Price inflation and competition in food and grocery manufacturing and supply

29 November 2023

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Summary

Background

1. The CMA's purpose is to promote competitive markets and tackle unfair practices. One of our medium-term priorities is to focus on areas where people spend the most time and money, and those who need help the most.[1] Reflecting the importance of groceries in consumer spending,[2] and the strain placed on household finances by high and persistent price inflation, we have been undertaking a programme of work in the groceries sector. Our aim in doing so has been to assess whether weak or ineffective competition has been contributing to high inflation, and to ensure people can shop around and compare prices easily and with confidence.

2. As part of this programme of work, on 20 July 2023 we published an update on competition and choice in groceries.[3] This update focused on retail competition, especially between the major supermarkets[4] and discounters.[5] The evidence we saw at that time indicated that high price inflation for groceries did not appear to have been driven at an aggregate level by weak or ineffective competition between retailers.

3. Grocery retailers set the prices paid by consumers, and so strong competition at this level of the supply chain is essential to containing cost-of-living pressures. But the prices set by retailers depend to a significant extent on how much they pay their suppliers, and what those suppliers in turn pay for ingredients and other inputs. As part of our July update, we therefore committed to considering over subsequent months whether weak or ineffective competition in other parts of the food supply chain – and particularly among branded and own-label groceries suppliers – was contributing to high food price inflation. This report sets out the findings from this work.

4. Given the complexity of the food supply chain, and the need to ensure our work was timely and impactful, we identified in our July update ten indicative product categories for closer examination: milk, poultry, bread, lemonade, ready meals, chilled desserts, pet food, baked beans, mayonnaise and infant formula. In selecting these products, we took account of a number of factors, including consumer and input price inflation; the importance of the products to consumers; and their potential to shed light on a range of features of the groceries supply chain and/or consumer behaviour.

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[1] CMA Annual Plan 2023 to 2024 - GOV.UK (www.gov.uk)
[2] For the average household, 12% of total weekly expenditure went on food and non-alcoholic drinks in the financial year ending 2022. This rose to 15% for the 5.6 million households in the bottom fifth of the income distribution, and is likely to be even higher for recent months as a result of high food price inflation. (Source: Family Food FYE 2022 - GOV.UK (www.gov.uk))
[3] Competition, choice and rising prices in groceries - GOV.UK (www.gov.uk)
[4] Asda, Morrisons, Sainsbury's and Tesco.
[5] Aldi and Lidl.

Our approach

5. The key focus of this update is to understand whether weak or ineffective competition between the firms that supply groceries retailers (which we refer to as 'manufacturers') has contributed to food price inflation. We have also considered the input costs faced by manufacturers, and how changes in these have influenced prices, and have examined at a high level the profitability of some key inputs common to a range of food production.

6. To obtain the necessary evidence to address these questions, we:

   - Issued voluntary requests for information (RFIs) to over 30 own-label and branded food manufacturers across the ten product categories, to obtain data and information, among other things, on their costs; financial performance; their negotiations and contracts with retailers; price setting; and views on competition in the markets they supply, and those they purchase inputs from.
   - Met with a subset of these manufacturers to discuss in further detail their written responses, as well a range of industry stakeholders, government departments and other interested parties and experts.
   - Examined published financial information for other businesses (additional food manufacturers, as well as suppliers of energy, fertiliser and packaging).
   - Procured detailed data on volumes purchased and prices paid by consumers across the ten product categories since September 2021.

7. We have observed significant differences between the own-label and branded sectors of the market, for example in the way manufacturers interact with retailers, trends in consumer purchases and profitability and we therefore present our conclusions separately for the own-label and branded sectors in turn. We have also observed differences between our ten product categories but note that these were generally driven by the relative importance of branded and own-label shares within these product categories. Although our analysis is based on a sample of product categories, we consider that our findings have broader relevance for the groceries market as a whole, given that we have assessed commonly purchased products with a broad range of characteristics, and that there was considerable consistency in what we heard from manufacturers within the own-label and branded segments.

Findings

Input costs and profitability

8. Food manufacturers have seen increases in their costs driven by higher input prices: principally for ingredients, fertiliser, labour, energy, and packaging. These cost increases were primarily driven by higher energy prices caused by the invasion of Ukraine, though there were other causes (eg labour shortages and general inflation causing wage growth, and weather events causing higher prices for some ingredients). Although some manufacturers noted that, for certain inputs,

they were reliant on a small number of firms, they did not identify specific competition problems in relation to the markets for their inputs.

9. Reflecting concerns expressed by some stakeholders about recent high profitability in these sectors, and their importance across a wide range of food production, we looked in more detail at public financial information for major fertiliser, energy and packaging suppliers. We found that:

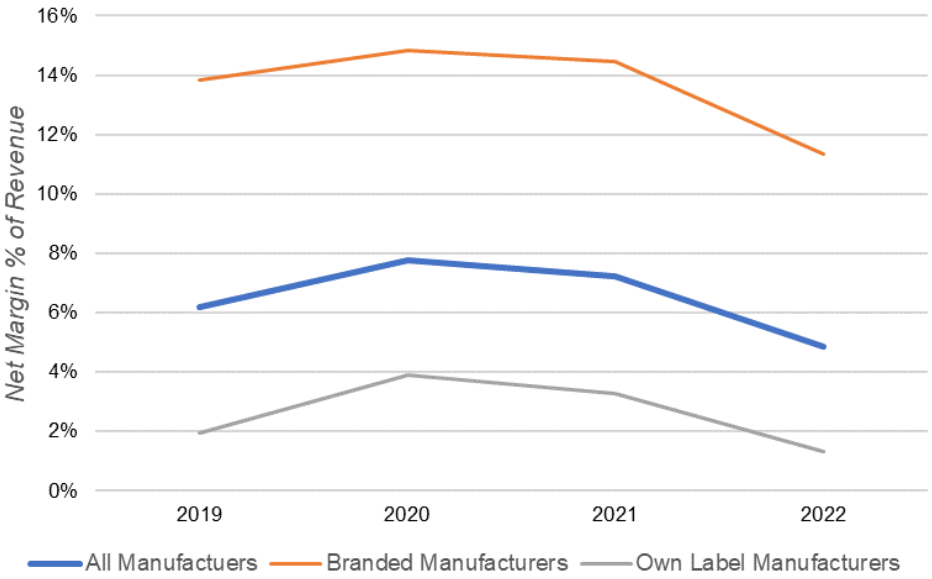
- In **energy**, some firms have made high profits as a result of higher energy prices, particularly those active in generation and fossil fuel extraction. This is principally a result of exceptional circumstances which have driven up the wholesale gas price, together with the way prices are set in the UK for electricity generation. In recognition of this, the government has imposed an additional tax on the profits of oil and gas producers.
- In **fertiliser**, suppliers made higher profits during 2022, in part due to scarcity of supply as Russian and Belarussian exports fell. However, additional production appears to have alleviated global supply scarcity and the profits of major fertiliser suppliers have since fallen.
- In **packaging**, prices have risen, but not by as much as input costs, and profits of packaging manufacturers do not appear to have been higher than historic levels.

Own-label manufacturing

10. Own-label food and drink manufacturers compete with each other to win and retain contracts from retailers. Although for some of our product categories (eg milk and poultry), there are relatively few own-label manufacturers, competition to win and retain supply contracts appears to be strong, switching does occur, and retailers generally appear to obtain competitive prices, assisted by the transparency of the costs of their own-label suppliers. This has continued to be the case as input costs have risen.

11. Our profitability analysis of own-label manufacturers is consistent with this finding. It shows that, **for most products, own-label margins are low and have generally fallen in the most recent financial year** (two thirds of own-label suppliers have experienced declining margins since 2021): Figure 1, below, illustrates average profitability across own-label and branded manufacturers. In some cases, we have observed own-label manufacturers raising their unit profitability – that is, pushing prices up by more than input costs. However, this is less prevalent than among branded manufacturers (see below) and, as noted, has been from a significantly lower starting point.

Figure 1: Average net margins for manufacturers, financial years 2019 – 2022



Source: CMA analysis of RFI responses

Note: Simple average across 31 suppliers.

12. Based on the evidence we have seen, across most of the product categories we have considered, weak or ineffective competition between own-label manufacturers does not appear to have contributed to food price inflation.

13. In July, we found that groceries retailers were competing with each other on price to retain and grow volumes, and consumers were shopping around to get the best deals. To the extent these conditions persist, retailers will generally be incentivised to obtain competitive prices from their own-label suppliers, and to reflect these in what they charge consumers. Taken together, this means that **consumers can have confidence that, for most of the product categories we have considered, they are getting competitive prices where they are able to access and choose own-label alternatives.**

14. However, **it is not possible to reach this conclusion with the same degree of confidence in respect of own-label infant formula**. This is because (unlike the other product categories), own-label infant formula is only sold by one retailer (Aldi), which sources the product from one own-label manufacturer. Nonetheless, own-label infant formula is generally cheaper than most branded infant formula products.

Branded manufacturers

15. For branded manufacturers, the relationship with retailers is different. The most successful branded products across our product categories (for example, Heinz Beanz, Hellmann's mayonnaise and Felix cat food) are 'must-stock' items for retailers, meaning that some customers will expect to see them in a store and might decide to shop elsewhere if they are consistently unavailable. Retailers also have limited visibility of the costs of their branded suppliers.

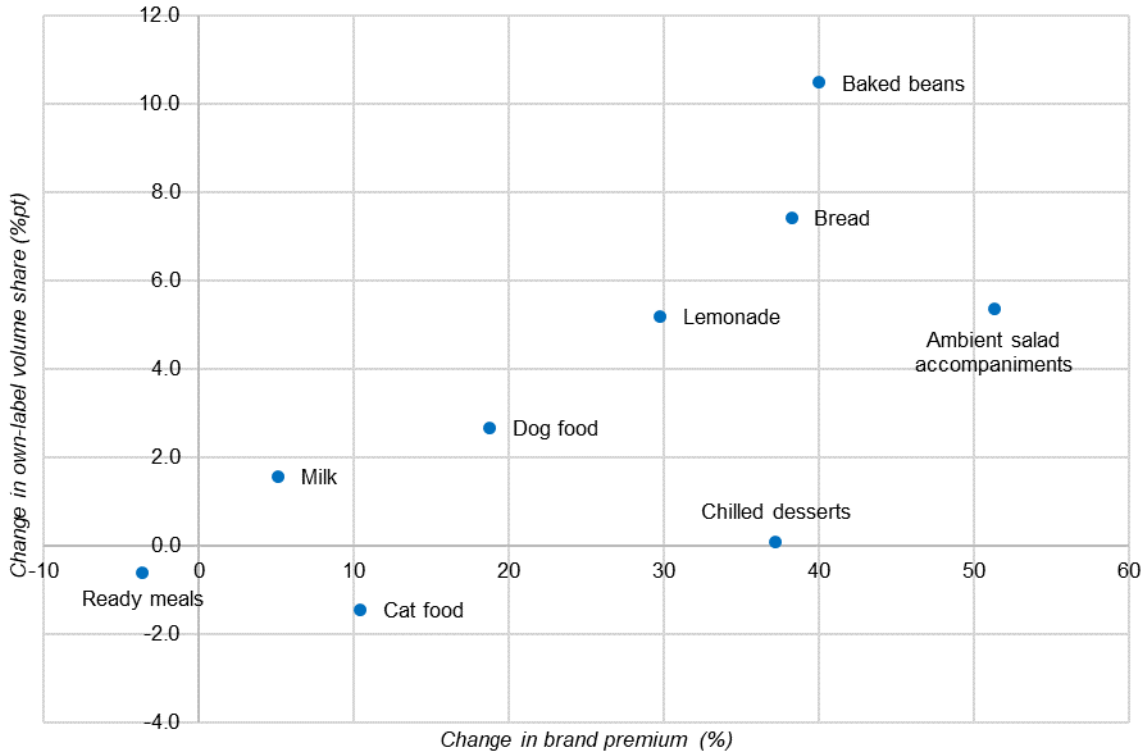
16. These features give branded manufacturers a source of pricing power that is not typically available to own-label suppliers. Our profitability analysis shows that **around three-quarters of brands that provided comparable data have increased their unit profitability during the recent period of high food price inflation**: that is, for the relevant product categories, they have pushed up the prices they charge to retailers by more than the rise in their input costs. However, in doing so, many have seen a reduction in volumes, market share (see below) and overall profits (see Figure 1, above).

17. Although retailers are able to take measures to counteract the pricing power of branded manufacturers as part of their negotiations with them, the key constraint that prevents 'must-stock' brands charging what they like comes from consumer behaviour, and their preparedness to switch away to cheaper alternatives, including own-label products, in the face of price rises: that is, the strength of brand loyalty. For this reason – and reflecting that own-label generally appears to offer competitively priced alternatives – we looked carefully at the extent to which switching had happened over the last two years in response to branded and own-label price differences.

Consumer switching and implications for competition

18. **Across most of our product categories where brands are present, we have** observed **switching to cheaper own-label products**. Switching has been particularly pronounced in some product categories where brands are traditionally strong, and where the brand premium (the difference between the branded and own-label price) has grown over the last two years, as illustrated in Figure 2, below.

Figure 2: Change in brand premium compared to the change in own-label market share between September 2021 and September 23



Source: CMA analysis of Kantar Worldpanel Take Home panel data

Notes:
(1) The x-axis shows the percentage change in the brand premium, calculated as the absolute difference between branded and own-label prices (in £/p), between September 2021 to September 2023.
(2) The y-axis indicates the percentage point change in the own-label volume-based market share between September 2021 to September 2023.
(3) Market shares and prices are calculated over the 12-week periods ending 05/09/2021 and 03/09/2023.
(4) Ambient salad accompaniments is a proxy for mayonnaise. Mayonnaise accounts for around 72% of sales of ambient salad accompaniments by volume.

19. Where branded manufacturers have set prices such that their unit profitability has increased, this will have aggravated cost-of-living-pressures for those who continued to stay loyal to these products. However, from a competition perspective, the switching and overall profitability trends we have observed across most product categories, together with evidence of effective competition in own-label supply, mitigate the concerns that might otherwise arise from unit profitability growth among some branded manufacturers. **While the choices made by some brands to increase unit profitability may have contributed to inflation, we do not, therefore, consider that this indicates weak or ineffective competition in manufacturing across the relevant product category** (ie including both branded and own-label suppliers).

20. Once again, **infant formula is an exception.** Profitability among branded suppliers is high, own-label presence is weak, and we see little evidence of consumers responding to significant price differences by switching (including between cheaper and more expensive brands). Reflecting this, and other features of infant formula supply and demand, **we have decided to carry out further work in this market.**

21. We note that these benefits of competition may not be available to everybody. Some consumers are dependent on local convenience stores for their shopping, if they are unable to travel to a larger store or are excluded from online shopping (eg through digital exclusion or minimum spend requirements). As we said in our July update, complete own-label ranges are typically only available in large stores and online and therefore some consumers will struggle to access these.

22. We have summarised our analysis on price changes, the consumer response to these price changes, and profitability in the section on consumer trends below below. This highlights a number of our findings:

- The brand share varies across products, from almost all branded in infant formula to no branded sales in fresh poultry.
- Prices rose for all the product categories, and own-label product prices generally increased by more in percentage terms (principally because they started from a lower base).
- The brand premium (the difference between the branded and own-label prices) increased for almost all relevant products.
- Sales of branded goods fell in all product categories; own-label sales rose in about half of the product categories, but sometimes also declined where the overall market shrank (eg cat food and chilled desserts).
- Profit margins are higher for branded products than own-label, across the board.
- Profit margins are higher for some products than others, and generally higher in categories where branded sales are most important. Infant formula, baked beans, pet food and mayonnaise have the highest margins; poultry and milk have the lowest.

Figure 3: Summary of findings across product categories

		Inf Formula*	Beans	Mayo**	Cat food	Dog food	Bread	Desserts**	Lemonade	Rdy meals**	Milk	Poultry***
Branded market share	Sep 23 (%)	95	41	55	76	52	46	37	19	12	15	0
	Change since Sep 21 (%pts)	↗ +2	↓ -10	↘ -5	↗ +1	↘ -3	↓ -7	→ 0	↘ -5	↗ +1	↘ -2	→ 0
Price change. Sep 21 to Sep 23****	branded	*24%*	*47%*	*47%*	*34%*	*39%*	*31%*	*28%*	*36%*	*17%*	*25%*	*N/A*
	own-label	*45%*	*57%*	*42%*	*65%*	*54%*	*29%*	*26%*	*47%*	*23%*	*38%*	*N/A*
Brand premium††	Sep-23 (£ per unit)†	£4.97	£1.47	£2.89	£2.12	£1.14	£0.47	£1.18	£0.48	£1.85	£0.41	N/A
	% change vs Sep-21	*-3%*	*+40%*	*+51%*	*+10%*	*+19%*	*+38%*	*+37%*	*+30%*	*-4%*	*+5%*	*N/A*
Volumes (change Sep 21 to Sep 23)	Total	-6%	-3%	-4%	-24%	-3%	-4%	-17%	-8%	-9%	-7%	-2%
	branded	*N/A*	*-23%*	*-12%*	*-14%*	*-8%*	*-17%*	*-17%*	*-28%*	*-4%*	*-16%*	*N/A*
	own-label	*N/A*	*+18%*	*+9%*	*-20%*	*+3%*	*+12%*	*-17%*	*-2%*	*-10%*	*-5%*	*N/A*
Net profitability‡	branded	Higher					Medium				n/a	
	change vs 2021	Mostly falling; slight declines					Mostly falling; substantial declines				n/a	
	own-label	Medium					Lower				Lower	
	change vs 2021	Mostly falling; mixed declines					Mostly falling; mixed declines				Mixed trends	

Source: CMA analysis of RFI responses; CMA analysis of Kantar Worldpanel Take Home panel data; CMA analysis of FSNT data.

** Figures for infant formula price changes refer to period between March 2021 and April 2023. Figure for infant formula current price refers to April 2023. Branded market share and changes for infant formula include both infant formula ('first milk') and follow-on milk. The infant formula market share figure is for February 2023 due to data limitations, and the change in market share is for the period September 2021 to February 2023. The infant formula market share is estimated by scaling the 52 w/e own-label total volume to quarterly data, calculating the proportion that it makes up of the total market volume, and then converting the own-label share to a branded share.*

*** Figure for mayonnaise refers to branded share in the wider category of 'ambient salad accompaniments'. Total volume sales of mayonnaise account for 72% of the market for ambient salad accompaniments. Figures for desserts and ready meals are for chilled desserts and chilled ready meals.*

**** 0% share for branded poultry based on RFI responses.*

***** With exception of infant formula, prices are calculated as total spend divided by total volume across all branded/own-label products in the relevant product category.*

† The unit of volume for cat food, ambient salad accompaniments, dog food, baked beans, bread, chilled desserts, chilled ready meals, infant formula and poultry is kilograms. The unit of volume for milk and lemonade is litres.

†† Brand premium is the difference between average branded and average own-label price.

‡ Assessments relate to profitability after subtracting all operating costs including production costs and overheads (eg management, rent), for the relevant groups of product categories. Figures are based on the latest available comparable information reported by manufacturers (either 2022 or 2023 financial year).

Outlook for manufacturers' profits and prices

23. On **profitability**, there is evidence that **some suppliers are aiming to rebuild their margins in the next financial year** as input costs fall (although not to the levels that are inconsistent with historical averages). Around half expect to increase profits as a share of revenue, with a mix of branded and own-label manufacturers in this group.

24. On **prices**, we heard that – rather than cut their list prices to retailers – many branded manufacturers are aiming to regain the volumes lost over the last two years through in-store promotions, whereby they 'invest' (sometimes jointly with retailers) to provide temporary (and typically highly visible) price discounts. Since Tesco and Sainsbury's now principally use loyalty schemes (Clubcard and Nectar) for such promotional activity, this is likely to lead to a growing prevalence of two-tier prices in these stores. More generally, a rise in promotional activity across large retailers could lead to a more complicated environment for consumers to compare and choose the best deals. For this reason, we are continuing our work on unit pricing, and plan to launch some more work on pricing within loyalty schemes, as set out below.

Infant formula

25. In assessing whether weak competition has been contributing to high prices across the ten product categories, we have considered the profitability of manufacturers; their strength in the market and *vis-à-vis* retailers; and consumer behaviour. For some product categories, we have observed that large, branded suppliers have pricing power, and have been able to push prices up by more than their input costs.

26. However, we have been reassured, from a competition perspective, by the availability of cheaper alternatives (including own-label) in these product categories, and evidence that consumers are able and willing to switch to these. In doing so, they have mitigated cost-of-living pressures for themselves and generated competitive pressure on the large brands in these categories.

27. In infant formula, the picture appears to be different. It is a **high-margin and highly-concentrated category, with strong brands and very limited own-label alternatives**. Unlike many other product categories, consumers often have no choice but to purchase infant formula. And, even as cost-of-living pressures have grown, **there is little evidence that consumers have switched to cheaper brands, or own-label alternatives** (or that consumers newly entering the market are choosing these options). This is despite there being significant savings from doing so, and despite all infant formula products providing all the nutrients a healthy baby needs, until complementary feeding is introduced.

28. Although brands are prohibited by regulation from marketing infant formula, or making any health-related claims about their products, other ways are used to influence consumers at key moments, and persuade them to choose more expensive brands. During the first year of life, the additional cost of a 'premium'

brand over the own-label alternative, or the cheapest-available brand, is over £500.[6]

29. It is important that consumers who decide to use infant formula are equipped to make well-informed choices, and that suppliers face incentives to offer infant formula products at competitive prices. The evidence that we have seen to date raises potential concerns as to whether this is happening. With this in mind, we plan to carry out further work in the infant formula market. As part of this, we will gather additional evidence to better understand:

    (a) consumer behaviour, the drivers of choice, and the information and advice available to consumers to support their decisions;

    (b) barriers to entry and expansion for infant formula manufacturers;

    (c) the role of the regulatory framework and its enforcement in influencing market outcomes.

30. We aim to set out our findings by mid-2024, which may include recommendations to the UK government and devolved administrations on how the market could work better.

Ongoing work and next steps

31. Although the rate of inflation for food and other groceries is now falling, it is important that consumers can continue to have confidence that competition issues are not contributing to inflation, and that they can shop around and compare prices easily and with confidence. With this in mind, the CMA's programme of work in the groceries sector will continue over the coming months. Key elements of our ongoing and planned work are set out below.

    (a) **Retail competition update.** In the July update on groceries competition and choice, we also committed to continue to monitor indicators of retail competition and profitability, to ensure that people continue to benefit from competitive prices as input costs fall. In order to be meaningful, any update should be based on sufficient additional material. We therefore plan to provide an update on this in spring 2024.

    (b) **Loyalty scheme pricing.** Reflecting recent and expected growth in price promotions, and the fact that major retailers now principally use loyalty scheme for promotional activity, we will begin work in January 2024 to consider loyalty pricing schemes, in particular to understand the impact on consumers and competition of this approach to promotions.

    (c) **Unit pricing.** In July, alongside our update on groceries competition and choice, we published the findings of our review examining how grocery retailers are displaying unit pricing information in-store and online. We identified problems with unit pricing that may affect consumers' ability to compare products, and made recommendations to government to reform the

[6] This estimate is based on analysis from the First Steps Nutrition Trust, which is explained further in Section 5.

Price Marking Order 2004 (PMO). We identified examples of non-compliance with the PMO, particularly among some variety store retailers. Since we published the findings of our review:

(i) The Department for Business and Trade issued a consultation on 4 September 2023 which (amongst other things) took forward the CMA's recommendations on unit pricing and sought views on reform of the PMO.[7] The CMA responded to the consultation, which ran until 16 October 2023,[8] and the Government is now considering the responses before announcing its proposed next steps. The CMA will continue to work closely with Government with a view to improving the legislation on unit pricing.

(ii) We are undertaking a further review of compliance by certain variety store retailers with the PMO, following the concerns we identified in our July update. This involves in-store and online checks to assess whether these stores are displaying unit prices correctly and consistently. Based on these checks, we will consider whether further action, including enforcement, is needed We expect to provide an update on this work in Spring 2024.

(iii) In order to raise consumers' awareness and understanding of unit pricing, and its potential to help people identify possible savings, we are preparing to launch a public campaign in January 2024. This will build on research that we have commissioned which has helped us to understand the ways in which people currently use (or do not use) unit pricing in their regular shopping.

(d) **Pricing accuracy.** Our July update identified concerns that certain grocery retailers in Scotland and Northern Ireland were not always displaying accurate prices. We said we would explore working in partnership with Trading Standards in England and Wales to assess the scale of the problem in these nations and drive compliance. The CMA is now taking forward work in this area.

(e) **Infant formula.** It is important that consumers who decide to use infant formula are equipped to make well-informed choices, and that suppliers face incentives to offer infant formula products at competitive prices. The evidence that we have seen to date raises potential concerns as to whether this is happening. With this in mind, we plan to carry out further work in the infant formula market. We aim to set out our findings by mid-2024, which may include recommendations to the UK government and devolved administrations on how the market could work better.

(f) **Grocery land agreements.** The Controlled Land Order 2010[9] is designed to stop large supermarkets from blocking other grocery businesses from opening their shops nearby. We will continue to enforce the Order to ensure

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[7] Consultation on improving price transparency and product information for consumers (publishing.service.gov.uk).
[8] CMA response to price transparency consultation (publishing.service.gov.uk).
[9] Groceries Market Investigation (Controlled Land) Order – Register of decisions - GOV.UK (www.gov.uk).

that large groceries retailers do not limit local competition by means of land agreements.

1. Context

Evidence gathering and stakeholder engagement

1.1 To inform our analysis and assessment, we have engaged extensively with food manufacturers and processors, as well as other relevant stakeholders. We would like to thank all those who provided information.

(a) We have met with and/or gathered responses to voluntary requests for information from 31 upstream suppliers of branded and own-label products within our ten product categories (between two and five suppliers per category, at least three in most categories).[10]

(b) We have also met with 16 industry stakeholders, including the British Poultry Council, Dairy UK, the Packaging Federation and the Chilled Foods Association. The Food and Drink Federation, which represents a large number of manufacturers, supplied us with a written response in addition to our meetings.

(c) We have spoken again to some retailers to further understand the retail dynamics of some of our product categories and retailer relationships with their suppliers.

(d) We have also met other stakeholders, such as Department of Health and Social Care (DHSC), some local Trading Standards organisations, the Advertising Standards Authority (ASA), NHS Supply Chain and other interested stakeholders.[11] Department for Environment, Food and Rural Affairs (Defra) assisted us in hosting a roundtable for small and medium-sized food manufacturers.

1.2 We purchased a dataset covering prices and volumes purchased for our ten product categories from Kantar.[12] This has enabled us to explore trends in consumer behaviour – such as switching to cheaper own-label products – and price differentials between branded and own-label products.

1.3 We have also gathered and analysed publicly available data, including commodity and fertiliser prices, published company accounts and profits. We reviewed industry reports and publications from expert commentators.

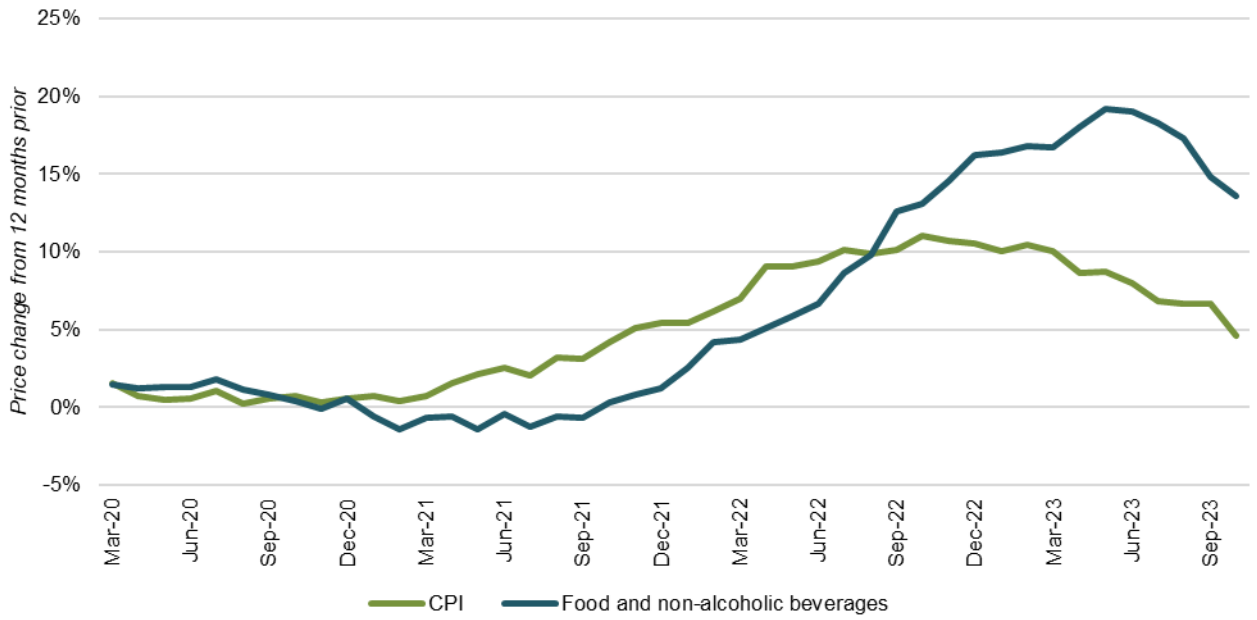
What has happened to food price inflation?

