers can be broken down into a number of elements, including price, quality, range and service.

Price

4.2 Overall, the evidence suggests that consumers have benefited from falling prices in the food retail sector over the last five years as Figure 4.6 below shows.

Figure 4.6: Trend in real food prices since 2000



Source: ONS RPI data

- 4.3 Using ONS data, we estimate that real prices for food fell by 7.3 per cent between January 2000 and December 2005.²⁷ One of the Big Four has also told us that the ONS food retail price statistics underestimate the true extent of the fall in real food prices. Tesco estimates that food price deflation (based on its prices) has been around 15 per cent in real terms over five years. There do not appear to have been any effects on overall food price inflation of the Big Four's moves into convenience store retailing.
- 4.4 We compared the average supermarket prices for a variety of products with the ONS average price and calculated the average difference. Our findings showed that the majority of commonly purchased products appear to be cheaper in the supermarkets, and by an approximate average of 10 per cent cheaper in the Big Four. We emphasise that this is based on a relatively small sample of products, and should not be viewed as a comprehensive price comparison.
- 4.5 The evidence we have reinforces the claim that consumers have benefited from strong competition and falling prices. One of the Big Four, for instance, reported a fall in its actual prices of 1.5 per cent in 2005. Another of the Big Four told us that it checks its prices against lines offered at its large and small supermarket competitors and matches the price on offer where it is found to be cheaper.

Quality

- 4.6 There is evidence that consumers may increasingly value quality of product over pure competition on price. This appears to be having benefits for some niche players, including independent stores.
- 4.7 Mintel has reported that the surviving niche players are doing better than they had previously. It believes that consumer concern about healthy eating and buying local produce has meant that butchers, bakers,

²⁷ ONS statistics

fishmongers, greengrocers, market stalls and farm shops were trading more successfully in 2005 than in any year since 2000.²⁸ It goes on to say that 'many of the food specialists that have survived have done so because they have focused on quality and service'.²⁹ However, Figure 3.4 above indicates that there are far fewer of these outlets.

- 4.8 The APPSSG Report states that there has been an 11 per cent increase in demand for organic products over the last year. It went on to say that independent retailers experienced a 43 per cent growth in sales of organic goods, while the percentage of sales by supermarkets has fallen for the third consecutive year from 81 per cent to 75 per cent.³⁰

Range

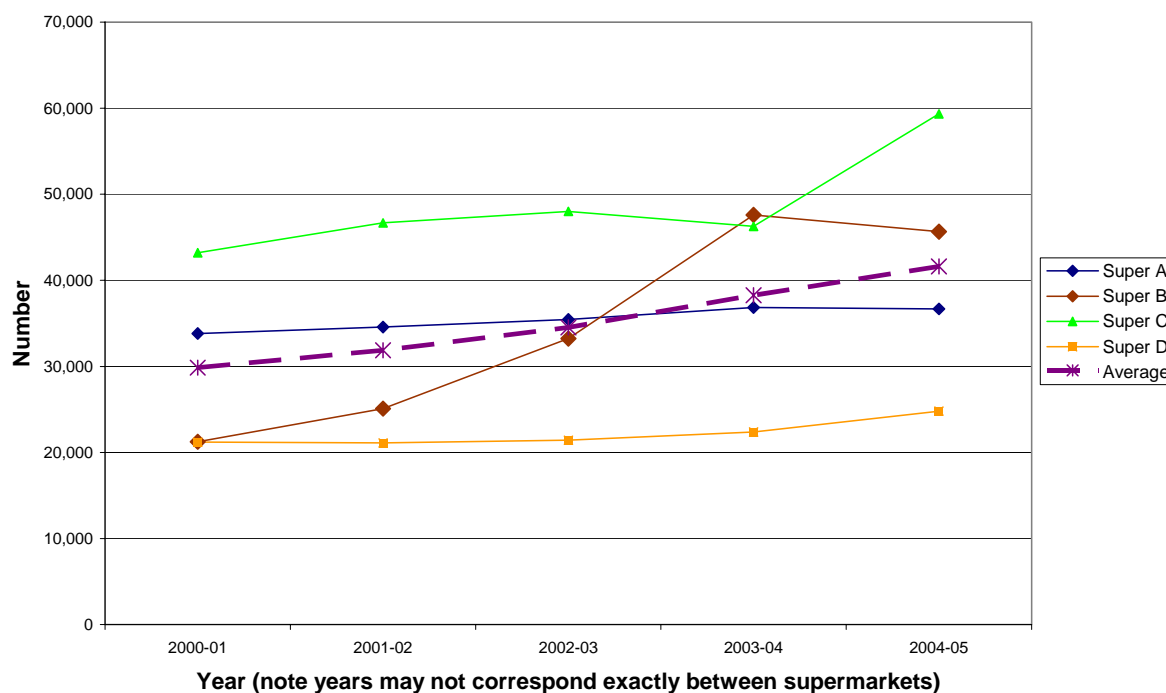
- 4.9 One of the key concerns about a reduction in the number of independent stores or increasing moves by some of the Big Four into the convenience store sector is that choice of store for consumers may be reduced where consumers have fewer different stores in their local area.
- 4.10 Nevertheless, it is also important to recognise another element of choice – the range of products provided within a given store. A major attraction of supermarkets over convenience stores (independent or otherwise) is that they stock a wider range of products under a single roof.
- 4.11 As part of the investigation prior to our August 2005 decision, we asked the Big Four to give us information on the number of lines they stocked. This is shown in Figure 4.7 below.

²⁸ Mintel (November 2005), *Food Retailing*

²⁹ Mintel (November 2005), *Food Retailing*

³⁰ All-Party Parliamentary Small Shops Group, *High Street Britain: 2015*, February 2006, page 21

Figure 4.7: Supermarkets' choice of product lines in all groceries



4.12 Calculated from the information provided to us, we found that in 2004/05 there were 41,622 lines sold on average across the Big Four, an increase of 40 per cent over five years. This appears to suggest that the range of products available to consumers in supermarkets has increased.

4.13 However, it is important to recognise that part of this increase in number of products might be viewed as a natural process of product differentiation and innovation, driven primarily by manufacturers and suppliers. We have not attempted to consider how far the increase in product range might have been a result of competition between supermarkets rather than other features.

4.14 Concerns have also been raised with us about the range of products available in convenience stores operated by the Big Four. It has been suggested that, in some cases, convenience stores which have been taken over by one of the Big Four have seen their range of products fall. We have not been able to find evidence to confirm or disprove this

allegation. However, it indicates the importance of looking at range at the convenience store, as well as the supermarket level.

- 4.15 Overall, in considering the impact of market developments on consumer choice, it is important to balance the impact of a reduction in the number of stores against, among other things, the apparent increase in range provided within the large supermarkets, and to consider whether product choice has actually been (or could be expected to be) impaired. Without a further more detailed examination we cannot conclude that choice has increased in all sectors of the grocery market.

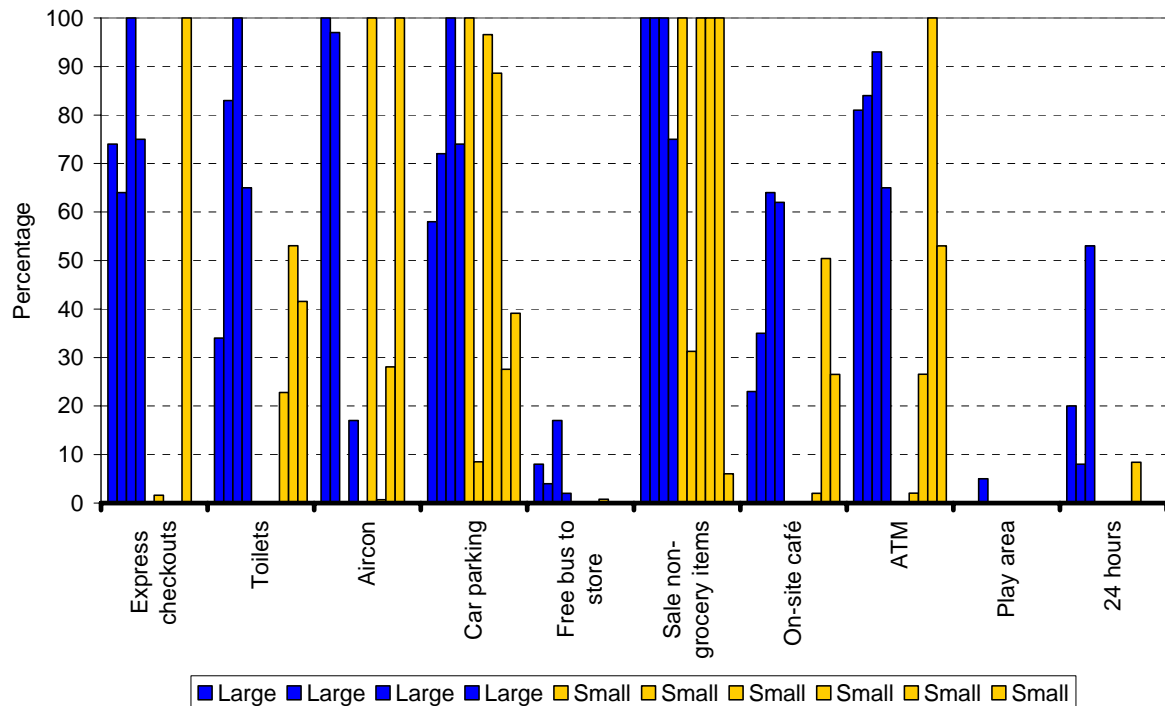
Service

- 4.16 The Verdict report 'Neighbourhood Retailing' (2006) states that 'the impact of Sainsbury's and Tesco's increasing pressure has raised competition and retail standards. The multiple retailers have brought fresher food, new ranges, lower prices, better store environments and increased scale to the neighbourhood and it has forced smaller players to improve to keep up'.
- 4.17 Evidence suggests that consumers have come to expect more from their local store and seek better prices, well stocked stores, and ease of access, among other things. However there is the possibility that this may have raised barriers to entry by increasing any sunk costs of opening a store, or indeed renovating an existing store (although arguably the increase in consumers' expectations about the service and quality that a store should provide is a positive change). For many independent convenience retailers, this has meant joining a symbol group. Some of the exits from the independent convenience store sector can be attributed to the growth of symbol and buying groups but the growth of these groups could have made entry easier into the convenience store sector overall.
- 4.18 *Which?* said in its report 'Comparison of Satisfaction of Retailers in the UK' (January 2006) 'Satisfaction with the [grocery] sector as a whole is higher than for the clothing and electrical sectors'. Waitrose (81.4 per cent) and Marks & Spencer (79.6 per cent) scored the highest levels of

consumer satisfaction within the grocery sector, topping the ratings for product and customer service, despite both featuring within the bottom three of the pricing category.

