Department for Business Innovation & Skills

GROCERIES CODE ADJUDICATOR

Impact Assessment

MAY 2011

Title: **Groceries Code Adjudicator** **Lead department or agency:** Department of Business, Innovation & Skills **Other departments or agencies:**	Impact Assessment (IA)
	IA No: BIS0116
	Date: 09/05/2011
	Stage: Final
	Source of intervention: Domestic
	Type of measure: Primary legislation
	Contact for enquiries: Chris Hopkins (020) 7215 0881

Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

In its investigation of the UK groceries market, the Competition Commission (CC) found that large grocery retailers were transferring excessive risks and unexpected costs to suppliers, by exercising their buyer power. The CC considered that this might have an adverse effect on suppliers' ability to invest and innovate, which could ultimately reduce choice and value and/or increase prices for consumers, relative to a well-functioning market. Under certain circumstances, retailers may have less incentive to take action to mitigate such risks, giving rise to moral hazard. Having failed to agree voluntary undertakings to establish a body to monitor and enforce the Grocery Supply Code of Practice (GSCOP), the CC has recommended that BIS set up such a body.

What are the policy objectives and the intended effects?

The principal objective of the GCA is to ensure the effectiveness of the GSCOP through monitoring and enforcement, preventing the practice of supply chain behaviour by grocery retailers, identified by the CC, which has an adverse impact on the willingness of suppliers to invest and innovate.

The intended effects are that the GSCOP will be appropriately monitored and there will be an avenue for suppliers to seek redress.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Two options are considered against the do nothing:

- Option 1: Establishing a Groceries Code Adjudicator with the power to protect the identity of suppliers (both direct and indirect) who make complaints by treating them confidentially.
- Option 2: Whether the Groceries Code Adjudicator should have the power to levy penalties as well as to protect the identity of suppliers (both direct and indirect) who make complaints by treating them confidentially.

The options being take forward is Option 1 – i.e. the adjudicator will be set up as a statutory office holder within the Department for Business, Innovation and Skills, with the power to protect the identity of suppliers (both direct and indirect) who make complaints by treating them confidentially, and that (option 2) powers will be provided for Government to introduce financial penalties at a later date if it's found to be necessary.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 3 years after set up **What is the basis for this review?** PIR. **If applicable, set sunset clause date:** Month/Year	
Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	Yes

Ministerial Sign-off For final proposal stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister: Edward Davey Date: 13/05/11

Summary: Analysis and Evidence

Policy Option 1

Description:

Establishing a Groceries Code Adjudicator with the power to protect the identity of suppliers (both direct and indirect) who make complaints by treating them confidentially.

Price Base Year 2011	PV Base Year 2013	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -13.9	**High:** -27.8	**Best Estimate: -17.4**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.1	1	1.6	**13.9**
High	0.2		3.2	**27.8**
Best Estimate	**0.2**		**2**	**17.4**

Description and scale of key monetised costs by 'main affected groups'

The transition costs of setting up the body are estimated to be £0.2m. The operational costs of the body are estimated to be £0.8m per annum. The other costs would be those incurred by retailers as the GCA carries out investigations on the basis of complaints received which are estimated to be £120k per retailer covered by the GSCOP (i.e. £1.2 million per year in total). However, these costs may vary, depending on the number of complaints the adjudicator receives and the number investigations it chooses to carry out.

Other key non-monetised costs by 'main affected groups'

The costs of arbitration for the retailers are not included in this impact assessment as these from part of the do nothing option, and are thus not additional. However, under the assumption of two arbitrations a year, one complex and one simpler, arbitrations are estimated to cost £66k per annum.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0		Unquantified	**Unquantified**

Description and scale of key monetised benefits by 'main affected groups'

The benefits associated with this option are those resulting from a potential improvement in investment and innovation within the groceries supply chain, which could ultimately lead to improvements in quality and choice for consumers, as well as lower prices in the long run. Although the CC agree with BIS that it has not been possible to quantify the potential improvement in investment and innovation and its consequent impacts, this will be monitored in the future and any refinements will be addressed as part of the post implementation review.

Other key non-monetised benefits by 'main affected groups'

Where action by retailers transferring excessive risks to upstream grocery suppliers has contributed to their going out of business (generating costs through job losses and loss of livelihood), there could be some benefits under this option if such actions are prohibited (and hence the associated costs of supplier exit are avoided). However, it has not been possible to quantify these.

Key assumptions/sensitivities/risks | **Discount rate (%)** 3.5

The main assumption impacting on both the benefits and costs is the number of investigations undertaken (and disputes arbitrated) by the adjudicator. As both costs and benefits are non-negative, this implicitly assumes that compliance will be below 100%. If all of the grocery retailers regulated by the Code are fully compliant, then the number of complaints (and therefore the costs under this option) would most likely tend to the operating costs of the body in the short run and zero in the long term, though this is unlikely. A potential risk is that the establishment of the adjudicator does not lead to any improvement in the conduct of retailers in relation to their suppliers. This would render the intended remedy to the CC's findings redundant – i.e. generating costs for retailers but no benefits.

Direct impact on business (Equivalent Annual) £m):			In scope of OIOO?	Measure qualifies as
Costs: 2.1	**Benefits:** 0	**Net:** 2.1	Yes	IN

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			01/04/2013		
Which organisation(s) will enforce the policy?			GCA		
What is the annual change in enforcement cost (£m)?			£0.8m		
Does enforcement comply with Hampton principles?			Yes		
Does implementation go beyond minimum EU requirements?			N/A		
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** n/a		**Non-traded:** n/a
Does the proposal have an impact on competition?			No		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			**Costs:** 100		**Benefits:** 100
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large** 100
Are any of these organisations exempt?	Yes	Yes	Yes	Yes	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on…?	**Impact**	**Page ref within IA**
Statutory equality duties[1] Statutory Equality Duties Impact Test guidance	No	34
Economic impacts		
Competition Competition Assessment Impact Test guidance	Yes	33
Small firms Small Firms Impact Test guidance	Yes	33
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	34
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	34
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	34
Human rights Human Rights Impact Test guidance	No	34
Justice system Justice Impact Test guidance	No	34
Rural proofing Rural Proofing Impact Test guidance	Yes	34
Sustainable development Sustainable Development Impact Test guidance	Yes	34

[1] Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Summary: Analysis and Evidence
Policy Option 2

Description:

Whether the Groceries Code Adjudicator should have the power to levy penalties as well as to protect the identity of suppliers (both direct and indirect) who make complaints by treating them confidentially.

Price Base	PV Base	Time Period	Net Benefit (Present Value (PV)) (£m)		
Year 2011	**Year** 2013	**Years** 10	**Low:** -16	**High:** -35	**Best Estimate:- -22**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	0.1	1	1.8	**15.6**
High	0.2		4	**34.7**
Best Estimate	0.2		2.5	**21.7**

Description and scale of key monetised costs by 'main affected groups'

The costs identified in option 1 will also apply in this option. As regards ongoing costs, in the absence of any better information, we have conservatively assumed that the costs of an appeal will be roughly £200,000 per case (£100,000 of costs to Government for staff time/overheads, £100,000 of legal costs for parties) and that there are between 1 and 4 appeals per year, so an additional cost of £0.2m-£0.8m a year.

Other key non-monetised costs by 'main affected groups'

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0		Unquantified	**Unquantified**

Description and scale of key monetised benefits by 'main affected groups'

In addition to the deterrence effect associated with negative publicity under the base case, if this is insufficient, penalty powers will increase the potential cost to retailers of not complying with GSCOP, and hence should increase the incentive for retailers to comply with the GSCOP. It has been assumed that this marginal impact on compliance has had the effect of improving compliance up to 100%, which could eliminate the cost associated with investigations and dispute resolution.

Other key non-monetised benefits by 'main affected groups'

A potential additional benefit under this option is the avoided costs for individual complainants of undertaking a follow-on action (in the absence of penalty powers) to cover punitive elements of a breach of GSCOP, which evidence indicates could be £250,000-£300,000 per case. However, as we do not have any data on the likely number of follow-on actions, this is very difficult to quantify. There is also realisation of benefits under full enforcement of the GSCOP, though these are unquantified.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Assumptions have been made about the cost of an appeal case and the likely number of appeals in a given year. However, the appeal costs per case could be significantly higher and the number of appeal cases per year could be much higher. For example, a response to the BIS consultation suggested that the new requirement to have agreements in writing would make breaches of GSCOP more clear-cut and easier to identify, leading to a low incidence of appeals.

Direct impact on business (Equivalent Annual) £m):			In scope of OIOO?	Measure qualifies as
Costs: 2.5	**Benefits:** 0	**Net:** 2.5	Yes	IN

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			01/04/2013		
Which organisation(s) will enforce the policy?			GCA		
What is the annual change in enforcement cost (£m)?			£1.1m		
Does enforcement comply with Hampton principles?			Yes		
Does implementation go beyond minimum EU requirements?			No		
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** n/a	**Non-traded:** n/a	
Does the proposal have an impact on competition?			No		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			**Costs:** 80	**Benefits:** 0	
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large** 100
Are any of these organisations exempt?	Yes	Yes	Yes	Yes	No

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Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

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Justice system Justice Impact Test guidance	No	34
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Sustainable development Sustainable Development Impact Test guidance	Yes	34

[1] Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessments of earlier stages (e.g. Consultation, Final, Enactment) and those of the matching IN or OUTs measures.

No.	Legislation or publication
1	Consultation on taking forward the establishment of a body to monitor and enforce compliance with the groceries supply code of practice (GSCOP) Impact Assessment
2	Government response to consultation on taking forward the establishment of a body to monitor and enforce compliance with the groceries supply code of practice (GSCOP) Impact Assessment
3	Repeal of Property Misdescriptions Act 1991 Impact Assessment
4	

+ Add another row

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7	Y_8	Y_9
Transition costs	0.2									
Annual recurring cost	2	2	2	2	2	2	2	2	2	2
Total annual costs	2.2	2	2	2	2	2	2	2	2	2
Transition benefits										
Annual recurring benefits										
Total annual benefits										

* For non-monetised benefits please see summary pages and main evidence base section

Evidence Base (for summary sheets)

Introduction

1. Chapter 5 (Consumer Protection) of the Coalition Agreement states, "We will introduce, as a first step, an Ombudsman in the Office of Fair Trading who can proactively enforce the Grocery Supply Code of Practice and curb abuses of power, which undermine our farmers and act against the long-term interest of consumers".

2. The introduction of the Groceries Code Adjudicator to enforce the Groceries Supply Code of Practice through the Groceries Code Adjudicator Bill forms part of the Department for Business, Innovation and Skills' 2011-2015 Business Plan. Structural reform priority 9 (Protect and Empower Consumers), Action 9.3 (Introduce stronger consumer protections) sets this out. This IA accompanies the Bill in Parliament, and if applicable, it may be updated at key stages of the Bill, before the Bill is enacted.

Overview

3. On 9 May 2006, the Office of Fair Trading (OFT) referred the supply of groceries by retailers in the UK to the Competition Commission (CC) for investigation. The CC had previously conducted an inquiry into the grocery retailing sector in 2000, stemming from criticisms of the prices and profits of UK grocery retailers during the late 1990s. During that investigation, the CC uncovered supermarket practices that were operating against the public interest in terms of the behaviour of five grocery retailers (Asda, Safeway, Somerfield, Sainsbury's and Tesco) towards their suppliers. This led to the establishment of the Supermarket Code of Practice (SCOP)[1] which regulated the conduct of the (now) four largest grocery retailers (Asda, Morrisons, Sainsbury's and Tesco)[2] with respect to their suppliers.