1.4 Price inflation for food and non-alcoholic beverages was 10.1% in October 2023. It continues to decline from its high of 19.2% in March 2023 – the highest rate in 45 years – but remains significantly higher than consumer price inflation (CPI), which was 4.6% in October 2023, as shown in Figure 1.1 below. Although food price inflation continues to fall and we have seen cuts in the price of some food items at

[10] Some manufacturers were present in more than one product category, so we have more than 31 sets of product category information.
[11] First Steps Nutrition Trust, a doctor specialising in the area of infant feeding research, Mumsnet.
[12] The data used is from Kantar Worldpanel Take Home panel.

supermarkets (especially dairy and bread products), overall food prices are still rising each month. Food and non-alcoholic drink prices were, in aggregate, 24.3% higher in October 2023 than they were before the Russian invasion of Ukraine in January 2022 and 29.6% higher than in January 2021, when UK COVID-19 restrictions started to ease.

Figure 1.1: CPI and food and non-alcoholic beverages 12-month inflation rate, January 2020 to October 2023



Source: ONS[13]

1.5 ONS data indicates that prices for food and non-alcoholic beverages rose by 0.1% between September and October 2023, having fallen by 0.1% between August and September 2023. This compares with a rise of 2.0% between the same two months a year ago. According to the ONS, inflation fell in 9 of the 11 product classes within food and non-alcoholic beverages, with the largest downward contributions coming from the 'milk, eggs and cheese' and 'vegetables' categories, though the inflation rate was unchanged for 'oils and fats' and 'coffee, tea and cocoa'.[14] We note that while ONS data includes prices of some products on promotion, it does not include prices of certain promotions, including where there is a discount for multiple purchases.[15]

1.6 The British Retail Consortium (BRC) compiles a different index of grocery prices: the BRC-Nielsen Shop Price Index, which considers the actual prices paid by consumers, including promotions. In October 2023, the found that food price inflation was 8.8%, down from 9.9% in September 2023.[16]

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[13] https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/latest.
[14] https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/latest.
[15] Consumer Prices Indices Technical Manual, 2019 - Office for National Statistics
[16] https://www.independent.co.uk/news/uk/home-news/uk-shop-price-inflation-fall-businesses-b2438780.html. The BRC explained that the reasons the SPI shows a different rate from the ONS data include: the SPI records loyalty card prices (eg Tesco Clubcard) whereas the CPI does not; the items in each index's respective baskets are not identical; and the weights allocated to these items differ.

1.7 Kantar has reported that, according to their data, grocery price inflation fell below 10% for the first time in 16 months and was at 9.7% for the four weeks to 29 October 2023 [17] Kantar noted that they had only seen 'year on year price falls in a limited number of major categories including butter, dried pasta and milk'.[18] Which? Also noted a fall in food inflation in its tracker: annual inflation for supermarket food and drink in their tracker fell to 12.4% for September 2023, down from 13.8% the previous month and 17% at its peak in April.[19]

1.8 In our July report, we cited some predictions for food price inflation.[20] Most retailers and commentators anticipated that food price inflation had peaked and would continue to fall throughout 2023, but that food prices themselves would continue to increase. The IDG estimated that inflation for food and non-alcoholic beverages would be 8 to 10% by the end of 2023[21] and recent developments appear to be in line with that trend.

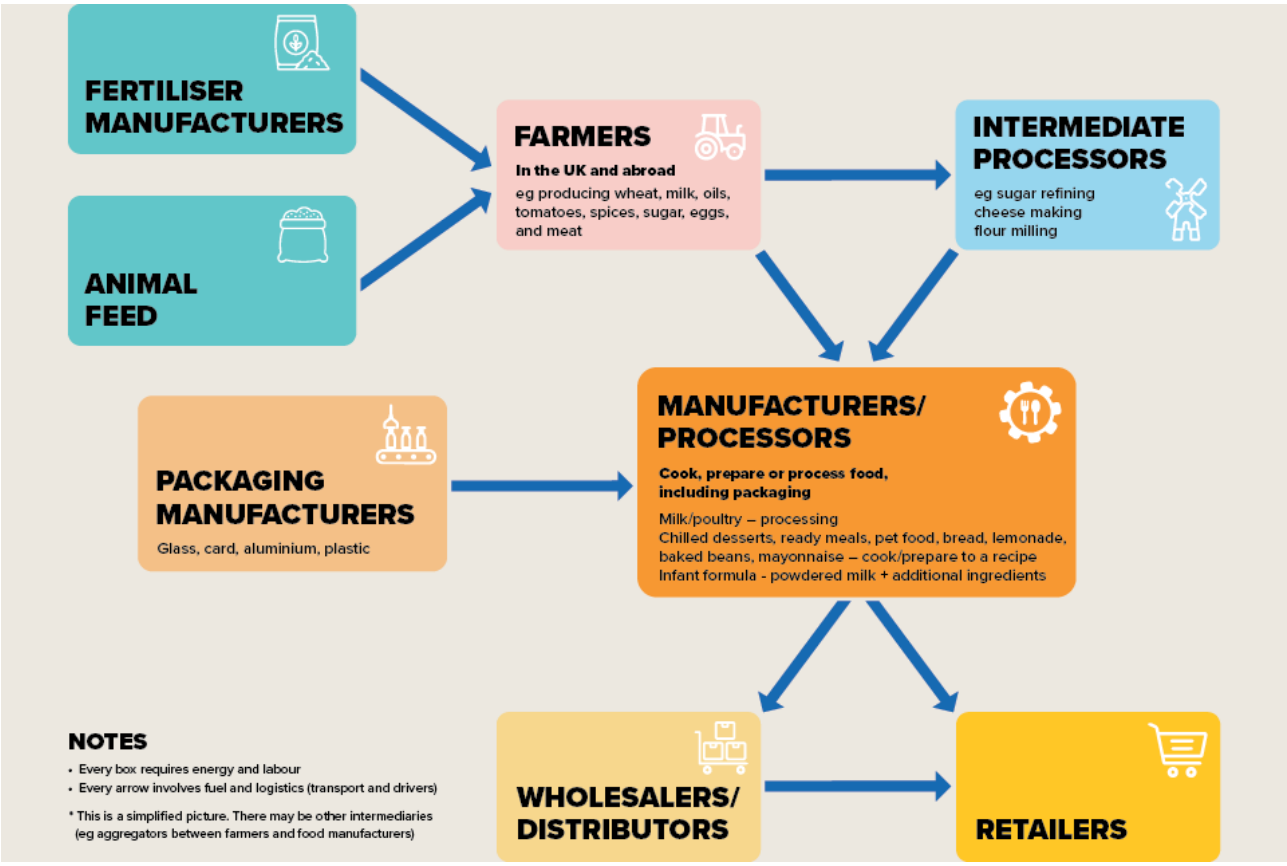
The food supply chain

1.9 Food supply is a complicated industry, comprising thousands of UK and overseas businesses, from farmers, through to processors, distributors and retailers. The larger retailers generally have hundreds of different suppliers (in some cases well over a thousand). According to the Food and Drink Federation (FDF), food and drink manufacturers directly employ over 450,000 people in the UK.[22]

1.10 Figure 1.2 below provides a simplified overview of the stages in the food supply chain, and some of the key costs incurred at each stage of production. The price that a customer pays for a food item in a supermarket is influenced by factors throughout the supply chain: in particular, costs of inputs into farming (animal feed, fertiliser, and commodities such as wheat), energy costs (for processing, transport and refrigeration), labour costs (for produce picking, processing, transport and staffing large retail stores) and exchange rates (which affect import costs).

[17] https://www.kantar.com/uki/inspiration/fmcg/2023-wp-grocery-price-inflation-hits-single-digits-for-first-time-this-year
[18] Ibid.
[19] https://www.which.co.uk/reviews/supermarkets/article/food-price-inflation-tracker-aU2oV0A46tu3.
[20] Paragraphs 3.41 to 3.44.
[21] Viewpoint Special: Exploring what's next for food inflation (igd.com).
[22] FDF Submission to the CMA, June 2023.

Figure 1.2: Simplified illustration of the food supply chain, including indicative examples of what happens at each stage



1.11 In this report, we are looking at the stage of the supply chain where food is manufactured from raw ingredients (eg ready meals, baked beans) or where raw ingredients are processed and packaged (eg milk, poultry). For ease, in this document, we generally refer to the food supply firms that are the focus of this work as 'manufacturers', even when it might be strictly accurate to call them 'processors' (eg for milk suppliers who process and package milk) or 'participants' (for those who manufacture in other countries and import their product for sale in the UK). They are suppliers to the retailers (and wholesalers who supply convenience stores) but we felt that 'suppliers' could be confusing, as the food manufacturers themselves have suppliers – of packaging, energy and ingredients.

'Shrinkflation' and 'scrimpflation'

1.12 Some consumers and commentators have raised concerns about 'shrinkflation': that is, the practice of reducing pack sizes to avoid raising prices (or to be able to raise them by less). Reports suggest that this does occur,[23] but also that many consumers are aware of this possibility and often do notice when items they have previously bought have become smaller.[24] Our analysis of consumer trends and manufacturer profitability, discussed in more detail below, is based on prices per

[23] Shrinkflation on the rise: Which? reveals the items that have shrunk in size, but not in price - Which? News.
[24] Hard-pressed UK shoppers feel food 'shrinkflation' | Consumer spending | The Guardian.

specific unit of product sold (eg kilogram or litre) and would therefore capture any price increases driven by ‘shrinkflation’.

1.13 It can be more difficult for consumers to compare prices if pack sizes are changing. A clear and consistent system of unit pricing could help with this, as the per unit price will rise with shrinkflation even if the overall price does not though it may not be sufficient as consumer generally will not know what the previous unit price was. In France, one of the large supermarket chains (Carrefour) has placed warning stickers on products which have shrunk in size but increased in cost, to draw attention to the practice (and perhaps to deter it).[25]

1.14 We consider that it is very important for unit pricing to be available and easy to understand for consumers, to help them assess the best deal, albeit it may not always be clear when shrinkflation has occurred. In July we published the findings from our review of grocery retailers’ unit pricing practices. This identified a number of problems, many of which stem from issues with the PMO. We called on retailers to begin making changes to how they display unit prices whilst the Government consults on possible changes to the PMO (see paragraph 31 above).

1.15 Another potential concern is that manufacturers may engage in ‘scrimpflation’ (eg reducing the quantities of certain ingredients in response to rising costs). We heard from many food manufacturers that they have implemented significant efficiencies in order to reduce costs – for example reducing staff overheads, or cutting advertising spend – and that they have, in some cases, reformulated recipes in order to manage scarcity of inputs. It is possible, therefore, that manufacturers may have reformulated recipes to reduce costs, though one branded manufacturer told us that they would rather raise prices than reduce quality. Manufacturers are unlikely to advertise any reduction in quality, and so customers will be unaware of the change, unless they detect a noticeable reduction in quality, at which point they may consider switching to an alternative product. (Although, we note that for pet food, for example, it may be very difficult for customers to notice changes in product formulation.) As long as manufacturers are competing for sales and consumers have alternatives to switch to, this should place pressure on manufacturers to maintain a good quality/price offering.

[25] French supermarket puts up ‘shrinkflation’ warning signs on products | Evening Standard.

2. Costs of inputs into food production

Introduction

2.1 We said in July[26] that increases in food prices were in a large part attributable to higher costs faced by farmers, food manufacturers and retailers, in particular higher prices for energy, fertiliser and commodities such as wheat. We consider increases in input costs for food manufacturers in more detail here, as well as some other important inputs such as labour, packaging and ingredients.

2.2 During this phase of our work, we asked suppliers for information about the main inputs used to produce the ten product categories; how these input costs had changed; how inputs were sourced and supplied; and any reflections on the strength and effectiveness of competition among input suppliers.

2.3 This section summarises the information we received on input costs. It goes on to consider in more detail how prices and profits in the fertiliser, non-domestic energy and packaging sectors have changed recently. The additional consideration given to these three inputs reflects their importance to a wide range of food production, and concerns expressed by some stakeholders about recent high profitability.

Context

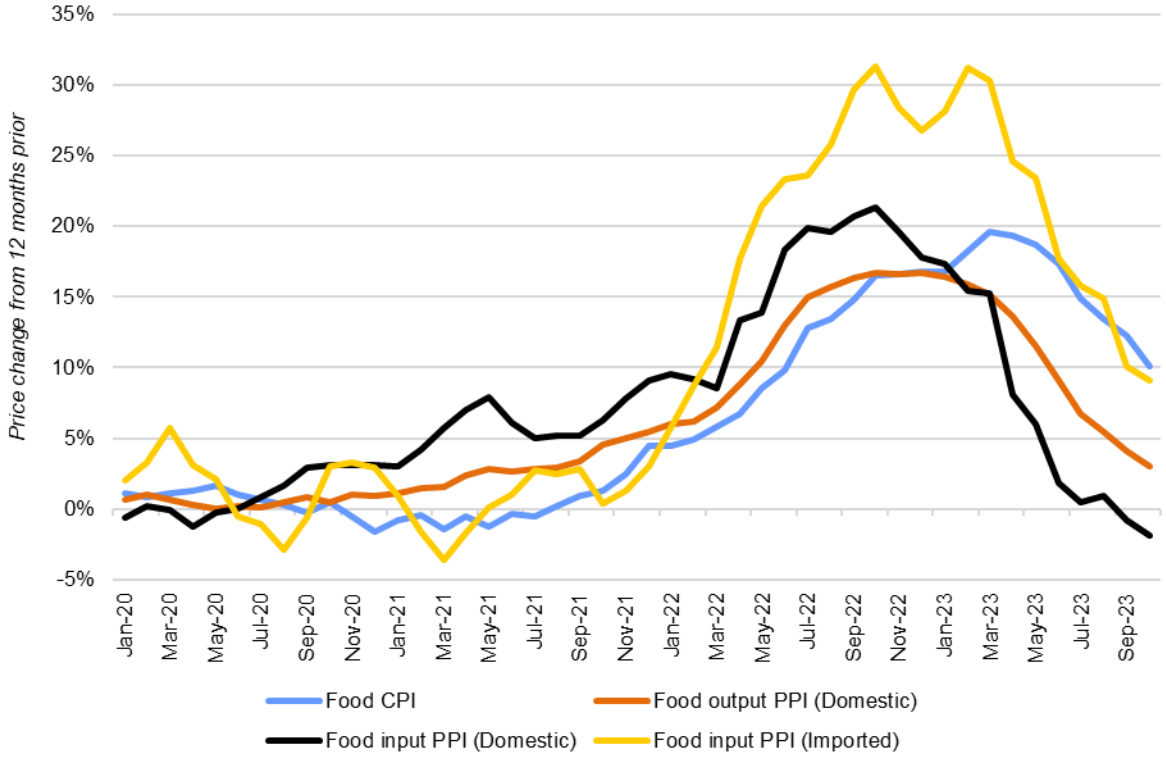
2.4 Figure 2.1 below shows trends in food prices and input prices:

- Food CPI (blue) is the price paid by consumers in shops,
- Food output PPI (orange) is the factory gate price, paid by retailers to food producers,
- Food input PPI is the price paid by food manufacturers – both for domestically produced inputs (black) and imported inputs (yellow).

2.5 We can see that factory gate prices started to fall before retail prices, and that retail prices are following the downward trend with a lag.

[26] CMA (2023); Competition, choice and rising prices in groceries; p.7.

Figure 2.1: Food input and output PPI with food price inflation, January 2020 to October 2023



Source: ONS producer price inflation data, ONS consumer price inflation data

2.6 Prices for many important inputs into food production have been falling for a number of months, though many remain above 2021 levels. Figure 2.1 above shows that input prices began to fall before consumer prices. In our July report, we explained that there was a lag between falling input costs and reductions in food prices (or food price inflation) for consumers, due to fixed contracts for energy, fertiliser and certain commodities, such as wheat, as well as lags inherent to the agricultural cycle.[27]

The principal input costs for manufacturers

2.7 The cost of producing all ten product categories depends principally on the price of ingredients, energy, packaging, and labour. The relative importance of each of these four inputs to the cost of production varies across the ten product categories although, for most, ingredients are the most important component.[28] Table 2.1 below, derived from information received from suppliers, provides an indication of the relative share of ingredients and packaging in the overall cost of production of each product category. The importance of labour and energy to the cost of production also varies between the products – for example, poultry, bread and ready meals are relatively labour-intensive, while bread is relatively energy-

[27] Paragraphs 2.29 to 2.38.
[28] For baked beans, ingredient and packaging costs account for a similar share of the cost of production.

intensive – although comparable figures for all product categories cannot be compiled from the information received from suppliers.[29]

Table 2.1: Share of ingredients and packaging in total production costs

Product category	Ingredients	Packaging
Bread	<40%	<10%
Baked beans	<40%	>20%
Lemonade	<40%	>20%
Desserts	40-60%	10-20%
Infant formula	40-60%	10-20%
Ready meals	40-60%	10-20%
Mayonnaise	>60%	10-20%
Milk	>60%	10-20%
Poultry	>60%	<10%
Pet food	variable	variable

Colour shading reflects relative importance (compared with other product categories) of that input in overall cost of production (red = relatively more important).

Source: CMA analysis of RFI responses

2.8 All suppliers highlighted how input costs had risen in recent years, with most citing significant increases across all of labour, packaging, ingredients and energy. Some suppliers stated that they had been able to mitigate the effects of certain input cost rises (particularly energy but also certain commodities/base ingredients, such as wheat) through hedging arrangements, and through longer-term fixed-price supply contracts. However, a number of suppliers also reported entering into contracts or hedging arrangements when prices were near their peak, noting that this had disadvantaged them relative to their competitors. They also noted that fixed-price contracts and hedges may hinder their ability to pass through input cost reductions fully and quickly because their input prices remain fixed at higher levels. Some large suppliers noted that they purchase ingredients and other inputs (such as packaging) on a European or even a global basis.

2.9 A number of ingredients were frequently cited by suppliers as having seen increases in prices that materially affected the cost of production. These are summarised together with information about changes in ingredients prices over the last two years in Table 2.2 below. We can see that price rises have been particularly high in eggs, imported sugar and tomatoes.

2.10 Price changes are primarily captured through Defra's Agricultural Price Index, a monthly publication that measures the price changes that UK farmers receive for their products (referred to as the farm-gate price).[30] The exception is sugar, where the Defra index is updated annually and so does not capture recent price changes.

[29] We did not receive sufficient information to understand the share of costs attributable to labour across each product category.
[30] Latest agricultural price indices - GOV.UK (www.gov.uk).

To account for this, we supplement the Defra data with ONS Producer Price data for imported Sugar.[31]

Table 2.2: Price rises for important ingredients across our product categories

Ingredient	***Used in***	***Price change since***			***Peak annual price rise since January 2020***
		Jan 2020	**Jan 2021**	**Jan 2022**	
Milk	Fresh milk, ready meals, chilled desserts, infant formula	26.0%	22.0%	2.3%	56.1% (September 2022)
Tomatoes*	Ready meals, baked beans	33.7%	59.1%	2.2%	77.2% (March 2022)
Wheat for flour	Bread, ready meals, pet food	57.4%	16.2%	-5.3%	62.6% (June 2022)
Rapeseed oil	Ready meals, mayonnaise	8.6%	-0.9%	-39.0%	78.8% (June 2022)
Eggs	Ready meals, mayonnaise	72.4%	52.8%	52.1%	42.8% (April 2022)
Beet sugar†	Lemonade, chilled deserts	31.4%	30.0%	0.0%	30% (January 2022)
Sugar (imported) (PPI)†	Lemonade, chilled deserts	119.6%	92.4%	82.7%	69.2% (April 2023)

Source: CMA analysis of Defra data and ONS data
** Tomato prices reflect wholesale prices (not the price farmers receive). These are averages of prices charged by wholesalers for selected home-grown fruit and vegetables at representative wholesale markets across the UK. Prices are not collected over the winter months (December, January, and February). We therefore compare latest prices against prices from November 2019, 2020, and 2021.*
† API Beet sugar prices are collected annually, meaning that the current price index is unchanged from January 2022. To capture recent trends in the price of sugar used in food production, we have drawn on ONS Producer Price Indices for imported sugar.

2.11 Distribution – that is, the delivery of products to customers – is also an important element of supplier costs. Again, the relative importance varies between product categories, with certain products (for example bulky, low-value products like lemonade, and those that are often delivered direct to stores rather than via regional distribution centres like milk and bread) tending to have a higher share of distribution costs than others. Many suppliers noted that rising fuel prices and lorry driver shortages had increased the cost of distribution in recent years. Many suppliers mentioned the difficulties in recruiting and retaining appropriate staff – factory workers as well as lorry drivers – with some saying that Brexit has increased difficulties in this area.

2.12 Most manufacturers cited increasing labour costs as a problem. Many employees in food manufacturing are paid the UK national living wage, which has increased

[31] Producer price inflation time series - Office for National Statistics (ons.gov.uk).

by 17% since 2021.[32] In June, the FDF told us that wage price inflation was a key factor in increasing costs and helping keep them 'baked in', as once wages have increased, they are nearly impossible to reduce.[33]

2.13 Some manufacturers also told us that aspects of regulation had increased their costs. For example, we heard that Brexit had caused additional costs when importing ingredients from the EU or selling products into EU markets. We also heard about costs from sustainability-related regulation, such as extended producer responsibility or packaging recovery notes (PRNs). We heard from SMEs in the food sector that the costs of regulatory compliance can present a disproportionately high burden on small manufacturers.[34] The FDF also said that: 'in recent years we have seen industry overburdened by ineffective, poorly constructed or outdated regulation which achieves little but imposes cost and requires valuable resources to be diverted to ensure compliance'.[35] A few manufacturers also cited the rising costs of CO2 (lemonade and poultry): we heard it was a very small share of cost but had risen significantly, in part because of the closure of a large UK production facility.[36]

2.14 In general, suppliers stated that the price rises they had implemented recently reflected substantial increases in their input costs. Indeed, many stated that they had absorbed a share of input cost rises, rather than passed them on in full through price rises. Many own-label manufacturers said that there were mechanisms to pass through some costs, such as core ingredients (especially milk and wheat). Cost pass-through for packaging is less common, but one supplier told us that their cost models included it. Few had cost pass-through mechanisms for labour, though one did. Energy is increasingly being included in these models in response to recent volatility in the energy market. The information received from suppliers on this point is assessed in further detail in the section on competition between manufacturers to supply retailers.

2.15 Suppliers did not raise specific competition problems in relation to the markets for their inputs. However, some noted that, for certain inputs, they were reliant on a small number of firms: carbon dioxide and sugar were cited by a number of suppliers in this context. Even where there may be a range of suppliers for certain inputs, it was reported by some suppliers that switching can be difficult. This was particularly the case for certain types of packaging, eg where suppliers enter into longer-term contracts with packaging manufacturers to meet bespoke requirements.

2.16 The information provided to us by suppliers about competition in inputs did not, on its own, warrant further investigation of these markets. However, reflecting their

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[32] National Minimum Wage and National Living Wage rates - GOV.UK (www.gov.uk).
[33] FDF written submission to the CMA, June 2023.
[34] Roundtable with SMEs and representatives in the food sector.
[35] FDF written response, October 2023.
[36] CO2 is a by-product of ammonia product. The closure of CF Industries' ammonia plant in the UK is discussed in more detail when we turn to assessing fertiliser below. The resilience of UK CO2 supply and implications for competition are considered in the CMA's Market resilience: Discussion paper - GOV.UK (www.gov.uk) (p.21-2)

importance to a range of food production, the energy, packaging and fertiliser sectors are considered in further detail below.

Energy

Importance of energy in food production and supply

2.17 Food manufacture and supply is highly energy intensive. Energy is used in processing (eg powering factories), farming (eg for milking machines and harvesting), the production of packaging, and in refrigeration and transportation. It is also an important cost for grocery retailers, used for lighting, heating and refrigeration. A significant rise in energy costs, therefore, increases the cost of production throughout the food manufacturing and supply process and many manufacturers cited difficulties from increasing energy costs.

2.18 The ONS estimates that food and non-alcoholic beverages have among the highest energy intensity[37] (2%) of all items in the basket of goods used to calculate the CPI.[38] In our stakeholder meetings, the National Farmers Union (NFU) and Agriculture and Horticulture Development Board (AHDB) both cited rising energy costs as one of the principal drivers for increasing food input costs.[39]

Recent developments in energy prices

2.19 Prices began rising above historic norms in 2021, as COVID-19 restrictions eased and gas demand rapidly increased. During 2022 energy prices rose even further to dramatic and historic highs after the invasion of Ukraine, as Russia systematically reduced pipeline natural gas supplies to Europe which had been a major gas supply source for the continent.

2.20 Wholesale gas prices peaked in August 2022 at a level around 12 times higher than that in February 2021, as shown in Figure 2.2 below. Since then, alternative supply sources and reduced gas demand have led to prices falling from the highs seen during 2022. However, the loss of Russian supplies means that there is now greater reliance on more volatile global markets to meet demand, leading to prices that are around double historical averages.[40]

2.21 Electricity prices in the UK followed a similar trend to gas prices. This is because the market price of electricity tends to reflect the variable cost of the most expensive method of generating electricity needed to meet demand, which is usually burning gas.

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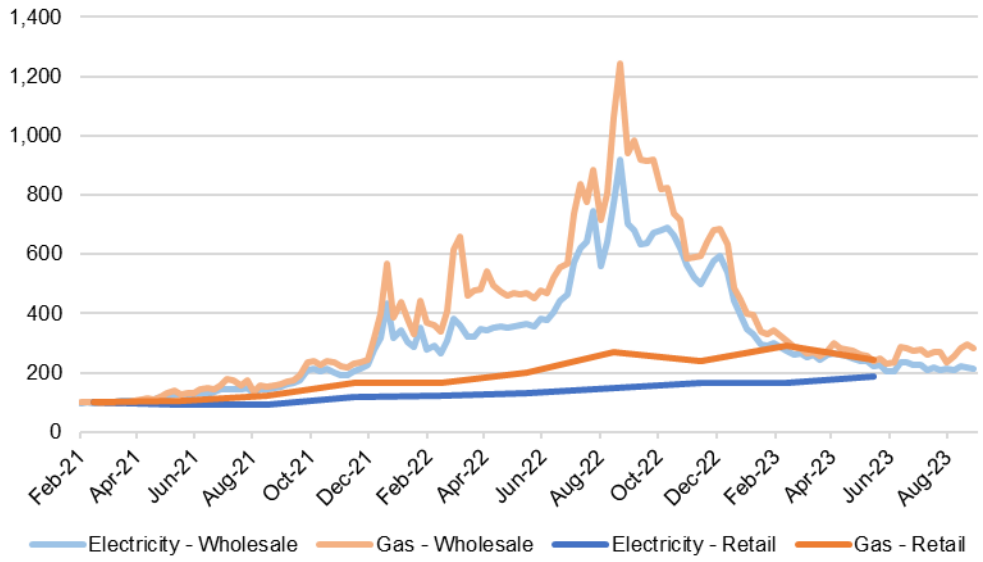
[37] Energy intensity is defined as total expenditure on energy used in domestic production as a proportion of the total value of output.
[38] Excluding sectors that are directly impacted by energy, such as transport and household gas and electricity supply, The energy intensity of the Consumer Prices Index - Office for National Statistics.
[39] Meeting with CMA and NFU; CMA and AHDB.
[40] Wholesale market indicators | Ofgem.; Gas and electricity prices in the non-domestic sector (www.gov.uk)

Figure 2.2: UK retail and wholesale gas and electricity prices, February 2021 to September 2023 (index, Q1 2021 = 100)



Source: Ofgem, ONS[41]

Note: Retail data reported quarterly only, latest available Q2 2023

2.22 In general, the use of fixed-price contracts means the price paid by businesses for gas and electricity is less volatile, and adjusts to prevailing market conditions more slowly, than the spot price. This is illustrated in Figure 2.2 above, which shows that the average price paid by business customers (ie the retail price) rose by around 90% for electricity. Although the retail price of gas to business customers has fallen since February 2023, it remains roughly 2.5 times the level it was in early 2021.

Have energy companies made large profits?

2.23 Energy supply depends on various levels of the supply chain:

(a) The energy companies which supply electricity and gas to final customers (including food manufacturers and supermarkets, but also domestic customers).

(b) Electricity generation companies (which produce electricity in the UK either from burning natural gas or by using renewable sources or nuclear power).

(c) The global oil and gas majors (eg BP and Shell) which extract oil and natural gas.