4.19 To quantify some of these elements of service we asked supermarkets to provide us with information on the amenities that they provide, such as express check-outs, air conditioning and toilets. The results showed that the Big Four provided better amenities in-store than competing smaller supermarket retailers: see Figure 4.8 below (the dark bars relate to individual Big Four supermarkets – and include data relating to their smaller format stores – and the yellow bars relate to individual smaller supermarket chains).

Figure 4.8: Amenities percentage for all stores 2005



4.20 We do not have sufficient evidence properly to compare change since 2000. However, the information we do have suggests that service in the form of amenities have improved over the last five years across the grocery market. A comparison of Tesco Customer Surveys for 2000 and

2005 indicated that consumers are increasingly satisfied with the prices, stocks and service provided. According to Simpson Carpenter National Survey (February 2006) 70 per cent of shoppers say grocery shopping in convenience stores has improved over the last five years.

5 PRICING BEHAVIOUR

- 5.1 The following three chapters set out specific features of the market that we have considered as possible grounds for a market investigation reference to the CC, in the light of the changes in the market outlined in Chapter 3. In order to make a market investigation reference, the OFT must have reasonable grounds for suspecting that features of the market prevent, restrict or distort competition. Where this threshold is met, the OFT's guidance on the exercise of its discretion³¹ says that in assessing whether the adverse effects of features of a market on competition are significant, we will consider whether they are likely to have a significant detrimental effect on consumers through higher prices, lower quality, less choice or less innovation. We have considered this question throughout the analysis of the features of the market which follows.
- 5.2 This chapter focuses on pricing behaviour, and in particular on allegations that the Big Four engage in below-cost selling and local price variation ('price flexing') in a way which could distort competition and harm consumers.
- 5.3 The ACS and others have argued that below-cost selling on known value items (KVIs) by the Big Four distorts competition with convenience stores, as found by the CC in 2000. It has also been argued that:
- the greater consolidation of the large multiples following Morrisons' takeover of Safeway is likely to exacerbate below-cost selling, leading to an increase in the number of small retailers leaving the market; and
 - the distortion of competition caused by below-cost selling practices is greater now than in 2000 because some of the Big Four have expanded into the convenience store sector and practise below cost selling in that sector as well as in their larger stores.

³¹ OFT 511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.27

- 5.4 On price flexing, the concern put to us by the ACS and others is that the Big Four price differently in local areas in response to local market conditions. In principle, this type of 'price flexing' could distort competition in two ways. First, it could tend to focus some element of price competition into localities where particular low-priced competitors are present and away from other areas, leading to higher prices being charged in areas where competition is weak. Second, local price reductions could, in principle, be used to drive competitors out of the market, after which prices could be increased to levels higher than they were immediately before the local price reductions were put into effect.

Previous analysis

- 5.5 In 2000, the CC concluded that the Big Four and other supermarkets priced below cost on some products including KVIs, and that this could harm smaller retail outlets, leading to adverse effects on competition. In particular, below-cost selling meant that some of the supermarkets' products were not fully exposed to competitive pressures and that the practice damaged smaller reference stores and non-reference grocery outlets. However, the CC also concluded that, given the market was generally competitive, no remedy was appropriate in the light of proportionality and a desire to minimise regulatory cost.³²
- 5.6 The CC's 2000 report found that a number of the parties 'engaged in the practice of varying prices in different geographical locations in the light of local competitive conditions, such variation not being related to costs'. The CC concluded at paragraph 2.406 that this practice distorted competition in the retail supply of groceries in the UK in that it tended to focus some element of price competition into localities where particular price-competitive competitors were present and away from other areas where competition was weaker. The CC also concluded that price flexing distorted competition by contributing to the position that a majority of grocery products were not fully exposed to competitive pressure. The CC

³² 'Supermarkets', Competition Commission 2000, paragraph 2.565

said that the distortions of competition operated against the public interest when engaged in by those supermarkets with significant market power (in that case Safeway, Sainsbury's and Tesco).³³ The CC went on to conclude that there were no proportionate available remedies.³⁴

5.7 Furthermore, the CC concluded in its 2003 Safeway merger report that price flexing was still likely to be a profitable strategy for each of Asda, Morrisons, Sainsbury's and Tesco following any proposed merger.³⁵ While it did not have any conclusive evidence of this, it cited the ability for all supermarkets to switch to pricing locally.³⁶ It found that Tesco and Sainsbury's had different pricing structures based on the format of their stores. During its consultation stage, the CC was given a number of representations by supermarkets that Tesco and Sainsbury's both price flexed, although neither admitted doing so. Asda claimed that Tesco priced more aggressively near its Asda outlets through varying its formats.³⁷ While the CC did not ascertain whether this was correct, it did foresee the possibility that parties might avoid competing using the same store sizes in areas where there were only two or three competitors present. The CC concluded that 'in our view [there is] no reason to conclude that national pricing must or will inevitably continue in the future. Given the scope for local pricing, we would expect firms to pursue whichever ... strategies ... [were] most profitable in the prevailing circumstances of the market.'³⁸ Likewise the CC's 2005 report on Somerfield's acquisition of 115 stores from Morrisons found that price flexing was being carried on by Somerfield.³⁹

³³ Supermarkets', Competition Commission 2000, paragraph 2.409.

³⁴ Supermarkets', Competition Commission 2000, paragraphs 2.566 and 2.567

³⁵ Safeway merger report, Competition Commission 2003, paragraph 2.98

³⁶ Safeway merger report, Competition Commission 2003, paragraph 2.96

³⁷ Safeway merger report, Competition Commission 2003, paragraph 2.96

³⁸ Safeway merger report, Competition Commission 2003, paragraph 2.98.

³⁹ Somerfield plc/Wm Morrison Supermarkets plc report, Competition Commission 2005, paragraph 7.52.

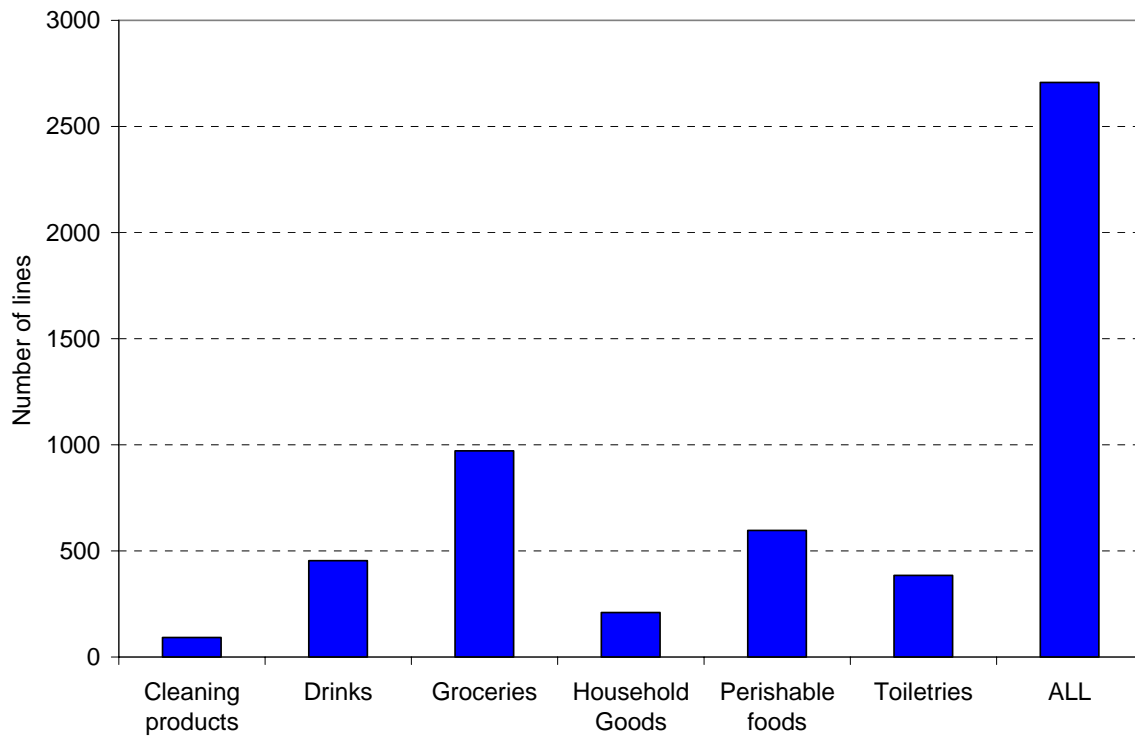
Evidence of below-cost selling

- 5.8 The ACS has provided specific instances which it believes suggest below-cost selling, in relation to Easter eggs and fuel.⁴⁰ We have carried out further research into the extent of below-cost selling by the Big Four, and whether this has changed since 2000. We asked the Big Four to list all grocery products where the gross margin on sales was less than 5 per cent. This figure was considered by the CC in 2000 to be a reasonable proxy for identifying below-cost selling and we consider it appropriate to use this measure for the purpose of gaining an appreciation of the extent of below-cost selling.⁴¹ We recognise that this figure ought to be treated with caution.
- 5.9 Figure 5.9 below shows the total number of grocery lines identified by the Big Four as being sold in their supermarkets with a margin less than 5 per cent. In total, we identified 2,708 lines sold below cost (on this definition) across the Big Four.

