

# **The grocery market**

**The OFT's reasons for making a  
reference to the Competition  
Commission**

**May 2006**

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## EXECUTIVE SUMMARY

The Office of Fair Trading (OFT) has decided to make a reference to the Competition Commission (CC) under section 131 of the Enterprise Act 2002 (the Act) for an investigation into the supply of groceries by retailers in the UK.<sup>1</sup> This confirms the OFT's Proposed Decision, which was published on 9 March 2006, and on which the OFT publicly consulted.

The OFT has based its decision on evidence of market developments and features of the market that might be preventing, restricting or distorting competition and thereby harming consumers. In deciding to make a reference, the OFT has taken account of the views expressed by respondents to the consultation, particularly in relation to the evidence and analysis set out in the Proposed Decision.

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

Overall, the evidence suggests that consumers have benefited in recent years from falling prices, an increase in product range within stores, and an apparent improvement in service. However, this may have been at the expense of choice of store at a local level, and there remain concerns about the strength of local market competition in some areas. Considered against this context, there are a number of features of the market that can reasonably be suspected of distorting

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<sup>1</sup> Full terms of reference for the investigation are attached at Annex A.

competition and, in the case of at least some of those features, the evidence suggests that consumers may be being harmed as a result:

- The planning system can reasonably be suspected of restricting or distorting competition by raising the cost of, and also limiting the scope for, new local market entry, particularly by way of new large format stores.
- There are reasonable grounds for suspecting that the land holdings of the large supermarket multiples may reinforce their existing market position in some local areas. The OFT has also found evidence of practices that could have an anti-competitive effect, including the use of restrictive covenants in relation to sites sold by the big supermarkets.
- There is evidence to suggest that the buyer power of the big supermarkets has increased since 2000, and that the differential between suppliers' prices to large supermarkets compared with those to wholesalers and buying groups has risen. Against the background of greater concentration within the market, there are reasonable grounds for suspecting that this buyer power could harm consumer choice by undermining the viability of alternative business models including wholesale distribution to the convenience store sector.
- Aspects of the large supermarkets' pricing behaviour – below-cost selling and price flexing – also provide reasonable grounds for suspecting that competition is being distorted, though the extent of the possible distortion is unclear. Although the OFT has not found evidence that consumers are being harmed as a result of these pricing practices, a CC market investigation would be able to examine in greater detail the effects that these practices may be having on competition and consumers.

In view of the size and importance of the market and the breadth of concerns that have been raised, the OFT remains of the view that a market investigation by the CC is the most appropriate way of resolving these issues and, if necessary, imposing remedies.

# 1 INTRODUCTION

- 1.1 On 9 March 2006, the OFT announced its proposal to refer the market for the supply of groceries by retailers in the UK to the CC for a market investigation. Its reasoning was set out in the OFT's *Grocery market: Proposed decision to make a market investigation reference* (OFT838) ('The Proposed Decision').
- 1.2 This Proposed Decision followed an appeal by the Association of Convenience Stores (ACS) against the OFT's decision in August 2005 not to make a market investigation reference. On 1 November 2005, the OFT withdrew its earlier decision and began a fresh inquiry into the grocery market, focusing initially on features of the grocery retail market highlighted by the ACS. As part of this inquiry, it collected evidence from supermarkets, wholesalers, buying groups and suppliers, as well as public sources. The OFT had not sought to carry out a detailed analysis of competition in the market, nor to reach firm conclusions as to whether or not competition is being harmed. However, in the OFT's view, the evidence it collected provided appropriate grounds for a reference to the CC under section 131 of the Act.
- 1.3 Under section 169 of the Act, where the OFT proposes to make a market reference to the CC, it must first consult, so far as practicable, any person on whose interests the reference is likely to have a substantial impact. The OFT invited comments on its Proposed Decision over a four week period ending on 6 April 2006. In total, it received around 1,250 responses. Of these, most were from consumers, with around 50 or so being from affected organisations or businesses.<sup>2</sup> The OFT has considered these responses carefully in reaching its final decision.

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<sup>2</sup> Further details of the responses we received are set out in Annex A.

- 1.4 This present document ('the Final Decision') sets out the OFT's reasons for deciding to confirm its Proposed Decision to make a reference to the CC. Where respondents commented on particular elements of the analysis in the Proposed Decision, these views have been included, wherever possible, within the analysis presented in this Final Decision document. Where respondents made more general comments on features of the market, these have been summarised in separate sections towards the end of each chapter.
- 1.5 The structure of this document follows that of the Proposed Decision, covering:
- market definition and background to the market (Chapters 2, 3 and 4)
  - features of the market that raise competition concerns (Chapters 5, 6 and 7), and
  - the case for a reference (Chapter 8).
- 1.6 There is also an additional section on scope and terms of the reference to the CC (Chapter 9).



## 2 MARKET DEFINITION

- 2.1 In making a reference to the CC, the OFT's guidance says that it must give 'some consideration to the definition of the relevant market', but 'the effects on competition of some features may be clear enough that firm conclusions on the definition of the relevant market by the OFT are unnecessary'.<sup>3</sup>
- 2.2 The OFT and the CC have considered the relevant economic definition of the market (or markets) for grocery retailing on several occasions in recent years. The CC has identified two interrelated markets for the supply of groceries to final consumers in the UK:<sup>4</sup>
- the retail market for 'one-stop shopping', and
  - the retail market for 'secondary shopping' (including convenience shopping).
- 2.3 The CC's 2000 report defined 'one-stop shopping' as 'the shop for the bulk of a household's weekly grocery needs, carried out in a single trip and under one roof'.<sup>5</sup> This is distinguished by the CC from other forms of shopping, characterised as 'secondary shopping', which typically involve the greater use of other types of grocery stores, a different product mix and a lower average basket spend.
- 2.4 It is important to distinguish these broad types of shopping from the separate classification of grocery retail stores. The CC has typically classified stores into three categories:
- one-stop shops: over 1,400 square metres (15,000 square feet)

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<sup>3</sup> *Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act* (OFT511), paragraph 4.8

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

<sup>5</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.26

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

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

2.6 The OFT is aware of criticism of the 'two markets' approach from a number of groups. For example, the recent All-Party Parliamentary Small Shops Group (APPSSG) report stated that 'the lines between 'top up' shopping and 'one-stop' shopping have become increasingly blurred with the presence of large retailers in both markets taking advantage of central buying'.<sup>6</sup> A limited number of consultation respondents raised similar concerns, suggesting that the approach to market definition used by the OFT and CC in the past has underestimated the competitive impact of supermarkets' expansion into the convenience store sector.

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

- 2.7 In practice, recent merger decisions<sup>7</sup> have acknowledged that secondary shopping occurs in a range of different store types, as discussed in paragraph 2.5 above. The OFT therefore believes that it is incorrect to characterise its approach as a 'two markets' approach which ignores the significant amount of secondary shopping that takes place at supermarket-owned stores (of all sizes). Furthermore, the fact that some supermarkets have started to more directly target the secondary shopping market (for example, by moving into the supply of groceries through dedicated convenience stores) does not necessarily result in the 'one-stop shopping' and 'secondary shopping' markets becoming merged into one. Nevertheless, these are issues that the CC may wish to consider as part of its investigation.
- 2.8 For the purposes of deciding whether to make a market investigation reference, the OFT has used the CC's product market definitions as the starting point. However, it has kept in mind the importance of considering the linkages between these markets, particularly when analysing the expansion of the supermarket multiples into smaller store formats. Unless otherwise stated, where the term 'the market' is used in this document, it refers to the market(s) for the supply of groceries by retailers in the UK, covering both one-stop shopping and secondary shopping.
- 2.9 In addition to the definition of the relevant product market, there is also a question of the relevant geographical market(s). The CC's 2000 report concluded that 'Taking the evidence as a whole, our view is that the ambit of consumers' search for groceries is essentially local'.<sup>8</sup> The analysis of mergers involving grocery retailing since the 2000 report has developed a detailed methodology using 'isochrones' based on average drive times between stores. For the purposes of this inquiry, the OFT has assumed that market power could, theoretically at least, be exercised at

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<sup>7</sup> For example, The OFT's decision of 5 March 2004 on the anticipated acquisition by Tesco plc of 45 stores from Adminstore and the OFT's decision of 26 October 2004 on the completed acquisition by J Sainsbury plc of Jackson Stores Ltd

<sup>8</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.47

a local as well as at a national level, although national competition clearly constrains the degree to which firms can operate in any locality unconstrained by competition. The terms of the OFT's reference to the CC cover the whole UK because the features it has identified are likely to apply to most local areas and, in the case of buyer power, affect broader upstream markets in the supply of groceries and in wholesaling, which then affect the downstream retail market.

### **3 MARKET STRUCTURE**

- 3.1 The following two chapters briefly discuss market structure and the impact of market developments on consumers. This sets the context for the discussion of specific market features later in the document.
- 3.2 This chapter focuses on the structure of the grocery retailing market and changes which have occurred since the CC report in 2000. Much of the analysis is based on publicly available information, supplemented by comments and data provided by the supermarkets and other retailers.
- 3.3 The OFT has identified three broad trends in market structure that are relevant to competition in the market:
- first, that national market concentration in the grocery sector is growing, and is relatively high in comparison with other countries
  - second, that some supermarket operators have moved into the convenience store sector, and
  - third, that market concentration at a local level limits the choice available to consumers in some areas.
- 3.4 The following sections look at the evidence behind each of these trends in the context of wider market developments.

#### **Structure of the grocery retailing market**

- 3.5 Total sales through UK grocery outlets were around £120 billion in 2005, a 4.2 per cent increase on 2004.<sup>9</sup> Of this total, around £95 billion comprised grocery sales, with the remainder representing sales of non-

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<sup>9</sup> IGD (August 2005), *Grocery Retailing*, page 3

grocery items. Groceries now account for nearly half of all retail sales, and around 13 per cent of all household spending.<sup>10</sup>

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

3.7 It is clear from observation that there is a wide variety of different types of grocery retail operator. These include:

- Supermarket multiples – including Asda, Morrisons, Sainsbury's and Tesco (the four largest supermarkets);<sup>11</sup> smaller chains such as Somerfield, Waitrose and Marks & Spencer; and 'discounters' such as Aldi, Lidl and Netto
- Symbol groups – can be loosely defined as multi-store chains where there is a single fascia, but where ownership can be fragmented: examples include Musgrave, which operates the Budgens and Londis fascias, and Spar
- Co-ops – that is, co-operative stores, which usually operate in a similar way to symbol groups, and
- Independents – stores which are independently owned and are not operated under a wider 'symbol'.

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<sup>10</sup> IGD (August 2005), *Grocery Retailing*, page 11

<sup>11</sup> The four largest supermarkets each have overall market shares of more than 10 per cent and a broad national presence. Somerfield is the next largest chain at a national level, with a market share of around 6 per cent based on TNS till roll data.

- 3.8 Within the 'supermarket multiples' group, there are substantial differences in the scale, strategy and product offering of the different firms. In the Proposed Decision, the OFT distinguished between the four largest supermarkets and other operators. A number of respondents criticised this approach, both for failing to recognise relevant differences between Asda, Morrisons, Sainsbury's and Tesco, and for ignoring the possibility that the behaviour of the four largest supermarkets might also extend to other smaller supermarket chains.
- 3.9 In gathering evidence on which to base a decision on whether to make a market investigation reference, the OFT concentrated on the four largest supermarkets because they each controlled more than 10 per cent of the market, had a broad national presence, and jointly represented more than 70 per cent of total grocery retail sales. The concerns expressed to us also related, in most cases, to conduct of the four largest supermarkets. However, in making a market reference, the OFT is interested primarily in the operation of the market as a whole rather than the behaviour of particular firms. The OFT considers that the terms of reference should give the CC the freedom to look at other grocery retail operators as well as the four largest supermarkets, and also at relevant differences in the market position and behaviour of Asda, Morrisons, Sainsbury's and Tesco.
- 3.10 The supply chain which serves the retailers is similarly diverse. Suppliers range from small local firms to large multi-nationals, and the grocery supply chain is complex, including producers, importers and farmers. Most of the wholesaling and distribution for the large supermarket multiples is carried out 'in-house'. However, for smaller retailers the picture is more complicated. A number of wholesalers (such as Palmer & Harvey McLane and Booker) serve many smaller retailers. There are also buying groups (for example, Spar and Costcutter) which negotiate collectively with suppliers on behalf of smaller stores. Some of these buying groups also operate fascias at the retail level. Finally, an important distinction can be drawn between branded and non-branded goods (that is, supplier branded vs. supermarket own-brand), and the supply chain characteristics can vary between these types.

## National market concentration

3.11 Figure 3.1 illustrates the movement in total grocery sales by different types of retailers since 2002.<sup>12</sup> It suggests that the national market share of the largest supermarkets (five supermarkets in 2002 and four in 2005 following the acquisition of Safeway by Morrisons) has stayed roughly constant at around 75 per cent by value of the grocery market. Allied with the growth in market share of Tesco, the market leader, this means that concentration has increased. In the remainder of the market, smaller brands, including symbol groups (for example, Spar, Costcutter), have also expanded, while others (notably independents) have lost market share.<sup>13</sup>

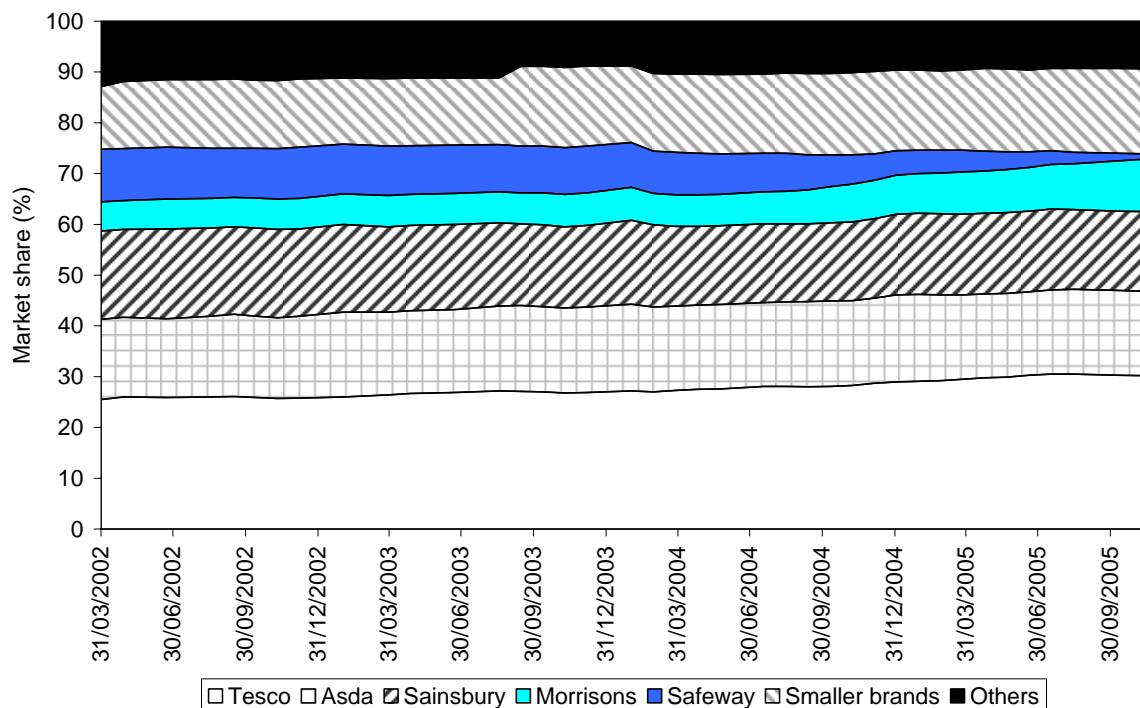
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<sup>12</sup> In terms of the economic markets described in Chapter 2, this covers both one-stop shopping and secondary shopping, but does not give a useful overview of changes in the sector.

<sup>13</sup> One of the supermarkets provided us with alternative figures for market shares, based on TNS retail tracker information (which includes grocery sales in non-grocers). This puts the market share of the four largest supermarkets at around 58 per cent in 2000, 60 per cent in 2002, and around 65 per cent now.



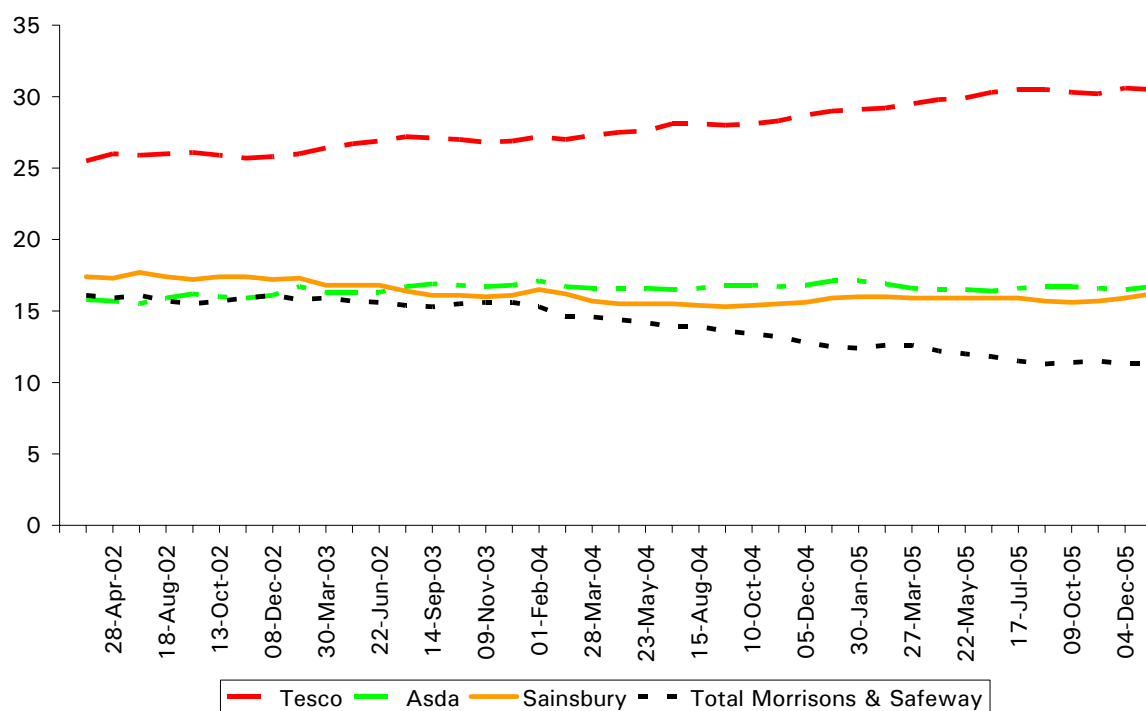
**Figure 3.1: Grocery national market shares by value 2002 - 2005**



Source: TNS data, till roll

3.12 Figure 3.2 below shows the estimated market shares for the four largest supermarkets (combining the figures for Morrisons and Safeway). This suggests that Tesco has increased its market share from around 25 per cent in 2002 to more than 30 per cent at the end of 2005. Of the other supermarkets, Asda had a 16.5 per cent share, Sainsbury's 15.9 per cent and Morrisons 11.3 per cent at the end of 2005. Tesco now appears to have nearly twice the market share (in terms of overall grocery retailing) of its nearest competitor.