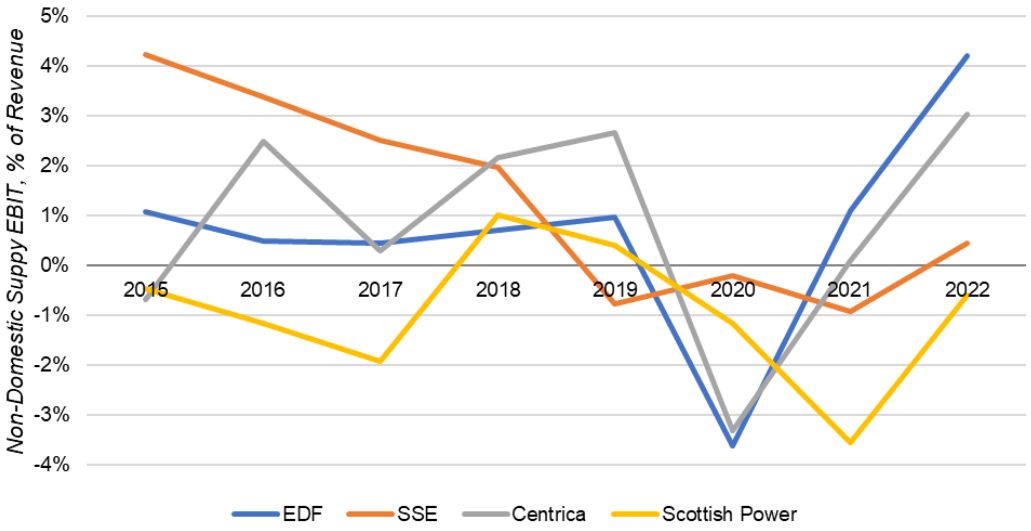
Retail energy sales

2.24 The integrated energy suppliers – EDF, SSE (Ovo), Centrica (British Gas) and Scottish Power – saw an increase in profit margins from retail energy sales[42] in 2022, as shown in Figure 2.3 below. This was partly a recovery from the low profits

[41] Wholesale market indicators | Ofgem, Gas and electricity prices in the non-domestic sector - GOV.UK (www.gov.uk).
[42] Calculated as EBIT (earnings before interest and tax) as a percentage of revenue.

during 2020 when COVID-19 restrictions reduced demand as many businesses closed for a period, although profits remain higher than the pre-pandemic average, especially for EDF.[43]

Figure 2.3: Integrated energy suppliers non-domestic supply EBIT margin, 2015 – 2022



Source: Energy suppliers' consolidated segmental statements[44]

Electricity generation

2.25 Published financial information shows that companies further up the energy value chain received greater benefits from higher prices: in generation and, more so, for major oil and gas companies. As the market price of electricity reflects the variable cost of the most expensive unit used in the system (which typically uses gas or coal), generation units with lower variable costs (such as nuclear or renewable) tend to make higher margins when the price of fossil fuel increases.

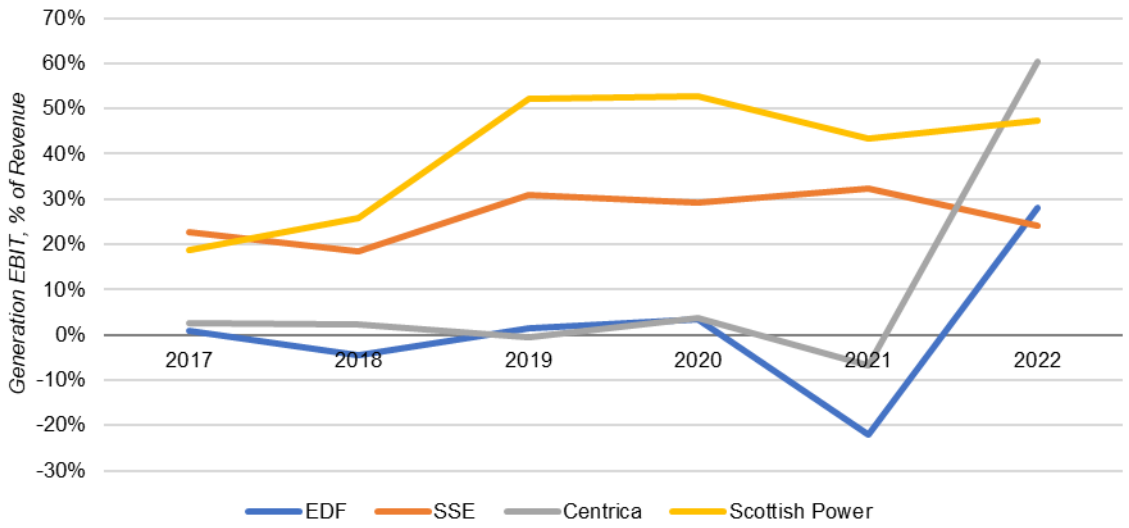
2.26 Integrated energy companies saw substantial growth in profits for energy generation, as shown in Figure 2.4 below, especially EDF and Centrica, which generate over 95% of their electricity from nuclear energy. By contrast, SSE, which relies on thermal generation and, therefore, fossil fuels, to a greater extent has a more variable cost base, and saw its margin contract slightly. All companies increased their absolute profit significantly, due to rising prices driving significant overall revenue growth.

2.27 Combined, EBIT from electricity generation rose from £0.5 billion in 2021 to £3.7 billion in 2022, an order of magnitude higher than the increase of £0.4 billion in EBIT from non-domestic electricity supply in the same time period.[45] Even accounting for the fact that this includes domestic energy (which is around 40% of

[43] The average EBIT margins in 2022 across these large players for retail energy sales was 2.5% in 2022, 1.3 percentage points higher than the pre-pandemic average (2015-2019).
[44] Energy companies' Consolidated Segmental Statements (CSS) | Ofgem.
[45] Energy companies' Consolidated Segmental Statements (CSS) | Ofgem.

UK electricity consumption), this demonstrates that energy inflation has driven significantly larger profits in generation than supply.[46]

Figure 2.4: Integrated energy suppliers Generation EBIT margin, % of revenue, 2017 – 2022

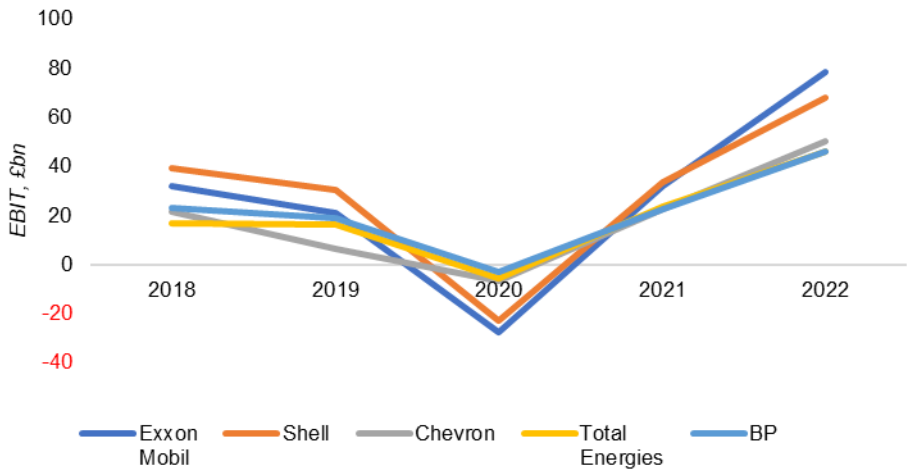


Source: Energy suppliers' consolidated segmental statements[47]

The oil and gas majors

2.28 The global oil and gas majors – Shell, Exxon Mobil, Chevron and BP – have benefited from rising prices for fossil fuel commodities driven by scarcity and disruption to production resulting from the Ukraine war. They all grew their total profits significantly in 2022, as shown in Figure 2.5 below. We can compare profits from the first half of each of the last five years (Figure 2.6) which show that profits are likely to be lower in 2023 than in 2022, though higher than in 2021.

Figure 2.5: Oil and gas majors EBIT margin, £bn, 2018 – 2022

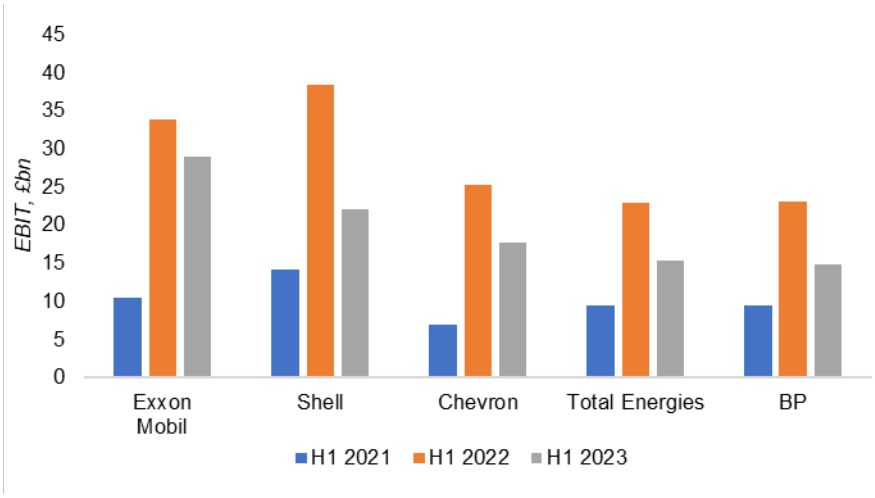


[46] Energy consumption in the UK 2022 - GOV.UK (www.gov.uk) In 2021, 38.3% of electricity consumption was domestic, and 61.4% of gas was domestic.
[47] Energy companies' Consolidated Segmental Statements (CSS) | Ofgem.

Source: Annual reports

Note: For BP, Underlying RC profit before interest and tax.

Figure 2.6: Oil and gas majors EBIT, £bn, H1 2021 – 2023



Source: Q2 Interim results

Note: For BP, Underlying RC profit before interest and tax.

2.29 In May 2022, the government noted that, '[o]il and gas producers in the UK are making extraordinary profits and this is expected to continue'.[48] In response to this, it introduced the Energy (Oil and Gas) Profits Levy in mid-2022, a temporary windfall tax on energy companies operating in the North Sea. In the Autumn Statement in November 2022, the government raised the rate of the levy from 25 to 35% and extended the end point from 2025 to 2028.

Conclusion on energy prices and profits

2.30 The surge in demand after the COVID-19 pandemic and, more importantly, the supply disruption from the war in Ukraine have significantly increased prices for energy in the UK for consumers and for business customers. As a result, some firms have made increased profits, particularly those active in generation and fossil fuel extraction.

2.31 This period of high profitability is principally a result of exceptional circumstances which have driven up the European gas price, though it is also to some degree a consequence of the way in which prices are set in the UK for electricity generation. In recognition of the extent to which oil and gas companies have benefitted from an unexpected windfall profit, the government has imposed an additional tax.

[48] Energy (Oil and Gas) Profits Levy - GOV.UK (www.gov.uk).

Fertiliser

Background

2.32 Chemical fertiliser is a critical input for many farmers,[49] used to improve crop yield. Although it is used across all crops, it is particularly important for cereals. Farmers often have little choice about how much fertiliser to use and can generally reduce consumption of fertiliser only to a limited extent in response to higher prices. For example, despite fertiliser more than doubling in price between 2021 and 2022, the application rate of nitrogen fertilisers dropped by just 9.2%.[50] There are few alternatives to nitrogen-based fertilisers, although Defra has recently delayed introducing restrictions on the use of urea, which is a cheaper alternative.[51]

2.33 There are three main types of fertiliser: nitrogen-, potassium- and phosphorus-based.[52] Nitrogen-based fertiliser is used in the highest volumes, accounting for around 60% of total consumption at both global and UK level.[53] All chemical fertiliser production is highly energy intensive. Nitrogen-based fertilisers also require natural gas (methane) as a direct input to the production process, in order to create ammonia.[54] Phosphorus-based fertilisers also use ammonia in their production.

2.34 While it can be difficult to transport natural gas and ammonia over large distances, it is more straightforward to transport fertiliser, which typically comes in pellet form. About 60 to 70% of fertiliser consumed in the UK is produced outside the UK and imported.[55] In the UK, fertiliser is sold primarily by three vertically integrated, multinational fertiliser producers: CF Industries, Yara, and Origin.[56] Since the decision by CF Industries in August 2022 to idle (and subsequently permanently close) its production facility at Billingham, the UK does not have any domestic ammonia production capacity.[57] Production of nitrogen-based fertiliser continues at Billingham using ammonia imported from a specialist terminal owned by CF Industries.

Fertiliser costs have increased dramatically

2.35 Fertiliser prices rose significantly in 2021, and still more markedly in 2022, following Russia's invasion of Ukraine. Some fertiliser prices peaked at 3.5 times

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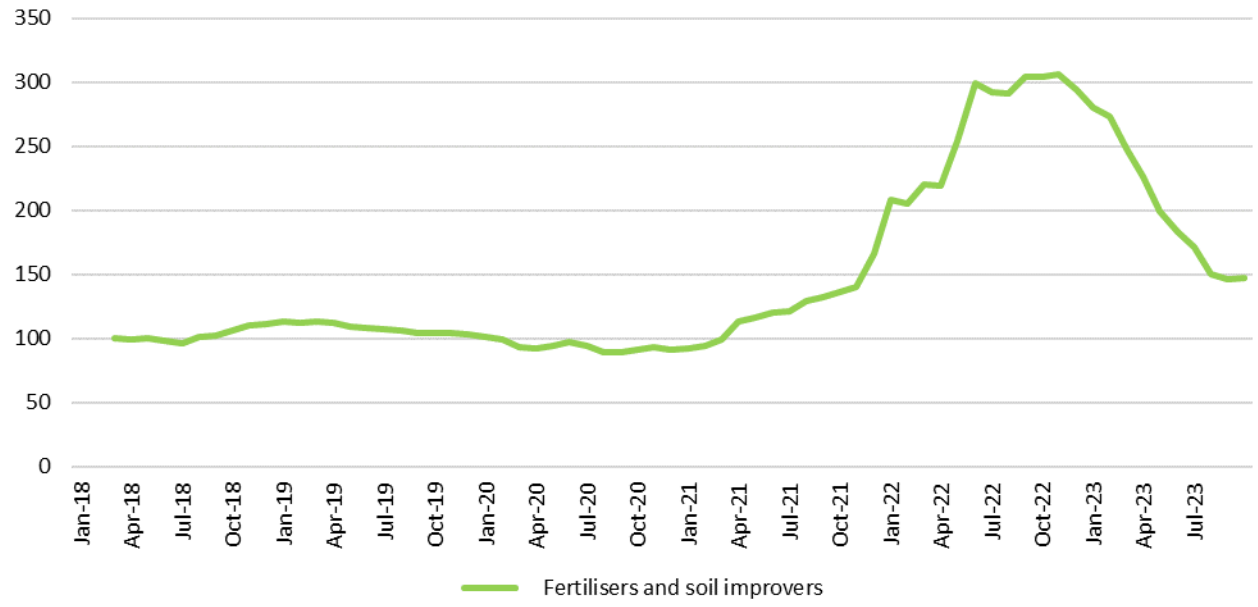
[49] For the purposes of this section, 'fertiliser' refers to chemical, or inorganic, fertiliser. Some farmers also use organic fertiliser (eg manure) as an alternative to, or in combination with chemical fertiliser which we have not considered in this report.
[50] Fertiliser usage - GOV.UK (www.gov.uk).
[51] Consultation on reducing ammonia emissions from solid urea fertilisers (publishing.service.gov.uk).
[52] All You Need to Know About Fertiliser (tradefinanceglobal.com).
[53] AIC Fertiliser Statistics Report 2022 (www.agindustries.org.uk).
[54] Approximately 60% of the natural gas is used as raw material to ammonia production, with the remainder employed to power the synthesis process. The ammonia is used to make nitric acid, with which it is then mixed to produce nitrogen-based fertilisers.
[55] UK farmers braced for spring fertiliser crunch after prices triple | Financial Times; Defra
[56] https://www.cfindustries.com/, https://www.originfertilisers.co.uk/, https://www.yara.com/
[57] CF Fertilisers UK Announces Proposal to Permanently Close Ammonia Plant at Billingham Complex | CF Industries

their 2020 levels. Although prices have declined since then, they remain substantially above pre-Covid levels, as shown in Figure 2.7 below.

Figure 2.7: UK price inflation for fertilisers and soil improvers, January 2018 – August 23 (index, January 2018 = 100)



Source: Defra[58]

2.36 The sharp rise in fertiliser prices was caused by two major factors: higher production costs and scarcity of supply.

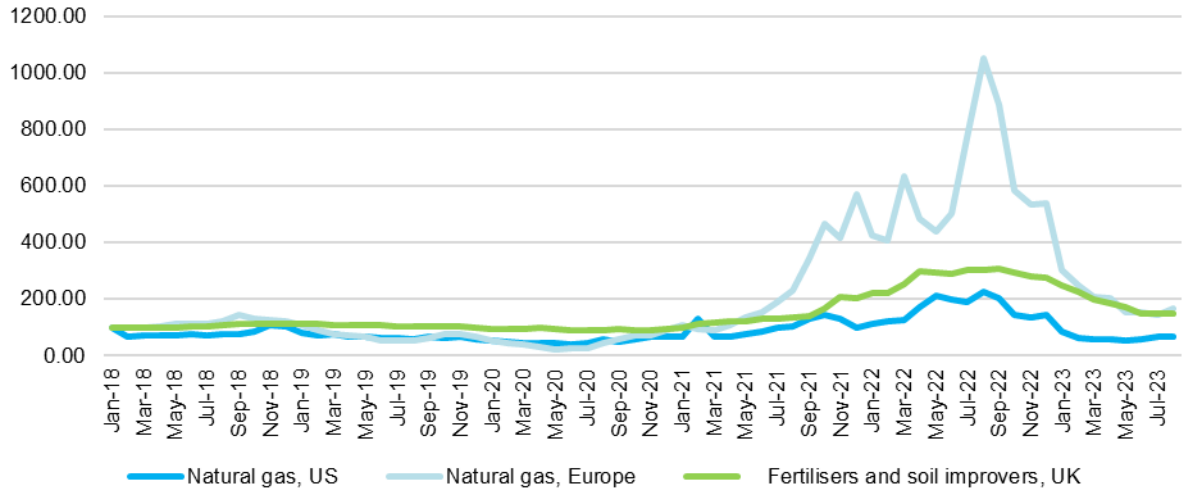
Higher production costs

2.37 Production cost inflation was the most significant driver of higher fertiliser prices. For example, Yara's cost per tonne rose from USD294 in 2020 to USD790 in 2022 (+169%).[59]

2.38 This has principally been caused by the high price of natural gas. Figure 2.8 below shows how the rise in UK fertiliser prices follow the rise in wholesale gas prices, though with lower volatility. The cost of production increased by significantly more in the UK than in the US, as the latter produces all of its own natural gas needs and was therefore less affected by the reduction in the Russian supply.

[58] Latest agricultural price indices - GOV.UK (www.gov.uk).
[59] Includes COGS and operating costs, excluding interest, depreciation, and amortisation. Reports and presentations | Yara International

Figure 2.8: Natural gas and fertiliser price inflation, January 2018 – August 2023 (index, January 2018 = 100)



Source: Defra,[60] World Bank[61]

2.39 As a result of these changes, it became relatively less economical to produce fertiliser in the UK and Europe, where gas prices were higher than in the US and other parts of the world. This resulted in plant closures, both in the UK (see paragraph 2.34), and elsewhere in Europe. For example, BASF announced its intention to shut down several ammonia plants in Germany in February 2023.[62] In April 2023, Yara announced it had idled over half of its European ammonia production capacity, and around a quarter of its fertiliser production.[63]

Scarcity of supply

2.40 The conflict in Ukraine significantly exacerbated scarcity of supply of fertiliser products from the beginning of 2022. Prior to the war, Russia accounted for 19% of potassium, 15% of nitrogen, and 14% of phosphorus global fertiliser exports. Belarus accounted for 18% of potassium-based fertiliser exports.[64] Although the UK was still permitted to import fertiliser from Russia and Belarus, import tariffs were significantly increased and supply chains were heavily disrupted. Scarcity was exacerbated by China imposing restrictions on fertiliser exports to limit domestic food price rises.[65,66]

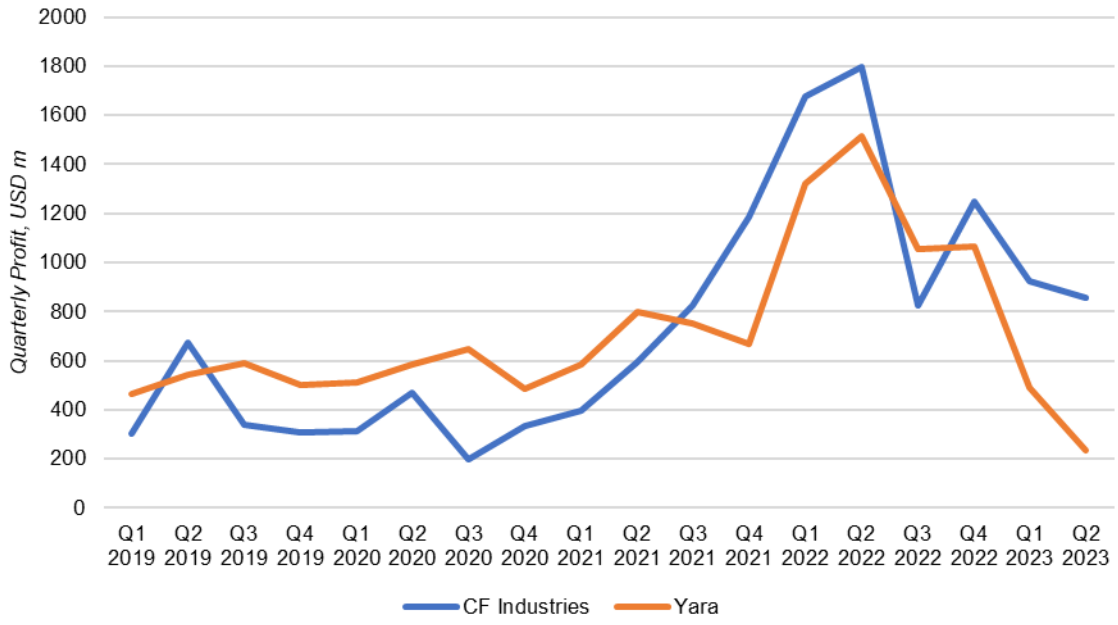
Profitability of fertiliser manufacturers

2.41 The scarcity of fertiliser enabled suppliers to increase their profits (Figure 2.9 below), as agricultural producers were willing to pay elevated prices to secure

[60] Latest agricultural price indices - GOV.UK (www.gov.uk)
[61] Commodity Markets (worldbank.org)
[62] BASF outlines further cost-cutting and 2,600 job losses as it downsizes in Germany | Financial Times (ft.com)
[63] Yara curbs European production amid lower fertiliser prices | Reuters
[64] UNFAO, Global fertilizer exports: how much comes from Russia, Belarus & Ukraine?, 2019 (ourworldindata.org)
[65] China issues phosphate quotas to rein in fertiliser exports - analysts | Reuters
[66] Rising cost of agricultural fertiliser and feed: Causes, impacts and government policy - House of Lords Library (parliament.uk).

supplies. Scarcity is a global issue and has driven higher fertiliser profits worldwide. In both 2021 and 2022, fertiliser producers increased their global profits significantly in both absolute terms and as a percent of revenue, while simultaneously reducing their total production volumes.

Figure 2.9: CF Industries and Yara, global quarterly profit, USD m, Q1 2019 – Q2 2023



Source: Company Annual Reports and Quarterly Results

Note: profit figures refer to earnings before interest, taxes, depreciation and amortisation.

2.42 As shown in Figure 2.8 above, fertiliser prices have fallen from their peak in September 2022, albeit they still remain high compared to pre-invasion levels. The market has responded to higher prices by increasing production, particularly in the US.[67] Russian fertiliser exports have also started to return to pre-invasion levels:[68] as fertiliser is a global commodity, this can help reduce prices for UK purchasers, even if they are not buying from Russia.

2.43 As prices for natural gas have fallen (to some extent), and scarcity is easing through higher production and trade reorientation, fertiliser prices, and profits for the largest fertiliser producers, have begun to fall, as illustrated in Figure 2.9 above.[69]

[67] For example, in June 2023, Yara announced plans to invest in a new ammonia plant in the US. Yara enticed by new blue ammonia capacity in the US as European plants face uncertain future | Profercy
[68] Russian fertiliser export revenue surged 70% in 2022 as prices jumped | Financial Times (ft.com)
[69] CF continued elevated profit reflects their North American production footprint, vs Yara, which has greater reliance on European production. In 2022, Yara's only production capacity outside North America was Billigham in the UK, which makes up less than 10% of production capacity. By contrast, a large majority of Yara production capacity is in Europe, Company annual reports.

Conclusion on fertiliser prices and profits

2.44 Farmers have raised concerns about high fertiliser prices, and the profits being made by the fertiliser industry.[70] Prices were extremely high for fertiliser in 2022 and, though they have since fallen from their peak, they remain well above 2020 levels. High prices have principally been driven by rising costs of production, although larger fertiliser suppliers also saw high profits during 2022. It appears, however, that these profits were due to external factors – in particular the invasion of Ukraine – causing conditions of supply scarcity that are starting to ease. In particular, additional production, both in Russia and the US, appears to have alleviated global supply scarcity and placed downward pressure on the profits of major suppliers.

2.45 The invasion of Ukraine also led to changes in the economics of fertiliser production. In particular, as the natural gas price in Europe increased relative to other parts of the world (particularly the US), European production facilities (particularly for ammonia and nitrogen-based fertiliser) became less competitive. This has led to the idling and closure of a number of European facilities, including in the UK, which now has no domestic capacity to produce ammonia, and relies for nitrogen-based fertiliser production on a single facility and ammonia import terminal. Competition in the supply of nitrogen-based fertilisers in the UK will depend on ongoing and reliable access to overseas imports from a range of suppliers.[71]

Packaging

Packaging is an important element in food supply

2.46 Packaging is an important element of food costs. It is used both in final packaging (eg tins, bottles, bags, trays) and in logistics (eg cardboard boxes and plastic wrap).[72]

2.47 There are four main categories of packaging that are important in the food sector: metals (especially, aluminium), glass, card, and paper and plastics. Packaging constitutes a particularly high proportion of cost when the grocery product is relatively cheap and/or expensive materials (eg aluminium or glass) are used in packaging. In terms of the product categories we have considered, the importance of packaging varies by category:

(a) Packaging forms a high proportion of costs in canned food and drink. For example, in baked beans, wet pet food, and carbonated beverages, packaging can make up over well over 20% of production cost.

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[70] https://www.nfus.org.uk/news/news/nfu-scotland-calls-for-fertiliser-market-to-be-referred-to-competitions-and-markets-authority

[71] The interaction between competition and supply resilience is discussed further in the CMA's Market resilience: Discussion paper - GOV.UK (www.gov.uk)

[72] RFI responses

(b) Packaging typically accounts for between 10 to 20% of production costs for infant formula, mayonnaise, milk, ready meals, chilled desserts and dry pet food.

(c) Categories with limited use of packaging and/or that use lower cost materials, such as flexible plastic wrapping, have lower packaging costs. For example, for bread and poultry, packaging makes up around 5% of production costs.

2.48 The Food and Drink Federation told us the food and drink sector was the biggest customer of the UK's packaging sector. It explained that packaging has long lead times, typically of 12-24 months for production and delivery, and that manufacturers typically bulk purchase packaging in advance. This can protect producers against short term price volatility but, where price increases are sustained, it can mean that higher prices are locked in for a longer period.

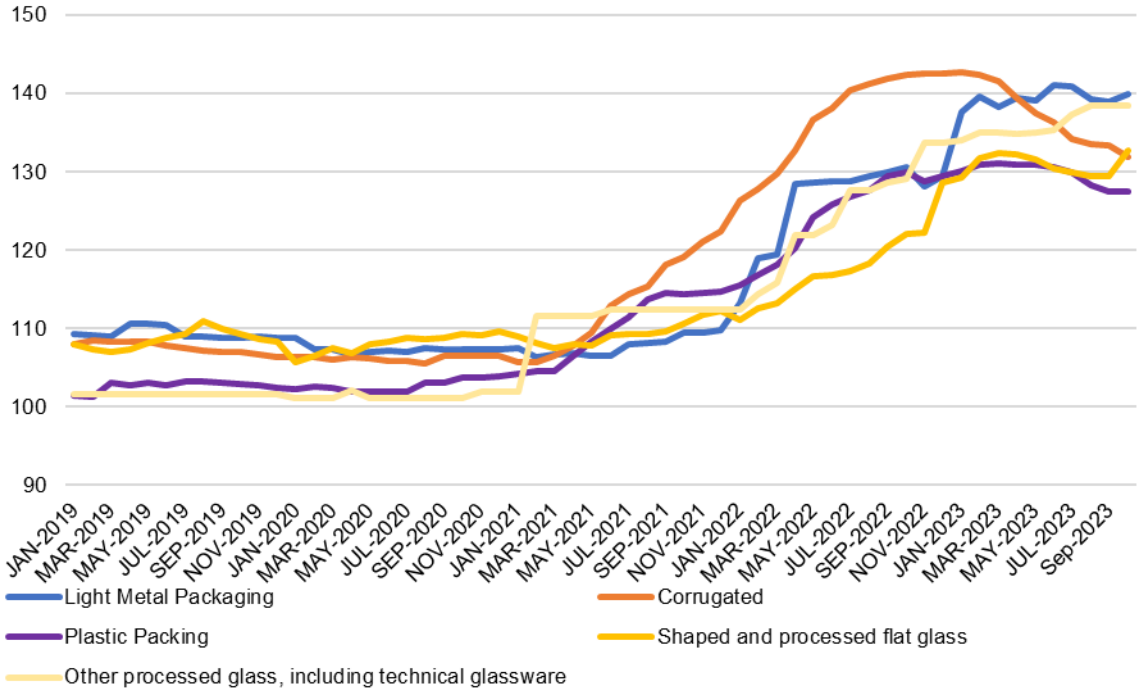
2.49 We heard from some food manufacturers that they do not have a large choice of packaging suppliers for certain types of packaging (sometimes just two or three that could meet their particular needs) and that in some cases it was difficult to switch because a packaging manufacturer had developed products that were specifically designed to meet their needs (such as a moulded plastic lid). However, none of the food manufacturers said that weak competition in the supply of packaging had contributed to higher production costs.

2.50 We heard from one food manufacturer that to some extent they had cost pass-through mechanisms for certain costs incurred by their own suppliers, including raw materials for packaging suppliers.

