Appendix E: Margins methodology

E.1 This appendix sets out our methodology for calculating gross profit margins for:

(a) manufacturers; and

(b) retailers.

Methodology for calculating manufacturers' gross profit margins from the supply of infant formula and follow-on formula

E.2 We requested data necessary for the calculation of gross profit margins from manufacturers of the following types of formula milks in the UK:[1]

(a) Infant formula; and

(b) Follow-on formula.

E.3 Monthly data was provided for the period January 2019 through to November 2024.

Revenue data

E.4 We requested 'product-specific' revenue data from each manufacturer.[2]

E.5 One manufacturer told us that our definition of revenue could exclude some transactions which have been recorded as trade support[3] but are closely connected to product sales. This is because rebates and trade support are not recognised accounting metrics in their own right. These metrics (and hence 'product-specific revenue') may be defined differently within and/or between different manufacturers' revenue data.

E.6 By contrast, another manufacturer told us that its accounting systems do not yet apply trade support by stock keeping unit. Therefore, its apportioning of trade support is 'fairly arbitrary from a systems point of view'.

E.7 One manufacturer recommended that we view its data over a lower frequency than monthly in order to deduce trends. This is because its monthly data could include accruals and subsequent reconciliations based on its actual sales volumes and spending.

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[1] We requested data from the largest manufacturers: Danone, Kendal, Nestle, HiPP, and contract manufacturers [✂].
[2] 'Product-specific revenue' means revenue entitled to be received in exchange for each unit of product (including any refunds, discounts, volume-based rebates, price concessions, credits, incentives or similar items, provided that they are directly attributable to the exchange of a particular unit of product).
[3] For example, payments by manufacturers to retailers to support them drive consumer purchases through staff training, better product placement or marketing activities.

Our approach

E.8 We recognise that it may not always be clear cut whether some transactions meet our definition of 'product-specific revenue'. However, because the definition is narrow[4] and these transactions are likely to be manual and infrequent in nature,[5] we do not consider that they will materially affect our calculations.

E.9 We note that there is a possibility that some manufacturers' product-specific revenue includes some transactions which, by their nature, do not follow the 'matching principle'.[6]

E.10 We have mitigated the potential impact of these limitations on our calculations by taking the steps set out in E.16 below.

Cost of goods data

E.11 We requested the following variable cost of goods data from each manufacturer[7]:

(i) Raw material costs;

(ii) Labour costs; and

(iii) Packaging costs.

E.12 One manufacturer told us that there was not a simple approach to providing a breakdown of its standard cost price. In particular, instead of providing its variable labour costs, it submitted that it could only provide a broader category of 'industrial costs', which includes plant and machinery, quality assurance, and labour costs allocated to products on the basis of volume produced for its UK customer business unit'.

Our approach

E.13 We note that manufacturers' variable cost of goods data could include some costs which are non-variable in nature[8] and/or costs which have been allocated to specific products using a degree of judgement.[9]

[4] For example, the definition of 'product-specific revenue' excludes transactions relating to brand building activities which aim to increase a manufacturers' market presence, such as in-store displays.
[5] By 'manual', we mean negotiated and recorded on an individual basis rather than through an automated sales process.
[6] The 'matching principle' is an accounting concept that involves matching costs with corresponding revenues in the same accounting period.
[7] Variable cost of goods data means costs which relate to the exchange of each unit of product.
[8] For example, supervisors' salaries.
[9] For example, costs may be allocated evenly across a range of products rather than on the basis of volume sales, or they may be recorded at a single point in time rather than being matched against particular sales.

E.14 In addition, we observe that several manufacturers have international operations and record transactions in foreign currencies which have been converted into pounds sterling.

E.15 We recognise that it may be very time consuming for manufacturers to review individual transactions over the period so that amounts can be categorised more accurately.

E.16 In our view, the limitations in the quality of the data set out above are unlikely to materially affect our analysis. We have therefore:

(a) used the data which manufacturers have provided in response to our requests, withstanding any limitations. This means that, in the case of the manufacturer which only holds records of its labour costs in the normal course of its operations under a broader category of 'industrial costs', we have used that data for our calculations.

(b) placed less weight on comparisons between the level of manufacturers' gross margins than we have on manufacturers' gross margin trends over time and their spreads.

(c) calculated gross margins on an annual basis.

Feedback following the interim report

E.17 In response to the interim report, Danone stated that it 'does not agree with the CMA's gross margin calculations'.[10] It criticised four aspects of our methodology, in particular:

(a) 'The CMA's gross margins calculations are inconsistent with both Danone UK's internal reporting and the accounting standards under which Danone is required to report'.

(b) 'Because the CMA leaves out important elements of revenues and costs falling under this definition, Danone UK considers it misleading for the CMA to refer to its calculated metric as 'gross margin'.

(c) 'The CMA's analysis does not allow for reliable comparisons of gross margins (i) across manufacturers; and/or (ii) over time'.

(d) 'The CMA's reliance on gross margins is inappropriate in the context of the IF market, given that this approach does not recognise many important costs

[10] Danone's response to the CMA's interim report, p42.

which are critical to the ongoing delivery of Danone's products and innovation efforts'.[11]

E.18 We consider each of the above in turn.

E.19 With regard to '(a)' above, we have not sought to replicate the accounting principles used by Danone for its internal reporting or statutory accounts. Our analysis is focused on gaining a better understanding of how well competition is working in the markets for the supply of infant formula and follow-on formula.