⁴⁰ Note that fuel costs are outside the scope of this investigation, which is looking only at grocery sales.

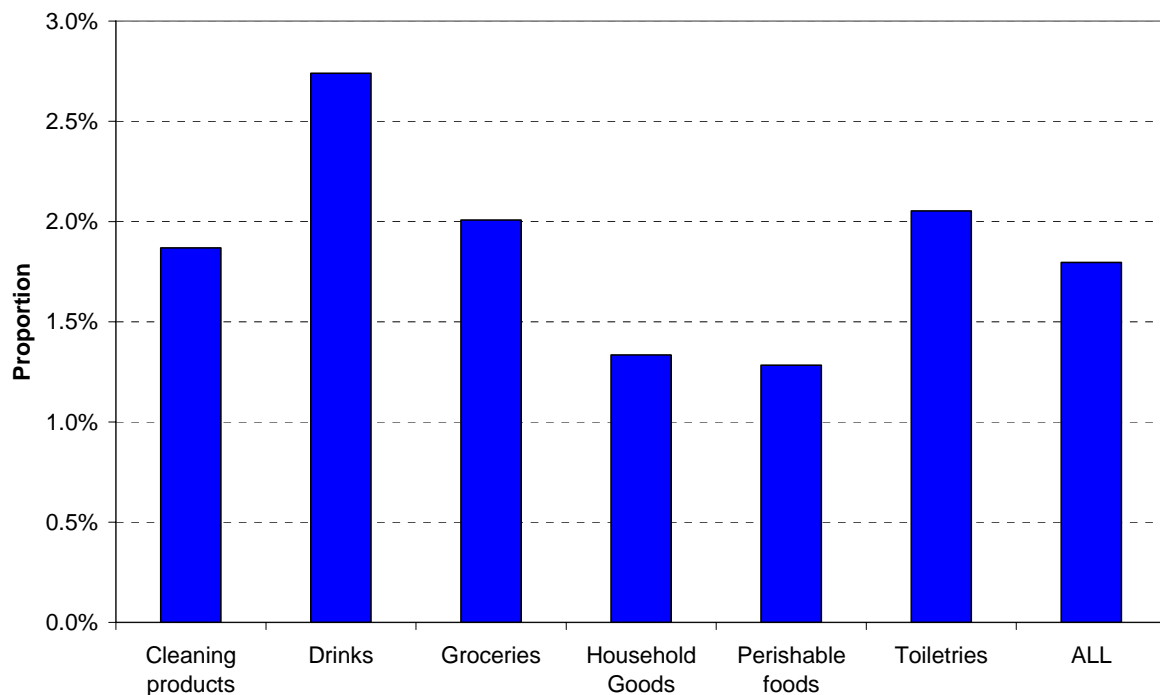
⁴¹ 'Supermarkets', Competition Commission 2000, paragraph 2.385

Figure 5.9: Number of lines sold by the Big Four with gross margins less than 5 per cent



5.10 Figure 5.10 below shows the number of grocery lines sold below cost as a proportion of total number of lines sold by the Big Four, calculated from figures they provided. We estimate that the 2,708 lines sold below cost represent around 1.8 per cent of the number of all grocery lines across the Big Four as a whole.

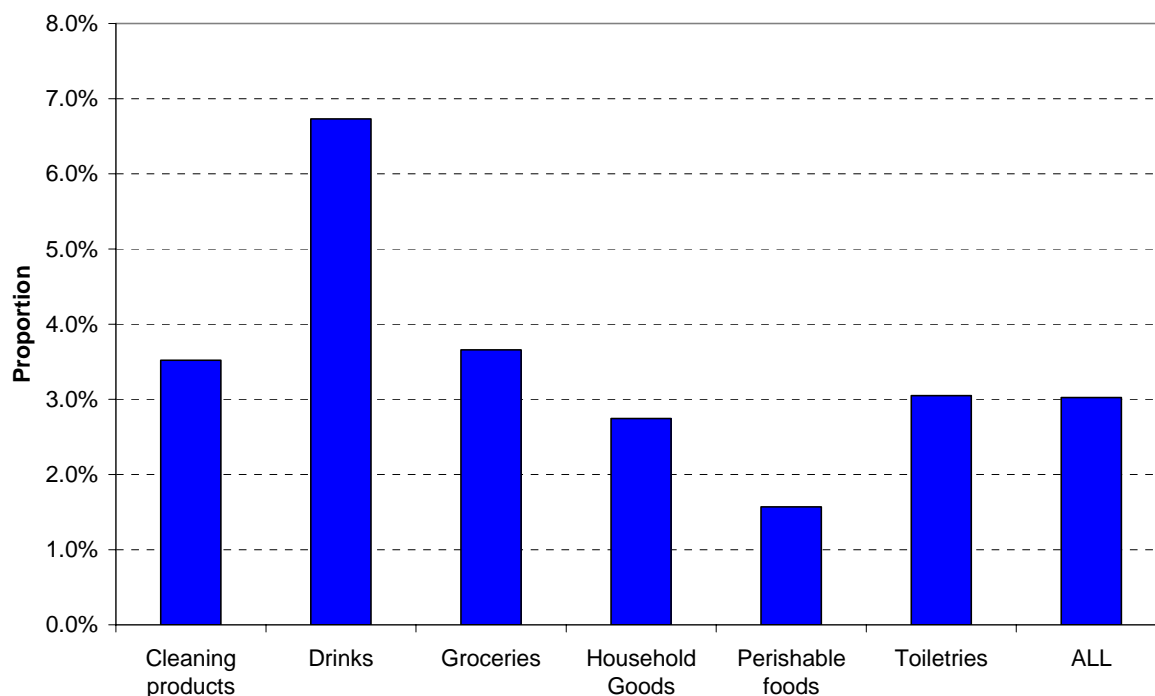
Figure 5.10: Proportion of the number of all grocery lines by product category in the Big Four sold with gross margin of less than 5 per cent



5.11 We also asked the Big Four to provide us with data on the value of their sales of groceries sold below cost. Figure 5.11 below shows our estimates of the proportion of total sales with gross margins less than 5 per cent in the Big Four by product category. Overall we estimate that the extent of below-cost selling relates to around 3 per cent of the Big Four's grocery sales.⁴²

⁴² Some of the Big Four challenged our analysis, saying that (i) we should be looking only at products sold with negative margins and (ii) many of the products with low margins are those where price reductions are not permanent (e.g. stock-clearance, seasonal sales). If this were accepted, there would be small falls in the proportions of the number of lines and sales of the totals of groceries which might be subject to below-cost selling.

Figure 5.11: Proportion of the Big Four's total sales by product category with gross margins less than 5 per cent



5.12 The fact that below-cost selling is higher as a proportion of sales than as a proportion of total lines indicates that products sold below cost tend to have above average sales – i.e. they are more popular/common products. This indicates that below-cost selling may be more important on faster selling items, which may benefit consumers, especially those who are less well off.

5.13 We also attempted to test the claims put to us that Tesco and Sainsbury's were extending the practice of below-cost selling into their convenience stores. We obtained data from Tesco and Sainsbury's on the number and sales value of grocery lines sold in their convenience stores with a gross margin of less than 5 per cent. The data indicate that the number of lines sold below cost in convenience stores is fewer than in supermarkets (partly because of increased costs per unit of turnover of the convenience store format, and partly because of the smaller number of product lines sold by the supermarkets in their convenience store

formats). In terms of sales value, our initial estimates suggest that the proportion of total sales sold below cost in convenience stores owned by the Big Four may be slightly lower than the proportion of sales sold below cost in their supermarkets (i.e. larger format stores).⁴³

- 5.14 Prima facie then, we have no evidence that the extent of below-cost selling is higher in the Big Four's convenience outlets than in their supermarkets. However, it is clear that high street convenience stores are facing some below-cost selling by convenience stores operated by some of the Big Four, in addition to below-cost selling in their larger format stores.
- 5.15 We do not have sufficient information to conclude whether the level of below-cost selling has increased or decreased significantly since 2000. A number of the supermarkets put it to us that the practice of below-cost selling is no more prevalent now than it was in 2000, and we do not have any evidence to refute this. However, given the rapid expansion of two of the Big Four into the convenience store sector, it can be reasonably expected that the total level of below-cost selling in that sector has increased, on the assumption that it was not already being done by the convenience stores acquired by the two of the Big Four.
- 5.16 We have found no evidence to suggest that below-cost selling of KVIs by the largest multiples now is significantly more or less likely to be restricting or distorting competition than it may have been in 2000. The CC's particular concern in relation to below-cost selling was the competition-distorting effect of the cross-subsidisation which it required between different products. That competition distorting effect is inherent in below-cost selling of KVIs and, in so far as the practice continues, there must also be reasonable grounds for suspecting that competition is being distorted as a result. However, it is also possible that below-cost selling on a small number of KVIs is part of a strategy that drives higher competition and thereby is an important feature of the market that

⁴³ We encountered a number of apparent anomalies in the data, which we are attempting to resolve with the parties.

benefits consumers. Investigation is needed to analyse these possible alternatives.