Packaging costs have risen with rising energy costs

2.51 Since 2020, there has been significant inflation in packaging prices in the UK across all categories, as shown in Figure 2.10 below. While packaging prices have stabilised, with the exception of corrugated card, they do not yet appear to be falling substantially.

Figure 2.10: UK packaging prices, January 2019 to October 2023 (index, 2015 = 100)



Source: ONS[73]

Notes:
(1) Packaging prices began to rise when people increased their use of online shopping, resulting in higher demand for cardboard boxes to pack the shipments, leading to pressure on supply. Since then, rising packaging prices have principally been driven by the higher costs of energy.
(2) While the ONS does not have a specific data series for packing glass, price movements will likely be reflected in the price movements of other types of glass, which are shown here.

2.52 Packaging production is highly energy intensive, particularly in the case of glass, which requires furnaces at very high temperatures, where energy makes up 20 to 35% of manufacturing costs.[74] Other methods of packaging production also require significant energy use. For example, production of flexible wrap requires plastic resins to be heated to high temperatures; energy is needed to roll and weld steel in the production of cans, and heat is needed to dry pulp into order to make cardboard. The Packaging Federation told us that, in general, raw materials account for more than 50% of the cost of most packaging, with energy accounting for around 10% in 'normal times'[75] (20% for glass) and a higher proportion now. In addition, plastic packaging is dependent on petrochemicals as a key input, and Russia was a major source of aluminium for cans which needs to be sourced from elsewhere since the invasion of Ukraine.

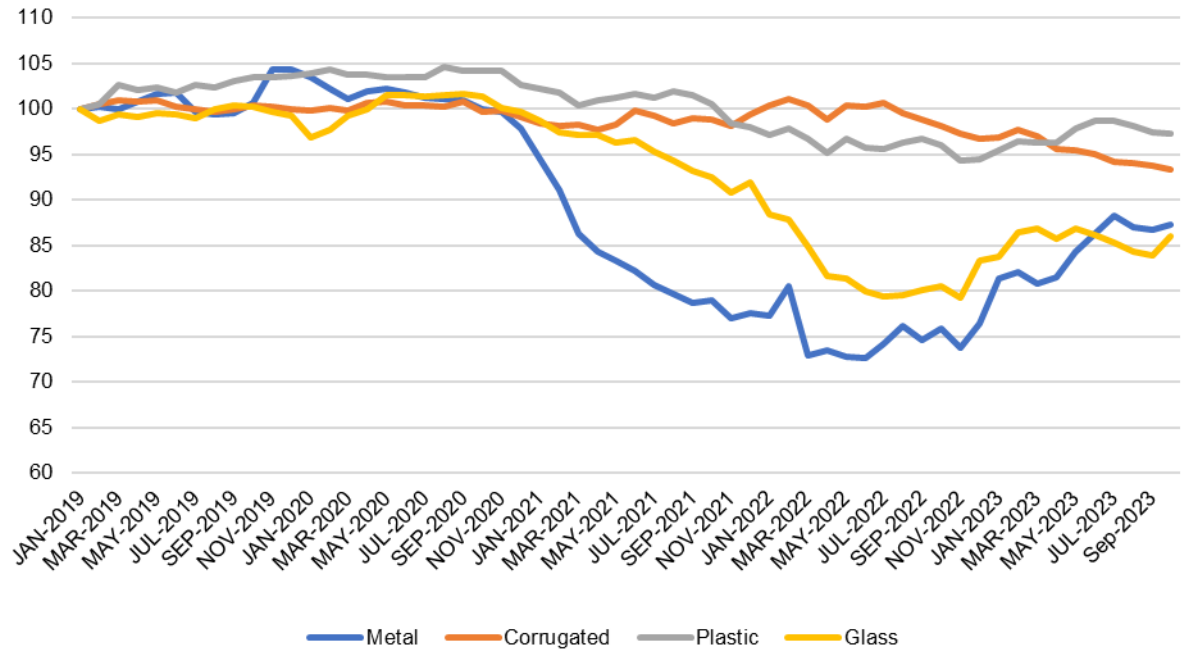
[73] Producer price inflation (MM22) - Office for National Statistics (ons.gov.uk); Corrugated Paper and Paperboard and Containers of Paper and Paperboard for Domestic Market - Office for National Statistics (ons.gov.uk); Plastic Packing Goods for Domestic Market - Office for National Statistics (ons.gov.uk); PPI INDEX OUTPUT DOMESTIC - C2312 Shaped and processed flat glass 2015=100 - Office for National Statistics (ons.gov.uk); PPI INDEX OUTPUT DOMESTIC - C2319 Other processed glass, including technical glassware 2015=100 - Office for National Statistics (ons.gov.uk).
[74] Glass Alliance Europe, glass-alliance-europe-position-paper-on-energy-crisis-20221115_file.pdf (glassallianceeurope.eu)
[75] Meeting with Packaging Federation.

2.53 One food manufacturer told us that the plastic tax had increased demand for recycled PET – plastic – bottles (rPET). We heard from the Packaging Federation that rPET bottles are more expensive than ordinary plastic bottles because more energy is needed to produce recycled plastics and more complex sorting is required.[76] We also heard from one manufacturer that it can be a challenge to obtain food grade rPET and there are fewer suppliers for this type of packaging.

Packaging prices have not risen by as much as input costs

2.54 ONS data on the costs of inputs into packaging compared to packaging prices suggests that prices of inputs into packaging have risen by more than packaging prices for all packaging categories, as shown in Figure 2.11 below. This suggests that price rises to food manufacturers have been driven by increases in input costs.

Figure 2.11: Relative price of packaging outputs to inputs, January 2019 to October 2023 (index, January 2019 = 100)



Source: ONS[77]
Notes:
(1) For glass, shaped and processed flat glass used.
(2) Where the index is less than 100, the output price of packaging has increased by less than the price of inputs since 2019. This indicates that packaging output prices have, across all categories, increased by less than input costs.

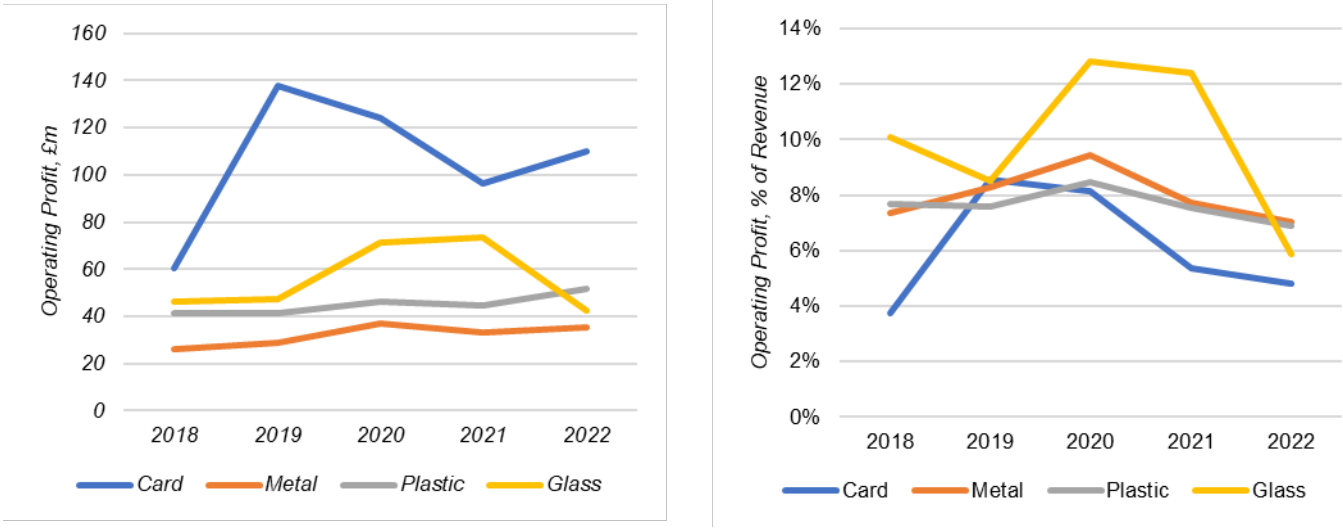
Packaging manufacturers do not appear to have made significant profits during this period

2.55 Figure 2.12 below shows that packaging suppliers do not appear to have significantly increased their profits as a result of rising packaging price rises. While operating profits increased in absolute terms in 2022 for suppliers of card, metal,

[76] Though it was noted that this is particularly true because virgin polymer prices are low. However they do fluctuate and rPET might be cheaper if virgin polymer prices rose significantly.
[77] ONS Producer price inflation, UK Statistical bulletins - Office for National Statistics (ons.gov.uk)

and plastic packaging (though not for glass), this remained within recent historical norms. Suppliers in all categories also experienced pressure on operating margins as a percentage of revenue.

Figure 2.12: Total Operating Profit, Packaging Suppliers, £m (LHS), % of Revenue (RHS), 2018 – 2022



Source: Companies House

Note: Includes a range of suppliers within each category. Suppliers are sourced from information provided in supplier RFIs, third party sources including the Packaging Federation, and business classifications on Companies House. Where suppliers have not reported 2022 results, they are excluded (eg DS Smith latest results are year April 2022 and so are excluded).
Suppliers include: Card - Saica Pack UK, Smurfitt Kappa UK, Cepac, Multi-Packaging, and VPK; Metal - Coppice Alupack, Ardagh, Trivium UK, and Canpack; Plastic - Proampac, Roberts Mart, Coveris, ALPLA, Bericap, and Faerch; Glass - OI-Glass, Encirc, Beatson Clark.

Conclusion on packaging prices and profits

2.56 Although packaging prices have risen considerably since mid-2021 and, especially, since Russia invaded Ukraine, this appears to be driven principally by rising energy costs. Packaging prices have not risen by as much as input costs, and profits of packaging manufacturers do not appear to have been higher than historic levels.

3. Our product categories

3.1 As illustrated in Section 2 above, food supply is a very complex industry with thousands of suppliers at different levels of the supply chain and very many products. The largest retailers sell tens of thousands of unique products in their grocery aisles. In order to explore competition, price setting and profitability in food supply and manufacturing within a reasonable timeframe, we decided to focus on a limited number of product categories.

3.2 In choosing these products, we did not use a formal decision rule but rather we used our judgement and took into account the following factors:

(a) The rate of price inflation for individual grocery items in the CPI basket from January 2021 to May 2023 and January 2022 to May 2023.[78]

(b) The extent to which price inflation for individual grocery items, over the same periods, differed from input and output inflation faced by producers. Divergence between producer prices and consumer prices for a product may indicate that retail prices are rising above a competitive level.[79]

(c) The extent to which price inflation for individual grocery products differed from inflation across their wider class of products over the same period. Products within the same class may have similar input costs, and so significant divergence in the inflation rate between a product and its wider class may indicate that its price is rising above a competitive level.[80]

(d) Importance to consumers, judged by reference to the product's weight in the CPI basket, and a qualitative assessment of its substitutability. The higher the share of spend, and/or the less substitutable, the greater the importance to consumers of a given product, and hence the greater the likely impact from identifying and addressing any competition issues associated with its supply.

(e) The potential of the product to illustrate features and developments in the food supply chain, and/or consumer behaviour, that merit further exploration.

3.3 We chose ten product categories which illustrate different features of food manufacturing and supply: from simple products with one ingredient (milk) to complex processes with very many (ready meals); basic staples of shopping baskets (bread) to discretionary purchases (chilled desserts or lemonade); categories where brands are very important (pet food) to where they hardly exist (poultry). We also included infant formula which can often be an essential and non-

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[78] We looked at two periods to allow for differing rates of pass through of cost increases. Item price indices were obtained using the ONS's Monthly Shopping Price Comparison Tool which tracks price movements of around 450 CPI basket items back to 2018. Shopping prices comparison tool - Office for National Statistics (ons.gov.uk)

[79] Here we compared the inflation rates of CPI items vs the rate of the most appropriate Output Producer Price Inflation (PPI)

[80] The ONS categorizes CPI items using a hierarchical system, aggregating item by consumption type. For example, just under the whole basket sit 12 Divisions, including Food and non-Alcoholic Beverages (FNAB). The path to a tin of baked beans would then be: Group (Food), Class (Vegetables including potatoes and tubers), Subclass (Dried vegetables, other preserved or processed vegetables), Item (Baked Beans, 400-425g tin). We compare an items inflation rate vs the rate of its parent Class. In the example above, the parent Class of Baked Beans would be Vegetables including potatoes and tubers.

substitutable product but also highly regulated to ensure its safety and suitability for infants and to avoid discouraging breastfeeding.

3.4 Before going on to our analysis, we first present information on our ten product categories, outlining their essential features and an overview of how the market works including number of suppliers, trends and importance of branded products.

PRODUCT CATEGORY SUMMARY TABLE

MILK

Description: Fresh bottled milk

Price change Jan 22 to Sept 23[1]: 36% (2 pints of semi-skimmed).

Features: Milk is a staple for shoppers and a known value item in shopping baskets, resulting in strong price competition between different retailers. Retail milk prices were among the first food prices to fall: all retailers followed quickly when the first retailer cut milk (and dairy) prices in April 2023. Milk has a short shelf life, and the exact volume of a retailer's order is often only specified on very short notice (eg a day or less). Milk volumes are slightly seasonal, with volumes peaking in the early spring. Overall, the fresh milk market has experienced a prolonged period of decline as preferences have changed.

Volume share of branded products[2] (Sept 2023): 15%

Main players: Predominantly own-label in supermarkets, though producers make brands for independent convenience stores (eg Freshways, Muller). There are two large producers (Arla and Muller) and some smaller regional players which compete for regional contracts. Producers fulfil contracts for fresh, liquid milk and then make butter and skimmed milk powder with any excess or sell fresh milk on the spot market.

POULTRY

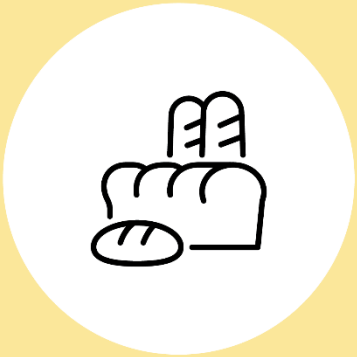
Description: Fresh, raw, packaged poultry – pieces and whole birds. Mainly chicken (some turkey).

Price change Jan 22 to Sept 23[1]: 23%

Features: Poultry is a staple for shoppers and a known value item in shopping baskets. The market is characterised by strong price competition between retailers. Poultry has a short shelf life and the exact volume of a retailer's order is often only specified on very short notice (eg one day or less). Fresh poultry retail volumes are slightly seasonal, peaking in winter.

Volume share of branded products[2] (Sept 2023): 0%

Main players: Entirely own label. There are a few large firms involved in processing. Poultry processors are usually active in a range of activities from chick rearing (subcontracted to farmers), through to abattoirs and packaging. There are large factories which produce a high volume of product.



BREAD

Description: Wrapped sliced bread.

Price change Jan 22 to Sept 23[1]: 21% (30% for sliced white loaf)

Features: Bread is a staple for shoppers and a known value item in shopping baskets - one which retailers want to price highly competitively. There is little product differentiation (more in the wider bread market). It has a short shelf life, so needs to be produced, delivered and sold within days. The market for sliced bread has been declining as more consumers are opting for 'artisan' breads and different sources of carbohydrate.

Volume share of branded products[2] (Sept 2023): 46%

Main players: Although there are some large brands (Hovis, Warburtons and Kingsmill), own label is strong (and growing). Customers choose based on 'colour' and size and then look to brand.

READY MEALS

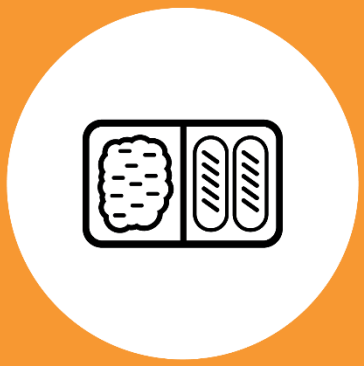
Description: Chilled ready to cook meals, often Italian, Indian, Chinese or 'British' (eg chicken pie).

Price change Jan 22 to Sept 23[1]: 28%

Features: Retailers see ready meals as being an important way to differentiate themselves from their competitors. Manufacturers tend to have developed the ranges in close cooperation with retailers, often based on very long-term supplier relationships. Meals have a short shelf life and manufacturers receive orders on a very short time scale (eg same day or previous day). Chilled ready meals volumes exhibit strong seasonality, peaking in the winter, with lower demand in summer. Annual volumes have fallen since 2021.

Volume share of branded products[2] (Sept 2023): 12%

Main players: Most ready meals are own-label. Retailers offer a range of tiers (usually standard and premium) with significant variety in quality and price. There are a few large firms which make the majority of the retailers' ready meals. They tend to specialise in one or two 'cuisines', such as Indian or Italian. Brands (eg Charlie Bigham) have small shares.



CHILLED DESSERTS

Description: Ready prepared desserts, kept in the fridge, usually ready to eat (trifles, cream cakes, cheese-cakes, tarts, mousses), also hot puddings which need cooking at home.

Price change Jan 22 to Sept 23[1]: 44% (chilled desserts pot)

Features: These are highly discretionary purchases and promotional sales are very important. Manufacturers tend to have developed the ranges in close cooperation with retailers and often have very long-term relationships. Chilled desserts have a short shelf life and manufacturers receive orders on a very short time scale (eg same day or previous day). Chilled desserts volumes exhibit significant seasonality, with demand peaking in the winter.

Volume share of branded products[2] (Sept 2023): 37%

Main players: Most chilled deserts are own label. Retailers offer a range of tiers (usually, standard to premium) and these offerings are closely tied to the retailer brand. There are some brands (eg Gu, Cadbury).

LEMONADE

Description: Most basic product is 2L bottle of clear lemonade, but also includes premium cloudy lemonades. Lemon/lime drinks (7UP and Sprite) are seen as separate by manufacturers.

Price change Jan 22 to Sept 23[1]: 47%

Features: This is a highly discretionary purchase and volumes fluctuate depending on promotional activity and the season (with peaks in summer and around Christmas). Traditional (clear) lemonade has seen declining sales. Promotional sales are very important as lemonade is seen as a cheap treat.

Volume share of branded products[2] (Sept 2023): 19%

Main players: Schweppes (owned by Coca Cola) is the brand leader. R-Whites is a much smaller follower brand. Own-label is much stronger in lemonade than in cola or lemon/lime carbonated drinks.

BAKED BEANS

Description: Tins of cooked beans in tomato sauce.

Price change Jan 22 to Sept 23[1]: 42%

Features: Baked beans are a well-known staple of shopping baskets. This is a declining market with little opportunity for innovation, though some brands are trying flavoured beans. Baked beans sales peak in the winter and early spring.

Volume share of branded products[2] (Sept 2023): 41%

Main players: Heinz is a very strong, long-established brand. Branston's, the next well-known challenger brand, and all retailers offer a range of own-label versions, with most offering both value and standard tiers.

MAYONNAISE

Description: Sauce in squeezy plastic bottles or glass jars.

Price change Jan 22 to Sept 23[1]: 56%

Features: This is a growing market, with mayonnaise increasingly seen as a sauce that can be used in a variety of dishes and on multiple occasions. There is some innovation in terms of flavoured mayonnaise. Sales for mayonnaise usually peak during summer in conjunction with barbecue season.

Volume share of branded products[2] (Sept 2023): 55%

Main players: Hellmann's is the brand leader, but Heinz has been growing as a challenger brand. Most retailers offer an own-label alternative, usually with additional low calorie options.

PET FOOD

Description: Includes a large variety of products, mainly wet and dry food for cats and dogs, as well as treats.

Price change Jan 22 to Sept 23[1]: 52% (can of dog food)

Features: Consumers have a huge choice of products (wet, dry, treats, multiple brands) which can be bought in pet shops as well as grocery retailers. Dry food is cheaper than wet food. The pet population is declining since the lockdown peak. Overall, retailer pet food sales have seen a general decline, primarily driven by a reduction in cat food sales.

Volume share of branded products[2] (Sept 2023): 76% (cat food), 52% (dog food)

Main players: There are a few large manufacturers with multiple brands, as well as a long tail of smaller suppliers with more niche products. For example, market leader Mars Petcare manufactures Dreamies, Pedigree, Sheba and Whiskas; Nestle UK Ltd manufactures Lily's Kitchen, Felix, Bakers, Winalot, Gourmet and Friskies. Cat owners tend to be more brand loyal than dog owners.

INFANT FORMULA

Description: For use in the first months of life, this is the only substitute for breastmilk which can, by itself, satisfy all healthy infants' nutritional requirements. Sold in powdered and liquid forms.[3]

Price change Mar 21 to Apr 23[1]: 25%[4]

Features: Highly regulated market with restrictions on nutritional content, labelling and marketing. NHS advice is that there is no evidence that switching to a different infant formula does any good or harm. Parents tend to choose an infant formula product early (often before the birth) and stick with it. Total infant formula sales volumes remained relatively constant over the past three years.

Volume share of branded products[2] (Feb 2023): 95%[5]

Main players: Danone (Aptamil, Cow & Gate) holds the largest share of the UK infant formula market, followed by Nestle (SMA, Little Steps), HiPP and Kendamil. Kendamil is a UK-based relatively new entrant which has successfully grown its market share. Own label is very minor; only Aldi offers it (Mamia). Sainsbury's and Boots used to sell own-label infant formula but no longer do so. Heinz also used to offer a branded infant formula product.

References:

[1] ONS consumer price inflation item indices

[2] CMA analysis of Kantar Worldpanel Take Home panel data

[3] Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation) seeks to ensure that all infant formula products will satisfy, by themselves, the nutritional requirements of infants in good health until appropriate complementary feeding is introduced

[4] Powdered cow's milk-based infant formula. Average price calculated using specific products. CMA analysis of FSNT data

[5] CMA analysis of Kantar data, February 2023 data (the last period when own-label sales data was available). Includes infant formula and follow-on formula

The role of brands and own-label products

3.5 One feature of many of our product categories is the presence of well-known brands, which tend to be significantly more expensive than retailer own-label alternatives. For example, in November 2023, one branded tin of baked beans was nearly three times more expensive per 100g than the standard level own-label equivalent, and five times more expensive when compared to the entry-level own-label version.[81]

3.6 For many of the product categories we have considered, there are one or two well-known and well-established brands, and often a clear category leader. Manufacturers use brands to differentiate their products from those of their competitors. A brand may get a reputation for being high quality among consumers who have tried it, but marketing and advertising generally plays a vital role in influencing consumer preference and building up brand loyalty. When consumers perceive all products to be the same, they will generally choose the cheapest. Strong brands, therefore, can become a source of market power, and allow manufacturers of branded products to charge higher prices without causing consumers to switch to cheaper products, and hence obtain larger profit margins.[82]

3.7 Strong brand loyalty can increase barriers to entry and expansion and make it more difficult for new entrants or smaller suppliers to compete for sales to customers, even if they can offer cheaper alternatives than established brands.

3.8 Retailers use own-label products as an alternative to branded products, one in which they have control over the quality and appearance, meaning they can use it to differentiate their store offering. Own-label products tend to be cheaper than branded goods, partly because the manufacturers do not spend anything on marketing. They provide consumers with a choice between different price and quality tiers, allowing consumers to select a price and quality combination that best suits their preferences and budget, though some own-label products tend to offer only one tier (eg lemonade).

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[81] Tesco prices for a can of baked beans are: Tesco value (Stockwell), 28p; Tesco standard, 50p, Heinz, £1.40. https://www.tesco.com/groceries/en-GB/search?query=baked%20beans&icid=tescohp_sws-1_m-ft_in-baked%20beans_out-baked%20beans

[82] We discuss manufacturer profitability in more detail in section 4 on Profitability of food manufacturers and in Appendix A.

3.9 Own-label varieties tend to dominate in categories where there is little scope to differentiate products (such as fresh milk). Own-label products also have a high share in product categories where the retailer can use it to differentiate their offering from their competitors and attract people into their stores, such as ready meals.

3.10 The product category summary table above indicates the share of branded products within each category. Brands are much more prominent in some categories than others. Milk, poultry and ready meals are predominantly own-label. Bread, chilled deserts, and lemonade are somewhere in the middle, ranging from a branded share of 19% for lemonade to 46% for bread. Brands are especially strong in mayonnaise (55%)[83] and pet food (76% for cat food).

3.11 Infant formula is a notable exception in that consumers are almost exclusively buying branded products, with only one retailer (Aldi) offering an own-label version. Among our product categories, infant formula, pet food, mayonnaise and baked beans have particularly strong brand presence.

3.12 As we will discuss further (from paragraph 4.63) consumers have been increasingly 'trading down' to own-label products in response to inflationary pressures.

[83] Figure for mayonnaise refers to branded share in the wider category of 'ambient salad accompaniments'. Total volume sales of mayonnaise account for 72% of the market for ambient salad accompaniments.

4. Analysis and findings

Overview

4.1 This section considers whether weak or ineffective competition in food manufacturing may have contributed to food price inflation, and particularly whether it may have caused consumer prices for our chosen product categories to be higher than they might otherwise be.

4.2 In considering this question, we have looked at three broad areas:

(a) **Competition between manufacturers to supply retailers:** in particular, the relative bargaining position between retailers and their branded and own-label suppliers, and the ability of retailers to switch suppliers. If retailers are unable to get competitive prices from their suppliers – for example, because they lack the necessary bargaining power – this may cause prices and inflation to be higher.

(b) **Consumer choices and behaviour:** in particular, the ability and willingness of consumers to switch in the face of rising prices. If consumers are unable or unwilling to shop around in response to changing prices – for example, between branded and own-label products – the incentives on manufacturers to keep prices low will be weaker.

(c) **Profitability**, and the extent to which branded and own-label manufacturers have been able to sustain or increase profit levels and margins as input costs have risen. High profitability is not a cause of weak or ineffective competition, but it can be an outcome of it.

4.3 Our conclusions are set out below, with the remainder of this section considering each of these three areas in more detail.[84] We have observed significant differences between the own-label and branded sectors of the market, for example in the way manufacturers interact with retailers, trends in consumer purchases and profitability. We therefore present our conclusions for the own-label and branded sectors in turn. We have also observed differences between our ten product categories, which we bring out in the analysis sections below, but note that these were generally driven by the relative importance of branded and own-label shares within these product categories.

Own-label: conclusions

4.4 Own-label manufacturers compete with each other to win and retain contracts from retailers. There is typically a tender process where retailers directly compare the

[84] The evidence we have gathered, and hence our analysis, is based on a sample of product categories and manufacturers. This work cannot, therefore, be taken to be a complete view of the state of competition between manufacturers of groceries products, and of the ability of retailers to obtain lower prices across the entire food supply industry. Nonetheless, we selected the product categories in order to understand the key issues affecting competition at this level of the supply chain, and much of the evidence that we heard was consistent across manufacturers and between product categories with similar characteristics. Our assessment is therefore likely to have broader relevance to the question of whether competition issues at this level of the supply chain have driven food price inflation.

price, quality and expectations of reliability of manufacturers. Although for some of our product categories (eg milk and poultry), there are relatively few own-label manufacturers, competition to win and retain supply contracts appears to be strong, switching does occur, and retailers generally appear to obtain competitive prices, assisted by the transparency of the costs of their own-label suppliers. This has continued to be the case as input costs have risen.

4.5 Our profitability analysis of own-label manufacturers is consistent with this conclusion. It shows that, for most products, own-label margins are low and have generally fallen in the most recent financial year (two thirds of own-label suppliers have experienced declining margins since 2021). In some cases, own-label manufacturers have seen a rise in their unit profitability for certain products.[85] However, this is less prevalent than for branded manufacturers (see section on profitability, below), and (reflecting their lower overall profitability) will generally be from a very low starting point.

4.6 Based on the evidence we have seen, therefore, across most of the product categories we have considered, weak or ineffective competition between own-label manufacturers does not appear to have contributed to food price inflation.

4.7 In July, we said that the evidence we saw at that time indicated that high price inflation for groceries did not appear to have been driven at an aggregate level by weak or ineffective competition between retailers: retailers were competing with each other on price to retain and grow volumes, and consumers were shopping around to get the best deals. To the extent these conditions persist, retailers will generally be incentivised to obtain competitive prices from their own-label suppliers, and to reflect these in what they charge consumers.

4.8 Taken together, this means that consumers can have confidence that, for most of the product categories we have considered, they are getting competitive prices where they are able to access and choose own-label alternatives, and that competition issues between manufacturers do not appear to have been a significant contributor to own-label food price inflation. This includes products (like milk and poultry) where own label may be the only choice on offer. Although we have only explored a limited number of products, we have no reason to expect that this will not apply more generally to a wider range of product categories where own-label presence is strong.

4.9 However, it is not possible to reach this conclusion with the same degree of confidence in respect of own-label infant formula. This is because (unlike the other product categories), own-label infant formula is only sold by one retailer (Aldi), which sources the product from one own-label manufacturer. Reflecting this, and other features of infant formula supply and demand, we have decided to carry out further work in this market (see Chapter 5).

[85] That is, the prices retailers pay for certain own-label products from certain manufacturers has risen by more than the manufacturer's input costs for that product.

Branded manufacturers: conclusions

4.10 For branded suppliers, the relationship with retailers is different. The most successful branded products (for example, Heinz Beanz, Hellmann's mayonnaise and Felix cat food) are ‘must-stock’ items for retailers, meaning that some customers will expect to see them in a store, and might decide to shop elsewhere if they are consistently unavailable. Manufacturers of branded goods often have a large portfolio of brands which the retailer wants to offer, retailers will need to purchase that particular brand from that specific manufacturer. Retailers also have limited visibility of the costs of their branded suppliers.