4. Following the 2000 investigation, the OFT continued to provide oversight of the SCOP and also conducted competition assessments of various mergers (e.g. Safeway and Somerfield).[3] In carrying out its responsibilities, the OFT continued to receive complaints and representations about grocery retailing with regards to the operation of SCOP, pressures facing convenience stores and the market position of Tesco. In response to continuing concerns about the effectiveness of the SCOP, the OFT commissioned and published the results of a compliance audit in 2005.[4]

5. In addition to inviting parties to present evidence related to the SCOP audit, the OFT also invited evidence on whether there were aspects of the supply of groceries by retailers that adversely affected competition. The OFT initially decided that there was no ground for a market investigation but following a challenge of this decision in the Competition Appeal Tribunal (CAT) by the Association of Convenience Stores (ACS) and Friends of the Earth, the OFT withdrew its decision. After further investigation the OFT referred a market investigation to the CC in May 2006.

6. On 30 April 2008, the CC published its final report (hereafter referred to as the 'CC report').[5] It found that, in many respects, competition in the UK groceries industry is effective and delivers good outcomes for consumers. However, among other findings, there were concerns that grocery retailers transfer excessive risk and unexpected costs to their suppliers through various supply chain practices. This resulted in an Adverse Effect on Competition (AEC) and the CC proposed the following remedies:

   - A new strengthened code of practice – the Grocery Supply Code of Practice (GSCOP) established by the Groceries Market (Supply Chain Practices) Investigation Order 2009;

   - A Supermarkets Ombudsman to oversee and enforce the GSCOP, and to arbitrate disputes arising under it.

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[1] http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538_9_7.pdf

[2] Somerfield was one of the original five but did not become a signatory of SCOP because its market share was less than 8 per cent, the threshold at which the CC decided that the SCOP should apply.

[3] Morrisons' proposed acquisition of Safeway in 2003 (http://www.oft.gov.uk/shared_oft/mergers/morrison.pdf) and Somerfield's acquisition of 114 stores from Morrisons in 2005 (http://www.oft.gov.uk/shared_oft/mergers_ea02/2005/somerfieldmorrisonsdecision.pdf)

[4] OFT, *Supermarkets: The code of practice and other competition issues*, OFT783, March 2005.

[5] http://www.competition-commission.org.uk/rep_pub/reports/2008/538grocery.htm

7. In August 2009, the CC concluded consultation on these remedies and established the GSCOP (or Code) using its powers under the Enterprise Act (2002). It also recommended that the Government establish a GSCOP Ombudsman, with the powers to impose penalties for breaches of the Code, after retailers failed to voluntarily establish such a body.[6] The Government's response, published on 13 January 2010, accepted the need for an enforcement body to monitor and enforce the Code.[7]

8. Since the end of the consultation, a new Government has been elected. In the coalition agreement, the Government stated its intention to introduce an Ombudsman based within the OFT to "proactively enforce" the GSCOP (i.e. not to create a new body).[8] However, as the Government is consulting on merging the OFT and CC, it has been decided to create the GCA as a statutory office holder in BIS. It is the Government's intention that the GCA would be transferred to the proposed Competition and Markets Authority at a later date, although would remain independent of its other functions.

9. Taking into account the evidence provided by responses to the consultation, Government expects that the deterrent which will have the greatest impact on changes in behaviour, is that of reputation. However, powers will be provided in the primary legislation for the Government to introduce financial penalties should future experience indicate that reputation alone is not sufficient. In relation to complaints, Government has decided that the body should have the power to receive anonymous complaints from anyone in the supply chain. This includes farmers who may not directly supply the relevant retailers and is in line with the Coalition Programme.

Background

10. In 2009, an estimated £146.3 billion of grocery sales were made through 93,000 grocery stores in the UK. It is an important sector, with food and grocery expenditure accounting for over half of total retail spending.[9] Groceries include food, pet food, drinks, cleaning products, toiletries and household goods.[10]

11. The CC identified seven major categories of grocery retailer in the UK.

- **Large grocery retailers** carry a full range of grocery products and have an integrated wholesaling function that purchases directly from food and drink manufacturers.[11] There are currently eight large grocery retailer brands: Asda; Morrisons; Co-operative Group Limited (CGL, which now also incorporates Somerfield); Marks and Spencer (M&S); Sainsbury's; Tesco and Waitrose.

- **Regional grocery retailers** (e.g. Booths in north-west England, Dunnes in Northern Ireland and regional Co-ops) operate in a particular part of the UK with mid-sized and/or larger grocery stores and may also operate convenience stores. They carry a full range of grocery products and generally use wholesalers to sources supplies or use buying groups to negotiate on their behalf with their suppliers.

- **Symbol group retailers** (e.g. Spar, Londis and Costcutter) operate stores under a common fascia (or symbol). They may be independently owned or directly owned by the symbol group or affiliated wholesalers. Symbol group retailers generally source supplies through affiliated wholesalers.

- **Convenience store operators** are all operators of convenience stores (smaller than 280 square metres) and include large grocery retailers, regional grocery retailers, symbol group retailers and independent non-affiliated convenience store operators. According to IGD, there are approximately 50,000 convenience stores in the UK (see below).

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[6] http://www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/gscop_2_bis_letter.pdf

[7] http://www.berr.gov.uk/files/file54194.pdf

[8] http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf

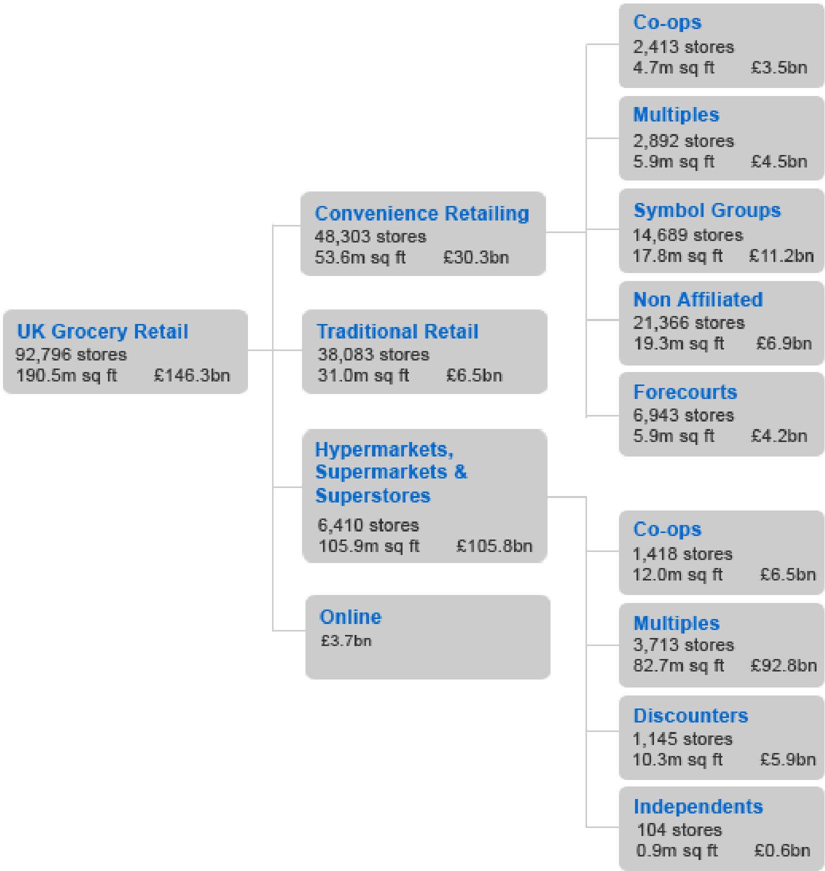
[9] http://www.igd.com/index.asp?id=1&fid=1&sid=17&tid=0&folid=0&cid=94

[10] This is the definition of groceries that was given in the CC's terms of reference and does *not* include: petrol, clothing, DIY products, financial services, pharmaceuticals, newspapers and magazines, greetings cards, CDs, DVDs, videos and audio tapes, toys, plants, flowers, perfumes, cosmetics, electrical appliances, kitchen hardware, gardening equipment, books, tobacco and tobacco products.

[11] Large grocery retailers, however, tend to purchase fresh produce from produce wholesalers rather than directly from primary producers

- **Limited Assortment Discounters** (LADs) carry a limited range of grocery products and base their retail offer on selling these products at competitive prices. The three major LADs in the UK are Aldi, Lidl and Netto.
- **Frozen food retailers** (e.g. Iceland and Farmfoods) specialise in the sale of frozen foods and generally carry a limited range of other grocery products.
- **Specialist grocery retailers** primarily sell an individual grocery product category and include bakeries, budget retailers, greengrocers and off-licences.

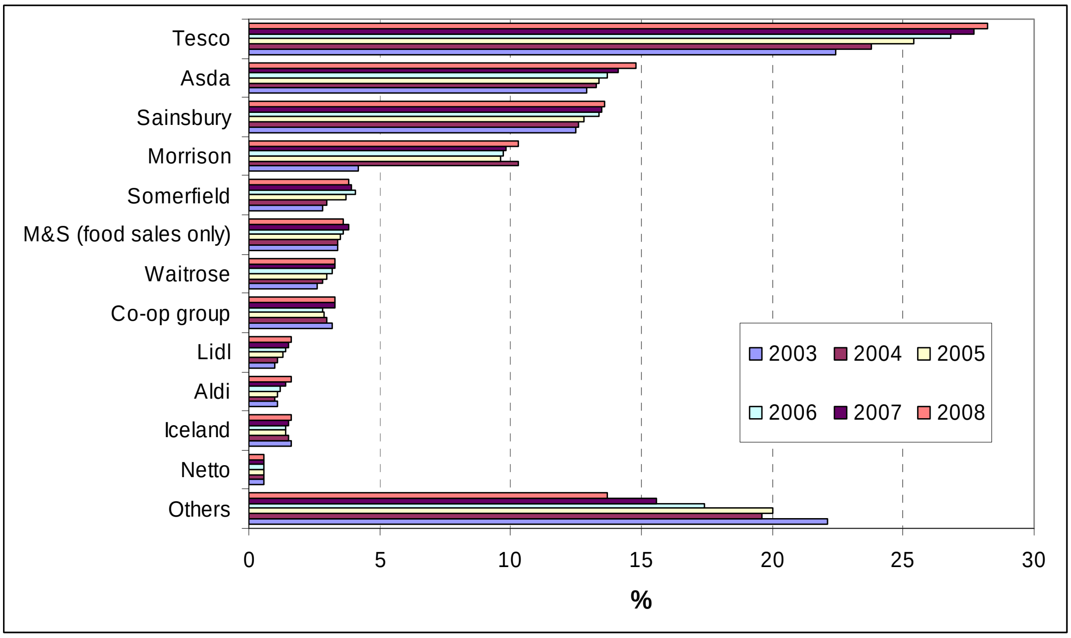
Figure 1: UK grocery retailing – store numbers & sector value



Source: IGD research (2009)

12. In 2008, large grocery retailers accounted for approximately 85% of the total grocery market, with the biggest four (Asda, Morrisons, Sainsbury's and Tesco) accounting for two-thirds of the total. Figure 2 shows how market shares have developed since 2003, with a notable increase for Tesco and Morrisons (with the latter primarily due to the acquisition of Safeway in 2004).