- 5.17 A key question is whether the move of two of the Big Four into the convenience store sector since 2000 has exacerbated any distortion of competition caused by below-cost selling. One of the supermarkets has put it to us that an extension of below-cost selling to the smaller format stores of the Big Four (rather than only their supermarkets) could actually *alleviate* the concerns identified by the CC in 2000. This is because the CC's key concern was that below-cost selling by the Big Four and other supermarkets would lead to a misallocation of resource between one-stop shops and convenience stores.⁴⁴
- 5.18 In principle, we agree that below-cost selling in supermarket-owned convenience stores could reduce the misallocation of resources between supermarkets and convenience stores owned by the Big Four. However, we believe that there are reasonable grounds for suspecting that below-cost selling in convenience stores owned by the Big Four could distort competition between these and other convenience stores, including independent stores. We believe that this could result in consumer detriment, particularly to the extent that the independent convenience stores contribute greater product variety.

Evidence of price flexing

- 5.19 The ACS has said that price flexing continues to be practised by the Big Four. Whether or not they generally have national pricing policies that allow prices to be set on a store-by-store or other localised basis by reference to local competitive conditions, there is observable evidence of

⁴⁴ In paragraph 2.381 of its 2000 report, the CC said that 'If consumers choose to shop at supermarkets because of their convenience, range, choice and value, then their success at the expense of smaller specialist or discount outlets is unobjectionable. However, if consumers are induced to shop at these larger outlets because some products are offered below the resource costs of producing and delivering them, then that would represent a misallocation of resources and a distortion of competition in the grocery market.'

price flexing in the form of local voucher promotions (e.g. 'spend £X and get £Y voucher', or 'spend £X and get £Y off').

5.20 We are aware of a number of claims of local price flexing by the Big Four. These include the following cases:

- Proudfoot has claimed that Tesco pursued a 4-week campaign, introduced specifically for its Withernsea store, offering £8 off for every £20 spent (total of four vouchers in each of the 15,000 mailshots sent out). This represented up to a 40 per cent discount - assuming the consumer purchased only £20 worth of products. Proudfoot alleged that this was predatory pricing aimed at eliminating the only other supermarket in a 15 mile radius.
- ACS has told us that in Bellshill, near Glasgow in May 2005 Tesco ran a voucher promotion offering £10 off with every £30 spent and that the same promotion was run in Hull.
- A small retailer cited an example of below-cost pricing in Grimsby – where Tesco advertised deep discounts on certain brands of coffee and tea only at the Tesco Extra stores in Cleethorpes and Grimsby which are allegedly in direct competition to one of the largest Nisa-Today's retailers.
- In July 2005, Sir Ken Morrison, chairman of Morrisons, told City analysts that Tesco was using selective discounts to lure shoppers from his newly refurbished stores. Sir Ken cited the example of the Isle of Wight, where, after the opening of a new Morrisons store, Tesco had sent vouchers giving shoppers £15 off every £40 spent - a discount of up to 37.5 per cent.

5.21 In an attempt to find more general evidence of local pricing behaviour, we asked the Big Four to outline their pricing decisions and the extent of local price variation. In response, all of them told us that almost all pricing decisions are made centrally. The general approach taken by the Big Four appears to be for prices to be determined through a national

price list, based on analysis of competitors' prices. There are variations in the precise pricing strategies adopted by the various players.

- 5.22 Looking behind these headline claims, the Big Four acknowledged that there is some limited degree of local price variation. Examples that we have found include some discretion for local managers – but the Big Four have stated that, in practice, this is on a very small proportion of sales, and typically relates to the sale of end of line or old stock.
- 5.23 In the light of these examples, and the fact that the Big Four have acknowledged that there is some (albeit limited) discretion to vary prices and offer 'buy x get y free' deals on a local basis (determined either locally or at a national level), there appears to be evidence that some price flexing does occur. However, there is no evidence to suggest that this is widespread.
- 5.24 The evidence presented by the Big Four suggests that price flexing, where it does occur, tends to be done to match competitors (which are frequently the other large supermarkets). Furthermore, we have no direct evidence that any competitors have been driven out of the market as a result of price flexing – whether by directly adjusting prices of the groceries concerned, providing 'buy x get y free' offers, money-off vouchers or extra loyalty card points. We examined the Proudfoot case in some detail under the CA98, and it was not viewed as persuasive.
- 5.25 We do not have any evidence to rule out the previous concerns raised by the CC that price flexing might tend to focus some element of price competition into localities where particular low-priced competitors are present and away from other areas. We believe that there is a strong argument that local price competition, where there is no predatory behaviour arising from the abuse of a dominant position in an area, could benefit rather than harm consumers. The existence of 'price flexing' could be a characteristic of a well-functioning competitive market. However, as acknowledged by the CC in 2000, there could be a concern if price flexing focuses some element of price competition into localities where particular lower-priced competitors are present and away from

other areas and thereby contribute to the position that a majority of grocery products are not fully exposed to competitive pressure.

Conclusions on distortions of competition and harm to consumers

- 5.26 The evidence we have gathered suggests that the Big Four price some products below cost (defined as having a gross margin of less than 5 per cent, in line with the CC's approximation in 2000). We have found 2,708 lines below cost, representing around 3 per cent of total sales by supermarkets. We have also found evidence of below-cost selling in smaller stores operated by the Big Four; but we have no evidence to suggest that the extent of below-cost selling is greater in smaller stores than in supermarkets.
- 5.27 Similarly, we have gathered anecdotal evidence to suggest the existence of price flexing, although information provided by the Big Four may suggest that significant local pricing is not widespread.
- 5.28 For supermarkets (as well as many other sectors), price discrimination (both across products and across locations) can play a key role in a genuinely competitive process. This will tend to benefit consumers overall (although some may be worse off). Such competitive (and welfare-enhancing) price discrimination may include a degree of below-cost selling (especially where this is used as a promotional device) and local price competition. Price discrimination could be helpful to consumers if it arises out of optimal yield management in a highly competitive market.⁴⁵
- 5.29 Legitimate competition concerns and harm to consumers could nevertheless arise if price discrimination, in the form of below-cost selling or price flexing, in some areas is used:

⁴⁵ e.g. low cost air fares advertised by Ryanair, EasyJet and others for short haul European destinations.

- to take advantage of an existing position of market power – for example, where prices in a location reflected lack of local competition and choice for consumers; or
- in a predatory way, to force competitors out of the market and create or reinforce a position of market power.

5.30 We have seen no direct evidence that local price differences have been used with predatory intent, or that consumers have been harmed by pricing practices engaged in by the Big Four. As noted in Chapter 4, the grocery market and the Big Four appear to be delivering lower prices, more choice and better service to consumers. This is relevant to the discussion of the appropriateness of a reference, and is discussed in more detail in Chapter 8.

5.31 Based on the evidence of below-cost selling and price flexing, and against the background of the CC's previous findings on pricing behaviour, we believe that there are reasonable grounds for suspecting that these practices are distorting competition in the supply of groceries to final consumers, but we cannot conclude that consumers are harmed. It would be important for any CC inquiry to test in more detail the balance between possible consumer benefits and costs as a result of these pricing practices.

6 BUYING POWER

- 6.1 The pricing behaviour issues discussed in the previous section relate to competition between retailers. In addition, there may be competition effects relating to the relationships between the Big Four and their suppliers. In certain circumstances, these vertical relationships could also affect competition between retailers. This chapter discusses features of the vertical supply chain that might be thought to raise competition concerns.
- 6.2 A number of parties, including the ACS, have raised concerns around the exercise of buyer power by the Big Four. The alleged buyer power of the supermarkets was investigated in the CC's 2000 report, and a remedy was imposed in the form of a code of practice between the Big Four and their suppliers. However, changes in the market and new concerns raised with us might justify the CC looking again at this issue.
- 6.3 We are aware of two broad areas of concern regarding the exercise of buyer power. First, the strength of buyer power of the Big Four might distort competition in the upstream supply market. For example, where suppliers are in a weak position relative to supermarkets, their incentives to invest or innovate in new products might be distorted if, for example, the supermarkets use their buyer power to reduce prices paid to them.
- 6.4 Second, arguments have been put to us that the exercise of buyer power in relation to suppliers might reinforce distortions of competition at the retail level. The ACS and others have made two specific claims:
- first, that the Big Four might use their buyer power to obtain better terms from suppliers to such an extent that suppliers are forced to charge higher prices to smaller retailers with less buyer power (the so-called 'waterbed effect'). It has been suggested that this places smaller retailers at a competitive disadvantage because they face higher costs which are not justified on purely commercial terms (e.g. taking account of higher costs that suppliers might legitimately charge when they are selling a smaller quantity of product). This

distortion has the potential to harm consumers by undermining the viability of smaller independent stores and thereby reducing consumer choice; and

- second, it has been argued that the exercise of buyer power could undermine the viability of the wholesale distribution network serving independent stores, leading to a 'tipping point' beyond which wholesalers and, consequently, independent retailers will not be able to survive profitably. It has been argued that the move of supermarkets into convenience retailing is having an adverse impact on the ability of buying groups to secure competitive terms for their members, which in turn weakens the position of small retailers.