**Figure 3.2: Market shares by value of the four largest supermarkets**



Source: TNS data, till roll

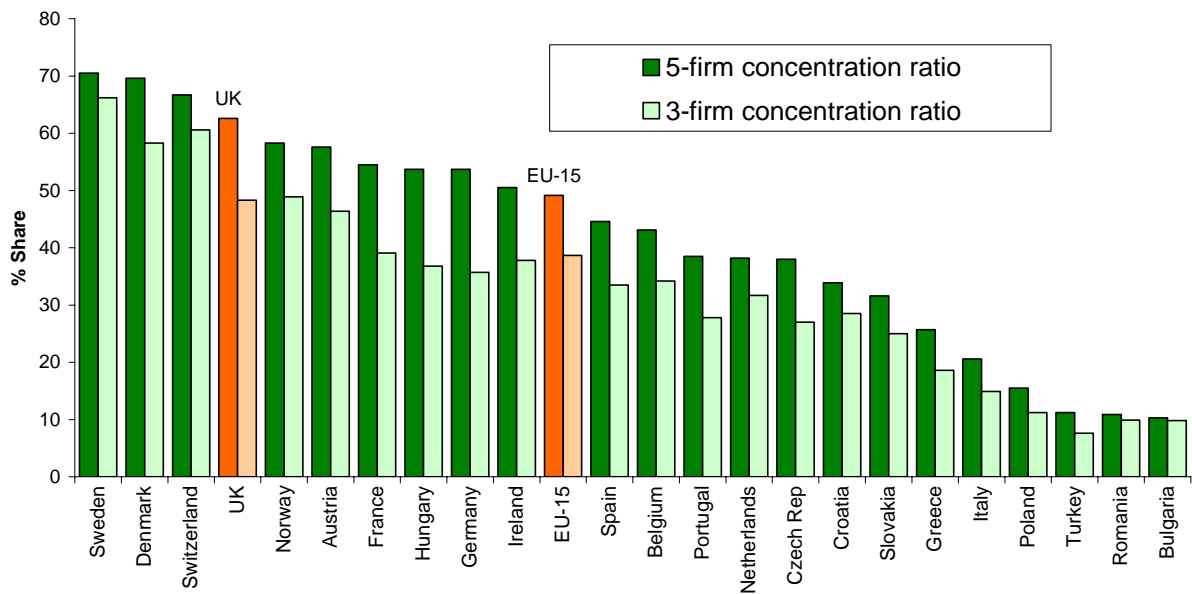
3.13 Among the smaller multiple retailers, Somerfield and Waitrose appear to have made significant gains over the last three years (Somerfield mainly through acquisition of former Safeway stores). Aldi, Netto and Lidl now together have just over a 5 per cent market share by value, representing modest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

3.14 Figures produced by the IGD suggest that the UK has one of the most concentrated grocery retail sectors in Europe, as measured by the market share of the three or five largest firms. Figure 3.3 below indicates that the top five UK grocery retailers account for 63 per cent<sup>14</sup> of the total grocery market. Care needs to be taken in interpreting these figures, given differences in the way the sector has developed, the role of the planning regime, and the impact of different consumer demands in

<sup>14</sup> Note that this figure and the 75 per cent figure noted in paragraph 3.7 are not directly comparable as the definition of groceries may be differently defined in arriving at both sets of figures.

different countries.<sup>15</sup> Nevertheless, the OFT observes that on some measures of market concentration, the UK market appears to be relatively highly concentrated.

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



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

<sup>15</sup> One of the supermarkets provided alternative figures (Planet Retail 2005, Grocery Retail Banner Sales) suggesting that the UK grocery sector is in fact less concentrated than average.

- 3.15 A number of respondents to the Proposed Decision commented on the OFT's analysis of national market concentration. Among the arguments made were that:
- The current market share of the four largest supermarkets is lower than was the market share of the five largest supermarkets (including Safeway) prior to the acquisition of Safeway by Morrisons in 2003. The apparent increase in concentration is thus due, in part, to mergers which were approved by the competition authorities.
  - Another respondent said that the increase in concentration had also been driven by growth in the market leader (Tesco) and decline in the market share of Morrisons, which could not necessarily have been foreseen by the competition authorities in their merger decisions.
- 3.16 Overall, these responses do not change the OFT's view set out in the Proposed Decision that the evidence suggests that there has been a slight increase in national market concentration in recent years. Part of this has been a predictable result of merger activity, but there has also been a shift in relative market shares within certain categories of operator, including amongst the four largest supermarkets. In relation to international comparators, there is evidence to suggest that market concentration in the UK is relatively high.

### **Structure and growth of the convenience retailing sector**

- 3.17 A second focus of recent concern has been the expansion of some of the largest supermarket multiples – predominantly Tesco and Sainsbury's to date – into the convenience store sector. In 2000 the four largest supermarkets owned 54 convenience stores in the UK but, by 2005, this figure had risen to 1,306.<sup>16</sup>

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<sup>16</sup> Source: data provided by the four largest supermarkets

- 3.18 Sales in convenience stores (that is, below 280 square metres) represent around 20 per cent of total grocery retail sales in the UK.<sup>17</sup> The convenience store share of the overall grocery retail market has increased over the last five years. The convenience store sector has grown by 31 per cent over the last five years compared with 24 per cent for all food retailing.<sup>18</sup> The IGD forecasts that convenience stores' share of the total grocery retail market is likely to continue to rise, increasing from 20 per cent to nearly 24 per cent by 2010.<sup>19</sup>
- 3.19 Part of this growth appears to be a response to changing consumer demands – for example changing work patterns leading consumers to place a higher value on convenience relative to cost. The IGD has commented that well-stocked convenience stores are ideally placed to meet consumers' needs for top-up and 'on-the-move' shopping. According to Mintel, 'the convenience store sector has been growing at a substantial pace in recent years. Industry estimates suggest that, in 2004, growth in sales was 5-7 per cent, one of the most buoyant sectors of food retailing'.<sup>20</sup> The overall picture therefore suggests healthy growth for the convenience store sector, resulting from growing consumer demand.
- 3.20 Nevertheless, concerns have been raised about the rapid growth of Tesco and Sainsbury's share of the convenience store sector and the impact that this has had on independent retailers in that sector. Figure 3.4 shows the change in value of sales through convenience stores over the last two years.<sup>21</sup> This shows significant growth in the sector for the grocery multiples from 3 per cent in 2003 to 10 per cent in 2005. Co-ops and symbol groups have also expanded. The main losers have been convenience specialists such as greengrocers and fishmongers (down 6 per cent) and independent stores (down 8 per cent).

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<sup>17</sup> IGD (August 2005), *Grocery Retailing*, page 19

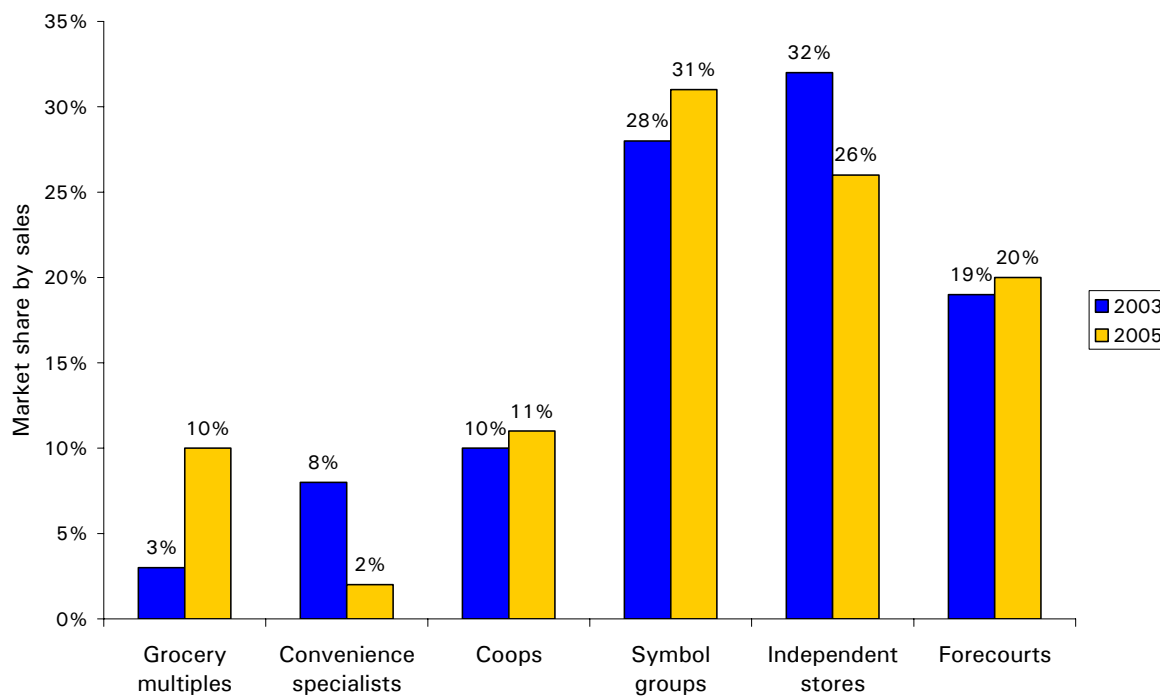
<sup>18</sup> Mintel (December 2005), *Convenience Retailing*

<sup>19</sup> IGD (August 2005), *Grocery Retailing*, page 191

<sup>20</sup> Mintel (December 2005), *Convenience Retailing*

<sup>21</sup> Mintel (December 2005), *Convenience Retailing*

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



Source: Mintel (2005), Convenience Retailing.

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

**Table 3.5: Numbers of convenience stores in the UK**

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

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

3.22 These figures suggest a significant fall in the number of unaffiliated independents. This is offset to some extent by an increase in the number of affiliated independents, reflecting the increasing success of symbol groups as shown in Figure 3.4. However, the figures still record a net loss of around 2,760 stores between 2001 and 2005. Government data show that retail sales through small food retailers grew by just 8 per cent at current prices between 2000 and 2005, compared with 27 per cent growth for large retailers.<sup>22</sup>

3.23 Some consultation respondents provided additional evidence of the impact on small retailers. The Federation of Small Businesses referred to a recent survey of its members, which indicated that of all business sectors in which its members are represented, the retail and wholesale sector is under significant strain, with the smallest proportion of businesses reporting increased turnover, profits and income. Other respondents commented on the benefits that they felt small retailers can provide to the local economy, as a service to local communities and a source of wealth creation.

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<sup>22</sup> Mintel (December 2005), *Convenience Retailing*

- 3.24 Looking just at convenience stores (that is, excluding convenience sales through larger supermarkets), it is clear that the sector is characterised by low levels of market concentration, and that the share of the four largest supermarkets remains relatively low at around 10 per cent. Figures from the Verdict Neighbourhood Retailing study suggest that Spar is the largest player in the sector with 9.7 per cent. Tesco is the second largest with an 8.2 per cent share.
- 3.25 However, as noted in Chapter 2, convenience retailing can also be carried out in larger format stores, including supermarkets, so calculations of market share should, arguably, include convenience sales through supermarkets. The difficulty is in estimating what proportion of a supermarket's sales represents convenience shopping. The ACS has estimated that the turnover of the supermarket multiples from convenience retailing in stores above 280 square metres was £18 billion in 2004.<sup>23</sup> On this basis, it estimates that grocery multiples account for around 50 per cent of total convenience shopping.
- 3.26 Some respondents commented that Tesco and Sainsbury's acquisitions of convenience stores had been approved by the competition authorities, and that the OFT had previously argued that the barriers to entry and expansion in the convenience market were low. The OFT acknowledges that, on a case by case basis, these acquisitions were not expected to result in a substantial lessening of competition. Nevertheless, the cumulative effect of the various mergers has marked a significant change in the market since the last major investigation by the CC in 2000.
- 3.27 In summary, the evidence confirms that the share of the convenience sector of the market controlled by the four largest supermarkets, both in terms of all convenience shopping, and considering only sales through convenience stores, has increased. However, the relative size of the convenience store sector has also grown, with smaller supermarkets and

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<sup>23</sup> May 2005 Europe Economics report commissioned by the ACS for its response to the OFT's March 2005 report on the *Supermarkets Code of Practice and other issues* (OFT807).



symbol groups benefiting as well as the large supermarket chains (that is, Tesco and Sainsbury's).

## Concentration in local areas

- 3.28 A final feature of market structure is the extent of local market competition and choice. The OFT is aware of various claims of supermarkets having high local market shares. For example, in areas including Inverness, Bicester, Milton Keynes, Twickenham, Southall and Hemel Hempstead, Tesco's share of supply in groceries is estimated to be over 40 per cent.<sup>24</sup> Respondents to the consultation also drew attention to concerns about a perceived level of local choice in a number of areas, including Aylsham, Stalham, Hailsham and the Wirral.
- 3.29 In order to provide an outline picture of local competition between the four largest supermarkets, the OFT asked each firm to identify the locations of its current stores. This information suggests that around a quarter of post code areas across the UK have no large stores owned by the four largest supermarkets, and around half have one store owned by one of the four largest supermarkets. The remaining quarter of post code areas have two or more big stores owned by the four largest supermarkets.
- 3.30 Data provided by one of the supermarkets suggest that over 80 per cent of consumers in Great Britain can reach three or more different one-stop shop fascias within 15 minutes. If mid-range stores are included, then around 93 per cent of customers have access to three or more operators within 15 minutes drive time. The same supermarket has acknowledged that there has been a slight reduction in the level of choice since 2000 due to the CC-approved acquisition of Safeway by Morrisons.

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<sup>24</sup> CACI estimates quoted in APPSSG report, *High Street Britain: 2015*, February 2006, page 23, based on CACI, UK Dominant Grocers, 2005. The CACI analysis is based on predicted consumer behaviour, taking account of factors such as drive-time to different stores and product offering of those stores. Individual results are then aggregated up to a post code area level.

- 3.31 Another supermarket provided alternative information based on relevant local markets being delineated by an approximate 10 minute drive time in urban areas and 15 minute drive time in rural areas. On this basis, 53 per cent of consumers in urban areas have access to fewer than three fascias (that is, 47 per cent of customers have access to three or more operators in their local area).
- 3.32 A number of respondents commented on the analysis of local concentration in the Proposed Decision document. One respondent stated that a full analysis of local market shares should be based on the time taken for consumers to reach different stores as an indicator of demand-side substitution. As stated in the Proposed Decision, the OFT has not attempted to carry out a full investigation of competition in local markets. Nevertheless, the information presented above (based in a number of cases on drive time analysis of local markets) suggests that there are local markets where high concentration may reflect substantial barriers to entry, and may exacerbate the competition effects of other features the OFT has identified.
- 3.33 Other respondents argued that the analysis of local choice should take account of social impacts, including access for vulnerable consumers and those in rural areas. One respondent argued that isochrone analysis should not necessarily assume that consumers are able to drive to local stores. The OFT accepts there are wider social issues in relation to the grocery market. To the extent that these issues affect the analysis of competition, the CC could take them into account in its investigation. However, the OFT believes that a number of these issues are more properly matters for government policy than for the competition authorities.
- 3.34 Other respondents argued that local competition concerns largely reflected the market position of Tesco. The OFT accepts that Tesco's position as the market leader means that there are likely to be more locations where Tesco stores may raise competition concerns than would be the case for the other supermarkets. However, the four largest

supermarkets each have areas of local strength, and the OFT's concerns over local choice are not limited to Tesco alone.

## **Other views of respondents**

3.35 A number of respondents commented on other market developments, aside from those included in the Proposed Decision. Some commented on the significant growth in non-grocery sales in supermarkets, and suggested that this marked an important change in the market since 2000. Others noted that sales of groceries over the internet (including by some of the large supermarket chains) were also affecting competition. The OFT agrees that these are important trends, which the CC may wish to investigate. The question of scope of the investigation is covered in more detail in Chapter 9.

## **Conclusions**

3.36 The grocery market is evolving rapidly. This is partly in response to changes in consumer demand (for example, changing work patterns, demand for convenience, and growing expectations about quality, range and service available from shops). However, these effects have also been accompanied by changes in the structure of the supply side of the market, including:

- an increase in national market concentration
- the expansion of some of the largest supermarkets into smaller store formats (for example, Tesco Express and Sainsbury's Local), competing directly alongside smaller supermarkets and independent stores
- the gain in market share of some symbol groups, but a decline in the number of independents, and
- continuing concerns about lack of local competition and choice in some areas.