Figure 2: Market shares by grocery retailer, 2003-2008



Source: Verdict – UK food & grocery retailers 2009

The UK groceries supply chain

13. As stated earlier, large grocery retailers purchase most goods directly from food and drink manufacturers while regional retailers, symbol group retailers and convenience store operators tend to purchase goods through wholesalers and buying groups. The latter are affiliations of several wholesalers that have been established to obtain more favourable terms from suppliers. The value of the groceries supply chain is of the order of £70 billion in annual sales to grocery retailers.[12]

14. There are a large number of firms that supply groceries to UK retailers, including food and drink manufacturers, primary producers and fresh food wholesalers (e.g. packers and processors). There are approximately 311,000 farm holdings, 3,600 fresh food intermediaries and 6,600 food and drink manufacturers in the UK (although not all of these necessarily supply grocery retailers).[13]

15. According to the CC, grocery retailers purchase relatively little of their fresh produce directly from UK farmers, as most of it is supplied through intermediaries such as packers, processors and fresh food wholesalers. Retailers told the CC that this is a more efficient method than dealing individually with a large number of farmers and intermediaries have a greater ability to source alternative supplies where there is a shortfall in domestic production. In 2006, six large grocery retailers (Asda, M&S, Morrisons, Sainsbury's, Somerfield and Tesco) informed the CC that the combined value of their direct purchases from farmers amounted to approximately £295 million. This compares to £14.3 billion in total agricultural production annually and £16.7 billion in fresh food sales by those grocery retailers in total.[14]

16. Nevertheless, the limited value of direct purchases by grocery retailers from primary producers can understate the importance of their relationship. Farmers may be members of, or shareholders in, intermediary businesses that market their produce to grocery retailers. Furthermore, the figure of £295 million does not include transactions with processors that are vertically integrated with primary production.

17. There is large variation in the size of businesses supplying grocery retailers. Suppliers include branded goods' producers such as Coca-Cola, Unilever, Kimberly-Clark and Procter & Gamble as well as small businesses and primary producers. Figure 3 shows the proportion of suppliers to grocery retailers according to their revenue. Comparing the revenues of grocery retailers and

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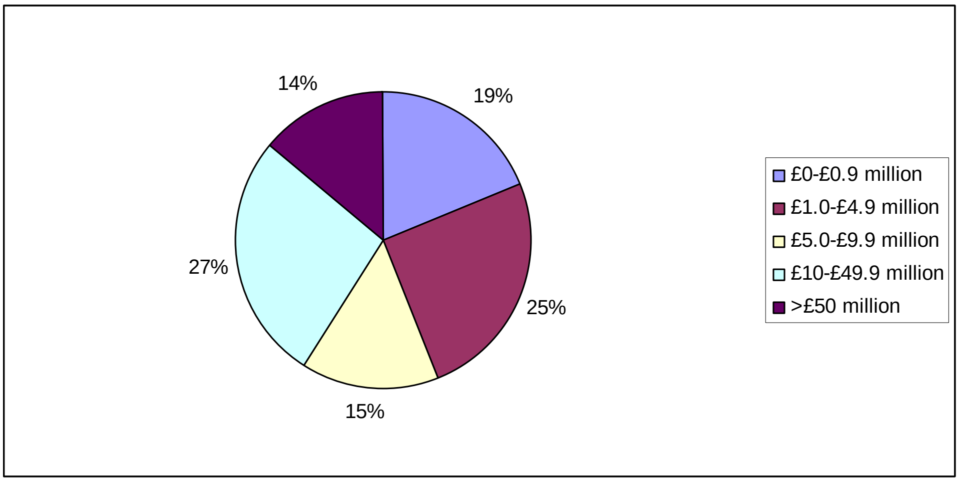
[12] CC report, paragraph 10.16

[13] CC Report, paragraph 3.31

[14] CC Report, paragraph 3.32

suppliers, it is clear that the majority of the latter are of a smaller size, with almost 60% having annual revenue below £10 million.

Figure 3: Suppliers to UK grocery retailers, by grocery revenue



Source: GfK, Research on suppliers to the UK grocery market: A Report for the Competition Commission, January 2007
Note: The GfK sample size was 426 suppliers

Rationale

18. Buyer power is a form of market power that a firm – in this case a grocery retailer – is able to exercise in relation to its suppliers. Exercising this power allows the grocery retailer to extract a better deal from its suppliers than would otherwise be the case, for example by obtaining lower prices or preferable purchasing terms from the supplier.

19. In general, the exercise of buyer power by grocery retailers is likely to have positive implications for consumers. For example, if retailers pass on the lower prices they obtain from suppliers (through the exercise of buyer power) this can result in lower retail prices for consumers. In addition, grocery retailers' buyer power may act as a countervailing force to any market power possessed by suppliers. Furthermore, the exercise of buyer power can spur innovation in the supply chain by creating incentives for suppliers to develop new products and ensure that their operations are cost-efficient.

20. However, the exercise of buyer power by grocery retailers (and wholesalers or buying groups) may have a detrimental effect on suppliers – for example, a supplier is likely to earn a smaller profit margin on goods sold to a grocery retailer with buyer power than those sold to grocery retailers that do not have buyer power. As outlined in the evidence above, grocery retailers account for a significant proportion of the total potential market for suppliers, limiting their opportunities to sell to other customers.

21. In particular, the exercise of buyer power by grocery retailers may raise concerns in certain limited circumstances if it allows retailers to impose excessive risks and unexpected costs on suppliers, which reduces suppliers' incentive or ability to invest and innovate. In the long run, this could lead to reduced capacity, reduced product quality and fewer new product offerings, and ultimately, a detriment to consumers.

22. In assessing the behaviour of grocery retailers in relation to suppliers, the CC particularly looked at the supply chain practices of grocery retailers that might transfer excessive risks or unexpected costs on suppliers and thereby reduce supplier investment and innovation, when compared with the levels of investment and innovation that would be observed in a well-functioning market.

23. In their analysis, the CC concluded that there are circumstances where allocations of risk may be agreed up-front between a retailer and supplier, but that the extent of risk transferred to the supplier is excessive. In particular, the CC raised concerns regarding the transfer of risk from grocery retailers to suppliers in situations where this transfer gives rise to 'moral hazard'.

24. In this case, such a situation arises where the retailer has the ability to affect the degree of risk incurred, but as a result of the transfer, the retailer has less incentive to minimize that risk. In these situations, the transfer of risk increases the total risk borne by the parties, and also increases the costs to the supplier. As an example of this, the CC references practices whereby retailers may impose liability for losses suffered as a result of 'shrinkage' (i.e. losses that arise where stock is lower than it should be, due to theft, the goods being lost or accounting error) on some of its suppliers. The CC felt that suppliers had almost no capacity to address losses due to shrinkage and that retailers were best placed to control risks associated with shrinkage (e.g. by improving security at depots or stores, or improving stock accounting procedures).

Issue

Existence of buyer power in the groceries supply chain

25. The CC study concluded that large grocery retailers (and some large wholesalers and buying groups) have buyer power in relation to at least some of their suppliers, although it could be offset by the market power possessed by suppliers of the most prominent branded goods. This conclusion was based on the fact that the majority of suppliers have significantly fewer sales than most of the retailers and because large retailers generally pay lower prices for grocery products. An econometric analysis showed that the four largest grocery retailers paid, on average, between 4 and 6 per cent less than the mean.[15] By contrast, large wholesalers pay, on average 2 to 3 per cent above the mean while small wholesalers pay prices that are, on average, 8 to 9 per cent above the mean. Further support for the existence of buyer power in the grocery market was provided by a supplier survey, commissioned by the CC as part of its investigation (see Table 1).

Table 1: Supplier customers from whom the lowest gross margins are received

Customers from whom the lower gross margins are received	%
Any of the four largest grocery retailers	53
Any other grocery retailers	17
Wholesalers/buying groups	8
Independent retailer	6

Source: GfK, Research on suppliers to the grocery market: A Report for the Competition Commission, January 2007

Supply chain practices that may affect supplier investment and innovation

26. Grocery suppliers make investments in an uncertain commercial environment where demand may fall or costs may rise unexpectedly. Investment decisions are made by estimating the likely returns and balancing this against the risks involved. The supply chain practices of grocery retailers are likely to have an important bearing on this calculation. In particular, if they transfer more risk and greater cost to suppliers then it may diminish suppliers' incentives to invest in new products, capacity or production processes.

27. The transfer of risks or costs between grocery retailers and suppliers is not necessarily a problem, but if excessive risks or unexpected costs are transferred, these may affect suppliers' willingness to invest or innovate. In deciding which supply chain practices might give rise to the transfer of excessive risks or unexpected costs, the CC considered both complaints submitted to them by suppliers regarding grocery retailers' conduct and evidence from suppliers as to the supply chain practices that would be most prone to reduce their investment or innovation.

28. Of the 52 practices considered by the CC during its investigation, it found that half had the potential to result in the transfer of excessive risks or unexpected costs from grocery retailers to suppliers.[16] In some cases, the impact of these practices depends on the specific way in which the practice is

[15] CC Report, Appendix 5.3: http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538_5_3.pdf

[16] These 52 practices refer to specific supply chain practices of grocery retailers that were identified in the CC's 2000 investigation. A full list of these can be found in Annex 3 of Appendix 9.8 of the CC's final report (http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538_9_8.pdf)

carried out by a grocery retailer. In other cases, certain practices will almost always have this effect.

29. The principal manner in which excessive risks or unexpected costs can be transferred from grocery retailers to suppliers is through retailers making retrospective adjustments to the terms of supply. Retrospective changes to previously agreed supply arrangements in favour of retailers will almost always create additional uncertainty, shifting risk and added costs to suppliers.[17]

30. Further, such retrospective adjustments are likely to diminish significantly suppliers' incentives to fund investments for the development of new products or improved production processes. Consequently, suppliers may come to expect that these retrospective changes might take place, hence they may become reluctant to undertake new investment projects. The level of uncertainty will increase as suppliers become unable to determine the nature of these unexpected adjustments, or their frequency, or to quantify their impact on future earnings. There was some support for this in responses to the BIS consultation – one party submitted that retrospective changes can have a significant impact on suppliers' incentives to invest, with even a small loss of investment likely to have significant detrimental impact on consumers.

31. Other practices may initially appear acceptable, but are also open to exploitation by grocery retailers as a means of effectively lowering the price paid to suppliers or transferring excessive risks to suppliers.[18]

32. A number of grocery retailers have made submissions to the CC stating that it is in their interest to establish strong relationships with suppliers and ensure that they invest.[19] The CC determined that while this is in the long-term interest of the retailers, it can be overshadowed by the short-term necessity of extracting the best possible terms and conditions from suppliers in order to compete effectively with other grocery retailers.

33. Effectively, a potential side-effect of competition between retailers with buyer power in the grocery market is reduced incentives to invest and innovate on the part of suppliers, which is also detrimental to consumers in the long run. However, they may have benefited in the short term from buyer power because large grocery retailers have passed lower supplier prices to consumers in the form of lower retail prices. Indeed, retailer responses to the BIS consultation included reference of their obtaining lower retail prices for consumers.

Evidence of supply chain practices

34. On the basis of the evidence collected, the CC concluded that supply chain practices which transfer excessive risks and unexpected costs to suppliers, including through the use of retrospective payments and other adjustments to supply agreements, are sufficiently prevalent to cause concern.

35. In a survey of 50 UK grocery suppliers conducted by Grant Thornton, the effects of commercial uncertainty on suppliers were studied.[20] It was found that:

- 31 per cent of suppliers felt that an order from a large grocery retailer was 'secure' only when the goods had been delivered to the retailer;
- 24 per cent of suppliers reported that they had experienced unexpected last-minute changes or cancellations and had received no form of compensation from the retailer concerned;
- only 50 per cent of suppliers felt highly confident at the time of delivery that the sale price would not be reduced by retrospective contributions sought.

36. One respondent to the BIS consultation submitted that they had received anecdotal evidence of practices resulting in barriers to either new products coming onto the market or scaling up of supply, such as prohibitive payments for listing. It was also suggested that actions that have the

[17] For example, a requirement for a price adjustment after goods have been ordered or after products have been delivered is a typical practice that is a source of unexpected costs to suppliers. Similarly, requirements for financing or promotions that were not agreed in advance with suppliers are also retrospective adjustments that are a source of uncertainty.

[18] For example, it may be quite legitimate for a grocery retailer to deduct sums from a supplier invoice where the supplier has not provided goods to the correct specification or as otherwise agreed between it and the grocery retailer. However, withholding payment either without cause or on a spurious basis may also be a means of imposing unexpected costs on suppliers.