6.5 In order to examine these concerns, we have asked whether:

- there is evidence that buyer power enables large supermarkets to purchase products from suppliers at prices that are significantly below those charged to other retailers or wholesalers, and whether buyer power has increased since 2000; and
- there is a case for thinking that the exercise of buyer power could harm consumers, either by adversely affecting smaller retailers through the waterbed effect and thereby reducing consumer choice, or by undermining the viability of the wholesale distribution network serving independent stores.

Previous analysis

6.6 In 2000, the CC concluded that imbalances in buyer power across grocery retailing as a whole were likely to be problematic for smaller retailers, in that their weakness relative to middle-ranking suppliers was likely to give suppliers the ability to compensate for the harder terms imposed on them by the major buyers by raising their prices and hardening their own terms to small retailers. The CC observed that the largest retailers were able to obtain non-cost-related discounts from suppliers and that the differentials in the prices charged by suppliers to large and small retailers could not be explained by cost differences. The

CC report analysed differences in prices paid by eleven grocery retailers for suppliers' top five lines.⁴⁶ Tesco was found to pay the lowest prices; Budgens was found to pay 11% more on average.

- 6.7 The CC also considered the waterbed effect in its 2003 Safeway merger report. It concluded from the evidence available to it that there might be 'some waterbed effect for some classes of suppliers, especially over the longer term'.⁴⁷ However, on the evidence at the time it was not able to conclude that any waterbed effect would be exacerbated by any of the mergers.

Evidence of the effects of buyer power on smaller retailers

- 6.8 Before our investigation, we were given anecdotal evidence from a number of parties to suggest that the Big Four are able to extract better terms from suppliers than were independent retailers, wholesalers and buying groups, to an extent that could not be explained purely in terms of legitimate commercial differences between them. For example, the report by Europe Economics submitted by the ACS in May 2005 theorised that the largest supermarkets might be obtaining buying prices which were 10 per cent lower on average than for the majority of the convenience sector. An independent wholesaler told us that the dominance of the major supermarkets over suppliers continued to drive a gulf in buying terms, and that this differential was greater now than that found in the 2000 CC report.

- 6.9 We asked a number of suppliers to give us information on the prices at which their ten top-selling items were purchased by different supermarkets, wholesalers and buying groups. Seven suppliers responded to our request for information, with turnovers ranging from around £35 million to over £1 billion. This was not intended to be either a comprehensive survey or to be a representative sample of suppliers. It was simply intended to give a rough indication, in the time available, of

⁴⁶ 'Supermarkets', Competition Commission 2000, paragraphs 11.113 – 11.117

⁴⁷ Safeway merger report, Competition Commission 2003, paragraph 2.248.

the possible magnitude of any difference in terms offered to different types of retailers.

- 6.10 The data suggested that terms can vary considerably between different types of buyers, and in some cases between individual firms within any given type. On the basis of the evidence provided, we estimate that wholesalers and buying groups might pay around 7 per cent more, on average, than the Big Four. Smaller supermarkets pay just over 2 per cent more. However, these averages mask significant differences across the suppliers we surveyed. In one case, the prices paid by wholesalers and buying groups were, on average, only fractionally below those paid by the Big Four. For another supplier, the differential was more than 13 per cent.
- 6.11 We also asked suppliers whether they thought the differentials in prices charged to different groups had changed since 2000. Of the five suppliers who commented on this, three gave evidence which suggested that the differential between the Big Four and wholesalers and buying groups had increased since 2000, one suggested that the differential had reduced, and the other said that the differential was broadly unchanged. One supplier commented that 'there now seems to be more 'clear water' between the prices achieved by the Big Four and the prices achieved by retailers such as Co-op and Somerfield'.
- 6.12 We asked the suppliers to explain the differences between prices charged to different groups. Most suppliers pointed to factors such as differences in scale and business model, suggesting that at least some portion of the price differentials reflected differences in the costs of supplying different customers. Some suppliers also stated that they worked from a national price list, with fixed variations covering factors such as supply options and promotional offers.
- 6.13 Nevertheless, others made clear that they have flexibility to negotiate on a case by case basis. In one case, a supplier cited factors such as the calibre of the buyer, and historical issues such as market position, as factors that might influence prices paid by different retailers. Given the

apparent size of the observed differentials in prices, we believe that there are reasonable grounds to suspect that buyer power of the Big Four is one factor which influences the terms that they are offered by suppliers.

- 6.14 The ACS and others have suggested that the difference in terms offered to different types of retailers is evidence of a waterbed effect, meaning that the Big Four use their buyer power to obtain better terms from suppliers to such an extent that suppliers are forced to charge higher prices to smaller retailers with less buyer power in order to recover their costs.
- 6.15 In our view, there are theoretical questions that would need to be resolved before accepting that the price differentials observed are evidence of a waterbed effect that distorted competition. For example, it is not clear how suppliers would be able to charge significantly above cost to smaller retailers without rivals undercutting them in the market; similarly, it is not clear why suppliers would price persistently below cost to the Big Four.
- 6.16 Europe Economics, on behalf of the ACS, has argued that the waterbed effect does not require suppliers to react in a conscious way to supermarket buying power by raising prices to non-supermarket buyers to recover lost profits. Considered on its own, this would imply that the suppliers concerned had market power (necessary in order to raise prices above the competitive level) and that they were not previously acting in a profit-maximising way in setting prices for non-supermarket buyers – which would be dubious assertions. Rather, Europe Economics suggests that the waterbed effect occurs through the dynamics of entry and exit in an (otherwise) competitive market distorted by buyer power. It also suggests that if the market for a particular grocery product is expanding, the waterbed effect could occur through a reduction in the level of entry rather than through the exit of existing firms.

6.17 We do not believe it is necessary for us to reach a final judgement on this issue in order to make a reference. If a reference were made, it would be for the CC to analyse these issues in more detail if it judged that they raised significant competition concerns. We simply observe that the CC has previously suggested that the waterbed effect could provide a route for the exercise of buyer power to impact on the wider retail sector. We also note that, having regard to the evidence that we have collected, in our view, this remains a possibility. If the proposed reference proceeds, the CC will need to evaluate whether, if the waterbed effect does exist, it counters the positive effect for consumers of more competition at supplier level (see paragraph 6.3 above).

Effects on wholesale distribution networks and the 'tipping point'

6.18 A connected argument that has been put to us is that the exercise of buyer power, allied with and contributing to a reduction in the number of independent convenience stores, is serving to undermine the viability of the wholesale distribution networks serving independent retailers. Broadly, as the number (and density) of independent stores declines, the average costs of supplying them may increase. Ultimately, it is argued that a tipping point might be reached beyond which wholesalers will no longer be able to profitably supply the independent convenience store sector.

6.19 It was beyond the scope of our investigation to look in detail at the costs of wholesale distribution networks and the way that these might be affected by the exercise of buyer power by the Big Four. However, we asked wholesalers and buying groups for information on the viability of wholesale networks to independents.

6.20 Points put to us included that, while membership of buying groups has increased in recent years, suggesting a strong market position, in reality many of the new stores are smaller profile or single site stores. Some of the largest members of buying groups have sold out or been acquired by the major multiples. This has tended to increase operating costs for the distribution businesses.

- 6.21 One wholesaler told us that it estimated that a tipping point for economic viability will be reached at approximately 60-70 per cent of current volumes. Another estimated that it would take a 15 per cent sales reduction for its operating profits to fall to zero. Another wholesaler estimated that if its wholesale business (to independents and symbol groups) were to reduce by 15 per cent, then the resource allocated to its supply chain service would have to be significantly reduced. A symbol group operator commented that the highest costs were associated with delivering to remote locations, and that if increasing costs forced it to cease delivery to these stores, rural communities would be negatively affected.
- 6.22 One of the Big Four contested the claim that there has been a decline in wholesalers who might be expected to be negotiating large volume supplies for smaller retailers. It pointed to recent government statistics indicating that there has been no recent decline in wholesaler numbers.

Conclusions on distortions of competition and harm to consumers

- 6.23 The evidence given to us by suppliers suggests that buyer groups and wholesalers face higher charges than the Big Four, and indeed other smaller retailers. There is also slightly weaker evidence that the differential between prices to wholesalers and buying groups and prices to the Big Four has increased since 2000. Furthermore, there is evidence that buyer power is at least one plausible explanation for this differential.
- 6.24 We believe it is significant that these observed differentials relate to prices paid by wholesalers and buying groups, rather than directly by independent retailers. Some of the Big Four have argued that smaller retailers should be able to group together to increase their buyer power in competition with the Big Four. While this appears plausible in principle, the evidence we have gathered suggests that there remain concerns in practice about the impact of the Big Four's bargaining power.