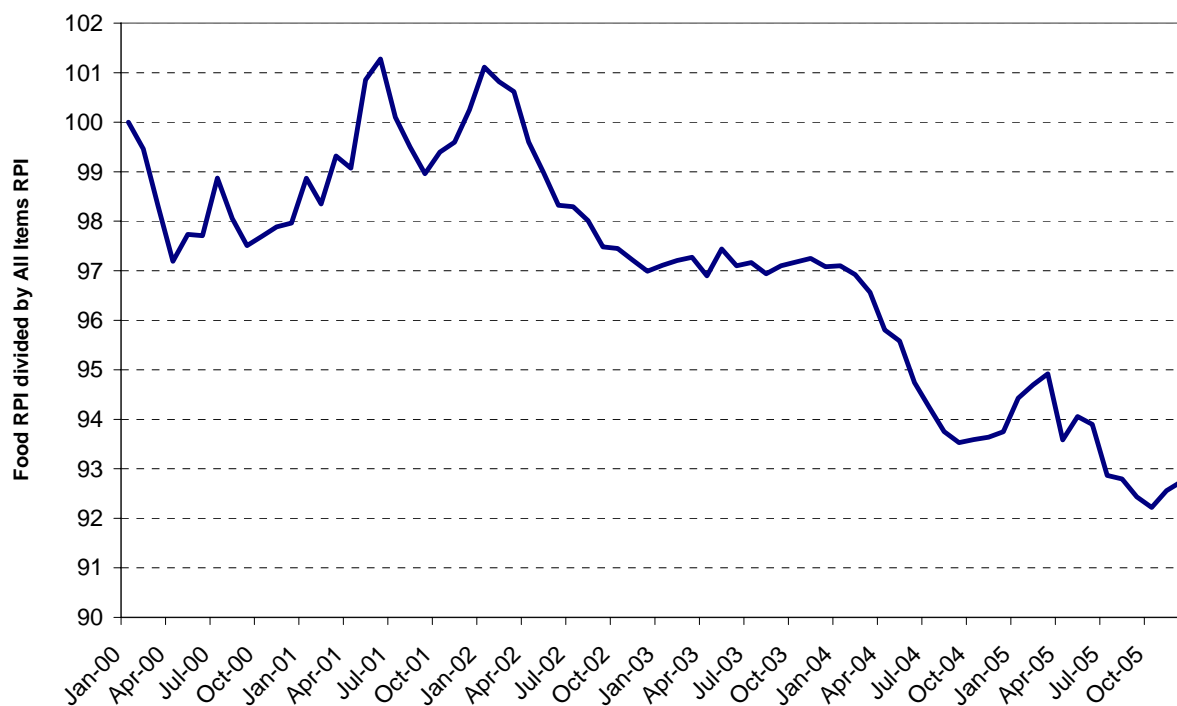
## 4 PRICE, QUALITY, RANGE AND SERVICE

4.1 This chapter considers how consumers have fared as a result of the market developments outlined in Chapter 3, in terms of price, quality, range and service.

### Price

4.2 Prices in the food retail sector have declined in real terms over the last five years, as Figure 4.6 shows. Based on ONS data, the OFT estimates that real prices for food fell by 7.3 per cent between January 2000 and December 2005.

**Figure 4.6: Trend in real food prices since 2000**



Source: OFT calculations based on ONS RPI data

4.3 The OFT compared the average supermarket prices for a variety of products with the ONS average price and calculated the average difference. The findings showed that the majority of commonly

purchased products appear to be cheaper by an approximate average of 10 per cent in the four largest supermarkets.<sup>25</sup>

- 4.4 Few respondents contested the evidence that prices have declined in recent years. However, some argued that it was too simplistic to focus solely on headline price figures. For example, one respondent argued that declines in prices have been offset by car usage costs, petrol, increased carbon emissions and increased traffic congestion.

## Quality

- 4.5 There is evidence that consumers may increasingly value quality of product over pure competition on price. This appears to be having benefits for some niche players, including independent stores.
- 4.6 Mintel has reported that the surviving niche players are doing better than they had done previously. It believes that consumer concern about healthy eating and buying local produce has meant that butchers, bakers, fishmongers, greengrocers, market stalls and farm shops were trading more successfully in 2005 than in any year since 2000.<sup>26</sup> It goes on to say that 'many of the food specialists that have survived have done so because they have focused on quality and service'.<sup>27</sup> However, Figure 3.4 indicates that there has been a sharp decline in the overall number of independent outlets.
- 4.7 The APPSSG Report states that there has been an 11 per cent increase in demand for organic products over the last year. It goes on to say that independent retailers experienced a 43 per cent growth in sales of

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<sup>25</sup> The OFT emphasises that this estimate is based on a relatively small sample of products, and should not be viewed as a comprehensive price comparison.

<sup>26</sup> Mintel (November 2005), *Food Retailing*

<sup>27</sup> Mintel (November 2005), *Food Retailing*

organic goods, while the percentage of sales by supermarkets fell for the third consecutive year from 81 per cent to 75 per cent.<sup>28</sup>

- 4.8 Some respondents argued that the OFT should take account of wider issues such as the quality and healthiness of food sold in supermarkets. The OFT has not attempted to measure this. In general, provided competition gives consumers a choice of types of food, the OFT would view issues of diet and healthiness of food to be outside its remit as a competition authority.

## Range

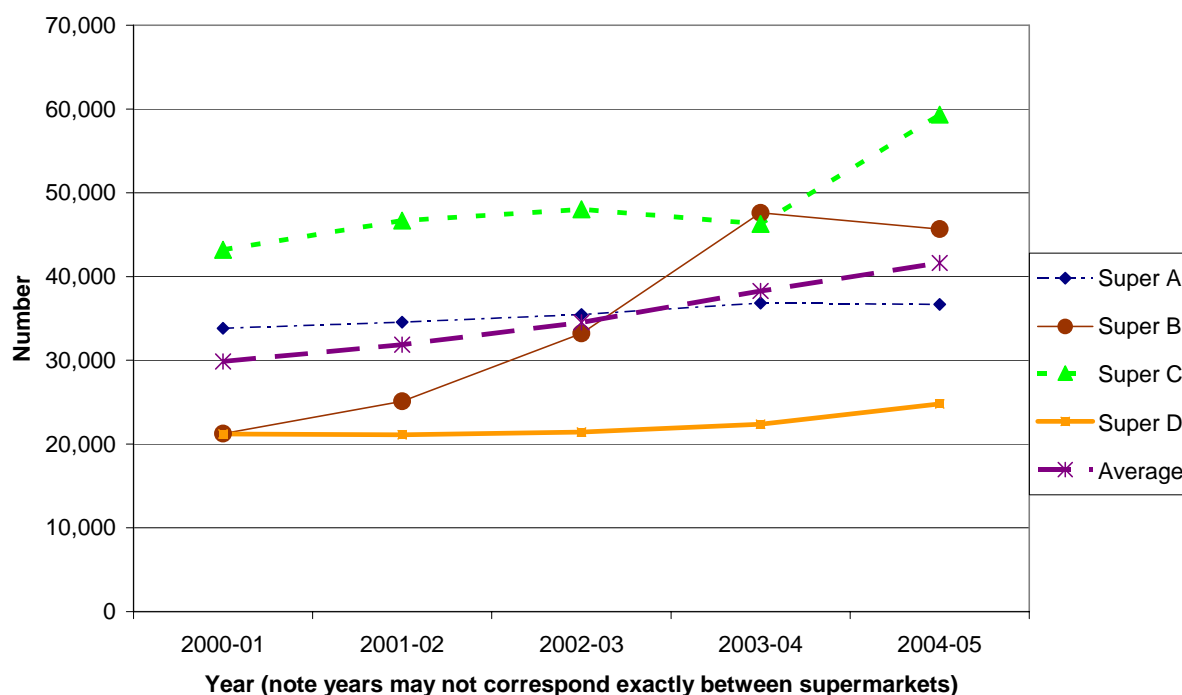
- 4.9 One of the key concerns about a reduction in the number of independent stores or increasing moves by some of the largest supermarkets into the convenience store sector is that choice of store for consumers may be reduced where consumers have fewer different stores (that is, fascias) in their local area.<sup>29</sup> Responses to the consultation on the OFT's Proposed Decision, particularly from individuals, made clear that access to a range of different stores (including independents) is valued by a significant number of consumers.
- 4.10 Apart from number of fascias, an important dimension of choice is the range of products provided within a given store. A major attraction of supermarkets over convenience stores (independent or otherwise) is that they stock a wider range of products under a single roof.
- 4.11 The OFT asked the four largest supermarkets to provide information on the change in number of lines stocked over time. As shown in Figure 4.7, these data suggested that, in 2004-05, there was an average of around 41,500 lines stocked by the four largest supermarkets, an increase of 40 per cent over five years.

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<sup>28</sup> All-Party Parliamentary Small Shops Group, *High Street Britain: 2015*, February 2006, page 21

<sup>29</sup> Evidence on local market concentration is considered in Chapter 3.

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



Source: OFT calculations based on data provided by the four largest supermarkets.

- 4.12 However, part of this increase in number of products might be viewed as a natural process of product differentiation and innovation, driven primarily by manufacturers and suppliers. The OFT has not attempted to determine how far the increase in product range might have been a result of competition between supermarkets rather than other features.
- 4.13 Overall, in considering the impact of market developments on consumer choice, it is important to balance the impact of a reduction in the number of stores against, among other things, the apparent increase in range provided within the large supermarkets, and to consider whether product choice has actually been (or could be expected to be) impaired.

## Service

- 4.14 The Verdict report 'Neighbourhood Retailing' (2006) states that 'the impact of Sainsbury's and Tesco's increasing pressure [in the convenience store sector] has raised competition and retail standards. The multiple retailers have brought fresher food, new ranges, lower prices, better store environments and increased scale to the neighbourhood and it has forced smaller players to improve to keep up'.
- 4.15 Evidence suggests that consumers have come to expect more from their local store and seek better prices, well stocked stores, and ease of access, among other things. However there is the possibility that this may have raised barriers to entry by increasing the sunk costs of opening a store, or indeed renovating an existing store (although arguably the increase in consumers' expectations about the service and quality that a store should provide is a positive change). This increase in consumer expectations may account for the decision of many previously independent convenience retailers to join symbol groups.
- 4.16 A recent report by *Which?* found that 'satisfaction with the [grocery] sector as a whole is higher than for the clothing and electrical sectors'. Waitrose and Marks & Spencer scored the highest levels of consumer satisfaction within the grocery sector, topping the ratings for product and customer service, despite both featuring within the bottom three of the pricing category.<sup>30</sup>
- 4.17 To quantify some of these elements of service the OFT asked supermarkets to provide information on the amenities that they provide, such as express check-outs, air conditioning and toilets. The results showed that the four largest supermarkets provided more amenities in-store than competing smaller supermarket retailers: see Figure 4.8 (the dark bars relate to individual large supermarkets – and include data

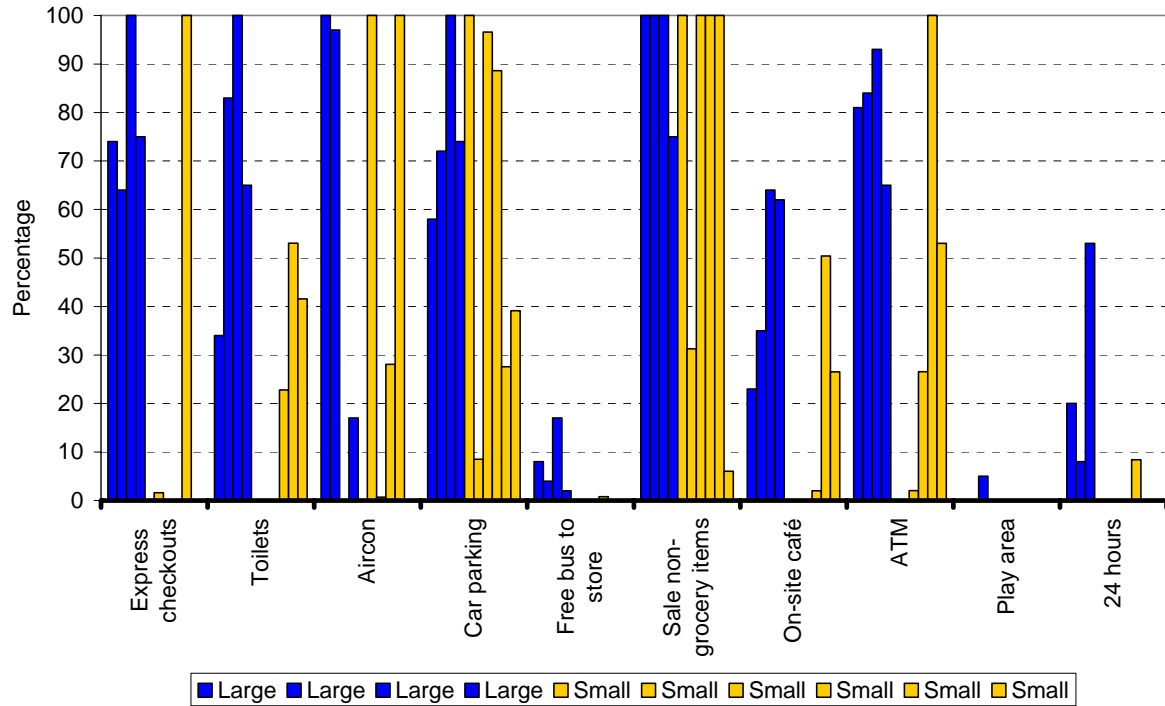
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<sup>30</sup> *Which?*, *Comparison of Satisfaction of Retailers in the UK* (January 2006)



relating to their smaller format stores – and the lighter bars relate to individual smaller supermarket chains).

**Figure 4.8: Amenities percentage for all stores 2005**



Source: OFT calculations based on information provided by the supermarkets.

4.18 The supermarkets could not provide consistent data to show the change in level of amenities since 2000. However, the limited information that the OFT has seen suggests that amenities have improved over the last five years across the grocery market.

## 5 PRICING BEHAVIOUR

- 5.1 In order to make a market investigation reference, the OFT must have reasonable grounds to suspect that features of the market prevent, restrict or distort competition. The following three chapters set out specific features of the market that the OFT has concluded give it grounds for making a market investigation reference to the CC, in the light of the changes in the market outlined in Chapter 3. This chapter focuses on whether supermarkets' pricing behaviour might distort competition and potentially harm consumers.
- 5.2 The ACS and others have argued that supermarkets (particularly the four largest supermarkets) sell some products, particularly known value items (KVIs),<sup>31</sup> below cost. It is argued that this below-cost selling continues to distort competition with convenience stores, as found by the CC in 2000. It has also been argued that:
- the greater consolidation of the large multiples following Morrisons' takeover of Safeway is likely to exacerbate below-cost selling, leading to an increase in the number of small retailers leaving the market, and
  - the distortion of competition caused by below-cost selling practices is greater now than in 2000 because some of the largest supermarkets have expanded into the convenience store sector and engage in below-cost selling in that sector as well as in their larger stores.
- 5.4 The ACS and others have also claimed that the four largest supermarkets price differently in local areas in response to local market conditions. This type of 'price flexing' could distort competition in two ways. First, it could tend to focus some element of price competition into localities where particular low-priced competitors are present and away from other areas, leading to higher prices being charged in areas

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<sup>31</sup> The CC has previously defined a KVI as 'a product which is high profile or well known, where price awareness among consumers may be higher than for most products'. (*Supermarkets*, Competition Commission 2000, Glossary).

where competition is weak. Second, local price reductions could, in principle, be used to drive competitors out of the market, after which prices could be increased to levels higher than they were immediately before the local price reductions were put into effect.

## Previous analysis

5.5 In 2000, the CC concluded that all four of the largest supermarkets and some other supermarkets priced below cost on some products including KVIs, and that in some cases this could harm smaller retail outlets, leading to adverse effects on competition.<sup>32</sup> In particular, below-cost selling of KVIs and other core products:

- distorted customers' perceptions of the value-for-money provided by supermarkets, thus unfairly damaging smaller competitor retailers whose more limited product ranges restricted their ability to cross-subsidise between products to the same degree that supermarkets could, and
- focused price competition on those products, meaning that other products sold by supermarkets were not fully exposed to competitive pressures.

5.6 The CC described its concerns as follows: 'Persistent below-cost selling by the supermarkets is likely to have a particularly marked effect on [smaller retailers, including convenience stores and specialist outlets] because the latter rely disproportionately on revenue from KVIs and other core products; and, unlike their larger competitors, they cannot so readily absorb losses by means of cross-subsidy. We should not be concerned if consumers were able to make a fully informed choice between the supermarket and higher-priced convenience store but where such choice is made as a result of persistent below-cost selling, then this distorts competition and damages the smaller store. As a result, such stores will be forced to raise prices to an uncompetitive level on other

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<sup>32</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.387

products; in extreme cases, the practice will contribute to small stores being put out of business. This may be expected to damage the grocery retail sector and reduce consumer choice and amenity.<sup>33</sup> The CC also found that, 'There [would] also be costs to consumers generally, when they buy other, higher-priced, products from which the below-cost prices are subsidised'.<sup>34</sup> These concerns led the CC to conclude that below-cost selling of KVIs and other core products was against the public interest. However, the CC also decided that, given that the market was generally competitive, no remedy was appropriate in the light of proportionality and a desire to minimise regulatory cost.<sup>35</sup>

5.7 The CC's 2000 report also found that a number of the parties engaged in 'the practice of setting retail prices across different stores in different geographical areas in the light of local competitive conditions, such variation not being related to costs'.<sup>36</sup> The CC concluded that this practice distorted competition in the retail supply of groceries in the UK in that it tended to focus some element of price competition into localities where particular price-competitive competitors were present and away from other areas where competition was weaker.<sup>37</sup> The CC also concluded that price flexing distorted competition by contributing to the position that a majority of grocery products were not fully exposed to competitive pressure. The CC said that the distortions of competition operated against the public interest when engaged in by those supermarkets with significant market power (in that case Safeway, Sainsbury's and Tesco).<sup>38</sup> The CC went on to conclude that there were no proportionate available remedies.<sup>39</sup>

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<sup>33</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.388

<sup>34</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.393

<sup>35</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.565

<sup>36</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.406

<sup>37</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.406

<sup>38</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.409

<sup>39</sup> *Supermarkets*, Competition Commission 2000, paragraphs 2.566 and 2.567

5.8 Furthermore, the CC concluded in its 2003 Safeway merger report that price flexing was still likely to be a profitable strategy for each of Asda, Morrisons, Sainsbury's and Tesco following any proposed merger.<sup>40</sup> While it did not have any conclusive evidence of this, it cited the ability for all supermarkets to switch to pricing locally.<sup>41</sup> It found that Tesco and Sainsbury's had different pricing structures based on the format of their stores. During its consultation stage, the CC was given a number of representations by supermarkets that Tesco and Sainsbury's both price flexed, although neither admitted doing so. Asda claimed that Tesco priced more aggressively near its Asda outlets through varying its formats.<sup>42</sup> While the CC did not ascertain whether this was correct, it did foresee the possibility that parties might avoid competing using the same store sizes in areas where there were only two or three competitors present. The CC concluded that 'in our view [there is] no reason to conclude that national pricing must or will inevitably continue in the future. Given the scope for local pricing, we would expect firms to pursue whichever ... strategies ... [were] most profitable in the prevailing circumstances of the market'.<sup>43</sup> Likewise the CC's 2005 report on Somerfield's acquisition of 115 stores from Morrisons found that price flexing was being carried on by Somerfield.<sup>44</sup>

## Evidence of below-cost selling

5.9 The ACS has provided specific instances which it believes suggest below-cost selling, in relation to Easter eggs and fuel.<sup>45</sup> Other respondents to the consultation provided anecdotal evidence of below

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<sup>40</sup> *Safeway merger report*, Competition Commission 2003, paragraph 2.98

<sup>41</sup> *Safeway merger report*, Competition Commission 2003, paragraph 2.96

<sup>42</sup> *Safeway merger report*, Competition Commission 2003, paragraph 2.96

<sup>43</sup> *Safeway merger report*, Competition Commission 2003, paragraph 2.98.