[19] CC Report, paragraph 9.43

[20] Grant Thornton UK LLP (2007), *Redressing the balance: Forging a more certain future for the UK grocery supply chain*, http://www.grant-thornton.co.uk/pdf/11910GTFoodsuppliersreportFINAL.pdf

effect of reducing the profitability (and hence viability) of primary producers are a recurrent complaint amongst suppliers.

Limitations of SCOP in preventing certain supply chain practices

37. Supply chain practices of the largest four grocery retailers are regulated under the SCOP, which was established after the CC's 2000 investigation. The OFT's compliance audit in 2005 did not identify widespread evidence of breaches and few formal complaints were made under the SCOP. There appeared to be concerns that vague terms in the SCOP made it difficult to tell whether the code had been breached and concerns over anonymity. During the CC's recent investigation, 380 concerns were raised by suppliers and supplier associations and almost half were related to the transfer of excessive risks or unexpected costs from grocery retailers to suppliers. One-third were related to requirements for retrospective payments or other adjustments to previously agreed supply arrangements.[21]

38. As part of the CC's supplier survey, evidence was collected from suppliers regarding a number of practices addressed under the SCOP. Table 2 shows that one-third to one-half of suppliers experienced practices such as payment delays, excessive payments for customer complaints and retrospective price adjustments from all grocery retailers (i.e. including retailers not regulated by the SCOP). Retailer responses to the BIS consultation suggest that they believe the reporting of certain retailer practices in the context of the CC inquiry to be overstated.

39. It also shows that SCOP has constrained the largest four retailers' buyer power to some extent but not completely. This is supported by evidence collected by the CC in a round-table discussion with grocery suppliers. The latter claimed that in many cases, retailers not covered by the SCOP sometimes imposed trading conditions that were worse than those imposed by the four largest retailers.[22]

[21] CC Report, paragraph 9.59
[22] CC Report, paragraph 11.280

Table 2: Suppliers reporting various practices (addressed under the SCOP) carried out by grocery retailers in the past five years

Practice reported	All grocery retailers %	Four grocery retailers covered by the SCOP %	Increased frequency in the past 12 months %
Obligatory contributions to the marketing costs of grocery retailers	61	38	53
Delays in receiving payments from a grocery retailer substantially beyond the agreed time	48	28	37
Required to make excessive payments to grocery retailers for customer complaints	48	36	40
Additional services required in relation to packaging and distribution	37	29	49
Requested price reductions for products soon before or after delivery	37	26	58
Obligatory payments in return for stocking or listing products	35	22	33
Not being given standard terms of business by a customer when asked for them	19	12	32

Source: GfK, research on suppliers to the grocery market: A Report for the Competition Commission, January 2007

40. During their investigation, the CC also reviewed correspondence, predominantly email, between two grocery retailers (Asda and Tesco) and their suppliers during the period 18 June and 22 July 2007.[23] This highlighted a number of instances where the retailer did not breach the SCOP but still had the effect of transferring excessive risks or unexpected costs to suppliers. This was either due to the fact that, in most cases, the SCOP regulates a practice (e.g. requires that the retailer undertake the practice reasonably) rather than prohibiting it outright or because the SCOP does not sufficiently address a poor practice.[24]

41. Furthermore, the correspondence reviewed by the CC provided examples of retailers levying an agreed flat-rate charge in instances of wastage (permitted under the SCOP) even though it may have been grossly disproportionate to the loss suffered by the retailer or the supplier may not have been provided with an opportunity to review the evidence and confirm that the fee was legitimately charged. The latter was raised as a concern by a number of suppliers to the CC and such a practice could give retailers an incentive to over-compensate customers at the expense of suppliers.

42. Another example where the SCOP has failed to effectively prevent the transfer of excessive risk is the issue of shrinkage.[25] Amongst the concerns raised by suppliers and supplier associations to the CC, the latter found instances of retailers imposing liability on some of its suppliers for losses

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[23] CC Report, Appendix 9.1: Case study of retailer and supplier correspondence, http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538_9_1.pdf

[24] For example, the SCOP indicates that a supplier should only be required to make a payment for wastage where it arises because of the supplier's negligence or default or there is an agreement in writing setting out the terms of such a payment. However, wastage is not technically defined and is capable of an interpretation that includes products that have deteriorated as well as those that have been ordered in excess of demand.

[25] CC Report, paragraph 9.48

suffered as a result of shrinkage. These are losses that arise where stock is recorded on a company's books but is not on hand, due to theft, the goods being lost or accounting error. In the vast majority of cases, the supplier has no capacity to address shrinkage losses suffered by the retailer, who by contrast can improve security at depots or stores and improve stock accounting procedures. This highlights the potential for moral hazard in the grocery supply chain, as set out in the rationale section above.

43. For further evidence regarding retailer behaviour towards to suppliers and the effectiveness of the SCOP, the reader should refer to Section 9 of the Competition Commission's final report[26] and Appendix 9.8.[27]

Evidence of impact on supplier investment and innovation

44. The evidence on supplier investment and innovation is not entirely clear. A number of studies reviewed by the CC have shown fairly stable, sometimes increasing, levels of investment and R&D expenditure by food and drink manufacturers during the period 1995-2006.[28] In addition, there was a steady growth in new grocery product launches in the UK during the period 2001 to 2005.

45. The GfK survey of suppliers provides further evidence that innovation has remained robust in recent years[29]:

- 90 per cent of respondents claimed to have developed new product lines in the past two years;
- 87 per cent had developed existing product lines;
- 82 per cent had improved their production processes, and
- more than one-third stated that they had carried out some other type of innovation.

46. There were few differences between types of supplier but, as one might expect, larger companies conducted more product and process innovations – more than 90 per cent had developed new and existing product lines and improved their production processes, whilst almost half conducted another type of innovation. Furthermore, most suppliers (almost 70 per cent) stated that they had a budget for developing new product lines and existing lines, while 59 per cent stated that they had a budget for improving production processes.

47. However, almost 20 per cent of suppliers had no budget for innovation. Although a significant proportion of suppliers (43 per cent) claimed to be spending more on R&D for grocery products than five years ago (as a proportion of groceries revenue), a substantial minority (14 per cent) said they were spending less.

48. Of this latter group, the majority (77 per cent) claimed that they did not have enough money to invest and/or that margins were being squeezed, whilst the next most common reason (25 per cent) was that there was insufficient return on the investment due to customers demanding low prices. Other notable responses were that margins could not be improved through R&D (13 per cent), and that there was insufficient return on investment due to copycat products (11 per cent).

49. The CC also received submissions from suppliers, a number of which claimed to be spending less on capital maintenance than is required.[30] This would affect product quality and new product development in the future. The Country Land and Business Association claimed that large grocery retailers' practices resulted in margins that are too tight for suppliers and, therefore, leave insufficient funds for investment in new equipment and product innovation. Other submissions indicated that higher input costs for suppliers could not be passed on to retailers, also leading to lower margins and a reduced ability to invest. The views put forward by these organisations may reflect a concern about likely future trends in product innovation, given the current actions of UK grocery retailers.

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[26] http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538.pdf

[27] Categorization of, and evidence on, supply chain practices of grocery retailers (http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538_9_8.pdf)

[28] CC Report, Appendix 9.2: Supplier profitability and investment in innovation, http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538_9_2.pdf

[29] GfK, *Research on suppliers to the grocery market: A Report for the Competition Commission*, January 2007

[30] CC Report, Appendix 9.2, paragraphs 40-45

50. It should be noted that product innovation is difficult to measure and a number of factors other than grocery retailers' buyer power might affect suppliers' propensity to invest and innovate. The CC concede that current trends in, and levels of, product innovation may not indicate a cause for concern. However, a simple appraisal of the level of investment and innovation does not take account of the fact that their levels might have been higher in a well-functioning market or whether this level of product innovation could be expected to continue in the future.

51. Evidence from the supplier survey (Table 2) indicates that the prevalence of practices that may adversely impact on investment and innovation is increasing. This raises concerns that current levels of innovation or investment would not be maintained in the future were these practices to continue.

52. In their responses to the BIS consultation, most retailers expressed their poor opinion of the CC findings. They felt that the CC's conclusions were very weak and based on evidence about what might happen, rather than what the evidence showed. Most retailers either asserted or gave evidence to show that levels of innovation were strong in relation to grocery retail, with customer satisfaction on choice and quality remaining unchanged since 2000, despite a strong rise in customer demand and expectations. It was almost universally felt that the most appropriate conclusion regarding supplier investment and innovation based on the evidence was that supply chain practices have had no effect. One retailer also submitted that innovation was a source of competitive advantage in the industry; this gave firms an incentive to invest to increase their own profitability and to avoid ceding any potential advantage to competitors.

Remedies

53. To address the Adverse Effect on Competition that buyer power creates, the CC established the Grocery Supply Code of Practice (GSCOP) using its powers under the Enterprise Act (2002).[31] This came into force on 4 February 2010 and is based on the existing SCOP but includes a number of amendments such as:

- applying the code to retailers that are controlled by corporate groups with, or which themselves have, an annual retail groceries turnover of £1 billion or more;[32]
- an outright prohibition on suppliers being held liable for losses due to shrinkage;
- a provision that ensures that suppliers are less subject to customer complaint charges;
- a prohibition on retailers from making retrospective adjustments to the terms of supply;
- a clear definition of wastage and a prohibition on retailers directly or indirectly requiring a supplier to pay for wastage unless it is due to the negligence or default of the supplier.

54. Therefore, the GSCOP clearly clarifies and addresses retailer practices that transfer excessive risk and unexpected costs to suppliers and prohibits practices where necessary, rather than regulating that they are undertaken reasonably.

55. Furthermore, the CC sought undertakings from retailers to establish a GSCOP Ombudsman to monitor and enforce compliance with the GSCOP, in order to ensure its effectiveness. The major grocery retailers declined to offer suitable undertakings and so, as a result, the CC recommended that the Department for Business, Innovation and Skills set up the Ombudsman.[33] The department received many representations in writing and held a number of face-to-face meetings on the issue. On 13 January 2010, it published a response and agreed that monitoring and enforcement of the GSCOP is necessary to ensure its effectiveness.[34]

56. Currently, disputes concerning breaches of the GSCOP should be pursued with the retailer, to be handled in accordance with the dispute resolution procedure set out in Part 5 of the Order (Groceries (Supply Chain Practices) Market Investigation Order 2009).

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31 http://www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/revised_gscop_order.pdf

32 Although there is an element of judgement in setting the threshold, the CC took into account the identity of the retailers where particular issues had been brought to its attention during the course of the investigation. There were very few cases which involved a grocery retailer with an annual turnover of less than £1 billion. Using this threshold, 10 grocery retailers will be subject to the GSCOP: Aldi; Asda; CGL (incorporating Somerfield); Lidl; Iceland; M&S; Morrisons; Sainsbury's; Tesco; and Waitrose.

33 http://www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/gscop_2_bis_letter.pdf

34 http://www.berr.gov.uk/files/file54194.pdf

57. In responses to the BIS consultation, a number of retailers felt that the creation of an additional enforcement body was a disproportionate response, with one feeling that it was based on groundless expectation by CC members that it would be better to have such a body than not. Other retailers felt that the GSCOP should be given more time to become properly established before taking further enforcement action, so that a full and accurate assessment of the associated costs and benefits could be carried out.

58. One retailer felt that the creation of a monitoring/enforcement body would lead to the imposition of unnecessary costs on industry and disrupt the bargaining relationship between suppliers and retailers, which would inhibit the ability of retailers to obtain lower prices on behalf of consumers. In their opinion, a balance needs to be found between properly governing the industry and avoiding over-regulation, with the creation of a new enforcement body being too far towards the latter.

Policy objectives

59. The principal objective of the GCA is to ensure the effectiveness of the GSCOP through monitoring and enforcement, preventing the practice of supply chain behaviour by grocery retailers, identified by the CC, which has an adverse impact on the willingness of suppliers to invest and innovate.