- 6.25 In our view, the evidence on the existence of a waterbed effect, as a way of explaining why smaller retailers might lose out as a result of the exercise of buyer power, is mixed. However, we note that the CC has previously left open the possibility of a waterbed effect in its investigations into the grocery sector.
- 6.26 Similarly, we are aware of claims from a number of sources that the viability of wholesale distribution networks serving independent stores is suffering and that a tipping point may eventually be reached beyond which independent stores will not be able to be supported. A number of wholesale groups attempted to quantify the effects for us, with some suggesting that a tipping point would be reached if sales fell by 15-40 per cent.
- 6.27 Overall, we consider that these features create reasonable grounds to suspect that consumers could be harmed by the exercise of buyer power by the Big Four, although we recognise that buyer power may also benefit consumers. A conclusion could only be drawn following a much more detailed analysis than we have been able to undertake in the context of this assessment, particularly given the complexity of the interplay between buyer power and consumer benefits or harm.

7 PLANNING AND LAND BANKS

7.1 A further feature of the market that may raise competition concerns is the planning regime, and the way in which land ownership and planning consents might be used by supermarkets to restrict entry. These planning issues relate primarily to local market power and local consumer choice. We are aware of growing concern about the perceived local dominance of large supermarkets in some locations.⁴⁸ In broad terms, it has been argued that the planning system makes entry by competitors (particularly for new large out of centre stores) more difficult in some areas – i.e. it creates 'systemic' entry barriers.

7.2 As a result of the constraints imposed by the planning system, some parties have alleged that the Big Four are also able to use land ownership to reinforce their local market positions by limiting entry by potential rivals. These might be viewed collectively as 'strategic' entry barriers. Points that have been put to us include that the Big Four:

- hold undeveloped banks of land which can be used to restrict entry by potential competitors;
- pay inflated prices for sites in order to block legitimate entry; and
- impose restrictive covenants on land that they sell to competitors, preventing it being used in future for grocery retailing.

Systemic barriers to entry caused by the planning regime

7.3 Almost by definition, the planning regimes in place in the UK⁴⁹ act as a barrier to entry. Broadly, the aim of any planning regime is to limit the way land is used and developed, in order to achieve wider benefits for society. In economic terms, land development by one party can have

⁴⁸ See discussion in Chapter 3, paragraph 3.23

⁴⁹ In the time available we have not been able to consider differences between the planning regimes applying in different parts of the UK, but the broad concerns we have identified are very likely to apply across the board.

effects on other parties ('externalities') which are not taken into account by the developer, and the planning system is a way of correcting or limiting the distortion that results from this.

- 7.4 However, the planning regimes in the UK may be a key reason why the productivity of UK supermarkets ranks low in international league tables.⁵⁰ An OECD Economic Survey in 2004⁵¹ stated that 'competition is impeded...planning restrictions could be relaxed' and 'land use restrictions hinder profitability'. (Note that this relates to all land use, not just retail).
- 7.5 The planning process for supermarkets outside areas designated for retail development differs from most other planning applications in that there is an initial test of 'need'. That test has been extended (in 'Planning Policy Statement 6' [PPS6]) to include 'choice'. However, PPS6 does not take different fascias into account when reviewing a planning application – merely the retail offering – so for example it would not consider whether there were already four fascias of the same supermarket already in the area, as long as the new supermarket could meet the retail 'needs' of the area as identified by PPS6.
- 7.6 The needs test is formulated by calculating the retail need of an area in sales. This is then turned into £'s capacity, which in turn is then translated into square metres. The effect is that if a retailer has high sales per square metre, it will be given less space to develop. This could make a difference and determine whether or not it is worth a potential entrant developing on a smaller site if it has to compete with a large incumbent. One of the smaller supermarkets provided examples of target towns which have fewer than four fascias – and therefore for the purposes of competition analysis a potential lessening of competition - but which it cannot gain entry to due to 'full capacity'.⁵²

⁵⁰ UK index of value added per employee in 2000 was 99, against EU average of 100. *OECD: Product market competition and economic performance in the UK, June 2005*

⁵¹ *OECD: Product market competition and economic performance in the UK, 2004*

⁵² Sevenoaks, Amersham, Durham, Hastings, Inverness and Salisbury.

- 7.7 Smaller players also claim to have difficulty acquiring new sites. PPS6 forces companies into town centres with greater costs, which can put off entry by smaller players. Also, incumbent operators out of town have a greater advantage as customers want free parking which may not be easily available in town centres.
- 7.8 More generally, the need to gain planning permission means that the process of building a new supermarket is protracted. One supermarket operator suggested to us that developing a site for retail could take up to five years. One of the Big Four told us that site development could take between 54 and 76 months, depending on the extent of central government involvement in the planning approval decision. Therefore, it is difficult for new stores – primarily large supermarkets – to enter the market, and entry takes a long time.
- 7.9 One of the Big Four argued that the planning regime imposes less of a barrier than is claimed by some of its competitors. For example, it noted that most of the construction of very large out of town retail outlets (frequently selling non-food as well as grocery products) has taken place since the change in rules on out of town developments during the 1990s. It was put to us that, since 1995, each of the Big Four has increased its numbers of large stores.
- 7.10 On balance, our view is that, although the planning regime does not prevent the development of sites outright, there are reasonable grounds to suspect that it distorts competition. The OECD and others have suggested that this could have a significant impact on UK productivity, and hence on consumer welfare. It also appears that the 'needs' test in its current form may distort competition, allowing less efficient retailers to gain market access on better terms and limiting the choice of fascias for consumers in some locations. Finally, there is evidence that the planning regime creates a framework within which the supermarkets may be able to engage in strategic behaviour to further restrict entry, as discussed in the following sections.

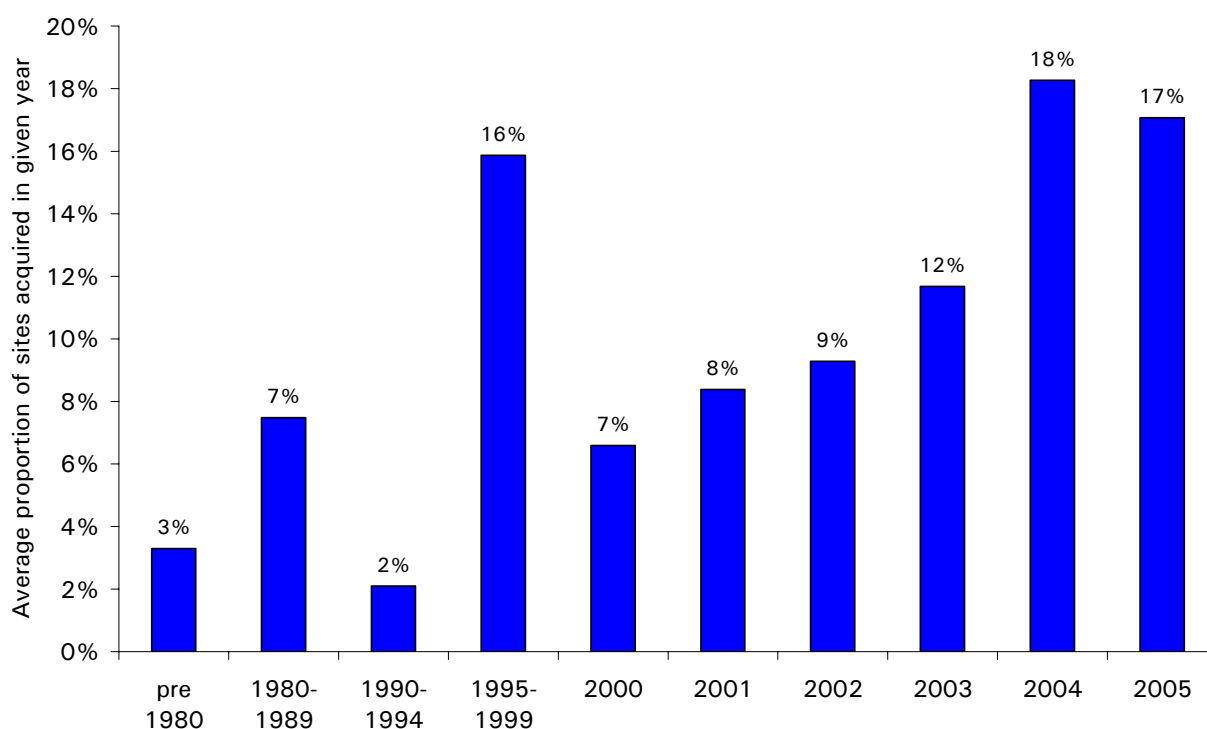
Size and distribution of land banks

- 7.11 Given that the planning system creates barriers to entry, there could be an incentive, in principle, for players to acquire land without an intention to develop the site, simply to stop others from competing in the market. We have received a number of complaints that the Big Four have built up significant land banks, and pay inflated prices for land with the intention of restricting entry. For example, Friends of the Earth has claimed that Tesco's land bank could give it a potential 45% market share, if it were to build on all the sites it holds.⁵³
- 7.12 We asked the Big Four to provide information on the sites that they own but have not yet developed. The information we received suggests that there are a total of 319 sites across the Big Four which are owned but not yet developed for retail. In addition, there are 149 sites we have identified on which there is some form of conditional contract or option, which can typically be exercised if planning permission is obtained.
- 7.13 We also attempted to explore the nature of these undeveloped sites. We asked the Big Four to tell us which of their undeveloped sites could be used for large retail development (i.e. which would be suitable for a store of greater than 1,440m² in size, consistent with the CC definition of a supermarket), and identified 158 such sites. We also found that 149 sites were in town centre locations.
- 7.14 We estimate that, on average across the Big Four, undeveloped sites are equivalent to around 10 per cent of the stock of existing stores. The figures are similar either when comparing all undeveloped sites against the total number of existing stores, or when comparing only the number of undeveloped sites suitable for a new supermarket with the existing number of supermarkets (i.e. large stores). The proportions vary significantly, however, between the Big Four.