<sup>44</sup> *Somerfield plc/Wm Morrison Supermarkets plc report*, Competition Commission 2005, paragraph 7.52.

<sup>45</sup> Note that fuel costs were outside the scope of the OFT's enquiries, which were directed at the retail supply of groceries. The OFT notes, however, that the below-cost selling by supermarkets of fuel or other non-grocery products might distort competition in the retail market for groceries insofar as the below-cost prices charged for non-groceries were generating higher custom by grocery-buying customers, at the expense of competing outlets.

cost selling, including in relation to the pricing of alcoholic drinks. The OFT carried out further research to estimate the extent of below-cost selling by the four largest supermarkets.<sup>46</sup>

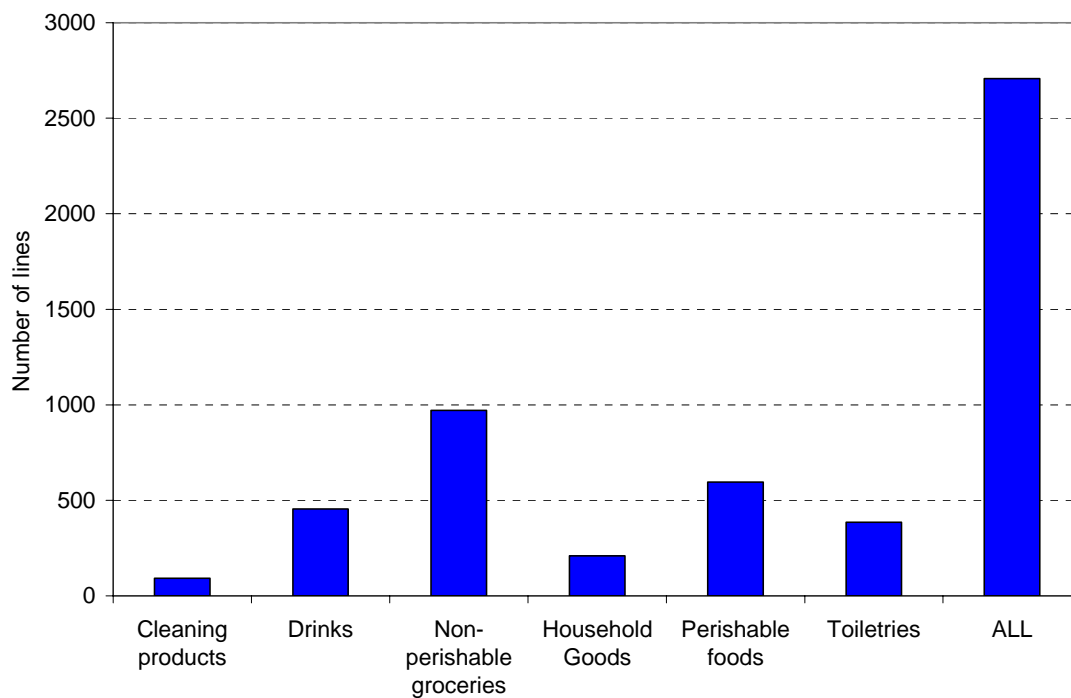
- 5.10 The OFT asked the four largest supermarkets to list all their grocery products where the gross margin on sales was less than 5 per cent. Some respondents questioned whether this measure was appropriate, suggesting that it might overestimate the degree of below-cost selling. As stated in the Proposed Decision, however, the 5 per cent gross margin figure was considered by the CC in 2000 to be a reasonable proxy for identifying below-cost selling<sup>47</sup> (although the OFT has not attempted to replicate the CC's analysis), and the OFT considered it appropriate to use this measure for the purpose of estimating the extent of below-cost selling.
- 5.11 Figure 5.9 shows the total number of grocery lines identified as being sold with a gross margin of less than 5 per cent by the four largest supermarkets. In total, the OFT identified 2,708 such lines.

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<sup>46</sup> The decision to collect evidence only from the four largest supermarkets was made primarily because of time constraints and with a view to minimising the overall burden of information requests on the industry. The OFT considers that similar pricing practices might also be engaged in by smaller retailers, and this may be something that a CC investigation would wish to explore.

<sup>47</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.385

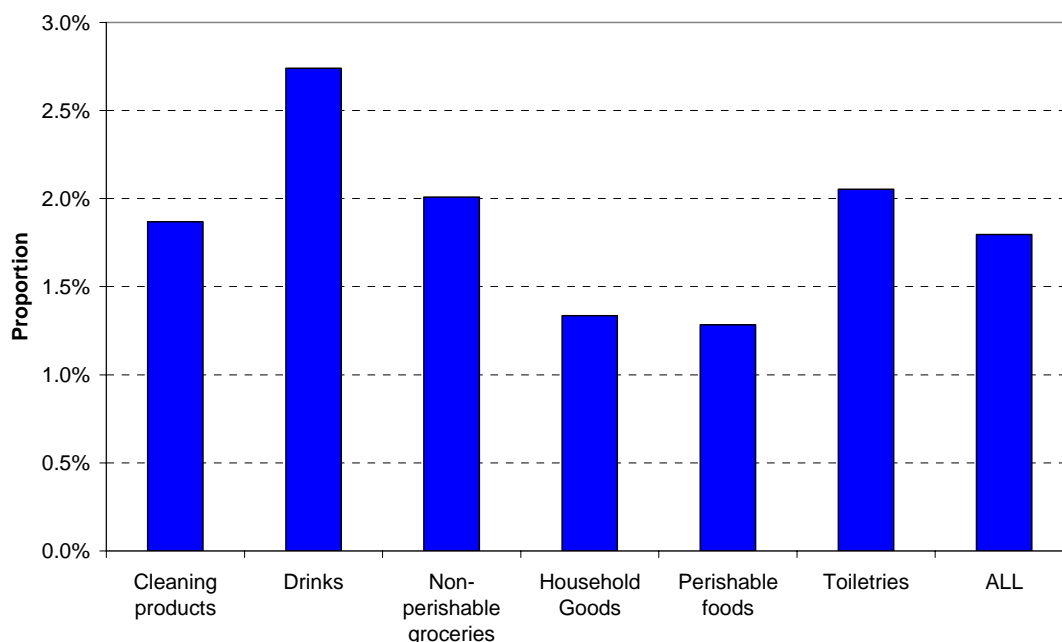
**Figure 5.9: Number of lines with gross margins less than 5 per cent in the four largest supermarkets**



Source: OFT calculations based on data provided by the four largest supermarkets.

5.12 Figure 5.10 shows the number of grocery lines sold below 5 per cent gross margin as a proportion of total number of lines sold by the four largest supermarkets, calculated from figures they provided. The OFT estimates that the 2,708 lines sold below 5 per cent gross margin represent around 1.8 per cent of the number of grocery lines aggregated across the four largest supermarkets.

**Figure 5.10: Proportion of product lines with gross margins of less than 5 per cent for the four largest supermarkets**



Source: OFT calculations based on data provided by the four largest supermarkets.

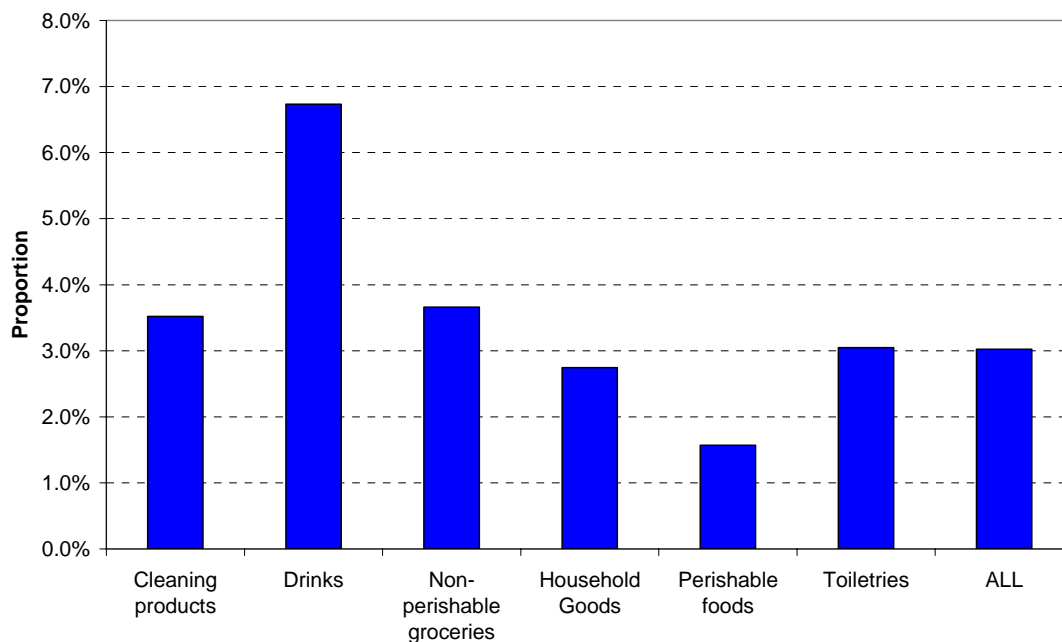
5.13 The OFT also asked the four largest supermarkets to provide data on the value of their sales of groceries sold below 5 per cent gross margin. Figure 5.11 shows the OFT's estimates of the proportion of total sales with gross margins less than 5 per cent in these supermarkets by product category. Overall, the OFT estimates that the extent of below-cost selling relates to around 3 per cent of grocery sales by the four largest supermarkets, in value terms.<sup>48</sup>

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<sup>48</sup> Some of the large supermarkets challenged our analysis, saying that (i) we should be looking only at products sold with negative margins and (ii) many of the products with low margins are those where price reductions are not permanent (for example, stock-clearance, seasonal sales). If this were accepted, there would be a reduction in the proportions of the number of lines and sales of the totals of groceries which might be subject to below-cost selling.



**Figure 5.11: Proportion of total sales by product category with gross margins less than 5 per cent for the four largest supermarkets**



Source: OFT calculations based on data provided by the four largest supermarkets.

- 5.14 The fact that below-cost selling is higher as a proportion of sales than as a proportion of total lines indicates that products sold below cost tend to have above average sales – that is, they are likely to be the more popular/commonly purchased products. This indicates that below-cost selling may be more important on faster selling items, which might be argued to benefit consumers, especially those who are less well off.
- 5.15 The OFT also attempted to test the claims that Tesco and Sainsbury's were extending the practice of below-cost selling into their convenience stores. Since the Proposed Decision, the OFT has clarified previous information provided by Tesco and Sainsbury's on the number and sales value of grocery lines sold in their convenience stores with a gross margin of less than 5 per cent. The adjusted data suggest that the number of lines sold below 5 per cent gross margin in convenience

stores, as a proportion of total lines sold, is slightly lower than in one-stop shops. In terms of sales value, the OFT estimates that the proportion of products sold below cost in convenience stores owned by Tesco and Sainsbury's is likely to be slightly under 1 per cent, compared with 3 per cent in one-stop shops.

- 5.16 On the basis of the evidence collected, the OFT cannot determine conclusively whether the extent of below-cost selling has increased or decreased significantly since 2000. A number of the supermarkets put it to the OFT that the practice of below-cost selling is no more prevalent now than it was in 2000. Nevertheless, given the expansion of Tesco and Sainsbury's into the convenience store sector, it can be reasonably expected that the total level of below-cost selling in that sector has increased, at least if it can be assumed that it was not already being practised by the convenience stores which Tesco and Sainsbury's have acquired.
- 5.17 The OFT has found no evidence to suggest that below-cost selling of KVIs by the largest multiples now is significantly more or less likely to be restricting or distorting competition than it may have been in 2000. The CC's particular concern in relation to below-cost selling was the competition-distorting effect of the cross-subsidisation which it required between different products and sectors. That competition-distorting effect is inherent in below-cost selling of KVIs and, in so far as the practice continues, there must also be reasonable grounds for suspecting that competition is being distorted as a result. However, it is also possible that below-cost selling on a small number of KVIs is part of a strategy that drives increased competition and thereby is an important feature of the market that benefits consumers. Investigation is needed to analyse these possible alternatives.
- 5.18 A key question is whether the move of Tesco and Sainsbury's into the convenience store sector since 2000 has exacerbated any distortion of competition caused by below-cost selling. One of the supermarkets has argued that an extension of below-cost selling to the smaller format stores of the large multiples could alleviate the concerns identified by the

CC in 2000. This is because the CC's key concern was that below-cost selling by the supermarkets would lead to a misallocation of resources between one-stop shops and convenience stores.<sup>49</sup> In principle, the OFT agrees that below-cost selling in supermarket-owned convenience stores could reduce the misallocation of resources between supermarkets and convenience stores owned by Tesco and Sainsbury's. However, the OFT believes that there are reasonable grounds for suspecting that below-cost selling in convenience stores owned by Tesco and Sainsbury's could distort competition between these and other convenience stores, including independent stores.

## Evidence of price flexing

- 5.19 The ACS has said that price flexing continues to be practised by the largest supermarket multiples. Whether or not they generally have national pricing policies that allow prices to be set on a store-by-store or other localised basis by reference to local competitive conditions, there is observable evidence of price flexing in the form of local voucher promotions (for example, 'spend £X and get £Y voucher', or 'spend £X and get £Y off').
- 5.20 The OFT is aware of a number of claims of local price flexing. These include the following cases:
- Proudfoot has claimed that Tesco pursued a 4-week campaign, introduced specifically for its Withernsea store, offering £8 off for every £20 spent (total of four vouchers in each of the 15,000 mail shots sent out). This represented up to a 40 per cent discount - assuming the consumer purchased only £20 worth of products.

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<sup>49</sup> In paragraph 2.381 of its 2000 report, the CC said that 'If consumers choose to shop at supermarkets because of their convenience, range, choice and value, then their success at the expense of smaller specialist or discount outlets is unobjectionable. However, if consumers are induced to shop at these larger outlets because some products are offered below the resource costs of producing and delivering them, then that would represent a misallocation of resources and a distortion of competition in the grocery market'.

Proudfoot alleged that this was predatory pricing aimed at eliminating the only other supermarket in a 15 mile radius.<sup>50</sup>

- ACS has told the OFT that in Bellshill, near Glasgow in May 2005 Tesco ran a voucher promotion offering £10 off with every £30 spent and that the same promotion was run in Hull.
- A small retailer cited an example of below-cost pricing in Grimsby – where Tesco advertised deep discounts on certain brands of coffee and tea only at the Tesco Extra stores in Cleethorpes and Grimsby which are allegedly in direct competition to one of the largest Nisa-Today's retailers.
- In July 2005, Sir Ken Morrison, chairman of Morrisons, told City analysts that Tesco was using selective discounts to lure shoppers from his newly refurbished stores. Sir Ken cited the example of the Isle of Wight, where, after the opening of a new Morrisons store, Tesco had sent vouchers giving shoppers £15 off every £40 spent - a discount of up to 37.5 per cent.

5.21 To obtain more general evidence of local pricing behaviour, the OFT asked the four largest supermarkets to outline their pricing strategies and the extent of permitted local price variations. In response, all of them stated that almost all pricing decisions are made centrally. The general approach appears to be for prices to be determined through a national price list, based on analysis of competitors' prices. However, there are variations in the precise pricing strategies adopted by the various players.

5.22 The four largest supermarkets acknowledged that there is some limited degree of local price variation. Examples include some discretion for local managers, although a number of the supermarkets have stated that, in

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<sup>50</sup> In 2005, the OFT examined whether Tesco's actions in the Proudfoot case constituted predatory pricing and abuse of a dominant position under the Competition Act 1998, but the evidence at that time was not viewed as persuasive.

practice, this is on a very small proportion of sales, and typically relates to the sale of end of line or old stock.