60. The previous Government accepted the need for a body to enforce the GSCOP and consulted on the nature and scope of its powers.[35] The previous Government also decided that the adjudicator should have a mechanism to hear anonymous complaints. This was considered to be particularly important, as a number of suppliers expressed concerns to the CC over being identified in an investigation of a retailer's supply chain practices. They believed this could have detrimental consequences, such as being delisted by the retailer. The CC acknowledged the existence of this 'climate of fear' among suppliers in relation to disputes under the existing SCOP.

61. The adjudicator will have regard to the overriding objective of the GSCOP Scheme to work in the long term interest of consumers and the findings of the CC. It will not facilitate or encourage coordination among retailers or suppliers, nor will it engage in any activity that is not focused on the overriding objective of GSCOP.[36] In particular, the adjudicator will confine its activities to evaluating the operation of the Code and should not consider other commercial elements of the supply agreement.

Options considered

62. During the consultation, the following options for the Groceries Code Adjudicator were analysed:
    - Do nothing (i.e. GSCOP is introduced without a separate enforcement body);
    - Self-regulation;
    - Base case (an adjudicator with the power to accept anonymous complaints);
    - Whether establishment of the Groceries Code Adjudicator requires the creation of a new body;
    - Whether the Groceries Code Adjudicator should have the power to levy penalties on retailers that breach the GSCOP;
    - Whether the Groceries Code Adjudicator should limit consideration of code-related complaints to only those direct supplier relationships covered by the GSCOP.

63. Given that the previous Government accepted the need for a GSCOP enforcement body, based on the evidence presented above, implementing the Code without such a body is not analysed in depth. Furthermore, an option allowing retailers to voluntarily ensure that the GSCOP is monitored and enforced has already been proposed by the CC but failed to materialise. Therefore, the 'do nothing' and 'self-regulation' options are purely hypothetical and are included in this impact assessment for completeness.

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[35] http://www.berr.gov.uk/files/file54425.pdf

[36] Such coordination could arise from, for example, round-table meetings and the encouragement of any dialogue between suppliers and retailers outside normal bilateral commercial arrangements.

64. The Government consultation sought views on the scope and nature of a GSCOP enforcement body, specifically:

- activities of the body;
- who the body should be;
- penalties regime;
- supplier coverage;
- and funding.

65. A detailed analysis was not required for each of these proposals; indeed it would have been unsuitable in some cases. Certain activities of the body – for example, whether it publishes guidance on specific provisions of the Code or reports publicly on the operation of the Code and enforcement scheme – are relatively marginal measures between which we are not able to easily distinguish analytically. Similarly, the allocation of funding for the Groceries Code Adjudicator has little effect on overall costs and benefits.

66. The options analysed in the previous impact assessment were the last three (i.e. whether establishment of the Groceries Code Adjudicator requires the creation of a new body, whether the Groceries Code Adjudicator should have the power to levy penalties and whether the Groceries Code Adjudicator should limit consideration to direct suppliers). In this context, the 'base case' represents the introduction of a Groceries Code Adjudicator that has the following characteristics: it has power to protect the identity of suppliers who make complaints by treating them confidentially; it is an existing body; it does not have the power to levy penalties; and it considers code-related complaints from both direct and indirect suppliers.

67. It is proposed to include in legislation, the ability for the government to allow the GCA to have powers to levy penalties for breaches in GSCOP. Therefore, we analyse an option including the power to impose penalties. However, if this power is to be enabled, the Government would consult and would set out a fuller assessment of the costs and benefits of enabling this power.

Options analysis

Do nothing

68. The GSCOP order has been established by the CC and took effect from 4 February 2010. Therefore, under this option the ten largest grocery retailers would still be regulated by the Code but it would not be monitored or enforced by a specific body. Suppliers may nevertheless make complaints, and retailers are obliged to submit them to binding independent arbitration at the retailer's expense (unless the arbitrator decides that the supplier's claim was vexatious or wholly without merit), at the request of the supplier.

69.

<u>Costs</u>

70. The CC originally estimated the upfront cost to retailers of establishing the GSCOP to be approximately £1 million, which comprises training and legal costs, as well as redrafting terms and conditions.[37] The ongoing annual cost associated with compliance with the GSCOP was estimated by the CC to be approximately £168,000 per retailer.[38] Aggregated across 10 retailers, this gives a total ongoing cost of £1.7 million per year.

71. Most retailers who responded to the BIS consultation felt that this estimate significantly understated the true costs associated with implementation of (and compliance with) GSCOP. One retailer submitted that 2 full-time staff had been employed to prepare training and respond to GSCOP-related queries, along with legal advice about the application of GSCOP and staff training. Other retailers estimated that GSCOP compliance had entailed 'significant costs' (with one estimating

[37] CC Report, paragraph 11.413. The figure is based on the result of the OFT commissioned audits of the SCOP and costs reported by Tesco and Asda of introducing the existing SCOP.

[38] This cost includes the following elements: regular training; code compliance management time; internal audit compliance; external legal advice; answering queries; and responding to disputes from named complainants (the latter of which is estimated to account for approximately £0.7 million of the ongoing cost).

costs of around £850,000 in the last 6 months), but could not be firmer about ongoing costs given that the GSCOP had only been in place since February 2010.

72. In light of these responses, the CC's original estimate of one-off costs does not seem suitable. Therefore, if it is assumed that the estimate of £850,000 is typical across all the covered retailers (and that such costs are front-loaded, to the extent that the total upfront costs would be around £1m), the one-off costs of implementing the GSCOP may be estimated at **£10 million**. In the absence of any further evidence, we do not have any reason to amend the CC's estimate for ongoing costs – i.e. **£1.7 million per year**.

73. There would also be operating costs associated with GSCOP arbitrations, which would depend on the number of such arbitrations. In the absence of an adjudicator, the resolution of disputes under the GSCOP would be performed by a single independent arbitrator, nominated by an external body with expertise in alternative dispute resolution. However, as arbitrations are required anyway under the GSCOP, costs of arbitration do not represent an additional cost associated with the Groceries Code Adjudicator.[39]

<u>Benefits</u>

74. The CC did not find it possible to directly quantify the consumer benefits associated with continued investment and innovation by suppliers in the future, which the GSCOP should ensure by preventing the exercise of excessive buyer power (provided compliance is high enough, in the absence of a designated enforcement body).

75. It is not possible to accurately forecast the level of compliance for GSCOP with and without an enforcement body. However, an alternative proxy indicator for the likelihood of compliance is the supplier survey conducted by GfK for the Competition Commission. Using the data in Table 2 and by taking the mean of the seven practices reported, it is estimated that the current level of compliance with the practices set out in the Code is 73% for the four largest retailers regulated by SCOP and would be 59%, if it were extended across all grocery retailers (including those not covered by GSCOP). The four largest retailers account for approximately 65% of the market, therefore by taking a weighted average there is currently a compliance rate of 68% across the grocery retailers subject to GSCOP.

76. A number of respondents addressed the expected compliance level, though few provided any specific estimates. Most respondents acknowledged the difficulty of estimating likely compliance levels due to the range of potential influencing factors (e.g. economic, commercial), but most retailers believed that compliance would be much higher than the estimated 73%. One retailer felt that the significant additional provisions and broader coverage of retailers would lead to GSCOP compliance levels being much higher relative to SCOP compliance, hence this would not be an appropriate benchmark.

77. Under the GSCOP it is expected that compliance will rise to 73% at the very least, as it represents an improvement to the existing SCOP and includes other large retailers with annual grocery turnover greater than £1 billion.[40] For those retailers that are not regulated by the GSCOP, the CC received very few cases during its investigation.[41]

78. Nevertheless, the CC determined that a small loss in investment and innovation would have a significant adverse effect on consumers, which was supported by one respondent to the BIS consultation. They noted that, in the context of annual retail grocery turnover of £110 billion and the value of the groceries supply chain (approximately £70 billion), even a small loss in investment and innovation by suppliers could have a significant detrimental impact on consumers.

79. Given that the Government has already accepted the need for a GSCOP enforcement body, based on the costs and evidence presented above, implementing GSCOP without such a body is not a feasible option for this impact assessment and has not been considered further.

[39] Unless it is expected that the costs associated with arbitration for a body to monitor and enforce the GSCOP would differ significantly from those of an ordinary arbitrator, which we would not.

[40] However, the CC expressed a view that effective monitoring and enforcement of the GSCOP requires both the resolution of disputes *and* proactive investigation of retailers' behaviour in respect of particular practices (based on anonymous complaints). If the Code solely relies on formal dispute resolution, which is the case under this option, it is possible that the effectiveness of GSCOP would be undermined. This is because a retailer must be told the identity of a supplier if the latter brings a dispute which, as discussed above, creates a disincentive for the supplier to complain if there is a risk that they will be de-listed. In this case, compliance with the GSCOP may not rise significantly above 73%.

[41] Given that the CC introduced the GSCOP as a remedy for selected grocery retailers, we would not expect retailers outside of GSCOP to be exercising buyer power that results in the transfer or excessive risk and/or unexpected costs.

Self-regulation

80. Under the previous code of practice, SCOP, practices that transfer excessive risk and unexpected costs to suppliers appeared to have persisted, as discussed above. Furthermore, large grocery retailers had twice been given the opportunity to voluntarily establish a GSCOP enforcement body to monitor and enforce compliance with the new code.

81. After the CC report was published in April 2008, it prepared an initial draft of undertakings. Failing to receive agreement from any of the grocery retailers, the CC published a formal consultation to accept undertakings from grocery retailers for an ombudsman scheme in April 2009.[42] Some retailers were opposed to any attempt to establish an enforcement body whilst some were prepared to sign up to undertakings, subject to changes that the CC felt would not be consistent with the final report. Other retailers were prepared to sign up provided that other retailers also signed up to them.[43] Without full agreement, however, the body could not be established. Therefore, an option allowing retailers to voluntarily ensure that the GSCOP is monitored and enforced has already been proposed by the CC and failed to be agreed, so this option is not considered further.

Option 1: Base case (Groceries Code Adjudicator with the power to protect the identity of suppliers who make complaints by treating them confidentially)

82. As set out above, the base case constitutes the introduction of a Groceries Code Adjudicator (GCA) with the power to conduct proactive investigations on the basis of complaints which have been treated confidentially in order to protect the identity of suppliers. The GCA will be a statutory office holder within the Department for Business, Innovation and Skills (co-located in the Office of Fair Trading) and will consider code-related complaints. Initially, it would not have the power to levy penalties on retailers in the event of a breach.

83. There are a large number of firms that supply groceries to UK grocery retailers, either directly or indirectly. This includes food and drink manufacturers, primary producers and fresh food wholesalers, including packers, processors and wholesalers. It is unclear precisely what proportion of total supply to grocery retailers is delivered directly (e.g. from wholesalers, manufacturers or primary producers) or indirectly through intermediaries.

84. The CC report that the majority of grocery retailers' fresh produce is supplied via intermediaries such as packers, processors and fresh food wholesalers, as retailers feel there are certain advantages to this supply channel.[44] Data provided to the CC during their inquiry suggests that the average value of direct purchases from farmers by a large grocery retailers in 2006 was approximately £49 million per year.[45] As an example, the CC report mentions about 20,000 milk producers compared to 200 milk processors, of which three (Arla, Dairy Crest and Wiseman) account for over 90 per cent of total processed liquid milk sold to grocery retailers in the UK.