⁵³ *'Supermarkets and the planning regime'*, Friends of the Earth, January 2006

7.15 We asked the Big Four to tell us when their land holdings were acquired. From the data we received, we estimate that the average age of undeveloped sites across the Big Four is just over eight years. However, this average age varies considerably between the different companies. Figure 7.12 below illustrates the distribution of ages of undeveloped sites held by the Big Four.

Figure 7.12: Acquisition dates of land purchased but not yet developed aggregated across the Big Four



7.16 As part of our analysis, we also looked at whether the location of undeveloped sites could tell us anything about whether they were held for the purpose of restricting competition. For example, if undeveloped sites were situated close to existing supermarkets, this could give grounds to suspect that they were held with the intention of blocking entry. However, we could not draw any definite conclusions from the analysis, largely because of the difficulty in equating post code area data with actual local markets, and have not included the results in the case for a reference.

Potential for strategic entry barriers

- 7.17 In itself, the existence of significant land banks owned by the Big Four could restrict entry by competitors, given the constraints imposed by the planning system. However, we also wanted to explore allegations that the Big Four might engage in strategic behaviour in order to deter entry.
- 7.18 A first possibility raised with us was that the Big Four could purchase options on land and use these strategically to block entry by other supermarkets. One of the smaller supermarkets provided us with an example of this. It claimed that it was interested in purchasing a site in a particular area but one of the Big Four subsequently bought the site in 2000 and has not developed it since. The same big supermarket operator is now considering bidding for another site in the same location, despite already owning an undeveloped site. The smaller supermarket has argued that this was done with the intention of blocking competition.
- 7.19 Second, it has been argued that supermarkets can submit planning applications to extend or redevelop existing sites in order to block entry of a competitor:
- One of the Big Four claimed that another of the Big Four has blocked planning applications from rival stores in a particular area. Allegedly, it had done this by submitting a planning application for an extension to an existing store in that area which was granted as the existing store is in a town centre location. Effectively, this prevented planning approval being granted for rival stores, due to the perceived need now being met. It has been claimed that this extension has yet to be developed.
 - The same supermarket gave evidence of a rival submitting an application for redevelopment of an existing site, allegedly in response to the supermarket's application for planning permission.
- 7.20 Third, it has been argued that supermarkets have in some cases overbid for sites, in order that incumbents can protect their position. While unconnected with any specific allegations, the CC stated in its 2003

report that 'in a sample of sites where three or more parties were bidding for a site of more than 1,400 square metres, where Tesco won the margin it won by was on average 48 per cent more than the next highest bidder'⁵⁴. Concerns were also expressed to us that overbidding for sites can mean rent and land prices in the area are raised, which in turn could be prohibitive for smaller players.

Restrictive covenants

7.21 Finally, we asked the Big Four to list sites and stores that they have sold since 2000 with restrictive covenants, i.e. where a site has been sold with restrictions on the buyer on its future use and development.

7.22 In total we have identified 75 sites across the Big Four where restrictive covenants have been used. Some of these restrictions have now expired as, in some cases, the covenants only lasted for two or three years, although in other cases the restriction is much longer, with 125 years in force in one instance.

7.23 In each of these cases, we believe that the evidence provides grounds to suspect that the Big Four engaging in strategic behaviour, with the intention of restricting competition at a local level. In this context, it should be noted that sale and purchase agreements where restrictions are accepted by the purchaser as well as or instead of the seller have attracted the attention of competition authorities in the past. For example, under the now repealed Restrictive Trade Practices Act 1976, and related Statutory Instruments, sale and purchase agreements had to be scrutinised individually if restrictions were accepted by purchasers, rather than in most cases being exempt from the provisions of this Act.⁵⁵ Following the Monopolies and Mergers Commission's 1989 report on the supply of beer, in which a number of adverse effects on the public

⁵⁴ Safeway merger report, Competition Commission 2003, paragraph 5.382

⁵⁵ Statutory Instrument 1997 No. 2945 The Restrictive Trade Practices (Non-notifiable Agreements) (Sale and Purchase, Share Subscription and Franchise Agreements) Order 1997

interest were found in relation to the activities of the brewers, brewers were prohibited from requiring that the purchasers of their pubs could not run a competing business in the pubs concerned.

Conclusions on distortions of competition and harm to consumers

7.24 The evidence we have collected suggests that:

- the planning system itself can distort competition, by making entry difficult for new players (specifically through the operation of the 'needs test', which does not take account of the impact of a planning assessment on local competition) and the encouragement of the entry of less efficient retailers;
- the Big Four hold a significant stock of undeveloped land, which could, in principle, act as a barrier to entry at a local level;
- the Big Four have the incentive to engage in strategic behaviour with regard to obtaining planning consents and bidding for land, which could have the effect of restricting competition at a local level; and
- the Big Four have imposed restrictive covenants on sites they have sold, which restrict the future use of those sites in a way which reduces the threat of competition.

7.25 We are aware of counter arguments that some of the Big Four have put to us that they do not hold land with the intention of restricting entry. One of the Big Four claims that its space growth is in line with the overall growth of the grocery retail market. It says that over the last five years it has added 36 per cent of trading space. Of this, replacement stores account for 7 per cent equating to a replacement asset rate of 2 per cent. It also says that much of this additional space relates to non-food. Extensions account for a further 10 per cent growth, with new stores accounting for 20 per cent of its growth. Mintel estimates that over this

period food retailing has grown by 24 per cent.⁵⁶ Accordingly, this supermarket's growth is broadly in line with the growth in consumer spending over this period.

- 7.26 We accept that, given the time needed to achieve planning consent on a site, it is commercially sensible for supermarkets to have a stock of land on which they are trying to obtain planning permission. However, in many cases, sites have been held for longer than might be reasonably expected for the purposes of gaining planning consent. The average age of undeveloped sites, based on information we have been given, is more than eight years; whereas one of the Big Four told us that they expected development of a site to take between 4.5 and six years (from purchase of the site through to store opening). This suggests that sites are being held for several years longer than would be necessary to plan the opening of new stores.
- 7.27 The use of land banks, strategic bidding for sites, and restrictive covenants to restrict the future use of a site, could all act to limit local entry into the market. This in turn could be reasonably expected to lead to consumer harm, through a reduction in local competition and consumer choice. We consider that the threat of new entry in a local market is an essential driver of competition in the grocery retail market both nationally and locally and that everything possible should be done to ensure that sites are available for new competitors.

⁵⁶ Mintel (December 2005), *Convenience Retailing*

8 PROPOSED DECISION ON A REFERENCE

- 8.1 In order to make a market investigation reference, the OFT must have reasonable grounds for suspecting that any feature or combination of features of a market in the UK for goods or services prevents, restricts or distorts competition in connection with the supply of acquisition of any goods or services in the UK or part of the UK (the 'section 131 test'). Where this threshold is met, the OFT has discretion as to whether in fact to make a reference. This section sets out the two stages of our decision-making process.

The section 131 test

- 8.2 On the other hand, previous considerations of the market by the CC, and the evidence that we have collected in the course of our own investigation, do, in our view, raise legitimate concerns that the aspects of pricing behaviour identified and the exercise of buyer power by the major supermarkets may, at least potentially, result in detriments to consumers, either now or in the future. Such detriment may arise out of increased local market concentrations (and associated higher prices to consumers in certain areas) as well as from a reduction of choice associated with the weakening or (in some areas) removal of competition from alternative fascia including in the convenience store sector, or reduction of product choice in individual stores.
- 8.3 As outlined in the previous sections, there are questions about the degree to which competition distortions caused by these features are likely to have significant negative impacts on consumers. This is relevant to discussion of the proportionality of a reference in the following section.
- 8.4 For the purposes of the section 131 test set out in the Act, we would observe that the potential competition concerns with respect to each of the features of the market are interlinked. For example, the constraints imposed by the planning system could, in our view, create conditions in which some supermarkets are able to exercise a degree of local market

power. This in turn affects the possibility that pricing practices might distort competition.

Appropriateness of a reference

8.5 Given our view that the section 131 test for making a reference is met, the decision on whether to make a reference rests on the exercise of the OFT's discretion. The OFT's guidance on market investigation references sets out four criteria that must, in our view, be met before we decide to make a reference:⁵⁷

- **proportionality**—the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it;
- **availability of remedies**—there is a reasonable chance that appropriate remedies will be available;
- **alternative powers**—it would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT; and
- **undertakings in lieu**—it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference;

8.6 These four factors are considered below.

Proportionality

8.7 A critical factor in assessing whether a reference is appropriate is whether it is proportionate to the scale of the concerns identified.