- 5.23 In the light of the examples in paragraphs 5.19 and 5.20, and the fact that the supermarkets have acknowledged that there is some (albeit limited) discretion to vary prices and offer 'buy x get y free' deals on a local basis (determined either locally or at a national level), there appears to be evidence that some price flexing does occur, albeit to a limited extent.
- 5.24 The evidence presented by the four largest supermarkets suggests that price flexing, where it does occur, tends to be done to match competitors (which are frequently the other large supermarkets). Furthermore, the OFT has not found conclusive evidence that any competitors have been driven out of the market as a result of price flexing – whether by directly adjusting prices of the groceries concerned, providing 'buy x get y free' offers, money-off vouchers or extra loyalty card points.
- 5.25 Nevertheless, the OFT does not have any evidence to rule out the previous concerns raised by the CC that price flexing might tend to focus some element of price competition into localities where particular low-priced competitors are present and away from other areas. In some circumstances, local price competition, where there is no predatory behaviour arising from the abuse of a dominant position in an area, could benefit rather than harm consumers – that is, the existence of price flexing could be a characteristic of a well-functioning competitive market. However, as acknowledged by the CC in 2000, there could be a concern if price flexing focuses some element of price competition into localities where particular lower-priced competitors are present and away from other areas and thereby contributes to the position that a majority of grocery products are not fully exposed to competitive pressure.

## Other views of respondents

- 5.26 Apart from the specific comments relating to the OFT's analysis of below-cost selling and price flexing included in the discussion above, a number of respondents commented more generally on the pricing behaviour of the supermarkets.
- 5.27 Two of the largest supermarkets argued that the Proposed Decision implied, incorrectly, that the four largest supermarkets all engaged in below-cost selling and price flexing to the same extent. The OFT acknowledges that the four largest supermarkets pursue different pricing strategies. The evidence they provided suggests that the extent of below cost selling and price flexing does indeed differ between these supermarkets. However, the OFT's concerns relate to the workings of the market as a whole, more than to the behaviour of any particular firm. In this regard, the OFT considers that the types of pricing behaviour addressed here could extend to other supermarkets, beyond the four largest multiples. The OFT has not attempted to collect data more widely at this initial stage, before a full CC investigation.
- 5.28 One respondent argued that the analysis of pricing behaviour should be extended to include non-groceries, on the grounds that some of the largest supermarkets have become 'destination stores' for non-groceries including CDs, books, some electrical items and clothing. The OFT agrees that below-cost selling is a feature that could extend to non-groceries, although it has not attempted to look for systematic evidence of below-cost selling in other product areas. The possible scope of the CC's investigation is discussed in more detail in Chapter 9.
- 5.29 Many of the respondents, including individuals, questioned the OFT's view in the Proposed Decision that there was no evidence of overall consumer harm from the pricing practices of the four largest supermarkets, arguing that the pricing behaviour of the large supermarkets was undermining the viability of smaller stores and thus reducing local choice. One respondent suggested that, whether or not consumers were being harmed at present, below-cost selling would harm

consumers in the medium to long term if it had the effect of driving smaller independent shops out of business. The OFT acknowledges that there could be an impact on consumer choice in the future if below-cost selling by the major supermarket multiples (particularly in their convenience stores) were to lead to a significant number of efficient independent stores being driven out of the market. As discussed further below, the OFT has not, in its necessarily limited investigation to date, found evidence to show that below-cost selling by supermarkets is responsible for the decline in the number of convenience stores or is likely to be responsible for such a decline in the future. Equally, however, the OFT has not found evidence to enable such effects to be ruled out.

- 5.30 Two respondents argued that the OFT should examine the cases of price flexing under the Competition Act 1998. This relates to the wider issue of whether there are alternatives to a market investigation that should instead be pursued, which is discussed in Chapter 8.

### **Conclusions on distortions of competition and harm to consumers**

- 5.31 The evidence gathered by the OFT suggests that the four largest supermarkets price some products below cost (measured, in line with the CC's approximation in 2000, in terms of products sold at a gross margin of less than 5 per cent). The OFT has identified over 2,700 lines that are likely to have been sold below cost, representing around 3 per cent of total sales by supermarkets. It has also found evidence of below-cost selling in convenience stores operated by the four largest supermarkets, albeit to a lesser extent than in one-stop shops.
- 5.32 Similarly, the OFT has gathered anecdotal evidence to suggest the existence of price flexing, although information provided by the four largest supermarkets suggests that local price variations occur only to a limited extent.

- 5.33 Price discrimination (both across products and across locations) can, in some circumstances, play a key role in a genuinely competitive process and benefit consumers overall.<sup>51</sup> Such competitive (and welfare-enhancing) price discrimination may include a degree of below-cost selling (especially where this is used as a promotional device) and local price competition.
- 5.34 Legitimate competition concerns and harm to consumers could nevertheless arise if price discrimination, in the form of below-cost selling or price flexing, in some areas is used:
- to take advantage of an existing position of market power – for example, where prices in a location reflected lack of local competition and choice for consumers, or
  - in a predatory way, to force competitors out of the market and create or reinforce a position of market power.
- 5.35 Based on the evidence of below-cost selling and price flexing, and against the background of the CC's previous findings on pricing behaviour, the OFT believes that there are reasonable grounds for suspecting that the pricing practices outlined in this chapter – below-cost selling and price flexing – are distorting competition, at least to some extent, in the supply of groceries by retailers in the UK.
- 5.36 The evidence the OFT has gathered does not demonstrate, however, that consumers are, at least at present, being harmed overall by those pricing practices. The OFT notes, in that regard, that the extent of below-cost selling appears (at least based on the figures provided by the big supermarkets, and using the 5 per cent gross margin measure as a proxy) to affect only a small percentage of supermarkets' total grocery sales: 3 per cent in terms of value, or 1.8 per cent in terms of the

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<sup>51</sup> For example, price discrimination could be helpful to consumers if it arises out of optimal yield management in a highly competitive market.



number of product lines. Equally, the OFT also cannot rule out the possibility of consumer harm, either now or in the future.

- 5.37 As has already been noted, in 2000 the CC concluded that below-cost selling and price flexing were being practised by a number of the supermarkets, and that this was contrary to the public interest. Given that these practices appear to be continuing in circumstances where the structure of the market has changed (as a result, for example, of increased concentration in grocery retailing, and supermarkets' expansion into the convenience store sector), and given that the OFT has also identified other features of the market which give rise to competition concerns, the OFT considers that it would be appropriate for the CC to again consider the impact of these practices and the desirability of any remedies in respect of them. It would be important for any CC investigation to measure in more detail than the OFT has been able to provide in its necessarily limited investigation to date, the extent of below-cost selling and price flexing, and to then consider where the balance now lies between the possible consumer benefits of, and any consumer detriments arising from, these pricing practices.

## 6 BUYER POWER

6.1 A number of parties, including the ACS, have raised concerns about the exercise of buyer power by the large supermarket chains. The OFT is aware of two broad areas of concern. First, the strength of buyer power of the supermarkets might distort competition in the upstream supply market. For example, where suppliers are in a weak position relative to supermarkets, their incentives to invest or innovate in new products might be distorted if, for example, the supermarkets used their buyer power to reduce the prices paid to them. A large number of respondents to the Proposed Decision argued that this was a critical issue.

6.2 Second, the exercise of buyer power in relation to suppliers might reinforce distortions of competition at the retail level. The ACS and others have made two specific claims:

- first, that the large supermarkets might use their buyer power to obtain better terms from suppliers to such an extent that suppliers are forced to charge higher prices to their other customers (including smaller retailers and the wholesalers who supply them) (the so-called 'waterbed effect'). It has been suggested that this places smaller retailers at a competitive disadvantage because they face higher costs which are not justified on purely commercial grounds (for example, taking account of the higher costs that suppliers might incur in selling a smaller quantity of product). This distortion has the potential to harm consumers by undermining the viability of smaller independent stores and thereby reducing consumer choice, and
- second, that the exercise of buyer power could undermine the viability of the wholesale distribution network serving independent stores, by simultaneously reducing the number of their independent store customers, and deepening the difference between the prices at which supermarkets could obtain supplies and those at which wholesalers could obtain them. This 'vicious circle' could eventually lead to a 'tipping point' being reached beyond which wholesalers would not be able to profitably continue to supply large numbers of

independent stores, thus leading to a collapse in the number of, and choice in, such stores. It has been argued that the move of supermarkets into convenience retailing is having a similar adverse impact on the ability of buying groups to secure competitive terms for their members.

## Previous analysis

- 6.3 In 2000, the CC examined the buyer power of the large supermarkets. It concluded that five multiples (the major buyers—Asda, Safeway, Sainsbury, Somerfield and Tesco), each having at least an 8 per cent share of grocery purchases for resale from their stores, had sufficient buyer power that 27 of the practices identified, when carried out by any of these companies, adversely affected the competitiveness of some of their suppliers and distorted competition in the supplier market—and in some cases in the retail market—for the supply of groceries.<sup>52</sup> As a result, the CC recommended a Supermarkets Code of Practice be put in place between supermarkets with 8 per cent or more of grocery purchases and their suppliers. Tesco, Sainsbury's, Asda and Safeway subsequently signed up to a statutory code of practice, and Morrisons also agreed to abide by the Code following its acquisition of Safeway.
- 6.4 The CC also concluded in 2000 that imbalances in buyer power across grocery retailing as a whole were likely to be problematic for smaller retailers, in that their weakness relative to middle-ranking suppliers was likely to give suppliers the ability to compensate for the harder terms imposed on them by the major buyers by raising their prices and hardening their own terms to small retailers. The CC observed that the largest retailers were able to obtain non-cost-related discounts from suppliers and that the differentials in the prices charged by suppliers to large and small retailers could not be explained by cost differences. The CC report analysed differences in prices paid by 11 grocery retailers for

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<sup>52</sup> *Supermarkets*, Competition Commission 2000, Table 2.14.

suppliers' top five lines.<sup>53</sup> Tesco was found to pay the lowest prices; Budgens was found to pay 11 per cent more on average.

- 6.5 The CC also considered the waterbed effect in its 2003 Safeway merger report. It concluded from the evidence available to it that there might be 'some waterbed effect for some classes of suppliers, especially over the longer term'.<sup>54</sup> However, on the evidence at the time it was not able to conclude that any waterbed effect would be exacerbated by any of the mergers.

### **Evidence of the effects of buyer power on smaller retailers**

- 6.6 The OFT is aware of anecdotal evidence from a number of sources suggesting that the large supermarkets are able to extract better terms from suppliers than independent retailers, wholesalers and buying groups, to an extent that cannot be explained purely in terms of the relative costs to suppliers of supplying each of those categories of customer. The ACS provided evidence from a wholesaler to suggest that the largest supermarkets might be obtaining buying prices which were 10 per cent lower on average than for the majority of the convenience sector.<sup>55</sup> An independent wholesaler told the OFT that the dominance of the major supermarkets over suppliers continued to drive a gulf in buying terms, and that this differential was greater now than that found in the 2000 CC report.
- 6.7 The OFT asked a number of suppliers to provide information on the prices at which their ten top-selling items were purchased by different supermarkets, wholesalers and buying groups. Seven suppliers responded to the request for information, with turnovers ranging from around £35 million to over £1 billion. Some respondents questioned the robustness of drawing conclusions on the basis of a relatively small sample. As stated in the Proposed Decision, however, the survey was

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<sup>53</sup> *Supermarkets*, Competition Commission 2000, paragraphs 11.113 – 11.117

<sup>54</sup> *Safeway merger report*, Competition Commission 2003, paragraph 2.248.

<sup>55</sup> Report by Europe Economics submitted to the OFT by the ACS in May 2005.

not intended to be a comprehensive study. It was simply intended to give a rough indication, in the time available, of the possible magnitude of any difference in terms offered to different types of retailers.

- 6.8 The data suggested that terms can vary considerably between different types of buyers, and in some cases between individual firms within any given type. On the basis of the evidence provided, the OFT estimates that wholesalers and buying groups might pay around 7 per cent more, on average, than the four largest supermarkets.<sup>56</sup> Smaller supermarkets pay just over 2 per cent more. However, these averages mask significant differences between the suppliers surveyed. In one case, the prices paid by wholesalers and buying groups were, on average, only fractionally higher than those paid by the four largest supermarkets.<sup>57</sup> For another supplier, the average differential was more than 13 per cent.
- 6.9 The OFT asked suppliers whether they considered that the differentials in prices charged to different groups had changed since 2000. Of the five suppliers who commented on this, three gave evidence which suggested that the differential between the four largest supermarkets and wholesalers and buying groups had increased since 2000, one suggested that the differential had reduced, and the other said that the differential was broadly unchanged. One supplier commented that 'there now seems to be more 'clear water' between the prices achieved by the big four supermarkets and the prices achieved by retailers such as Co-op and Somerfield'.
- 6.10 The OFT asked the suppliers to explain the differences between prices charged to different groups. Most suppliers pointed to factors such as differences in scale and business model, suggesting that at least some portion of the price differentials reflected differences in the costs of supplying different customers. Some suppliers also stated that they

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<sup>56</sup> It may, of course, be that the terms offered to each of the four largest supermarkets are different; the figures in this section are based on the average price paid by these supermarkets.

<sup>57</sup> The Proposed Decision incorrectly stated that the prices paid were 'fractionally lower'. In fact, prices paid were 'fractionally higher'. The text has been corrected accordingly.

worked from a national price list, with fixed variations covering factors such as supply options and promotional offers.

- 6.11 Nevertheless, others made clear that they have flexibility to negotiate on a case-by-case basis. One supplier cited factors such as the calibre of the buyer, and historical issues such as market position, as factors that might influence prices paid by different retailers. Given the apparent size of the observed differentials in prices, the OFT believes that there are reasonable grounds to suspect that the buyer power of the large supermarkets is one factor which influences the terms that they are offered by suppliers.
- 6.12 The ACS and others have suggested that the difference in terms offered to different types of retailers is evidence of a waterbed effect, meaning that supermarkets use their buyer power to obtain better terms from suppliers to such an extent that suppliers are forced to charge higher prices to smaller retailers with less buyer power in order to recover their costs.
- 6.13 In the OFT's view, there are theoretical questions that would need to be resolved before concluding that the price differentials observed are evidence of a waterbed effect. For example, it is not clear how suppliers would be able to charge significantly above cost to smaller retailers without rivals undercutting them in the market; similarly, it is not clear why suppliers would price persistently below cost to the large supermarkets.
- 6.14 Europe Economics, on behalf of the ACS, has argued that the waterbed effect does not require suppliers to react in a conscious way to supermarket buyer power by raising prices to non-supermarket buyers to recover lost profits. Rather, it suggests that the waterbed effect occurs through the dynamics of entry and exit in an (otherwise) competitive market distorted by buyer power. It also suggests that if the market for a particular grocery product is expanding, the waterbed effect could occur through a reduction in the level of entry rather than through the exit of existing firms.

6.15 The OFT has not reached a final view on these issues, and it would be for the CC to investigate them in more detail if it judged that they raised significant competition concerns. One respondent challenged this approach, saying that without certainty on the theory, it would be wrong to use the evidence of buyer power as the basis for a reference. Nevertheless, the OFT observes that the CC has previously suggested that there may be a waterbed effect for some classes of suppliers, especially over the longer term,<sup>58</sup> and the OFT has obtained practical evidence of differentials in prices to different groups which could be consistent with the existence of a waterbed effect. In the OFT's view, this is sufficient to provide reasonable grounds for suspecting that competition may be being distorted, as required by section 131 of the Act.

### **Effects on wholesale distribution networks and the 'tipping point'**

6.16 A connected argument that has been put to the OFT is that the exercise of buyer power, allied with and contributing to a reduction in the number of independent convenience stores, is serving to undermine the viability of the wholesale distribution networks serving independent retailers. Broadly, as the number (and density) of independent stores declines, the average costs of supplying them may increase. This could force wholesalers to contract the scale of their operations or raise their prices to the extent that a significant number of independent stores would find themselves unable to obtain supplies at a price which allowed them to operate profitably. Ultimately, a 'tipping point' might be reached beyond which the wholesale distribution network would break down and large numbers of independent stores would have to close.

6.17 It was beyond the scope of the OFT's investigation to look in detail at the costs of wholesale distribution networks and the way that these might be affected by the buyer power of the four largest supermarkets.

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<sup>58</sup> *Safeway merger report*, Competition Commission 2003, paragraph 2.248

However, the OFT asked wholesalers and buying groups for information on the viability of wholesale networks to independents.

- 6.18 The OFT was told that, while membership of buying groups has increased in recent years, suggesting a strong market position, in reality many of the new stores are smaller profile or single site stores. Some of the largest members of buying groups have been acquired by the major multiples. This has tended to increase operating costs for the distribution businesses.
- 6.19 One wholesaler told the OFT that it estimated that a tipping point for economic viability will be reached at approximately 60-70 per cent of current volumes. Another estimated that it would take a 15 per cent sales reduction for its operating profits to fall to zero. Another wholesaler estimated that, if its wholesale business (to independents and symbol groups) were to reduce by 15 per cent, then the resource allocated to its supply chain service would have to be significantly reduced. A symbol group operator commented that the highest costs were associated with delivering to remote locations and that if increasing costs forced it to cease delivery to these stores, rural communities would be negatively affected.
- 6.20 One of the supermarkets contested the claim that there has been a decline in wholesalers who might be expected to be negotiating large volume supplies for smaller retailers. It pointed to recent government statistics indicating that there has been no recent decline in wholesaler numbers. Another noted that, in 2004, total grocery wholesaling sales grew by 1.9 per cent to £16.7 billion<sup>59</sup> and IGD expects growth to continue at an annual compound rate of 1.8 per cent to £18.3 billion by 2009.<sup>60</sup>

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<sup>59</sup> IGD Grocery Wholesaling 2005, p.11

<sup>60</sup> IGD Grocery Wholesaling 2005, p.147



6.21 One respondent argued that the tipping point analysis could be extended beyond the wholesale distribution network, to take account of the overall viability of smaller retailers against the large supermarkets. The OFT has not attempted to extend the analysis in this way, but acknowledges that there may be scope for CC to explore the issue.