85. In their letter recommending the creation of a GSCOP enforcement body, the CC makes reference to there being 7,000 (direct) suppliers in the grocery supply chain.[46] This seems to be a very small number, especially taken in context of the earlier figures regarding the number of farm holdings, fresh food intermediaries and food & drink manufacturers. However, given that the CC reports that the market for grocery wholesale is relatively concentrated, with the 15 largest grocery wholesalers accounting for more than three-quarters of grocery wholesaling revenue, these 7,000 suppliers could account for a significant proportion of the overall supply of groceries to retailers.[47]

86. Responses to the BIS consultation did not provide any further evidence on the number of (direct or indirect) suppliers in the grocery supply chain. One trade association estimated there to be over 10,000 suppliers within one part of the food manufacturing sector, while responses from retailers

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[42] http://www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/ombudsman_undertakings.pdf

[43] http://www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/gscop_2_ombudsman_response.pdf

[44] Such as: efficiencies arising from a single intermediary undertaking processing/packing on behalf of a number of farmers; the costs to a grocery retailer of trying to deal individually with the large number of farmers; the effectiveness of intermediaries at carrying out quality assurance activities compared with grocery retailers, and intermediaries' greater ability to source alternative supplies where there is a shortfall in production.

[45] £295 million across 6 retailers (Para 3.32, CC report), compared to £16.7 billion in fresh food sales for these retailers; it should be noted that the comparatively large proportion purchased by Morrison's through this channel is likely to distort an average figure across all retailers.

[46] Para 2.7 of http://www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/gscop_2_bis_letter.pdf

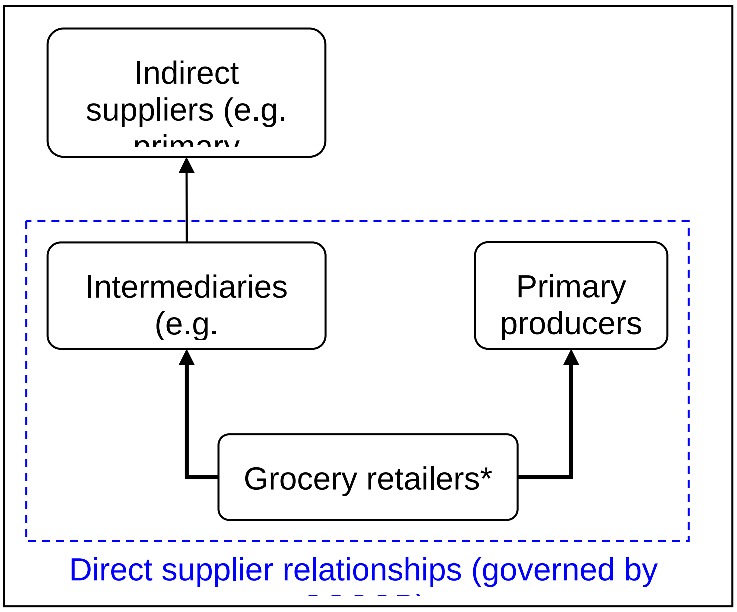
[47] CC report, paragraph 3.27

indicated that they had 2,500-3,000 direct suppliers (though it is difficult to know the potential for overlap between these suppliers for different retailers).

87. The original SCOP was designed to govern the relationship between retailers and their direct suppliers, not between intermediaries and primary producers. However, during their investigation, the CC reviewed some complaints from primary producers and found that it was not uncommon for processors and other intermediaries, in discussions with their suppliers (including primary producers), to attribute particular supply chain practices to direct intervention or pressure placed on the processor or intermediary by grocery retailers. The CC was told by grocery retailers that, in many cases, this attribution was incorrect and that the supply chain practices were in fact instigated unilaterally by the processor or intermediary, with no input from the retailer.

88. In order to increase transparency with respect to supply chain practices, the CC considered that primary producers and other suppliers to intermediaries and processors should also be permitted to make complaints to the adjudicator about alleged breaches of the GSCOP (i.e. retailers' conduct with respect to processors and intermediaries) where the primary producer or other supplier reasonably considers that the breach has had a direct or indirect effect on its interests.[48] Increased transparency would help to reveal supply chain practices and the exercise of buyer power, which might in turn benefit those parts of the groceries supply chain with little or no market power.

Chart: Groceries supply chain



- * - Only those grocery retailers covered by GSCOP (i.e. with turnover in excess of £1bn)

<u>Costs</u>

89. The costs associated with a Groceries Code Adjudicator would include both the one-off costs of setting up and ongoing cost of operating the adjudicator's office, and the ongoing costs incurred by retailers (and suppliers) in interacting with the adjudicator. The set up and operational costs are to be met by the retailers covered by the GSCOP.

Costs to Business

90. Under this option, the role of the adjudicator would go beyond arbitration to include receiving complaints and carrying out investigations on the basis of this information. These costs are very difficult to forecast as they will depend on the number of complaints the adjudicator receives and the number of investigations it chooses to carry out. For example, if compliance were 100%, then it

[48] It should be noted that retailers' contracts with suppliers based outside of the UK are also regulated by the GSCOP (as they were under the SCOP) and those suppliers have the right to arbitrate and make complaints to the enforcement body. There is no distinction based on country of origin and, in the case where the enforcement body receives complaints from indirect suppliers, this also applies to foreign intermediaries and primary producers.

could be expected that the additional costs associated with this option would be zero, as there would be no (meritorious) complaints that would require investigation.

91. Responses to the BIS consultation did not provide any further evidence that might help to estimate the likely level of complaints under the GSCOP. One respondent felt that there might be potentially more dispute than under the SCOP due to broader retailer coverage, but the number would remain low because of the importance to suppliers of strong trading relationships. Another respondent felt that much of the work of an adjudicator would be to focus on a small number of systemic complaints. One retailer felt that the most likely indicator of disputes under GSCOP was the number of complaints under SCOP. A couple of retailers submitted that most complaints were currently resolved internally through mutual agreement, which would continue to be the case.

92. In estimating the costs associated with investigations undertaken on the basis of anonymous complaints, the incremental additional costs under this option are those pertaining to complaints that would not have been made under the do nothing option. On the basis that complaints could be received from all parties (not just direct suppliers), but that the adjudicator did not have the power to impose penalties, the CC estimated the cost of enforcement (including OFT oversight) to be approximately £120,000 per retailer.[49] Across the ten grocery retailers subject to GSCOP, this would suggest an incremental additional cost of **£1.2 million per year** associated with this option, though it is difficult to estimate whether this is an upper bound.[50]

93. One retailer submitted that the cost of the adjudicator would be heavily determined by how disruptive it would be, but that the estimated costs were in any case likely to be an under-estimate. It was suggested that a comparison could be drawn with the Financial Services Authority (FSA), which was originally estimated to cost £15m-20m, but now has a funding requirement in excess of £450m. While this may indicate the potential degree of imprecision regarding estimates of likely complaint levels, the FSA is unlikely to be a good comparator, either in terms of its functions or coverage.

94. Costs associated with arbitration are not additional to this option as they would be incurred in the absence of an adjudicator in any case (i.e. under the hypothetical 'do nothing' option).

GCA set-up costs

95. In the consultation, it was estimated that based on the cost incurred by the CC in setting up a home credit comparisons website,[51] the one-off costs associated with establishing an independent body as the body to monitor and enforce the GSCOP could be up to £0.2m.

96. During the consultation, one retailer submitted that a home credit comparison website was not a good comparator for evaluating the potential costs associated with setting up a new enforcement and monitoring body for the GSCOP. An alternative comparator might be the creation of the Financial Ombudsman Service, the set-up costs for which were estimated to be £3-4 million.[52] However, this seems to be a very different body in nature to the GCA.

97. Therefore, internal analysis has established that the set up costs for the body are likely to be in the region of £140k-£155k which are set out in table 3. However, we have taken account of the fact costs can often be underestimated and we include an optimism bias[53] of 50% to take account of the possibility of underestimation. This leads to a best estimated cost of approximately £220k.

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[49] Covering the cost of inquiries based on anonymous supplier complaints (CC Report, paragraph 11.408). This cost is determined by a number of factors, including the likely number of investigations, such as: the nature of the investigations, how retailers decide to respond to investigations, amount and nature of regular monitoring, and retailers' responses to regular monitoring.

[50] This cost will be maximised where there is no overlap between those complainants who are willing to be identified and those who are not. If there is some overlap, the costs associated with enforcement will be lower, as some of these complainants have already been accounted for by dispute costs assessed under 'do nothing'.

[51] Which was similar in that it was operated by an independent body and funded by the home credit companies

[52] Based on figures given in Financial Ombudsman Service reports, 2000-1 and beyond

[53]

Table 3: Setup costs of GCA[54]

	Estimated Costs	Best estimate costs with 50% Optimism Bias
	£000's	**£000's**
Staff and recruitment	85	128
Legal	35	53
IT	12	18
Accommodation	15	23
Other	1	1
Total	**150**	**220**

98. *Staff and recruitment*: This will cover the costs of recruitment of the adjudicator, and pay of staff as the body is being set up, before it is receiving cases. We assume that staff would be in place for up to 3 months and the staff mix employed would cost £410k per annum. In total, it is estimated that staff and recruitment set up costs would be in the region of £85k.

99. *Legal*: This will cover the costs for drawing up contracts for sharing premises, back office functions and guidance on procedures and policies including recovering costs on investigations. It is estimated that this would cost between £30k and £40k.

100. *IT*: As the GCA will be initially based in Fleetbank House, costs are estimated based on OFT IT costs and staff requirements. In addition, the GCA will need a web presence and set up costs for this is included. This is estimated to be approximately £12k

101. *Accommodation:* Accommodation in Fleetbank House for an initial set up period of 3 months is likely to cost in the region of £15k based on space requirements of the GCA.

102. *Other:* Other costs incurred could include photocopying and travel. These are likely to be low initially, although set up costs could be up to £1k.

Operating costs of GCA

103. The operating costs of the GCA will depend heavily on the number of investigations it runs. However, for the purposes of this IA, we are only measuring the additional cost from having a GCA. Costs of arbitration would be incurred with or without a GCA, so these costs cannot be considered additional.

104. Table 4 sets out the estimated cost of operating the GCA, minus the costs of arbitration, to be in the region of £400k - £2m, with a best estimate of £800k.

[54] Numbers in total may not add up due to rounding

Table 4: Operating costs of GCA

	Low estimate	High estimate	Best estimate
	£000's	**£000's**	**£000's**
Investigations	100	1500	400
Staff	200	400	300
IT	11	11	11
Accommodation	62	62	62
Other	30	30	30
Total[55]	**400**	**2000**	**800**

105. *Investigation costs*: The costs per investigation would clearly depend on the nature of the complaint and the complexity of investigating it. One potential comparator is the cost of OFT market studies, which were estimated to cost £380k each.[56] However, discussions with OFT suggest that the likely cost per investigation would be lower than this due to the likely narrower scope of investigations. Based on the staff requirements for an investigation and other costs such as consultancy and research, costs could range from £50k to £150k per investigation. However, we will use the OFT market studies cost to for sensitivity analysis.

106. The other key variable will be the number of investigations that the GCA runs per year, which was discussed above in the costs to business section. If there were no cases, clearly there would be no cost. However, many stakeholders have informed the government of the need for this body and we estimate the number of investigations to be between 2 and 4 a year. However, if there are no meritous complaints, or it is the case that complaints can be dealt with in adjudication and are not persistent issues, then the number of investigations may be lower.

107. Based on the costs per investigation outlined above and the number of investigations per year, we estimate that investigations will cost between **£0.1m and £1.5m**. Taking a more central estimate of each investigation costing up to £100k, with 4 cases per year the overall costs would be approximately **£0.4m**

108. *Staff*: The staff costs estimated take into account the fact that some staff will need to be operational, regardless of whether there are any investigations or adjudications, but staff can be seconded in from appropriate bodies for investigations. Therefore the staff costs outlined above exclude the costs of investigation and arbitration.

109. Based on the staff composition, total staff costs are estimated to be approximately £400k. The staff need to cover the work of the body such as receiving and responding to complaints, producing and interpreting guidance on the GSCOP, providing advice, publishing regular and annual reports on its activity, investigations where no breach of the code is found (or where the GCA decides not to exercise their discretion to recover costs from the retailer).