4.11 These features give branded manufacturers a source of pricing power that is not typically available to own-label suppliers. Our profitability analysis shows that margins are typically higher for branded manufacturers than for own-label: average operating margins in 2022 across the branded suppliers that provided comparable data were around 11%, compared with under 2% for own-label suppliers.

4.12 Our analysis shows that three-quarters of brands that provided comparable data have increased their unit profitability during the recent period of high food price inflation: that is, for the relevant product categories, they have pushed up the prices they charge to retailers by more than the rise in their input costs.

4.13 Although retailers are able to take measures to counteract the pricing power of branded manufacturers as part of their negotiations with them, the key constraint that prevents ‘must-stock’ brands charging what they like comes from consumer behaviour, and their preparedness to switch away to cheaper alternatives, including own-label products, in the face of price rises.

Consumer switching and implications for competition

4.14 We have analysed Kantar data[86] to examine more closely the extent to which consumers have switched from branded to own-label alternatives during the recent period of high food price inflation: in effect, we have measured the prevalence and strength of brand loyalty. Across most of our product categories where brands are present, we have observed switching to cheaper own-label products. Switching has been particularly pronounced in some product categories where brands are traditionally strong, and where the brand premium (the difference between the branded and own-label price) has grown over the last two years: for example, the average branded price for baked beans has increased by over 50% and the branded share of the market has fallen by over 10 percentage points. Switching to own-label products has been somewhat lower in pet food, particularly cat food, while the limited own-label presence in infant formula – combined with strong brand loyalty – has led to little or no observable switching, despite significant price differences with branded alternatives.

4.15 Our profitability analysis shows the impact that reduced volumes (driven in part by switching) have had on branded manufacturers over the last two years. Most

[86] Specifically, the Kantar Worldpanel Take Home panel.

branded manufactures have seen a fall in their overall profitability, although margins remain materially higher than those among own-label manufacturers.

4.16 Where branded manufacturers have set prices such that their unit profitability has increased, this will have aggravated cost-of-living-pressures for those who continued to stay loyal to these products. However, from a competition perspective, the switching and overall profitability trends we have observed, together with evidence of effective competition in own-label supply, mitigate the concerns that might otherwise arise from unit profitability growth. While the choices made by some brands to increase unit profitability may have contributed to inflation, we do not, however, consider that this indicates weak or ineffective competition in manufacturing across the relevant product category (ie including both branded and own-label suppliers).

4.17 Once again, infant formula is an exception. Profitability among branded suppliers is high, own-label presence is weak, and we see little evidence of consumers responding to price differences by switching (including between cheaper and more expensive brands). Reflecting this, and other features of the infant formula market, we have decided to carry out further work in this market (see Section 5).

The benefits of competition and choice are not distributed equally

4.18 Switching is not only important for competition, but for consumers, who, in doing so, have been able to partly mitigate the financial pressures that have come from high food price inflation (though possibly with an actual or perceived loss of quality). But, as we noted in our July update, these mitigations are not available to all consumers. Some consumers are dependent on local convenience stores for their shopping, if they are unable to travel to a larger store or are excluded from online shopping (eg through digital exclusion or minimum spend requirements). As we said in our July update, complete own-label ranges are typically only available in large stores and online and therefore some consumers will struggle to access these.

What will happen now that some input costs are falling?

4.19 Looking ahead, there is evidence that some suppliers are aiming to rebuild their margins in the next financial year (although not to the levels that are inconsistent with historical averages) – around half expect to increase profits as a share of revenue, with a mix of branded and own-label manufacturers in this group.

4.20 We heard that – rather than cut their list prices to retailers – many branded manufacturers are aiming to regain the volumes lost over the last two years through in-store promotions, whereby they ‘invest’ (sometimes jointly with retailers) to provide temporary (and typically highly visible) price discounts. To the extent that retailers co-operate with this strategy, consumers will need to seek out products on promotion to access the best deals, and will be paying the non-discounted prices for periods when products are not on promotion.

4.21 Since Tesco and Sainsbury’s now principally use loyalty schemes (Clubcard and Nectar) for promotional activity, this strategy could lead to a growing prevalence of ‘two-tier prices’ in these stores and mean that consumers who do not join these

schemes will not be able to access these lower prices. We are therefore considering further work in relation to promotional prices and loyalty schemes.

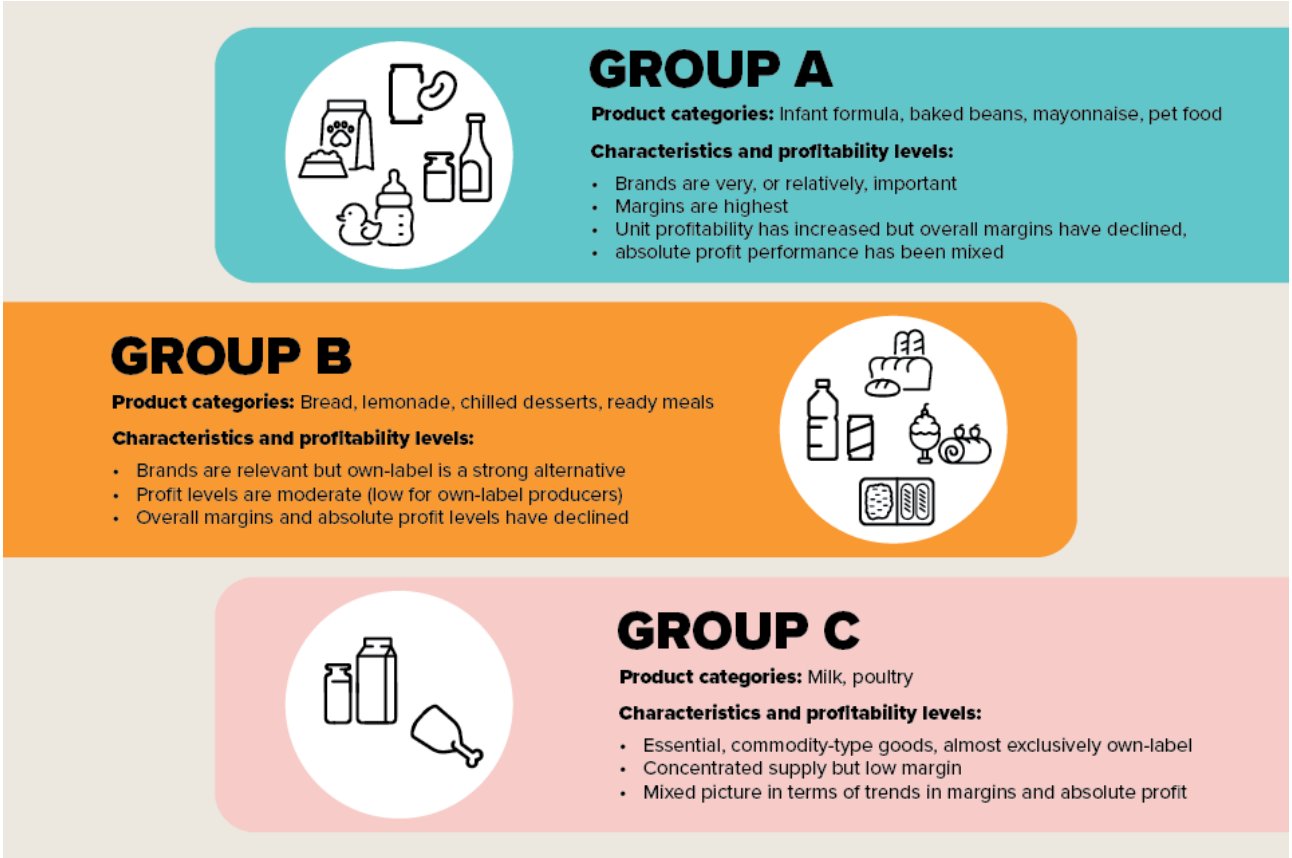
4.22 We now present the evidence and analysis which supports these conclusions, giving more detail on competition among manufacturers, consumer trends and profitability in turn.

Product groupings

4.23 As shown in the infographic in paragraph 3.4, the product categories vary in terms of their basic characteristics and market features, such as number of suppliers, product differentiation, and importance of brands. However, some product categories also share certain features and we have observed some commonalities between the profitability performance for manufacturers across product categories, which fits into the same broad groupings.

4.24 We have, therefore, found it useful to combine our ten product categories into three groupings as shown in Table 4.1 below. These are not firm delineations, but rather represent convenient ways of organising the ten product categories when presenting our analysis.

Table 4.1: Broad groupings for our ten product categories



Competition between manufacturers to supply retailers

4.25 The prices that retailers pay manufacturers (and which, in turn, affect prices for consumers) will depend on the outcome of a negotiation or tender process between these manufacturers and retailers. Prices paid – and the extent to which

manufacturers can pass through any increases in their input costs – will, among other factors, be influenced by the relative bargaining power of retailers and manufacturers. For instance, if retailers have a strong position in negotiating over prices, and there is strong competition between manufacturers to supply them, this can put pressure on suppliers to offer competitive prices (or improve other elements of their offering). The strength of retailers' bargaining power will depend largely on their importance as a customer, the availability of suitable alternative suppliers and the measures available to them in negotiations with manufacturers.

4.26 Overall, about half of the sales in major supermarkets are branded, and about half are own-label,[87] though discounters and some smaller retailers have a different model (eg discounters sell fewer branded products, whereas M&S is almost entirely own-label). Retailers want to stock products that customers will buy, whether these are the most popular established brands, new or innovative brands that are aiming to grow share, or their own-label versions which compete with these brands.

4.27 Retailers also see own-label products as a way to differentiate themselves and attract customers. One retailer told us that own-label products 'drive store choice' and a retailer can differentiate themselves through the quality and price of their own-label offering, especially where the quality can vary significantly such as with a ready meal lasagne. As a result retailers often have very strong (and in some cases very long) relationships with some of their own-label supplier base, sometimes lasting decades. Given the importance of some own-label products to their competitive position, retailers can also be closely involved with their suppliers in product development.

4.28 In this section, we examine how price negotiations are carried out between manufacturers and retailers and consider their relative bargaining positions, as well as exploring market structure and the importance of promotions. The suppliers involved[88] and the context for the negotiation differs significantly between branded and own-label manufacturers, and we consider each in turn.

The range of manufacturers for retailers to choose between

Own-label

4.29 In terms of own-label manufacturing, most of the product categories we considered are fairly concentrated sectors.[89] We generally found that, in each market, there were four manufacturers or fewer that supply most of the UK retailers with their own-label products. There are more suppliers in the market for chilled desserts and ready meals, though these markets are highly segmented with manufacturers generally specialising in one or two subsegments (eg Italian ready meals).

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[87] https://www.kantar.com/inspiration/fmcg/2023-wp-battle-for-shoppers-heats-up-as-grocery-price-inflation-hits-new-high

[88] Very few of the manufacturers we spoke to make own-label as well as branded products for these product categories, though one did.

[89] This includes poultry, milk, beans, mayo, lemonade, pet food and infant formula.

4.30 We heard from manufacturers about some barriers to entry or expansion that own-label suppliers might face. For instance, some manufacturers said that retailers value long term relationships in the market to build up trust in terms of quality and reliability. We had also previously heard from retailers that they have many longstanding relationships with their own-label suppliers, in some cases lasting decades.[90] Other barriers to entry and expansion raised by own-label manufacturers include high fixed costs, high regulatory requirements and large vertically integrated players.

4.31 In the market for milk, we heard that there have not been any new entrants for a significant period of time due to low margins. We heard that, in the poultry sector, the only successful recent new entrant had already been active in the adjacent pork sector and had existing relationships with retailers, as well as experience in a related market.

4.32 When we spoke to retailers – in preparing our July report – we asked them if there were any product areas where they felt there was weak competition in supply for own-label products and we did not hear of any concerns.

Branded

4.33 For branded products, there is necessarily only one supplier, which will be identical across retailers: only Hellmann's makes Hellmann's mayonnaise. The negotiating position of the retailer will largely depend on how much it considers that it needs to stock a specific manufacturer's product portfolio and the availability of suitable alternatives. If this portfolio includes brands that customers expect to see on the shelves, retailers will have a strong incentive to conclude negotiations to purchase this product, ideally at a price that compares favourably with what its competitors are paying. On the other hand, if the retailer represents a significant proportion of the manufacturer's sales volumes, then the brand will, in turn, have a strong incentive to conclude a negotiation and supply that customer.

4.34 New or challenger brands may face barriers to entry or expansion in overcoming strong brand loyalty to existing products, and may set prices at a discount to the brand leader. An entrant will need to spend on advertising or promotions in order to build up a profile with consumers in order to challenge established brands. This process might be easier for a manufacturer that already has a brand profile through other products. For example, we have heard that Heinz is growing its share in the mayonnaise category as a challenger to Hellmann's. We also heard that brands might find it difficult to break into markets that are dominated by trusted own-label brands (for example in ready meals) or in more commodity products (such as milk) where it is more difficult to differentiate. Other barriers to entry include high fixed costs, regulatory requirements and large vertically integrated players.

[90] July report, paragraph 4.12.

The dynamics of negotiations between manufacturers and retailers

Own-label

4.35 The supply of own-label products is typically agreed through a tender process, in which retailers invite manufacturers to submit detailed price quotes and product specifications for a particular range, and then choose their preferred manufacturer for the contract. We heard that these tenders can be drawn-out processes which require considerable effort on the part of the suppliers.

4.36 Own-label manufacturers told us that the terms on which they supplied retailers were often more of a detailed 'agreement to supply' than a contract with fixed volumes. Although price per unit was agreed (sometimes with volume discounts), specific volumes were not agreed at the time of winning the tender. We heard that there is often a short lead time for orders from retailers and that, although retailers may provide suppliers with a forecast of the expected volumes, actual volume orders may only be given 24 to 48 hours in advance. Typically, different weather affects consumption patterns and therefore drives what retailers want to offer on their shelves.

4.37 The length of own-label supply agreements varies depending on the product category. Long agreements – up to five years – are more common in markets for key value items such as poultry and milk. We also heard that agreements tend to be longer in markets such as ready meals and chilled desserts where manufacturers are required to create bespoke recipes for retailers. However, in some markets, such as lemonade, agreements may be just for one year.

4.38 Manufacturers may win tenders to supply all of a retailer's volume needs although tenders may also be awarded to multiple suppliers for partial supply (poultry), for all supply to a particular region (milk) or for specific ranges (ready meals and chilled desserts).

4.39 In contrast with branded manufacturers, many agreements with own-label suppliers use 'open book' pricing and cost pass-through mechanisms:

(a) Manufacturers that operate on an **'open book'** basis provide retailers with full information on all their input costs. This means that retailers have a clear sight of any cost increases (or decreases) faced by their supplier.

(b) **Cost pass-through mechanisms** track input prices for ingredients and commodities and allow suppliers to automatically pass through a proportion of these costs to retailers.[91]

4.40 Having an 'open book' mechanism in place does not necessarily mean that changes in input costs are automatically reflected in manufacturers' prices to retailers: there will still need to be a negotiation to agree a cost-price rise, but this will be based on extensive information about costs. Generally, multi-year tender

[91] While the process is considered to be automatic, retailers will usually review changes on a monthly basis ahead of any price increases or reductions.

agreements are ‘open book’ while annual agreements are offered on a ‘closed book’ basis.

4.41 Within some cost-pass through models, and some contracts, manufacturers are able to pass through up to 100% of key ingredient-related input costs (eg farmgate milk prices).[92] Even when they are in place, cost pass-through mechanisms do not tend to cover all of a manufacturer’s costs. Typically, core ingredients and commodities are included but it is less common to include other costs such as energy and packaging, although we have found some instances where suppliers have managed to negotiate these costs into these mechanisms (and even sometimes labour costs), especially in light of recent price volatility for some of these inputs. Suppliers will usually review cost pass-through mechanisms with the relevant retailers on a regular basis, ranging from every quarter to once a year.

4.42 Manufacturers are required to separately negotiate price increases for costs not captured by the cost pass-through mechanisms (including many cases where suppliers are on an ‘open book’ model). These re-negotiations of terms within the existing tender have been increasingly important during this inflationary period. As with branded manufacturers, own-label suppliers are usually required to provide retailers with 12 weeks’ notice, during which negotiations with retailers will take place. The generally high levels of transparency of input costs constrain suppliers’ ability to argue for price increases beyond those directly related to their input costs, however they can often assist them when requesting cost price increases driven by inflation.

4.43 We also heard that retailers encourage their own-label suppliers to make cost savings, advising them on ways to improve efficiency or procure inputs more cheaply. Sometimes retailers also assist manufacturers by purchasing key ingredients on their behalf alongside their own purchasing, which enables the retailer to reduce overall cost and also to control the source of the ingredient.

4.44 Although for some product categories, supply contracts may have long duration, and there may be a small number of credible suppliers in the market, we also heard many examples of when retailers had switched large contracts to different suppliers, including in ready meals, poultry and milk. Contracts with some retailers can be for very large volumes (even for the output of a whole factory or processing plant), and losing a contract can have a significant impact on a supplier. We also heard that there was excess capacity in the poultry market. This suggests that own-label suppliers will be strongly incentivised to offer competitive terms to retailers in order to win their business.

Branded products

4.45 We spoke to a range of branded manufacturers to understand how negotiations operate. There was a great deal of consistency in what we heard across the different product categories in the broad outlines of the negotiation process.

4.46 There are several elements in the negotiation between branded manufacturers and larger retailers. The core of the discussion is the list price (or cost price): the

[92] Meetings with Muller and Arla.

price to the retailer per unit of product sold. However, the negotiation will typically encompass various additional elements, often known collectively as a 'joint annual business plan'.

4.47 As part of negotiations over joint annual business plans, manufacturers will tend to offer concessions to retailers while negotiating a list price, such as discounts for higher volumes sold or, especially, investment in promotions (that is, offering the product for lower prices during certain periods so that it can be promoted by the retailer).[93] One retailer told us that they do not negotiate over the list price, which is the same for all customers, but instead over the level of investment in promotional funding. For their part, the retailer can offer various incentives to obtain better prices, such as prime positioning or greater shelf space.

4.48 We heard that these negotiations can often be difficult, and typically require a number of iterations to conclude, not least because lately they have been taking place in the context of increasing costs and attempts by manufacturers to raise prices. When seeking a price increase, suppliers are usually required to provide retailers with 8 to 12 weeks' notice during which they will negotiate with retailers. We heard, as we had from retailers previously, that these negotiations generally take place annually, but that recent high input price inflation has led to manufacturers approaching retailers to renegotiate list prices more frequently (sometimes quarterly).

4.49 Branded manufacturers told us that they typically present evidence to retailers to justify cost price increases, setting out how their costs have changed. The transparency of branded manufacturers costs will, therefore, be dependent on what they choose to share. We said in July that retailers had told us they tend to have little visibility of branded manufacturers' costs.[94] The retailer may have some knowledge of the costs of its own-label suppliers for similar products, which will give a partial view of the costs for a branded manufacturer.

4.50 If a manufacturer cannot agree a new price with a retailer they may, at the limit, refuse to supply. The credibility of such a threat will depend on how important the retailer is to the manufacturer's sales volumes across their product portfolio. As such, a retailer with a larger market share might have a stronger negotiating position than a smaller one. Retailer do have some, limited, mechanisms to push back on a requested price increase from a branded manufacturer, such as buying lower volumes or putting another brand or own-label product in a more prominent position. One retailer told us that, in the extreme, they could continue purchasing at the previously agreed (lower) price, pushing the manufacturer to decide whether or not to refuse to supply at this price. We heard from manufacturers that stopping supply entirely was extremely rare. Last year, it was reported that products such as Heinz Beanz, Ketchup, and a number of pet food brands were temporarily not stocked in Tesco, following pricing disputes between Tesco, and Heinz and Mars Petcare.[95]

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[93] The retailer may also decide to 'invest' in a promotion and cut prices even lower, reducing its own revenue from sales.
[94] Paragraph 4.18.
[95] Heinz and Mars won't beat Tesco in a PR battle over price rises | Comment and Opinion | The Grocer

4.51 Some food manufacturers with very small volumes, and niche brands, told us that it could be very difficult to negotiate prices (and especially price increases) with supermarkets.[96] They said that the only power they had was to not supply the retailer on the offered terms, which was a fairly frequent occurrence for these small businesses. Some suppliers told us that also pursued alternative ways of reaching consumers, such as online sales or through hospitality channels.

4.52 In the section on profitability, we set out how operating margins tend to be higher for branded products than for own-label, which suggests that branded manufacturers are in a stronger negotiating position *vis-à-vis* their customers than own-label manufacturers.

Increased promotions as input costs fall

4.53 Promotions are extremely important for branded goods (with the notable exception of infant formula, where promotions are prohibited, see Section 5 below). Promotional activities are particularly significant for discretionary products, such as lemonade or chilled desserts, where sales via promotions represent 65 to 80% of total sales volumes. Quantity-related promotions (eg two for one offers) are not as effective for staple products, such as bread, which will be bought in certain patterns, regardless of promotional activity.

4.54 Most large branded manufacturers told us that, as and when their input costs start to fall, they aim to pass on any cost savings in the form of increased promotional activity, rather than by reducing list prices. This approach has two advantages for manufacturers. First, it allows them to increase sales volumes, by ensuring that any price reductions are highly visible as part of a promotion. In addition, any price reductions are time-limited. Retaining higher list prices gives the manufacturer a degree of flexibility should input costs rise again: that is, it avoids the need to provide 12 weeks' notice, and to enter into negotiation with retailers, to implement a price rise. Kantar has said that all the large groceries retailers have increased the proportion of their sales through promotions compared to last year which, (they said) has only happened once in nearly ten years, and that consumer spending on promotions was over 27% of all grocery sales.[97]

4.55 Retailers will need to agree to this strategy as part of the negotiation over list prices and promotions and may try to push for a lower list price. If the large, branded manufacturers are able to follow through on this strategy, then consumers may encounter increasing numbers of promotions over the coming months. It is important that consumers are able to shop around and compare prices with confidence. One important driver of this is the ability to compare products by reference to unit prices.[98]

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[96] Roundtable with SME food manufacturers and representatives. The attendees were not necessarily from our ten selected product categories, but were the food sector SMEs who are part of Defra's network.
[97] Grocery price inflation hits single digits for first time this year (kantar.com)
[98] Unit pricing is a labelling system for displaying the cost of different products by reference to standard units of weight or volume.

4.56 Our recent review of retailers' pricing practices found some issues with unit prices for products that are on promotion.[99] We found that that retailers were taking different approaches to displaying unit prices for products on promotion both in-store and online, with some retailers not displaying unit prices for discounted products at all.

4.57 Our view, as expressed in our response to the government's consultation on proposed reform of the PMO (see paragraph 31 above), is that retailers should be explicitly required to display the promotional unit price for all products offered for sale to consumers on promotion, wherever practical. We are concerned that where a unit price is not given for products on promotion it is difficult for consumers to compare products on offer with products that are not and to work out which is best value. Consumers may focus on the fact that a product is on promotion and wrongly assume that it is better value than a different product that is not on promotion.

4.58 Ahead of any changes made by Government to the PMO, we called on retailers in our July update to begin making changes to their unit pricing practices, to ensure that unit prices for products on promotion are displayed wherever practical.

4.59 In July we noted that, in some retailers, discounts or promotional offers are increasingly only available to loyalty card holders. For example, Tesco told us that all in-store promotional discounts (as opposed to price-matching or price-freezing schemes) require a Clubcard to access.[100] Sainsbury's introduced discounts for Nectar card holders in April 2023 and is expanding the number of promotions within the scheme. It has also started to introduce personalised discounts for online shopping.[101] Where price reductions are being passed on through promotions which are part of loyalty schemes, these lower prices will not be available to consumers outside these schemes.

4.60 Reflecting recent and expected growth in price promotions, and the fact that major retailers (particularly Tesco and Sainsbury's) now principally use loyalty scheme for promotional activity, we will begin work in January 2024 to consider loyalty pricing schemes, in particular to understand the impact on consumers and competition of this approach to promotions.

Analysis of consumer trends

4.61 In this section, we consider how retail prices have changed and how consumers have responded to these changes. We first present some evidence which sets the context, showing that consumers are buying less in their grocery shop overall (but spending more) than two years ago, and that own-label products had experienced higher price inflation than brands but that this has recently converged for standard and premium tier products.

[99] CMA Review of unit pricing in the groceries sector (publishing.service.gov.uk).
[100] Tesco meeting, June 2023.
[101] J Sainsbury plc Interim Results 2324 Statement.pdf (sainsburys.co.uk)

4.62 We then present our analysis of the detailed pricing and volume data across our product categories.

Trends across the food and groceries sector

4.63 Food shopping is a significant and essential element of household spending. In our July update, we discussed the impact of persistently high food price inflation on consumers, particularly those from lower-income households.[102] We found evidence that consumers had responded to food price rises in the following ways:

(a) Consumers have been 'trading down' to cheaper product ranges. This includes switching from branded to own-label products and switching from premium to standard and value tier own-label products.

(b) Consumers have been 'trading out' and moving to lower priced retailers. Aldi and Lidl have seen their market share grow at an increased rate during the inflationary period.

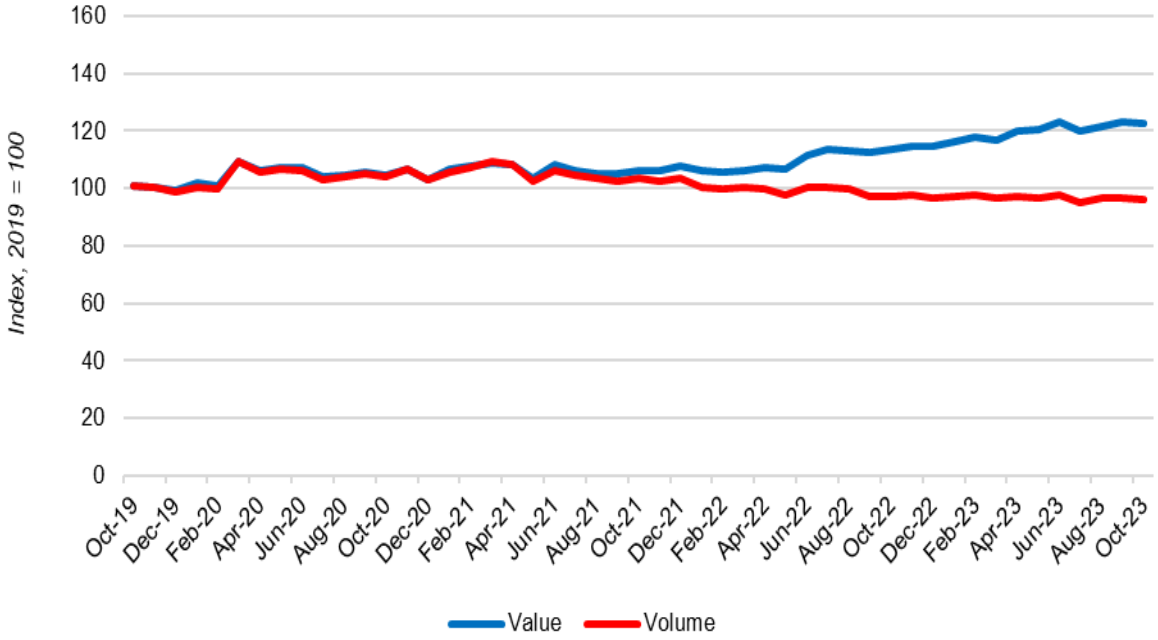
(c) Some consumers have switched to cheaper types of products. For example, we noted that consumers have moved from expensive proteins (eg fish or beef) to cheaper proteins (chicken).

(d) We also found that visits to food banks had increased and there was evidence of people eating less healthily, taking risks with uncooked food or out of date food in order to save money. [103]

4.64 There has been a continued decline in total retailers' sales volumes since October 2019, as shown by Figure 4.1 below. There has been a 5% fall in the volume of food sold by retailers between October 2019 and October 2023. However, the value of food retailer sales has increased by 21% over the same period. This would suggest that consumers are paying considerably more for given quantities of food and groceries in October 2023 compared to October 2019 and overall purchasing less food than they did two years ago.

[102] CMA (2023), Competition, choice and raising prices in groceries paragraphs 1.15 to 1.27.
[103] CMA (2023), Competition, choice and raising prices in groceries paragraphs 1.23 to 1.24.