### **Other views of respondents**

6.22 A large proportion of respondents raised concerns about buyer power. Many of these expressed concerns about the impact of buyer power on the wider grocery supply chain, stretching back to producers and farmers, and criticised the OFT's Proposed Decision for not commenting on these features of the market. Among the comments made were that:

- The risk/reward ratio is tilted against producers/growers, creating concerns about long-term supplies. Another respondent similarly argued that the 'climate of ever-decreasing prices' will eventually lead to an unsustainable supply chain.
- The increasing shift to own-label brands leaves suppliers vulnerable. One respondent argued that this effectively created a situation of vertical integration without the associated managerial or financial responsibility. Another said that internet auctions for own label supplies were undermining manufacturing capability.
- A number of respondents argued that it was essential that the CC investigates impacts on small suppliers, especially farmers. One respondent commented that prices paid to suppliers squeeze down wages and lead to job losses.

6.23 As suggested in paragraph 6.3 of the Proposed Decision, the OFT agrees that there may be relevant competition issues relating to the impact of supermarkets on the supply chain. Given that the audit of the Supermarkets Code in 2005 focused on relationships between supermarkets and suppliers, the OFT has purposely focused its information-gathering in the current inquiry at the retail level. However, for buyer power to affect competition at the retail level there must also

be a significant adverse effect on suppliers. The OFT intends that the CC should be able to consider these issues as part of a market investigation, to the extent that they are relevant to competition in the retail supply of groceries.<sup>61</sup>

- 6.24 A large number of respondents also questioned the effectiveness of the Supermarkets Code. The specific issues raised are summarised in Annex C. In principle, the CC would be able to consider changes to the Code as part of its market investigation. However, unless and until the CC recommends changes, the existing Code will remain in force and the OFT will continue to monitor compliance.

### **Conclusions on distortions of competition and harm to consumers**

- 6.25 The evidence given to the OFT by suppliers suggests that buying groups and wholesalers face higher charges than the four largest supermarkets, and indeed the other smaller supermarket chains. There is also slightly weaker evidence that the differential between prices to wholesalers and buying groups and prices to the four largest supermarkets has increased since 2000. Furthermore, there is evidence that buyer power is at least one plausible explanation for this differential.
- 6.26 These observed differentials relate to prices paid by wholesalers and buying groups, rather than directly by independent retailers. Some of the supermarkets have argued that smaller retailers should be able to group together to increase their buyer power in competition with the four largest supermarkets. While this appears plausible in principle, the evidence gathered by OFT suggests that there remain concerns in practice about the impact of the bargaining power of the four largest supermarkets.
- 6.27 In the OFT's view, the evidence on the existence of a waterbed effect, as a way of explaining why smaller retailers might lose out as a result of the exercise of buyer power, is mixed. However, the OFT notes that the

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<sup>61</sup> See also further comment on buyer power issues in chapter 9.

CC has previously left open the possibility of a waterbed effect in its investigations into the grocery sector.

- 6.28 Similarly, the OFT is aware of claims from a number of sources that the viability of wholesale distribution networks serving independent stores is suffering and that a tipping point may eventually be reached beyond which large numbers of independent stores will not be able to be supported. A number of wholesale groups attempted to quantify these effects, with respondents suggesting that a tipping point might be reached if sales fell by between 15 and 40 per cent.
- 6.29 Overall, the OFT considers that there are reasonable grounds to suspect that consumers could be harmed by the exercise of buyer power by the large supermarkets, either through a reduction in competition or choice at the supplier level, or by undermining the viability of smaller retailers. There are also ways in which buyer power could benefit consumers. A conclusion as to the balance between these effects could only be drawn following a much more detailed analysis than the OFT has been able to undertake in the context of this assessment. However, the OFT remains of the view that there are reasonable grounds for suspecting that buyer power is a feature that prevents restricts or distorts competition in the market for the supply of groceries by retailers in the UK.

## 7 PLANNING AND LAND HOLDINGS

7.1 This chapter considers the potential competition effects of the planning regime, and the way in which land ownership and applications for planning consents might be used by supermarkets to restrict entry. In broad terms, it has been argued that the planning system makes entry by competitors (particularly for new one-stop shops) more difficult in some areas. Some parties have also claimed that the large supermarkets are also able to use their ownership of land to limit entry by potential rivals.

### Competition effects of the planning regime

7.2 The CC examined planning and land issues in 2000, and concluded that 'by far the severest constraint on a grocery retailer seeking to enter, or expand within, the grocery retailing market is the shortage of sites suitable for development, exacerbated by aspects of the planning system'.<sup>62</sup> Similarly in 2003 the CC found that the planning regime was the main barrier to entry in the one-stop grocery market.<sup>63</sup> The CC concluded that 'Taking all the evidence together, we believe that, since the 2000 report, the general trend has been towards a contraction in entry opportunities for one-stop grocery shopping and this has made the acquisition of new sites more difficult for all the multiple grocery retailers. The high market shares of Asda, Sainsbury's and Tesco, however, give these companies correspondingly greater strength in competition for new sites.'<sup>64</sup>

7.3 The need to gain planning permission inherently creates additional sunk costs of entry and thus raises barriers to entry.<sup>65</sup> This does not mean that a planning regime is unnecessary. The underlying constraint on competition comes from a shortage of sites suitable for retail

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<sup>62</sup> *Supermarkets*, Competition Commission 2000, paragraph 2.199

<sup>63</sup> *Supermarkets*, Competition Commission 2003, paragraph 2.157

<sup>64</sup> *Supermarkets*, Competition Commission 2003, paragraph 2.172

<sup>65</sup> Two respondents argued that the planning system imposes high costs particularly on smaller businesses.

development in some areas, as noted by the CC. Planning policy can be an important mechanism to influence and direct land use in cases where available land is in short supply. Nevertheless, the planning regime can also have important competition effects, which should be considered alongside other government policy objectives.

- 7.4 The key objective of the Government's planning policy in relation to England, as set out in Planning Policy Statement 6 ('PPS6'), is to promote the vitality and viability of town centres.<sup>66</sup> Under PPS6, local authorities' development plans are required to allocate sufficient sites to meet future retail need, following a sequential approach, looking first at suitable locations in existing centres, secondly at edge-of-centre locations, and finally at out-of-centre sites.
- 7.5 When applying for planning permission for retail development which is in an edge-of-centre or out-of-centre location, and is not in accordance with an up-to-date development plan, applicants are required to demonstrate a quantitative need for their proposal (the 'needs test'), alongside other key considerations including the sequential approach. One of the smaller supermarkets provided examples of towns which have fewer than four fascias but which it cannot gain entry to due to 'full capacity'.<sup>67</sup>
- 7.6 Smaller players also claim to have difficulty acquiring new sites. PPS6 forces companies into town centres with greater costs, which can put off entry by smaller players. In addition, it is claimed that incumbent operators out of town have a greater advantage, as customers want free parking which may not be easily available in town centres. One respondent to the consultation argued that the costs of submitting planning proposals have a disproportionate impact on smaller businesses.

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<sup>66</sup> In the time available, the OFT has not been able to consider in detail differences between the planning regimes applying in Wales, Scotland and Northern Ireland. However, the broad concerns identified here are likely to apply across the UK as a whole.

<sup>67</sup> These include Sevenoaks, Amersham, Durham, Hastings and Salisbury.

- 7.7 The policy guidance outlined in PPS6 makes clear that it is not the role of the planning system to restrict competition, preserve existing commercial interests or prevent innovation.<sup>68</sup> The OFT also notes that PPS6 allows a number of qualitative factors, including local choice, to be considered in the assessment of retail need.<sup>69</sup> However, a planning authority cannot explicitly consider the strength of local competition when reviewing a planning application; for example it would not consider whether there were already four fascias of the same supermarket already in the area, as long as the new supermarket could meet the retail 'need' of the area as identified by PPS6.
- 7.8 More generally, the need to gain planning permission means that the process of building a new supermarket is protracted. One supermarket operator suggested to us that developing a site for retail could take up to five years, and another told us that site development could take between 54 and 76 months, depending on the extent of central government involvement in the planning approval decision. Therefore, it is difficult for new stores – primarily large supermarkets – to enter the market, and entry takes a long time. The OFT understands that the Government has acted to speed up the planning process, reducing the validity of planning permissions for outline and detailed permission from three to two years and five to three years respectively. This is a welcome development.
- 7.9 There are a number of international surveys suggesting that planning regimes in the UK may be a key reason why the productivity of UK supermarkets ranks low in international league tables.<sup>70</sup> An OECD Economic Survey in 2004<sup>71</sup> stated that 'competition is impeded...planning restrictions could be relaxed' and 'land use restrictions hinder profitability'. A number of consultation respondents questioned whether there was evidence of a significant productivity

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<sup>68</sup> ODPM: Planning Policy Statement 6 (2005) paragraph 1.7

<sup>69</sup> However, one respondent commented that it was not clear how choice of fascia should be addressed within the PPS6 guidelines.

<sup>70</sup> UK index of value added per employee in 2000 was 99, against EU average of 100. *OECD: Product market competition and economic performance in the UK, June 2005*

<sup>71</sup> *OECD: Product market competition and economic performance in the UK, 2004*

impact. The OFT has not attempted to analyse the productivity claims in any detail. However, to the extent that competition is a key driver of productivity, there are grounds to suspect that features of the market that limit competition will also have a negative impact on productivity.

- 7.10 One supermarket argued that the planning regime imposes less of a barrier than is claimed by some of its competitors. For example, it noted that most of the construction of very large out of town retail outlets (frequently selling non-food as well as grocery products) has taken place since the change in rules on out of town developments during the 1990s. Several respondents to the consultation made similar points, with one respondent suggesting that even since the implementation of PPS6, 60 per cent of development still takes place out of town. Nevertheless, other respondents did agree that the planning regime imposes significant entry barriers, particularly for out of town stores.
- 7.11 More generally, a significant proportion of consultation responses, including those from individuals, commented on the planning regime and agreed that it should be considered as part of a CC investigation. However, a large number of respondents appeared to oppose a liberalisation of planning law that could make it easier to develop new large stores. For example, one respondent argued that allowing a significant increase in new supermarket growth would not be in the long-term interest of consumers. Another respondent commented that liberalisation of the planning regime could expose small retailers to more supermarket competition rather than less. A further respondent stated that competition policy should not take primacy over planning laws.
- 7.12 The OFT's view is that, from a competition perspective, reducing barriers to entry for new supermarkets is likely to strengthen competition and benefit consumers. The more difficult question is how the planning regime might best be enhanced to achieve this objective. The OFT accepts that competition policy should work with, rather than taking precedence over, planning policy. It also acknowledges that a simple reduction in the costs of achieving planning consent might allow existing players to consolidate their market position, rather than encouraging

entry by new competitors (or the expansion of smaller existing operators). However, the OFT does not believe that a general tightening of the planning system would be in the interests of consumers.

## Land holdings and land agreements

- 7.13 The OFT has considered whether supermarkets' land ownership and applications for new planning consents could prevent, restrict or distort competition. Although this feature of the market is separate from the general planning issues discussed above, the OFT notes that incentives for supermarkets to acquire land might be affected by the nature of the planning system.
- 7.14 The OFT has received a number of complaints that the four largest supermarkets have built up significant land holdings, and pay inflated prices for land with the intention of restricting entry.
- 7.15 The four largest supermarkets provided information to the OFT in relation to sites that they own but have not yet developed.<sup>72</sup> The information received, which was clarified following the Proposed Decision, suggests that there are a total of 302 sites across the four largest supermarkets which are owned but not yet developed for retail use.<sup>73</sup> In addition, there are 149 sites on which there is some form of conditional contract or option, which can typically be exercised if planning permission is obtained.
- 7.16 The OFT asked the supermarkets to clarify which of these undeveloped sites could accommodate a new one-stop shop (that is, which would be suitable for a store of greater than 1,440m<sup>2</sup> in size), and identified 151

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<sup>72</sup> The supermarkets queried some of the figures on land holdings set out in the Proposed Decision, and subsequently clarified the information they had previously provided. As a result, the OFT has revised some of its original calculations, as explained in the paragraphs below.

<sup>73</sup> The Proposed Decision stated that there were 319 sites; however, we have subsequently amended our estimate in the light of new information from one of the supermarkets.



such sites.<sup>74</sup> The data provided also suggest that 149 sites are in town centre locations.

7.17 On average across the four largest supermarkets, the OFT estimates that undeveloped sites are equivalent to around 10 per cent of the stock of existing stores by number (including convenience stores). These figures are similar either when comparing all undeveloped sites against the total number of existing stores, or when comparing only the number of undeveloped sites suitable for a new supermarket with the existing number of supermarkets (that is, large stores). The proportions vary significantly, however, between the four largest supermarkets.

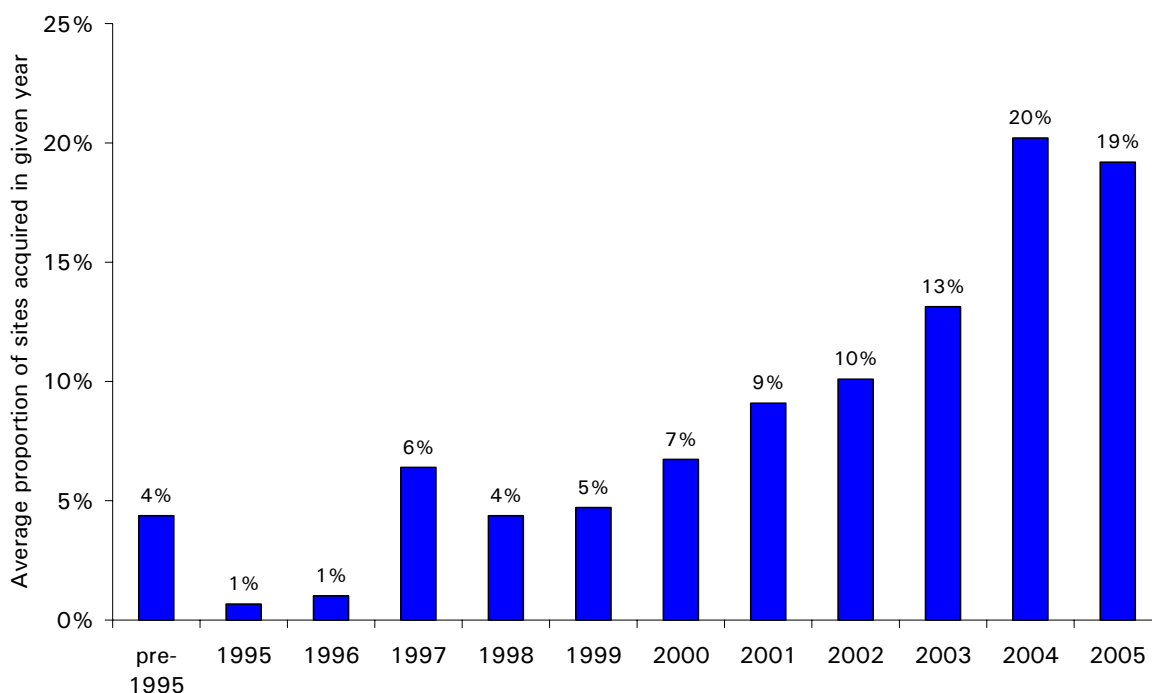
7.18 The four largest supermarkets also provided information on the date of acquisition of each site. These data, amended following the Proposed Decision, suggest that the average age of undeveloped sites across the four largest supermarkets is more than four years.<sup>75</sup> Figure 7.12 illustrates the distribution of ages of undeveloped sites.

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<sup>74</sup> The Proposed Decision stated that there were 158 sites suitable for development of a new supermarket; the OFT has subsequently adjusted this estimate following clarifications from one of the supermarkets.

<sup>75</sup> The Proposed Decision incorrectly stated that the average age of sites was eight years. This was due to an error in the original calculation, and to further information from one of the supermarkets showing that a number of their older sites are leased to third parties and should not be included in the calculations of average age of development sites. The fact that land is leased by a supermarket, rather than merely retained, does not, of course, necessarily remove any scope for competition concerns since the supermarket is likely to be able to exercise a degree of control over the use to which the land can be put, and may use that control to prevent the land becoming available for the development of retail premises by a competitor.

**Figure 7.12: Acquisition dates of land purchased but not yet developed aggregated across the four largest supermarkets**



Source: OFT calculations based on data provided by the four largest supermarkets.

7.19 A number of respondents to the consultation questioned the argument that the existence of significant land holdings owned by the four largest supermarkets could restrict entry by competitors. As noted in the Proposed Decision, given the time needed to achieve planning consent on a site, the OFT accepts that it is commercially sensible for supermarkets to have a stock of land on which they are trying to obtain

planning permission. For example, one of the supermarkets argued that its space growth was in line with the overall growth of the grocery retail market.<sup>76</sup>

- 7.20 Nevertheless, in some cases, sites have been held for longer than might be reasonably expected for the purposes of gaining planning consent. For example, one of the supermarkets claimed that it expected development of a site to take between 4.5 and six years (from purchase of the site through to store opening). Assuming an even distribution of sites at different stages of development, the average age of sites on this basis would be expected to be around 2.7 years. By comparison, the average age of undeveloped sites, based on the information provided by the four largest supermarkets, is more than four years. Figure 7.12 also shows that more than 20 per cent of the development sites held by the four largest supermarkets were acquired prior to 2000.
- 7.21 Furthermore, the OFT remains of the view that, even if there is no intention to abuse market power, the ownership of land, allied to features of the planning regime, could create barriers to entry.
- 7.22 The OFT also explored allegations that the supermarkets might engage in strategic behaviour in order to deter entry. A first concern is that supermarkets could purchase options on land and use these strategically to block entry by other supermarkets. One of the smaller supermarkets provided the OFT with an example of this. It claimed that it was interested in purchasing a site in a particular area, but another supermarket subsequently bought the site in 2000 and has not developed it since. The same supermarket operator is now considering bidding for another site in the same location, despite already owning an

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<sup>76</sup> Over the last five years the supermarket added 36 per cent of trading space. Of this, replacement stores account for 7 per cent equating to a replacement asset rate of 2 per cent. It also says that much of this additional space relates to non-food. Extensions account for a further 10 per cent growth, with new stores accounting for 20 per cent of its growth. Mintel estimates that over this period food retailing has grown by 24 per cent. Accordingly, this supermarket's growth is broadly in line with the growth in consumer spending over this period.

undeveloped site. The smaller supermarket has argued that this was done with the intention of blocking competition.<sup>77</sup>

7.23 Second, it has been argued that supermarkets can submit planning applications to extend or redevelop existing sites in order to block entry of a competitor:

- One supermarket claimed that another operator has blocked planning applications from rival stores in a particular area. Allegedly, it had done this by submitting a planning application for an extension to an existing store in that area which was granted as the existing store is in a town centre location. Effectively, this prevented planning approval being granted for rival stores, due to the perceived need now being met. It has been claimed that this extension has yet to be developed.
- The same supermarket gave evidence of a rival submitting an application for redevelopment of an existing site, allegedly in response to the supermarket's application for planning permission.