110. The standing staff requirements for the GCA could be between **£200k and £400k**, with a best estimate of **£300k**. The adjudicator will be required to report on its activity and costs and a post implementation review will seek to establish the actual costs incurred.

111. *IT*: The estimated costs for IT are made up of estimates based on OFT IT costs and the operation costs for a web presence for the GCA.

112. *Accommodation:* This will cover the costs of accommodation and facilities in Fleetbank House, based on estimates provided by OFT.

113. *Other:* Other costs incurred could include photocopying and travel and subsistence, and training of staff. The travel element is the largest item and includes allocation for visiting the ten retailers, trade associations, suppliers, and attending conferences.

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55 Numbers may not add up due to rounding

56 Frontier economics report on markets regime

Benefits

114. As set out above, under the GSCOP it is assumed that compliance across the groceries market would rise from 68% to 73% (at least). The existence of an adjudicator should increase the level of compliance to a level above 73%.[57] However, even if this level of compliance could be accurately assessed, it is still not possible to quantify the potential costs incurred by suppliers as a result of retailer practices that transfer excessive risk to them. This will be monitored in the future and more information will be gathered on this specific area as part of the post implementation review.

115. In the absence of an adjudicator with the power to accept anonymous complaints, the resolution of disputes requires the identification of the supplier bringing the dispute. Under the existing SCOP, a number of suppliers claim that they run the risk of being de-listed by retailers if they are identified during a dispute.[58] It should be noted that the GSCOP prohibits delisting other than on genuine commercial grounds. However, in the case of complaints made on a confidential basis, the adjudicator would investigate areas of recurring concern and help build confidence in the operation of the groceries supply chain.

116. Experience from Germany suggests that the power to initiate proceedings on the basis of anonymous complaints can be helpful in encouraging complainants to come forward (and also remedy cases informally without having to issue a decision).[59] This should help ensure that suppliers can make investments with a reasonable degree of certainty regarding their expected returns and the allocation of risk.

117. Due to the difficulties in knowing the appropriate counterfactual about the level of investment and innovation in a perfectly functioning market, it is not possible to accurately know the total size of benefits possible from implementation of the GSCOP. However, the CC stated that it expected the investment and innovation performance that it observed in the groceries supply chain would have been better in the absence of the practices it observed. The GSCOP and Ombudsman are designed to address these practices. Further, the marginal benefit from the GCA improving the operation of the GSCOP is similarly difficult to quantify.

118. The CC noted that as the value of the groceries supply chain is of the order of £70 billion in annual sales to grocery retailers, even a small loss in potential investment and innovation is likely to have a significant impact on achieved supply chain sales value and profitability and/or on product quality and choice. In this context even a 1% reduction in supply chain profitability would equate to £42 million[60] per annum of profits that could no longer be potentially used to fund investment and innovation projects.

119. An additional benefit that has not been quantified is the avoided potential cost of upstream grocery suppliers potentially going out of business, as a result of actions taken by retailers that have the effect of transferring excessive risks and unexpected costs to them. Such costs could result from job losses and/or loss of livelihood, which could also have a consequential deleterious impact on the local economy.

Risks

120. The estimated cost of this option, will vary depending on the number of disputes and anonymous complaints that the adjudicator receives and is partially based on CC assumptions. If all of the grocery retailers regulated by the Code are fully compliant, then the number of complaints (and therefore the costs under this option) would most likely tend to £0.4m, which is the cost of the body without investigations.

121. A risk identified by one of the six CC Members who conducted the groceries inquiry (Professor Bruce Lyons) was that anonymity will not be protected in all cases. In Germany, the BKA stated that if an informal solution to anonymous complaints cannot be found, it has to issue a formal decision. In this case, the identity of the complainant needs to be revealed. However, given that

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[57] Unlike the SCOP, where disputes were mediated by an independent mediator appointed and paid for by the retailer, the proposed enforcement body would act as an arbitrator and also conduct proactive investigation of retailers' behaviour in respect of particular practices. The latter is important because it can be done on the basis of anonymous complaints.

[58] CC report, paragraph 11.348

[59] In Germany, the Bundeskartellamt (BKA) has conducted a number of investigations into the exploitation of buyer power by grocery retailers under German Competition Law and in 1999 was given the power to initiate proceedings based on anonymous complaints.

[60] Table 1 of Appendix 9.2 in the CC report shows food and drink profit margins (net profit before tax/operating revenue) from 2000 – 2004 varying between 4.87% and 6.81%. Applying an average figure of (say) 6% and applying this to £70 billion gives a total profit of £4.2 billion. 1% of £4.2 billion is £42 million.

the adjudicator will investigate recurring practices or specific patterns (e.g. complaints related to a certain retailer or a specific sector), which may involve a number of suppliers, this risk should be mitigated to some extent.

Decision

122. As explained earlier, the base case represents the establishment of an adjudicator with the power to conduct proactive investigations on the basis of anonymous complaints. Therefore, the costs and benefits associated with this option will be incurred – in terms of those that can be quantified, this amounts to annual costs of £2m.

Option 2: Power to levy penalties

123. The CC has recommended to BIS that the adjudicator should have the power to impose monetary penalties on retailers in respect of breaches of the GSCOP. However, the CC did not carry out any specific analysis of the proportionality (i.e. benefits versus costs) of giving the adjudicator powers to impose penalties.

124. Under the base case, if the Groceries Code Adjudicator found in favour of a complainant, they would only have the power to award financial costs equal to the amount originally imposed on the complainant – i.e. the original costs imposed on the supplier would be given back to them to compensate for their loss. However, there would be a deterrence effect under the base case, due to the reputational risk associated with breaches of GSCOP, where such breaches could be identified and publicised by the adjudicator. This would be likely to result in negative publicity for the retailer, which would deter further breaches, both by the individual retailer and potentially across all retailers subject to GSCOP.

125. Under this option, the adjudicator would have the ability to impose a punitive element in addition to the original costs incurred by the supplier. That is, the Groceries Code Adjudicator would be able to impose a fine or penalty on the retailer that has breached GSCOP in excess of the costs incurred by the supplier as a result of the breach. In relation to the original scenario (i.e. where the adjudicator does not have this power), the only route available to claiming any money would be to take a follow-on case, based on the judgement of the adjudicator.

Costs

126. Under this option, all the costs incurred under option 1 would still be incurred. In addition, adding the power to impose penalties could affect both the costs and benefits of the adjudicator. For example, the possibility of penalties might give retailers more incentive to prolong investigations by disputing every point, however small, which would increase the cost of each individual investigation.

127. As there would also need to be a right of appeal, costs could also increase to the extent that decisions are appealed and it may be noted that the adjudicator is unlikely to have a strong incentive to avoid appeals since its budget needs to be flexible.[61]

128. The cost of an appeal case varies widely according to the specifics of each case. The use of an existing appeals body for this purpose is likely to be more efficient in terms of overheads, staff costs etc. According to the GSCOP Order made by the CC[62], the High Court or Court of Appeal will be the relevant route. However, it has not been possible to gather accurate data on the costs associated with a case in this court. Data from the Competition Appeals Tribunal (CAT) for 2009 suggests that average case costs (in terms of staff costs, overheads etc) are around £102,000 per year.[63]

129. We have not been able to accurately assess how many appeals there might be in any given year and responses to the BIS consultation did not provide any further evidence to address this. One respondent suggested that the new requirement to have agreements in writing would make breaches of GSCOP more clear-cut and easier to identify, leading to a low level of appeals

[61] The CC recommended that the enforcement body should have a flexible budget with a large contingency as it was concerned about the possibility that retailers would attempt to exhaust the enforcement budget in the knowledge that effectiveness of monitoring and enforcement would be compromised (see footnote to paragraph 11.338 of the CC report).

[62] http://www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/revised_gscop_order.pdf

[63] Composed of £80,000 staff costs and £22,000 operating costs

(possibly even single figures). One retailer felt that the CAT would be best placed to hear appeals, but the likely standard of proof required could lead to protracted and costly cases (i.e. in excess of £100,000 per case). Another retailer felt that appeal costs could be even higher, if suppliers used the new complaint process for tactical commercial advantage, or potentially to raise publicity for a cause.

130. In the absence of any better information, we have used the conservative estimate of £200,000 for the costs associated with an appeal (£100,000 for costs to Government associated with the appeal court, £100,000 in legal costs to the parties involved) and have assumed that the number of appeal cases per year could vary between 1 and 4 appeal cases per year, at an average cost of £200,000 – i.e. a total ongoing cost of **£0.2m-£0.8m per year**. Over a 10-year period (discounted at 3.5%), this implies a net present cost of **£1.7m-£6.9m**.

Benefits

131. In addition to the deterrence effect associated with negative publicity identified above, penalty powers will increase the potential cost to retailers of not complying with GSCOP, and hence will increase the incentive for retailers to comply with the GSCOP. A key factor affecting the size of benefits from penalty powers is the extent of GSCOP compliance in the absence of penalties. If compliance (in the absence of penalties) is high, then the incremental benefit of better compliance will be small. On the other hand, if compliance in the absence of penalties is low, improving compliance may realise the additional benefits of implementing the original recommendation.[64]

132. Responses to the BIS consultation on the effectiveness of a penalty regime were mixed. One respondent felt that the availability of fines would be unlikely to lead to full compliance, but that compliance in the absence of fines would be markedly lower. However, one retailer submitted that, given that the GSCOP would apply in the context of a legislative agreement between retailer and supplier (with the supplier as one of the parties to the agreement), the likelihood of detection would be 100% and there would be no improvement to compliance as a result of introducing penalties.

133. In general, retailers felt that the existing GSCOP framework would already provide significant incentives for retailers to comply, such that the incremental benefits arising from availability of penalties would be low. It was also felt that the introduction of penalties may lead to a more litigious environment and an increase in the likelihood of appeals rather than resolution through negotiation or arbitration. As a consequence, it was felt that this would then lead to increased costs and delayed resolution.

134. Currently, the adjudicator has not yet come into operation and the GSCOP has was only introduced in February 2010. Consequently, there is no direct basis for assessing compliance in the absence of penalties. It may be possible to get a better view after the new regime has been in operation for a period of time.

135. For the purposes of this impact assessment, we considered whether data on compliance with the SCOP would enable us to make an estimate of GSCOP compliance by an adjudicator without penalty powers. However since the inadequacy of the SCOP and the absence of an enforcement body was the reason for establishing the GSCOP and recommending the establishment of the adjudicator, we concluded that SCOP compliance data was not useful in estimating GSCOP compliance by an adjudicator without penalty powers.

136. An alternative proxy indicator for the likelihood of compliance is the supplier survey conducted by GfK for the Competition Commission. This suggests that 68% of retailers had undertaken action that would be in breach of the GSCOP, once it comes into force.

137. If the GCA is already established, then it will already be investigating breaches in the code and compliance will have risen but, to what extent it will rise is unknown at this point. Part of the Post Implementation Review (PIR) will be to establish the effectiveness of the GCA and whether any further action, either legislative (i.e. introducing penalties) or non-legislative need to be considered. In the absence of more precise information, we have assumed that the marginal impact of conferring penalty powers on the adjudicator could increase compliance up to 100%. As set out earlier, that would mean that the ongoing cost associated with the adjudicators complaints and

[64] An OFT study on enforcement of competition law found that most companies and lawyers considered that fines were important or very important in deterring infringements, supporting the idea that compliance would be lower in the absence of financial penalties (http://www.oft.gov.uk/shared_oft/reports/Evaluating-OFTs-work/oft962.pdf; Table 5.11, Table 18 in Annex A and Table 15 in Annex B).

investigation function is reduced to zero – i.e. an avoided cost (benefit) of £1.6m per year[65]. However, it is clear that this is an upper estimate and is highly contingent on the effectiveness of the GCA without penalty powers.