Figure 4.1: Food retailers' total sales value and volume, October 2019 to October 2023 (2019 = 100)



Source: ONS retail sales, Retail sales, Great Britain - Office for National Statistics (ons.gov.uk)[104]

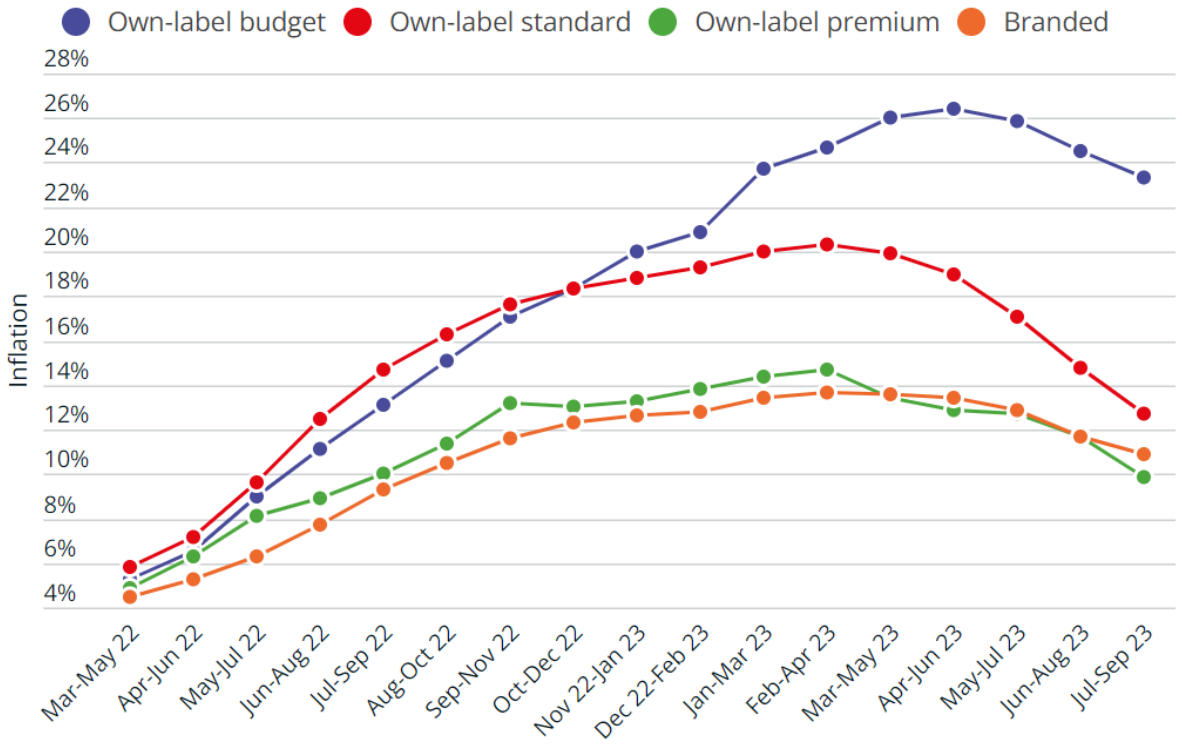
4.65 We also heard reports of declining sales volumes in some of the product categories we considered. For example, we heard that some product categories (such as lemonade and chilled desserts) are highly discretionary, meaning that purchases of these are likely to be reduced as budgets are squeezed. Others (like milk, bread and baked beans) have been in long-term decline as consumer preferences gradually change.

4.66 In the July report, we presented evidence from Which? that own-label products had experienced a higher rate of inflation compared to branded goods.[105] This is partly explained by the fact that these products typically have a lower starting price, and so register a higher percentage inflation rate for the same absolute (pounds and pence) price increase.[106]

4.67 Figure 4.2 below shows additional information from Which? on inflation rates across own-label tiers and branded products. Own-label 'budget' ('value') tier products have seen the highest inflation rates. Inflation has fallen for all own-label tiers and branded products in the past few months, and there is now little difference in the rate of inflation for standard and premium own-label tiers, and branded goods.

[104] Retail sales, Great Britain - Office for National Statistics (ons.gov.uk)
[105] Paragraph 4.5 and Table 4 in Competition, choice and raising prices in groceries. The inflation rate presented for own-label and branded goods was based on changes to a basket of goods monitored by Which?.
[106] Mathematically a given absolute increase will give a higher increase in percentage terms for lower-priced items.

Figure 4.2: Annual inflation for the three months from July to September 2023 for different ranges of groceries



Source: Which? supermarket inflation tracker, Which? analysis[107]

Analysis of consumer behaviour in response to price changes

Introduction

4.68 Although food manufacturers cannot dictate retail prices, the price they charge to retailers will influence the prices faced by end consumers. Manufacturers are directly affected by changes in sales volumes for their products which will, in part, depend on the retail prices.

4.69 When consumers are price sensitive (ie they are willing and able to switch in response to price increases), manufacturers are constrained in their ability to raise prices without suffering a loss in volumes to competitors. Branded suppliers who provided relevant information told us that they consider the impact on volumes (ie consumer demand) when setting prices charged to retailers. The evidence we have seen, including our own analysis, suggests that, across most of the product categories, consumers have responded to price increases by switching to cheaper alternatives.

Outline of our data analysis

4.70 We have used data from Kantar Worldpanel Take Home panel to conduct quantitative analysis across our ten product categories. This panel is made up of around 30,000 households and is weighted to be demographically representative

[107] https://www.which.co.uk/reviews/supermarkets/article/food-price-inflation-tracker-aU2oV0A46tu3

of the population of Great Britain, such as by region of the country, household size, presence of children, and age of main shopper. The panel reports on a continuous basis on all Fast-Moving Consumer Goods purchases that are brought back into the home (FMCG). The panel reports where items were purchased, what was purchased, how much was paid and whether the product was on promotion (eg multibuys or extra (volume) free).[108] We received data in relation to sales, volumes, and average prices per volumes for our ten categories, split by retailer, and by product range. The data ran from 12 week-ending January 2021 to 3 September 2023.

4.71 There are several caveats that are important to keep in mind when interpreting analysis based on this data. First, the data captures purchases from most retailers including the major supermarkets (ie Tesco, Sainsbury's, Asda and Morrisons) and the discounters (Aldi and Lidl). However, for some product categories detailed data (eg on individual product ranges) was not available for premium retailers (Waitrose and M&S), online-only retailer Ocado, and convenience-focused stores (eg the Co-op). In these instances, Kantar have calculated total market volumes sold and average prices for only the available retailers.

4.72 We also note that the data for average prices, including average own-label and average branded prices, is weighted by volume (ie calculated as total spend divided by total volume). Volume-weighted average prices will include substitution effects (eg consumers buying larger volumes of cheaper products over time) and may underestimate the change in average prices if the product mix has changed considerably. However, we have found that price changes are generally in line with the reported ONS figures.[109]

4.73 Changes in manufacturers' volumes do not necessarily indicate consumer switching from or to a different product within the same category. They could, instead, be indicative that a market is growing or declining in size. For example, we heard that sales in some of our product categories have been gradually declining as preferences and tastes have changed (such as milk, sliced bread, baked beans and cat food) or as COVID-19 lockdown restrictions were removed (when consumers replaced ready meal consumption with eating out). We consider evidence below on changes in branded and own-label shares of sales volumes, which does indicate where consumers have switched between products in a particular category.

4.74 Many of the product categories we considered display strong seasonality (eg higher sales in summer months). Therefore, we have compared average prices and volumes between September 2021 to September 2023 to get a meaningful comparison.

4.75 There are also some product-specific caveats and limitations to our analysis:

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[108] Kantar submission to the CMA on methodology. Kantar adds that "Once shopping is brought into the home, the task is for all FMCG product barcodes to be scanned. A codebook is used for non-barcoded items. It covers online and instore grocery purchases. Kantar collects receipt images from a section of the panel, from which pricing information is extracted, linking receipt line descriptions to specific products."
[109] ONS consumer price inflation data

(a) We have been unable to assess the market for mayonnaise separately, and instead report on the wider market for 'ambient salad accompaniments'. However, as total volume sales of mayonnaise account for 72% of the market for ambient salad accompaniments within our dataset,[110] trends in the wider market are likely to be heavily influenced and, therefore, reflective of the general trends within the market for mayonnaise.

(b) We have found that, within the market for pet food, the trends for cat food and dog food differ. As these products are not substitutes for each other, we have assessed trends for cat and dog food separately.

(c) Data limitations has meant that we were unable to assess the market for infant formula separately, and instead we report on the wider market for infant formula and follow-on milk.

(d) Finally, price data for infant formula lacked robustness. Therefore, we have restricted our analysis of infant formula to only volume-based market shares. Where we have assessed changes in average prices across product categories, we have used the First Steps Nutrition Trust (FSNT) estimates for infant formula instead of the Kantar price data.[111]

4.76 We now present the results of our data analysis.

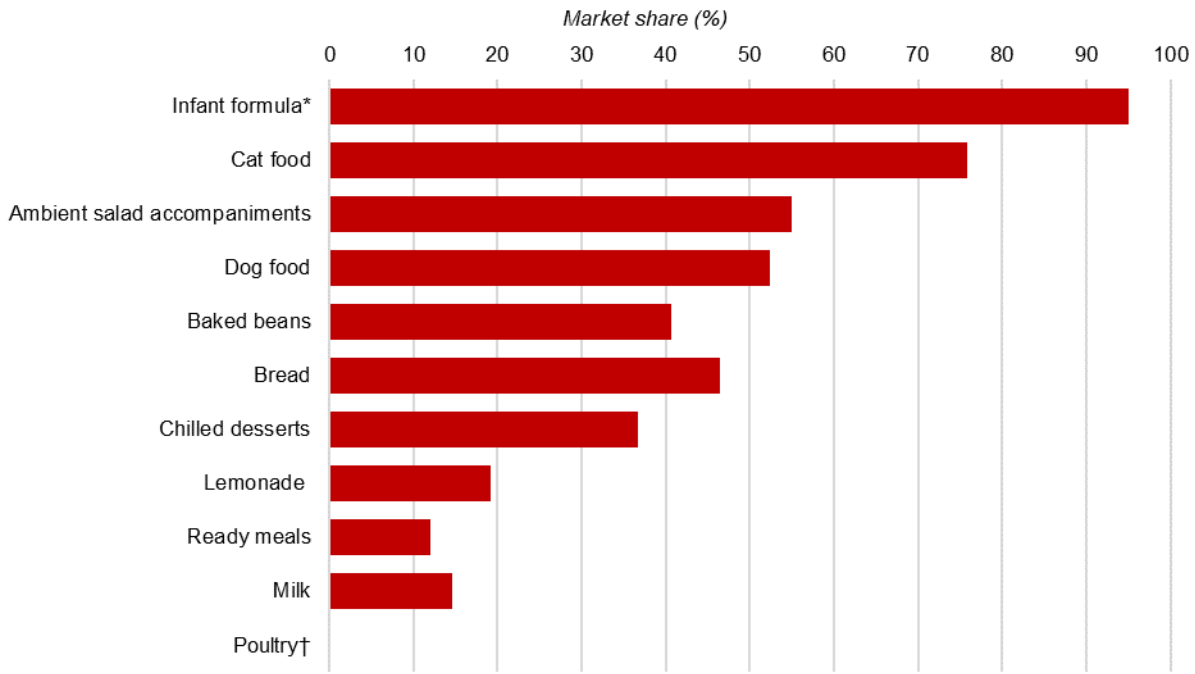
Results of our data analysis

Branded shares

4.77 As discussed in Section 3 above, brands are more important in some product categories than others, reflecting the potential for differentiation and the willingness of consumers to buy brands in those categories. Figure 4.3 below shows the relative importance of branded *vis-à-vis* own-label products in our ten product categories in September 2023.

[110] Mayonnaise accounts for 72% of the market for ambient salad accompaniments by volumes sold in the 12 week ending September 2023.
[111] The FSNT estimates are based on simple average prices of specific products (including products supplied by what FSNT classifies as market leaders and Aldi's own-label product) of powdered and cows' milk-based infant formula, and does not include follow-on milk products.

Figure 4.3: Branded market shares by volume in September 2023



Source: CMA analysis of Kantar Worldpanel Take Home panel data
**Infant formula includes both infant formula ('first milk') and follow-on milk. The infant formula market share reported reflects the shares from February 2023 due to data limitations. The infant formula market share is estimated by scaling the 52 w/e total own-label volume to quarterly data, calculating the proportion that it makes up of the total market volume, and then converting the own-label share to a branded share.*
† The poultry branded share is estimated to be 0% based on RFI responses.

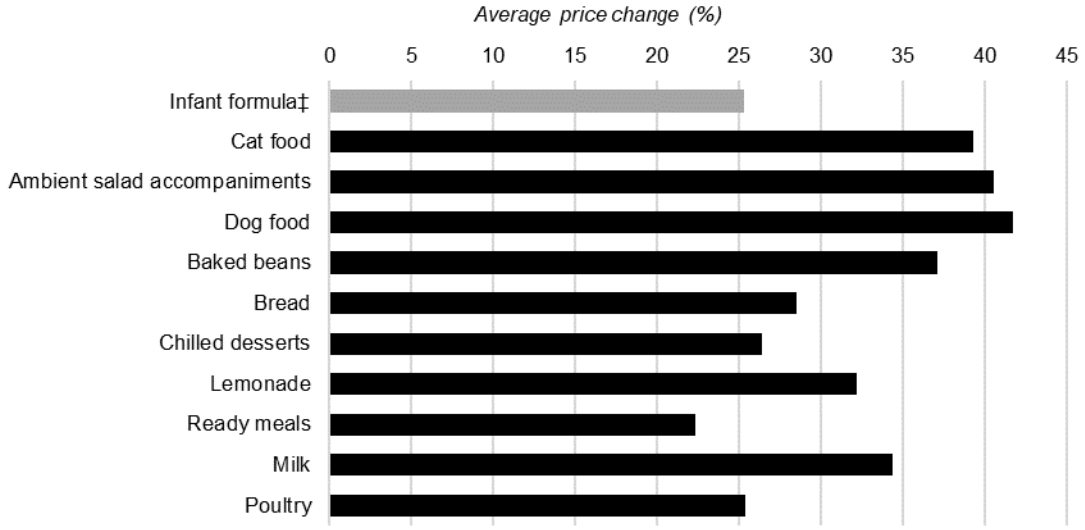
Notes:
(1) Market shares are calculated over the 12-week period ending 03/09/2023. The February 2023 market share for infant formula is calculated over the 12-week period ending 19/02/2023.
(2) Ambient salad accompaniments is a proxy for mayonnaise. Mayonnaise accounts for around 72% of sales of ambient salad accompaniments by volume.

Price trends

4.78 Figure 4.4 shows the percentage change in average prices between September 2021 and September 2023).[112] We can see that prices have increased across all ten product categories between September 2021 and September 2023. Products in Group A generally saw the largest increases in prices during this period: dog food (42%), ambient salad accompaniments (41%) and cat food (39%).

[112] The unit of volume differs across each of the product categories. The unit of volume for cat food, ambient salad accompaniments, dog food, baked beans, bread, chilled desserts, chilled ready meals, and poultry is kilograms. The unit of volume for milk and lemonade is litres. The unit of volume for infant formula is a pack of 800-900g of infant formula sold.

Figure 4.4: Percentage change in average price per volume between September 2021 and September 2023



Source: CMA analysis of Kantar Worldpanel Take Home panel and FSNT data.
‡ The estimate for infant formula uses FSNT data. The percentage change in price for infant formula is calculated between March 2021 and April 2023 using average prices (calculated as a simple average) of specific products (including products supplied by what FSNT classifies as market leaders and Aldi's own-label product) of powdered cows' milk-based infant formula and does not include follow-on formula products. The unit of volume for infant formula is a pack of 800-900g of infant formula.

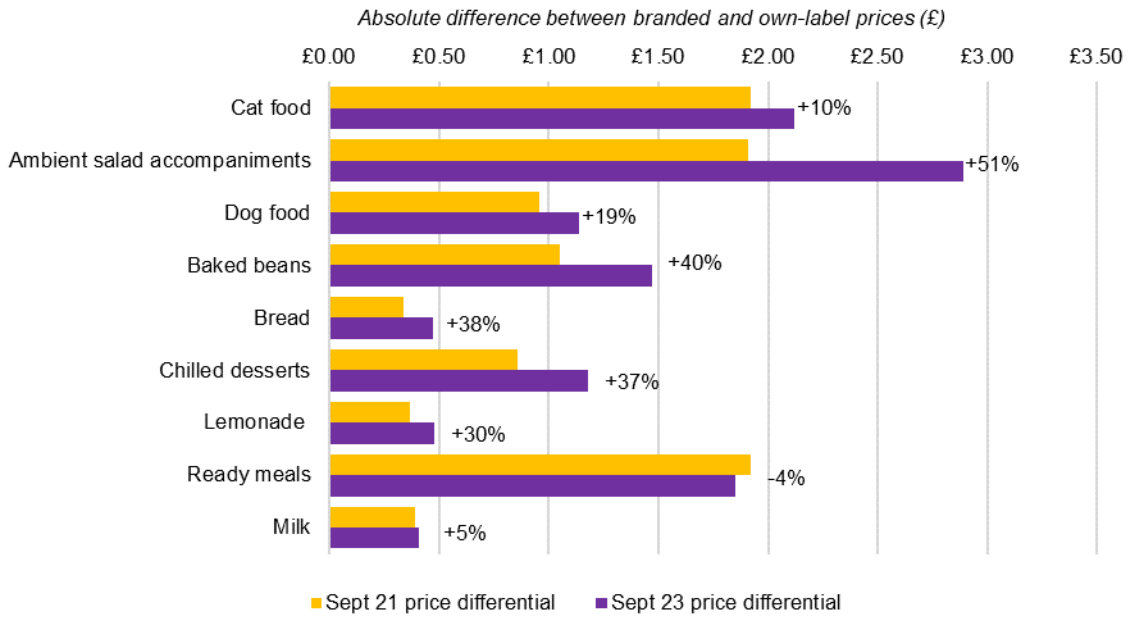
Notes:
(1) Prices are calculated over the 12-week periods ending 05/09/2021. The change in prices is calculated between the 12-week periods ending 05/09/2021 and the 12-week period ending 03/09/2023.
(2) Ambient salad accompaniments is a proxy for mayonnaise. Mayonnaise accounts for around 72% of sales of ambient salad accompaniments by volume.
(3) Prices are reported in per unit volume terms, rounded to two decimal places. The unit of volume for cat food, ambient salad accompaniments, dog food, baked beans, bread, chilled desserts, ready meals and poultry is kilograms. The unit of volume for milk and lemonade is litres.

Price differentials between branded and own-label products and how they have changed

4.79 Figure 4.5 below shows that the brand premium[113] in absolute terms across the ten product categories and how it changed between September 2021 and September 2023. Our analysis has found that brands in all of our ten product categories were more expensive than own-label products in the same category,[114] and that price differential between brands and own-label products increased in absolute terms (£) in most markets between September 2021 and September 2023.

[113] We use this term to denote average brand premium, ie the difference between average branded and average own-label prices.
[114] While the pricing data on infant formula lacked robustness, we can still make this finding based on qualitative evidence from manufacturers in this market.

Figure 4.5: Absolute difference and changes in average prices between branded and own-label from September 2021 to September 2023



Source: CMA analysis of Kantar Worldpanel Take Home panel data

Notes:
(1) The labels at the top of the differentials show the percentage change in the pricing differential between branded and own-label products between September 2021 and September 2023.
(2) Prices are calculated for the 12-week periods ending 05/09/2021 and 03/09/2023. The change in prices is calculated between the 12-week period ending 05/09/2021 and the 12-week period ending 03/09/2023.
(3) Ambient salad accompaniments is a proxy for mayonnaise. Mayonnaise accounts for around 72% of sales of ambient salad accompaniments by volume.
(4) Prices are reported in per unit volume terms. The unit of volume for cat food, ambient salad accompaniments, dog food, baked beans, bread, chilled desserts, ready meals, and poultry is kilograms. The unit of volume for milk and lemonade is litres.
(5) Poultry is excluded from this figure as there is no branded manufacturers in this market, and therefore average prices cannot be reported separately for branded and own-label poultry products.
(6) Price data for infant formula lacked robustness and therefore, has been excluded from this figure.

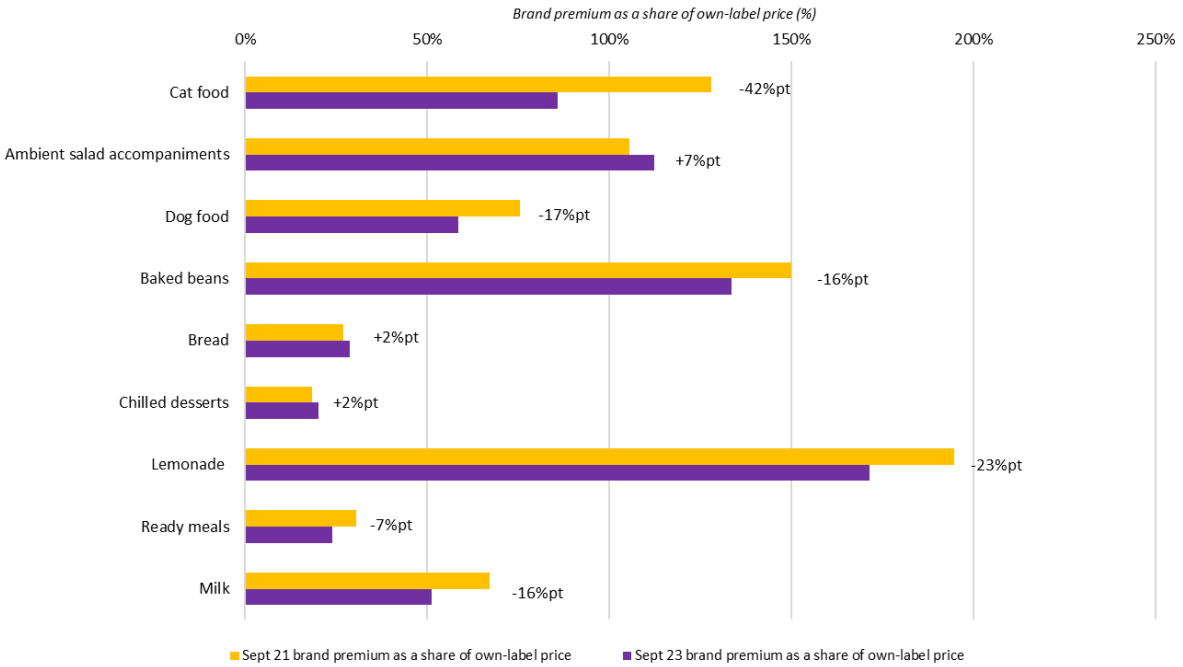
4.80 Between September 2021 and September 2023, there were significant increases in the brand premium for almost all product categories. Ambient salad accompaniments (51%), followed by baked beans (40%), both in Group A, saw the largest increases in percentage terms in the brand premium during this period, followed by bread (38%), chilled desserts (37%) and lemonade (30%) from Group B There were smaller increases in the brand premium for cat food (10%) and milk (5%) between September 2021 and September 2023. The market for ready meals is the only market where we find that the brand premium has fallen slightly, though we note that the branded share in ready meals was only around 12% in September 2023.

4.81 Another way of looking at the relative prices of brands and own-label products is to consider the brand premium as a share of the own-label price. Figure 4.6 below presents the difference between the average branded price and the average own-label price as a percentage of average own-label price. When the brand premium in Figure 4.6 is 100%, that means that the brand is twice the price of the own-label equivalent. Between September 2021 and September 2023, the relative brand premium has fallen for several product categories (including pet food, baked beans, lemonade, ready meals and milk) despite also growing in absolute terms.

This is consistent with the Which? evidence above that own-label products have been seeing higher price inflation. It also reflects the fact that own-label prices would have been lower to start with, and that own-label manufacturers have lower margins and would need to pass on more of the cost increases they face, as explained further in Box 4.1 below.

4.82 Despite this trend, brands remained significantly more expensive than own-label. Brands were, on average, more than twice as expensive as own-label products in ambient salad accompaniments, baked beans and lemonade, in September 2023. The brand premium was lowest in bread, chilled desserts, chilled ready meals (Group B) and milk (Group C), in September 2023.

Figure 4.6: Brand premium as a percentage of own-label price and changes from September 2021 to September 2023



Source: CMA analysis of Kantar Worldpanel Take Home panel data

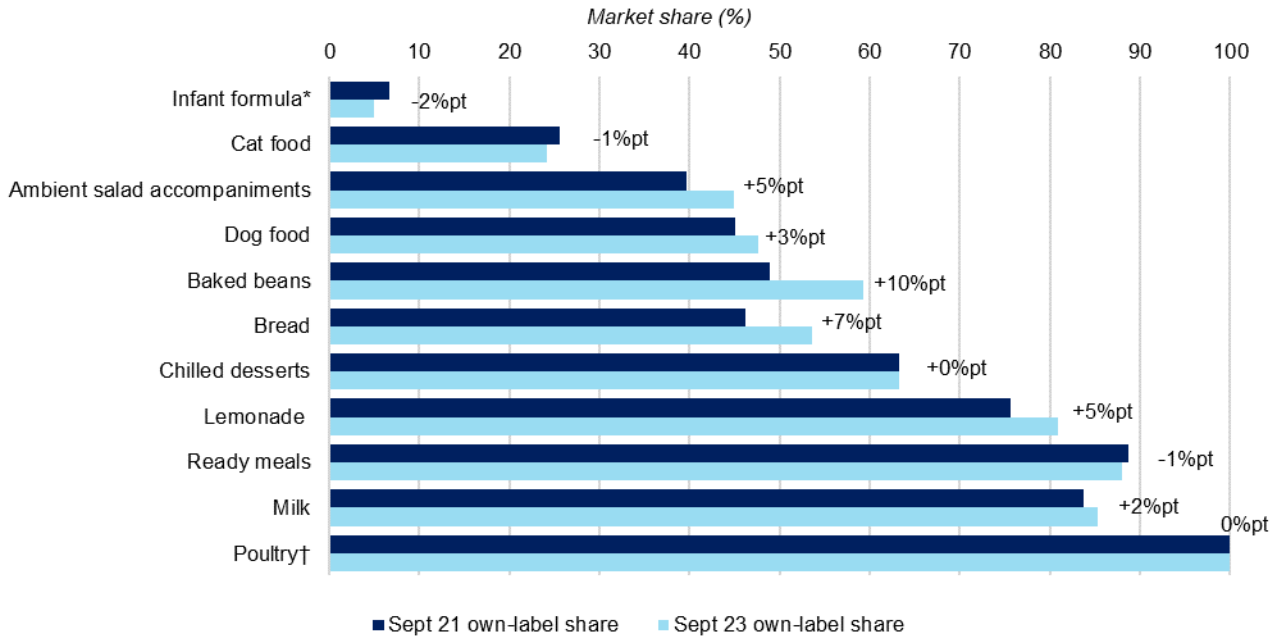
Notes:
(1) The figure illustrates the brand premium above the own-label price. The labels indicate percentage point changes between September 21 and September 23.
(2) Prices are calculated for the 12-week periods ending 05/09/2021 and 03/09/2023. The change in prices is calculated between the 12-week period ending 05/09/2021 and the 12-week period ending 03/09/2023.
(3) Ambient salad accompaniments is a proxy for mayonnaise. Mayonnaise accounts for around 72% of sales of ambient salad accompaniments by volume.
(4) Prices are reported in per unit volume terms. The unit of volume for cat food, ambient salad accompaniments, dog food, baked beans, bread, chilled desserts, ready meals, and poultry is kilograms. The unit of volume for milk and lemonade is litres.
(5) Poultry is excluded from this figure as there is no branded manufacturers in this market, and therefore average prices cannot be reported separately for branded and own-label poultry products.
(6) Price data for infant formula lacked robustness and therefore, has been excluded from this figure.

Consumer switching between branded and own-label products

4.83 As we noted above, we saw evidence in July that consumers have been switching to cheaper products, such as from branded to own-label, within own-label to cheaper tiers and from more expensive retailers to cheaper ones. Manufacturers also told us that they had observed these trends, and this is borne out across most of the product categories by our own data analysis, set out below.

4.84 Figure 4.7 below shows that the share of own-label products grew (in volume terms) for most product categories between September 2021 to September 2023.

Figure 4.7: Own-label market share by volume and changes from September 2021 to September 2023



Source: CMA analysis of Kantar Worldpanel Take Home panel data
** Infant formula includes both infant formula and follow-on milk. The infant formula market shares are reported as the shares from September 2021 and February 2023 (light blue bar) due to data limitations. Market shares are estimated by scaling the 52 w/e own-label total volume to quarterly data, calculating the proportion that it makes up of the total market volume.*
† The poultry share is estimated to be 100% based on Kantar data and RFI responses.

Notes:
(1) The labels show the percentage point change in the market share between September 2021 and September 2023 for all products other than infant formula, which shows the percentage point change between September 2021 and February 2023.
(2) Market shares are calculated over the 12-week periods ending 05/09/2021 and 03/09/2023. The change in market shares is calculated between these two periods.
(3) Ambient salad accompaniments is a proxy for mayonnaise. Mayonnaise accounts for around 72% of sales of ambient salad accompaniments by volume.
(4) For infant formula, market shares are calculated over the 12-week period ending 05/09/2021 and 19/02/2023. The change in market share is calculated between these two periods.

4.85 The extent of switching to own-label varies across the product categories. For some – such as baked beans and bread – it has been very significant. For example, own-label share of baked beans increased by 10 percentage points, from 49% to 59%, between September 2021 and September 2023 (while the branded share correspondingly fell from 51% to 41%). Other products – such as ambient salad accompaniments and dog food – saw more modest switching (5 and 3 percentage point increases in own-label share, respectively).