E.20 With regard to '(b)' above, Danone told us that it 'does not recognise the measure of revenue used by the CMA, which does not represent the *actual* revenue Danone UK recognises or ultimately the cash flow it receives from customers from the sale of baby formula, nor does it represent the full scope of revenue (specifically discounts to revenue) which it is required to report and is subjected to audit under the relevant accounting standards'.[12] Danone explained that it also provides other forms of customer assistance which it recognises as part of its total measure of revenue in line with the relevant accounting standards.[13]

E.21 Similarly, Danone told us that the CMA's approach only uses a subset of Danone's cost of goods. It explained that our approach 'ignores a range of costs which Danone UK considers to be variable in nature and are captured within Danone UK considers to be variable in nature'[14], including [✂].

E.22 In our view, the methodology we have used is commensurate and appropriate for the purpose of gaining a better understanding of how well competition is working in the market. Our most important consideration was to take a consistent approach across all manufacturers and to use data provided by them (noting that they likely have different business structures and accounting policies). Our analysis of manufacturers' revenues[15] and cost of goods sold[16] is focused on amounts which directly relate to the volume of infant and/or follow-on formula sold on a consolidated basis (eliminating intercompany transactions). We consider that the quality of our analysis is improved by excluding transactions which could have an impact over a different time period and/or across a broader range of product types. For example, costs relating to trade support and training of retail staff which could

[11] Danone's response to the CMA's interim report, p42.
[12] Danone's response to the CMA's interim report, p42.
[13] Danone's response to the CMA's interim report, p42.
[14] Danone's response to the CMA's interim report, p43.
[15] The CMA asked manufacturers to provide their 'Product-specific revenue' which met the following definition: – whether debits or credits – entitled to be received in exchange of each unit of the product (including any refunds, discounts, volume-based rebates, price concessions, credits, incentives or similar items, provided only that they are directly attributable to the exchange of a particular unit of the product). For the avoidance of doubt, this category should include (ie net debits against credits, where applicable) any rebates, trade support or other assistance that is directly linked to the supply of a specific volume of the product.

[16] The CMA asked manufacturers to provide details of their variable raw materials, variable labour and variable packaging.

have an impact which lasts beyond the sale of an infant formula or follow-on formula product. In addition, we have sought to exclude transport, warehousing and foreign exchange costs because they are not comparable between manufacturers with different sizes, product mixes, production facilities and geographic locations.

E.23 With regard to '(c)' above, we recognise that there may be differences between how manufacturers recognise their revenues and cost of goods sold. We note that it might not always be clear cut whether transactions meet our definition of 'product-specific revenue'. We also noted that some transactions may not follow the 'matching principle'.

E.24 We have mitigated the impact of these limitations by:

(a) calculating gross margins on an annual basis; and

(b) placing less weight on comparisons between the level of manufacturers' gross margins than we have on how each manufacturer's gross margins have changed over time and their spreads.

E.25 With regard to '(d)' above, in determining which methodology to use for this Market Study, we chose not to take into account overhead or research and development costs. This is largely because these amounts can vary significantly between manufacturers and are not directly comparable between manufacturers with different sizes, production facilities, geographic locations and length of time in business.

Calculation of manufacturers' gross margins

E.26 The annual gross margins generated, in aggregate across all manufacturers weighted by revenue, across the markets for the supply of infant formula and follow-on formula, have been calculated as:

- The sum of annual product-specific revenues generated by all of the manufacturers in the relevant market after deduction of the manufacturers' corresponding annual variable cost of goods, divided by the sum of annual product-specific revenues generated by all of the manufacturers in the relevant market.

E.27 The annual gross margins generated by each brand, weighted by revenue, across the markets for the supply of infant formula and follow-on formula, have been calculated as:

- The sum of annual product-specific revenues generated by a particular brand in the relevant market after deduction of the brand's corresponding annual

variable cost of goods, divided by the sum of annual product-specific revenues generated by the brand in the relevant market.

E.28 The annual gross margins generated by each brand's most popular (by revenue) 800g or 900g powder products across the markets for the supply of infant formula and follow-on formula, have been calculated as:

- The sum of annual product-specific revenues generated by each brand from the supply of the 800g or 900g powder in the relevant market after deduction of the brand's corresponding annual variable cost of goods, divided by the sum of annual product-specific revenues generated by each brand from the supply of the 800g or 900g powder in the relevant market.

Methodology for calculating retailers' gross profit margins from the supply of infant formula and follow-on formula

E.29 We requested data necessary for the calculation of gross profit margins from retailers in the UK[17] for the following types of formula:

(a) Infant formula; and

(b) Follow-on formula.

E.30 Monthly data was provided for the period from January 2019 through to November 2024.

Revenue and cost of goods data

E.31 We requested details of retail sales revenue and variable cost of goods data.[18]

E.32 We calculated retailers' gross margins using the variable cost of the finished goods after deduction of any offsetting amounts (ie discounts, rebates and other similar items).

Calculation of retailers' gross margins

E.33 The annual gross margins generated, in aggregate across all retailers weighted by revenue, across the markets for the supply of infant formula and follow-on formula, have been calculated as:

- The sum of annual retail sales revenues generated by all of the retailers in the relevant market after deduction of the retailers' corresponding annual

[17] We analysed data from [✂].
[18] 'Variable cost of goods data' means costs which relate to the exchange of each unit of product.

variable cost of goods, divided by the sum of annual retail sales revenues generated by all of the manufacturers in the relevant market.

E.34 The annual gross margins generated by each retailer, weighted by revenue, across the markets for the supply of infant formula and follow-on formula, have been calculated as:

- The sum of annual retail sales revenues generated by a particular retailer in the relevant market after deduction of the retailer's corresponding annual variable cost of goods divided by the sum of annual retail sales revenues generated by the retailer in the relevant market.