7.24 Third, it has been argued that supermarkets have in some cases overbid for sites, in order that incumbents can protect their position. While unconnected with any specific allegations, the CC stated in its 2003 report that 'in a sample of sites where three or more parties were bidding for a site of more than 1,400 square metres, where Tesco won the margin it won by was on average 48 per cent more than the next highest bidder'.<sup>78</sup> A number of parties also expressed concerns that overbidding for sites can mean rent and land prices in the area are raised, which in turn could be prohibitive for smaller players.

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<sup>77</sup> Further similar claims are made in Friends of the Earth, 2006, *Calling the Shots: How supermarkets get their way in planning decisions*. The OFT has not attempted to validate these claims.

<sup>78</sup> *Safeway merger report*, Competition Commission 2003, paragraph 5.382

7.25 Finally, the OFT asked the four largest supermarkets to list sites and stores that have been sold since 2000 with restrictive covenants, that is, where a site has been sold with restrictions on the buyer on its future use and development. In total the OFT has identified 69 sites across the four largest supermarkets where restrictive covenants have been used. Some of these restrictions have now expired, where the covenants only lasted for two or three years. However, in other cases the restriction will remain in place for a long period—for example, up to 125 years in one instance. The precise nature of the restriction varies from case to case, but all the examples we have found place some restriction to prevent the future use of a site or store for grocery retailing.

7.26 One supermarket argued that the use of restrictive covenants was limited relative to the total number of transactions.<sup>79</sup> Another supermarket commented that most of the sites on which it placed restrictive covenants were contiguous with or included a vacant or former store. The OFT is not persuaded that either of these comments affects the case made in the Proposed Decision that, at a local level, restrictive covenants can create barriers to entry to the detriment of competition and, ultimately, consumers.<sup>80</sup>

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<sup>79</sup> Information provided by the supermarket suggested that restrictive covenants were used in around one in seven cases.

<sup>80</sup> In this context, it should be noted that sale and purchase agreements where restrictions are accepted by the purchaser as well as or instead of the seller have attracted the attention of competition authorities in the past. For example, under the now repealed Restrictive Trade Practices Act 1976, and related Statutory Instruments, sale and purchase agreements had to be scrutinised individually if restrictions were accepted by purchasers, rather than in most cases being exempt from the provisions of this Act. Following the *Monopolies and Mergers Commission's 1989 report on the supply of beer*, in which a number of adverse effects on the public interest were found in relation to the activities of the brewers, brewers were prohibited from requiring that the purchasers of their pubs could not run a competing business in the pubs concerned.

## Other views of respondents

- 7.27 Aside from the specific comments included in the text above, there was a high general level of support for including concerns around planning and supermarkets' land holdings as part of the case for a market investigation reference.
- 7.28 Other consultation responses gave us additional evidence of situations where there could be competition concerns in relation to land ownership. One respondent claimed that the supermarkets' move into the convenience store sector had created inflationary pressure on acquisition prices. The OFT has not attempted to test these claims, although it notes that a simple inflation in land prices would not necessarily indicate an anti-competitive effect. There might be concern if supermarkets were using profits made in one area to cross-subsidise store expansion, and this is an area that the CC may wish to explore as part of its investigation.

## Conclusions on distortions of competition and harm to consumers

- 7.29 The OFT believes that, although the planning regime does not prevent the development of sites outright, there are reasonable grounds to suspect that it distorts competition. The OECD and others have suggested that this could have a significant impact on UK productivity, and hence on consumer welfare. It also appears that the 'needs' test in its current form may distort competition.
- 7.30 In relation to land holdings, sale and acquisition of sites, and applications for planning consent, the evidence the OFT has seen suggests that the four largest supermarkets:
- hold a significant stock of undeveloped land, which could, in principle, act as a barrier to entry at a local level

- have an incentive to engage in strategic behaviour with regard to obtaining planning consents and bidding for land, which could have the effect of restricting competition at a local level, and
- have all imposed restrictive covenants on sites they have sold, which restrict the future use of those sites in a way which reduces the threat of competition.

7.31 The use of land holdings, strategic bidding for sites, and restrictive covenants to restrict the future use of a site could all act to limit local entry into the market. This in turn could be reasonably expected to lead to consumer harm, through a reduction in local competition and consumer choice. The OFT considers that the threat of new entry in a local market is an essential driver of competition in the grocery retail market both nationally and locally and that everything possible should be done to ensure that sites are available for new competitors.

7.32 Overall, the OFT concludes that there are reasonable grounds for suspecting that aspects of the planning regime, and the issues around land holdings identified in this chapter, are features that prevent, restrict or distort competition in the market for the supply of groceries by retailers in the UK.

## 8 FINAL DECISION ON A REFERENCE

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

### The section 131 test

8.2 The OFT has identified that there has been increasing consolidation of the grocery sector, with the move of some supermarket multiples into the convenience store sector. Developments in the market appear to have contributed to lower prices to consumers but this may have been at the expense of choice of store at a local level, and there remain concerns about the strength of local market competition in some areas.

8.3 Considered against this context, there are a number of features of the market that can reasonably be suspected of distorting competition and, in the case of at least some of those features, the evidence suggests that consumers may be being harmed as a result:

- The planning system can reasonably be suspected of restricting or distorting competition by raising the cost of, and also limiting the scope for, new local market entry, particularly by way of new large format stores.
- There are reasonable grounds for suspecting that the land holdings of the large supermarket multiples may reinforce their existing market position in some local areas. The OFT has also found evidence of practices that could have an anti-competitive effect, including the use of restrictive covenants in relation to sites sold by some supermarkets.



- There is evidence to suggest that the buyer power of the four largest supermarkets has increased since 2000, and that the differential between suppliers' prices to large supermarkets compared with those to wholesalers and buying groups has risen. Against the background of greater concentration within the market, there are reasonable grounds for suspecting that this buyer power could harm consumer choice by undermining the viability of alternative business models including wholesale distribution to the convenience store sector.
- Aspects of the supermarkets' pricing behaviour – below-cost selling and price flexing – also provide reasonable grounds for suspecting that competition is being distorted, though the extent of the possible distortion is unclear. Although the OFT has not found evidence that consumers are being harmed as a result of these pricing practices, a CC market investigation would be able to examine in greater detail the effects that these practices may be having on competition and consumers.

8.4 Taken in the round, the OFT believes that there are reasonable grounds for suspecting that competition is prevented, restricted or distorted in connection with the supply of groceries in the UK in relation to these features. For the purposes of the section 131 test, the OFT would observe that the potential competition concerns with respect to each of the features of the market identified above are interlinked. For example, the constraints imposed by the planning system could create conditions in which some supermarkets are able to exercise a degree of local market power. This in turn affects the possibility that, and extent to which, pricing practices might distort competition.

### **Appropriateness of a reference**

8.5 Where the section 131 test is met, the final decision on whether to make a reference rests on the exercise of the OFT's discretion. The OFT's guidance on market investigation references sets out four criteria

that would normally have to be met before the OFT would decide to make a reference:<sup>81</sup>

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

8.6 These four factors are considered below.

### **Proportionality**

8.7 With regard to proportionality, the OFT recognises that a reference to the CC would impose a substantial burden on the businesses affected, particularly in terms of management time, and have considerable resource implications for the CC itself. This point was emphasised by a number of supermarkets in their responses to the consultation. The market for groceries in the UK is, however, worth some £95 billion annually and represents around 13 per cent of expenditure for the average household (and more for lower income groups). The benefits of remedying any adverse effects which might be found to exist could, therefore, be expected to outweigh these costs.

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<sup>81</sup> *Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act (OFT511)*, paragraph 2.1

- 8.8 The OFT has also taken into account that many of the concerns raised by the ACS and others are not new, and were examined in detail by the CC in 2000, with remedies being imposed where appropriate. The rapid development of the market since 2000 means, however, that a CC investigation would cover new issues, and would not be restricted to only looking at the large store sector as was the case in its previous investigation.
- 8.9 The OFT's guidance states that it will only make a reference where it has reasonable grounds to suspect that the adverse effects on competition of the features it has identified are significant. In making this assessment it will consider whether these suspected adverse effects are likely to have a significant detrimental effect on consumers through higher prices, lower quality, less choice or less innovation.<sup>82</sup> The guidance goes on to acknowledge the possibility that market features that adversely affect competition may also produce offsetting consumer benefits, and states that, where the OFT is confident that these benefits exceed the likely detriment from the adverse effect on competition, it will not make a reference. Where, however, there is uncertainty, the OFT will normally wish to leave the weighing of benefits and detriments to the CC.<sup>83</sup>
- 8.10 The evidence outlined in Chapter 4 suggests that consumers have benefited over recent years from falling prices, an increase in product range within stores, and an apparent improvement in service. This is not enough, in itself, however, to conclude that there are no significant competition concerns, particularly at a local level. The OFT acknowledges that the way in which the convenience sector has developed, in particular the entry of some of the largest supermarket chains through acquisition, may have reinforced their market power in local areas so as to restrict competition in that sector. So far as larger

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<sup>82</sup> *Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act (OFT511)*, paragraph 2.27

<sup>83</sup> *Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act (OFT511)*, paragraph 2.29

stores are concerned, the existence of barriers to entry and expansion suggest that competition is prevented, restricted, or distorted.

- 8.11 With respect to the specific features discussed in Chapters 5-7, the OFT believes that there are reasonable grounds for suspecting that the planning and land issues identified not only restrict competition, but harm consumers. The planning and land issues reinforce concerns around local market power of the supermarket multiples, and open up the real possibility that at least some consumers are being prevented from having a reasonable choice of outlets at a local level.
- 8.12 As discussed in Chapters 5 and 6, the likely impact on consumers of below-cost selling and price flexing and the exercise of buyer power is less clear. In many situations, price discrimination (both across products and across locations) can play a key role in a genuinely competitive process, to the benefit of consumers overall. Similarly, where there is effective competition at the retail level, the exercise of buyer power can lead to lower prices for consumers.
- 8.13 On the other hand, previous considerations of the market by the CC raise legitimate concerns that aspects of pricing behaviour and the exercise of buyer power by the major supermarkets may, at least potentially, result in detriments to consumers. In the case of buyer power, the CC's findings have been supplemented by the evidence that the OFT has collected in the course of its own inquiry that consumers may be harmed, either now or in the future. In particular, the CC's findings, taken together with the evidence which the OFT has collected, suggest that aspects of the supermarkets' pricing behaviours and the exercise by them of buyer power may harm consumers, for example, by causing the market exit of efficient independent or other non-supermarket grocery retailers, thereby contributing to increased market concentrations in some localities and a reduction of choice, and by depriving consumers of the full benefit of effective price competition in certain localities or in relation to certain products.

- 8.14 One respondent stated that the OFT's arguments on proportionality in the Proposed Decision appeared to rely on speculative future detriments, and placed insufficient weight on current benefits to consumers. The OFT agrees that it would be wrong to justify a reference based on mere speculation as to a possibility of future harm to consumers. Equally, however, the OFT should not have to wait for likely future harm actually to occur before a market can be referred to the CC – otherwise, the reference could come too late to prevent damage to competition, and harm to consumers, that might prove difficult to reverse. In the case of the market we are examining here, there are, in any event, reasonable grounds to suspect current detriment to consumers in respect of a number of features of the market (including the planning and land issues). There is also evidence of other features (such as buyer power and certain aspects of supermarkets' pricing behaviour) which provide grounds for suspecting that consumers could be harmed in the long run, if the current direction of market developments were to continue.
- 8.15 Taking all these factors into account, the OFT believes that a reference, which would allow the CC to investigate these issues in more detail and assess the extent to which any adverse effects on competition identified may lead to harm to consumers, is a proportionate response to the concerns which have been raised about this market.

### **Availability of remedies**

- 8.16 The OFT also considered whether there was a reasonable chance that appropriate remedies would be available. The discussion of potential remedies in this section is not intended in any way to limit the scope of the CC to come to its own views on possible remedies and their appropriateness in the light of a full market investigation.
- 8.17 Considering each of the features of the market identified in turn, remedies to address the concerns regarding the planning regime would have to be in the form of recommendations to Government. Neither the CC nor the OFT could directly impose remedies in relation to those features. A possible approach which the CC might recommend would be

to allow or require decisions on planning permission to take into account the identity of a planning applicant, where this could have an impact on local competition.<sup>84</sup>

- 8.18 On land holdings, the CC could require divestment of land if it concluded there were particular concerns about entry barriers. Similarly the CC could impose constraints on the use of restrictive covenants in relation to food retail sites, particularly in areas where there is local concern. The CC could possibly also require that planning applications are submitted within a certain time from the acquisition of the land and that sites are developed within a certain time from obtaining planning permission.
- 8.19 On pricing behaviour, the CC's 2000 report concluded that below-cost selling was distorting competition but found no remedy that would improve the overall outcome for consumers. The ACS has stated that the OFT should look at the effectiveness of measures taken in other countries since 2000 (France, Germany, Spain, Italy, Austria, Portugal and Ireland).<sup>85</sup> Some respondents to the consultation cited specific overseas examples that could, in principle, be copied in the UK, including the Loi Galland in France and the Robinson-Patman Act in the United States.
- 8.20 If price flexing were thought to be distorting competition and harming consumers, there are some available remedies that the CC could use, including mandating national price lists. One respondent to the

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<sup>84</sup> The OFT notes that the Government is currently conducting an independent review of land use planning. The findings of that review could be relevant to the CC's consideration of appropriate remedies.

<sup>85</sup> An OECD report of 23 February 2006 on a recent discussion of regulations prohibiting below-cost selling expressed scepticism on the benefits to consumers of such laws and said that they could harm consumer interest. The OECD said that resale below cost laws raise the floor on the pricing that a dominant firm can undertake above the predation standard. The OECD went on to say that quite often the explicit purpose of such laws is to protect smaller competitors and that comes at a price for consumers; for example, the Irish Competition Authority's recent estimate that removing below-cost selling restrictions (imposed by the Groceries Order) would save an average household up to 500 Euro over 12 months. These considerations suggest that remedies targeted at below cost selling in isolation might harm consumers' interests in lower prices, in order to achieve the aim of preserving diversity in the market.

consultation suggested that the CC could mandate greater price transparency. The OFT notes that the CC discussed and rejected a number of possible remedies to local price flexing in its 2000 report.<sup>86</sup> The CC would clearly have to consider carefully the costs and benefits to consumers of implementing such options in the light of the increased market concentration and other changes that have taken place in recent years.

- 8.21 Remedies to address buyer power might include publishing transparent price lists, publishing terms of agreements with suppliers, and revising the Supermarkets Code. The CC would naturally need to assess the impact of these potential remedies on consumers. The OFT is also aware of the Law Commission's recent work on the possibility of extending the scope of unfair contract terms regulations to small businesses; the CC might wish to consider whether this could have an impact on appropriate remedies.
- 8.22 Specifically in relation to the Supermarkets Code of Practice, one respondent argued that, since the OFT's 2005 audit found little evidence of the Code being breached, there were no grounds for believing that a revision of the Code could be an appropriate remedy for concerns about buyer power. The OFT disagrees with this assessment. As noted in Chapter 6, there may be changes to the Code that could be sensibly made following a market investigation, were these to be justified by reference to the adverse effects of features of the market.
- 8.23 Overall, in view of the interrelationship between the features of the market identified, it may be that the CC would consider it appropriate to impose remedies in relation to one feature (for example, strategic behaviour in relation to planning issues) that had a knock-on impact on other features (for example, local price flexing), as opposed to trying to address remedies to each individual feature in isolation. However, this does not mean that all the potential competition concerns identified

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<sup>86</sup> At paragraphs 2.566 to 2.577

could necessarily be addressed by a single remedy (such as a change in the planning regime).

- 8.24 In summary, the OFT concludes that there is a reasonable chance that one or more appropriate remedies will be available in respect of the adverse effects on competition arising from the features of the market it has identified. In some cases the OFT would question whether these remedies – particularly a ban on below-cost selling – would benefit consumers. However, remedies that address the adverse effect from some features may also reduce harmful effects of others, and the CC should be allowed to decide on whether to apply the remedies in the light of developments in the market since 2000.

### **Alternative powers**

- 8.25 The OFT considered whether it would be more appropriate to use alternative powers to deal with the features of the market that raise competition concerns.
- 8.26 If below-cost selling or price flexing could be shown to constitute the abuse of a dominant position in a local market by means of predatory or selective pricing, it would normally be appropriate to pursue this under Chapter II of the Competition Act 1998.<sup>87</sup> However, the concerns about pricing behaviour by the four largest supermarkets are not merely isolated local matters, nor dependent on the existence of positions of 'dominance' within the meaning of this Act, but are likely to affect a substantial number of local markets and relate to the process of competition between undertakings across the UK as a whole.
- 8.27 In relation to concerns about buyer power, the OFT is not aware of any alternative powers that could appropriately be used. The Supermarkets Code of Practice exists to regulate the relations between the four largest

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<sup>87</sup>Chapter II of the Competition Act 1998 states that '...any conduct on the part of one or more undertakings which amounts to an abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.'



supermarkets and their suppliers, and may therefore already be providing a degree of protection for competition in the retail market from the full effects of supermarkets' upstream buyer power. However, the Code was designed to limit or prevent certain specific practices of the supermarkets in relation to their dealings with their suppliers, which the CC's 2000 report had found to be operating against the public interest, primarily because they were adversely affecting the competitiveness of some suppliers and distorting competition in the supplier market. The Code was not intended to directly and comprehensively address the kind of concerns that the OFT has now identified in relation to the possible adverse impact of buyer power on competition in the downstream retail market.