4.86 In some product categories, own-label manufacturers' position has weakened slightly relative to brands. In ready meals, own-label shares of volume sold fell by one percentage point between September 2021 and September 2023. As can be seen from Figure 4.5 this was the only product category in which the absolute branded price premium fell between September 2021 and September 2023. This suggests that average own-label prices increased at a faster rate than average branded prices during this period. We heard from ready-meal manufacturers that there were two consumer trends in this market: consumers switching from eating

out to buying premium ready meals, and switching away from cheaper ready meals to cooking from scratch. This is consistent with the slight growth in branded ready meals which tend to be at the premium end of the market (eg Charlie Bigham).[115]

4.87 Own-label shares of volume sold in the market for cat food also saw a decline of one percentage point between September 2021 to September 2023. We were also told that strong brand loyalty in this market has meant that branded cat food has been more resilient to volume declines than own-label sales. The Kantar data shows a decline in overall volumes of cat food sold (branded and own-label) at the retailers included, which could be driven by a decreasing population of cats after the peak in the cat population during the COVID-19 pandemic. We also heard that cat owners are choosing to feed their pets cheaper food, such as human food scraps.[116]

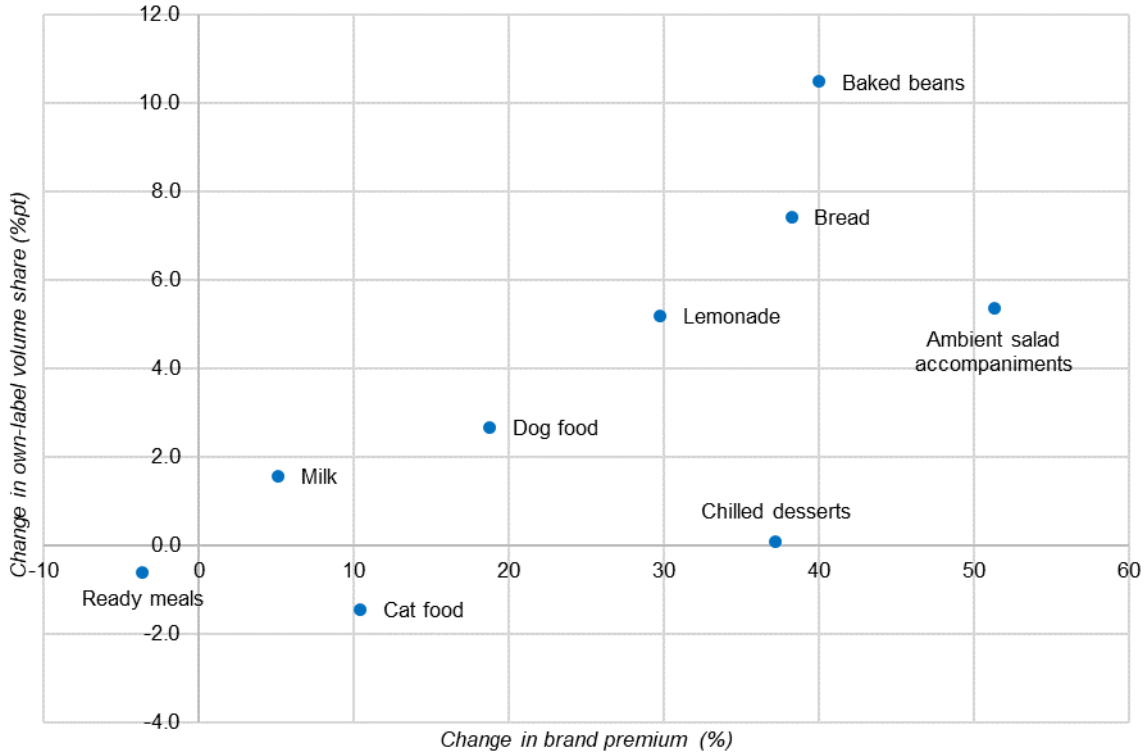
4.88 In the market for infant formula, volume-based own-label shares have declined by 2 percentage points.[117] Own-label manufacturers have found it difficult to compete with larger brands in the market characterised by strong brand loyalty.[118]

4.89 Overall, for most product categories, our analysis finds that consumers are switching to cheaper own-label alternatives although, in some markets characterised by strong brand loyalty – such as infant formula and cat food – own-label shares have declined.

4.90 Figure 4.8 below further illustrates the relationship between the increase in the absolute brand premium (as presented in Figure 4.5 above) and the change in the own-label share of supply across our product categories (as shown in Figure 4.7 above). This shows that product categories which have seen the highest increases in brand premium (such as ambient salad accompaniments, baked beans, lemonade and bread), generally also saw highest increases in own-label volume shares between September 2021 and September 2023. This suggests that, in general, consumers are switching away from brands in response to rising average branded prices.

[115] This does not include tinned or frozen ready meals, which are more likely to be value products.
[116] Mintel have also reported (Pet Food – UK – 2023) that 5% of pet owners are saving money by feeding their pet less shop bought food.
[117] Figure refers to share changes in infant formula (‘first milk’) and follow-on milk.
[118] We note that unlike other product categories, due to data restrictions, we have only been able to calculate the change on own-label infant formula changes between the 12-week ending in September 2021 and the 12-week ending in February 2023.

Figure 4.8: Change in brand premium compared to change in own-label share between September 2021 and September 23



Source: CMA analysis of Kantar Worldpanel Take Home panel data

Notes:
(1) The x-axis shows the percentage change in the brand premium, calculated as the absolute difference between branded and own-label prices (in £/p), between September 2021 to September 2023.
(2) The y-axis indicates the percentage point change in the own-label volume-based market share between September 2021 to September 2023.
(3) Market shares and prices are calculated over the 12-week periods ending and 05/09/2021 and 03/09/2023.
(4) Ambient salad accompaniments is a proxy for mayonnaise. Mayonnaise accounts for around 72% of sales of ambient salad accompaniments by volume.
(5) Price data for infant formula lacked robustness and therefore, has been excluded from this figure.
(6) Poultry is excluded from this figure as there is no branded manufacturers in this market.

Profitability of food manufacturers

Box 4.1. Unit profitability and competition

As part of our analysis of the financial performance of food manufacturers, we assessed how their unit profitability had changed since 2021. Manufacturers that have increased their unit profitability will have raised their prices by more than the rise in their input costs.

Economic theory suggests a complicated relationship between unit profitability and competition. In particular, it predicts that in highly competitive markets, manufacturers will need to pass through most or all of their input cost changes because their margins will be very low. Unit profitability in such markets is likely to be low and steady. Where a degree of market power exists, however, the optimal (profit-maximising) response to input cost changes can vary, depending on the context, and particularly on how customers react to price changes.

Where customers become less price sensitive as prices rise, manufacturers will find it more profitable to increase prices by more than the rise in their input costs (ie to increase their unit profitability). This may happen, for example, where there is strong brand loyalty among a segment of consumers, so that – as prices rise and more price-sensitive consumers switch away – the remaining demand comes from consumers that are loyal (and hence less price sensitive). In such cases, faced with rising input costs, manufacturers may find it more profitable to charge a high price on the small share of demand that is 'captive', than to charge a lower price to capture the additional share of demand that is more responsive to price.

Our analysis shows that, in a number of product categories, branded manufacturers have increased their unit profitability, and experienced a loss of volume as more price-sensitive customers switch away.

Overview

4.91 We have reviewed the financial performance of food manufacturers, using information provided in their responses to our voluntary requests for information and publicly available financial statements.[119]

4.92 The analysis is based on data covering UK sales of products within our chosen product categories, rather than their overall business which may encompass several products or multiple countries.[120] In some cases, a single manufacturer may produce a number of brands within a given category – for example, a pet food manufacturer might produce multiple brands of cat food and multiple brands of dog

[119] The information available varies by manufacturer, due to both differences in reporting and differing levels of detail supplied. For example, some manufacturers have different approaches to tracking product profitability, including different approaches to cost allocation. In addition, some manufacturers provided us with detailed volume, unit pricing, and unit profitability metrics, whereas others did not. The data cited in this section is illustrative of our findings and the amount of commentary provided differs across different product categories.

[120] For publicly available accounts, we have included only manufacturers for whom UK sales of the relevant category are the primary focus of the manufacturer.

food. Some manufacturers also produce products in more than one of our ten product categories, in which case they are included separately in each.[121]

4.93 We have compared historical profitability to the latest available comparable information (either 2022 or 2023 financial year). Specific time periods vary by manufacturer due to differences in financial year ends. For the purposes of this analysis, financial years are referred to as the calendar years to which they are most closely aligned: for example, year-ending March 2022 is referred to as 2021; year-ending September 2022 is referred to as 2022.[122] We comment on trends without identifying individual manufacturers, and in some cases show anonymised manufacturer data.

4.94 There are differences in profitability characteristics and trends between different product categories and manufacturers, which we present in more detail below. We first summarise some general findings, based on our observations of the financial data we have gathered.

(a) All the manufacturers have experienced significant input cost rises during the last 18 months (for the reasons discussed in Section 2). As a result, they have all increased the prices at which they sell to retailers over this period. This aligns with what we heard from retailers, as outlined in Section 2 of our July update.

(b) Profitability of own-label manufacturers was generally lower (sometimes considerably so) than that of branded goods manufacturers. Own-label manufacturers also tended to experience a slightly greater decline in net profits[123] than branded manufacturers.

(c) Margins are higher in some product categories than others, for both branded and own-label suppliers. We observed the highest margins in infant formula, baked beans, pet food and mayonnaise (Group A).

(d) Where we received suitable data, we looked at unit profitability, that is, the amount of profit made per unit sold (eg per litre of lemonade, or per kilogram of baked beans). Most manufacturers of branded goods have increased their absolute profit per unit since 2021.[124] In other words, for each unit, price rises in absolute terms (£ and pence) exceeded manufacturers' input cost rises over this period. Some own-label suppliers, particularly for product categories in Group A (which includes infant formula, baked beans, mayonnaise and pet food), have also increased their unit profitability.[125] Box 4.1 above, explains the relationship between unit profitability and competition.

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[121] Where manufacturers produce multiple products, or branded and own-label, they are treated as a unique manufacturer in each category. Eg if a brand made branded beans, own-label beans, and branded ready meals, they would appear three times (twice in beans, once in ready meals).
[122] In one case, year end is June. In this case, FY ending June 2022 is referred to as 2022.
[123] Net profit is the profit a manufacturer makes after subtracting all operating costs including production costs and overheads (eg management, rent).
[124] If comparable year-to-date 2023 figures available, 2021-23YTD. Otherwise, 2021-22.
[125] 13 of 20 manufacturers who reported unit profitability had increasing unit profitability, 2021-Latest available at EBIT / net profit if available, contribution, gross profit if net profit unavailable.

(e) The evidence suggests that most manufacturers (branded and own-label) have made lower overall profits in the most recent year, both as a percentage of their revenue and in absolute terms:

(i) Two thirds of the manufacturers we reviewed had declining profit as a percentage of revenue.[126]

(ii) More than half of manufacturers also had declining total profit in absolute terms.

(iii) Fewer than one in three grew total profits at a faster rate than the growth in consumer price inflation.[127,128]

(f) As discussed above, the reasons for the lower overall profits are twofold:

(i) Most manufacturers of branded goods have seen their volumes decline (primarily because consumers have switched to cheaper own-label products in response to relative price increases and cost-of-living pressures).[129] Even when per unit profitability has increased, lower volumes mean that overall profitability has fallen.

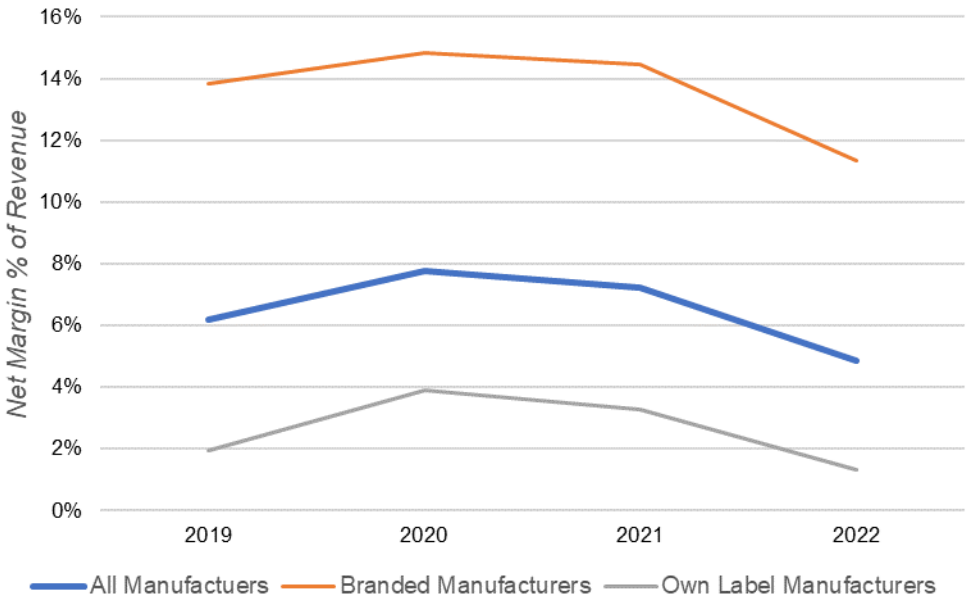
(ii) As discussed above (paragraphs 4.35 to 4.44), manufacturers, particularly manufacturers of own-label products, are also under pressure from retailers not to fully pass on their input cost increases.

Our analysis

4.95 Figure 4.9 below shows average net profit margins across all the manufacturers that provided comparable information.[130] On average, margins are significantly lower among own-label manufacturers than branded manufacturers. Average margins fell in the most recent year (2022), just as they did for large grocery retailers. However, profitability levels and trends vary significantly between manufacturers. These differences are considered further below.

[126] 26 of 38 manufacturers had declining profit as a percent of sale (EBIT if available, if not gross profit / contribution) from 2021-Latest available
[127] 21 of 38 manufacturers had declining absolute profit. 4 grew at sub-inflationary rates. 2 became positive after making loses in 2021. 10 grew at rates higher than CPI for the relevant time period, matched to their reporting periods.
[128] All items CPI, matched to relevant reporting time periods.
[129] We also note that some markets are in general decline, as noted in our Product Category Summary Table, such as sliced bread and milk.
[130] 20 own-label and 11 branded suppliers.

Figure 4.9: Average net margins for manufacturers, financial years 2019 – 22



Source: CMA Analysis, RFI responses, Companies House

Note: Simple average across 31 suppliers.

4.96 We observe that net margins for branded manufacturers are in general considerably higher than those we observed for grocery retailers (which are similar to those for own-label manufacturers). Average margins for large grocery retailers were (in aggregate) between 2.9% and 3.3% from financial year 2019/20 to financial year 2021/22 and fell to 1.8% in 2022/2023.[131]

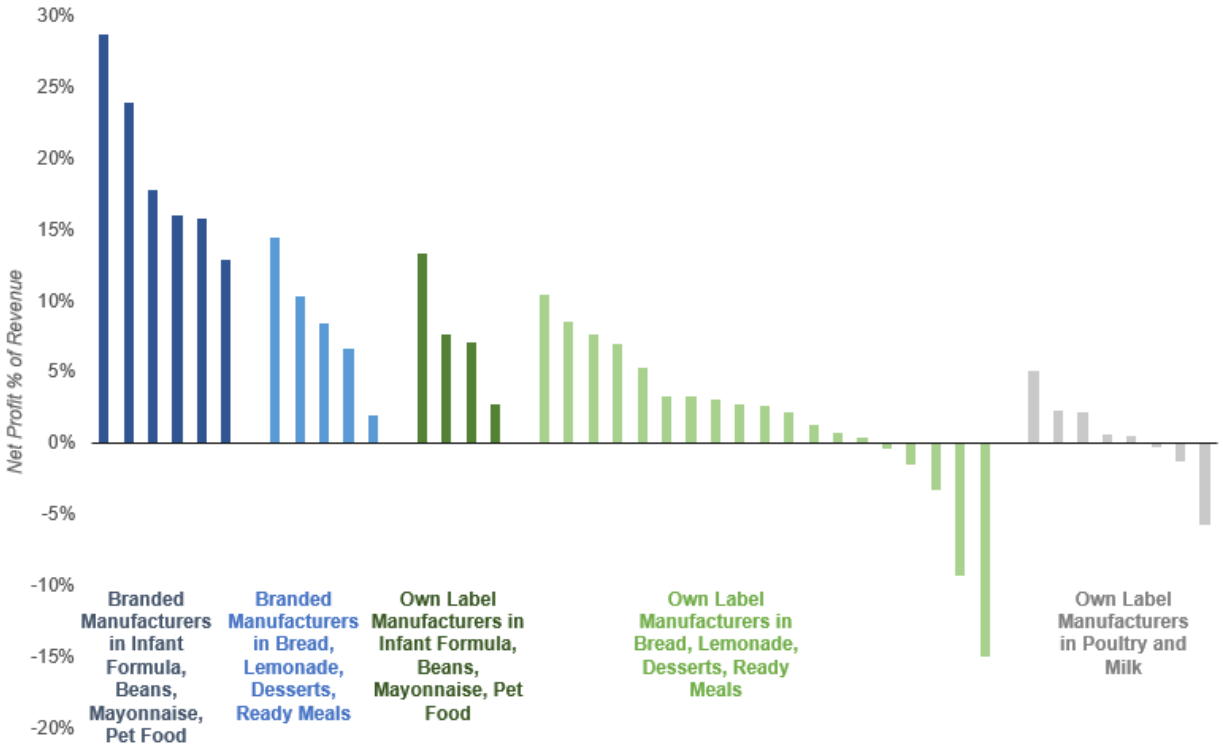
4.97 The FDF has argued that this difference is explained by the very different business models of branded manufacturers and retailers. The FDF argues that the latter function as intermediaries bringing products from manufacturers to final consumers, whereas branded manufacturers take on the risk of developing new and innovative product lines, including marketing spend to introduce them to the public. The FDF argues that retailers often 'piggyback' on this investment, adapting successful new products for their own-label versions which then compete on price.[132]

4.98 Figure 4.10 below shows net profit margins across all the manufacturers that provided sufficiently comparable data. Each bar represents data for an individual (anonymised) manufacturer, either of branded or own-label goods, within a particular product category, coloured and sorted according to our groupings. The evidence shows that brands in general have higher profitability than own-label manufacturers, and that some categories – especially commodity products such as poultry and milk – are less profitable than others.

[131] July report, paragraphs 4.25 to 4.26, figure 19.
[132] FDF written response, October 2023.

Figure 4.10: Manufacturer net profitability by category group

Net profit as % of revenue, simple average, 2020-22



Source: CMA Analysis, RFI Responses, Companies House

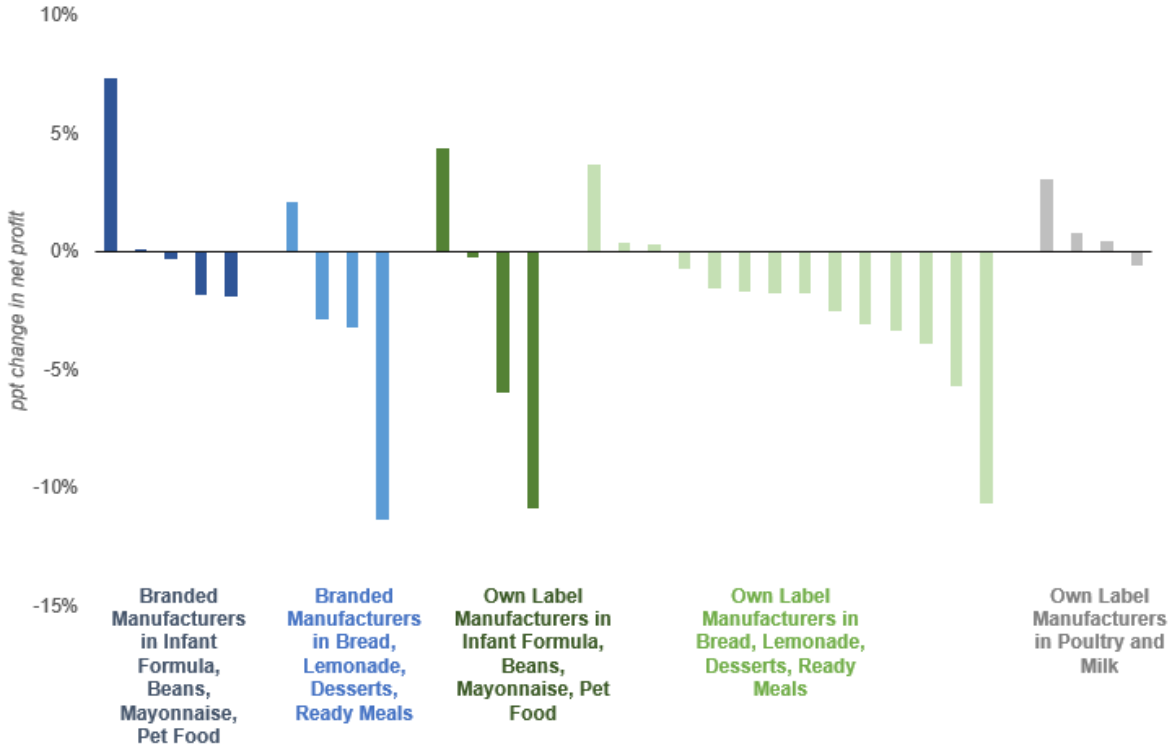
Notes:
(1) Profit metrics – for data based on public financial information, earnings before interest and taxes (EBIT) were used; for data provided as part of RFI response, specific metrics vary. Where no sufficiently comparable metric available was provided by a manufacturer, they are excluded from the figure.
(2) Average 2020-23 chosen to provide indication of typical level of profitability without being affected by specific trend in a given year.

4.99 We have also looked at changes in profitability across the product categories (Figure 4.11 below). Almost all of the manufacturers experienced a fall in their net profit[133] as a share of revenue. For a large majority of manufacturers, this has also translated into reductions in absolute net profit (ie net profit in £).

[133] Gross profit is the profit a manufacturer makes after subtracting from revenue the cost of producing the product in question. Costs subtracted would include, for example, ingredients and labour required for making the product, but would exclude management costs, head office costs, etc.

Figure 4.11: Change in manufacturer net profitability by category group

Operating profit as % of revenue, percentage-point change, 2021 to latest available



Source: CMA Analysis, RFI Responses, Companies House

Box 4.2. Unit profitability and profit margins

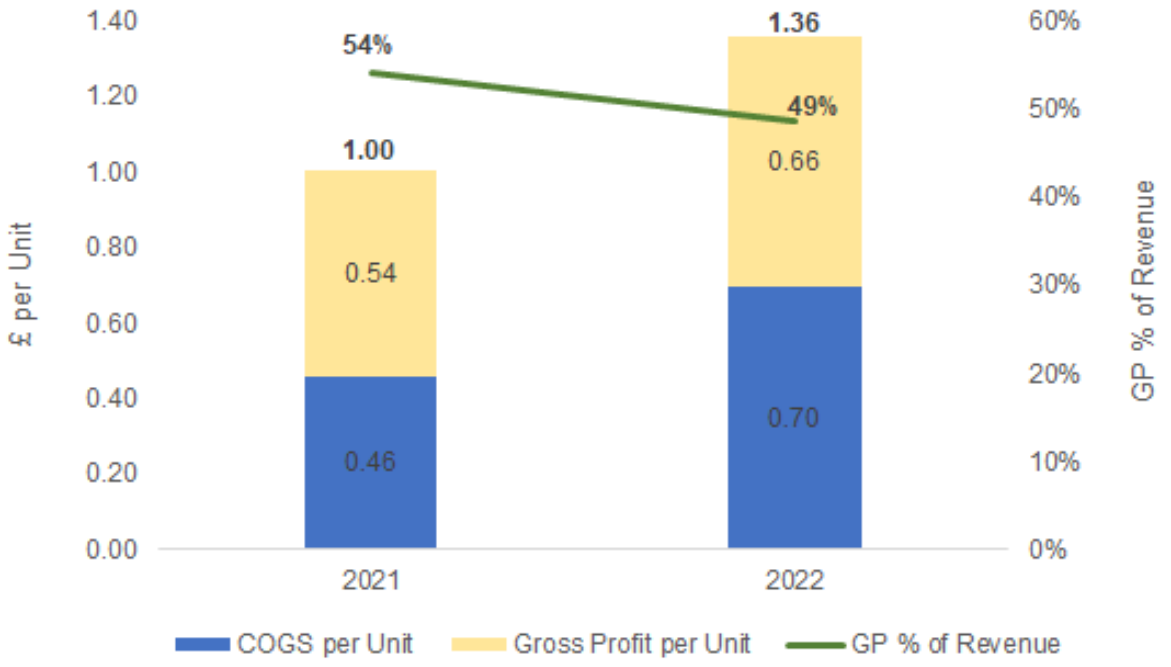
Many branded manufacturers in Group A saw a rise in unit profitability, at the same time as their profit margins (measured as a percent of revenue) declined. Figure 4.12 below is based on data for one typical, anonymised manufacturer to help explain these trends.

In this case:

- The manufacturer has increased prices from £1.00 per unit to £1.36 (a rise of 36p or 36%)
- The cost of goods sold[1] (COGS) has increased from 46p to 70p (a rise of 30p or 52%)
- Gross profit (price minus COGS) has therefore increased in absolute terms from 54p to 66p (a rise of 12p or 21%).

Because the rate of increase in price is less than the rate of increase of costs (price has increased by 36% but COGS has increased by 52%), gross profit as a percentage of revenue has declined from 54% to 49%.

Figure 4.12: Unit Pricing and Profitability Evolution for One Branded Manufacturer



Source: RFI Responses, CMA analysis

4.100 The remainder of this section considers the evidence on profitability in more detail, based on the product groupings.

Group A: infant formula, baked beans, mayonnaise, and pet food

4.101 In summary, these categories saw the highest profit margins of all that we considered. For branded manufacturers in this group, we have observed three broad trends since 2021:

(a) Revenues have risen;

(b) Unit profitability has risen, but volumes have declined;

(c) Profits as a percent of revenue have generally fallen; while for absolute profits, the picture is more mixed.

Branded manufacturers

4.102 In infant formula, baked beans, mayonnaise, and pet food, branded manufacturers achieve higher profit margins than branded manufacturers in other categories (and higher than own-label manufacturers of these products). Typical net margins for branded manufacturers in these product categories are 15-30% of revenue, compared to less than 15% for brands in other categories (see Figure 4.10).

4.103 Branded manufacturers in these categories have typically increased their unit profitability since 2021 (in other words, for every kilo or litre of product sold, they have made a larger profit). This is true in respect of both gross and net unit profitability, for every brand for which data is available. At the same time, almost all brands saw profit decline as a percentage of revenue, both at a gross profit level and at operating profit level (see Figure 4.11).[134]

4.104 Together, rising unit profitability with decreased margins as a percentage of revenue indicates that in absolute terms, prices have increased by a larger amount than costs have increased, but that prices have risen at a lower rate than cost inflation.

4.105 All branded manufacturers in this group increased their absolute revenue in the last two years, as a result of rising prices. However, most of these manufacturers lost sales volumes, with customers switching from branded to cheaper, primarily own-label, products, or buying less of these products overall (see section on consumer trends). In absolute terms, profit trends were mixed. Around half of manufacturers grew profits by more than CPI inflation. Of the remainder, some grew profits at a sub-inflationary rate, and some had declining profit in nominal terms.[135]

Own-label manufacturers

4.106 In all product categories, including those in this group, typical profitability levels of own-label manufacturers are materially lower than branded competitors. Net profitability for own-label manufacturers is typically less than 15% of revenue.

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[134] There is one material exception, which had unrelated trends driving significant profitability improvement.
[135] Net profit, if available. If not (eg because shared overheads not allocated to products) contribution/gross profit.

4.107 Around half of own-label manufacturers have increased unit profitability since 2021.[136] Despite rising prices, own-label manufacturers experienced a lower reduction in volume than their branded competitors. Volumes either declined at lower rates than branded manufacturers or increased. This likely reflects some buyers switching away from brands to own-label alternatives, as outlined above in the section on consumer trends.

4.108 Some manufacturers had declining total profits, but in general, profits for own-label manufacturers grew in nominal terms (albeit at a level lower than CPI inflation).

Group B: bread, lemonade, chilled desserts, and ready meals

4.109 In summary. products in this group are generally less profitable for manufacturers than those in Group A. Most branded and own-label manufacturers have experienced declining profits since 2021.

Branded manufacturers

4.110 In bread, lemonade, chilled desserts and ready meals, the net profitability of branded manufacturers tends to be below 15% – lower than in infant formula, beans, mayonnaise, and pet food, as shown in Figure 4.10 above.

4.111 Unit profitability has increased for around half of branded manufacturers in this product category. The other half of manufacturers were unable to fully pass on increases in the cost of production, meaning unit profitability fell. However, nearly all branded manufacturers in this product category have experienced a decline in profitability as a percent of revenue (both gross and net), as shown in Figure 4.11 above.

4.112 Most branded manufacturers had lower sales volumes in 2022 than in 2021, and sometimes these reductions were significant (a decline of more than 10%). Others grew volumes, but growth rates were modest (less than 5%). As a result, despite some manufacturers being able to increase unit profits, most manufacturers saw declining absolute profitability.

Own-label manufacturers

4.113 Profitability for own-label manufacturers in this group varies widely – net profit margins ranged from -15% to +10%, as shown in Figure 4.10 above – but is generally lower than for branded manufacturers for this group of products.

4.114 Profitability trends have been mixed. Some own-label manufacturers have managed to increase unit profitability (in some cases becoming profitable, having previously been loss-making); for others, unit profitability has declined.

4.115 Most own-label manufacturers saw significant declines in profit as a percentage of revenue as shown in Figure 4.11 above:

[136] Where exceptions exist, these are explained by atypical circumstances.

(a) For 12 of the 14 manufacturers for which we have gross profit figures, profitability declined as a percentage of revenue.

(b) For 11 of the 14 manufacturers, net profitability declined as a percentage of revenue.

4.116 For all except one manufacturer, revenue grew, reflecting both price growth and, in some cases, volume growth (with some own-label manufacturers benefiting from consumers switching away from branded products).

4.117 Absolute profit performance was mixed, but generally tended to be negative. Since 2021,[137] only two of 14 own-label manufacturers increased their net profit in excess of CPI inflation. One grew profit at a sub-inflationary level; one turned positive after a loss in 2021; and the ten remaining manufacturers either had lower profits, became loss-making, or became increasingly loss-making.[138]

Group C: poultry and milk

4.118 There is very limited brand presence in poultry and milk, and therefore we only consider profitability evidence for own-label manufacturers (strictly, processors in this case). Poultry and milk are low-margin categories, in which manufacturers consistently make low – or in some cases negative – profits, as shown in Figure 4.10. Net margins are typically less than 5% of revenue, and there is no evidence that manufacturers have been able to materially increase margins during the recent period of high price inflation in these categories.