138. A potential additional benefit under this option is the avoided costs for individual complainants of undertaking a follow-on action, following a favourable judgement by the adjudicator. Estimates from work on implementing the Consumer Advocate suggest that the average cost per action could be around £250,000 and £300,000.

139. Unfortunately, in the absence of information about the likely number of complaints once GSCOP comes into force, it is not possible to predict how many follow-on actions there might be in any given year and therefore quantify any associated costs that might be avoided.

Risks

140. An important factor that may affect the net benefits of adding penalty powers is the risk of the adjudicator's investigations finding 'false positives'. These involve erroneously finding breaches of the GSCOP (though these will ultimately be corrected by the appeals process), or finding breaches of the GSCOP that do not contribute to the adverse effects on supplier investment and innovation identified by the CC. To the extent that there are 'false positives', penalty powers could induce behaviour by retailers that is costly rather than beneficial.

141. An additional risk is that the punitive element imposed by the adjudicator in upholding a complaint could then be passed on to consumers in the form of higher prices. This could be particularly problematic for low-income consumers, for whom expenditure on food makes up a higher proportion of their income.

142. The adjudicator would only impose penalties where there is strong and convincing evidence that a retailer has committed a breach of the GSCOP. The CC accepted that it would not be appropriate to impose penalties based on anonymous complaints from suppliers.[66] Therefore, any dispute that could result in the imposition of a penalty would involve the supplier(s) being identified to the retailer. This may deter suppliers from seeking such resolutions if they consider the risk of de-listing to be sufficiently high.

Decision

143. It has been decided that powers will be provided in the primary legislation for the Government to introduce financial penalties, should future experience indicate that reputation alone is not a sufficient deterrent for retailers. Without more accurate information on how these penalties will be levied in practice, we have calculated some illustrative impacts above, but more precise impacts will be calculated if this power is exercised.

One in One out considerations

144. All the costs of the preferred options will be incurred by retailers, either directly or indirectly through a levy to fund the body. Therefore, based on the Net Present Value of option 1, the equivalent annual net cost to business is £2.1m. This is an IN and the corresponding OUT will be the repeal of the Property Misdescriptions Act 1991, which the government is currently consulting on.

Wider impacts

145. In terms of indirect impacts, there is potential for the costs imposed as a result of the introduction of the Groceries Code Adjudicator to be passed on to consumers in the form of higher retail prices. Indeed, the response from one retailer indicated that, if the creation of the adjudicator added materially to operating costs, that price rises would be 'inevitable'.

146. This is likely to impact most heavily on low-income consumers, for whom food makes up a higher proportion of total expenditure. For example, Defra calculates that between August 2007 and October 2009 food prices rose by 16%, which impacted proportionately more on low-income

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[65] £1.2m cost for retailers and £0.4m cost for GCA

[66] CC report, 11.372

households[67] (with spending on food and non-alcoholic drink rising from 15.2% in 2007 to 16.8% in 2009, compared to 10.5% to 11.7% for all households).[68] This effect could be mitigated by substitution towards cheaper products, but this is difficult to estimate without more detailed data.

147. Secondary issues relating to UK grocery sector, such as the sustainability of the food supply chain, security of supply as it relates to food and carbon footprint of the supply chain, have been raised by stakeholders but have not been subjected to detailed analysis here, as this will not be the primary focus of the adjudicator. Nevertheless, the actions of such a body could have an indirect impact on these issues, though it is not possible at this stage to predict what these impacts might be and their relative size.

Risks

148. There is a risk that the body does not receive the level of complaints envisaged by the CC and is therefore under-utilised. To mitigate this risk, the body is to be reviewed after three years and may be disbanded if these complaints do not materialise.

149. There is a risk that the proposed deterrent (reputational risk) that the GCA possesses is not sufficient in preventing retailers breaching the GSCOP. To mitigate this risk, the GCA will have reserve powers to impose financial penalties. However, a consultation and parliamentary approval will be needed before these can be implemented.

150. There is a risk that some complaints submitted to the GCA are vexatious or wholly without merit, intending to mislead the GCA into conducting an investigation. This is mitigated by the GCA's responsibility to verify the validity of complaints i.e. that they are related to breaches of the GSCOP, and the fact that complainants will be liable for costs related to investigations that arise if their complaints were subsequently proven to be vexatious or wholly without merit.

Summary and preferred option

151. In their report, the CC recommended that the Government establish a GSCOP Ombudsman, with the powers to impose penalties for breaches of the Code, after retailers failed to voluntarily establish such a body. The UK Government supports the need for such a body. The previous Government accepted the need for a body to monitor and enforce the GSCOP and have the power to receive anonymous complaints. It launched a public consultation as soon as the GSCOP came into force. The Coalition Government Programme, published on 18 May, commits the Government to introduce, as a first step, an Ombudsman in the Office of Fair Trading to enforce the Grocery Supply Code of Practice and curb abuses of power which undermine our farmers and act against the long-term interest of consumers.[69]

152. This impact assessment focuses on several aspects of the establishment of such a body, notably:

- The costs and benefits of establishing the GCA
- Whether such a body should have the power to levy penalties on retailers that breach the GSCOP

153. In relation to the first of these it has been concluded that, in line with the Coalition Programme, the body should be based within the OFT, but will be remain independent. The benefits are those resulting from a potential improvement in investment and innovation within the groceries supply chain, which could ultimately lead to improvements in quality and choice for consumers, as well as lower prices in the long run. Although it has not been possible to quantify the potential improvement in investment and innovation and its consequent impacts, this will be monitored in the future and any refinements will be addressed as part of the post implementation review. In relation to the second, the Government expects that the deterrent with the greatest impact on behaviour change is that of reputation. However, powers will be provided in the primary legislation for the Government to introduce financial penalties should future experience indicate that reputation alone is not sufficient.

[67] Defined as those in the lowest 20% of the income distribution
[68] UK Food Security Assessment: Detailed Analysis, Defra (2010)
[69] http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf

Summary table of costs & benefits associated with each option

	Costs (£m)		**Benefits (£m)**	
	Transition	Ongoing	Transition	Ongoing
Option 1: Base case	0.2	2	Unquant.	Unquant.
Option 2: Power to levy penalties	0.2	2.5	Unquant.	Unquant.

Annexes

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. If the policy is subject to a sunset clause, the review should be carried out sufficiently early that any renewal or amendment to legislation can be enacted before the expiry date. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review:

A review has been committed to in the impact assessment and would be undertaken to assess the effectiveness of the legislation taken forward to implement the Groceries Code Adjudicator.

Review objective:

The review would be intended to verify the assessment of the estimated costs, benefits and administrative burdens associated with implementation of the preferred option. If there are significant discrepancies between the estimated and actual figures, efforts will be made to understand the reasons for this and act if necessary. The review will also help determine whether the Department needs to take any further action, legislative or non-legislative.

Review approach and rationale:

The review would make use of the regular reporting by the OFT (and eventually, the adjudicator) on the level of compliance with GSCOP. This should take into account stakeholder views – including both retailers and suppliers – and include both quantitative (e.g. number of complaints/disputes) and qualitative (e.g. expert opinion) data. The review will weight qualitative evidence, accounting for both relevance and bias.

Baseline:

The baseline position is the situation that prevails under the current UK regulatory regime (i.e. now that the GSCOP is in place). The impact of the preferred option will then be measured relative to this baseline.

It should be possible to distinguish between the impact of the GSCOP and the impact of the adjudicator by using the evidence from the Competition Commission's market investigation, which was undertaken prior to the introduction of the GSCOP. In addition, the GSCOP will have been in place for over a year by the time the GCA is established.

Success criteria:

Success will be judged against the potential breaches of GSCOP by the relevant retailers – if compliance is high, there should be a low level of complaints/disputes for the adjudicator to deal with. However, a high level of complaints alone is likely to be insufficient to declare the policy a failure, as the nature of those complaints and whether they are considered meritorious or not will be taken into account.

Over the longer term, the policy will be judged against the levels of investment and innovation in the groceries supply chain (likely to be measured through supplier questionnaires). If the remedy is successful, these measures should not be adversely impacted following the introduction of the adjudicator.

Monitoring information arrangements:

Ongoing monitoring is part of the adjudicator's role and it is expected that it will publish annual reports on compliance, which may impose burdens on the retailers subject to GSCOP. It would be expected to report on a regular basis regarding the nature of complaints and disputes that it has investigated.

Reasons for not planning a review:

N/A

Annex 2: Specific Impact Tests

Competition Assessment

Would the proposals directly limit the number or range of suppliers?

None of the proposed options would directly limit the number of grocery retailers or suppliers.

Would the proposals indirectly limit the number or range of suppliers?

None of the proposed options would indirectly limit the number or range of grocery retailers as the GSCOP only applies to the ten largest retailers with annual grocery sales of more than £1 billion. They may, however, affect grocery suppliers. By ensuring that the GSCOP is monitored and enforced, thereby preventing the transfer of excessive risk and unexpected costs to suppliers, it is less likely that they could be forced out of business, for example due to reduced profit margins or retrospective price adjustments. It is even possible that new entrants could enter the market if the returns were sufficiently high.

If the power to levy penalties is ultimately enacted, this could further increase retailer compliance, potentially leading to market entry and/or enhancement of supplier investment and profitability.

Would the proposal limit the ability of suppliers to compete?

None of the proposals should limit the ability of grocery retailers to compete with each other as they are all subject to the same Code and regulations. They should, however, allow grocery suppliers to compete on a level playing field, regardless of their size relative to the retailers they supply. As suppliers that are based outside of the UK are also covered by the Code, there is no additional incentive for grocery retailers to contract with foreign grocery suppliers (hence no increase in the likely probability of foreign suppliers supplanting domestic suppliers).

The level of competition in the upstream groceries supply chain may possibly increase as a result of the adjudicator receiving complaints from indirect (as well as direct) suppliers, by providing certainty around supply agreements and allowing them to avoid any losses which they might have otherwise incurred.

Would the proposal reduce suppliers' incentives to compete vigorously?

On the contrary, grocery suppliers would have greater incentive to compete assuming that the adjudicator ensures that they know, with certainty, the costs and risks of their operations.

What alternative proposals have been considered?

A self-regulatory approach to establishing the Groceries Code Adjudicator has been proposed on two previous occasions and in both instances it failed to materialise. Therefore, it was not considered in this consultation. Implementing the GSCOP without an enforcement and monitoring body was also not considered because such a solution was applied under the existing SCOP and it failed to fully address the adverse effect on competition.

Other proposals have been included, namely the activities of the adjudicator and how it is to be funded, but neither is substantively analysed in the impact assessment, as their overall impact on costs and benefits is likely to be marginal.

Small Firm Impact Test

The GSCOP regulates the practices of larger grocery retailers with annual sales of more than £1 billion. Therefore, none of the proposed measures will have an impact in small grocery retailers. However, they may have a positive impact on small grocery suppliers (e.g. primary producers) by preventing their customers from transferring excessive risk and unexpected costs to them. A larger number of small firms that are indirect suppliers may also benefit from the adjudicator as it will accept complaints from them too.

Sustainable Development

By ensuring that primary producers and other grocery suppliers do not have their profit margins reduced by the exercise of buyer power, those enterprises will have greater financial resources to invest in innovative products and technology that reduces the environmental impact of production.

Race, Disability and Gender Equality Test

After initial screening as to the potential impact of this policy on race, disability and gender equality it has been decided that there will not be a major impact upon minority groups in terms of numbers affected or the seriousness of the likely impact.

Rural Proofing

To the extent that the adjudicator improves the operation and competitiveness of primary producers and rural enterprises that supply groceries, each option would have a beneficial effect in rural areas.

Justice Impact test

After consultation with MOJ, it was not considered that the policy would have a significant impact on the justice system.

Other impact tests

After initial screening, no impact was anticipated in the areas of environmental impacts or social impacts, except for rural proofing as noted above.

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URN 11/937