- 8.28 In relation to land and planning issues, the OFT has considered carefully the possibility that it could carry out a market study into the planning system, rather than making a reference to the CC. A market study might be able to look more widely than supermarkets (that is, looking at the whole issue of retail planning, both in relation to supermarkets and non-grocery retailers), and the OFT's less formal processes in a market study might make it easier to advocate changes in government policy. There would, however, be nothing to stop the CC from considering planning issues as part of a market investigation, and making similar recommendations to government. Any suggestions made in respect of supermarket planning issues might, in any event, be expected to have knock-on effects on retail planning more generally.
- 8.29 Most importantly, there are no clear alternatives to a market investigation reference for considering the concerns about land banking and restrictive covenants. The exclusion of land agreements from the Chapter I prohibition in the Competition Act 1998 virtually rules out the possibility of Chapter I enforcement at least in relation to land holding per se. It may also be arguable that agreements for the sale of land that include restrictive covenants governing potential retailing activities by the purchaser are protected by the Competition Act 1998 (Land Agreements Exclusion and Revocation) Order 2004. Similarly, enforcement under Chapter II directed at the acquisition or retention of

land by a major supermarket would need to be pursued on a case by case basis, and would probably be dependent on the ability of the OFT to prove local market dominance. While such investigations may be pursued in appropriate cases, the use of restrictive covenants in particular appears to be a feature of the industry more generally, and may therefore be more effectively examined in the course of a CC market investigation. An OFT market study of planning could look at land holdings but, given that the powers in section 174 of the Enterprise Act 2002 can only be exercised for the purposes of assisting it in deciding whether to make a reference under section 131 or to accept undertakings in lieu under section 154, the OFT could not demand information from parties and would not be able to impose remedies (such as divestment of land). There is no indication at present that any individual agreement or network of agreements, or conduct meet the threshold for enforcement of Article 81 and/or Article 82 of the EC Treaty.

- 8.30 Overall, the OFT concludes that a market investigation reference would be the most appropriate route for addressing the concerns raised about the various features that appear to be preventing, restricting or distorting competition in the market.

### **Undertakings in lieu**

- 8.31 Finally, the OFT considered whether there were undertakings in lieu of a reference that could be offered by the supermarkets to address the concerns raised without the need for a market investigation reference. One respondent suggested that the supermarkets could give an undertaking not to use restrictive covenants on the sale of sites. However, while the OFT would welcome an end to the use of such covenants, this would not address the other features of the market identified in this Decision. There have been no other offers of undertakings in lieu from other parties to the inquiry. Therefore, the OFT concludes that there are no available undertakings that would remove the need for a market investigation reference.

## **Conclusion on the case for a reference**

8.32 Taking account of all the relevant factors outlined in its guidance on market investigation references, and the responses to consultation on the Proposed Decision, the OFT has concluded that the balance of arguments points in favour of exercising its discretion to make a reference to the CC.

## 9 SCOPE AND TERMS OF REFERENCE

- 9.1 Having concluded that there is a case for a reference to the CC, the OFT has considered the appropriate terms of this reference, taking account of the appropriate scope of the CC's investigation. Section 133(1) of the Enterprise Act requires the OFT, when making a market investigation reference under section 131, to set out a description of goods or services to which the feature or combination of features concerned relates. In addition, section 133(2) permits, but does not require, the OFT to frame the reference so as to require the CC to confine its investigation to the features of the markets for the specified goods or services as exist in connection with either a particular description of supply, or a particular description of acquisition, of the goods or services concerned.
- 9.2 A high proportion of respondents to the Proposed Decision commented on what the scope of the reference should be. Many of these raised specific features of the market that could be considered by a CC investigation. It is important to recognise, however, that the CC is not limited to examining the features of the market identified in the OFT's reasons for reference.
- 9.3 Comments from respondents fell into three main groups, which are discussed in more detail in the remainder of the chapter:
- Whether an investigation should consider non-grocery sales by supermarkets
  - Whether an investigation should look at the impact of supermarkets on the grocery supply chain, running from first-tier suppliers through to primary producers and farmers, and
  - Whether an investigation should be narrowed to look only at the convenience store sector or small chains.

## Non-grocery sales by supermarkets

9.4 A significant number of respondents, including some supermarkets and representatives of smaller retailers, suggested that the scope of any investigation should extend beyond groceries to include other non-grocery products sold by the major supermarkets. Among the arguments made were that:

- supermarkets have expanded into non-grocery sales to such an extent that any investigation focusing purely on groceries would be ignoring a crucial change in the market since the 2000 CC report
- supermarkets are able to use their market position and consumer base to expand into other markets, with at least the possibility of loss-leading in an attempt to build up market share in other product markets, and
- some of the perceived effects of supermarket expansion on independent grocery stores are analogous to effects witnessed in other areas; for example, one group identified a significant decline in the number of independent electrical retailers, and suggested that this was partly due to supermarkets expanding into the market for retail electrical goods.

9.5 Some respondents identified particular areas that they believed should be included within the scope of a CC investigation. These included books; CDs and DVDs; retail electrical goods; clothing; and petrol.

9.6 The OFT is aware of substantial evidence that supermarkets' non-grocery sales have indeed grown rapidly since 2000. For example, Mintel estimates that sales of core non-grocery products in supermarkets grew by 61 per cent between 2000 and 2004, to around £12.8 billion.<sup>88</sup> Of this total, the largest categories were health and beauty (£4.1 billion),

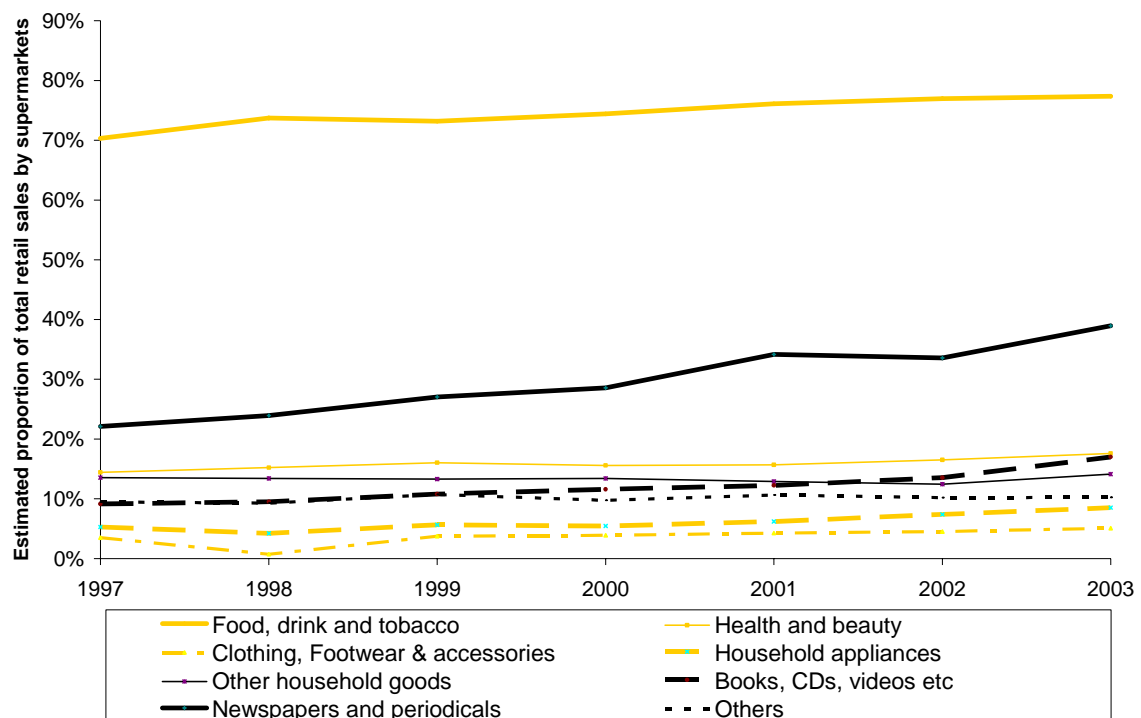
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<sup>88</sup> *Mintel: Non-foods in Grocery Multiples UK*, April 2005, page 16

clothing and footwear (£2.5billion) and home entertainment software (£1.3billion).

9.7 However, although supermarkets have increased their market share in non-groceries, they still have relatively small shares of non-grocery product markets. For example, Figure 9.13 shows an estimate of the share of total retail sales through predominantly food stores, based on ONS data. This suggests that, while supermarkets' share of grocery sales is in excess of 70 per cent, supermarkets' share of sales in most other product categories is less than 20 per cent.

**Figure 9.13: Estimated share of total retail sales through food stores**



Source: OFT calculations based on ONS ABI data. Figure shows sales in non-specialised stores with food, beverages or tobacco predominating, excluding confectioners, tobacconists and newsagents, as a proportion of total retail sales by category.

9.8 In the OFT's view, there are good arguments for thinking that certain features identified as reasons for the making of a reference, including land acquisition and planning, could be having at least some effect on

competition in relation to non-grocery products, not only because supermarkets sell non-grocery products, but also because land availability and planning difficulties may affect market entry by non-supermarket retailers (for example, electrical goods retailers wishing to build new out-of-town superstores).

- 9.9 However, the OFT considers that supermarkets' current market power arises primarily from their grocery sales. It was to the market for the retail supply of groceries that the concerns raised by the ACS primarily related, and it was to competition in that market that the OFT directed its enquiries in deciding whether a reference was appropriate. In other product areas where supermarkets command a much smaller share of the market, one might reasonably expect that supermarkets' non-grocery sales currently increase, rather than reduce competition, and benefit consumers. Thus, if there is a competition concern in relation to supermarkets, it is likely to be around the relationship between grocery and non-grocery sales. It may be the case, for example, that supermarkets use their existing market position in groceries to compete unfairly with competitors in other product markets, or price below cost on non-grocery products (such as electrical goods or fuel) in order to enhance customers' perceptions of the value-for-money provided across the store, or to otherwise increase footfall by customers whose spending will primarily be on grocery products.

9.10 Therefore, the OFT has decided, on balance, not to expand the scope of the reference to include markets for the supply of non-grocery products. That would not, however, prevent the CC from investigating the relationship between supermarkets' grocery and non-grocery sales, and the potential effects that this may be having on competition in the market for the supply of groceries by retailers in the UK.<sup>89</sup>

### **Impact of buyer power on the supply chain**

9.11 A large number of consultation responses, both from individuals and affected organisations, criticised the Proposed Decision for not analysing the impact of supermarkets' buyer power on upstream participants in the food supply chain, including farmers.

9.12 By confirming its decision to refer the market for the supply of groceries by retailers in the UK, however, the OFT is not seeking to prevent the CC from looking at the supply chain, including the impact of supermarkets' buyer power on other parties in that chain, where this is relevant to competition at the retail level.

### **Arguments for limiting the terms of reference**

9.13 While the majority of consultation respondents called for the terms of the market investigation reference to remain the same or be widened, a small number of respondents called for the terms to be narrowed. One of the supermarkets argued that, if the OFT were to make a reference, this

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<sup>89</sup> Section 134(1) of the Enterprise Act 2002 requires the CC to decide whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK (or part of the UK). Once the CC has identified such an effect it has a duty under section 138 to consider how to remedy it. According to section 134(3), 'relevant market' for these purposes means the goods or services of the description specified in the OFT's reference (in this case groceries, when supplied by retailers in the UK). The definition of a 'feature' of the market in section 131(2)(b) makes clear that the conduct of a person who supplies or acquires goods in the market concerned – even if that conduct is in a different market – can be a 'feature' for the purposes of Part 4 of the Act. Accordingly, the CC will be able to identify, and if appropriate impose remedies in respect of, supermarkets' conduct in relation to the supply of non-grocery products insofar as such conduct has an effect on competition in the supply of groceries.



should be focused on convenience stores. Another body representing wider retailers wanted the reference to focus on the impact on smaller chains and independent stores.

- 9.14 The OFT does not believe that it is appropriate to limit the terms of reference in this way. First, a reference only of convenience stores would not address the OFT's concerns around planning and land issues, which relate primarily to larger store formats. Secondly, even in relation to the concerns raised around pricing behaviour and buyer power, it is not clear that a reference of convenience stores alone would address the core issue of the relationship between supermarkets and smaller stores. In particular, it would cut across the question of market definition, and the extent to which convenience shopping takes place in larger format stores, which then compete with convenience stores including independents.

### **Conclusions on terms of reference**

- 9.15 The OFT has carefully considered the arguments made by respondents, particularly in relation to the case for expanding the terms of reference to include non-groceries and making more explicit reference to the grocery supply chain. However, the OFT notes that the concerns into which it has enquired, and the suspected market features which it has identified as a result, relate primarily to the supply of groceries. It is in the supply of groceries that the supermarkets' have a 'market' share of in excess of 70 per cent, and groceries also represent the vast majority of the products sold both by the largest supermarket chains (particularly in their dedicated convenience stores) and by independent and other non-supermarket convenience stores. The OFT therefore considers that the market for the supply of groceries by retailers in the UK should be the focus of the CC's investigation. Nevertheless, the OFT anticipates that the CC will, in carrying out its investigation, also wish to consider supermarkets' relationships with their suppliers and supermarkets'

conduct in relation to the selling of non-grocery products since those matters might reasonably be thought to be affecting competition in the retail market for groceries. The terms of the market investigation reference are set out in Annex A.

# ANNEXES

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## A TERMS OF REFERENCE

The OFT, in exercise of its powers under section 131 of the Enterprise Act 2002, hereby makes a reference to the Competition Commission for an investigation into the supply of groceries by retailers in the United Kingdom.

The OFT has reasonable grounds for suspecting that a feature or a combination of features of the market or markets in which the reference goods are supplied prevents, restricts or distorts competition in connection with the supply of the reference goods in the United Kingdom.

For the purposes of this reference:

- The expression 'groceries':
  - includes food (other than that sold for consumption in the store), pet food, drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods
  - excludes petrol, clothing, DIY products, financial services, pharmaceuticals, newspapers 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.

Dated:

Signed:

## B SUMMARY OF CONSULTATION RESPONSES

B.1 Following publication of its Proposed Decision, the OFT received around 1,250 consultation responses from interested parties before the closing date of 6 April. Of these, just around 50 responses were from affected organisations or businesses. The OFT also received nine letters from MPs. The remainder of the responses were from individual members of the public, including around 1,030 who sent standard-form emails originating from the Friends of the Earth website. Table B.14 gives a more detailed breakdown of responses received.

**Table B.14: Breakdown of number of responses received**

Type of respondent	Number of responses
Individuals	
FoE standard email	1,030
Others	170
Total	1,200
Firms and organisations	
Supermarkets	5
Other retailers	4
Wholesalers	14
Producers/suppliers	7
Others	20
Total	50

B.2 The vast majority of respondents favoured a reference. Aside from the four largest supermarkets, only two respondents argued against a reference. However, respondents also raised many substantive issues about the analysis in the Proposed Decision, and the scope of a possible CC investigation. As far as possible, these points have been summarised and addressed in the main text of this document.

## **C SUPERMARKETS CODE OF PRACTICE**

C.1 This section summarises issues raised by consultation responses relating to the Supermarkets Code of Practice. Although the CC could, in principle, recommend changes to the Code following a market investigation, the Code in its current form will remain in force until any such recommendation is made.

C.2 Specific issues which have been raised with us about how the Code works include:

- the Code should apply to all supermarkets, not just Asda, Sainsbury's and Tesco (Morrisons has agreed to abide by the principles of the Code following its takeover of Safeway)
- an anonymity clause should be included in the Code to protect suppliers wanting to make a complaint
- the Code should be widened to include producers and growers, not just direct suppliers to the supermarkets
- the Code should ensure that supermarkets apply the same standards to their overseas suppliers, and
- the Code should be more prescriptive.

C.3 Many of these were issues raised during the OFT's last Code review in 2005. The OFT's audit of the Code that the supermarkets who were covered by it were by and large complying with it. However, the OFT also noted that concerns had been expressed about the Code's effectiveness. Those concerns essentially related to the lack of prescriptiveness of the standards in the Code, and the apparent reluctance of suppliers to raise complaints under the Code, perhaps out of fear of commercial reprisals.

- C.4 A number of respondents presented anecdotal evidence of abuses of the Code by some of the supermarkets. However, this evidence was anonymous and not backed up with documented evidence demonstrating a breach. The OFT cannot act without this evidence being put to it and the suppliers being prepared to be identified. In practice, the OFT has observed a recent increase in suppliers willing to use the Code, and talking to the OFT seeking advice. This is an encouraging development.
- C.5 A number of parties highlighted the issue of how supermarkets deal with their overseas suppliers. In theory, the Code does apply to overseas suppliers to supermarkets, but the OFT acknowledges that many overseas suppliers are unaware of the Code or who and what it applies to. The OFT will consider how to address this as part of its ongoing monitoring of the Code.
- C.6 In its August 2005 report, the OFT discussed what could be done to improve confidence in the effectiveness of the Code in regulating the relationship between the supermarkets and their suppliers. The OFT committed to monitoring the Code more proactively.
- C.7 Following the reference to the CC, the Code will remain. Therefore, the OFT continues to encourage supermarkets to provide written terms to suppliers. The OFT will also refocus its monitoring of the Code on facilitating and checking compliance. This could involve talking to the supermarkets and supplier trade associations on a regular basis, and discussing any scope for improvement and changes as they arise. The OFT remains willing to discuss alleged specific breaches of the Code with suppliers and their trade associations on a confidential basis.
- C.8 Although the market investigation reference that the OFT is now making to the CC is focused on competition at the retail level, one of the features of the market which the OFT suspects of distorting competition on that market is the buyer power of the large supermarket multiples. In looking at that suspected feature, the CC can be expected to consider the ability of the supermarkets to exercise buyer power in their dealings with suppliers. If the CC decides that buyer power is a feature which is

distorting competition, the CC might reasonably be expected to consider changes to the Code as a possible route for remedying that feature.