⁵⁷ OFT 511, 'Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.1

- 8.8 We recognise that a reference to the CC would have considerable resource implications for the CC itself, and impose a substantial burden on the businesses affected, particularly in terms of management time. The market for groceries in the UK is, however, worth some £120 billion annually and represents around 13 per cent of expenditure for the average household (and more for lower income groups). The benefits of remedying any adverse effects which might be found to exist could, therefore, be expected to outweigh these costs.
- 8.9 We have also taken into account that many of the concerns raised by the ACS and others are not new, and were examined in detail by the CC in 2000, with remedies being imposed where appropriate. The rapid development of the market since 2000 means, however, that a CC investigation would cover new issues, and would not be restricted to only looking at the large store sector as was the case in its previous investigation.
- 8.10 Our guidance states that we will only make a reference where we have reasonable grounds to suspect that the adverse effects on competition of the features we have identified are significant. In making this assessment we will consider whether these suspected adverse effects are likely to have a significant detrimental effect on consumers through higher prices, lower quality, less choice or less innovation. The guidance goes on to acknowledge the possibility that market features that adversely affect competition may also produce offsetting consumer benefits, and states that where we are confident that these benefits exceed the likely detriment from the adverse effect on competition we will not make a reference. Where, however, there is uncertainty we will normally wish to leave the weighing of benefits and detriments to the CC.
- 8.11 We have substantial evidence that consumers have benefited from competition between the supermarkets and their expansion into the convenience store sector, through falling prices, an apparent increase in choice and improving quality. This is not enough, in itself, however, to conclude that there are no significant competition concerns, particularly at local levels. We acknowledge that the way in which the convenience

sector has developed, in particular the entry of some of the Big Four through acquisition, may have reinforced their market power in local areas so as to restrict competition in that sector. So far as larger stores are concerned, barriers to entry and expansion may mean that competition is prevented, restricted, or distorted.

- 8.12 With respect to the specific features discussed in Chapters 5-7, we believe that there are strong grounds for believing that, in particular, the planning and land issues we have identified not only restrict competition, but also have the potential to cause, or may already have caused, harm to consumers. The planning system reinforces concerns around local market power, and opens up the real possibility that consumers are being prevented from having a reasonable choice of outlets at a local level.
- 8.13 As discussed in Chapters 6 and 7, our view is that the likely impact on consumers of below-cost selling and price flexing and the exercise of buyer power is less clear. Broadly speaking, in many situations, price discrimination (both across products and across locations) can play a key role in a genuinely competitive process, to the benefit of consumers overall. Similarly, the exercise of buyer power can, at least where there is effective competition at the retail level, benefit consumers through lower prices. We have found very little specific evidence to suggest that the Big Four's pricing behaviour or buyer power are currently harming consumers.
- 8.14 On the other hand, previous considerations of the market by the CC, and the evidence that we have collected in the course of our own investigation, do, in our view, raise legitimate concerns that the aspects of pricing behaviour identified and the exercise of buyer power by the major supermarkets may, at least potentially, result in detriments to consumers, either now or in the future, by contributing to local market concentrations (and associated higher prices to consumers in certain areas) as well as to a reduction of choice associated with the weakening or (in some areas) removal of competition from alternative fascia including in the convenience store sector.

8.15 Taking all these factors into account, we believe that a reference, which would allow the CC to investigate these issues in more detail and assess the extent to which any adverse effects on competition identified may lead to harm to consumers, is a proportionate response to the concerns which have been raised about this market.

Availability of remedies

8.16 A second factor we have considered is whether there could be appropriate remedies available to meet the competition concerns we have outlined. In view of the interrelationship between the features of the market that we suspect to be distorting competition, it may be that the CC would consider it appropriate to impose remedies in relation to one feature (e.g. strategic behaviour in relation to planning issues) that had a knock-on impact on other features (e.g. local price flexing), as opposed to trying to address remedies to each individual feature in isolation.

8.17 Remedies to address the concerns regarding the planning regime would have to be in the form of recommendations to Government. Neither the CC nor the OFT could impose direct remedies. A possible approach might be to allow or require decisions on planning permission to take into account the fascias of any planning applicants.

8.18 On land banks, the CC could require divestment of land if it concluded there were particular concerns about entry barriers. Similarly the CC could impose constraints on the use of restrictive covenants in relation to food retail sites, particularly in areas where there is local concern. The CC could possibly also require that planning applications are submitted within a certain time from the acquisition of the land and that sites are developed within a certain time from obtaining planning permission.

8.19 On pricing behaviour, the CC's 2000 report found that below-cost selling was distorting competition but found no remedy that would improve the overall outcome for consumers. The ACS has stated that the OFT should look at the effectiveness of measures taken in other countries since 2000. (France, Germany, Spain, Italy, Austria, Portugal and Ireland).

- 8.20 An OECD report of 23 February 2006 on a recent discussion of regulations prohibiting below-cost selling expressed scepticism on the benefits to consumers of such laws and said that they could harm consumer interest.⁵⁸ The OECD said that resale below cost laws raise the floor on the pricing that a dominant firm can undertake above the predation standard. The OECD went to on to say that quite often the explicit purpose of such laws is to protect smaller competitors and that comes at a price for consumers; e.g. the Irish Competition Authority's recent estimate that removing below-cost selling restrictions (imposed by the Groceries Order) would save an average household up to 500 Euro over 12 months. These considerations suggest that remedies targeted at below cost selling in isolation might harm consumers' interests in lower prices, in order to achieve the aim of preserving diversity in the market.
- 8.21 If price flexing were thought to be distorting competition and harming consumers, there are some available remedies that the CC could use, including mandating national price lists. However, we note that the CC discussed and rejected a number of possible remedies to local price flexing in its 2000 report.⁵⁹ The CC would clearly have to consider carefully the costs and benefits to consumers of implementing such options in the light of the increased market concentration and other changes that have taken place in recent years.
- 8.22 Remedies suggested by the ACS (and others) to address buyer power might include publishing transparent price lists, publishing terms of agreements with suppliers, and revising the Supermarkets Code of Practice. The CC would naturally need to assess the impact of these potential remedies on consumers.
- 8.23 In summary, remedies are, in theory, available in respect of all identified features of the market. In some cases we would question whether these remedies would benefit consumers – particularly any aimed at a ban on

⁵⁸ Source: Directorate for Financial and Enterprise Affairs Competition Committee - Resale below cost laws and regulations (23 February 2006) – see <http://www.oecd.org/dataoecd/13/30/36162664.pdf>

⁵⁹ At paragraphs 2.566 to 2.577

below-cost selling. However, remedies that address some features may also reduce harmful effects of others and there is a legitimate argument that the CC should be allowed to decide on whether to apply the remedies in the light of developments in the market since 2000.

Alternative powers

- 8.24 We have considered whether it would be more appropriate for the OFT to use alternative powers to deal with certain features of the market identified above.
- 8.25 If below-cost selling or price flexing could be shown to constitute the abuse of a dominant position in a local market by means of predatory or selective pricing it would be appropriate to pursue this under Chapter II of the CA98.⁶⁰ However, the concerns about pricing behaviour by the Big Four in the market for the supply of groceries are not merely local matters, nor dependent on the existence of positions of 'dominance' within the meaning of the CA98, but relate to the process of competition between undertakings in the market as a whole.
- 8.26 In relation to concerns about buyer power, we are not aware of any alternative powers that the OFT could use. The Supermarkets Code of Practice already exists to regulate the relations between the Big Four and their suppliers. However, this does not deal with any concerns that may exist in relation to the impact of buyer power on the structure of the downstream retail market. Changes to the Code to address the current state of the market could only be made by the CC itself, following a reference.
- 8.27 In relation to land and planning issues, we considered carefully the possibility that the OFT could carry out its own market study into the planning system, rather than making a reference to the CC. Asda called

⁶⁰Chapter II of the CA98 states that '...any conduct on the part of one or more undertakings which amounts to an abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.'

publicly for us to follow this approach. We considered arguments that a market study would be able to look more widely than supermarkets (i.e. looking at the whole issue of retail planning), and that the OFT's less formal processes in a market study might make it easier for the OFT to advocate change within government. There would, however, be nothing to stop the CC from considering planning issues as part of a market investigation, and making similar recommendations to government; and any suggestions made in respect of supermarket planning issues might be expected to have knock-on effects on wider planning concerns.

- 8.28 Most importantly, there are no clear alternatives to a market investigation reference in considering the concerns about land banking and restrictive covenants. Exclusion of land agreements from the Chapter I prohibition virtually rules out the possibility of Chapter I enforcement at least in relation to land-banking per se. It is questionable whether agreements for the sale of land that include restrictive covenants governing potential retailing activities by the purchaser are caught by the Competition Act 1998 (Land Agreements Exclusion and Revocation) Order 2004. Similarly, enforcement under Chapter II directed at the acquisition or retention of land by a major supermarket would be likely to be extremely difficult, and would need to be pursued on a case by case basis. An OFT market study of planning could look at land banks but, given that the powers in section 174 of the EA02 can only be exercised for the purposes of assisting it in deciding whether to make a reference under section 131 or to accept undertakings in lieu under section 154, we could not demand information from parties and we would not be able to impose remedies (such as divestment of land). There is no indication at present that any individual agreement or network of agreements, or conduct meet the threshold for enforcement of Article 81 and/or Article 82 of the EC Treaty or of the CA98.
- 8.29 Overall, we have concluded that a market investigation reference would be the most appropriate route for addressing the concerns raised about competition in the market.

Undertakings in lieu

8.30 Finally, we need to take account of possible undertakings in lieu of a reference that could be offered by the supermarkets to address the concerns raised without the need for a market investigation reference. Given the complex interrelationship between the features of the market that we have identified as a cause of concern, we believe it is unlikely that undertakings offered at this stage would be able satisfactorily to address the concerns. However, we would consider any undertakings that were offered by parties in the light of this consultation.

Conclusions on the case for a reference

8.31 Taking account of all the relevant factors outlined in the OFT's guidance document on market investigation references, we believe that the balance of arguments points in favour of exercising our discretion to make a reference to the CC.