4.119 For most manufacturers, revenue grew, but – reflecting mixed profitability trends as shown in Figure 4.11 – absolute profit trends varied.

4.120 There has been no consistent unit profitability trend in the last two years: for some manufacturers, unit profitability has increased; for others, it has declined. Nonetheless, all manufacturers have remained at an overall low level of profitability.

Looking forward

4.121 Some manufacturers gave us evidence of projected margins and how they expected their profits to develop over the next few months. There is evidence that some suppliers are aiming to rebuild margin in the next financial year. Around half of suppliers expect profitability as a share of revenue to increase, and around two thirds expect absolute profit levels to improve in the next financial year.

4.122 However, most suppliers projected absolute profit to be lower than 2021 in real terms. In addition, most of those projecting absolute profit growth have relatively low margins vs suppliers in general. Overall, we have not seen evidence to suggest that suppliers are aiming to rebuild margins to a level that will drive levels of profitability outside of recent historical norms.

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[137] 2021-22 except two cases, where 2021-23 11month actual + one month budget.
[138] Net profit if available, otherwise gross profit/contribution.

5. Infant formula

Introduction

5.1 In assessing whether weak competition has been contributing to high prices across the ten product categories, we have considered the profitability of manufacturers; their strength in the market and *vis-à-vis* retailers; and consumer behaviour. For some product categories, we have observed that large, branded suppliers have pricing power, and have been able to push prices up by more than their input costs.

5.2 However, we have been reassured, from a competition perspective, by the availability of cheaper alternatives (including own-label) in these product categories, and evidence that many consumers are able and willing to switch to these. In doing so, they have mitigated cost-of-living pressures for themselves, and generated pressure on the large brands in these categories.

5.3 In infant formula,[139] the picture appears to be different. Even as cost-of-living pressures have grown, there is little evidence that consumers have switched to the cheapest brands, or own-label alternatives (or that consumers newly entering the market are increasingly choosing these options). This is despite there being significant savings from doing so, and despite regulations ensuring that all infant formula products provide all the nutrients a healthy baby needs, until complementary feeding is introduced.[140] For many who buy it, infant formula is an essential, non-substitutable product, and there have been concerning reports of consumers who are struggling with the cost-of-living resorting to shoplifting formula, buying it on the black market, or using unsafe feeding practices, like watering down bottles.[141]

5.4 Reflecting these differences from the other product categories, we set out in in this section additional detail on the infant formula market, and the evidence we have gathered. Based on this, we have concerns that weak or ineffective competition may be keeping prices higher than they might otherwise be. The section also sets out the further work we plan to carry out in this market.

What is infant formula?

5.5 The World Health Organisation recommends that children are 'exclusively breastfed for the first 6 months of life' and that, 'from the age of 6 months, children should begin eating safe and adequate complementary foods while continuing to

[139] References to infant formula and follow-on formula in this report include infant milk and follow-on milk as defined in Annex VI to Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation).
[140] NHS advice states that 'Formula milk provides babies with the nutrients they need to grow and develop. However, it does not have the same health benefits as breastfeeding for you and your baby'. Some infant formula milks marketed as foods for specific medical purposes should only be used under medical supervision. Such products have been excluded from our analysis. Advice on which infant formula to choose is provided by the NHS here.
[141] Desperate parents are stealing baby formula to keep their children fed, Sky News

breastfeed for up to two years of age or beyond'.[142] For governments in the UK, breastfeeding is an important public health priority.[143]

5.6 There can, however, be circumstances where breastfeeding is not possible, or only possible in combination with bottle feeding. Alternatively, parents may make a choice not to breastfeed, or to combine breast and bottle feeding. Infant formula is designed for use in the first months of life and is the only substitute for breastmilk which can satisfy, by itself, the nutritional requirements of healthy babies until appropriate complementary feeding is introduced.[144] It is sold in both powdered and liquid forms, and in different package sizes.[145]

5.7 The essential, non-substitutable nature of infant formula is compounded by the fact that it can be very challenging to start (or re-start) breastfeeding once a mother's milk supply has ceased, and increasing breastmilk supply where a combination of breast and bottle are used can take time. The proportion of infants totally or partially breastfed in England at six to eight weeks stands at around 49%.[146] In other words, it is likely that over half of infants in England are fed either wholly or partially with infant formula for at least some of their first year of life.

5.8 The composition of infant formula is tightly regulated to ensure its safety and suitability for infants (defined here as children under the age of 12 months). For example, the requirements cover energy value, macronutrient and micronutrient content and are based on scientific advice.

[142] World Health Organisation recommendations
[143] See, for example, Public Health England guidance
[144] DHSC guidance on retained Commission Delegated Regulation (EU) 2017/127
[145] Powdered formats require the addition of water before they can be fed to an infant while liquid formulations are ready-to-use.
[146] Breastfeeding at 6 to 8 weeks after birth, Apr 22 to Mar 23, Office for Health Improvement and Disparities. Experimental data.

Box 5.1: Nutrition law is an area of devolved competency

Responsibilities for legislating and enforcement regarding infant formula and follow-on formula sit with each of the UK's devolved nations. The Department of Health and Social Care (DHSC), the Scottish Government and the Welsh Government are the competent authorities for each nation in Great Britain.

In Great Britain, the nutritional content, labelling and marketing of infant formula and follow-on formula is principally regulated via the Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation).[147] The Food for Specific Groups Regulation (EU) No 609/2013 (Retained direct EU legislation) is also relevant as it sets out general rules on the composition and labelling of food for infants and young children.[148]

The Northern Ireland Protocol (NIP) means that EU legislation relating to nutrition (as detailed in Annex 2 to the NIP) is directly applicable in Northern Ireland. The DHSC explains in guidance that Northern Ireland continues to play a vital role in policy development for nutrition legislation in Great Britain and that the UK-wide provisional common framework for Nutrition Related Labelling, Composition and Standards ensures that any impacts on the UK internal market are limited.[149]

These regulations are enforced in England by The Food for Specific Groups (Food for Special Medical Purposes for Infants, Infant Formula and Follow-On Formula) (Information and Compositional Requirements) (Amendment Etc.) (England) Regulations 2020 and The Food for Specific Groups (Information and Compositional Requirements) (England) Regulations 2016.[150] Similar enforcement legislation applies in Scotland, Wales and Northern Ireland.

5.9 Ingredients other than those required can be voluntarily added by manufacturers – unless prohibited or restricted in the regulations, and where their suitability (covering expected benefits and safety considerations) for infants can be demonstrated using appropriate data and studies.[151] The relevant competent authority must be notified of any changes to the formulation of, or ingredients added to, infant formula products already on the market in Great Britain (as well as when an infant formula is first placed on the market).[152]

5.10 However, the regulations seek to ensure that **all** infant formula products will satisfy, by themselves, the nutritional requirements of infants in good health until appropriate complementary feeding is introduced. The NHS states, this means that, 'there's no evidence that switching to a different formula does any good or

[147] Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation)
[148] Following the UK's exit from the EU, retained EU regulations and tertiary legislation relating to nutrition were amended by the Nutrition (Amendment etc.) (EU Exit) Regulations 2019 and the Nutrition (Amendment etc.) (EU Exit) Regulations 2020. The Nutrition (Amendment) And Food For Specific Groups (Food For Special Medical Purposes For Infants, Infant Formula and Follow-On Formula (Information and Compositional Requirements) (Amendment) Regulations 2021 amended the date of application of the provisions relating to infant formula and follow-on formula made from protein hydrolysates under Commission Delegated Regulation 2016/127 (Retained direct EU legislation).
[149] DHSC guidance on retained Commission Delegated Regulation (EU) 2017/127
[150] DHSC guidance on retained Commission Delegated Regulation (EU) 2017/127
[151] Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation)
[152] Notification of infant formula. Notification in Great Britain is centrally coordinated by DHSC.

harm'.[153] UNICEF UK's guide for parents states that 'there is no evidence that one company's milk is better for your baby than any other'.[154] First Steps Nutrition Trust's (FSNT) guidance on bottle feeding states that 'it doesn't matter which brand you use, they [formulas made from cows' and goats' milk] are all very similar'.[155]

5.11 Complementary feeding begins at around six months. From this point and up to one year of age, consumers will still need to provide infants with either breastmilk, infant formula or follow-on formula.[156] As such, infant formula or follow-on formula can, for some consumers, continue to be essential and non-substitutable products (albeit with declining significance as infants increasingly gain their nutrients from solid/non-solid foods and liquids). From 12 months onwards, cow's milk can be introduced.

5.12 Although consumers have a choice during this period (when an infant is aged 6-12 months) to use either infant formula or follow-on formula, the NHS recommends that: 'first infant formula is the only formula your baby needs. Your baby can stay on it when you start to introduce your baby's first solid foods at around six months, and they can drink it throughout their first year.'[157] The Scientific Advisory Council on Nutrition (SACN) states that: 'Infant formula is the only alternative to breastmilk considered suitable for infants younger than one year of age. Follow-on formula can be given from six months of age, but there is no nutritional justification for this change.'[158] UNICEF UK's guide for parents states that '[i]t is not necessary to move your baby on to [follow-on] milks' and FSNT's guidance on bottle feeding states that '[t]here is no need for follow-on formula. Stick to a first infant formula throughout the first year.'[159] Like infant formula, the composition of follow-on formula is specified in regulations.[160]

5.13 The primary focus of our evidence-collection and analysis has been on infant formula, although we have considered follow-on formula to the extent that it affects how the market for infant formula works. We have not considered as part of this work infant milks marketed as foods for special medical purposes, which fall under a different regulatory framework.[161]

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[153] Types of formula, NHS
[154] A guide to infant formula for parents who are bottle feeding, UNICEF.
[155] Responsive bottle feeding, FSNT (an independent public health nutrition charity).
[156] Follow-on formula is for use by infants when appropriate complementary feeding (which includes all liquids, semi-solid and solid foods other than breastmilk and infant formula) has been introduced and which constitutes the principal liquid element in a progressively diversified diet. DHSC guidance on retained Commission Delegated Regulation (EU) 2017/127
[157] Types of formula, NHS
[158] Consideration of the place of "good night" milk products in the diet of infants aged 6 months and above, SACN
[159] A guide to infant formula for parents who are bottle feeding, UNICEF. Responsive bottle feeding, FSNT
[160] Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation).
[161] This includes soy-based and lactose-free infant milks, and infant milks marketed as 'anti-reflux', 'comfort' and 'anti-colic' milks. Although it is a regulatory requirement that such products be used under medical supervision, the law does not limit their sale to the public. Advice on which infant formula to choose is provided by the NHS here.

Market structure and recent trends

5.14 The market for infant formula is highly concentrated, with very limited own-label presence. There is one main manufacturer, Danone, which produces the Aptamil and Cow & Gate brands. Other branded manufacturers have lower shares. These include Nestle – which produces SMA and Little Steps – HiPP, and Kendamil both of which manufacture branded products of the same name. Kendamil is a relatively new entrant to the market which positions itself as a uniquely British brand, with organic milk as an important part of its proposition.[162] Nannycare is a further branded manufacturer, albeit a much smaller player in the market, focused on offering goats milk-based products.

5.15 Each manufacturer may offer several different infant formula products as well as follow-on formula and milks for older children. Both Danone and Nestle offer three different, progressively more expensive, product 'tiers', for each of their infant formula, follow-on and toddler milks.

5.16 According to IRI market share data we received from one infant formula manufacturer, in the 52 weeks to July 2023, Danone was the market leader in the UK with a combined share by value in infant formula of 71%. Nestle's SMA and Little Steps infant formula products accounted for 14%, while Kendamil and HiPP had relatively smaller shares of this market at 9% and 5% respectively.

5.17 There is very weak own-label presence in the market for infant formula. Aldi is the only retailer to produce an own-label product. CMA analysis of Kantar data shows that own-label products account for 5% of the market for infant formula and follow-on formula by volume.[163] Sainsbury's and Boots used to sell own-label infant formula but no longer do so. Heinz also used to offer a branded infant formula product.

Labelling and marketing of infant formula

5.18 The labelling, promotion and advertising of infant formula is tightly prescribed in regulations (see Box 5.1). The introductory text to Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation) explains that this is to avoid discouraging breastfeeding and protect infant health.

5.19 With regards to the labelling of products, Article 6 of retained Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation) requires that infant formulas must include a statement that the product is 'suitable for infants from birth who are not breastfed' and Article 8 prohibits nutrition and health claims. DHSC guidance on the regulations explains that claims which might not be permitted on infant formula include: 'contains all the nutrients your baby need to grow strong and healthy', 'easy to digest' or 'gentle'.[164]

5.20 In addition, and as Box 5.2 explains, the regulations also effectively prohibit the advertising and promotion of infant formula directly to consumers, including

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[162] Kendamil website
[163] Kantar, February 2023 data (the last period when own-label sales data was available). Includes infant formula and follow-on formula.
[164] DHSC guidance on retained Commission Delegated Regulation (EU) 2017/127

commercial practices at the retail level such as special displays or discount coupons which could induce sales. Also prohibited is the provision of free or low-priced products to members of the general public or to pregnant women, mothers or members of their families.

5.21 DHSC guidance explains further that both print and digital media, such as Instagram, YouTube videos or other social media, could be considered to be advertising. It also explains that loyalty or reward card schemes, 'buy one get one free' and gifts provided via baby clubs or similar activities could be considered as the provision of free or subsidised products.[165]

5.22 The regulations are different for follow-on formula. Advertising and promotion to consumers is allowed for this product, although the regulations require that: 'The labelling, presentation and advertising of infant formula and follow-on formula shall be designed in such a way that it avoids any risk of confusion between infant formula and follow-on formula and enables consumers to make a clear distinction between them, in particular as to the text, images and colours used.'[166]

Box 5.2. Article 10: Requirements for promotional and commercial practices for infant formula[167]

Advertising of infant formula shall be restricted to publications specialising in baby care and scientific publications. The appropriate authority may further restrict or prohibit such advertising. Such advertising shall contain only information of a scientific and factual nature. Such information shall not imply or create a belief that bottle-feeding is equivalent or superior to breast feeding.

There shall be no point-of-sale advertising, giving of samples or any other promotional device to induce sales of infant formula directly to the consumer at the retail level, such as special displays, discount coupons, premiums, special sales, loss-leaders and tie-in sales.

Manufacturers and distributors of infant formula shall not provide, to the general public or to pregnant women, mothers or members of their families, free or low-priced products, samples or any other promotional gifts, either directly or indirectly via the health care system or health workers.

Donations or low-price sales of supplies of infant formula to institutions or organisations, whether for use in the institutions or for distribution outside them, shall only be used by or distributed for infants who have to be fed on infant formula and only for as long as required by such infants.

5.23 These regulations are not always adhered to. Over the past few years, the Advertising Standards Agency (ASA) has ruled that several advertisements have

[165] DHSC guidance on retained Commission Delegated Regulation (EU) 2017/127
[166] Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation).
[167] Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation).

breached the UK Code of Non-Broadcast Advertising and Direct & Promotional Marketing (CAP Code).[168]

5.24 More specifically, the ASA ruled that several advertisements had the effect of one or more of the following: marketing infant formula; confusing between infant formula and follow-on formula; discouraging breastfeeding; making health claims for infant formula; making health claims for follow-on formula which breached the Code; and making disease treatment claims which breached the Code.

5.25 These include advertisements on Kendamil's Facebook page, a paid-for Facebook advertisement for Kendamil, reviews from Facebook and other third-party websites pulled onto Kendamil's website, a post on Kendamil's LinkedIn account, and an in-app advertisement for Kendamil in the Candy Crush game. Other rulings relate to a podcast ad for Cow & Gate Baby Club which was subsequently discussed on another podcast and four paid-for Google ads for Boots which referenced several different brands of infant formula.[169]

5.26 Iceland has also expressed concern that the strict limits on promotional and commercial practices relating to infant formula risk preventing consumers from getting the best deals on an essential product which their customers were struggling to afford. Specifically, Iceland felt that it should not have been asked to stop informing consumers that it had reduced the price of infant formula. It has also noted that the law prohibits allowing infant formula to be purchased with loyalty points or store gift cards.[170]

5.27 While the regulations prevent promotional activity around infant formula (including price promotions), nothing in them prevents manufacturers from reducing their list price to retailers, nor retailers making unpromoted cuts to the prices offered to consumers.

5.28 A snapshot of infant formula prices in November 2023 showed that the prices for different infant formula products (Aptamil, Cow & Gate, Little Steps, HiPP and Kendamil) did not vary across the major supermarkets[171] and the UK's largest pharmacy chain, Boots. Iceland was cheaper than the major supermarkets, Aldi and Boots for the infant formula products we examined which it had available, ie Aptamil, Cow & Gate and Kendamil, with different product prices at Iceland being between 7 and 23% (or 75p to £2.75) lower. Aldi's Mamia infant formula was the cheapest infant formula product per 100g on the market.[172]

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[168] The CAP Code (along with the Broadcast Advertising Code) has regard to the rules on advertising infant formula and follow-on formula contained in the Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation). The ASA advises marketers to have regard to these regulations and other relevant food law when preparing ads. Advertising codes - ASA | CAP

[169] Kendal Nutricare Ltd - ASA | CAP, Kendal Nutricare Ltd - ASA | CAP, Kendal Nutricare Ltd - ASA | CAP, Nutricia Ltd - ASA | CAP, Boots UK Ltd - ASA | CAP

[170] It's time to change the law on infant formula – About Iceland

[171] Comprising Tesco, Sainsbury's, Asda and Morrisons.

[172] Data collected online on 16 November 2023 for Aptamil 1 First Baby Milk Formula Powder from Birth, Cow & Gate 1 First Baby Milk Formula Powder from Birth, SMA Little Steps First Baby Milk Formula from Birth, HiPP Organic Infant Milk, Kendamil First Infant Milk 1 from Birth and Mamia First Infant Milk. All products are powdered, 800g apart from Mamia which is 900g. Aldi also sold Cow & Gate in a 700g tin at an equivalent price per 100g to the big four Supermarkets and Boots. Some brands offer larger packs which cost less per 100g.

How consumers choose an infant formula product

5.29 The information consumers receive about infant formula through labelling and promotional and commercial practices is limited through regulation to avoid discouraging breastfeeding and protect infant health.[173] However, when consumers need to, or have chosen to, use infant formula, they will naturally want to make the best possible choice for their baby, and will look for information, advice and assurance in order to do so.

5.30 There is limited published research on what influences consumer choice of particular infant formula products, or whether to use infant formula at all. However, we have seen evidence that around three quarters of consumers choose an infant formula product pre-birth or at birth (in hospital). This can be a particularly vulnerable time.

5.31 Despite the lack of published research, we heard concerns from stakeholders that consumers may not have the right information at the right time to make well-informed purchasing choices. In particular, we heard concerns that there is low consumer awareness that all infant formula products provide all of the nutrients a healthy infant needs until complementary feeding is introduced.

5.32 A range of stakeholders told us that the following factors are the likely biggest drivers of consumer decision-making in this market:

- Recommendations from friends and family;
- Advice from health professionals (nurses, midwives, health visitors, doctors);
- Brand awareness through the marketing of follow-on formula and toddler milks, as well as baby clubs (which tend to provide online advice, tools and problem-solving support relating to newborn, baby and toddler nutrition, health, wellbeing and development as well as advice and guidance relating to conception and pregnancy), advice lines and social media;
- Previous experience with a particular brand (eg through previous children); and
- Seeing and using a particular brand in healthcare settings.

5.33 Despite the fact that all infant formula products provide all the nutrients a healthy infant needs, until complementary feeding is introduced, and the significant price differences between the cheapest and most expensive products, we heard that lower prices were not a significant factor in consumer decision-making. One supplier sent us survey data received from MetrixLab in 2023 showing that only 5% of parents make decisions on infant formula based on pricing.

5.34 There is also relatively little switching between infant formula brands. The same survey data showed that over 65% of parents only use one brand of infant/follow-on formula. Where switching does occur it is not usually for cost reasons. Of the 35% of parents who switched infant formula brand in this survey, almost half did so

[173] Commission Delegated Regulation (EU) 2016/127 (Retained direct EU legislation).

because their baby was not happy[174] and only 18% did so because the brand was too expensive.

5.35 Although there are regulations on marketing infant formula, reaching consumers pre-birth or very shortly afterwards is important for brands to sustain and grow market share, given that choices are made early on, switching is low, and consumers are only in the market for a short period of time. Stakeholders told us that, notwithstanding these regulations, manufacturers were able to raise awareness of their brands, and influence consumer choices about which infant formula to purchase, through other means: for example, targeted digital marketing of baby clubs;[175] the promotion of follow-on formula in similar packaging to infant formula; the use of customer reviews and testimonials; the supply of formula to NHS hospitals; and marketing and provision of information to health professionals.

5.36 In the US, where infant formula products can be marketed direct to consumers, products are typically marketed as being suitable from birth to 12 months, and follow-on products are not widely available. The infant formula produced by Kendamil for the US market is also labelled in this way (unlike its UK infant formula product), and it offers no follow-on product in the US market.

5.37 In the UK – where follow-on formula can be marketed to consumers, but infant formula cannot – follow-on products are available from all the branded manufacturers. Brands typically market follow-on formula as being suitable from 6-12 months, and as representing the 'next stage' of the feeding process. Infant formula is normally labelled as being suitable 'from birth', but information is often presented in a way that implies it is intended for use up to 6 months only. For example, the Aptamil website describes its infant formula products as '0-6 Months Formula Milks' and states 'Your baby can stay on it until you start to introduce solid foods at around 6 months when you might consider changing to follow on milks'.[176] As set out above, SACN considers that there is 'no nutritional justification' for a change at 6 months to follow-on milk.

Consumer prices

5.38 Although all infant formula products provide all the nutrients a healthy baby needs, until complimentary feeding is introduced, there are large price differences between products. According to FSNT, the price per 100ml of reconstituted powdered infant formula based on cows' milk in August 2023 varied from 13p per 100ml for the cheapest product (Cow & Gate First Infant Milk, 1200g pack) to 35p per 100ml for the most expensive (Aptamil 1 First Milk Tabs, 552g pack). Aldi's own-label product, Mamia, costs 14p per 100ml (900g pack).[177]

5.39 As data from FSNT set out in Figure 5.1 below shows, the cost of feeding a child during the first year of life can vary significantly depending on which infant formula

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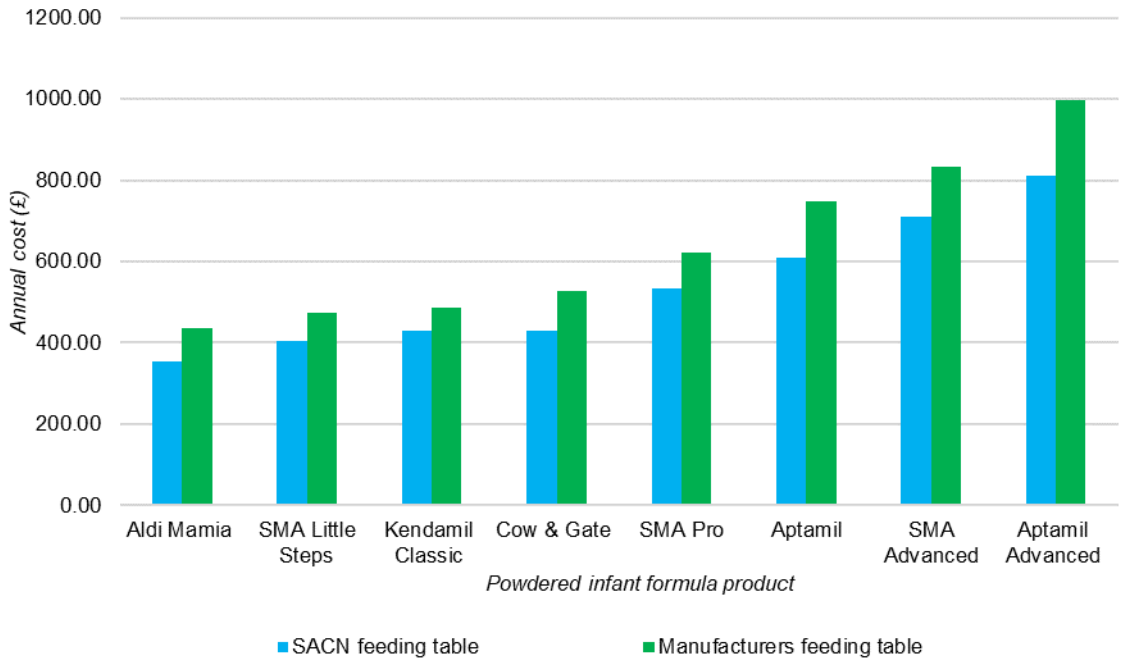
[174] 'My baby did not get on well/had stomach issues' (29%) and 'My baby did not like the taste' (18%)
[175] Eg Aptamil baby club, https://www.aptaclub.co.uk/.
[176] Aptamil® 1: 0-6 Months Formula Milk | Aptaclub [Accessed 16 November 2023]
[177] First Steps Nutrition Trust (2023), Costs of infant formula, follow-on formula and milks marketed as foods for special medical purposes available over the counter in the UK, Table 3. Aldi's Mamia was the cheapest product in a standard sized pack.

is chosen. For instance, the annual costs of using the most expensive branded product can add up to £1,000 – more than twice as much as using own-label infant formula.[178] FSNT's analysis also highlights that the feeding volume guides suggested by manufacturers are systematically higher than those recommended by the SACN.

Figure 5.1: Annual cost of infant formula in the first year of life, based on August 2023 prices



Source: FSNT

Notes:
(1) The annual costs have been estimated using prices from August 2023.
(2) Annual costs have been calculated separately per feeding volumes based on requirements for energy for infants as published by the SACN and the volumes recommended by the manufacturers on product labels. Cost calculations are based on costs per 100ml as published in Table 3 of FSNT 2023 report on Costs of infant formula, follow-on formula and milks marketed as foods for special medical purposes available over the counter in the UK.
(3) The FSNT analysis focuses on powdered infant formulas based on cows' milk as these are the most widely available products, and the cheapest products available to parents.

5.40 FSNT told us that differences in annual cost between brands were driven not only by differences in price per gram and millilitre of reconstituted liquid formula, but also in differences between manufacturers' recommendations as to how much of the reconstituted product should be made up and fed to infants at different ages. To the extent this is the case, unit pricing for infant formula may be of more limited use in enabling consumers to make accurate price comparisons for infant formula than for other products.

5.41 The price of infant formula has been rising in the recent years. CMA analysis of FSNT data indicates that, between March 2021 and April 2023, the average price

[178] The annual cost may be higher for parents that use goats' milk or liquid based infant formula products.

per pack of powdered cows' milk-based infant formula increased by 25%.[179] The average price rise for the market leaders was 24%, compared to 45% for Aldi's Mamia.[180] Reflecting the often essential nature of infant formula, despite price rises, total sales volumes have remained relatively constant during this time.[181]

5.42 Finally, manufacturers have increased their unit prices for infant formula by a higher amount than their costs have increased, leading to increasing unit profitability (in £ per kg). Some suppliers have seen modest reductions in overall profitability in recent years, but as a share of revenue, margins of major suppliers in infant formula remain among the highest of all the product categories we have considered.

Conclusions and next steps on infant formula

5.43 On the demand side, infant formula it is an essential product for many consumers, who must buy it in the same quantities even as the price rises. Consumers appear to have little regard to price when they initially choose an infant formula brand, and there is little evidence that they have switched to cheaper brands or own-label as prices have risen and cost-of-living pressures grown more acute. On the supply side, infant formula is highly concentrated category, dominated by strong brands that in recent years have been able to sustain high margins, and raise prices faster than input costs.

5.44 Together, these features indicate that price competition in infant formula may be weaker than in other product categories we have examined. This weakness may be compounded by regulatory prohibitions on direct promotion (including price promotion) of infant formula intended to avoid discouraging breastfeeding and protect infant health.

5.45 It is important that consumers who decide to use infant formula are equipped to make well-informed choices, and that suppliers face incentives to offer infant formula products at competitive prices. The evidence that we have seen to date raises potential concerns as to whether this is happening. With this in mind, we plan to carry out further work in the infant formula market. As part of this, we will gather further evidence to better understand:

(a) Consumer behaviour, the drivers of choice, and the information and advice available to consumers to support their decisions;

(b) Barriers to entry and expansion for infant formula manufacturers;

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[179] Please see Figure 4.4 for further details. Average price calculated using specific products, including what FSNT classifies as market leaders (Aptamil Advanced (Danone), Aptamil Organic (Danone), SMA Pro (Nestle), SMA Little Steps (Nestle), SMA Advanced (Nestle), Aptamil (Danone) and Cow & Gate 1 (Danone)) and Aldi's own-label product, Mamia.
[180] Cost of powdered infant formulas in the UK: How have they changed since January 2020?, FSNT, May 2023. Graph 1 which compares the unit cost of all brands cows' milk based powdered infant formula and Graph 2 which examines the unit cost of market leaders' powdered first infant formula and Aldi's Mamia compared to the weekly Healthy Start allowance.
[181] CMA analysis based on Kantar Worldpanel Take Home panel data.

(c) The role of the regulatory framework and its enforcement in influencing market outcomes.

5.46 Following this further work, and reflecting the importance of the regulatory environment in this market, we may make recommendations to the UK government and devolved administrations on how the market could work better.